ENDING THE GREAT AUSTRALIAN COMPLACENCY OF THE EARLY TWENTY FIRST CENTURY

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One of the many joys of living in Melbourne is a ride across from Princes Hill near The University of Melbourne, to where Maribyrnong Road crosses the river, and then along the bike path next to the river to the Bay. You ride past the place where Humes made cement pipes for carrying water and waste around a vigorous young city and then, a hundred years ago, from whence they took what they had learned in building Melbourne to Singapore and other growing cities of Southeast Asia. Past the lovely grounds down to the river of the main campus of the University that is our host tonight. Past the picturesque racetrack where one of the world's most famous horse races has been run each year for one and a half centuries.

And then past a large, solid brick factory building, where many men and more women once put together the fibres and fabric to clothe Australians, confident that they were making a strong Australia as well.

A quarter of a century ago, the clatter of the textile machines went silent. But the building didn't. The same economic reforms that caused Australians to buy most of their clothes from countries better suited to making them, made Australia the natural home for new firms built on the energy and talents of clever, well educated and adventurous people who were comfortable in the whole of a changing world. So the large, solid brick factory building on the Maribyrnong became the home of the world's largest and most successful publisher of travel guide books. The Lonely Planet headquarters buzzed with young people distilling the tongues of Babel into intelligible phrases and condensing the knowledge from millions of hours of adventure through every corner of the earth. I got to know the buzz after Tony and Maureen Wheeler, boat people from the United Kingdom a couple of decades before, asked me to chair the Board of their company for a while.

A few years ago, Lonely Planet was purchased by the BBC in London. My curiosity got the better of me when riding past the old brick building a month ago. When I wandered inside and introduced myself, some of the desks had busy people behind them. But in large parts of the old textile factory the desks were no longer weighed down with piles of books and photographs and maps. Nor was there the old noise of disputation about the reliability of food in a small hotel in the Deccan. Parts of the old factory were empty. Melbourne Australia was no longer so clearly the best place in the world to bring together knowledge of travel through the whole of the earth.

The old building is still large and solid alongside the Maribyrnong. It will still be there tomorrow, but the clatter and buzz may not.

Australians' Choice

This evening's lecture places before Australians the fateful choice that we will make in the months and years ahead, about how to respond to hard times after more than two decades of extraordinary prosperity.

Let me anticipate a question by saying at once that I am not talking about the choice that the Australian electorate will make on September 14 this year. There is no reason to doubt that the betting odds have the possibilities about right, but that is not central to our discussion. The issues that I am raising tonight will be difficult for whichever side of Australian politics has responsibility for national leadership later this year. Both sides of politics are taking to the election some policies and preconceptions that would get in the way of Public Interest responses to the challenges facing Australia.

The prosperity of the past two decades has been a wonderful thing. It has enhanced Australians' financial security and self confidence. Our households have enjoyed wider access to important services and to an expanding range of transfer payments. We avoided the debilitating unemployment that other developed countries experienced when the US technology boom went bust at the end of the century and when the global financial system foundered after the Great Crash of 2008. We have so far avoided the tensions that have tested the democratic institutions of many countries in Europe, and the bitter political deadlock of the United States of America.

It has been a good time for business. Governments have extended support in misfortune without asking for much to be repaid when the wheel of fortune turns. New regulatory arrangements have been introduced for power and some other utilities that guarantee high prices and rates of return and make investments in Australia attractive beyond comparison with opportunities in other countries. Retail margins keep prices for internationally traded goods way above the norm elsewhere. The profit share of national income rose to levels unknown in earlier modern times.

Australian average incomes measured in international currency rose from below the average of the developed countries in the early twenty first century, to one quarter above the United States, one third higher than Japan and one half higher than the European Union in 2011.

Expanded incomes in international currency have made Australia a more attractive place of residence for talented people from everywhere. They have increased our diplomatic weight.

Increased international purchasing power has brought within the means of ordinary Australians a wonderful abundance and variety of foreign travel, goods and services. Young and old Australians travel abroad in unprecedented numbers to an unprecedented range of destinations. The economic constraints on citizens of other developed countries have thinned the crowds, making tourist travel more comfortable. The latest information technology is more quickly within the financial reach of large proportions of Australians than of people from other developed countries.

In a University of Melbourne seminar last Friday I described how net exports of beverages—mainly wine and spirits—had risen from near zero in the mid-eighties to almost a quarter of a percent of GDP in the early years of this century, and then fallen back to near zero today. I described this movement as a journey "from Champagne to Coonawarra and back to Champagne".

John Maynard Keynes was asked at the end of his rich and varied life if he had any regrets. "Yes", he is said to have responded. "I wish I had drunk more French champagne".

Maybe after the long millennial boom, fewer Australians will die with regrets!

Be that as it may, we have a big challenge ahead of us if we are to avoid the economic and political legacies of the long boom giving Australians much to regret.

The long expansion culminating in the decade-long China resources boom has left three challenging legacies, that together will test the wit, the will, the values and the cohesion of Australians in the years ahead.

The first challenge is that the real exchange rate has risen during the long boom way beyond the levels that will be consistent with full employment and continued expansion in economic output once the resources boom dims its lights. It must be reduced by a large amount. That is easier said than done. A real depreciation involves not only a fall in the exchange value of our currency against others, but restraint in the passing through of the resulting increase in prices of imported goods and services into the number of Australian dollars we earn and spend.

Real expenditure has also risen above sustainable levels, but we will find that effective correction of the overvaluation of the real exchange rate will also deliver most if not all of the correction in real expenditure that is required. That still means some contraction in the overall purchasing power of Australian households and institutions as well as a larger proportionate reduction in their international purchasing power.

The second challenge is to change entrenched expectations that living standards will rise inexorably over time; that household and business incomes and services will rise and taxes will fall, as they have done for a full generation. Those expectations must be reversed in the process of dealing with the legacy of the boom, or our efforts in reform will be defeated by bitter disappointment with political leadership and eventually political institutions.

The third challenge is that our political culture has changed since the reform era 1983-2000, in ways that make it much more difficult to pursue policy reform in the broad public interest. If we are to succeed, the political culture has to change again.

The new barriers to productive change in our political culture are not only or especially a legacy of Australia's millennial boom. They are part of the contemporary political reality of the United States and Europe. But whatever their origins in other places, in Australia the long period of prosperity has provided a congenial environment for the entrenchment of a new political culture that elevates private over public interests and the immediate over the longer term.

After the decades of prosperity, Australians now must choose between two radically different approaches to our problems.

We can continue to conduct our public life as if the approaches that were good enough in the days of easy prosperity can deliver acceptable outcomes in harder times. If this is our choice, we continue to live behind the veil of ignorance that has descended around our public life over the past dozen years. We make public choices within a political culture distorted by the intrusion of market values into relationships and processes that only work within ethical systems of other kinds.

Or we restore discipline of the kind that framed public choice in the reform era from 1983 to the end of the last century, are prepared to think hard about the actual effects of policy proposals rather than repeat political slogans, and act consistently with the results of clear analysis even when that damages some interests and lesser values.

I call these the “Business as Usual” and “Public Interest” approaches to policy.

The “Business as Usual” and “Public Interest” approaches lead to radically different outcomes. If we continue within the political culture of the later years of high prosperity, “Business as Usual”, we will live in greater comfort for a short while. But sooner rather than later we will experience deep economic recession with high unemployment--probably unemployment rising with each new recessionary episode without falling much in the years between.

The memory of 1974 to 1983 may help older Australians to visualise this future. As I will show, the awful truth is that the starting place is more difficult this time than in 1974 and the consequences of failing to deal effectively with problems correspondingly worse. If we make the Business as Usual choice, we can expect disappointment as public services that have enhanced Australians’ welfare are diminished bit by bit in response to successive fiscal crises. We can expect bitter political conflict within our society, and unhappiness about our institutions.

Conflicts and incoherence within our polity in the years immediately ahead would be the more dangerous because they would emerge at a time of international financial uncertainty, still dragged down by the overhang from the global financial crisis, with the causes of the crisis mostly remaining at large, and with the eventual withdrawal of some extraordinary monetary strategies at some time to lead the northern developed world into uncharted waters. They would come at a time of ideological uncertainty, with doubts growing about whether the political and economic systems of the developed world of which Australia is part still have the capacity to deliver prosperity to most of their citizens. They would be the more dangerous because they would be emerging at a time of strategic uncertainty, when Australians’ confident ancient presumption that might is right and on our side is challenged by the divergent economic fortunes and therefore strategic weight of the old developed and large Asian developing countries. The tensions within our society and polity would be the more dangerous because they would come at a time of growing impacts of climate change and widespread recognition of the importance of maintaining a proportionate contribution to the global mitigation effort.

I don’t have time this evening to go into these large matters, but they all add to the importance of making good choices now.

The Public Interest is a much harder choice with more wholesome consequences. For Australia to choose the Public Interest approach, a lot of us—enough to influence policy choice at a high political level—would have to put aside the slogans that have taken the place of thought about public policy so far in the twenty first century. We would have to question the validity of propositions to which we have become attached. That's hard. Harder still, we would have to change our minds when the evidence supported change.

The Public Interest approach will not be chosen unless many Australians are prepared to support changes that damage some aspects of their personal interests.

The problems that we face and the remedies that are necessary to deal with them are so far outside the range of Australian political discourse in the twenty first century, that political leaders will have to explain to their supporters the need for changes in some policies that have strong support. Where there is conflict between specific policy commitments, and the general commitment to govern in the interest of Australians, the latter must prevail.

The Public Interest choice would return us to realistic analysis of the consequences of policy choice issue by issue, and to policy action on the basis of analysis and the ascendency of public over private interests.

The odds favour the path that is easier for the immediate future. The odds favour Australians choosing Business as Usual—the continuation of what I have been calling for a decade The Great Australian Complacency of the Early Twenty First Century.

But let us at least think about seeking a good outcome in the Australian public interest against the odds. Let us at least think about alternatives to sleepwalking into a deeply problematic future as if we had no choice at all.

This lecture seeks to explain the choice that faces Australians.

It sketches the central issues that we must confront in building an alternative to the Great Australian Complacency.

The economic challenge to Australia is relatively straightforward.

The challenge to our polity and society is more demanding.

The Simple Economic Challenge

Between the recession of 1990-91 and now, mid-2013, Australians have enjoyed the longest period of economic expansion unbroken by recession of any developed country ever. The first decade's expansion in the 1990s was built on solid foundations: rapid increases in productivity that had their origins in far-reaching productivity-raising reform from 1983. The second decade's expansion was built on sand that was bound eventually to shift: at first a housing and consumption boom funded by bank borrowing from international wholesale debt markets; and then an unprecedented lift in the "terms of trade" (prices for Australia's exports relative to imports), leading eventually to an increase in investment in resources to a share of the economy that has no precedent.

The housing and consumption boom ended by the middle of the century's first decade. Its conclusion would have disrupted the prosperity and the global financial crisis would have descended upon us at a time of weakness were it not for the timely arrival of the China resources boom.

The resources boom was caused by a historically unique period of economic growth in China: the strongest longest episode in "catch-up" economic growth that the world has ever seen, using energy and metals more intensively than other countries had done, in the world's most populous country on the way to becoming the world's largest economy. It was a fabulous episode in world economic history. China completed the investment-led period of its economic growth around 2011, and entered a new period of transition to a modern economy. China's new model of economic growth will see continued strong increases in output but with much slower increase in demand for energy, especially thermal coal, and metals (Cai, Garnaut and Song, 2013).

The resources boom radiated white heat when resource mining and energy companies were taken by surprise by the intensification of investment-led and therefore energy- and metals-intensive growth in China at the beginning of the twenty first century. The depth of the slump that stretches out before us flows from commodity producers' failure to see in advance that the resource-intensive phase of Chinese growth would soon have run its course. The absence of foresight and prudence in public policy over a decade mean that Australia has no buffer against the coming sharp downturn in the resources sector.

Through the second decade of this extraordinary economic expansion, Australian business and households became accustomed to easy increases in incomes, ever-lower taxation and rewards that bore no close relationship to effort or achievement. They demanded more and more of these good things. Governments met those demands not from sustainable productivity growth, but from the temporary bounties of the housing and consumption and then China resources booms.

Incomes and expenditures and costs rose to the limits that could be supported temporarily by the housing and consumption and then China resources booms. Australia's real exchange rate against other developed countries—an inverse measure of Australian competitiveness—rose to unprecedented levels. The high real exchange rate caused the stagnation and then decline of what had been rapidly expanding Australian exports of services and high-value manufactures from the early years of the reform period 1983-2000.

The China Resources Boom has passed its highest point and will soon end. Export prices in the resources industries are falling, and bringing down Federal and State Government revenues. Resources investment has reached its peak and is about to decline. We will be left with an extraordinarily high real exchange rate, forcing contraction of the trade-exposed industries outside the resources sector that are essential for the expansion of employment and output as the China resources boom recedes into history.

The increase in the real exchange rate over the past decade is of historic dimension.

Ian McLean's recent economic history of Australia, *Why Australia Prospered*, cites Adrian Pagan on the aftermath of the resources boom of the early 1970s: "...real exchange rate appreciation (1972 to 1974) was disastrous...(and)...quickly brought the long (postwar) boom to an end" (McLean 2012, p. 217).

The real effective exchange rate rose by 16% from June 1970 to its peak in September 1974, and was back to its 1970 levels by 1977.

This was a small and short episode in real currency appreciation compared with that of the China Resources Boom.

The real effective exchange rate rose by 69% from December 2002 to its peak in March 2013.

Here I will present a number of Charts that illustrate the points that I have been making about the unusual extent and structural consequences of the real exchange rate legacy that has been left by the resources boom.

Multi-factor productivity—the amount of economic output per unit of capital as well as labour that is applied to production--rose more rapidly in Australia than in other developed countries through the 1990s in the aftermath of internationally-oriented reform. This followed relative underperformance through most of the twentieth century. Total factor productivity growth ended early in the twenty first century and went into a decline that continued at least until 2011.

Chart 1: Total Factor Productivity Growth: Australia 2001-2011.

I noted this marked downturn in productivity growth in discussing The Great Australian Complacency of the Early Twenty First Century in a number of public lectures and papers from 2005.

Labour productivity growth was also low through much of the first decade of the twenty first century, despite large increases in the amount of capital per worker after the resources boom entered its investment phase from about 2005. Productivity by this measure has lifted in the past year or so—but the lift has to be sustained if it is to contribute to solutions to our problems. In any case, increases in labour productivity are a less reliable source of sustainable increases in living standards than increases in total factor productivity, as use of additional capital has a cost.

Australian average incomes in international currency grew even more strongly after the cessation of rapid total factor productivity growth at the beginning of the new century than in the 1990s.

Chart 2: Labour Productivity and Gross National Income Per Capita (Australia as a percentage of the US).

The continued increase in incomes from 2003 was underwritten by an extraordinary rise in the terms of trade which persisted to 2011, with a break for a year or so after the Great Crash in late 2008.

Chart 3: Australia's Terms of Trade 1959-2013.

There has been a considerable fall since 2011. The fall has a long way to go, as deceleration of the growth in global demand runs into acceleration of expansion in supply capacity.

From the Great Crash of 2008 to the end of 2011, nearly all of the growth in world demand for Australia's main commodity exports, iron ore, coal and petroleum, was in China. More than the total increase in world demand for aluminium, nickel and copper was in China.

After double digit growth in Chinese demand for metals and fossil energy in the decade to 2011, Chinese demand is now likely to grow at only a few percent per annum for most of these commodities—somewhat faster for gas, and not at all for thermal coal. At the same time there is massive investment in expansion of supply capacity, induced by high prices, for most metals, coal and gas. Prices will fall enough to bring supply and demand into balance—perhaps overshooting for a while as decisions are taken to close or to cut back production at high cost mines.

In Australia as around the world, investment in the resources sector rose to unprecedented heights in lagged response to the high prices and expectations of strong Chinese economic growth. Australian investment in the resources sector has reached a peak in 2013, and will soon decline.

Chart 4: Business Investment by Sector as Share of GDP.

Chart 5: Stock of On-Going Future Resources Investment.

Chart 6: Real Effective Exchange Rate 1983-2013.

The real exchange rate as conventionally measured is now much higher than at any time since the floating of the Australian dollar in 1983.

There are two good reasons for looking beyond the trade-weighted real exchange rate to bilateral rates against developed countries in assessing impacts of currency appreciation on the Australian economy.

One reason is that the Australian trade-weighted index allocates large influence to lower-income countries in the "catch-up" phase of economic development, in which productivity growth is exceptionally high. These include Japan in the nineteen seventies; Hong Kong, Singapore, Taiwan and Korea in the later seventies and the eighties, and China over the past eight years. The real exchange rates of Australia and other developed countries should be depreciating against these countries at these times to maintain overall competitiveness.

The second reason for looking beyond the trade-weighted real exchange rate is that Australian growth after the resources boom is going to require large increases in investment in and exports from the trade-exposed industries outside the resources sector—in services, manufactures and farm products. Australia is competing mainly against developed countries in these industries,

The Australian dollar real exchange rate in March 2013 is 51% higher against the United States dollar than on average from 1983, the year of the float, to 2013. Against the UK Pound it is 40% higher, and 64% against the Japanese yen. The Euro wasn't around for the first one and a half decades after the float; the Australian dollar is now 44% more expensive in real terms against the Euro than it was on average 1999-2009. The Australian dollar has appreciated by large amounts in real terms even against other resource-rich developed countries: by 29% against Canada and 33% against Norway in March 2013 relative to 1983-2003.

The contributions to the economy of investment and exports in the trade-exposed industries outside the resources sector have fallen sharply since the early twenty first century, after vigorous expansion through the reform era to 2000.

Chart 4 presented the data for investment in manufacturing and in other industries outside resources.

Chart 7 reveals sharp declines in the role in the Australian economy of exports of each of services, manufactures and rural products from the turn of the century, reversing established rising trends.

Chart 8 shows education exports having stronger upward momentum for longer than exports from industries other than resources, but falling away over recent years.

Chart 9 tells a powerful story of inbound tourist numbers growing much more rapidly than outbound from early in the reform period until 1995, at about the same rate until 2002, and much more slowly over the past decade.

Chart 10 maps the journey from Champagne to Coonawarra and back to Champagne (or Marlborough).

Chart 11 describes a rapid decline of net exports of processed foods from 2002, from 1.2% of GDP to one quarter of that proportion.

Chart 12 tells a similar story for metals.

There is strong momentum in the decline of investment in the export and import-competing industries outside resources which will only turn around with large changes in incentives and the passing of time.

From whence can growth come, to hold up employment and incomes as metals and energy prices and investment decline?

Why not expand economic activity and employment by increasing government spending as we did in response to the global financial crisis, and by cutting taxes and reducing interest rates to promote private spending?

Our external position is weaker now, after the China resources boom, than it was during and immediately after the Great Crash of 2008. If all we did was to increase spending at home, a large excess of current foreign payments over current earnings would emerge. We would soon find it difficult to obtain enough overseas money on reasonable terms to cover the excess. Our current account deficit is running just below 4% of GDP even with today's historically favourable terms of trade. The current account deficit will increase substantially with the continuing retreat of export prices on world markets and the eventual normalisation of global interest rates, with only a modest offset from the reduction in average import intensity of GDP as the resource investment share of the economy retreats.

A smaller contraction of investment in resources would ease the adjustment. However, realistic assessment of supply, demand and price prospects disappoints hopes that re-ignition of a resources boom could substantially reduce the challenge that Australia faces. The most influential variable in determining the extent of the decline in resources investment in the period ahead is the extent of real exchange rate depreciation—the same variable that will have the main influence on investment and exports in trade-exposed industries beyond resources.

Australia will, of course, experience historically strong growth in energy and metals export volumes following the resources investment boom. This will influence Australia's capacity to sustain expenditure almost exclusively through the contribution to government revenue. The increased volumes are likely fully to compensate, maybe more than compensate, for price reductions in contributions to State royalties, which are mostly based on the value of sales. Commonwealth revenue from the resources sector derives overwhelmingly from taxes based on profit or cash flow. For these Commonwealth sources of revenue, the accumulation of capital deductions and to a lesser extent interest deductions in the resource investment boom are likely to hold revenues below earlier peaks for a number of years, despite expansion of export volumes.

Australia has generally found it easier than most countries to fund high current account deficits. It has not been easy, however, in periods of stress in international financial markets. The closure of international capital markets to Australia precipitated deep depressions in the 1890s and 1930s. The private sector was unable to fund its deficits through and immediately after the Great Crash of 2008, when crisis was avoided by the Government guaranteeing nearly $160 billion of overseas debt incurred by the commercial banks. It would be imprudent for the banks or for the Commonwealth Government to expect that such action could be repeated at reasonable cost if the borrowing capacity of the private sector were tested again by such a breakdown in global capital markets. I presume that the Commonwealth prudential regulatory agencies if not the boards of the banks themselves will be cautious about allowing a return to the large-scale borrowing in international markets that funded the extravagant bank lending of the early twenty first century.

It follows that increases in demand, economic activity and employment in the period ahead will be undermined by weaknesses in our financial relations with the rest of the world unless they are accompanied by large increases in exports from the services, manufacturing and agricultural industries. That has to be preceded by large increases in investment in these industries.

You cannot fatten the pig on market day. The sooner we start the restoration of competitiveness with depreciation of the real exchange rate, the sooner we can enjoy the benefits in the marketplace.

A big fall in the exchange rate doesn't sound so difficult. It will happen sooner or later anyway, as operators in the international foreign exchange markets recognise the weakness in Australia's external position with the approaching end of the China resources boom. It started to happen early this month, with the Reserve Bank's reduction of interest rates and change of rhetoric on the strong dollar, and the government's shaking free of an earlier embrace of the strength of the national currency. The recent fall in the foreign exchange value of the Australian dollar is a start, but has to go many times further.

In any case, the dollar's fall is the beginning and not the end of the adjustment that Australians must make to the end of the long boom. What matters is not the exchange rate that is displayed on the television news each night, but the real exchange rate—the overall competitive position of Australia after taking into account differences in inflation rates as well as the exchange rate. A fall in the exchange rate would raise average prices. This reduces living standards—the amount of goods and services that Australian incomes and expenditure support—unless there are corresponding increases in the productivity with which Australian resources are used.

Some payments from government and some regulated prices for transport and utilities services and some profits for privately as well as publicly owned utilities are protected from inflation by indexation or guaranteed rates of return. Some are protected by natural and contrived monopolies.

Protection of prices and profits is more widespread in Australia than other developed countries, and more pervasive in Australia after than before the long boom. It needs to be challenged in any Public Interest programme of reform.

No doubt there would be pressures on government to compensate for the effects of the depreciation on other incomes and prices, beyond those that are explicitly guaranteed by government or supported by monopoly. If everyone is protected from the rise in import prices, no-one is protected: the exchange rate fall gives us inflation and no improvement in competiveness and the old problems remain. The retention of protection of incomes or profits or prices for some interests increases correspondingly the fall in real incomes that must be absorbed by others.

Higher productivity can help: the greater the improvement in productivity, the less the required reduction in real incomes and expenditures. In addition, the greater the steps that are taken now to increase productivity in future (and most reform measures yield their full fruits only after lags of many years), the less risky it would be to increase foreign debt to fund partial maintenance of incomes during the adjustment period. Uninhibited efforts to restore Australian productivity growth after its early twenty first century stagnation should be at the centre of a Public Interest reform programme.

Productivity growth has natural speed limits. Australia enjoyed total factor productivity growth around 2 percent per annum in the last decade of the reform period. That is as good as it gets. It is unrealistic to think that the required improvement in competitiveness can come from productivity growth alone. So there has to be downward adjustment in real incomes and expenditure as well as an increase in productivity and reduction in regulatory and monopolistic guarantees to prices and profits.

How much?

That depends on how successful we are in restoring growth in our trade-exposed industries outside the resources sector. The lower real exchange rate raises the price of imported goods relative to home production, and leads to the switching of demand from imports to home production. Some of us will switch back from Champagne to Coonawarra. The rise in prices of exports relative to home sales leads to the switching of resources from production for the home market towards production for international markets. Switching increases exports and reduces imports, allowing greater expansion in domestic expenditure and higher levels of economic activity and employment without running into external payments problems.

If there is a strong revival of investment and exports in services, manufacturing and agriculture as well as some moderation of the decline in resources investment, the reduction in real incomes and expenditure only has to be large enough to make up the gap left by declining terms of trade and resources investment. Not small, but not frighteningly large.

Public Interest reform to tax and social security would allow us to minimise the reduction of the standards of living of average Australians.

One possible reform would integrate the tax and social security systems so as to allow substantial protection of people on lower incomes alongside some reduction in real wages, while maintaining incentives to work. This would be good for workers, but may be opposed by trade unions.

Substantial reform of the business and personal income tax systems would remove expensive concessions that mainly provide benefits to people on high incomes, while reducing taxes that are genuinely deterring investment and employment. It would reduce the fall in living standards that is necessary within a Public Interest reform programme. The contests over mining taxation in 2010, and the weight of support for cuts in taxes on superannuation (2006) and capital gains (2001) that gutted future revenues, tell us is that this is easier said than done.

If there is no “switching” of our production effort towards exports and our expenditure away from imports in response to exchange rate depreciation, and the whole of the adjustment is achieved by reducing expenditure, then the decline in average living standards will be large. This happens automatically if we choose Business as Usual. The large adjustment will eventually be forced on us by international financial markets. Worse, it is likely that the reduction in living standards would be unevenly spread, with the load being carried disproportionately by a large increase in the number of Australians who want paid work but can’t find it no matter how hard they look.

So this is the economic choice. Do we accept persistent large increases in unemployment and large declines in living standards under Business as Usual?

Or do we accept a Public Interest approach: think hard about how to achieve a large reduction in the real exchange rate and how to lift productivity and to share across the Australian community a moderate reduction in living standards? The moderate reduction in living standards will be smaller and of shorter duration the more it is accompanied by restoration of strong productivity growth.

If we choose Public Interest reform, we are also choosing large changes in some recently but deeply entrenched features of our political culture. That is the hard part of the choice.

The Complex Political Challenge

Many changes in policy settings are necessary for Australians to choose effectively the Public Interest approach to the challenge ahead of us. Every one of these changes involves some loss of income for some people, and some sacrifice of short term comfort for future gains. Viewed in isolation, each element of reform is politically challenging. Viewed together, at first sight they look impossible.

It is a paradox of reform that it is sometimes easier to implement many changes together than one by one, even though each of them is difficult politically. Households and groups may recognise that they will benefit from the reform programme as a whole, although they are hurt by some elements of it in isolation.

Whether comprehensive Public Interest reform is possible depends a great deal on the quality of political leadership.

Quality of leadership is partly about the confidence a community has in its leaders. Others can contribute more than me to the analysis of the qualities that allow some leaders greater success than others in asking citizens to sacrifice some personal and immediate interests for the public interest and the longer term. I note only that the elusive quality of Prime Ministerial charisma was important to the success of the Lyons government in implementing measures that gradually took us out of the Great Depression, and in higher degree, to the success of the Hawke government in the reforms of the 1980s and early 1990s.

Political leaders will have to introduce some changes that disappoint their strongest supporters. That is hard for political leaders; but earlier successful leaders of Australia were able to do such things when new understanding of the national interest required it. The Lyons' Government's acceptance of elements of what we would now describe as a social democratic agenda surprised and disappointed some of the interests that organised its ascent to power, but were important to Australia's relatively early emergence from the worst of the Great Depression. Supporters of Menzies' second rise to the Prime Ministership saw the dismissal of the "socialist" advisers to Chifley as the essence of victory. Coombs records in his autobiography how Menzies' focus in their first meeting after the change of government, to his surprise, was not focussed on his resignation, but rather on whether Coombs could deliver good economic outcomes. Coombs ran Australia's monetary policy throughout the Menzies years. The Hawke Government's willingness to put aside popular parts of the programme that it had taken to the 1983 election laid the foundations for the most successful period of productivity-raising reform in Australian history.

It is a lesson of Australian history that successful periods of restraint—in wartime or to secure safe passage out of difficult economic times--require the equitable sharing of sacrifice. The development of a framework of equity will be important to the success of a Public Interest choice.

Quality of leadership is partly about capacity to explain to citizens the nature of the choices that must be made on their behalf. Public education is an essential element in any reform programme. It was critical to the implementation of productivity raising reform especially in the Hawke Government (1983-91), but also to reforms under Prime Ministers Paul Keating (1991-6) and John Howard in his early years (1996-2000).

Whether comprehensive Public Interest reform is possible also depends a great deal on whether there is a substantial independent centre of the national polity, interested in public policy because of its national interest effects and not because of its effects on their private interests. There is always potential for mobilisation of an independent centre of the Australian polity. The independent centre has been crucial to the success of public interest reforms in the past. It is essential to the prospects for a Public Interest approach to our current challenges.

Economic reform in the public interest is difficult anywhere and anytime. National difficulties or even full-blown national crises do not automatically transform this reality, as demonstrated by the fate of European governments through the troubles in the aftermath of the global financial crisis. Difficulties and crises do, however, provide opportunities for the exercise of high orders of leadership, if the people occupying high office at a time of difficulty or crisis are up to the task, and have before them programmes of reform that are well judged to deal with the problem.

It is an unhappy reality that policy change in the public interest seems to have become more difficult over time at least in the capitalist democracies, and probably in authoritarian market economies like China as well, as interest groups have become increasingly active and sophisticated in bringing financial weight to account in influencing policy decisions. We can recognise distinct changes in political culture in the union campaign against the Howard Government's industrial relations reforms in 2007, affected businesses' campaign against climate change policy reform from 2008 to 2011, the mining industries' campaign against resource rent taxation in 2010 and the gambling industry's campaign on poker machine reform in 2012.

Two things have changed. The range of instruments available for influencing policy has expanded with modern media and information systems. And interest groups have come to feel less inhibition about investment in politics in pursuit of private interests.

The second change reflects a tendency through the short history of modern economic growth for individuals and firms to be less constrained internally over time in pursuing private interests. From Weber (1905) through Hirsch (1976) to contemporary critics of United States political economy from elevated strata of mainstream economics (Stiglitz, Krugman, Sachs), scholars of the politics and sociology as well as the economics of capitalism have observed that a successful market economy requires citizens to accept restraint in the pursuit of private interests outside the areas traditionally identified as the sphere of market exchange. Capitalism doesn't work if many members of society—leaders and citizens—seek to maximise private interests outside the traditional areas of market exchange. They have also observed that the ideological and social constraints on private behaviour are diminishing over time.

Hirsch said that capitalism works because it stands on the shoulders of a pre-capitalist ideology, and that the diminution of this moral legacy over time is problematic. Modern economic life everywhere is testing the limits of intrusion of private interests of many kinds into setting the rules for a market economy. This is making reform in the public interest more and more difficult—explaining the incapacity of United States and European governments to deal crisply with the consequences and to apply the lessons for policy from the global financial crisis.

The challenges are more acute in Australia following the long boom. For a long time, these past dozen years, it has been rare for private interests of any kind to be asked to accept private losses in the interests of improved national economic performance. When asked, the response has been ferocious partisan reaction rather than contributions to reasoned discussion of the public interest in change and in the status quo. A new ethos has developed in which there can be no losers from reform. Business has asserted a property right to continuing benefits of regulatory mistakes. It demands compensation for corrections to errors in policy. Households have been led to expect that no policy changes will cause any of them to be worse off.

It is a small step forward that some household expectations were moderately disappointed in the budget for 2013-14. It is a small step forward that the Opposition on this occasion desisted from denunciation of measures that reduced some entitlements to funding from the fisc.

So the scale of the economic adjustment that must be made, the expectations that living standards will continue to rise when on average and for a while they must fall, and developments in Australian political culture are all reasons to doubt that our polity and society will choose a Public Interest response to the problems that lie ahead.

But while we need to be realistic about the extent of the difficulties that we face, the barriers may not seem so high if we examine critically some of the recent episodes of uninhibited private interest pressure on the policy process. For example, the retrospective conventional wisdom that the miners' campaign against new mining taxation in 2010 was effective in the electorate warrants close examination. The campaign was certainly effective in policy outcomes. A cool look at the data informs us that it did not persuade community opinion.

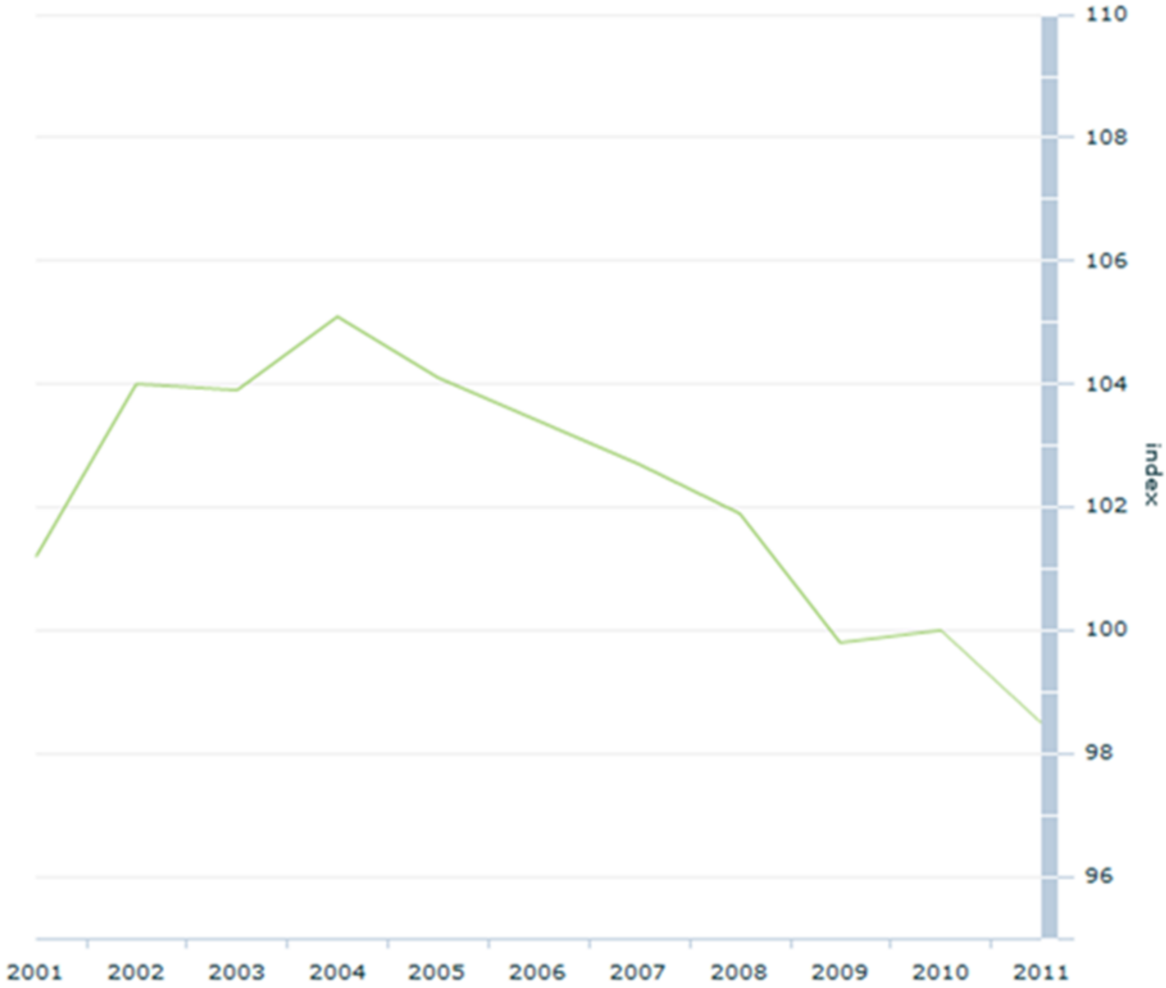
It is worth our while to take a close look at the conditions which made far-reaching policy change in the public interest successful against intense pressure from private interests in the reform period 1983-2000.

I myself have concluded from looking at this history that we do have a choice. An Australian leadership committed to the Public Interest approach to the immense challenges facing Australia, supported by the engagement in policy discussion of a substantial community of Australians with concerns for the public interest, could choose the more wholesome outcomes for Australians.

The scale of what is at stake makes it worthwhile to put some effort into bringing The Great Australian Complacency of the Early Twenty First Century to a close.

Charts

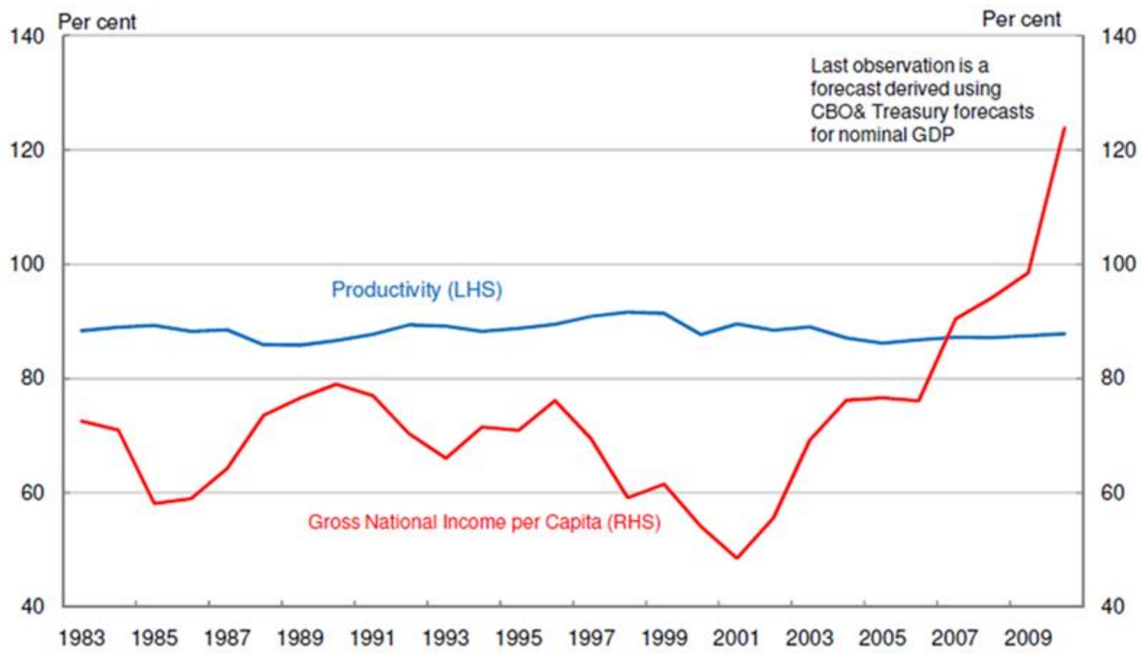
Chart 1: Total Factor Productivity Growth: Australia 2001-2011



Footnote: (a) Gross domestic product per combined unit of labour and capital. (b) Reference year is 2009-10 = 100.

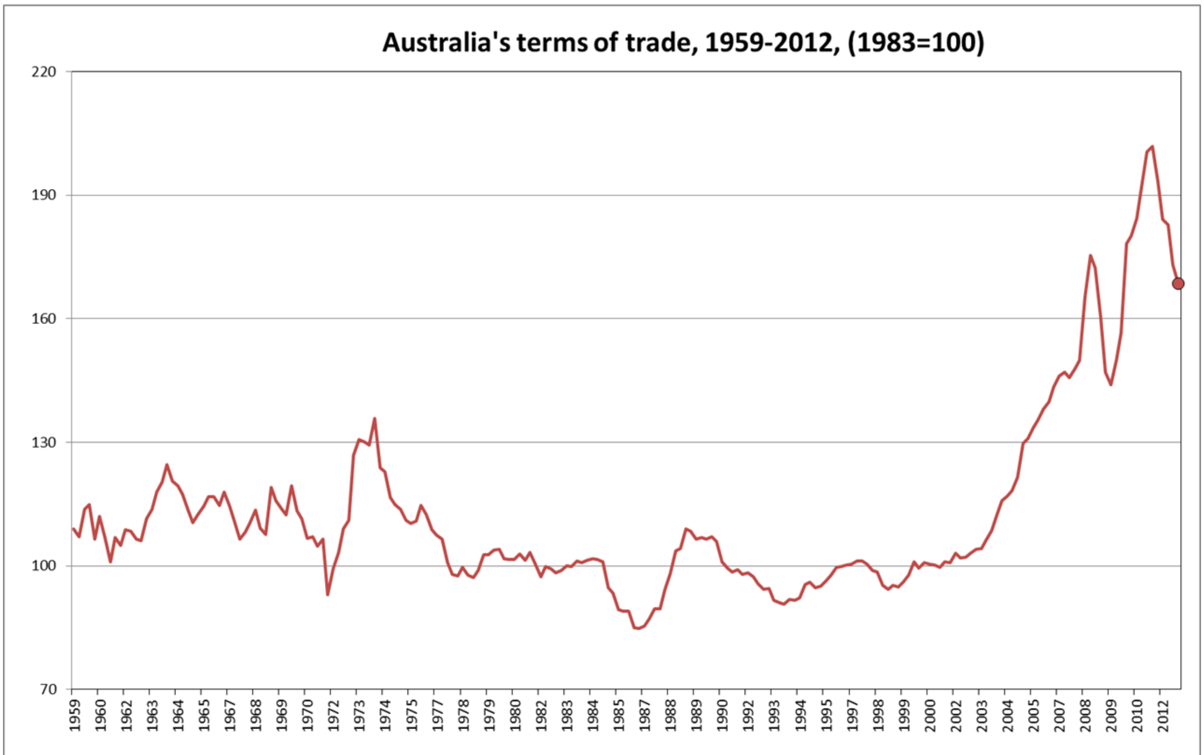
Source: ABS Australian System of National Accounts, 2010-11 (cat. no. 5204.0).

Chart 2: Labour Productivity and Gross National Income Per Capita (Australia as a percentage of the US)



Source: Treasury, * Australian GNI/capita in $US converted at exchange rate of year concerned

Chart 3: Australia’s Terms of Trade 1959-2013



Source: ABS Catalogue number 5206.0

Chart 4: Business Investment by Sector as Share of GDP.

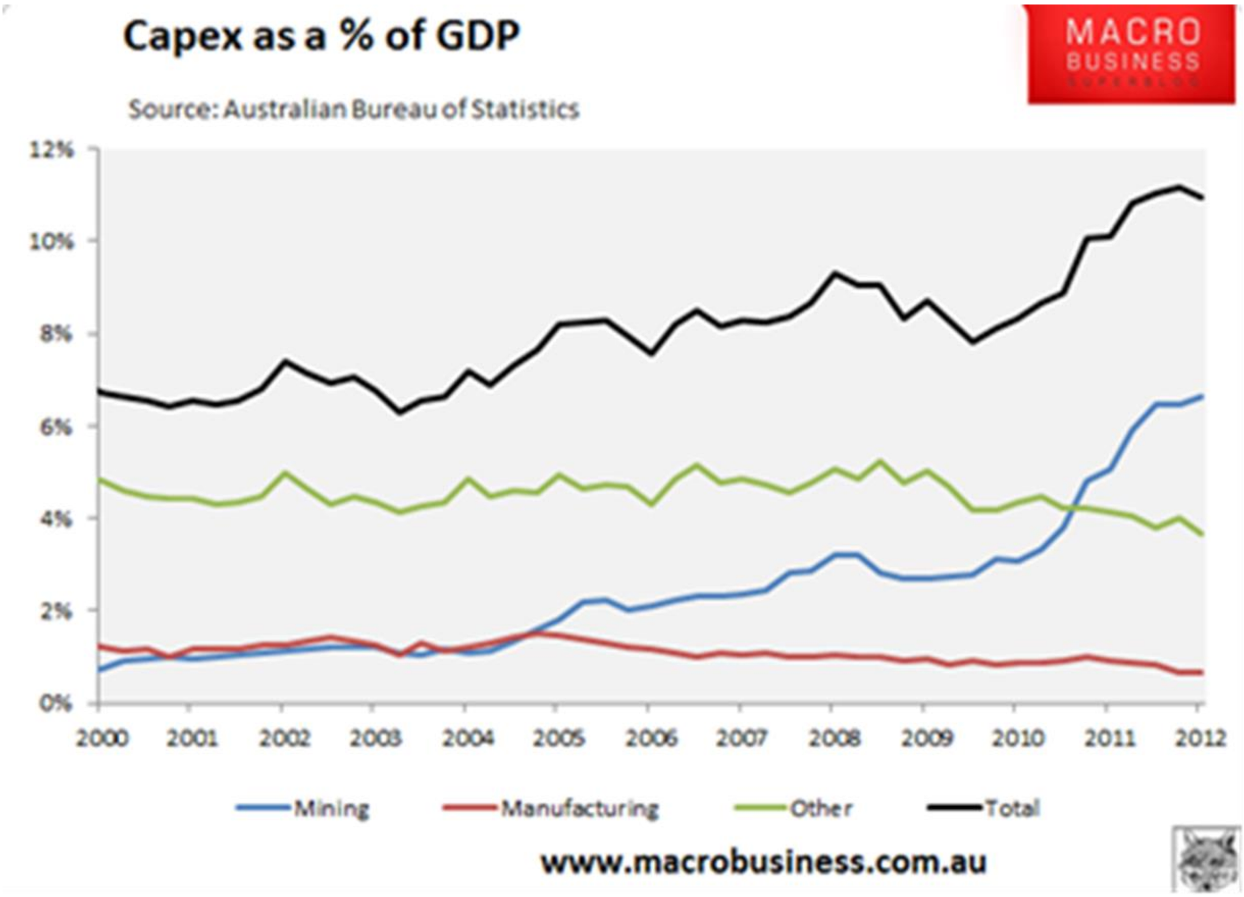
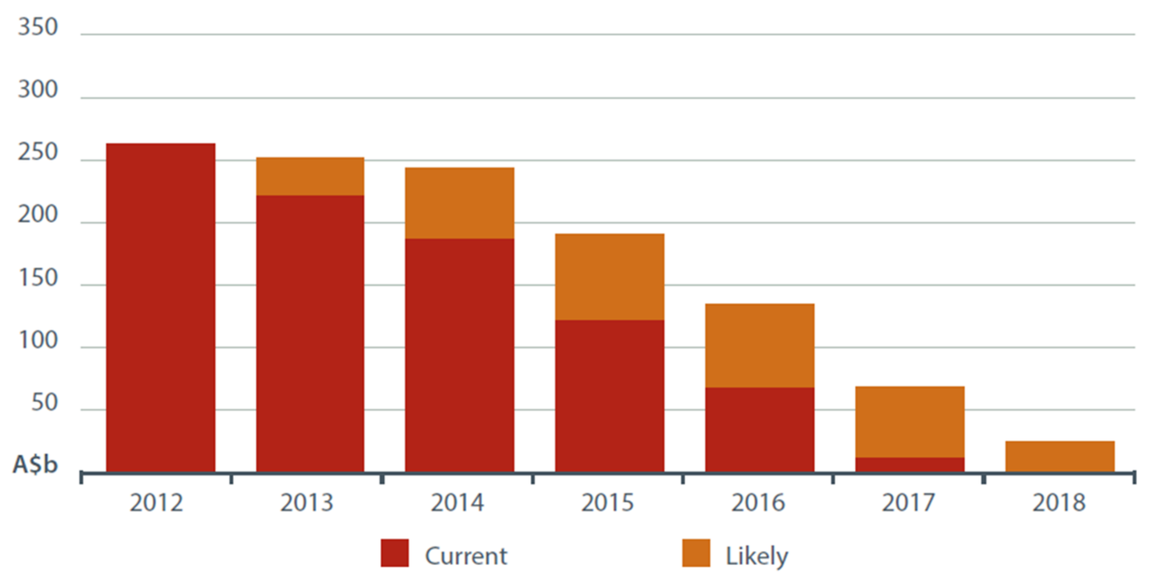
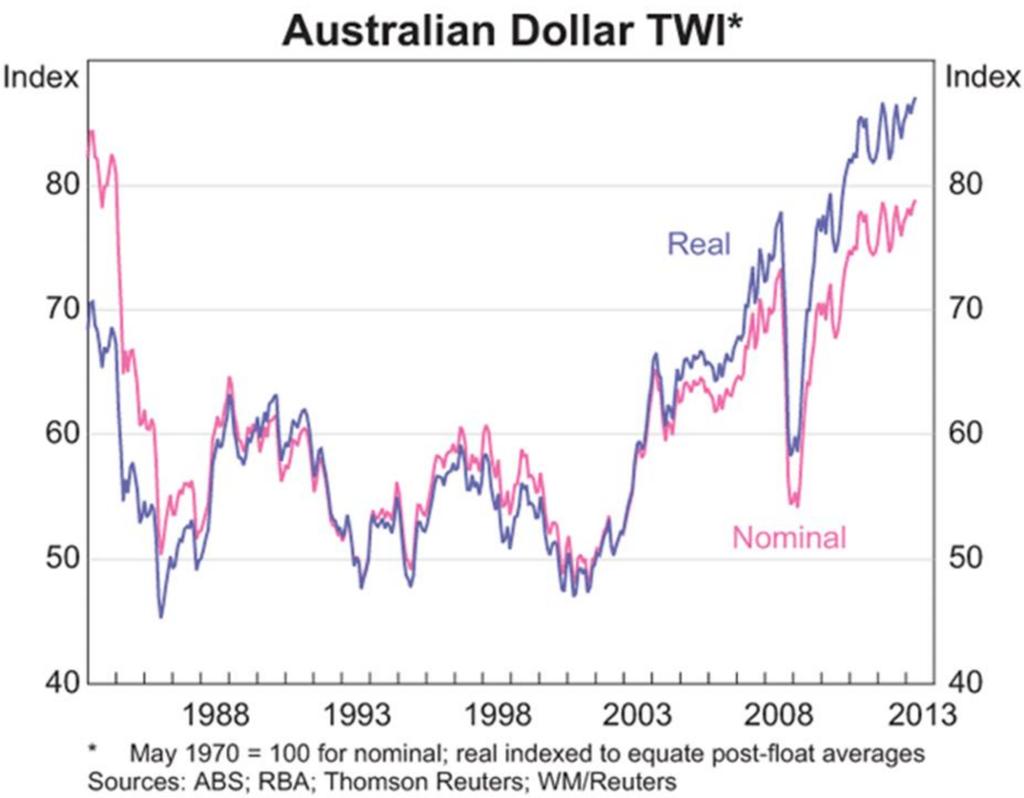


Chart 5: Stock of On-Going Future Resources Investment.



Source: Bureau of Resources and Energy Economics, Resources and Energy Major Projects, released 22 May 2013.

Chart 6: Real Effective Exchange Rate 1983-2013



Source: Reserve Bank of Australia chart pack released 8 May 2013.

Chart 7: Exports by sector as share of GDP

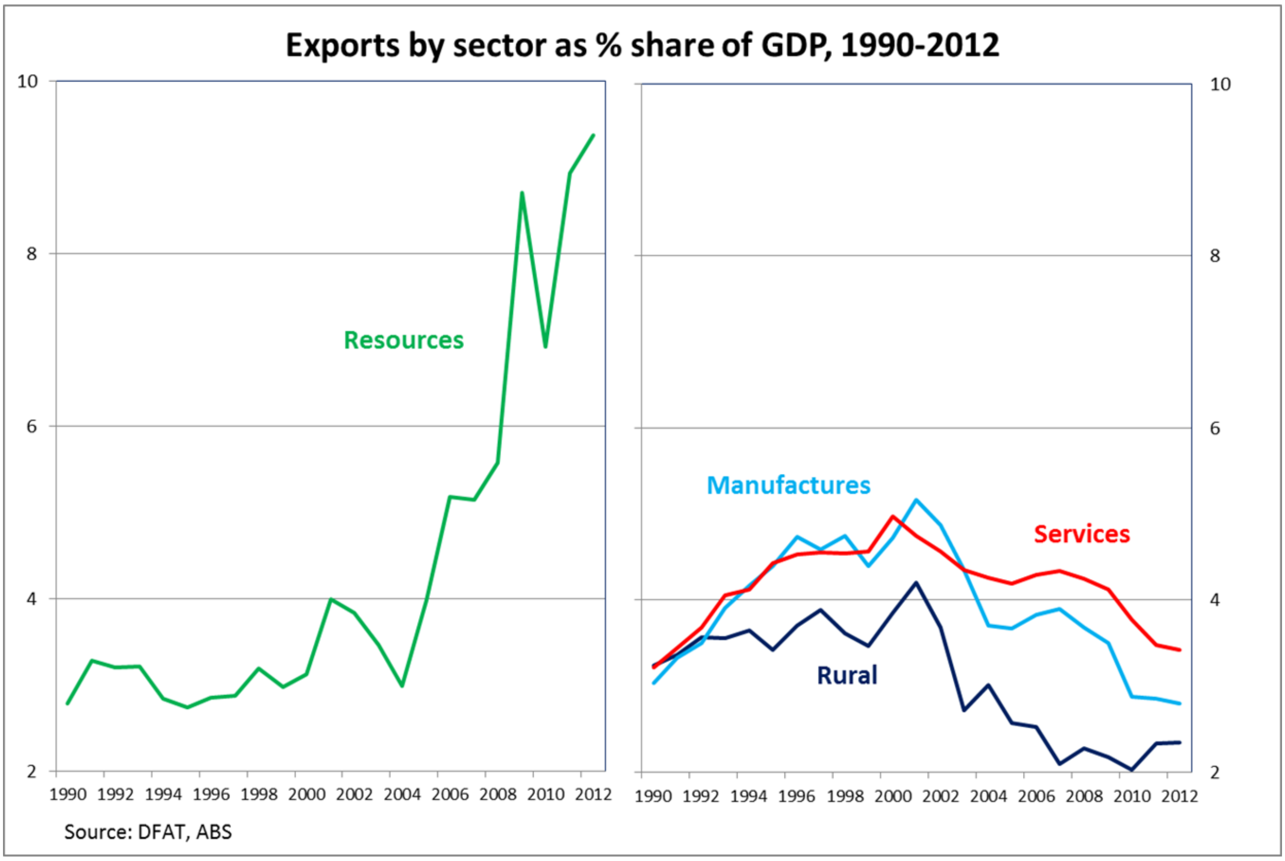


Chart 8: Education

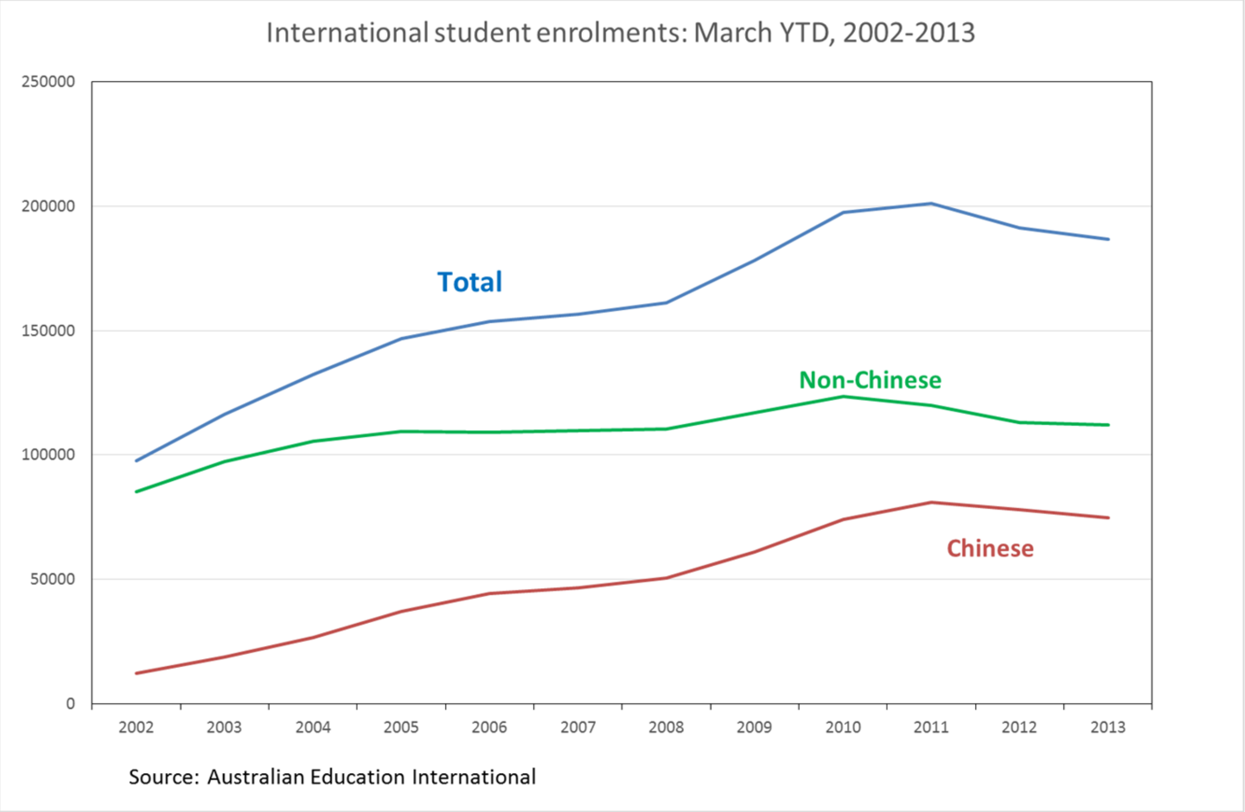


Chart 9: Tourism

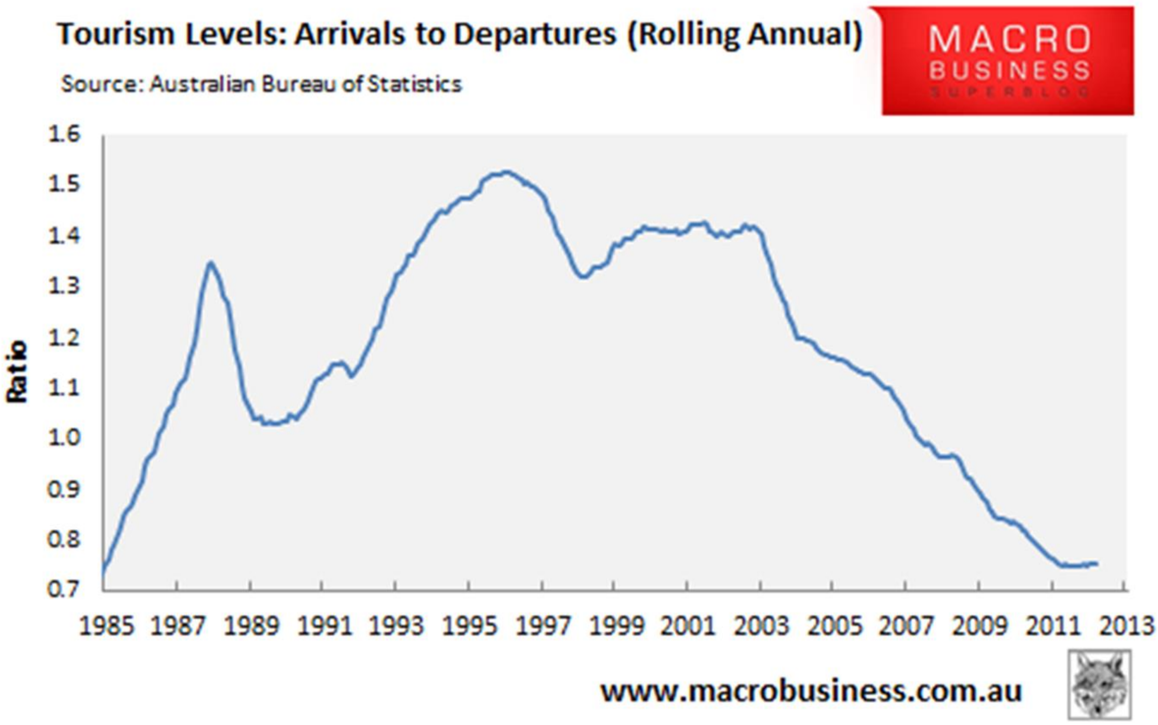


Chart 10: Net Exports of Beverages as Share of GDP 1988-2012

Chart 11: Net Exports of Processed Food

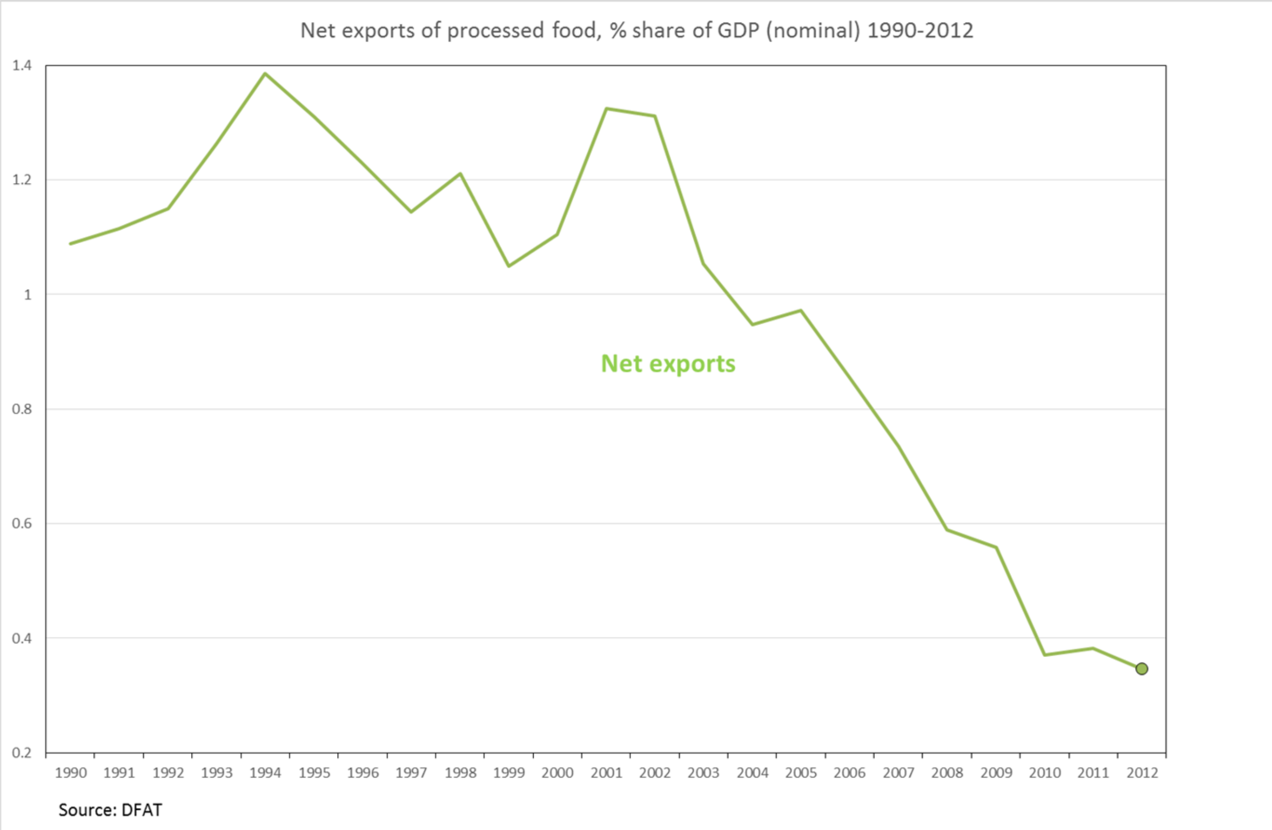


Chart 12: Net Exports of Metals

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