The 29th HR Nicholls Society Conference
Dinner Address
28th March 2009

Australia: Still Living in the Dream Time

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Peter Hartcher, writing in the SMH on Feb 28th last described a very important event in Canberra which took place sometime last October; an event, as far as I know, reported by no one else. This event tells us pretty much all we need to know about the Prime Minister's understanding of how nations survive and prosper. It also tells us a great deal about the intellectual formation of the Secretary of the Treasury, Ken Henry.

Hartcher wrote:

> When they had finished putting together the $10.4 billion "cash splash" handouts last October, Kevin Rudd thanked the secretary of the Treasury, Ken Henry, for his efforts with a gift.
>
> The Prime Minister handed his senior official an inscribed copy of one of the most famous and influential books of the last century: *The General Theory Of Employment, Interest And Money*.
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> The British economist John Maynard Keynes published it during the Great Depression in the 1930s. And as Rudd gave it to Henry in front of a small gathering of officials he remarked: "We're all Keynesians now."

Hartcher does not tell us who wrote the inscription. If it was Keynes, then it was a valuable gift, rather like having a first edition of Das Kapital with Karl Marx's signature on the flyleaf. If it was the Prime Minister, then that explains much of the rhetoric and policy concerning the GFC which has come from the Prime Minister in recent months.

One of the lines often quoted from *The General Theory* is from Chapter 12, entitled *Concluding Notes*

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.

It obviously did not occur to the Prime Minister that his gift to the Secretary of the Treasury was an important example of exactly what Keynes was talking about.

Before moving from Keynes and his *General Theory* to our present difficulties, I wish to make a few points about his beliefs and his influence.

Keynes hated everything which had made Victorian Britain the centre of the global economy and the workshop of the world. He found Victorian morality abhorrent which, given that he was an active homosexual, was not surprising. He was vehemently opposed to thrift, as it suppressed what he called "effective demand", a mythical abstraction which is still alive and well in the minds of our political leaders and most of the economics commentariat. As a corollary to his distaste for thrift was his strong support for consumption and the necessity of government inspired and financed consumption whenever unemployment rose.

He was also strongly opposed to sound money. The aphorism often attributed to him "gold is a barbarous relic" is a contraction of his 1923 comment in *A Tract on Monetary Reform*: "the gold standard is already a barbarous relic." He found the restraints which were consequent to adhering to the gold standard to be an unwarranted barrier to the execution by wise governments of policies for the betterment of the people.

His attack on gold mining in *The General Theory* is an argument which bewilders an old gold-miner like me.

> "Gold-mining, which not only adds nothing whatever to the real wealth of the world but involves the disutility of labour, is the most acceptable" to the orthodox of all methods of creating employment. "If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coal mines which are then filled up to the surfaced with town rubbish, and leave it to private enterprise on well-tried principles of laissez-faire to dig the notes up again . . . there need be no more unemployment" (p.129)

How could such nonsense become part of the conventional economic wisdom?
A short and very readable account of Keynes and his fallacies, published in 1959, is Henry Hazlitt's book entitled *The Failure of the New Economics - An Analysis of the Keynesian Fallacies,* and I quote two sentences to summarise Haslitt's position.

> Although I have analysed Keynes's *General Theory* theorem by theorem, chapter by chapter, and sometimes even sentence by sentence, to what to some readers may appear a tedious length, I have been unable to find in it a single important doctrine that is both true and original. What is original in the book is not true, and what is true is not original.

Steve Kates' article *The Dangerous Return to Keynesian Economics,* in the current issue of Quadrant, is an important contribution to the debate we now have to have. Let me quote just one paragraph.

> . . to believe it is possible for governments to spend our way to prosperity would be a major error. There is no previous occasion in which such spending has been shown to work, while there are plenty of instances in which it has not. On every occasion that such spending has been used, the result has been a worsening of economic conditions, not an improvement."

I have focussed on Keynes because, as the presentation by the PM of the Keynesian bible to Ken Henry demonstrates; if we are to understand how we have gotten to our present, very serious predicament, we have to understand what it was that Keynes argued, and why his influence on the next two generations of economists around the world was so profound, and so disastrous.

A very important thing about the GFC, now morphed into the GEC or Global Economic Crisis, in my view, is that none of our key institutions with responsibilities for monitoring the state of the economy, and advising governments and the community at large on what was going wrong, and what had to be done to avert the situation we now find ourselves in, made the right call when it was all beginning to come together.
I include myself in that category, at least in a modest way. For many years I served on the board of the RBA, and made myself a bit of a pest by asking questions which gave me a reputation for gloom and doom. But I never had the courage or the gall to really pursue the issues which were bothering me.

When we look at the three pillars of the economic establishment in Australia, the RBA, the Commonwealth Treasury, and the Productivity Commission, we find that none of them made a warning call when it was most required, despite the fact that the evidence of gathering disaster was piling up month by month.

It was beyond argument that the rate of change in the growth of credit in all markets, particularly the household sector; the rate of growth in the money supply, however defined; the rate of growth in consumption and the staggering increase in housing prices; were proceeding at an unsustainable rate. It is just not possible to have credit growth and money supply increases in the realm of 14 per cent compound, without a disaster occurring.

You may well ask 'If it were that simple, why wasn't the bell rung much earlier?"
I have struggled with this question and there can be no simple answer. However, an important factor is that for all the Central Banks two elements coincided. First, during recent decades, indicators such as money supply were down-graded as forward indicators. Money supply went out of fashion. Second, inflation became the dominant, perhaps the only, reference point for how the economy was performing, and how well the central bank was discharging its responsibilities.

There are two dangers in setting inflation rates as the only important parameter. First it is retrospective, more so than other indicators. Inflation tells you nothing about buying intentions; nothing about future orders in capital investment (although these figures were readily available and were of the same magnitude as the increase in credit); nothing about those wishing to work more hours; and yet inflation rates were the only benchmark of central bank accountability.

The inflation rates also disguised the difference between the prices of traded and non-traded goods. As china supplied the world with ever cheaper manufactured goods, the traded goods prices masked the ever-rising non-traded goods influence on the calculation of inflation. The two sectors were going in opposite directions. But at some point of course, that continuing divergence came to an end.

Back in the days when Bob Menzies was Prime Minister, and Roland Wilson was Secretary of Treasury, Roland Wilson briefed the Cabinet every month on Australia's economic position. He took three graphs to the cabinet meeting. They were the Balance of Payments, the inflation rate, and the unemployment rate. From his perspective the most important of these was the balance of payments. Were we paying our way in the world?

In those days we had a fixed exchange rate. We were tied to the pound sterling and thus British inflation was immediately transferred to the Australian pound. But it was the Korean War wool boom which, because of its inflationary potential and the measures which the Menzies-Fadden government used to ward off inflation, which nearly brought it down in the 1954 election. Our Terms of Trade, which the price of wool drove to heights which have not been reached since, brought a tidal wave of overseas money into Australia, and there was nothing to spend it on. We had a closed economy. Tariff walls kept imports out. There was a limit to what we could produce at home, and so we were faced with great inflationary pressures. The Government's solution was to quarantine the incomes received by the wool growers. That action almost wrecked the Coalition and in 1954, the ALP led by Dr Evatt, received a majority of votes but missed out on winning a majority in the House.

The wool boom duly collapsed, as did our Terms of Trade.

This time we have enjoyed the China boom. In fact we are still enjoying the China boom because contract prices for iron ore and coal are still the old boom prices. That will very soon change. Then we will find what deep, world-wide economic recession really means. And the fact that our Government is still pretending that we are in good shape - better than the rest of the world - and thus able to borrow money to give to pensioners, carers, and other worthy recipients; a Xmas handout which they were urged to spend forthwith; and then to repeat the exercise on a much grander scale three months later, is something which I am convinced would have caused Roland Wilson to submit his resignation.

From the earliest days of European settlement, Australia has had an economy which was linked to the metropolitan economies of Europe, principally Britain, and more recently to the US, Japan, and now China, as a provider of commodities; wool, gold, and other rural and mineral products. Our prosperity, which was enviable for most of our history, was based on our skills at producing these commodities efficiently. During these last two centuries we have been the continuing recipients of overseas capital, which we have used to develop these resources, and to build infrastructure for our cities and our transport networks. The continuing readiness of overseas investors to lend these funds was based on their confidence in our creditworthiness, our ability to repay, and on our capacity to continue to run our affairs effectively and efficiently.

This is still the situation today. Although the Commonwealth Government was debt free a few months ago, it is now clear that the current financial year will produce a substantial deficit, and the next financial year a much larger one; unless of course there is a major change of policy; or a change of government with an anti-Keynesian understanding of how the world really works.

The States are not debt free, and Australian household debt is larger than pertains either in the US or the UK. In 1984, Australian household debt was 33 per cent of disposable income. In 2006 it was 157 percent, higher than the US and just behind the UK. The big increase in household debt took place between 1998 and 2008 and it is important to comment on why that happened.

This was the period in which house prices for Sydney, Melbourne, and other capital cities increased three and fourfold. People whose major asset had been valued at, say, $250,000 now saw houses in their neighborhood selling for $750,000. Prime Minister John Howard, and the State Premiers, should have been extremely worried by this sudden change. It generated a rush of household borrowing and consumption which led to the increases in indebtedness that I have cited. But although the Howard Govt asked the Productivity Commission to explain why this had happened, the Prod Comm came up with the same answer which Treasury and the RBA had given: and that was that the price surge was due to excessive demand, a demand exacerbated by government policies such as the absence of the CGT to principal residences, first home buyer subsidies, and so on.

There was complete unanimity by the economics establishment on this issue, and it took heroic efforts by Bob Day, a plumber turned home-builder; a man whose mind had not been confused by undergoing Keynesian indoctrination at a university, to decisively refute this consensus. As he showed beyond all possible doubt the inflation in house prices which took place under the Howard Government was due overwhelmingly to the stranglehold which State government bureaucracies had over the release of land on the outer fringes of our major cities, and which brought very great monopoly profits to State Governments and to the developers who lived very close to those governments.
Because of the great harm which that price surge has brought about, particularly the very great increase in household debt, I would have thought some serious mea culpas were in order from the economics establishment. None have appeared.

I now return to my main theme. And that is that Australia is still a small provincial economy, based on the supply of commodities to world markets; wholly dependent on continuing overseas investment to sustain our indebtedness and to keep up the investments which are required to produce mineral commodities at globally competitive prices, and to develop our urban infrastructure.
Whether that overseas investment will be willing to come here will be critically dependent on the way in which we conduct ourselves in the crisis years ahead. There have been adverse comments from both sides of politics recently about the perils of "talking the economy down".

Actions in these affairs speak much, much louder than words. A government decision to spend many millions of dollars - which will have to be borrowed - to install insulation into domestic ceilings not already insulated, invites only derision. Our most perceptive commentator about these matters, in my view, is Patrick Cook, who, in describing the responses from a focus group to the PM's stimulus package in the Spectator of 14th February, quoted a "female professional" as wondering
". . . whether, if global credit could be restored by the government stuffing her ceiling with Pink Batts, would do the government also do something about the gutters while they were up there?"

Earlier, on10th January, Patrick Cook writing as the Prime Minister, told us:

> "Do I have a plan to stimulate employment? Yes, I do. Does this plan involve not handing over the entire industrial relations system to the bone people of the union movement, and also forgetting all about the redundant carbon taxes on business, because after these initiatives no one in their right mind would invest money in Australia ahead of a groundnuts scheme in Burkina Faso? No, it doesn't."

As Patrick Cook raised the carbon tax or ETS issue, it should be emphasized just how serious a threat to the electricity supplies of Eastern Australia, this ETS really is. Paul Simshauser is the Chief Economist and Group Head of Corporate Affairs at AGL and in The Electricity Journal of January 7 last he concluded a very detailed description of the financing arrangements which underpin our power stations both in the Latrobe Valley and in NSW and QLD with the following sentence:

> "So will an ETS create toxic debt in Australia? The answer to this question in the case of our 1,000 MW power station was, in absence of a suitable structural adjustment package, quite simply, yes."

A much easier policy than finding the money for a "suitable structural adjustment package"; one that would cost no money, and would restore a great deal of confidence, is the abandonment by the Rudd Government of the ETS legislation and, failing that, a commitment by the Coalition to repeal any such legislation on winning office.

A sobering analysis of our national position was in a report published in the Financial Review on 14 March last from Anthony Hughes in New York. He was reporting on the Goldman Sachs J B Were Australian Investment conference held in New York on 13 March. Tim Toohey, Chief Economist of GSJBW, said

> "Many international investors believed Australia was deluding itself into thinking it could avoid the pain of the global economic downturn. This reflected a view that Australia was a small economy highly exposed to global trade flows, and the end of the commodity boom would prompt an income shock that would mean a deep and prolonged recession.
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> Mr Toohey said the local economic data most commonly requested by overseas investors were household liabilities and personal debt servicing ratios, both of which were at levels even greater than the US and UK.
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> Offshore investors were also concerned that the Australian dollar was set for a deep cyclical decline, and as a debtor nation would find it difficult to fund itself."

That is where we now stand. And the consequence of that situation for us is that Keynes is out and the Victorian values he despised are in. Thrift, sound money, balanced budgets, lower taxes, beginning with the abolition of payroll tax, which inevitably means slashing government expenditure. Above all, no immediate changes to the current labour relations law as demanded by Julia Gillard, no ETS as demanded by Penny Wong, and no Keynesian adventures into "increasing aggregate demand". On the contrary a statement repudiating Keynes, particularly his views about the inviolability of wage rates, would be a confidence building move of great importance.

The HR Nicholls Society is above all else concerned about persuading Australians to embrace freedom in the labour market as the only real road to prosperity. That message has particular urgency today as unemployment rates begin to climb and as the Rudd Government continues to persist with Keynesian delusions about the labour market. Let me quote Keynes on this point.

> "To suppose that a flexible wage policy is a right and proper adjunct of a system which on the whole is one of *laissez-faire*, is the opposite of the truth. It is only in a highly authoritarian society, where sudden, substantial, all-round changes could be decreed that a flexible wages policy could function with success. One can imagine it in operation in Italy, Germany or Russia, but not in France the United States or Great Britain."

In 1936 Italy was ruled by Mussolini, Germany by Hitler, Russia by Stalin. What was Keynes smoking when he wrote those words? And yet it is Keynes whose writings now inhabit the collective minds of our Government and its advisers not only here, but in the US and the UK.

The US is at the very centre of the GFC and how the Obama Administration responds to the crisis will have a very big impact on the rest of the world. Indeed, for the first time ever, the possibility of a run on the US dollar is now under serious consideration. It is noteworthy that Franklin Delano Roosevelt's New Deal is now often quoted as the model upon which Obama should build his policy. Keynes's influence within the Roosevelt Administration was extraordinary. Benjamin M Anderson, writing in 1949 said this

> "Keynes's influence in the Roosevelt Administration was very great. His influence upon most of the economists in the employ of the Government is incredible great. There has arisen a volume of theoretical literature regarding Keynes almost equal to that which has arisen around Karl Marx" (Benjamin M Anderson, *Economics and the Public Welfare,* Van Nostrand 1949 p301)"

In his Quadrant article of a month ago, Stephen Kates discussed the influence of Keynesian doctrines within the Roosevelt Administration and he published a table showing unemployment rates in the US, the UK and Australia, from 1929 to 1938. As the figures demonstrate, the US was still mired in terrible unemployment in 1938, and much of this unemployment was due to new labour market regulation inspired by Keynesian doctrine.

Unemployment Rates

Australian and the United States

1929-1938

Year	United States	UK	Australia
1929	3.2%	10.4%	8.0%
1930	8.7%	16.1%	12.7%
1931	15.9%	21.3%	20.1%
1932	23.6%	22.1%	23.0%
1933	24.9%	19.9%	21.0%
1934	21.7%	16.7%	17.9%
1935	20.1%	15.5%	15.5%
1936	16.9%	13.1%	12.6%
1937	14.3%	10.8%	10.9%
1938	19.0%	12.9%	8.9%

Source: Australian data Withers and Pope (1993)
United States data U.S. Bureau of Labor Statistics
UK data Garside, W.R. 1990. *British Unemployment 1919-1939: s Study in Public Policy*. Cambridge, Cambridge University Press.

Thrift, sound money, balanced budgets, lower taxes, slashing government expenditure are not policies which would appeal today to many, perhaps any, of our political leaders. But as Samuel Johnson remarked more than 200 years ago:

> "Depend upon it, Sir, when a man is to be hanged in a fortnight it concentrates the mind wonderfully."

As the months go by, and our situation deteriorates, Johnson's words will begin to resonate throughout the community. We should now begin preparing for the day when governments, commonwealth and state, will be forced to confront a position as serious as that which confronted the Lyons Government when it came into office after the collapse of the Scullin government on 6th January 1932.

History is never exactly repeated. But there are themes in Australia's history which keep recurring. Good times, generated by high commodity prices, lead to confidence, borrowing, rapid credit growth, and predictions by many economic commentators that the business cycle is a thing of the past.

Those who do not believe in the end of the business cycle, and who begin to worry about rising stock markets, rapidly increasing house prices, and high gearing ratios, find themselves socially isolated and condemned by the commentariat for not using their balance sheets effectively.

The failure of the Scullin Government to see out its elected term, and the way in which the Lyons Government responded to the 20 percent unemployment of 1931, is a history to which we should now be giving very close attention. We should also be examining with great care the unspoken assumptions upon which our key economic institutions are basing their advice.

Above all else, we must remember that we are a debtor nation, and that policies which increase that debt, rather than reducing it, must be put aside for future commodity booms. A run on the Australian dollar would be calamitous for us and false steps by governments could easily trigger such a calamity.

Every time we read or hear the words “aggregate demand” or “stimulus” we are back in the world of Keynesian fantasy. It is necessary now to put away these Keynesian fantasies, which are found in virtually every press comment and government statement, and which prevent us from seeing the reality which surrounds us. Unless we do this we will turn what is a serious recession into an Australian tragedy of truly epic proportions.