H R Nicholls Society Address

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The title for this conference is drawn from the witches' cabal in *Macbeth* – "Fair is Foul, and Foul is Fair". Could this be a reference to a certain "Welsh witch" who rides the Rudd Government's industrial relations whirlwind with an iron broomstick? More mundanely, I construe it as highlighting that the consequences of the so-called *Fair Work Act* 2009 for the Australian economy will be extremely foul, and that only witches could be so wicked as to describe its foul measures as being "fair".

When Ray Evans wrote asking me to speak to you this evening, he indicated what he would like me to talk about.

He began by observing that this year will see the 25th anniversary of my Shann Memorial Lecture, which he described as "arguably the seminal document in the campaign for liberalising our labour market". He said he would be glad if I "would pick up the *leit motif* from that lecture and bring it up to date, in the knowledge that we are heading into perhaps the most serious recession since the 1930s".

In passing, let me delete that word "perhaps". The recession in which we now find ourselves is certainly the most serious since the 1930s, and in some dangerous respects it is unprecedented in the Federation's history.

Ray then referred to some predictions of mine last year about the future of Mr Kevin Rudd, and potentially therefore of his government, and asked me to suggest some "things which a post-Rudd government ought to do to ameliorate what will be an unemployment crisis greater than that of 1982".

To respond fully to that brief would take a little longer than the 30 minutes to which (you will be glad to know) I propose to confine myself. So I have asked myself how, within that compass, I can conform to those guidelines. I shall try to do so under four heads:

- First, I shall say something about the economic situation likely to confront us in 18 months' time.
- Second, I shall speculate briefly on the consequences of that for the Labor leadership in Canberra.
- **Third, I note that, however politically propitious the economic circumstances late next year might seem to be for the Coalition parties, they have little hope of winning office under their present leadership.**
- Fourth, since I may be wrong in that judgment, or the Coalition parties may meanwhile find themselves another, more electorally acceptable leader, I assume for the sake of argument that they do prevail at the 2010 election – or that even if they don't, by that time the Labor Party will have sufficiently come to its senses to amend its current policy stance. On one or other of those assumptions, I consider how the unemployment crisis then prevailing should be addressed.

The Economic Situation and Prospect: Australia's economic situation grows more serious by the day. When the Rudd Government was elected 16 months ago, we were extraordinarily well-placed. We had no federal debt, a federal budget in strong surplus and a well regulated banking system largely free of the excesses of many of its overseas counterparts. We were enjoying strong economic growth, with record business investment and extremely low unemployment. Whether Labor likes to admit it or not, this was the legacy of the Howard-Costello Government.

Today, federal debt is growing by leaps and bounds. The budget is already heavily in deficit and destined to become much more so. Economic growth has vanished, business investment is beginning to fall, and unemployment is rising sharply. Our banking system is still relatively robust by international standards, but is under strain nevertheless.

Not all of this is the Rudd Government's fault. Many of the depressive forces acting upon our economy have their origins abroad. **The real charge against the government is that, in addressing those depressive forces, its analysis has been defective and its actions have been as reckless as they have been unproductive (or even counter-productive).**

To make matters worse, the recent enactment of the *Fair Work Act* constitutes a disaster in the making. That Act not merely repeals the Howard Government's *Work Choices Act* but also takes labour market regulation back, in many respects, to pre-Keating days. **At a time when the restoration of business confidence is a vital ingredient in any recovery process, Julia Gillard has laid an axe to it.**

Moreover, although it is not a topic for this conference, **the government's Carbon Pollution Reduction Scheme, which it stubbornly proposes should come into operation next year, would be another blow to our cost structure and hence, again, to business confidence**. Even if you believed in the dodgy "science" purporting to underlie it, it would simply make no sense at this juncture in our economic affairs.

Why do I say that the government's – and I fear, the Treasury's – analysis of our problems has been defective? It is because, I believe, it has wrongly diagnosed the very nature of those problems.

In a newspaper article last month I urged the government to think about how the present situation has arisen:

"For years now, many Australians, and many of our corporations, have over-borrowed. While the Howard-Costello Government was paying off the Commonwealth's entire net public debt, the private sector was hell-bent on the path of debt-financed asset inflation. The fact that most of the developed world (the United States in particular) was also doing so enabled this process.

"That has all changed. Asset inflation ……has been replaced by asset deflation. Share markets have fallen dramatically. Commodity markets, with the significant exception of gold, have fallen even more dramatically. House prices have fallen, and will undoubtedly fall further; so have commercial property values, despite developers' notable reluctance to admit it; ……Unemployment is rising, as are bankruptcies. Confidence, both of individuals and businesses, has been shot to pieces".[1]

Last October, when the Prime Minister made his "decisive" decision to blow $10.4 billion of our money, he apparently did so on the basis of Treasury advice to "go early, go hard, go households". That advice was said to be based upon the Keating Government's experience when dealing with – or failing to deal with – the 1991-92 recession. **If so, I believe that was a mis-diagnosis. Apart from its likely unemployment consequences, the recession on which, by last October, we were already embarked bears little relationship to that of 1991-92.**

The difference was well defined in a paper[2] given to a special meeting of the Mont Pelerin Society in New York which I recently attended. It drew a sharp distinction between "conventional" recessions (like ours of 1991-92) – usually brought on because the monetary authorities have been forced to raise interest rates to check inflation – and the much rarer (and much more difficult to deal with) "balance sheet" recessions.[3] In this latter kind of recession, "corporate, financial or household balance sheets will have been swollen by large quantities of debt. Typically the debt will have been used to buy assets…..and the fall in asset prices will create widespread negative equity for firms and individuals, triggering an economic downturn. **The main focus of indebted firms or households in this situation is de-leveraging or debt repayment**". (Emphasis added)

The key point is that, once this kind of recession has become established, both households and corporations will wish to give priority not to spending, but to repairing their balance sheets. Even though "banks may have funds to lend, households or firms may **not** want to borrow, preferring to repair their balance sheets before spending again".[4]

This "deleveraging" process seems to me to describe very accurately the situation today not only in Australia but throughout the developed world. If so, no wonder Mr Rudd's $8.7 billion handout last December appears to have had so little noticeable effect on consumer demand. Most of it, as I suggested in that newspaper article, would have gone to repairing household balance sheets. I expect the same will be true of the $12.7 billion now being distributed as part of Mr Rudd's $42 billion February package.

On that basis, these two measures boil down to requiring taxpayers to hand over $21.4 billion to people who have borrowed imprudently so that they can reduce their debts!

If I am right about likely household behaviour in these circumstances, consumer demand is unlikely to recover for some time. Indeed, if household confidence is further sapped by watching the government "making it up as it goes along", it will fall further. Falling business investment, including downward inventory adjustment, will exert further recessionary pressures.

Export demand, in turn, seems likely to suffer from the **similarly mistaken fiscal policies enacted abroad by President Obama, Mr Gordon Brown, and to a lesser**

extent, others. To quote again that earlier newspaper article, "today's world leaders and self-interested International Monetary Fund spokesmen all seem hell-bent on committing errors similar to our own, thereby worsening the international environment".

There is much talk these days, both here and abroad, about the need for banks to "go on lending". Mr Rudd is even suggesting, as part of the "seven point plan" he is self-importantly taking to next week's G20 meeting, that any bank receiving government support (e.g., through sovereign guarantees on deposits) "must formally agree to maintain regulated levels of lending".[5] There are two problems with that fatuous prescription. First, it would be madness to pressure banks into lending to individuals or businesses no longer creditworthy. Isn't that how the sub-prime mortgage disaster came into being? Second, even otherwise creditworthy businesses who have belatedly recognized that they have too much debt "may not want to borrow, preferring to repair their balance sheets……".

The coming federal Budget offers a last major opportunity to call a halt to Mr Rudd's style of decision-making. But don't hold your breath. Apart from general utterances both from him and the Treasurer about doing "whatever it takes", we have already been promised a significant increase in pensions from a budget that can no longer afford that. And there will be no lack of other spending proposals coming forward, most of them of the same low quality as those now comprising Julia Gillard's $14.7 billion "education revolution".

The Treasury figuring provided last month in the Updated Economic and Fiscal Outlook paper is already out of date. I suspect that the revised figuring that we will receive in the Budget papers will also be dead on arrival. Apart from any other reasons**, this is because the Treasury – and for that matter, private sector forecasters also – are trying to forecast an economic scenario for which there is no precedent in their data bases.**

(The same comment, incidentally, applies to the Treasury's attempt last year to forecast the effect upon the Australian economy in 40 years' time from the introduction of a measure – the emissions trading scheme – specifically directed towards changing the whole nature of the economy).

So where will we be in 18 months' time? **The only honest answer is to admit that neither we nor the government knows with any precision, and to acknowledge that there are serious grounds for apprehension**. Unemployment will certainly be much higher – perhaps even doubling from its current level. So will be the level of government debt. Business investment will have plummeted. Because we entered the recession with an appreciable level of unsatisfied housing demand, dwelling investment may be relatively less affected, but is unlikely to be buoyant. Governments, both State and federal, will be increasing both current and capital expenditures – most of which, however, like the "education revolution" spending referred to earlier, will be relatively unproductive.

By that time, the I M F will have issued perhaps the 15^{th} revision of its economic outlook forecasts over the preceding two years. The situation overseas will have become worse – perhaps a lot worse – although China, importantly, may be an exception. By that time, some individuals and some businesses may have sorted out – or be on the way to sorting out – their balance sheet imbalances. But with the ground constantly changing, or threatening to change, beneath their feet, I doubt whether their "animal spirits" will be much in evidence.

Labor Leadership Fallout: In a *National Observer* article[6] last year, I said:

"Mr Rudd appears to suffer from a serious personality flaw – one might almost call it a disorder – of a kind, and an intensity, which should disqualify him from occupying the most powerful office in the land".

"Whatever may be the clinical description for the personality flaw ……, a man who will brook no opposition to his 'decisive' views is clearly a danger not merely to his party's prospects of remaining in government, but also, and more importantly, to Australia".

Given that judgment, the evidence for which has mounted since it was written, I queried whether his colleagues would allow Kevin Rudd to lead them to the next election. "Enter Julia", I said, "stage Left".

Whether or not there is a change in its leadership before the next election, there is no doubt in my mind that, other things being equal, Labor could then be eminently beatable. There is just one problem – the present state of the Coalition parties in general, and their present leadership in particular.

The Coalition's Problems: We can all recall elections, both State and federal, where governments eminently deserved to be defeated, yet nevertheless survived. The best known federal example was when the Coalition, under John Hewson's leadership, lost the "unloseable" election of 1993. At the State level, the New South Wales election of March, 2007 should have been a lay down *misere* for the Coalition, but under Peter Debnam's leadership it became merely another in a succession of such Coalition debacles.

The lesson is, I suggest, that while the voters will throw out incumbent governments, as they did federally in the 1996 landslide, **they will only do so if the potential replacement has policies in which, and a leader in whom, they feel they can repose confidence. The federal Coalition parties in Canberra are presently vulnerable on both counts.**

There is no kindly way of putting this. At the heart of the problem is Malcolm Turnbull himself. He is unquestionably talented, and comes over, rightly or wrongly, as having a pleasant personality. But since gaining the office he had so long – and in some ways, so unscrupulously – sought, he has:

- Systematically trashed John Howard's Liberal Party legacy.
- Surrounded himself, in his shadow ministry, by ineffectual third-raters such as Senator Helen Coonan (Finance, Competition Policy and Deregulation), Dr Sharman Stone (Immigration and Citizenship) and others of a similarly soft-Left persuasion.
- Over-promoted second-raters such as Christopher Pyne (now the ineffectual Manager of Opposition Business in the House).

- **Displayed, time and again, astonishingly poor political judgment, most damagingly in his initial concession that the government had a "mandate" for its *Fair Work Bill*. As the Labor Party demonstrated in 1999 after "the GST election", there is no such thing as a mandate.**
- Advanced one silly position after another on the emissions trading scheme question, to the point of seeking almost to "out-green" the Greens!
- **More generally, persistently demonstrated a set of values that have much more to do with the elites of the electorate of Wentworth than with the values of average Australians – and even less of those "Howard battlers" whom the Coalition will have to win back if it is to regain office.**

Let me elaborate a little on that last point. Today, the values of the Turnbull-led Opposition seem to bear little or no resemblance to those that kept the Coalition in office for almost 12 years. For example, when did you last hear a shadow Cabinet spokesman (or woman) attack the government over any of the following matters:

- the composition (and in current economic circumstances, size) of our immigration program, **including the huge intake of culturally incompatible, often non-English speaking people from various dreadful places around the world, with the massive rise in ethnic crime they have brought with them.**
- **the insane proposal (supported by, of all people, the National Party!) to import so-called "guest workers" from various South Pacific failed states, including not least the crime and corruption-ridden one that Papua-New Guinea has now become** under a succession of "big men" living high off the hog of (among other things) Australia's aid program.
- **the Prime Minister's dangerous proposal to seek, at whatever cost to our budget and our foreign policies, a seat on the Security Council of that most corrupt of international organizations, the United Nations.**
- **Kevin Rudd's apparent willingness – partly in pursuit of that worse than worthless UN Security Council objective – to hand over major parts of our mining industry to companies that are nothing more than agents of the Chinese Communist Party and its government.**
- **the ineffectual pursuit of the policies, initiated in 2007 by Mal Brough, to begin to repair some of the destruction wrought among Australians of Aboriginal descent by 40 years of failed policies of separatism from both sides of politics.**

That list could be extended much further. The real problem here, I fear, is that policies of the kind I am criticizing probably appeal to many of those Wentworth electorate elites referred to earlier. **Yet as the 1999 republic referendum showed, winning Wentworth can't win you Australia.**

I could go on, but I merely reiterate that, however politically propitious the prospective economic circumstances late next year might seem to be for the Coalition parties, they have little hope of winning government under their present leadership.

Nevertheless, What If? In these circumstances, there are three possible outcomes of the next federal election:

(1) I may prove wrong, and Malcolm Turnbull may become Prime Minister.

(2) The Liberal Party may, before then, find itself a more electorally acceptable leader, and that person may become Prime Minister.
(3) The Labor Party, whether or not still under Kevin Rudd's leadership, and notwithstanding the economic shambles then confronting us, may nevertheless prevail, while coming to understand (as the Hawke Government did in 1983) that it needs to change course decisively.

So what should that new course comprise? In thinking about that I have, as Ray Evans requested, re-read my 1984 Shann Memorial Lecture – delivered shortly after I had made known my intention, in the near future, to resign my office as Secretary to the Treasury, and from the Commonwealth Public Service.

Much has happened since then, and in an Appendix to the written version of this paper to which I shall not refer further this evening, I have spelled out both the background to that Lecture and a staccato time-line of labour market events in the almost 25 years since its delivery.

In 1984 there were many similarities to the problems confronting Australia in the early 1930s that Shann was then addressing in his writings. Today, those similarities have diminished. As my earlier newspaper article observed, we now have a flexible exchange rate, an independent central bank and a less-regulated labour market subject to less trade union monopoly power.

Consider, however, that last point now that the *Fair Work Bill* has passed into law. It is bad enough that a huge number of small businesses, having 15 to 100 employees, will shortly be subjected again to the costly blackmail of "go away money". But the real threat, as the former Labor Treasurer of New South Wales pointed out recently, lies elsewhere. I quote from Michael Costa's article:

"The real problem with the legislation is its model of collective bargaining. This model is more than a restoration of the pre-*Work Choices* [Howard] or even pre-*Workplace Relations Act* [Reith-Kernot] arrangements. It goes much further.
"Even the ACTU acknowledged this was unprecedented ……… when [last year] it said: 'The new collective bargaining laws ……will ….. represent one of the most momentous overhauls of industrial relations in this country for 100 years'.
"The introduction of compulsory 'good faith' bargaining with a new arbitral body, Fair Work Australia, means that an effective broad re-regulation of the labour market is likely. This overturns not only *Work Choices* but also important reforms made in labour market regulation under the Hawke and Keating Labor governments".[7] (Emphasis added)

Hard Policies for Hard Times: The most important need, in addressing the post-election situation, will be for public political pronouncements to face up to reality. Part of the Rudd Government's problem has been that, at the outset, "neither Mr Rudd nor his Treasurer, Wayne Swan, could bring themselves politically to concede the quality of their inheritance".[8] Later, neither man could bring himself to utter the words "budget deficit". Until last week, neither man could admit that Australia would suffer a recession.

Australian voters are not children. They deserve the truth, even when it is as unpalatable as much of it will be over the next year or two. The reckless promise of a pensions increase, for example, owes much to the government's unwillingness to tell the electorate the truth that we can't afford it. (Tony Abbott, who had the courage to raise the issue, was immediately demonized – including, no doubt, by his own Party room – for having done so).

Two years from now, Australians on average will be significantly poorer. Many more of them will be unemployed. Many will be much less productively employed in one government spending program or another. Our gross domestic income will have suffered appreciably from the sharp fall in our terms of trade, and our national indebtedness to foreigners will be higher.

All this needs to be spelled out, and against that background, reality suggests a need for two things: first, to start cutting our coat according to our cloth; and second, the adoption of policies that will increase the amount of that cloth available.

On the last occasion when we were facing anything like (albeit far worse than) the present situation, even the then Arbitration Court showed some signs of coming to its senses. In its judgment of January, 1930 it said:
"The difficulty [in the hearing before the Court] was to get union advocates not to live in the past but to face the present situation and future prospects".

Later in the same judgment, the Court said:
"Great and increasing unemployment is strongly symptomatic of a wage level too high for our present capacity".

One hard lesson which, under the stress of the economic realities of that time, Australians were forced to learn was (and is) "that full employment is not only, or even primarily, a matter of governments manipulating aggregate demand, and that the labour market itself, and its participants, have a critical role to play".[9]

This is not the occasion for a 2009 Shann Memorial Lecture, but one other element of that 1930s situation may be worth recalling. In a joint submission to the February, 1931 Premiers' Conference the heads of four State Treasuries (headed, in those days, by public servants of substance as distinct from "politically acceptable" appointees) said:
"….the grievous position of many thousands of [unemployed] people imposes a responsibility upon governments no less severe than the responsibility to restore financial stability. The differences between the two are these: (a) Financial stability is within the control of governments, and it is a condition precedent to the restoration of employment; (b) The restoration of employment is not directly within the control of governments".

And they went on:
"Employment must be made profitable. This cannot be done by government relief works or subsidies to private industry, but only by removing obstacles to reduced costs, and by the restoration of confidence". (Emphasis added)

Some will say, no doubt, that not only were these State Treasury officers writing prior to the revelations of John Maynard Keynes, but also before the advent to the U S Presidency of Franklin Delano Roosevelt and the subsequent wonders of his New Deal.

During my student days I would have broadly accepted both those caveats. By the early ’70s I had parted company with the first of them, and these days I no longer accept the historical validity of the second. This is not the place for a lecture on either matter; but as to the second, I cannot recommend too strongly a highly readable book on the subject, *The Forgotten Man*,[10] by Amity Shlaes. Sub-titled *A New History of the Great Depression*, the recently published paperback edition (a copy of which I acquired while in New York) has become a *New York Times* bestseller.

By the end of next year, whatever scope now remains for assistance from monetary policy will have already been fully utilized.

As to fiscal policy, the government has already committed to spend more than $52 billion in two major packages, as well as billions more in other announcements. If we set aside the CPRS (a net tax should it come to pass), the UEFO paper indicated a total of such new fiscal commitments since October of $58.1 billion.[11] In short, the Budget is already in disarray, and 18 months from now looks certain to be more so – probably much more so. **By that time, the only budgetary policy that will make any sense will be one of doing no further harm.**

In effect, then, the only way in which, by then, unemployment could be quickly reduced would be via a significant cut in labour costs (as was eventually done, incidentally, in Australia during the Depression). Reductions in the many other regulatory barriers to job creation would also be helpful.

Today, as in 1931, **“employment must be made profitable”.**

So far as the export industries are concerned, their profitability will chiefly depend on demand for their products in overseas markets, and on the exchange rate. They too, however, can be helped by reducing their costs – in particular, the regulatory costs (such as the whole Native Title “right to negotiate” racket) that miners face in both exploration for and development of their mines.

For businesses serving the domestic market, costs are the principal impediment to profitability – which brings us back to such matters as the Fair Work Act, the proposed emissions trading scheme, the lock-out of the low-skilled and the uneducated through the operation of the minimum wage, and so on.

By the end of next year we may again be forcibly reminded, as that 1930 Arbitration Court judgment said, that **“great and increasing unemployment is strongly symptomatic of a wage level too high for our present capacity”.**

To end on an optimistic note, however, the world meanwhile will have gone on steadily cooling!

[1] *Rudd set to reprise Whitlam's mistakes*, John Stone, *The Australian Financial Review*, 25 February 2009. (Note incidentally that the sub-editor's title is somewhat misleading).
[2] John Greenwood, *How to Escape from Balance Sheet Recessions: Lessons from Japan*, Paper to the Special Meeting of the Mont Pelerin Society, New York City, 7 March 2009.
[3] These recessions might also be known among professional economists (among whom I do not claim to be numbered) as "Fisher recessions", after the American economist Irving Fisher. See his paper *The debt-deflation theory of great depressions*, *Econometrica*, 1933, pp.337-57 (particularly 341-42).
[4] John Greenwood, *op.cit.*.
[5] *Global fix for a global problem*, Kevin Rudd, *The Australian*, 6 March 2009.
[6] *The Future of Mr Kevin Rudd*, John Stone, *National Observer*, Spring 2008, No.78. Because of publication lags, this article was actually filed on 2 November 2008.
[7] *Unions may yet rue Rudd's IR reforms*, Michael Costa, *The Australian*, 20 March 2009.
[8] *The Future of Mr Kevin Rudd*, *op. cit.*.
[9] John Stone,*1929 and all that* (1984 Shann Memorial Lecture, University of Western Australia, 27 August 1984), p.37.
[10] Amity Shlaes,*The Forgotten Man: A New History of the Great Depression*, Harper Collins, 2007, and Harper Perennial, 2008 (paperback).
[11] *Updated Economic and Fiscal Outlook*, February 2009, Appendix A: Policy Decisions taken since the 2008-09 MYEFO.