

The following speech is from former Treasury Secretary Ken Henry, which was delivered at The Crawford School of Public Policy on Tuesday 16 September 2014.

This will be something of a homily to some of my colleagues in the economics profession who have felt motivated to involve themselves in the task of economic reform. I hope the address will be of wider interest.

Recently, one of those colleagues, Ric Simes, called for a clearer focus on ultimate objectives, and much less on rhetoric. Similar views are being expressed by leaders of business. The Business Council of Australia recently launched a publication entitled *Building Australia's Comparative Advantages*. In the words of BCA President Catherine Livingstone, the report underscores the case for 'putting in place deliberate strategies to improve our competitiveness, fostering innovation and playing to our strengths'. Catherine argues that it is time 'to confront our complacency', and that we need 'to imagine and fashion our future', then to pursue 'a path of purposeful action'. She argues that there is no point in pursuing 'growth' that doesn't generate 'wealth' and that so-called 'structural reform' must assist in 'transforming the economy'.

In this address I am going to focus on two questions: how should one assess the wealth of a nation; and what are its policy determinants?

Australian mercantilism

These questions were the subject of Adam Smith's *Wealth of Nations*, published in 1776.³ In that treatise, the Scottish moral philosopher mounted an assault on the dominant economic narrative of the time, which held that the wealth of a nation should be measured by its reserves of gold, which represented the accumulated bounty of its export activity. Before Adam Smith, if public policy had a purpose, it was to protect and advance the mercantile activity that generated exports.

Like Adam Smith, we know that mercantilism is misguided. The idea that public policy should be organised to protect and advance the interests of exporters has no support in economics.

And yet, in Australia today, 238 years after the publication of *The Wealth of Nations*, the dominant economic narrative goes like this: reforms that enhance productivity and cut costs build international competitiveness; international competitiveness drives exports; exports drive growth; growth drives jobs; and jobs support living standards.

Gold isn't mentioned in this narrative. But, with its focus on exports as the foundation of living standards, it is strongly redolent of the mercantilism that Adam Smith set out to discredit all those years ago. So I am going to label the narrative 'Australian mercantilism'.

Australian mercantilism hasn't been all bad. The emergent public support for tariff reform in the late 1980s and early 1990s was welcome, even though the case that was being argued was classically mercantilist: tariffs on imported equipment had to be removed because they undermined the international competitiveness of exporters reliant upon imported equipment, especially agricultural exporters. And there were many other structural reforms in the two decades from 1983 for which Australian mercantilism proved equally expedient, including labour market deregulation, a national competition policy and indirect tax reform.

But we are now paying a price for past expedience. The mercantilist narrative is so deeply entrenched that it is crippling sensible attempts to deal with some of our biggest challenges.

In this address I am going to explore a more honest narrative of the wealth of nations. Along the way, I will attempt a re-framing of the concept of international competitiveness; the need for which has been illustrated by recent commentary about the dangers of governments 'picking winners'. But I will argue that the wealth of a nation should be assessed according to metrics that go beyond international competitiveness.

I will illustrate some of the limitations of our mercantilist narrative with three contemporary examples of policy underperformance: first, making the most of the so-called mining boom; second, implementing responsible climate change policy; and third, finding Australia's place in the Asian century.

The elementary economics of international competitiveness

But first, a short 'refresher' on some elementary economics.

Our conventional measure of the international competitiveness of a business or a country is about as sophisticated as the pre-Ricardian labour theory of value; we call this metric the 'real exchange rate'. For Australia, it is approximated by multiplying an index of domestic nominal unit labour costs by the trade weighted index of nominal exchange rates and comparing this product with an average of the nominal unit labour costs in our major trading partners. Nominal unit labour costs are obtained by dividing the average wage rate by average labour productivity. If we observe that the Australian product has increased at a faster rate than the index of unit labour costs in our major trading partners, then we say that Australia has experienced a 'real appreciation', and lost international competitiveness, and conversely for a 'real depreciation'.

Unit labour costs are a crude measure of the unit cost of production. More sophisticated concepts recognise other components of unit cost, including the true opportunity cost of additional capital that has to be utilised to expand production, the costs of various intermediate and other inputs, including transport costs, and, of course, various taxes embedded in production. All of these things, too, contribute to a country's level of international competitiveness as commonly understood.

In the case of a single Australian producer, the various core components of international competitiveness – wage rates relative to foreign competitors, labour productivities relative to foreign competitors and nominal exchange rates – might be regarded as independent; exogenous. But for a country, they may not.

One influence on real exchange rates that has featured a lot in Australian commentary is the stance of fiscal policy. An expansionary fiscal policy pursued by one country in isolation will normally cause a real appreciation in that country, with both the nominal exchange rate appreciating and unit costs of production increasing at a faster rate than in other countries. Accordingly, expansionary fiscal policy, unless it occurs in a country's trading partners at the same time, will usually weaken international competitiveness.

Other shocks have their impacts muted, or even completely offset, by movements in the real exchange rate that they induce. For example, the \$A normally depreciates if world demand for our exports softens, or if capital markets anticipate such a softening. This is what happened in

the wake of the Asian financial crisis of 1997--98, when the \$A depreciated in trade--weighted terms by about 10 per cent; again following the United States' 'tech wreck' of 2000--01, when the \$A TWI depreciated by almost 30 per cent; and again during the so-- called Global Financial Crisis, when the \$A TWI fell by about 20 per cent over the two months following the collapse of Lehman Brothers. In each case, the nominal depreciation compensated, to some extent, for weaker demand for Australian exports by reducing the costs of our exports measured in the currencies of our consumers. As the terms of trade have fallen recently with declining iron ore prices, a nominal depreciation has once more been observed. As on earlier occasions, it has not been as large, nor has it happened as quickly, as some would want.

Nominal exchange rate movements can also compensate, to some extent, for domestic cost shocks. For example, if Australia's nominal unit labour costs increase at a faster rate than our competitors' – either because of faster wages growth or slower labour productivity growth – then there are good reasons in economic theory to expect a depreciation of the nominal exchange rate. That depreciation would restore our international competitiveness, at least to some extent.

Thus, in a small trading economy like Australia, subject to large and variable shocks, some of the components of the real exchange rate act as automatic stabilisers. And the real exchange rate also provides a useful, if highly simplified, pedagogic tool for describing the transmission mechanism for both monetary policy and fiscal policy.

But how did the concept get to occupy such a prominent space in the Australian economic policy toolkit?

The answer to this question explains both the origins of Australian mercantilism and why it should, by now, have been consigned to history.

The origins of a narrative based on international competitiveness

The \$A was floated, and capital controls abolished, in December 1983. Ironically, the principal economic argument for floating the currency was that it would disenfranchise a lazy rural constituency that had been able to persuade successive governments to pursue artificially low nominal exchange rates as a source of international competitiveness. And, with its shackles removed, the currency did indeed appreciate for a time before appearing to stabilise into 1984. But, by the middle of 1985, with the terms of trade having fallen by 6½ per cent, the \$A had depreciated by nearly 20 per cent in trade--weighted terms. Over the next twelve months – through to June 1986 – associated with a further 6 per cent fall in the terms of trade, the \$A depreciated by a further 13 per cent, having lost more than a quarter of its value from when the Hawke Government was elected. Then, in just one month – July 1986 – the exchange rate depreciated by a further 12 per cent.

These nominal depreciations provided a considerable boost to Australia's international competitiveness. But much of the gain was being eroded by strong increases in nominal unit labour costs; increases of about 10 per cent a year. The policy problems lay in two areas: first, Australia had a centralised wages system characterised by a strong element of wage indexation, according to which nominal wages were adjusted to compensate for increases in consumer prices; and second, Australia's product markets were characterised by a distinct lack of competition, allowing labour cost increases, and increases in import prices due to currency depreciation, to be passed onto domestic consumers. An economy with these features will

experience a permanent spiral of wage inflation, consumer price inflation and currency depreciation. These dynamics are what characterises a group of economies labelled 'banana republics'. And that is how Australia's challenge was described by Treasurer Paul Keating in 1986; that Australia was at risk of becoming a banana republic.

Treasurer Keating's challenge was to ensure that nominal currency depreciations became real depreciations. That required that wage indexation be abolished, that Australia's product markets be made more competitive through tariff cuts and the introduction of robust domestic competition policies and institutions, and that microeconomic reforms be pursued to lift national productivity. Real wages had to fall, except to the extent they could be supported by gains in productivity.

But how do you persuade a sceptical electorate that they need to accept lower real wages, a substantial lift in workplace productivity and embrace the chill winds of international competition? You convince them that their living standards are tied to the success of Australian exporting; that they will actually be made better off, in due course, if they accept the sacrifice of lower wage increases and large scale structural adjustment, in the present; because exports means growth; and growth means jobs; and jobs means higher living standards. Thus was born Australian mercantilism. It was quite an achievement.

And there was another, complementary, piece of the narrative developed in Australia in the 1980s: a tighter fiscal policy would improve the prospects of a real depreciation, further boosting exports, and export growth would cause the current account deficit to narrow, thus dealing with the threat posed by ever-- increasing international indebtedness. Thus was born the sub--narrative of 'debt and deficits', part of the broader story of Australian mercantilism.

The narrative, with the real exchange rate sitting at its core, proved powerful in motivating action: to deregulate the labour market; to enhance product market

competition; to implement a broad--ranging set of microeconomic reforms to boost productivity; and to pursue aggressive fiscal consolidation.⁴ The set of reforms implemented in the 1980s and 1990s boosted international competitiveness. Exports did grow strongly. And while the Australian economy experienced a deep recession in the early 1990s, that turned out to be but a brief interruption to a very long period of strong economic growth and employment growth that has continued until very recently. Average living standards also grew strongly.

But, for some time now, Australian mercantilism has been compromising policy development. I want to illustrate that point with three examples.

The mining boom

Policy makers in a country blessed with an abundance of mineral and energy resources should be asking themselves how those natural endowments might be transformed into higher value foundational investments that benefit future generations. Instead, Australian policy has been pre--occupied with the cost competitiveness of Australian exports, including minerals and energy products.

From late 2003 accelerating world prices of Australian minerals and energy exports caused a significant real appreciation; in the order of 50 per cent. The real appreciation damaged our international competitiveness. The fact that it also played an important role in macroeconomic

stabilisation and provided the principal endogenous mechanism for redistributing to Australian households the benefits of higher world commodity prices was beside the point.⁵

According to Australian mercantilism, if our international competitiveness falls then governments should do something about it. Thus, successive Australian governments have had to respond to various proposals designed to reverse the real currency appreciation caused by international commodity price inflation: cut business costs, especially wages and taxes; boost productivity; and cut government spending. That is what governments were being called on to do when the terms of trade were rising strongly, from late 2003 through to 2011. Now that the terms of trade are weakening, and amid concerns about declining aggregate real national income, governments are being called on to do what? Well, it will sound familiar: cut business costs, especially wages and taxes; boost productivity; and cut government spending. No matter what the malady, Australian mercantilism will always prescribe the same treatment. And of course it must, because no volume of exports will ever satisfy a committed mercantilist.

And then there is the matter of tax. Taxes on minerals and energy provide the means of financing foundational investments in the nation's future. So why was the Rudd Government's mining tax unsuccessful? Myths abound. Most don't matter, but some should be addressed.

None of the tax reforms of the 1980s and 1990s, other than tax cuts, enjoyed bipartisan political support. Most were also deeply unpopular in the broader community. New taxes are not easy. But the task of legislating a new tax on mineral and energy resources faced headwinds that the GST and those other tax reforms did not; these headwinds came from Australian mercantilism. If our mercantilist narrative was having difficulty accepting an endogenous loss of international competitiveness due to currency appreciation and wage inflation, then we should not have been surprised by its intolerance of higher taxes on mineral and energy products. Even a consummate communicator was going to have difficulty explaining why it made sense to apply a new tax to an accelerating export sector while at the same time promoting the narrative that the cost competitiveness of exports was the principal driver of growth, jobs and living standards. One might even have been accused of wanting to kill the goose that was laying the golden eggs.

Climate change policy

The second example that illustrates deficiencies of the mercantilist narrative is climate change policy. Australian mercantilism sees any domestic price on carbon as an unfair imposition on Australian producers who have to compete internationally. Exports will be weakened, imports will be encouraged, GDP will be damaged, jobs will be destroyed and living standards will suffer.

Australia in the Asian century

The White Paper on Australia in the Asian century was commissioned by Prime Minister Gillard because it had become obvious that the Australian mercantilist narrative could not support thinking about the requirements posed by the Asian century.

According to Australian mercantilism, our international competitiveness is being damaged by the costs to business of a set of national attributes developed over generations: excellence in governance; incorruptibility; respect for the rule of law; safe working conditions; a concern with environmental sustainability and animal welfare; and institutions that support social harmony, economic and social opportunity, and tolerance. For good reason, many Australian policy

thinkers would rank these attributes among our greatest assets in doing business in Asia. But Australian mercantilism maintains that all are costly to business; that Australia's international competitiveness could be improved by ditching any or all of them. And, indeed, all are at risk.

Adding meaning to the term 'international competitiveness'

The failure of policy in these three areas – the mining boom, climate change and the Asian century – should have had all Australia's economists wondering about the policy narrative. All of us should have been wondering whether the simple metrics we have been employing in talking about Australia's international competitiveness – the notion of international competitiveness that is embedded in Australian mercantilism – really makes any sense. Is international

competitiveness really about nothing more than the real exchange rate? And is international competitiveness really what it should all be about anyway?

Some people have been wondering. Some have even been prepared to venture a more meaningful concept of international competitiveness as part of a vision for Australia's future. The former government's White Paper on Australia in the Asian century is one example. Another is the Business Council of Australia's recently released report, *Building Australia's Comparative Advantages*. Given the limitations of the Mercantilist narrative, with its tired fixation on the real exchange rate, it must be especially galling for some of those involved in these projects to find themselves accused of recommending that governments 'pick winners'.

During the 1980s and 1990s, Australian mercantilism was used to motivate support for a set of policy reforms that was long overdue. But it is long past time when, in respect of those things for which the Australian mercantilist narrative could conceivably prove useful, we should have been declaring success. We no longer have centralised industrial relations delivering wage indexation. Instead, we have some measure of aggregate wages flexibility, as has been demonstrated by the moderation in nominal wages growth as the terms of trade have receded in recent times. Capital markets are open and flexible. We no longer have a highly distorting Wholesale Sales Tax. We no longer have most of the economy shielded from effective competition, with lazy business operators able to pass all costs forward, onto consumers. The structure of the economy has been transformed, in a process that provided a considerable boost to productivity. We even have a bipartisan political commitment to a medium-term anchor for fiscal policy.

But we face a new set of challenges. And these are challenges for which the narrative of Australian mercantilism either provides no answer or the wrong answers. It is time for a more honest narrative.

Towards a more honest narrative

The case for reforms to boost competition, enhance labour market flexibility and provide the conditions for productivity growth is strong. But it does not rest on export competitiveness. Whether they induce a real depreciation and boost exports or not, these things should be pursued because they expand opportunities, enhance freedoms and, in so doing, improve the wellbeing of the Australian people. The same is true of much of the rest of the economic reform program implemented in Australia from 1983. The mercantilist narrative diminishes the efforts of a generation of Australian policy reformers, some of whom have been focussed on more respectable goals.

All economists since Adam Smith have emphasised the dependence of aggregate economic outcomes upon the exercise of individual agency. Recent contributions by Nobel Laureates Joe Stiglitz⁶ and Edmund Phelps⁷ draw attention to some of the capabilities required of individual agents if they are to be relied upon to support the wealth of nations. And they draw attention also to the need to nurture those individual capabilities.

Edmund Phelps' *Mass Flourishing* details the primary role played by innovation in an historical accounting of material progress, economic inclusion and human fulfilment. According to Phelps, innovation⁸ has been driven, historically, by 'grassroots dynamism', which he sees as the product of 'modern values' transcending 'traditional values'. And he maintains that this grassroots dynamism has broken down due to short-termism in government, business and finance; and, in a thundering echo of Adam Smith, by corporatism organised to protect vested interest. The poor consequences of short-termism and of the advancement of vested interest are emphasised also by Stiglitz in *The Price of Inequality*.⁹

The importance of an emphasis on individual capabilities has been argued forcefully, for some decades now, by another Nobel Laureate, Amartya Sen.¹⁰ Sen emphasises individual capability not only because of its implications for aggregate outcomes, but because individual capability is a matter of primary interest in itself; indeed, the primary matter. The core concern should be the extent to which individuals enjoy a set of capabilities that provides them the freedom to choose a life of value.

A renewed focus on individual agency and, in particular, the capabilities enjoyed by citizens, informs a more sophisticated understanding of international competitiveness and a more honest economic reform narrative. The narrative should comprehend the role played by national endowments in driving national performance; that is, it should be capable of explaining how the economic, social and environmental outcomes of a nation, and the distribution of those outcomes among its people, rest upon its particular set of endowments.

National endowments and individual capability

Some of a nation's endowments are a consequence of nature. Others have been developed by earlier generations of humans. In the former category are a set of natural assets, including: geographic location; demography; energy, minerals and soil deposits; and native flora, fauna and ecosystems. While these endowments are the product of nature, they are not static. The human population of Australia is growing rapidly, and it is ageing. Mineral, energy and soil resources are being depleted. Native flora, fauna and ecosystems are being degraded, in many cases irreparably. In the category of endowments created by humanity are to be found the products of foundational investments in such things as: our rich indigenous cultures; modern multiculturalism; the visual and performing arts; our legal and regulatory structures; education and health facilities; economic infrastructure; systems supporting research and innovation; policy frameworks that promote freedom and economic security; and working conditions that support human dignity.¹² These foundational investments have been truly 'transformational', in precisely the sense that Catherine Livingstone has demanded of those who, today, advance various 'structural reform' proposals.

National endowments are the source of individual capability. A core component of individual capability is human capital. But no amount of human capital will ensure that an individual has the opportunity to choose a life of value if national endowments omit other capabilities. These other capabilities include a set of freedoms and institutions that, for some years now, and at

increasing cost, we have been taking for granted, including: freedom from bigotry; a well--functioning political system, with politicians who are motivated to enhance national wellbeing; a well resourced and respected public service strengthened by the doctrine of ministerial responsibility; independent transparency mechanisms; an accessible judicial system; independent, unpoliticised media; a tax system that can be relied upon to meet emerging fiscal requirements with minimal damage to incentives to work, save and invest; infrastructure governance that anticipates a better future; education systems that offer pathways to knowledge; and science and innovation systems that support creativity and the dissemination, and commercialisation, of ideas.

The need to ensure that Australians are endowed with the capabilities that will be relevant to success in this Asian century calls for a renewed focus on these, and other, national endowments. The White Paper on Australia in the Asian Century identified a need for new foundational investments, including public investments: in our schools, universities and vocational training centres; in developing Asia--capable workplaces and institutions; in developing a much deeper understanding of the history, cultures, languages, geography and governance of our regional neighbours; in devoting more effort to what has become known as 'track 2 diplomacy'; in building strong people--to--people relationships based on trust and mutual respect; and in encouraging adaptability. And those involved in writing the White Paper would have endorsed Edmund Phelps' emphasis, also, on the fostering of 'grassroots dynamism'. International competitiveness in the Asian century will be enhanced by paying attention to all of these endowments, and leveraging them into commercial partnerships, not by pursuing a race to the bottom on wages, taxes, social foundations, environmental standards or animal welfare.

I observed earlier that the concept of the real exchange rate embodied in Australian mercantilism is no more sophisticated than pre--Ricardian concepts of absolute advantage. Whilst still constrained by the highly restrictive labour theory of value, David Ricardo demonstrated that it is not a country's absolute labour productivity advantage that determines the pattern of production and trade, but rather relative rates of labour productivity as between different industries. Post--Ricardo, economists should have been spending more time describing international competitiveness in terms of comparative advantage, rather than the simplistic concept of absolute advantage that underpins the real exchange rate. Neoclassical expositions of comparative advantage are even more enlightening: liberated from the labour theory of value, they describe the role played by national endowments in determining the pattern of production and trade.

Picking winners

The counsel against governments 'picking winners' in terms of products and industries is well--based historically. But governments do have a responsibility for building national endowments. And we should be comfortable with the fact that a country's pattern of national endowments favours some industries and products over others.

You might accept all of that, yet still want to maintain that governments should be disinterested in the pattern of commercial activity that emerges; taking no interest in the shape of Australia's industrial development.

I want to encourage you to think differently. A reluctance to describe consequences compromises the effectiveness of a narrative. Australian mercantilism identifies a 'winner'; it is

exports. Like Adam Smith, we know that narrative should have no support in economics, but we have been happy to go along with it. And that is because we know that our reforming arguments will not be persuasive without a compelling narrative. In the 1980s we accepted that for governments, and for those who advise them, it is not enough to talk, in abstract terms, about the importance of freedom, opportunity, competition, productivity and economic efficiency. We understood that governments have to explain to people the probable outcomes of the exercise of personal freedoms, the consequences of people having access to greater opportunity and the commercial implications of reforms to enhance economic efficiency. Indeed, it would be unconscionable of government not to do so.

In developing compelling narratives, there is no choice but to identify winners. That is a large part of what makes them compelling. The identification of winners is the attractive 'vision' bit that follows the scary 'burning platform' part of the story that we economists feel more comfortable telling. But once the winners of government policy have been identified, a government can hardly maintain that it would have preferred a different set of winners. In this very real sense, the winners of government policies are those the government has 'picked'.

Concluding remarks

I have argued that the concept of international competitiveness embodied in the Australian mercantilist narrative, with its focus on the costs confronting exporters, has outlived its usefulness. It is clouding our understanding of structural adjustments underway in the Australian economy, especially as a

consequence of the China boom, and it is compromising efforts to deal effectively with a number of confronting policy challenges, including climate change and making a success of the Asian century. We need a richer understanding of international competitiveness. And that understanding has to be both capable of, and comfortable with, identifying the winners of a more internationally competitive Australia.

As a profession, we are never going to agree on who those winners should be. And many of you will never feel comfortable even thinking about policy objectives at that micro--outcomes level. But I would encourage you not to be too critical of those who are prepared to give it a go. I would encourage you to accept, at least, that the discussion is one worth having.

In the meantime, we economists could serve a useful purpose by articulating a respectable goal for economic policy at whatever level of abstraction we find comfortable. To that end, I am going to conclude with some propositions with which I feel comfortable.

An internationally competitive Australia would be a place in which political activity is predictable, with policy based on sound theory and robust evidence. It would, therefore, be a place in which government policy avoids short--termism and has no taste for protecting vested interest; a place in which governments have the intellectual capacity and political courage to articulate a compelling vision of what could be.

An internationally competitive Australia would be a good place to do business. It would be a place that provides access to labour with the right skills, and to deep and liquid capital markets that are sophisticated and robust. It would be a place in which those developing regional and global value chains expect to find world-- class partners, with a sophisticated understanding of Asian languages, cultures and institutions. It would be a place that offers its people a high quality education, and rewarding jobs and careers. It would be a place in which 'grassroots

dynamism' flourishes; in which intellectual development is encouraged; and in which science, innovation and effort is rewarded.

In more abstract terms, Australia's international competitiveness should be assessed according to the richness of the set of opportunities it offers the people who live in it, and those who could live in it in generations to come.

But international competitiveness, even conceptualised in the more sophisticated manner for which I have argued here, does not represent the ultimate goal of public policy. That has to be stated at an even higher, even more abstract, level. In this address I have emphasised the responsibility of public policy in the nurturing of national endowments. The public policy of Australia should be directed to ensuring that all Australians, including those not yet born, are endowed with the capabilities that afford them the opportunity to choose a life of value. That is the measure of the wealth of Australia and also of the sources of its wealth.