Economic *Roundup*

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CONTENTS

Debt, the Budget and the Balance Sheet — David Woods and Michael Xanthis **1**

The implications of global economic transformations for Australia — Dr Martin Parkinson PSM **15**

Australia and China — grasping opportunities in an uncertain world — Dr Martin Parkinson PSM **33**

Key themes from Treasury's Business Liaison Program **49**

Arthur Fadden: Treasurer in a golden age — John Hawkins **53**

Debt, the Budget and the Balance Sheet

David Woods and Michael Xanthis[1]

Understanding the relationship between the budget and the balance sheet, and the impact of debt on both, is critical in assessing fiscal sustainability. This paper briefly describes the concepts of debt and the cost of servicing debt that are reported in the budget papers.

1 The authors are from the Budget Policy Division, the Australian Treasury. This article has benefited from the contributions and comments of Tony McDonald, Brenton Goldsworthy, Michael Bath, Andrew Johnson and David Nicol. The views in this article are the views of the authors and not necessarily those of the Australian Treasury.

Introduction

The *Charter of Budget Honesty Act 1998* ('the Charter') provides the framework in which the government conducts and reports its fiscal policy.

The Charter requires that the government's fiscal strategy be based on principles of sound fiscal management. The Charter defines these principles to include the maintenance of debt at prudent levels, though it also provides for fiscal policy to vary to moderate cyclical fluctuations in economic activity.

The consequence of a change in fiscal policy — as measured by a change in the fiscal and underlying cash balances — will be a change in the government's balance sheet as the government either finances budget deficits through the issuance of debt or the sale of financial assets or it invests budget surpluses in financial assets.

The size and composition of the government's balance sheet will also change where the government issues debt in order to acquire financial assets, either for policy purposes as in the case of the NBN, or in order to maintain a liquid debt market as the basis for the pricing and management of interest rate risk through the broader economy.

This paper examines the different concepts published in the budget papers that summarise the state of the balance sheet; the concepts of the cost of servicing debt; and the factors affecting those costs. The paper sets out a worked example of the costing of the interest savings generated by the sale of a financial asset.

Debt and other balance sheet concepts

The government's balance sheet reports the stock of all government assets and liabilities. Measures such as Commonwealth Government Securities (CGS) on issue, net debt, net financial worth and net worth are aggregates that can be drawn from the balance sheet to provide an indication of the government's financial position at a point in time.[2]

The government's balance sheet, presented in Budget Paper No. 1, details the market value of CGS on issue over the forward estimates. **Commonwealth Government Securities** on issue is a large component of the government's total liabilities, representing around 95 per cent of interest bearing liabilities (commonly referred to as gross debt).

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2 The Government prepares its financial statements – including the balance sheet and the aggregates described in this paper – based on the external reporting standards mandated by the Charter and is obliged to report any departures from these standards. Details of the external reporting standards and accounting policies are published in Budget Paper No. 1.

While CGS on issue provides information on the most common form of government debt, it does not take account of amounts that are owed to the government by other parties. Governments, as do individuals and businesses, hold assets that can be sold to meet financial obligations.

Net debt is a commonly quoted measure of a government's financial position that takes account of some of the assets held by the government. Net debt provides a useful measure for international comparisons, as published by the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development.

Net debt is equal to interest bearing liabilities less a pool of liquid financial assets. Table 1 below, presents the main components that are included and excluded from the calculation of net debt. As shown in the table, the unfunded superannuation liability is not included in the calculation of net debt, nor is the stock of equities and non-financial assets.

Table 1: Components of the key balance sheet aggregates

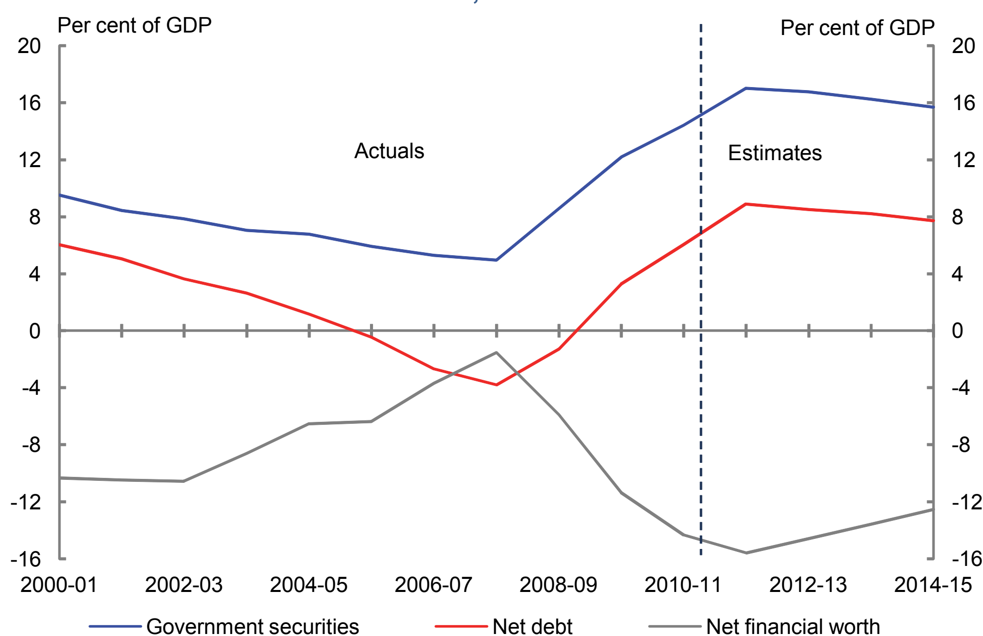
	Assets	Liabilities
Net debt	**Cash deposits** **Advances paid** *(for example, HELP loans)* **Investments, loans and placements** *(for example, Future Fund investments in interest-bearing assets)*	**Commonwealth Government Securities** **Loans** *(for example, IMF capital subscription)* **Deposits and other borrowing**
Net financial worth	As above, plus: **Equity investments** *(for example, equity in government business enterprises such as the NBN)* **Other receivables** *(for example, tax receivables)*	As above, plus: **Provisions and payables** *(for example, superannuation liability)*
Net worth	As above, plus: **Non-financial assets** *(for example, buildings and military equipment)*	As above

Source: The Treasury.

Net financial worth is equal to total financial assets less total liabilities. In other words, net financial worth is a broader measure that takes account of a subset of the government's assets — it excludes non-financial assets — but includes the full range of the government's liabilities recognised on the balance sheet[3].

Net financial worth includes the government's liability for the superannuation of public servants and military personnel, the largest single difference between net financial worth and net debt.

Chart 1: Government securities, net debt and net financial worth[4]



Source: 2011-12 MYEFO, Final Budget Outcomes for 2000-01 to 2010-11.

In taking account of the full set of the government's liabilities, net financial worth provides a more robust sense of the longer term sustainability of the government's financial position, noting though that it is subject to the short term volatility associated

3 The Statement of Risks published as part of the budget papers discloses the government's contingent liabilities and other fiscal risks that are not recognised in the financial statements because of uncertainty about their timing, magnitude or likelihood.

4 Forward estimates of net financial worth are prepared on the basis of a superannuation liability valued using the actuarially determined discount rate contained in the Long Term Cost Reports for the civilian and military schemes. Actual net financial worth as reported in the Final Budget Outcome is prepared on the basis of a superannuation liability valued using the spot rate on the 10-year government bond prevailing on the last day of the financial year, consistent with Australian Accounting Standards.

with movements in interest rates used in the calculation of the superannuation liability.[5]

Against these liabilities, net financial worth takes account of the full range of liquid financial assets but, in contrast with **net worth**, it excludes non-financial assets that are often illiquid and cannot be easily sold to meet the Government's financing needs (and which are generally held to provide goods or services to the community rather than to yield a financial return).

This means that net financial worth provides a measure of the Government's ability to withstand adverse economic shocks by drawing on its stock of liquid assets to finance its budget.

Impact of debt on the budget: fiscal and underlying cash balances

The budget summarises the government's revenue and expenditure over a specified period of time. In the broad, the budget aggregates measure the extent to which the government commands and allocates the real resources of the economy over that period of time.

The two key budget aggregates — the fiscal balance and the underlying cash balance — measure the net result of these revenue and expenditure *flows* over a financial year, distinct from the *stock* concepts reported on the balance sheet.

- The fiscal balance measures the Australian Government's investment-saving balance. It measures in accrual terms the gap between government revenue and its expenses and investment in non-financial assets.
- The underlying cash balance plus Future Fund earnings is the cash counterpart of the fiscal balance, reflecting the Australian Government's cash investment-saving balance.[6]

The concept of a budget is distinct from how it is financed.

5 Net debt increased by 9.9 per cent of GDP from 2007-08 to 2010-11 whereas net financial worth fell by 12.9 per cent of GDP (the inverse relationship reflects that net debt is calculated as liabilities less assets whereas net financial worth is calculated as assets less liabilities). The bulk of the difference in the size of the movement in the two aggregates was an increase in the superannuation liability of 2.0 per cent of GDP, largely owing to a fall in the ten year bond rate used to discount the future stream of superannuation payments in the Final Budget Outcome.

6 The government also publishes the headline cash balance which is equal to the underlying cash balance plus Future Fund earnings plus net cash flows from investments in financial assets for policy purposes such as equity injections and the Higher Education Loan Program.

A government running a budget that is in deficit (that is, where its revenues are less than its expenses and investments in non-financial assets) can choose to finance the deficit by liquidating its financial assets, where available, or by increasing its issuance of debt. Conversely a government running a budget that is in surplus can choose to use the surplus monies to invest in financial assets or to retire its stock of debt.

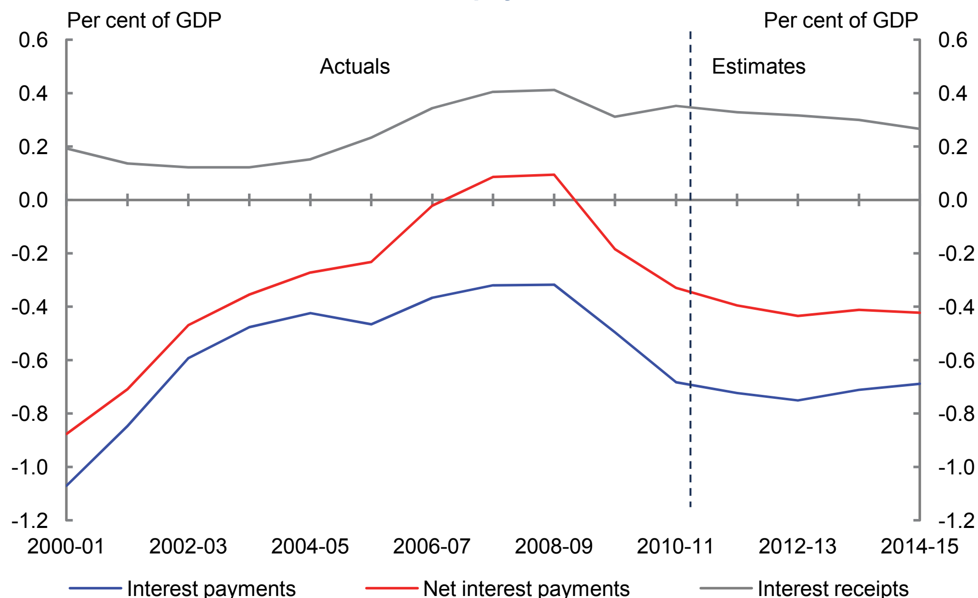
These financing transactions will be disclosed as a change in the composition of the government's balance sheet and are not themselves reflected in the fiscal or underlying cash balances.

The same approach applies at the level of an individual transaction. The impact of any spending on the fiscal or underlying cash balances remains the same regardless of whether that spending is financed through the sale or drawdown of a financial asset or through the increased issuance of debt.

That said, changes in the government's issuance of debt or its holdings of financial assets feed back into the fiscal and underlying cash balances through the resulting changes in the cost of servicing its debt or in the return generated by its financial assets.

Two commonly reported concepts that summarise the effect of the government's debt and financial assets on the cash budget are interest payments and net interest payments.

Chart 2: Australian Government interest payments, interest receipts and net interest payments[7]



Source: 2011-12 MYEFO, Final Budget Outcomes for 2000-01 to 2010-11.

Interest payments (or 'public debt interest') are payments on the government's debt liabilities. Over 95 per cent of the government's interest payments are those made on Commonwealth Government Securities. It is a straight measure of the cost of servicing the government's debt, but it does not take account of the cash interest receipts earned by the government on its investments in interest-bearing financial assets.

Net interest payments are equal to the difference between interest paid and interest receipts. As such, net interest payments take account of cash interest receipts from the government's financial investments (though not of dividends paid on the government's holding of equities). The government's interest receipts are largely derived from its investments through the Future Fund, the Nation Building Funds, the Higher Education Loan Program and investments in Residential Mortgage-Backed Securities[8].

7 Net interest payments are reported in the budget papers as interest payments less interest receipts, but are shown in Chart 2 as interest receipts less interest payments to illustrate its correlation with interest payments.

8 Net interest payments is conceptually comparable with the headline cash balance rather than the underlying cash balance given that it takes account of Future Fund earnings.

Reporting on budgetary impacts of debt

The government reports on its estimated debt and its associated budgetary impact as part of the annual budget and the Mid-Year Economic and Fiscal Outlook (MYEFO), consistent with its reporting obligations under the Charter.

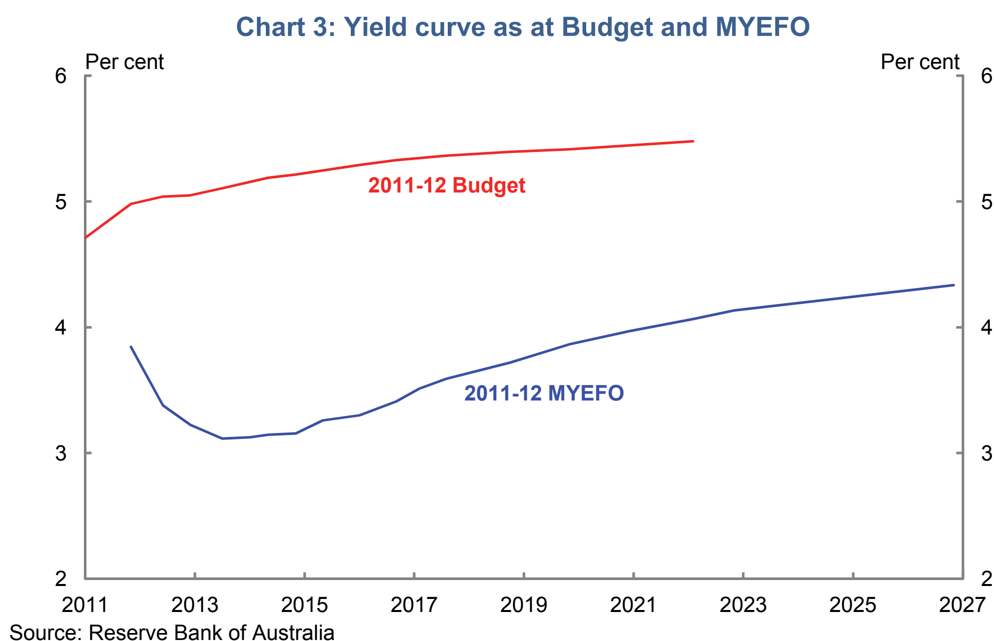
Estimated levels of **debt** are primarily a function of the market value of outstanding CGS on issue and any new issuance required to finance projected budget deficits and investments in financial assets that are not otherwise financed by drawing down on financial assets such as the Nation Building Funds.

- The Government announced in the 2011-12 Budget that it will continue to monitor the liquidity of the CGS market as the budget returns to surplus to ensure that it continues to support the bond futures market. This will mean at some stage the issuance of CGS to acquire financial assets alone rather than to finance the budget (Budget Paper No. 1).

Estimates of **debt servicing costs** are a function of the level of debt, the yield curve and the Government's debt management strategy which is the responsibility of the Australian Office of Financial Management (AOFM).

The yield curve is the comparison of the interest rates on government bonds of different maturity, which is determined by market conditions. Chart 3 shows the shift in the yield curve from the 2011-12 Budget to the 2011-12 MYEFO.

Chart 3: Yield curve as at Budget and MYEFO



Source: Reserve Bank of Australia

The shift in the yield curve will affect the cost of servicing *new* issuance of debt but will have no impact on the cost of servicing the *outstanding* stock of debt, the cost of which was fixed by the interest rate at the point in time that it was issued. The interest payments reported in the budget papers therefore include both the projected cost of servicing new debt issued across the current yield curve and the historic cost of debt issued in the past. To estimate the cost on new debt issuance the AOFM takes a snapshot of the yield curve at the time estimates are prepared and assumes that it will apply over the estimates period.[9]

The AOFM's objective in managing the government's debt portfolio is to meet its financing task in a cost-effective manner, subject to acceptable risk and to maintain liquidity in the bond and bond futures markets. The AOFM retains flexibility in its issuance across the yield curve to achieve a balance between meeting investor demand, managing refinancing and interest rate risks and minimising the costs of the debt portfolio (AOFM 2010-11).

Preparing estimates of the cost of servicing new debt is a complex process which is sensitive to market conditions and the debt management strategy. Estimates of debt servicing costs are therefore centrally prepared by the AOFM and updated through the budget and the MYEFO processes.

Such a centralised process allows the AOFM to prepare its estimates taking account of the complete financing task for the budget; a necessary approach as debt servicing costs cannot be broken down to the level of individual programs or lines of expenditure given that financing is fungible and there is no basis on which to classify individual programs as being funded from taxation revenue or financed through issuance of debt.

The exception to this rule is the costing of the public debt interest impact resulting from any proposal to purchase or sell a financial asset. Such estimates are prepared in order to provide the government with an approximation of the impact of the proposal on the fiscal and underlying cash balances. Box 1 provides a worked example.

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9 The constant yield curve methodology used in the preparation of the budget estimates means that the yield curve prevailing at the time of the estimates update is expected to be the same for the issuance of new CGS throughout the estimates period, a technical assumption that reflects the high degree of difficulty in forecasting interest rates.

Box 1: Costing the purchase or sale of a financial asset

Transactions in financial assets represent a change in the composition of the government's assets and liabilities on its balance sheet. The principal invested or raised through the purchase or sale of a financial asset does not affect the fiscal or underlying cash balance unlike the flows associated with that financial transaction (such as the interest on the associated debt or the dividends earned on that investment).

The estimated interest cost or saving associated with the purchase or sale of a financial asset is highly sensitive to market conditions and the Government's debt management strategy, as outlined above. Estimates of interest costs are prepared by the AOFM at each published update of the fiscal outlook taking account of the Government's entire financing task. Given the fungibility of the financing task, it is not possible to disaggregate the interest costs associated with an individual transaction.

However agencies preparing costings of proposed transactions in financial assets are required under the government's budget process operational rules to include an indicative estimate of the interest cost associated with the proposal. This estimate is prepared in order to provide the government with some sense of the impact of the proposal on the fiscal and the underlying cash balances. Such costings necessarily involve a 'rule of thumb' methodology based on simplifying assumptions on interest rates and on timing of financial flows and assuming no change to the government's debt management strategy.

Interest rates

The estimate is prepared using a weighted average cost of funds, reflecting the average cost of raising new debt with weightings reflecting the Government's debt management strategy in issuing across the yield curve. Where there is an upward sloping yield curve, this means that the average cost of funds will be less than the ten year bond rate reflecting the lower interest on issuance at the short end of the yield curve.

Estimates of interest costs prepared for costings purposes use the weighted average cost of funds for the issuance of new debt underpinning the most recently published report on the economic and fiscal outlook prepared under the Charter.

The same interest rate assumptions are used for the costing of the sale of a financial asset as for the costing of the purchase of a financial asset. This is a simplifying approach which implicitly assumes that the cash raised by the sale of a financial asset will be used to reduce the level of CGS on issue by limiting new issuance.

Timing of financial flows

Costings normally present the financial impacts of a proposal across the forward estimates on a yearly basis.

However the interest cost associated with a financial transaction is sensitive to the assumption about the timing of that transaction *within* years. The annual interest paid on a transaction at the start of a year is greater than that of a transaction that occurs near the end of a year.

In the absence of specific information about the within-year timing of a transaction,

interest costings are normally prepared using a simplifying assumption that a transaction will occur halfway through the year.

Worked example of a hypothetical proposal

The rule of thumb methodology can be illustrated through a worked example of a hypothetical proposal to sell a financial asset for $1 billion in 2011-12.

The interest savings from the sale of the asset are calculated:

- based an assumption that the sale proceeds of $1 billion are received half way through 2011-12;
- using a illustrative weighted average cost of funds for new borrowing of 5 per cent; and
- with interest savings compounding across the forward estimates.

The calculations are summarised in the table below, showing total interest savings of $187 million over the forward estimates.

	2011-12 $m	2012-13 $m	2013-14 $m	2014-15 $m
Profile for asset sale	**1,000**	**0**	**0**	**0**
Weighted average cost of funds (%) (a)	**5.0**	**5.0**	**5.0**	**5.0**
Compound interest on principal (b)	**25**	**51**	**54**	**57**
Impact of asset sale on the fiscal balance/ underlying cash balance	**25**	**51**	**54**	**57**

(a) Weighted average interest rate paid on new issuance of debt. Illustrative rates only.
(b) Interest impact in the first year is calculated on the assumption that the sale proceeds are received halfway through the year.

The costing of the proposal would also take account of the costs of selling the assets as well any forgone interest or dividends generated by the financial asset which would offset — partially or wholly — the impact of the interest savings on the fiscal and underlying cash balances.

Conclusion

The fiscal and underlying cash balances record the government's command and allocation of resources through the flow of its revenue and expenses and investment in non-financial assets over a given time frame, conventionally a financial year.

The fiscal and underlying cash balances are distinct from the financing transactions entered into by the government. The government can finance a deficit by raising debt through the sale of CGS or by selling financial assets; the principal involved in these transactions will affect balance sheet aggregates such as net debt or net financial worth but not the fiscal or underlying cash balances.

The assets and liabilities on the government's balance sheet have a feedback effect on the fiscal and underlying cash balances through their associated flows such as the interest payments on debt and the dividends paid on government equity investments.

Costing the impact on the fiscal and underlying cash balances of any proposal to purchase or sell a financial asset needs to take account of the estimated revenue generated by that asset as well as its impact on the government's interest payments associated with changing debt levels, an approximation of which can be calculated through a simplified rule of thumb methodology albeit the results are highly sensitive to the assumed cost of funds (interest rates) and the timing profile of the transaction.

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The implications of global economic transformations for Australia

Dr Martin Parkinson, PSM[1]
Secretary, Australian Treasury

This speech was delivered on 19 September 2011 to the Australian Industry Group Annual National Forum.

1 I would like to acknowledge the contribution of my Treasury colleague Tim Wong in preparation of this address.

Introduction

I would like to thank the Australian Industry Group for inviting me to be with you today. The theme of this year's forum — Making Sense of Good Fortune is very appropriate.

As everyone here knows, Australia and the world are going through an unusual period of upheaval and transformation. Global economic weight is moving toward the emerging market economies and away from the advanced economies. The rapid pace of globalisation, and the economic re-engagement of at least one third of the world's population, combined with the troubles plaguing parts of the developed world have resulted in a 'multispeed' global economy (Spence, 2011).

Stellar growth in the 'fast lane' — the populous emerging economies — has resulted in an unprecedented pace of industrialisation and urbanisation. This has been the case for the Asian giants, China and India, but is also true for others in our region (for example, Indonesia and Vietnam) and beyond.

This shift in the world's economic clout has been underway for some time but the momentum accelerated abruptly with the advent of the global financial crisis.

The forces driving those Asian economies in the 'fast lane' have major implications for Australia, including for the shape of our industries.

Today, I would like to make some remarks about these profound global transformations and to reflect upon some of their implications.

In doing so, though, it's worth beginning with an overview of those countries in the global 'slow lane' — not just for the sake of completeness, but because the plight of much of the developed world provides a helpful counterpoint to Australia's current circumstances.

The global slow lane

The outlook for the world's major advanced economies has become markedly uncertain — with recovery remaining fragile and downside risks intense. Growth almost everywhere has been sluggish with the US economy weaker in the first half of 2011 than in the second half of 2010. Many of the advanced economies face persistently high rates of unemployment — around 10 per cent for the euro area, 9 per cent for the US and 8 per cent for the UK.

The effects of the sovereign debt crisis in Europe pose a key risk, especially for the European banking sector but also for global financial markets more broadly.

Most of the advanced world faces serious long term fiscal challenges. This is not just a point about their recent sharp accumulations in public debt — which would not be as problematic if they were merely cyclical. Rather, and this is particularly the case in continental Europe, these challenges relate especially to a loss of international competitiveness and a failure to pursue much needed structural reform. The result has been unsustainable tax and transfer settings and a build-up of sovereign debt. And all this occurs against a backdrop of long term pressures on these economies — especially demographic change — and an emerging sense that their political institutions are incapable of an effective response.

The challenge, therefore, for many advanced economies is to manage fiscal consolidation while at the same time promoting sustainable growth and improved competitiveness.

Australia's starting point could not be more different.

It is not that we face no challenges — we do, and they are large — nor that we are impervious to events in the US and Europe. Rather, it is that as we manage the structural transformation of our economy, reinvigorate our productivity performance and prepare for an ageing population, we do so with sound fundamentals and with great opportunities.

The public balance sheet is in an enviable position compared to the rest of the developed world and our financial institutions are well regulated and capitalised. While consumer caution is dampening growth, it also means that household balance sheets are strengthening.

Australia's policy frameworks have provided us with an effective shock absorber in the face of global events. The flexibility of our market determined exchange rate and our credible medium term approach to monetary policy have cushioned volatility and helped to smooth demand and inflationary pressures. These have been complemented by sound fiscal policy settings — including a clear focus on returning the budget to surplus and paying down the small (as a share of GDP) stock of debt built up in recent years.

In decades past, an external shock (or 'impulse') from the terms of trade would have been spread ('propogated') throughout the economy by our then fixed exchange rate and centralised wage-fixing system, resulting in high inflation, declining competitiveness in many industries and sharply rising unemployment.

As a result of the reforms of the last quarter century, today's external shock is still affecting the competitiveness of individual sectors yet inflation remains controlled and unemployment low.

In short, we are seeing, and will continue to see, our past reforms paying healthy dividends, notwithstanding the painful adjustment underway in some industries (such as manufacturing, education and tourism services) as a result of the higher exchange rate and the capacity of the mining sector to bid away skilled labour.

It is also unsurprising that as the extent of the transformation being thrust upon us becomes more apparent that there would be some calls to resist change. In some cases, even for a return to hidden and not so hidden forms of protectionism.

The issue here is not just the budgetary cost of the explicit transfer of resources through such protection. Our history suggests that unsheltered workers and businesses would lose out if a small number of select producers were supported in resisting adjustment.

Our history also shows that protection represents a transfer of resources and opportunities, both explicit and implicit, away from consumers towards that same small number of sheltered producers.

In short, responding to these calls would fly in the face of the lessons from our history, lessons that we learned the hard way. With the passage of time it is perhaps all too easy to now forget that our history was littered with the failures of winner-picking protectionist policies in the post-war period — what is less reasonable is to forget the success of the deregulatory and liberalisation agenda of the last quarter century.

Don't get me wrong — I am not advocating we do nothing to assist the management of this economic transformation, that the Government wipe its hands of the challenge. To the contrary, Government has a clear responsibility to assist, but how this is done and over what time period is critical. And there is no magic pudding. Any action taken will come with costs and these need to be recognised.

Good policy actions will help industry, workers and regions adjust, not just to the circumstances we face today, but to what we will face in the decade(s) ahead.

In particular, it is clear that emerging market economies are moving up the value add chain in many areas, but particularly in manufacturing.

Our comparative advantage is, therefore, shifting and we too need to continue the move into niche markets, find new places in global supply chains and become world leaders based on technology and knowledge advantages.

Our manufacturing sector is not homogeneous and many of our firms are already doing this — they are highly innovative, successful and productive, notwithstanding

the level of the exchange rate. But other parts of our manufacturing sector will need help to evolve, to transform, to adapt.

Individuals and businesses will need to adjust and innovate in the face of change, and policy interventions should focus on helping firms to help themselves. Policy settings which foster investment, innovation and skills, and enhance business management capabilities and networks, help build on Australia's existing comparative advantages — and encourage new competitive one.

It is also imperative that we do not wind back the clock on the structural reforms that have helped us avoid the difficulties plaguing the rest of the developed world. Suggestions that we intervene to 'adjust' the exchange rate fall into this category. But resisting backsliding is not enough — we need to continue to think carefully about what next in our reform agenda. If we think that all that is needed is to reprise what's been done beforehand, which appears to underlie some of the comments on industrial relations, then we have completely misjudged the magnitude of the transformation underway.

Let's be clear. As competition intensifies, as the global economy transforms, and as our population ages, we will need to look to further improvements in productivity to lift Australian living standards.

Productivity is not about working harder or longer but about working smarter with what we have. This requires quality infrastructure, a competitive tax system, a highly skilled and flexible labour force and top notch management skills able to innovate and capture opportunities.

Many of these productivity improvements will increasingly be found in new areas, especially the services sectors — in education and training, in health and in aged care. Others will come from continued efforts in existing areas, facilitated by increasing competition, revisiting market structures and continuing the reform of our tax system.

Needless to say, the ability to deliver these reform outcomes will invariably depend on the capacity of Australia's institutions. The Commonwealth's actions in many areas are central. But in a Federation, so are the actions of collaborative institutions such as COAG. Reforms are not just a Commonwealth responsibility. The commitment of the states and territories is critical to delivering on the productivity challenge.

The global fast lane

One of Australia's major tasks is to make the most of the opportunities emerging as the rise of Asia fundamentally re shapes our economic future.

The rise of Asia and the resources boom

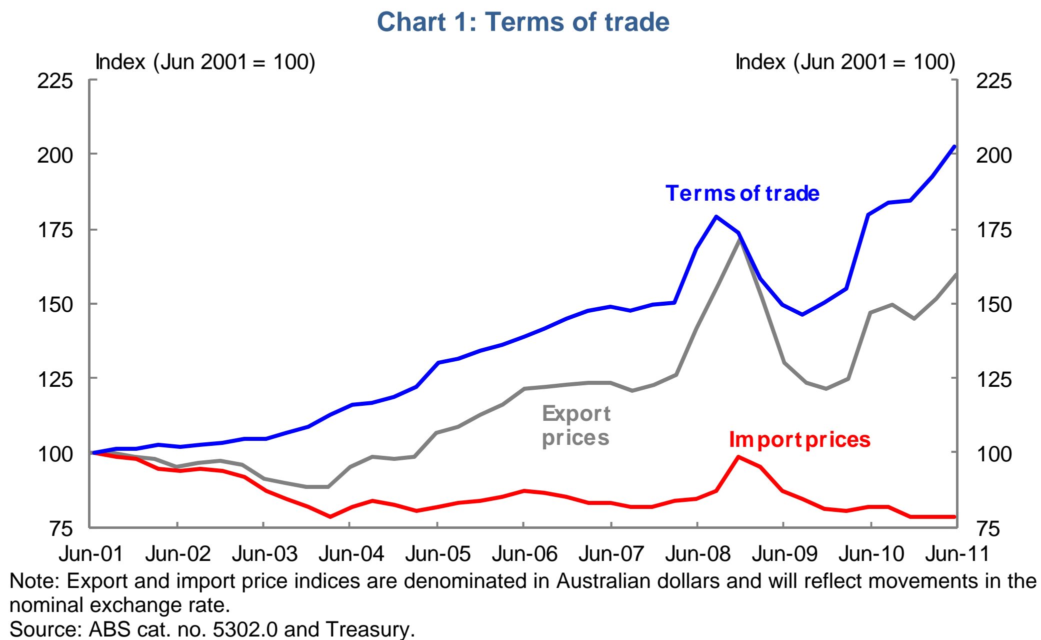
Despite accounting for almost 40 per cent of the world's population in 1990, China and India together only accounted for less than one-tenth of the world economy. However, the rapid pace of their continuing emergence is shifting the centre of world economic activity.

In 2010, they accounted for around one-fifth of world GDP: in 2020, this could rise to more than a quarter — the equivalent to the combined share of the US, Japan and the ASEAN-5 — and by 2030 they could account for around one-third of the world economy.

The resource intensity of their economic development — underpinned by the rapid growth in their industrial base and the urbanisation of their population — has boosted the demand for Australia's mineral and energy resources and resulted in historically high prices for Australia's exports.

So we are in the midst of the largest and longest terms of trade shock in our history — boosting the purchasing power of our exports and lifting our national income. (Chart 1)

Chart 1: Terms of trade



Note: Export and import price indices are denominated in Australian dollars and will reflect movements in the nominal exchange rate.
Source: ABS cat. no. 5302.0 and Treasury.

As I have mentioned elsewhere, it was as if we woke up one morning to find that global forces have conspired in our favour to increase the value of Australia's national wealth (Parkinson, M 2011).

On numerous occasions, my colleagues and I have discussed the implications for Australia's mineral and resource exports and I do not intend to reprise that here.[2]

The rise of Asia and industrial production

However, what is often overlooked in the discussion of Australia's terms of trade is the role of the price of Australia's imports, that is, the denominator in the terms of trade.

The secular downward pressure on the price of manufactures over the last ten years has boosted the purchasing power of Australian firms and consumers as we are net importers of these goods. The main contributors have been imports of capital goods and intermediate inputs.

Put another way, if we did things to stop those lower prices coming into the Australian economy we would have been deliberately raising the costs of producing other goods and services here, making ourselves poorer in the process (to say nothing of giving us higher inflation!).

In part, the decline in our import prices has reflected global productivity improvements. But it has also been a direct result of permanent changes in global economic structures. As the big emerging economies re-engaged the world, they have developed large, low cost manufacturing centres reflecting their comparative advantage. They have, amongst other things, drawn upon their sizeable and relatively cheap labour force.

For example, in 2010, Chinese and Indian employment combined was estimated to be around 1¼ billion (which is half the size of their collective population). By comparison, US employment was around ten per cent of this figure while Australian employment was less than one per cent.

And it should not be surprising that their labour costs are relatively low. Many workers in developing economies have come from poverty and subsistence, seeking material advancement. The much higher (and rising) wage rates on offer in the urban manufacturing centres — while still lower than in the developed economies — are a powerful magnet pulling underutilised labour from agriculture to manufacturing, much as it did in the developed economies during the Industrial Revolution (Williamson, 1988).

Just this cursory glance should give an appreciation for the scale of their existing and future comparative advantage and, hence, in their capacity to impact the structure of global markets.

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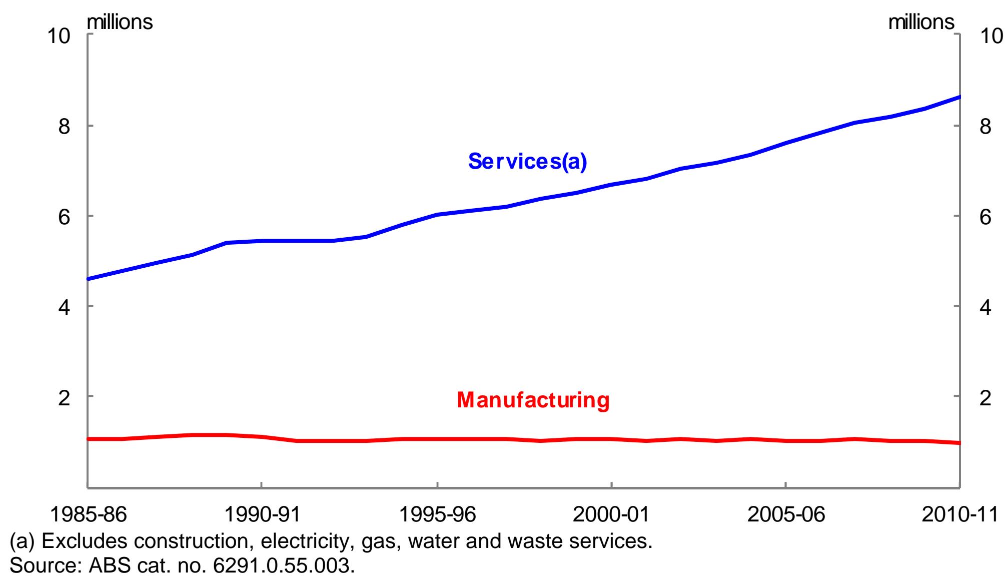
2 I would suggest, in particular, reading Statement 4 in Budget Paper No. 1 from Budget 2010-11 and Budget 2011-12.

At the same time, existing global manufacturing centres have faced greater competition from the emerging economies in these more commodity-style manufactured goods — that's why we've seen the falling price everyone receives, and pays, for these products. It should not be surprising, then, that the emergence of the developing economies has seen manufacturing employment in the advanced economies continue its decline as a share of total employment.

This is neither new, nor uniquely Australian (Chart 2). It is also neither new nor uniquely Australian that a primary driver of employment has been the rise of the services sectors, which has more than offset the decline of manufacturing employment.

Chart 2: Manufacturing and services employment in Australia

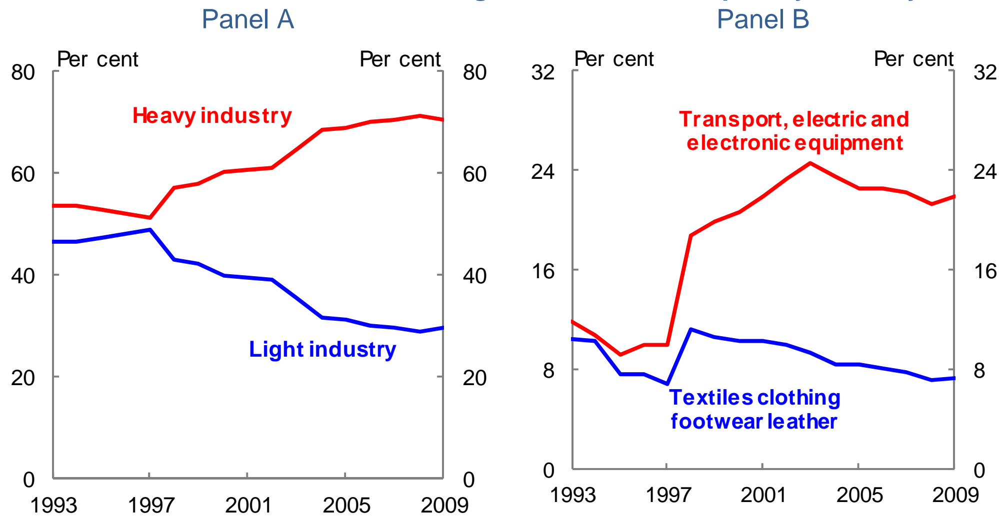


(a) Excludes construction, electricity, gas, water and waste services.
Source: ABS cat. no. 6291.0.55.003.

As I mentioned earlier, as countries get richer their producers move up the value added chain, just as we did as Australia developed.

For decades, Chinese industrial output was split evenly between light industries (which are broadly those producing goods like textiles and clothing) and heavy industries (which broadly produces capital goods, including intermediate inputs) (Chart 3).

Chart 3: Share of Chinese total gross industrial output, by industry



Source: CEIC China database.

Since the pace of China's economic expansion took-off in the mid 90s, this composition has been changing. While all industries have expanded rapidly, light industrial output has declined relative to the heavy industries.

As part of this, Chinese producers moved up the value chain to make items that were, for many decades, predominantly the domain of producers in developed countries.

The production of transport equipment (including cars) rose from around five to eight per cent of industrial production over this time — with motor vehicle production rising from 1.3 million units per year in 1993 to 18 million in 2010.

For China to continue to deliver rising living standards, and to offset the impact of even newer emerging economies, it will need to continue to move up the value chain. The available data suggests that wage costs are escalating at a rapid pace, with nominal wages in Chinese manufacturing rising at double digit rates over the last decade. Such wage growth, combined with their rate of productivity growth, is reducing their relative competitiveness in low value added production. So even while China's nominal exchange rate may be relatively inflexible, the signs are that their real exchange rate is rising.

It's not hard to see how the trends we are now seeing in China and elsewhere parallel the history of economic evolution in the West, including Australia in the first half of the 20th century.

As labour costs escalated, technologies advanced and as tastes changed, Australian processing industries that were intensive in low skilled manual labour became

uncompetitive and gave way to up and coming forms of industrial production. Our emphasis moved away from dyeing cloth and tanning leather towards activities that we would now ascribe as 'hallmarks' of 20th century progress: automobiles, whitegoods, machinery, and chemicals.

The latter part of the 20th century saw further transformation. The protectionist measures that had been sheltering domestic producers buckled under the weight of global economic forces — having held back Australian living standards for many decades. As tariff walls, onerous product market regulations and inflexible institutions became unsustainable and were eventually dismantled in the 80s and 90s, Australian producers were placed under great pressure.

But rather than trying to continue making low value goods for the lowest possible cost, many Australian producers successfully moved up the value chain.

Even today, more and more stories are emerging of Australian manufacturers finding ways to add value, make their processes more efficient, offshoring parts of their operations, cornering their place in global and domestic markets and beating their competition.

These industrial trends have been the norm in other advanced countries.

Examples that immediately come to mind include Germany and Japan. As the lower end of the market became tight, they outsourced low-skilled assembly lines to low cost manufacturing centres — including Eastern Europe and Asia. However, the production of premium and specialised goods — as well as design services, marketing services, intellectual property and management acumen — were retained domestically.

There is a certain distinction attached to premium goods that are 'designed in Germany' or 'made in Japan'. Rather than being the cheapest goods, they are labels that signal quality. It is my view that the same cachet can and should be attached to those premium goods made or designed in Australia.

As the transformative forces of globalisation continue to play out, the determinants of the future success for Australian industry will continue to be found — just as always — in adaptation and innovation.

The structures of our economy and of our businesses have never stood still. And so, inevitably, the path to prosperity involves creating and adapting business models. Hoping and waiting for external conditions to become benign for existing business models risks stagnation and failure.

The rise of Asia and the burgeoning global middle class

But the story of the global fast lane does not end here. The resource boom and the global trends in manufacturing are merely the early, but probably the most obvious, manifestations of Asia's rise. The risk facing us today is that, because of the immediacy of the challenges, our attention is forced away from the long term horizon towards the ground at our feet.

The changing world economy will continue to present opportunities for Australia as the Asian middle class rises.

The Asia Pacific region could have more people in the middle class than the rest of the world combined by 2020. China could have a middle class market that surpasses the US in dollar terms. By 2030, if India follows China, two thirds of the global middle class, around 3.2 billion, could be in the Asia Pacific region.

None of this is preordained and, as I have said elsewhere, there are no guarantees that the emergence of China and India will follow a smooth path.

Rightfully, questions have been asked: 'What if Chinese growth slows? What if these economies are unable to rebalance? What about the possibility of policy missteps?'

These concerns are sensible and one needs to be humble in projecting the future Treasury's thinking about Australia's economic future attempts to factor in these medium term risks.

Nevertheless, we are already seeing some of the benefits of the rise in the Asian middle class. Global demand for agricultural commodities, tourism services and for consumer durables has been boosted over the last decade — as increasingly well-off Asians seek a better quality, more protein-rich diet, the greater comfort of 'mod cons' and different cultural and recreational experiences.

Because of our regional ties, these are huge opportunities being brought closer to Australia's doorsteps. The unanswered question is whether we are up to grasping them.

A further reflection

In light of this, it is worth reflecting on concerns about Dutch disease.

In the written version of the speech I go through this issue in detail but given the time I will briefly touch on it here.

Dutch Disease concerns are overstated

Dutch disease refers to changes in the economy caused by an appreciation in the real exchange rate arising from a commodity boom.

Dutch disease got its name from the anticipated adverse effect on Dutch manufacturing following the 1960s and 1970s exploitation of North Sea gas discoveries. In light of limited gas reserves, the fear was that their *temporary* commodity boom would *permanently* harm the Dutch industrial structure — leading to long term economic underperformance, lower living standards and high unemployment.

In recent times, concerns about Dutch disease in Australia have intensified. But is the Dutch situation relevant for Australia?

One line of concern that I recently heard relates to the size of Australia's resource deposits. But unlike the Dutch, Australia has a great abundance of natural mineral and energy resource wealth.[3]

But for the sake of argument, let us say that our plight was that the price of our resources plunge. What then?

Dutch disease would only be problematic to the extent that it harmed our long term welfare because of future economic underperformance or the creation of entrenched problems like persistently high unemployment.

As Statement 4 in this year's Budget papers went to some length to discuss, the international evidence suggests that Dutch disease does not reduce overall economic growth. This was even the case for the Dutch — as Chart 4 shows. Dutch manufacturing exports (the blue line on the left panel) declined during an intense period of energy resource extraction (the red line on the left panel). This period ended in the early- to mid-1980s.

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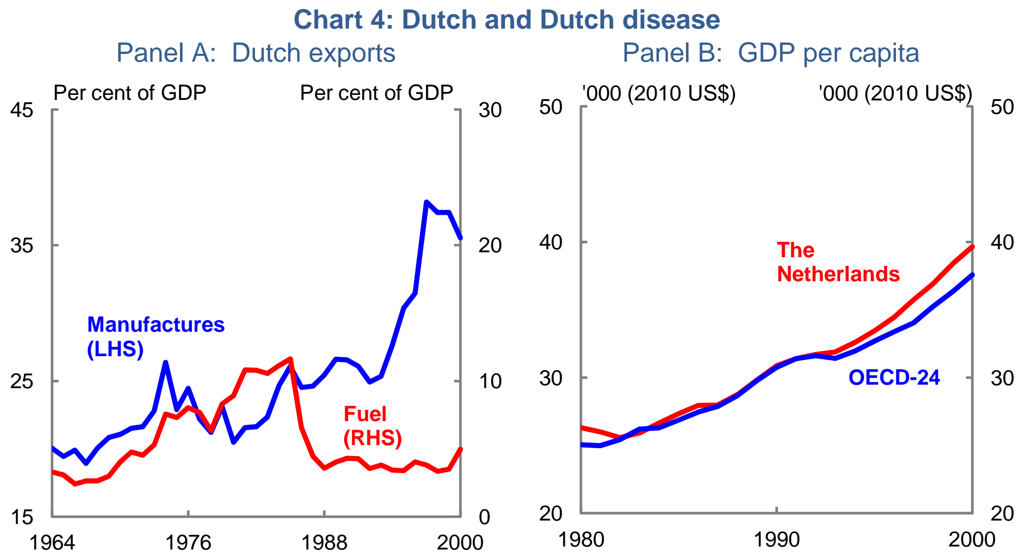
3 As a nation, we have the world's largest recoverable deposits of lead, silver rutile, zircon, nickel, tantalum, uranium and zinc. We rank second in the world for iron ore, bauxite, copper, gold and ilmenite and we are in the top ten for a number of other minerals, including black coal. (Geoscience Australia, *2010)*.

Subsequently, Dutch manufacturing exports rebounded, both as a share of GDP and as a share of total exports. Manufacturing exports continued its resurgence in the 20 years following the Dutch disease period — reaching nearly 40 per cent of GDP and around 70 per cent of total exports in 1997. This period was also matched by solid long term per capita GDP growth (the red line on the right panel) — matching and, for long periods, exceeding average growth in the OECD (the blue line on the right panel).

Chart 4: Dutch and Dutch disease



Source: Statement 4, Budget Paper No. 1, Budget 2011-12.

But you might ask, 'What about the effect of commodity booms on employment? Didn't the Dutch experience rapid rises in unemployment in the 70s?'[4]

Again, the relevance of this line of argument for Australia is difficult to substantiate — as both aggregate unemployment and the spread of unemployment declined during mining boom mark I. The boom has also meant that regions which were previously experiencing difficulties have now benefited from strong income and employment growth.

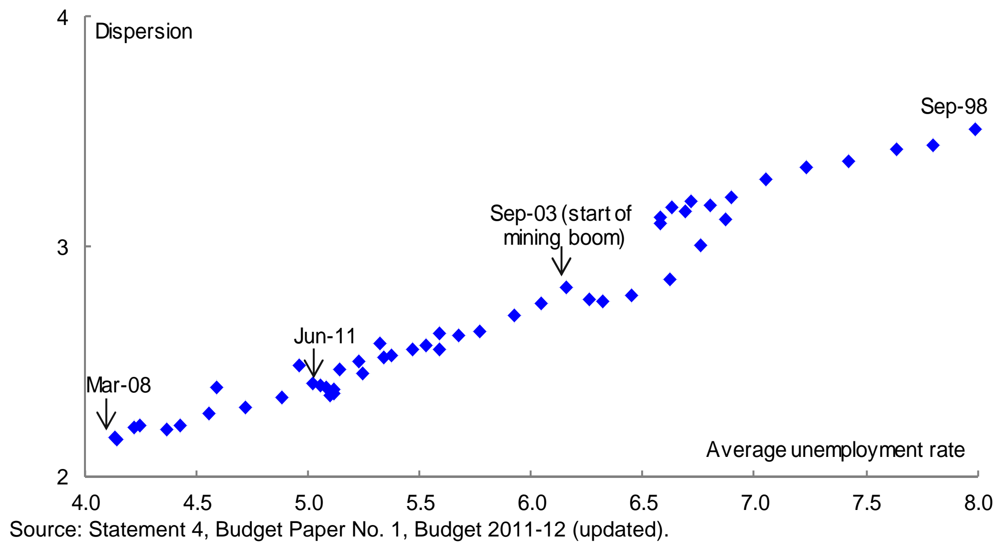
Consider Chart 5, which shows the regional dispersion of unemployment in Australia (the vertical axis) relative to the aggregate unemployment rate (the horizontal axis).

The dot on the top right hand side of the chart shows that, for September quarter 1998, the average unemployment rate was around 8 per cent. The degree to which unemployment was dispersed evenly between the regions is measured by a regional

4 The Dutch unemployment rate quadrupled between 1970 and 1975, from 0.9 to 3.7 per cent. Over the same period, unemployment in the United States and Australia, rose from 5.0 to 8.5 and 1.6 to 4.8 per cent respectively.

'dispersion' indicator.[5] Referring to the vertical axis, this indicator was around 3½ in September 1998. The bigger the number, the more unequal the distribution of unemployment.

Chart 5: Unemployment across the economy



Source: Statement 4, Budget Paper No. 1, Budget 2011-12 (updated).

Since at least 1998, regional disparities in unemployment rates have declined as aggregate unemployment declined. This relationship has not changed since the onset of the mining boom in 2003. That is, a larger proportion of regions in Australia are experiencing lower rates of unemployment.

This is not to say that outcomes for some regions have not been patchy — I'm thinking of areas like Far North Queensland. Nevertheless, the evidence is that, despite different rates of economic growth between regions and industries, the material gains of our national success are being spread broadly to people across Australia through (amongst other mechanisms) improved labour market outcomes.

We should have strong reservations about the relevance of Dutch disease for Australia. Overstating Dutch disease concerns could mean that we understate the ability and resilience of Australia's people and businesses. In doing so, the risk is that we end up taking actions which would squander the opportunities from global economic conditions swinging in our favour.

5 In technical terms, this dispersion indicator is called the 'standard deviation' — which, in this case, has been weighted to account for Australian regions of different sizes.

What matters...

Let me conclude. As the developing economies in the global fast lane have grown, their rapidly expanding industrial sector and the resource intensive nature of their economic development have led to remarkable benefits for Australia. These trends in the global economy are expected to be sustained into the foreseeable future.

But this also represents a major force shifting the shape of Australian industry — placing pressure on the non-mining parts of the economy to adjust and adapt. This will be an uncomfortable process for many businesses.

But this is not the first time we've had to manage major transitions — Australian industry has always faced continuous change. While not all have been winners, many have adapted successfully and prospered. I believe that Australian business will continue to adapt successfully. But needless to say, this will in many ways depend on the actions of those sitting in this room today.

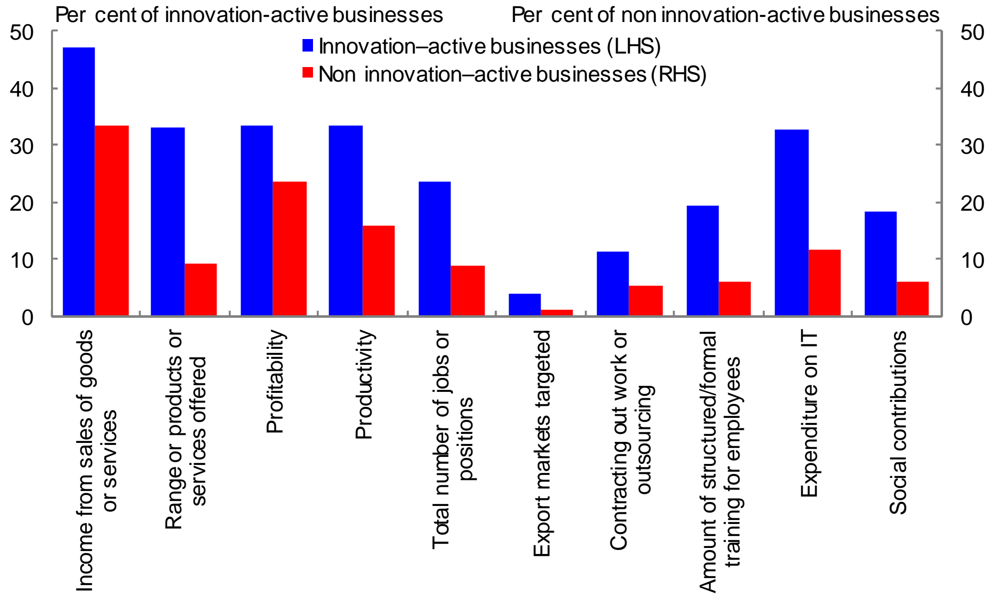
It will be critical that we in the bureaucracy hear the experience of business as this transformation unwinds and I want to encourage continuing close engagement and candid communication between you, and your representatives such as AiG, and the Treasury.

And while business models need to be innovative and responsive to the changing world, Australia's policy and institutional settings also need to be conducive to the development and use of skills, human capital and investment.

The final chart for today illustrates this point. Chart 6 shows the relationship between firms that are innovative and how well they have performed. As you can see, those firms that see themselves as being active in innovation are more likely to have experienced improvements in performance across a whole range of indicators — profitability, productivity, they have a larger range of products and services, in jobs and positions and also in the amount of training they provide.[6]

6 See also Soames L, Brunker, D, and Talgaswatta T, 2011.

Chart 6: Increases in business performance over the past year by innovation status (2008-09)



Source: ABS cat. no. 8167.0.

It is not preordained that Australian business will succeed or fail from the mining boom. In fact, it is not preordained that we will succeed or fail from any of the other manifestations of Asia's economic development.

What we do know is that whether we succeed or not depends on the quality of business and government decisions made today.

Thank you.

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Australia and China — grasping opportunities in an uncertain world

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This speech was delivered at the 8th Annual Goldman Sachs Global Macro Economic Conference on 18 October 2011.

1 I would like to acknowledge the assistance of Sam Hurley in preparing this address. All errors remain my own.

Introduction

Thank you for the opportunity to be here today.

This Conference occurs in what we might euphemistically describe as 'interesting' times. Indeed, for anyone with a passing awareness of global issues, 'interesting' doesn't do it justice. The forces currently shaping, and shaking, the global economy — including excessive debt, deleveraging and deficient demand in major advanced economies, shifts in global industrial structure and comparative advantage, and the continued transformation and re-engagement of the emerging economy giants — are all interacting in ways which create great risk, but also great opportunity.

We have seen the consequences of inconsistency between underlying international competitiveness and fiscal policies result in excessive debt and fear of sovereign default in Europe. The result is playing out on a daily basis, with marked volatility in equity markets and a sharp decline in risk aversion.

Other forces, like the re-emergence of China and India, are more like the shifting of tectonic plates, slow moving but profoundly altering the global landscape.

As these forces play out, the decade ahead looks to be a particularly volatile one for the global economy.

Today I want to focus on China and on its role in the complex phase of economic adjustment which lies before us. This will cover both China's own difficult policy choices as it seeks a more sustainable growth model but also the implications of China's emergence, both in terms of patterns of growth and production but also in the approach to international architecture and policymaking needed to accommodate China's rise.

Before turning to China, though, let me make a few brief observations on the current situation and draw out some implications for the global financial architecture.

Global economic developments

The proximate causes of the acute financial market volatility over recent months are well known: unsustainable sovereign debt positions among certain euro area economies; policy responses that are manifestly inadequate given the scale of the debt and related financial sector vulnerability; an ongoing fear that political institutions are incapable of implementing the right responses; and a growing recognition that the recoveries in both the US and Europe will be weaker than previously expected.

However, these growth and debt concerns ultimately reflect an underlying competitiveness problem. In short, in Europe, and to a lesser extent the United States,

there is a fundamental mismatch between tax and transfer policies and the structural policies that drive competitiveness and growth, the result being weak fiscal positions and ensuing financial sector fragility.

In Europe, poorly designed labour market and social policies have led to these competitiveness imbalances, which are exacerbated by a common currency. In the US, in his State of the Union address, President Barack Obama described America's current economic and competitiveness malaise as this generation's 'Sputnik moment'.

Despite a decade in which economic growth and job creation were artificially inflated by a damaging housing bubble, we can have confidence the US system will drive the innovation and investment needed to spur competitiveness and growth. However, the US' medium-term fiscal challenge remains to be addressed and success will take time and sustained political commitment.

On the other side of the Atlantic, after 'mucking around with this for 18 months', as the Treasurer so aptly described it yesterday, the Europeans are now much more aware of the need for action. It will be important that a sustainable solution to the financial and sovereign debt crisis is unveiled in the next few weeks, but the competitiveness challenge will take much longer to address.

As a result, three years on from the depths of the global financial crisis the recovery in broad swathes of the developed world remains tepid at best. As of the June quarter this year, in five of the seven 'major advanced economies' — that is, in all of the G7 except Germany and Canada — real GDP still remained below pre-crisis levels.

The US, where the recession began in December 2007, is almost halfway to its own lost decade.

In the euro area, the combined investment level in Greece, Ireland and Portugal has fallen by almost 40 per cent, while in the rest of the euro area investment has fallen by more than 10 per cent. Together with unemployment that still averages 10 per cent across the euro area, this suggests a very real risk of a permanent decline in Europe's already anaemic rate of potential growth.

Given this extremely weak lead from the G7 economies, overall growth for advanced economies as a whole has been disappointing. Based on IMF forecasts, by the end of 2011 real advanced economy GDP will be barely 1 per cent higher than the levels at the end of 2007.[2]

2 In contrast, Australian GDP is 7 per cent higher than at the end of 2007, an outcome matched or exceeded by only 5 other advanced economies (Taiwan, Singapore, Hong Kong, South Korea and Israel).

Of course, the other side of the global economic story is one you will also be familiar with — the ongoing strength of the emerging world, and particularly emerging Asia.

This has been particularly visible post-crisis, but in truth the strength of the emerging world has been apparent for some time. Between 2001 and 2007, developing economies on average contributed around two-thirds of annual global growth — up from less than half in the 1990s. Over the five years to 2016, the IMF is forecasting the developing world to account for around 75 per cent of global growth.

In turn, over that period the bulk of developing world growth — around two-thirds — is expected to come from developing Asia, with China expected to be responsible for lower than two-thirds of that — or around one-third of global growth.

These changes obviously have important implications for the global centre of economic gravity, which continues to shift from West to East.

International architecture

These global economic trends mean that we have to manage an international environment where expectations around representation, engagement and behaviour in international forums are changing (and where such expectations can sometimes be mismatched).

Greater economic weight for emerging economies will bring greater geo-strategic weight. However, these shifts in global power balances should not be seen in simplistic terms as a clear transfer of power, prestige or influence.

Greater economic weight should bring greater representation for emerging economies if our global institutions are to retain legitimacy. That is why Australia has been a staunch supporter of IMF quota and governance reform for well over a decade.

However, for emerging economies greater representation and greater integration into the global economy also bring greater responsibility, more difficult policy choices and a greater expectation that they will contribute to the provision of global public goods.

For its part, the global financial crisis made clear that the United States can no longer provide a global market of last resort for consumer goods. It is increasingly looking to others to share the burden in ensuring a sustainable global recovery. Indeed, given its current domestic preoccupation, the US cannot be expected to singlehandedly lead the push for solutions to problems besetting the global commons.

But what should we expect of the new powers?

Improving the representation of developing economies through the pursuit of quota and governance reforms at the IMF and World Bank is important but representation does not guarantee effectiveness. For effectiveness of these institutions to be improved, emerging economies will have to be willing to play a significant part in resolving the challenges facing the global economy.

Indeed, by virtue of its sheer size, no major global public policy issue will be capable of resolution without China. But if China and the other large emerging economies are not seen as engaging constructively, their interests, as well as ours, will ultimately suffer.

The emergence of the G20 at Leaders' level has been crucial in providing a forum through which emerging economies can make a contribution to addressing global challenges. It brings all the major economies into a manageable forum. But just as with the IMF and World Bank, the legitimacy of the G20 depends critically on its ability to deliver results.

The recent G20 Finance Ministers' Meeting stressed the need to have a comprehensive response to the European sovereign debt crisis to avoid further contagion. This will require further measures to boost the European Financial Stability Facility — the October 23 meeting of the European Council will be critical in this regard — as well as ensuring that the IMF is adequately resourced to respond as needed. This plan to address the immediate crisis should be supported by a 'roadmap' of reforms to strengthen global growth — including a commitment to boost domestic demand in emerging economies through enhanced exchange rate flexibility.

As a trade oriented economy, and one that would not be in any smaller global grouping that emerges if the G20 fails, Australia has a vital national interest in the success of the G20, which explains the emphasis placed on these current meetings by the Prime Minister and the Treasurer.

Development challenges ahead for China

Our region is right at the centre of the transformative rise of emerging economies. Indeed the reintegration of almost 3 billion people into the global economy that we are seeing in China and India is an event without precedent.

It is tempting to weave a very general narrative encompassing both China and India but China started its reform process more than a decade before India, and India is a

fascinating challenge in its own right. But as China is larger, has grown faster, and is more integrated with the global economy, it will be the main focus today.[3]

We're all familiar with the broad outlines of the China story — and the implications for Australia.

It is fair to say though, that this story is occasionally portrayed somewhat crudely.

On some tellings, the rise of China and Asia is inexorable and will inevitably take Australia along for the ride.

On others, we're hopelessly exposed to a supposedly imminent China collapse. In the meantime, if you believe what you hear, every strong feature of the Australian economy comes with a 'Made in China' stamp.

The truth is that the China story and outlook is formidably complex and that these complexities matter deeply for both Australia and the world.

Recently my predecessor Dr Ken Henry has been tasked by the Prime Minister to lead the work on a White Paper on Australia in the Asian Century. The very fact of such a project reinforces just how important the rise and transformation of Asia is to Australia, and underlines the importance of understanding the economic, social and strategic changes which are underway in China, India, Indonesia, Vietnam and elsewhere in the region.

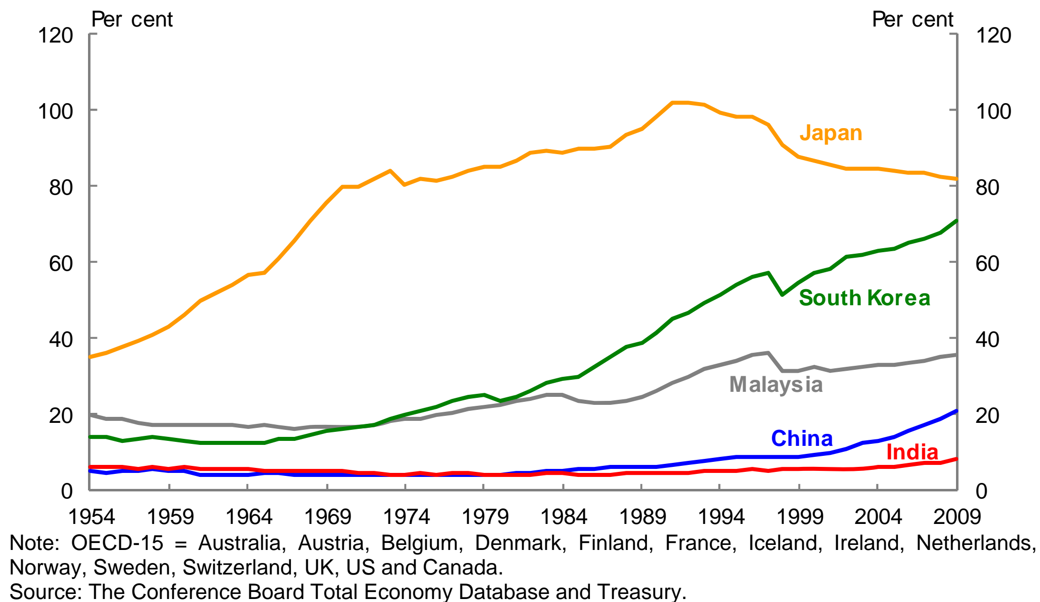
For its part, Treasury has often been portrayed as eternally optimistic on the Chinese economy — in fact, our analysis is far more nuanced than that.

In the short-term, while there are certainly risks — not least the vulnerable international outlook — we believe that the outlook for China is strong and that a 'hard landing' is unlikely. Domestic demand continues to grow strongly and China has much policy space should there be a major slowdown in global growth.

In the long term we are optimistic about the potential drivers of strong growth in China, given by the large scope for urbanisation and industrialisation (Chart 1).

3 While I will leave a deeper consideration of India for another occasion, it is worth noting that Treasury now has a senior officer posted in New Delhi. Treasury has been represented in Beijing since 1994.

Chart 1: GDP per capita (per cent of OECD-15 average)



Note: OECD-15 = Australia, Austria, Belgium, Denmark, Finland, France, Iceland, Ireland, Netherlands, Norway, Sweden, Switzerland, UK, US and Canada.
Source: The Conference Board Total Economy Database and Treasury.

However, while the potential is there, continuation of strong growth in China isn't pre-ordained. The medium term policy challenges China faces are daunting and even when the right policy decisions are made there will be risks in implementation.

As a result, we tend to describe a picture 20 years hence where, through the prism of history, even a highly successful China is seen as having had a rising trend in GDP but with significant economic cycles of a sort not seen over the last two decades.

On the international front China's trade and overall balance of payments surpluses — and related issues around the valuation of the RMB and China's massive accumulation of foreign reserves — are major sources of tension and potential instability in the global economy and at the same time serious inhibitors to more balanced growth.

The major domestic policy challenge facing China is the handover from investment to consumption-led growth. In 1980, investment accounted for around 35 per cent of Chinese GDP, and private consumption around 50 per cent. By 2010, these numbers had effectively swapped: consumption 34 per cent of GDP, investment 49 per cent.

Looking at the developmental experience of other economies, a sharp fall in the consumption share of GDP is exactly what we expect at the levels of per capita income through which China has been progressing over recent decades.

However, 34 per cent of GDP is an extraordinarily low consumption share of GDP by any reference point. Both major advanced economies and emerging and newly-industrialised in the region typically have shares around the mid 50s or higher.[4]

None of this is to say consumption growth has been slow in China. Indeed, over the last 5 years, private consumption has expanded at an annual rate of around 13 per cent in nominal terms. But investment has grown even faster — particularly following the infrastructure-heavy stimulus package introduced during the global financial crisis.

There are a range of factors behind this imbalance between investment and consumption, but central among them is that China has an industrial structure which, by design, systematically favours capital over labour, and corporations or SOEs over households and predominantly privately-owned small and medium enterprises.

The undervalued nominal exchange rate encourages investment for export production, while at the same time reducing consumer purchasing power. Suppressed deposit and lending interest rates reduce earnings on savings while artificially lowering capital investment costs, even as a lack of financial market development funnels savings into low-return deposits and reduces consumers' ability to access credit and smooth consumption spending out over time. Regulated input prices favour corporations. State-owned-enterprise dividend policy promotes retention and reinvestment of funds at the expense of greater dividends and an improved tax take.

And yet despite all this the real exchange rate appreciates, as it must. But this occurs through higher inflation, which brings with it another set of issues for policymakers.

Layered on top of this suppression in the labour income share of GDP are a range of other factors which drive high rates of precautionary savings. These include a hukou or residency permit system which entrenches vulnerability of rural migrant workers, limitations in the healthcare system, and broader weakness in social safety nets.

Given the systemic nature of these factors, what are the prospects for rebalancing the role of investment and consumption in driving Chinese growth?

The good news is that urbanisation will continue to shift surplus rural labour into more productive industrialised sectors in the years ahead, driving increased wages and living standards. This increasingly urban population will, as incomes continue to rise, divert an increasing share of total spending away from basics like food and into durable goods and, importantly, services.

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4 At levels of GDP per capita similar to China's today, Taiwan, Korea and Malaysia all had a consumption/GDP ratio of around 50 per cent, while Hong Kong was at 65 per cent.

However, to boost the labour share of income these forces will need to be supported by reforms to lift minimum wages, free-up factor prices, progress financial market liberalisation, and improve the tax and transfer systems. Other reforms, particularly to residency laws, credit markets, pension systems and healthcare, also need to be taken further to reduce the need for precautionary savings.

Many of these issues are recognised in the 12th Five-Year Plan, which emphasised the importance of boosting domestic demand, and especially consumer demand; boosting the services share of GDP; reducing social inequality; and achieving targets for minimum wage and overall incomes growth.

However, the impact of the 12th Five-Year Plan will depend crucially on effective design and implementation of these policies. The targets are encouraging, but the market mechanisms and the political will necessary to achieve them need to be developed and applied. And just like in Western democracies, success will require China's leaders to tackle stubborn vested interests.

Moreover, in managing these reforms and transitions China will need to maintain solid economic growth and avoid further increases in inequality, while operating in an international environment likely to be characterised by slow growth in major advanced economies and ongoing economic uncertainty and volatility.

Next year's leadership transition is an added complication. The next generation of Chinese leaders will need to walk a fine line between maintaining stability and continuity and positioning China for continued sustainable growth.

Clearly, the transition that China faces between now and 2020 is a complex one. The strong long-term outlook for growth that we see in China doesn't imply consistently strong growth, or rule out major fluctuations around the positive longer-term story.

If you look back over the last 100 years of strong GDP growth in the US — the US Century if you will — it is clear that there were some major deviations around that trend. Unfortunately, we are in the midst of one now. Shocks and policy mis-steps do occur, even in economies with strong growth potential, and China will be no different.

Moreover, the broader economic history of the last 100 or so years teaches us that countries have often experienced difficulties in progressing from middle to upper income status.

There are some important success stories (including in Asia) that suggest we should be sceptical about a fully-fledged 'middle income trap', whereby some emerging economies become stuck in the transition between labour intensive, low-cost manufacturing led growth and a more advanced capital-, knowledge- and

services-intensive growth model. However, it's equally apparent that economies like Japan and Korea have faced some major shocks along the way to high income status.

Similarly, while there are good reasons to be optimistic about the eventual 'convergence' of emerging economy incomes towards advanced economy levels, this process doesn't happen by default.

There have been cases where economies and incomes have plateaued well before traditional convergence theory would suggest. It is relatively easy to identify a broad sweep of policy or institutional conditions which are associated with sustained longer-run growth. However, as Harvard economist Dani Rodrik (2011) recently argued, it is harder to be clear on the exact policy changes that are needed to deliver these conditions.

On a more positive note, China's urbanisation, industrialisation and growth still has some way to run before it reaches 'middle income trap' territory. And China's strong reform credentials over recent decades suggest that while the process will be challenging, it is capable of making the structural adjustments needed to drive its economy through the next phase of its development.

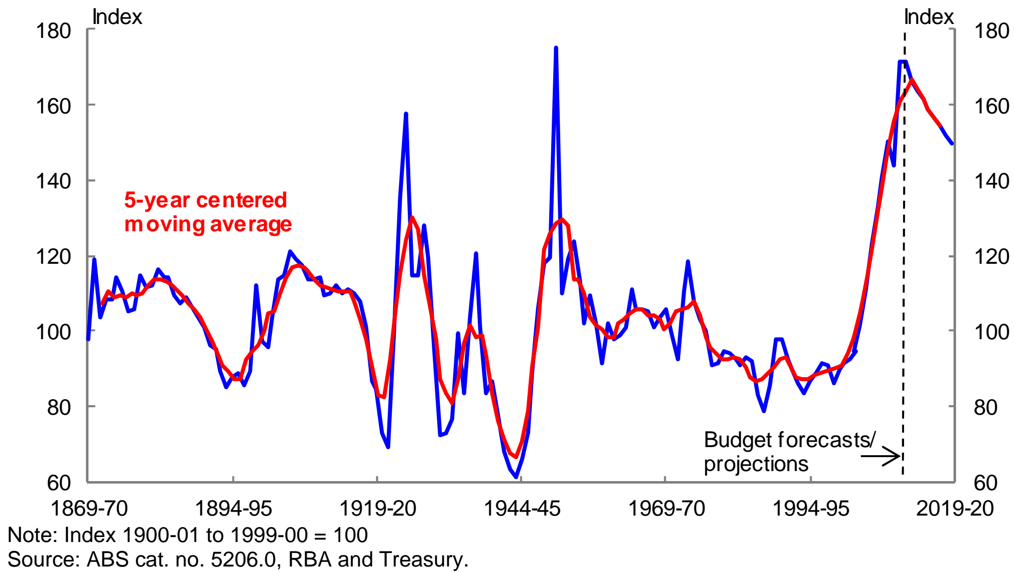
It is also worth noting that, by virtue of the sheer size of the Chinese economy, the additional annual impetus to global GDP from China will remain substantial even as growth rates slow.

Purely as an illustration — assume that China's economy was to double in size again over the next decade (implying average annual real growth of around 7 per cent) and then grow at around 5 per cent annually in real terms thereafter. The initial year of 5 per cent growth would be the equivalent of adding to world demand an economy the size of Indonesia today.

Implications for Australia

Let me turn to the implications of China's development for Australia.We're all familiar with surging Chinese demand for resources pushing Australia's terms of trade to record levels and resulting in a vast investment pipeline of around $430 billion — equivalent to around 30 per cent of nominal GDP! (Chart 2)

Chart 2: Australia's terms of trade



Note: Index 1900-01 to 1999-00 = 100
Source: ABS cat. no. 5206.0, RBA and Treasury.

However, with the high dollar, trade exposed industries outside the resources and energy sector have come under great pressure. Competitiveness has been lost and skill shortages have emerged — while manufacturing gets the media attention, key service exporters like tourism and education have also been hard hit. (Chart 3)

Chart 3: AUD-USD exchange rate

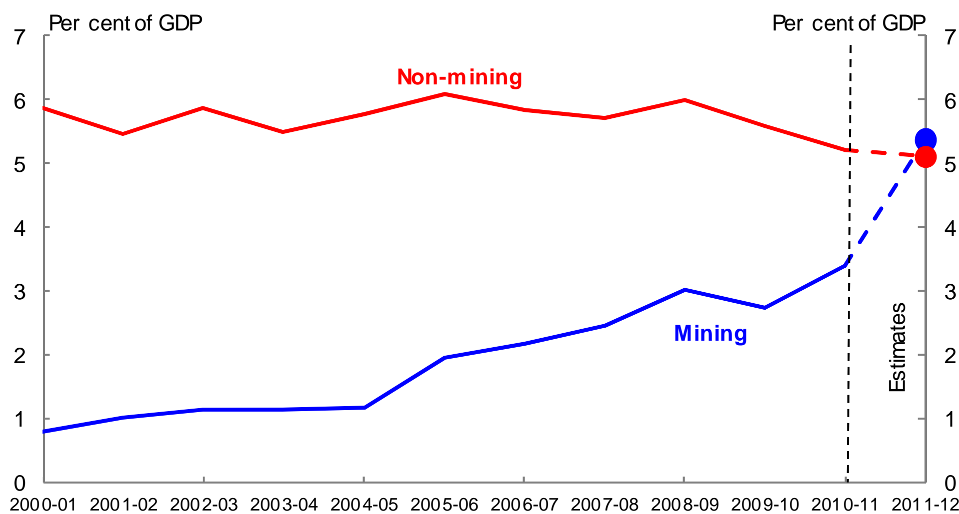
Source: RBA.

While this is a source of considerable community anxiety, it is an inherent part of a successful transformation. We have to accept that labour and capital need to be

deployed differently and that some sectors and firms will need to grow more slowly so that others can expand more rapidly. (Chart 4)

Australia's policy settings need to facilitate these changes, rather than trying to impede them. This means policies that promote investment, innovation, education and skills — policies which can increase our ability to innovate and capture new opportunities and which will deliver the productivity gains needed to continue to lift living standards. Even if our terms of trade were to remain at their current historically high levels — which, to be clear, we do not expect — the period of windfall gains for national income from an increasing terms of trade is over, meaning we will need faster productivity growth to sustain growth in living standards in the future.

Chart 4: Mining and non-mining investment intentions share of GDP



Note: Estimates for 2011-12 from ABS CAPEX survey, and based on the long-run average realisation ratios.
Source: ABS cat. no. 5206.0, 5625.0 and Treasury.

Australia's trade linkages with China also expose us to policy mis-steps or major fluctuations in China's growth.

There is nothing new in this — we've been reliant at other times on markets in the UK, US and Japan. What's new is that unlike China, those countries were not themselves trying to manage their own massive structural transformation — and it is this that heightens the probability of mis-steps.

As a result, Australia must retain the flexibility to adjust to temporary shocks, a flexibility which has been a defining feature of our strong economic performance in recent decades. The flexibility of the currency, the independence of the RBA, a strong medium term fiscal framework, a strong and well regulated financial sector and an

ongoing structural reform agenda — all of these are fundamental to Australia's ability to manage the impacts of external volatility at home.

Australia should also be doing all that it can to reduce external sources of volatility. This includes playing a constructive role globally, including through the G20 and other multi- and bi-lateral fora, to encourage international cooperation and smooth rebalancing towards more sustainable growth models.

Australia must also be awake to the longer-term opportunities flowing from sustained growth in China and emerging Asia more broadly. If the resources boom is the first wave of impacts on Australia, the transition to higher incomes and consumption-led growth promise two more:

- higher demand for our agricultural commodities as higher incomes lead to changing food consumption patterns; and
- opportunities for rapid growth in the services demanded by increasingly affluent societies.

On some projections, by the end of this decade there will be an additional 1.2 billion middle class consumers in Asia, making the region the single largest middle class market in the world (Kharas and Gertz, 2010).

The opportunities that come with this are tremendous. But just as it took world's best expertise to transform our mineral wealth into the mining boom, it will take world's best business and policy approaches to make the most of our favourable geography.

Geography is important, but it doesn't give us a free pass to Asian middle class markets. Competition will be intense, with more countries able to provide the goods and services these Asian consumers will demand.

Australia's success in positioning for Asia's middle class is not pre-ordained. To make the most of these opportunities, Australia will need to pursue a broad-based agenda to increase productivity, innovation and both labour and management skills. In short, an agenda which will assist not only to ease the structural shifts of today but pave the way for the structural change of tomorrow.

We also need to bolster Asian literacy — in a literal sense, as well as commercially and culturally.

And we need a continuation of strong inflows of foreign direct investment, not just in our natural resources sector but also in our agricultural, tourism, infrastructure and education sectors. Given the scale of our investment needs, the alternative is either

lower rates of Australian consumption or greater inflows of shorter term capital, with all the consequences that brings.

Conclusion

As I said at the outset, we live in interesting and complex times. The global economy is in the midst of a century-defining shift. The Asian region is right in the middle of that shift with China at its heart, and Australia is intimately interconnected with Asia and with China in particular.

The major changes already in train have had significant benefits for people right around the world. Hundreds of millions have been lifted out of poverty in Asia. Hundreds of millions in the advanced world have benefited from the boost to real incomes which has come from lower manufactured goods prices.

But significant transitions like these don't happen without tensions and costs. Shifting patterns of global comparative advantage have forced some difficult structural changes in many advanced economies over recent decades — including the shift away from manufacturing employment in some industries where competition has hit hardest.

In the US and Europe, underlying issues with competitiveness have manifested in part in the burgeoning sovereign debts which are a defining feature of today's global outlook. Social and economic strains are likely to be compounded by a prolonged phase of fiscal consolidation and adjustment. And inevitably, there will be pockets of political fallout.

Likewise, to continue its drive towards middle and high income status, China must manage its own set of transitions and adjustments: to a more market-determined currency, higher wages, more costly capital, and higher value added industries.

When we think about these sorts of changes — both within economies, and between them — there is a temptation to fall into a winners-losers, zero sum analysis. But we should resist this.

Internationally, for instance, the shifting in economic and geopolitical weight from West to East is often portrayed as a 'rise and decline' — as an absolute loss of power, prestige and influence by the US and Europe.

But the US is in no danger of losing its superpower status. Moreover, the US, Europe and other advanced economies like Australia stand to reap ongoing benefits from China's economic rise. All of us have an abiding interest in having China at the table of global governance, in encouraging Chinese economic reform, and in facilitating China's growing role as a responsible stakeholder internationally.

Similarly, although China itself is reaping vast and deserved rewards from its economic growth of the last three decades, its transformation won't be without pain. China's next stage of growth will require difficult reforms. China is already facing increased competition from cheaper labour offshore and pressure to innovate and move up the value chain. It too will have to deal with the political, economic and social impacts of structural change.

China's opening up isn't all one way. China has changed the world, but in the process the world is also changing China. Further globalisation means more pressure for market-based reform — and, ultimately, more benefits for both China and the world around it.

In all countries there will be difficulties in this sort of transition process. The costs can be concentrated, and there are always sensitivities in dealing with change, risk and uncertainty.

But whether it's Australia, China, the US or Europe, the forces at work are irreversible. Acknowledging them, adjusting to them, and harnessing them to our benefit, is the only way to deliver increased wellbeing to each nations' citizens.

Thank you.

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Key themes from Treasury's Business Liaison Program

Overview

As part of its quarterly Business Liaison Program, Treasury met with 53 businesses and organisations in November, in five capital cities and by teleconference. Treasury greatly appreciates the commitment of time and effort made by the businesses and organisations that participate in the program.

Liaison discussions confirm strong activity in the resources sector supported by robust demand from emerging Asia, particularly China. As demand is being driven by the longer-term needs of these economies, the deterioration in global conditions and recent falls in non-rural commodity prices are not expected to have a significant impact on activity or investment. However, weak conditions persist in some industries outside of the resources sectors. Weak demand continues to constrain growth in retail and construction, and the high exchange rate is maintaining pressure on the manufacturing sector notwithstanding the recent modest depreciation.

Labour market conditions in the mining sector remain tight, with strong wages growth for skilled labour in some occupations. On the other hand, wage pressures are easing across the majority of the non-mining sectors of the economy where most workers are employed.

Activity

Activity in the mining sector is buoyant, driven by growth in the emerging economies of Asia, which so far remains intact despite the weakness in advanced countries and global financial volatility. The recent drop in iron ore prices is not expected to have a significant impact on activity as contacts attribute it to seasonality, additional supply from South America and large stockpiles of iron ore in China, which are factors unrelated to the longer-term dynamics driving demand for Australia's resources. However, the slower-than-expected recovery from the adverse weather events in early 2011 will continue to have some impact on coal production over the coming months.

Economic activity remains uneven across the rest of the economy. Conditions in the manufacturing sector are mixed, with firms servicing the mining sector outperforming businesses in the non-mining sectors. However, most manufacturers continue to cite the high exchange rate as having a negative impact on their business, notwithstanding recent falls in the Australian dollar.

Retail sector contacts report a sluggish start to the Christmas sales period with soft consumer spending on discretionary items, although spending on non-discretionary items remains solid. This weakness is affecting transport activity with little product moving on the east coast. Consumer sentiment remains below its long-run average despite a recent pickup, in part reflecting continuing volatility in global financial markets and uncertainty about how this could impact on Australia. After slow sales

growth in September and October, retailers are now looking to November's interest rate cut to boost sales in the coming months. Those contacts that are experiencing growth attribute this to gains in market share through the opening of new stores.

Contacts report that conditions in the commercial property sector remain weak. Discussions confirm that conditions in the residential construction sector also remain subdued, consistent with the softening housing market. In Victoria, residential construction activity is likely to moderate further from recent elevated levels, while the outlook for the Queensland market remains pessimistic. However, the New South Wales detached housing market is starting to recover from the record low levels of recent years.

Employment and wages

Hiring intentions continue to vary across sectors with strong intentions in mining and a more subdued outlook for the non-mining sectors. Firms in the mining and mining-related sectors of the economy report high levels of turnover with skilled labour able to move between firms with ease. Businesses report that the strong competition for labour means that potential recruits are placing significant value on non-pecuniary factors such as conditions, quality of work and firm reputation.

Contacts suggest that strong growth in wages and other forms of remuneration on offer in the mining sector are now starting to attract labour from non-mining firms, with those in Western Australia and Queensland reporting more difficulty in recruitment than non-mining firms in other states.

Strong wages growth in the mining and mining-related sectors of the economy, where shortages of skilled labour are being felt most acutely, is expected to continue in the near term. By contrast, contacts in the non-resources-related sectors report that wage pressures are easing across the majority of the non-mining sectors of the economy.

Costs and prices

Contacts report that the outlook for prices is generally benign, although some firms expect the recent modest depreciation in the Australian dollar to put upward pressure on the price of imported goods in the near term. Retail contacts expect this to place additional pressures on margins with firms having little scope to increase prices given weak consumer demand.

Financing and investment

Mining-related investment remains strong despite the recent volatility in global commodity prices as investment plans are being made over long time horizons. However, capacity constraints are emerging due to shortages in some specialised skills and delays in the completion of infrastructure to support further investment.

An uncertain outlook for construction sector activity means some firms are limiting their expansion plans to alterations or additions that are absolutely necessary. Access to credit remains an issue in the non-residential construction sector with banks imposing more restrictive conditions on lending, leading to projects being delayed or scaled back.

Arthur Fadden: Treasurer in a golden age

John Hawkins[1]

Sir Arthur Fadden served as treasurer for nine years and brought down eleven budgets. In his first budget he faced the challenges of funding military expenditure in World War II. Returning to the Treasury in the early 1950s, there were again challenging times as the Korean war boom exacerbated inflationary pressures. In response Fadden brought down the 'horror budget', the first explicitly Keynesian approach to fight inflation. Critics called it 'too much, too late' but inflation was squashed and the economy grew well for the rest of the decade. In many ways, Fadden' period as treasurer coincided with a golden age for the Australian economy.

Source: National Library of Australia[2].

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1 The author was formerly in the Domestic Economy Division, the Australian Treasury. This article has benefited from comments by Selwyn Cornish. The views in this article are those of the author and not necessarily those of the Australian Treasury.

2 'Portrait of Arthur William Fadden, M.H.R Treasurer in the Australian Cabinet, 1941', Bib ID: 1020543.

Introduction

Sir Arthur Fadden PC GCMG[3] was better known as 'Artie'. He brought down eleven budgets.[4] He was Australia's second-longest serving treasurer, but as prime minister he only 'reigned for forty days and forty nights' (like the Great Flood, as he put it).[5]

Parliamentary contemporaries recalled him as 'energetic, outgoing, shrewd and immensely likeable' and 'sharp-witted with a fund of jokes'.[6] He had an enormous zest for living.[7] 'His heavy frame, massive head and jowls, and gift for simile and anecdote suggested a bushman dressed in a double-breasted suit to do battle in the cities'.[8] While an effective speaker, he had 'no pretensions to oratory'. He was 'a tough and rugged fighter in party, cabinet, parliament and on the hustings'[9] but he cultivated co-operation and loyalty from those with whom he worked.[10]

An economic historian's assessment was that 'Fadden was a shrewd judge of economic interests and a competent administrator but he was not an innovator'.[11] On the other hand, the prosperity that Australia enjoyed during his tenure led some leading economists to nominate Fadden as Australia's best treasurer.[12] While 'neither an academic nor an intellectual'[13], Fadden was 'a hard working treasurer and knew the job'.[14] Fadden 'was interested in economic and financial issues. He read official papers and listened attentively, but his judgements were intuitive'.[15]

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3 Fadden was knighted KCMG in 1951 and upgraded to GCMG in 1958.

4 The 1941 budget did not pass the House so by some reckonings Fadden had only ten budgets.

5 He was, however, acting prime minister for 692 days; Fadden (1969, p 151) and Davey (2011, p 133). This is longer than the combined tenures of Watson, Reid, Page, Forde and McEwen.

6 Beale (1977, p 50). Daly (1977, pp 25, 29, 32) includes some examples of Fadden's wit. Davey (2011, p 47) describes him as a 'hail fellow, well met' character. Enid Lyons (1972, p 98) recalled 'everyone whole-heartedly liked Artie'. Veteran journalist Alan Reid (1961, p 12 and 1980, p 366) recalls a prankster, mimic and raconteur who was 'so likeable' and 'earthy'.

7 Gough Whitlam, *Hansard*, 1 May 1973, p 1467; E Holt (1969, p 69).

8 Obituary, *Canberra Times*, 24 April 1973, p 2.

9 Ellis (1963, p 305). Crabb (2010, p 297) describes him as 'pugnacious, charming and ribald'.

10 Cribb (1996).

11 Schedvin (1992, p 185). Costar and Vlahos (2000, p 213) give a similar verdict.

12 Professor Ross Garnaut commented 'if the role of the treasurer is primarily one of maintaining economic stability, then the people who have presided over long periods of stable growth have to get high marks' and Professor John Neville agreed; *The Age*, 9 May 2005, p 4.

13 Reid (1961, p 13 and 1980, p 366). A parliamentary colleague described him as having 'made no claims to being highly intellectual'; McEwen and Jackson (1983, p 39).

14 Holt (1969, p 70). He was 'a master of the subject' of taxation; Spaull (1998, p 98). McEwen and Jackson (1983, pp 39, 57) describe Fadden as 'a shrewd man' who was 'very aware of what could and what could not be sold to people and this made him a very able politician'.

15 Coombs (1981, p 154).

Fadden's early life

Fadden was born in Ingham, Queensland, on 13 April 1895. He was the eldest of ten children. Both his father and maternal grandparents had been Irish immigrants. His father was a policeman in a small rural village and young Artie's bedroom was next door to a cell. He grew up in the cane fields and 'gambolled with the Tom Sawyers and Huckleberry Finns on the banks of the Pioneer River'.[16] As a young man, he excelled at cricket, rugby, running and boxing. He also performed in amateur theatre. Being treasurer of a vaudeville troupe was his first experience of balancing the books.

After attending the local state school, Fadden worked as an office boy at a mill and then a clerk for Mackay Town Council. When he discovered defalcations in the books kept by the town clerk (missed by five auditors), the clerk was dismissed and Fadden appointed in his place. After studying accountancy by correspondence he became a public accountant in Townsville in 1918.[17] When a cyclone hit Mackay in January 1918 Fadden narrowly escaped drowning. He worked tirelessly with the relief effort.

In December 1916 Fadden married Ilma Thornber, a milliner. Her father, grandfather and brother-in-law had all been mayors of Mackay, so the marriage brought him closer to political circles. He spoke at a public meeting in support of a friend running as a Nationalist against Theodore in 1925, but declined an offer from the Country and Progressive National Party to run himself at the 1929 state elections.

His first serious foray into politics was his election to the Townsville City Council in 1930.[18] He then narrowly won the Queensland Legislative Assembly seat of Kennedy for the Country and Progressive National Party in 1932 and in 1934 was appointed to lead for the opposition in financial debates. After a redistribution, he unsuccessfully contested the sugar belt seat of Mirani in 1935.

Into federal parliament

A by-election in late 1936 for the federal seat of Darling Downs gave Fadden the chance to return to politics. He won the seat for the Queensland Country Party off the United Australia Party. He held it until 1949 when he moved to the neighbouring seat of McPherson which he kept until his retirement. Fadden's first parliamentary speech ended by outlining his vision of a 'varied and balanced economy'.[19]

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16 Ellis (1963, p 306).

17 As Senator Barnaby Joyce, himself the only accountant in the parliament, notes 'the trouble with politics is that it has a great potential to attract lawyers and no ability to attract accountants'; Crabb (2010, p 298).

18 He led a non-party team known as the 'servicable six'.

19 *Hansard*, 17 June 1936, p 40.

In 1939 Fadden tried to dissuade the Country Party leader Earle Page from attacking Menzies in the House. Failing in this, Fadden and three colleagues withdrew from the Country Party until after Page stood down. Fadden was critical of what he termed the Government's 'half-baked scheme known as national insurance'.[20]

When Menzies needed to appoint Country Party ministers in April 1940, Fadden became minister assisting the treasurer. In this role he claimed (without giving any details) that the Government was funding the war 'by the most scientific means at its disposal, to find one-half from indirect tax and one-half from direct tax'.

He had been booked on the plane which crashed in August 1940 killing three ministers, but fortunately had taken the train instead. He was appointed minister for air and civil aviation in addition to assistant treasurer.

First (and short) term as treasurer

Following the 1940 election there was a challenge to the leadership of the Country Party and the vote was tied between former leader Earle Page and future leader John McEwen. To break the deadlock Fadden was appointed acting leader, and therefore unofficial deputy prime minister, and was confirmed as party leader in April 1941.

Fadden was promoted to treasurer[21], and in November 1940 brought down his first budget, increasing a range of taxes (including a 'greatly increased yield from the middle incomes'[22]) and borrowing heavily to pay for vastly increased military spending. Concerned about rising inflationary pressures, Fadden rejected reliance on further expansion of credit. He regarded inflation as the least equitable means of raising revenue from the public.[23] Fadden failed in an attempt to convince the states that they should yield income taxes to the federal government. Price controls had been introduced 'preventing profiteering and safeguarding the interests of the Australian consumers'.[24] A payroll tax was introduced to help fund child endowment.

Former Commonwealth Bank governor 'Nugget' Coombs recalled 'Fadden's first budget was phrased in more traditional financial terms and its Keynesian structure was less apparent'.[25]

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20 *Hansard*, 23 November 1938, p 1931.

21 Spender (1972, pp 73-74) believed Fadden demanded it as his right as deputy prime minister, although Menzies tried to present it as his own decision to make the best use of Fadden's accounting background.

22 *Hansard*, 21 November 1940, p 87.

23 *Hansard*, 21 November 1940, p 85; Hasluck (1952, p 282).

24 *Hansard*, 21 November 1940, p 80.

25 Coombs (1981, p 10).

Fadden and Treasury Secretary Stuart ('Misery Mac') McFarlane were not temperamentally compatible.[26] An Economic and Industrial Committee of Cabinet was established in June 1941, chaired by Fadden and with Professor Copland as Economic Consultant, but it only operated for a few months.[27] More influential was the 'F&E Committee' of leading economists.[28] Acting on advice from F&E Fadden tried unsuccessfully in February and June 1941 to persuade the states to transfer income tax powers to the federal government.[29]

Prime minister and treasurer

Menzies resigned as prime minister in August 1941 and a joint party room meeting chose Fadden as his replacement despite his being from the smaller party in the coalition. But his government was only to last forty two days.

Fadden remained treasurer as well as being prime minister. He regarded the 1941-42 budget as one of the two best he presented.[30] He viewed war with Japan as inevitable, so was concerned with new measures to raise revenue. He planned 'compulsory loans'[31] from singles earning over £100 a year, reaching 90 per cent on very high incomes, to accrue interest at 2 per cent and be repaid after the war.[32] A 'high profits' tax was proposed for companies earning over 8 per cent on capital. The budget included forecasts of national income, and said about 15 per cent of this would be needed for war purposes.[33] He persuaded the private banks to place deposits with the Commonwealth Bank and follow its policy on advances.[34]

The parliament, however, voted against the budget as two independents withdrew their support from the coalition government. Curtin became prime minister and a new budget was brought down on 29 October 1941 by Ben Chifley, dropping the 'compulsory loans' and focusing the income tax increases on high income earners.

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26 In addition to his dourness, 'McFarlane's style of presentation sometimes showed a carelessness of detail which offended Fadden's accountancy standards' leading Fadden to complain of some tables 'bloody thing doesn't add up!'; Coombs (1981, pp 6, 11).

27 The Committee is described in Hasluck (1952, pp 429-430) and Weller (2007, pp 74-75).

28 Maddock and Penny (1983) describe this committee.

29 Maddock and Penny (1983, p 38).

30 Fadden (1969, p 66 and 1973, p 8). The other was the 1951-52 'horror budget'.

31 This was an idea of Keynes, also known as 'deferred pay', 'post-war credits' or 'national contribution', suggested by the F&E Committee; Coleman, Cornish and Hagger (2006, p 192), Davey (2011, p 63), Maddock and Penny (1983, p 39) and Markwell (1985, p 50). It had been strongly advocated by one of the independents on whom Fadden relied to hold government but Fadden was particularly proud of the idea; Fadden (1973, pp 8-9).

32 *Hansard*, 25 September 1941, p 574. Similarly there would be compulsory loans out of company income.

33 *Hansard*, 25 September 1941, p 570.

34 *Hansard*, 25 September 1941, p 576.

Opposition

Fadden was unanimously chosen as leader of the opposition, with Billy Hughes taking over the leadership of the United Australia Party from Menzies. Surprisingly given his past record, Hughes was a loyal supporter for Fadden. But Menzies was not.[35] Fadden led the divided opposition to a landslide defeat in the 1943 election.

Menzies became leader of the opposition and set about forming a new Liberal Party. Fadden remained leader of the Country Party, which declined overtures to merge with the new party. Fadden campaigned against Labor's economic (particularly banking) policies and its referenda proposals to increase Commonwealth powers. He helped persuade Menzies to promise to abolish petrol rationing, a popular move which helped the coalition to victory in 1949.

As opposition leader, Fadden was very critical of Chifley's wartime banking regulations: 'we are fighting dictatorships today and we should not constitute the Commonwealth Treasurer a dictator of the financial policy of this country'.[36] A common theme was the danger of 'insidious inflation, which is the worst possible form of taxation' and 'the worst enemy of the worker and the poor man'.[37] He cited Keynes in critiquing rationing.[38] Despite their policy differences, however, Fadden and Chifley got on well with 'a shared knowledge and understanding of finance and their temperamental compatibility'.[39]

At this time, Fadden was no fan of economists; warning that 'economic advisers…with even larger staffs … from their armchairs in Canberra will dictate to the nation'.[40]

35 When Menzies criticised a Fadden policy, Fadden publicly referred to 'this stab in the back, another betrayal in the series for which Mr Menzies has become notorious'; Joske (1978, p 131). Privately he referred to Menzies as 'that big bag of ----'; Perkins (1968, p 143). Fadden had earlier resented Menzies' lack of appreciation of his work as acting prime minister; Fadden (1969, pp 60-62) and Davey (2011, p 51). He also resented Menzies' failure to support him in the budget debate; Fadden (1969, p 71). Fricke (1990, p 127) refers to 'a bitter hostility' between the two. They went on to work together in government in the 1950s but Enid Lyons (1972, p 99) recalled 'neither particularly admired the special gifts of the other, and each was slightly out of his depth in the other's intellectual sphere'.

36 *Hansard*, 5 November 1941, p 82.

37 *Hansard*, 8 October 1943, p 287 and 22 June 1943, p 19.

38 *Hansard*, 10 September 1942, pp 166-7.

39 E Lyons (1972, p 98).

40 *Hansard*, 20 July 1944, p 327.

Second (and long) term as treasurer

In December 1949, the Liberal and Country parties returned to office, with Fadden treasurer and unofficial deputy prime minister.[41]

Inflationary pressures were building. The incoming Menzies government removed controls and long pent-up demand was finding expression in a consumption and construction boom. The inflow of immigrants and a post-War 'baby boom' added to the demand pressures. Large capital works projects such as the Snowy Mountains Scheme were underway. Wages were accelerating. In September 1949, the Chifley Government had devalued the Australian pound by 30 per cent against the US dollar, following the British lead, adding further inflationary pressure and the 1949 budget was stimulatory. A number of economists were arguing that deflationary policies were needed.[42] The public was also becoming more concerned.[43] One of the main promises of Menzies and Fadden at the 1949 election was to 'put value back in the pound'. The subsequent Korean War boom was described as 'like a bee stinging a runaway horse'.[44]

The Korean war boom and the 'horror budget'

Australia was still 'riding on the sheep's back' in 1950. A blow had just been struck against the sheep's traditional rival, the rabbit, with CSIRO scientists successfully introducing the lethal disease myxomatosis. A new rival in the form of synthetic fibres was only just emerging. While the relative size of the rural sector had been in gradual decline for decades, it still accounted for around a fifth of GDP. Wool alone accounted for almost half of Australia's exports in 1949.[45]

It therefore had a marked impact on the economy when the outbreak of the Korean War saw a surge in the global demand for wool.[46] The greasy wool price rose from

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41 Fadden as Country Party leader could choose his own portfolio and his preference was treasurer; McEwen and Jackson (1983, p 41).

42 Whitwell (1986, pp 97-100) gives examples of minutes from the Commonwealth Bank and Treasury to this effect.

43 In an opinion poll in December 1949 about the major issue the Government needed to address in the coming year, 'living costs' was only nominated by 10 per cent of those polled. By December 1951 it was nominated by 48 per cent; Hazlehurst (1979, p 328).

44 Badger (1955, p 78).

45 Wool production had represented around 5 per cent of GDP from 1930 to 1946 but the boom took it to a peak of over 18 per cent in 1950-51; Badger (1955, p 65).

46 The wool stockpiles that accumulated during the second world war had been run down by 1951, and the United States government announced plans to rebuild its stockpile to meet military needs for uniforms. While the US had once been self-sufficient in wool, its sheep numbers were now at their lowest in almost a century and it was importing two thirds of its wool. Commercial users of wool, and even the public, started to fear that wool and woollen clothing would become unavailable or prohibitively expensive and there was a rush to purchase them; Goldbloom, Hawkins and Kennedy (2008).

49 pence per pound in 1949 to almost a pound per pound at its March 1951 peak.[47] At the same time the price of wheat, Australia's second most important export, also rose strongly. Notwithstanding some large increases in import prices, these developments meant the terms of trade had increased by 64 per cent from 1945-46 to 1949-50 and they rose a further 46 per cent in the following year, adding a massive 7 per cent to real gross domestic income in 1950-51. Unsurprisingly, this fuelled already strong demand; real private consumption almost doubled between 1943-44 and 1953-54. The unemployment rate fell to very low levels, probably the lowest since the 'gold rush' a century earlier and never matched since. The consumer price index increased by 13 per cent in 1950-51, an increase also not experienced since the gold rush, and went over 20 per cent the following year.

Despite its rhetorical concern with inflation, the Menzies Government shared its predecessor's enthusiasm for national development and the provision of infrastructure which made it hard to cut back government spending significantly and its political criticisms of Chifley made it hard to increase taxes.[48] It was not until after the April 1951 election that a more restrictive fiscal policy was adopted.[49]

While Fadden decried the 'dangerous rate' of inflation[50], economic policy was slow to respond. In a confidential memo to the cabinet in February 1951 Fadden referred to the 'certain prospect of further and very substantial rises in the domestic price level'.[51] He gave as possible responses reducing credit, increasing interest rates, voluntary or compulsory increases in savings, budgeting for a surplus, price controls, increasing imports, currency appreciation and price subsidies.[52]

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47 In October 1950 Fadden referred to the 'sensational rise in wool prices'; *Hansard*, 12 October 1950, p 765.

48 Schedvin (1992, pp 173 and 297) argues that Treasury shared this preference for development. See also Cornish (1992, pp 43-44). In his 1950 budget speech Fadden referred to inflation as 'the familiar growing pains of a vigorous economy' and said that 'the Government has been determined that migration and essential development should go on, and, as far as possible, be accelerated'; *Hansard*, 12 October 1950, pp 763-4.

49 Fitchett (1977).

50 *Hansard*, 21 June 1950, p 4667. His speech put more emphasis on the need to 'destroy the menace of communism as the first and fundamental prerequisite to putting value back in the pound'.

51 19 February 1951, *Menzies papers*, NLA MS 4936, box 438, folder 5.

52 Coombs had suggested many of these measures to Fadden in May 1950; Rowse (2002, pp 206-7).

Menzies wanted to appreciate the pound but Fadden refused.[53] One of his arguments was that the high wool price might prove temporary and there would be opposition to any subsequent devaluation.[54] As an alternative, a wool sales deduction scheme was introduced in 1950, under which 20 per cent of the value of wool sold or exported was paid to the Treasury and credited against woolgrowers' income tax obligations.[55] It was very unpopular with farmers and repealed the following year.

In the September 1951 budget the Government demonstrated the first use of Kenyesian anti-inflationary fiscal policy.[56] There were increases in income tax, company tax, sales tax and excise duty and special depreciation allowances were removed. One estimate put its impact on personal income at almost 6 per cent.[57] The government budgeted for a significant surplus, which Fadden argued 'is one of the most effective weapons currently available to the government — and also one which interferes as little as possible with the freedom of the economy to shape its own course'.[58]

An explicitly Keynesian tone was adopted in the budget speech; 'the financial operations of governments can, if appropriately directed, do a great deal to redress unstable conditions developing within the economy … modern thought on the relation of public finance to economic stability is quite clear … that, in times of excessive demand and scarcity of labour, governments should draw away from the public in taxation and loans more than they spend for current purposes'.[59] He concluded, in a somewhat mixed metaphor, that 'the whirlwind of rising prices may be exhilarating for the few who can ride it out, but for many inflation can become a whirlpool which ever more rapidly engulfs their savings and ultimately their jobs'.[60]

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53 A measure of the strength of his opposition was that reflecting in retirement on his 22 years in federal parliament, he named preventing an appreciation as his most notable achievement. Fadden, Page and his other Country Party colleagues argued strongly against appreciation. As Ellis (1963, p 288) points out, there was an implicit threat: the Labor Party had said they opposed appreciation too and the combined Labor and Country Party vote in the House exceeded that of the Liberals. Davey (2010, p 87) and Fadden (1969, p 116) report that during this tense period, some Country Party ministers carried signed letters of resignation in their pockets.

54 Fadden (1969, p 115).

55 Davey (2010, p 87) describes how Fadden initially wrote up the plan on lavatory paper, all that he had available on the night he had the idea.

56 See Hawkins, Goldbloom and Kennedy (2007) and Whitwell (1994).

57 Artis and Wallace (1967, p 423). Auld's (1967, p 344) study concludes the 1951-52 budget was deflationary but much less so than the 1960-61 budget, and similar to the 1955-56 and 1956-57 budgets.

58 A memo in January 1951 cited in Whitwell (1986, p 105).

59 *Hansard*, 26 September 1951, pp 53-54.

60 *Hansard*, 26 September 1951, p 66.

The reaction was sharp. A tabloid headline screamed 'Huge sales tax rise in horror budget', a sobriquet coined by Arthur Calwell that was forever attached to it.[61] Fadden later judged the budget as one of the two best of the eleven he presented.[62] But at the time he felt 'I could have had a meeting of all my friends and supporters in a one-man telephone booth'.[63] In rather an understatement, Fadden said 'it was not intended to make anyone giggle'.[64]

Menzies rejected backbench suggestions of blocking wage increases, suggesting any interference by the Government in the deliberations of the Arbitration Court would be highly improper.[65]

The timing of the government's counter-cyclical moves proved very unfortunate as rather than standing against an ongoing boom, it reinforced a weakening resulting from a collapse in wool prices from April 1951. The greasy wool price almost halved from an average price of 175 pence per pound during 1951 to an average of 89 pence in 1952. The economy went into recession from around mid-1951 to end 1952. The turnaround was both reflected in and amplified by a stock cycle. With hindsight, economists regard this recession as relatively mild.[66] But it had a marked impact on sentiment: the majority of respondents in an October 1953 opinion poll said their living standard had dropped over the past year; less than a tenth reported any progress.[67]

As Schedvin remarks, 'it is difficult to explain why so little note was taken of the collapse in the price of wool around April 1951'.[68] He suggests that 'as the government had been so difficult to persuade, senior officials were unwilling to encourage backsliding by softening their recommendations in the light of altered circumstances'.[69]

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61 *The News* (Adelaide), 26 September 1951, p 1. Apparently Menzies himself had earlier referred to the need for a 'horror' budget and Calwell reminded the house of this; *Hansard* 3 October 1951, p 286.

62 Fadden (1969, p 66). The other was the 1941-42 war budget.

63 Cribb (1996).

64 *Advertiser*, 29 September 1951.

65 Martin (1999, p 211).

66 Whitwell (1986) comments 'the recession of 1952-53 was neither particularly deep … nor protracted'. Schedvin (1992, p 174) agrees 'the downturn was moderate'. It was also partly attributable to a minor drought. It is hard to be sure of its size as while the income-based estimates of real GDP show a fall of around 1 per cent in 1952-53, the expenditure-based estimates show an increase.

67 Murphy (2000, p 107).

68 Schedvin (1992). In his speech presenting the 'horror budget' Fadden himself remarked 'wool prices have already fallen a long way from the peak reached early in 1951'; *Hansard*, 26 September 1951, p 52.

69 Schedvin (1992, pp 186 and 189).

It was not until the second half of 1952 that policy responded to the changed circumstances. In August 1952 the fiscal measures of the horror budget were largely reversed. The 1952-53 budget was brought forward several weeks and included cuts to company and sales tax. Fadden opened by remarking that 'it has now become traditional … that the budget speech should deal also with the impact of the budget, and of the measures associated with it, on the progress and prosperity of the country'.[70] He stressed the 'dramatic changes in basic economic conditions' since the previous budget; the fall in wool prices, the surge in imports and the subsequent fall in international reserves. Business, he noted, had 'passed into a phase of slackness and uncertainty' while 'demand for some types of goods is inadequate to absorb the supplies available and, in consequence, some unemployment has emerged'.

Fadden lamented the 'great change of attitude on the part of businessmen…there is in some quarters a good deal of fear about the economic future. I believe it to be basically unfounded, but the fact that it exists is something we cannot ignore. Psychology is enormously important in economic affairs and can never be safely disregarded'.

Fadden was aware of the danger of allowing inflationary expectations to become entrenched and the large output costs that would then be necessary to tame them. 'Plans and commitments are built upon the belief that prices will continue to rise and scarcities to persist. When these conditions are brought or come to an end, as they must some time, expectations are falsified, plans go wrong and losses are incurred. Left to run its own course, inflation will inevitably bring its own drastic solution in bankruptcies and mass unemployment.'

Given the change in economic circumstances, Fadden explained the government intended to 'reduce taxation as far as the Commonwealth budgetary position makes possible, but we are not going to go into deficit'. Views differ about how effective this fiscal response was. Whitwell opines the budget was 'mildly expansionary'.[71] Auld's study concludes that the automatic stabilisers were helpful and were augmented by discretionary tax reductions but substantially offset by cuts in government spending, leading to the conclusion that 'in terms of discretionary anti-recession policy, the government's decisions were destabilising'.[72]

By the time of the 1953-54 budget in September 1953, inflation had been checked, international reserves had been rebuilt and the Korean War was over. It was back to business as usual with a balanced budget. Fadden opened his budget speech by announcing cuts to a range of taxes and was able to congratulate himself on how his

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70 The budget speech extracts in this section are from *Hansard*, 6 August 1952, pp 65-78.
71 Whitwell (1986, p 108).
72 Auld (1967, p 339).

Keynesian tools had handled the collapse of the boom; 'equilibrium has now been restored … the action taken proved both timely and adequate … we have now practically attained that stability we set out to achieve in the strenuous days of 1950 and 1951 … the recent boom, one of the sharpest in our history, was brought under control without incurring anything, that, by any stretch of imagination, could be called a slump. That, I venture to claim, was a quite unprecedented achievement'.[73]

Banking and monetary policy

Fadden introduced banking bills in 1950 making the Commonwealth Bank governor answerable to a board rather than to the government. When these were rejected by the Senate, they formed the trigger for the 1951 double dissolution election which gave the Liberal-Country coalition a Senate majority.

Monetary policy had a smaller role than fiscal policy in fighting inflation. Interest rates were increased for the first time since the start of world war two, but there was a reluctance to push interest rates up much, in part due to concerns about inflicting capital losses on those patriotic citizens who had bought war bonds. Furthermore, both the Prime Minister and the Treasury apparently did not regard monetary policy as very potent.[74] There was an increase in special accounts and a lending directive to rein in credit, which were reversed after the economy moved into recession.

In 1952 Fadden attended a Commonwealth finance ministers' conference to discuss a balance of payments crisis in the Sterling area. Fadden refused to accept British suggestions for limits on Australian imports to bolster sterling against the dollar.

When re-establishing the Commonwealth Bank board, Fadden said he had no intention of separating its central banking function. But the private banks complained it had an unfair advantage in its commercial operations and particularly resented the special accounts. In 1953 the Commonwealth Trading Bank was made a separate entity, but still under the overall control of the Governor. The private banks maintained their pressure and in 1957 Fadden introduced legislation for a split.[75] The

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73 *Hansard*, 9 September 1953, pp 41-2. Similarly, when presenting the 1954 budget Fadden was able to refer to 'real and substantial material progress [with]…retial and wholesale prices generally steady throughout the year … we have tasted the fruits of stable progress'; *Hansard*, 18 August 1954, pp 384-5.

74 Treasury argued in February 1951 that 'a government decision deliberately to raise interest rates unless carried to very high levels could not be regarded as an important contribution to anti-inflationary policy'; cited by Whitwell (1986, p 104). Menzies wrote to Fadden in June 1950, 'I have very little faith in the virtue of a rise in interest rates as such a means of restraining excessive investment demands'; cited in Schedvin (1992, p 169).

75 Cornish (2010b, pp 13-17). The bills were much like Theodore's proposals almost three decades before, which were then frustrated by the non-Labor parties in the Senate. Labor and the non-Labor parties had now swapped sides on the argument.

central banking functions were retained in a renamed Reserve Bank of Australia. The commercial banking activities were transferred to a new Commonwealth Banking Corporation comprising the Savings Bank, Trading Bank and a new Commonwealth Development Bank which Fadden regarded as his 'own brainchild … designed to overcome the lack of adequate long-term borrowing finance for farm development and small industries'.[76] The legislation was initially blocked by the Senate but passed when the Government gained control of the Senate after the 1958 election.

Fadden and his colleagues

While 'Menzies did not admit it publicly, he paid great heed to Fadden's opinions on the economy'.[77] Fadden had control of the macroeconomic levers, but McEwen had a strong influence on overall economic policy 'with his controversial all-round protectionism for both the rural and manufacturing industries'.[78] Despite his experience as treasurer, there is little evidence of Page trying to be a 'back seat driver' on economic policy to his Country Party colleague.

Fadden and the economists

Fadden 'fitted in well at Treasury'.[79] He appointed as secretary, and then relied heavily on the counsel of, Roland Wilson — 'the epitome of the "good Treasury man"; confident, authoritative, resolute, academically gifted, coldly logical, acerbic and quick-witted'[80] — but was a 'shrewd assessor' of his advice.[81] Fadden also had a warm relationship with Wilson's deputy Richard Randall, and with Nugget Coombs at the Commonwealth Bank.[82] Treasury was more pro-growth and longer-term than the Bank

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76 Fadden (1969, p 147); Ellis (1963, pp 297-8); and Davey (2010, p 102).

77 Fitchett (1977, p 26).

78 Brown (2002, p 62). Treasury had opposed the powerful new Department of Trade created in 1956; McEwen and Jackson (1983, p 49).

79 McEwen and Jackson (1983, p 57).

80 Whitwell (1986, p 23). Wilson was a strong personality; the formidable 'Black Jack' McEwen, an opponent of Treasury as trade minister, once remarked to Wilson 'you don't terrorise easily'; Golding (1996, p 12). A leading financial journalist called Wilson 'the outstanding public servant of his generation' while even Keynes respected Wilson's wisdom and pertinacity; cited by Cornish (2010a, p 1).

81 Cribb (1996). Coombs (1981, p 132) judged that Fadden 'greatly admired Roland Wilson's capacity, and depended heavily on his judgement, but he found Roland too cold and unyielding for a wholly satisfactory partner. Indeed it could almost be said that he was a little afraid of Wilson's razor-sharp intellect, his intolerance of human frailty, and his acid tongue'. Fadden was not however so overawed by Wilson as to be above a practical joke, once planning to leave a fish in his hotel bed; Fadden (1969, p 141). But his preference was to be accompanied by deputy secretary Randall on his overseas trips.

82 Coombs (1981, p 131).

which was generally concerned about fine-tuning the economy to avoid the short-term risk of inflation.[83]

On gaining office, Menzies proceeded with Chifley's plans of transferring the Economic Policy Division from the Department of Post-War Reconstruction to his own department, giving him an alternative source of economic advice to Treasury.[84] In 1950 Menzies established a National Security Resources Board, based on a similar body in the US, to prepare plans for controls required in any future war, which many ministers thought could be soon. The Board included public servants, business leaders and a trade unionist and was chaired by the prime minister.

Macroeconomic policy in the latter 1950s

Privately Menzies wished Fadden had retired in 1954 after a serious road accident but felt obliged to keep him on as treasurer.[85] By 1957 Fadden was himself tiring of the job, describing himself as 'about as tired and overworked and often as lonely as a drover's dog'.[86] Nonetheless Fadden continued to achieve results. He merged the income tax and social services contribution, making the tax system simpler. He also introduced many changes favourable to farmers such as increasing depreciation rates and abolishing land taxes.

By the mid-1950s inflationary pressures were again building.[87] Once more electoral considerations inhibited action. It was only after the Menzies Government was re-elected in December 1955 that a package of deflationary measures was announced in a mini-budget in March 1956. Spending was cut, company and sales tax were raised, additional taxes levied on alcohol and tobacco and interest rates were increased. With the economy judged to have slowed to 'a state of substantial balance',[88] the 1957-58 budget increased government spending and cut taxes.

While critics described these responses as 'stop/go', overall the Fadden era appeared economically a golden age; with unemployment averaging under 2 per cent and

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83 Cornish (2007, p 231).

84 Lee (1995, p 127).

85 Davey (2010, p 95); Martin (1999, p 269). The accident prevented Fadden from voting at the 1954 election.

86 Fadden, letter to Harrison, cited in Martin (1999, p 367). In his memoirs, Fadden gave as his reason for retiring only that he was physically tired and wanted a long holiday, although he noted that many in politics stay too long. Reid (1961, p 12) also refers to the loss of a deeply-loved son.

87 Menzies wrote in July 1955, 'inflation is once more on the way and some faintly heroic measures will be needed'; Henderson (2011, p 6). Fadden only referred to 'a mild and incipient from of inflation' in his 1955 budget speech; *Hansard*, 24 August 1955, p 29.

88 *Hansard*, 3 September 1957, p 215.

economic growth around 4½ per cent in the 1950s. After the Korean War boom, inflation averaged around 2½ per cent.

The record looks less impressive when compared internationally. The 1950s were a golden age across most of the western world with Australia slipping behind; its average annual growth in real per capita GDP of 1.7 per cent was below the Western European average of 4.2 per cent and slightly slower than that of Canada.[89]

After politics

With his health suffering from the strains of office,[90] Fadden stood down as Country Party leader in March 1958, did not contest the elections that year and handed over the treasurership to Harold Holt in December.[91] (Unusually, he held the treasurer's job for a little while after he ceased to be a member of parliament.)

He was hurt not to be given the chair of the Commonwealth Banking Corporation. He accepted a number of directorships and published his memoirs.

He died on 21 April 1973, survived by his wife, two daughters and a son.

89 The global average was 2.8 per cent; based on estimates in Maddison (2001).

90 McEwen and Jackson (1983, p 57).

91 As he notes in his memoirs (1969, p 148), Fadden was one of the few treasurers to step down voluntarily and know when they are presenting their last budget, and was able to refer to his then record term in his final budget speech; *Hansard*, 15 August 1958, p 20.

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