UNEMPLOYMENT IN AUSTRALIA: THE EFFECTS OF MACROECONOMIC POLICIES

Marc Lombard*

Unemployment in Australia over the last 15 years has been persistently high. Traditional explanations have emphasised inappropriate real wages and other labour market rigidities. On the contrary, the evidence shows unemployment to be primarily the result of the restrictive macroeconomic policies which have dominated economic policy-making.

The Australian Experience

Since 1983, Australia's annual (standardised) unemployment rate has only once been (marginally) below the OECD average: in 1989, when it reached a record low for the 15-year period of 6.1%. This record low, however, was soon followed by a record high of 11.0% in 1992, the highest rate of unemployment since the Great Depression.

Australia's average unemployment rate for the last 15 years stands at 8.6%, compared to 7.4% for the OECD. Yet, while the difference between the Australian and the OECD rates was relatively small throughout the 1980s, it has considerably widened since 1989 (see Figure 1).

Why has Australia consistently been a relatively poor performer in the labour market? The 'rigidities' associated with Australia's unique award

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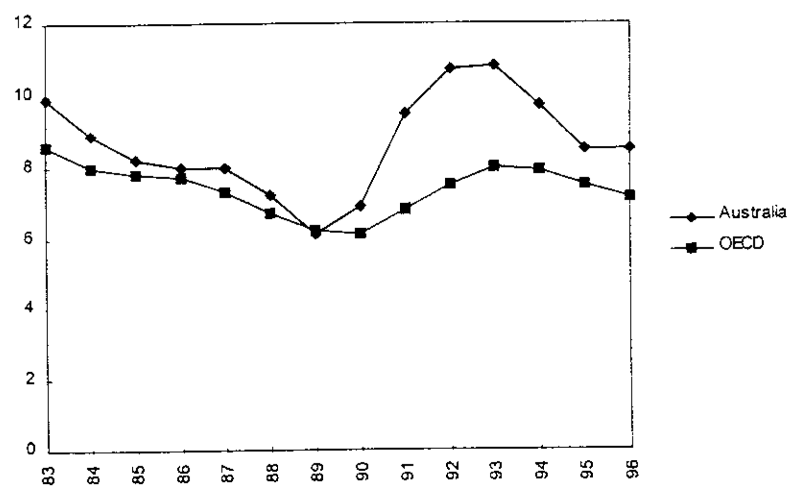
wage system have often been blamed for the relatively high level on unemployment. Yet, empirical evidence is wanting. Paradoxically, it is while Australia has been gradually moving towards labour market deregulation that the unemployment rate differential between Australia and the OECD has been widening. Paradoxically also, Australia's economic growth for the 15-year period has been above the OECD average, yet has failed to deliver a better labour market outcome.

Figure 1: Standardised Unemployment Rates - Unemployment as per cent of Total Labour Force, 1983 - 1996



Source: OECD (1997), *Economic Outlook*

The major explanations for the presence of unemployment are basically threefold: the inappropriateness of the level of real wages, the lack of aggregate demand for goods and services and the existence of a natural rate of unemployment (NRU). These explanations can be labelled neo-classical, Keynesian and new classical. Each can be considered in turn.

Excessive Real Wages?

Excessive real wage levels are often cited as the major cause of unemployment in Australia (see, for instance, Valentine 1993). Yet it is a cause which is not easy to prove. The best unit of measurement to evaluate the effect of wages on employment should be the index of real unit labour costs (RULC) in the non-farm sector. This takes into account the productivity of labour. It is calculated as the ratio of nominal hourly labour costs to average hourly productivity (real gross non-farm product per hour worked by all employed persons), to use the Australian Bureau of Statistics definition.

However, this RULC measure is not without flaws and can produce a misleading perception of the relationship between unemployment and wages. A rise in unemployment may result in an increase in RULC, especially if the majority of those retrenched are low-to-average income earners, as is usually the case. Such retrenchments may cause the average wage cost to increase (on the numerator side) without an equivalent increase of GDP per employee (on the denominator side) since the latter contains non-wage incomes. So causality is reversed; it is not high wages that cause RULC to rise but rather higher unemployment that does so. Similarly, any reduction in gross non-farm product will cause an increase in RULC. This can be triggered by a number of factors such as a deterioration of the current account deficit, a fall in investment or consumption expenditure or budget cuts. In short, RULC is at best an ambiguous indicator when used to assess the causes of unemployment.

In any case, the fluctuations in RULC are much too small to explain why, for instance, the unemployment rate nearly doubled between 1989 and 1993 (see Table 1).

Other units of measurement relating wages to unemployment provide no supporting evidence of high wages being the major cause of unemployment in Australia. Between 1983-84 and 1995-96 award rates of pay increased by 58.6% while prices increased by 76.6% (ABS, 1997, 1993). So there was a fall in real wages during the period while the unemployment rate fluctuated but remained relatively high. Over the same period of time, the profit share of national income (corporate gross operating surplus as a percentage of gross non-farm product at factor cost) increased by nearly 15% while the wage share (comprising non-farm wages, salaries and supplements) decreased by 5% (ABS, 1997, 1993).

Table 1: Unemployment Rates and Real Unit Labour Costs

Year	Unemployment Rate	RULC*
1989-90	6.2	96.8
1990-91	8.3	97.8
1991-92	10.2	98.2
1992-93	11.0	97.7
1993-94	10.5	97.3
1994-95	8.9	96.6
1995-96	8.5	97.3

* Real unit labour costs in the non-farm sector

Source: ABS (1997)

The OECD's own study of unemployment (OECD,1994) points to the increased wage dispersion that has occurred in English-speaking countries in recent years. In the case of Australia, the real wages of low-paid workers (workers in the tenth percentile of the overall earnings distribution for males) fell over the 12-year period under consideration, 1980 to 1991. So it is hard to see how excessive real wages could be the major cause of unemployment in Australia.

A point worth noting is the distinction between the original neo-classical theory of labour market and its current selective interpretation. Originally, inappropriate wages, because they were either too low or too high, were seen as an impediment to reaching market equilibrium between supply and demand for labour. Nowadays, the expression 'inappropriate wages' is no more than a simple substitute for *excessive* wages, and 'flexible labour market' virtually refers to a market where wages are predominantly flexible *downwards*.

A Natural Rate of Unemployment?

The new classical theory of unemployment is based on the so-called 'natural rate of unemployment' (NRU). A variation on this theme which has been adopted by 'new Keynesians' is the 'non-accelerating inflation rate of unemployment' (NAIRU) which avoids the perception that unemployment is inevitable but emphasises the difficulty of reconciling full employment and low inflation. The NRU is, in its original form, no different than the neo-classical view of unemployment, since Friedman (1969) explained unemployment in terms of workers' response to real wages. If we remove the unwillingness or incapacity to work at prevailing market wages (i.e., voluntary unemployment) from the concept of the NRU or NAIRU, we are left with an amalgam of different causes of unemployment broadly divided into two components: frictional and structural unemployment.

The major aspect of the structural component, the so-called mismatch in the labour market, explains unemployment in terms of inappropriate skills. Reference is sometimes made, for instance, to an alleged pool of unskilled labour unable to handle the latest technologies. This explanation of unemployment can easily be dismissed in the case of Australia, as well as in most OECD countries, by relating the number of vacancies to the number of job seekers. In 1996-97, in Australia, there were 77 vacancies per thousand unemployed: the annual average for the last 7 years is 55 vacancies per thousand unemployed (ABS, 1997). Had the unemployed had all the skills required, 95% of them would still not have found a vacancy.

The second component of the NRU, frictional unemployment, usually refers to job search, involving people in-between jobs or new entrants to the market. It also refers to labour market rigidities associated with welfare states. These rigidities are manifest in three forms: high 'income replacement' ratios, restrictive hiring and firing rules and non-wage labour costs. However, it can be shown that these factors have little application in determining the cause of relatively high unemployment in Australia.

The income replacement ratio, relating disposable income while unemployed to disposable income when employed, is a measure of the 'generosity' of unemployment benefits. Australia's benefits are actually far less generous than the European Union's, since they are meant to provide only a minimum income in order to survive and are not an attempt to maintain past wage income. As an indication, Australia's standard unemployment benefit for a single-earner household in 1994 stood at 37% of an average production worker's total earnings, well below the OECD average of 55% and far behind the income replacement rate of Northern European countries (see Table 2).

Table 2: Income Replacement Rate

(Unemployment benefit for a single-earner household as percentage of an average production worker's earnings -1994)

Country	Percentage
Sweden	80
Denmark	86
Netherlands	70
OECD Average	55
Australia	**34**

Source: OECD (1997). Economic Survey, Australia

Similar reasoning applies to the other two aspects of labour market rigidities - hiring and firing rules and non-wage labour costs - in that their application in Australia is much more narrow than in the European Union member countries. Employment protection laws, redundancy payments, employers' compulsory contributions to employees' social security funds make employment - and dismissal - in most European Union member countries more onerous and less flexible than in Australia. Yet, despite these rigidities, unemployment in Scandinavian countries (all of which are members of the European Union except for Norway) has been on average much lower than Australia's. If we take the example of Sweden, for instance, a country that has had a well-developed welfare state, its performance in the labour market has been far better than Australia's. Throughout the 1980s, Sweden's annual unemployment rate never exceeded 4%[1]. In the case of Norway, it never exceeded 5%. Finland's never exceeded 5.5%. During the same period of time, Australia's unemployment rate fluctuated between 6% and 10% (OECD, 1997). Obviously, the major reason why Australia has been a relatively poor performer on the unemployment front cannot be attributed to these labour-market rigidities.

Deficient Aggregate Demand?

The third major theory of unemployment, the Keynesian one, explains unemployment as the result of aggregate demand deficiency. The validity of this explanation can be assessed by examining variables that impact on demand, i.e. real interest rates, cyclically adjusted fiscal balance and world trade. This analysis also draws attention to the influence of monetary and fiscal policies.

Restrictive Monetary Policy

Empirical evidence on interest rates shows that monetary policy in Australia, relative to other leading national economies, has been restrictive in the last 15 years.

For the period 1983 to 1989 Australia's short-term real interest rate, averaging nearly 7%, was well above those of the 3 largest economies, the USA, Japan and Germany. Since 1990, the interest rate differentials have widened further. While Australia's real interest rate dropped to an average of nearly 5% for the period 1990-1996, it was more than twice the average Japanese rate and three times the average US rate.

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1 Coincidentally, the rise of unemployment in Sweden in the 1990s (reaching a peak of 9.8% in 1994) occurred at the time of labour market deregulation and followed the election in 1991 of a conservative alliance, after 60 years of social-democratic government.

Table 3: Real Interest Rates* (Annual Averages)

Year	Australia	USA	Japan	Germany
1983-1989	6.9	3.8	4.0	3.7
1990-1996	4.9	1.4	2.3	3.7

* These are 3-month money market interest rates. Real rates have been calculated by subtracting the percentage change in the CPI since the previous year from nominal rates.
Source: OECD (1997)

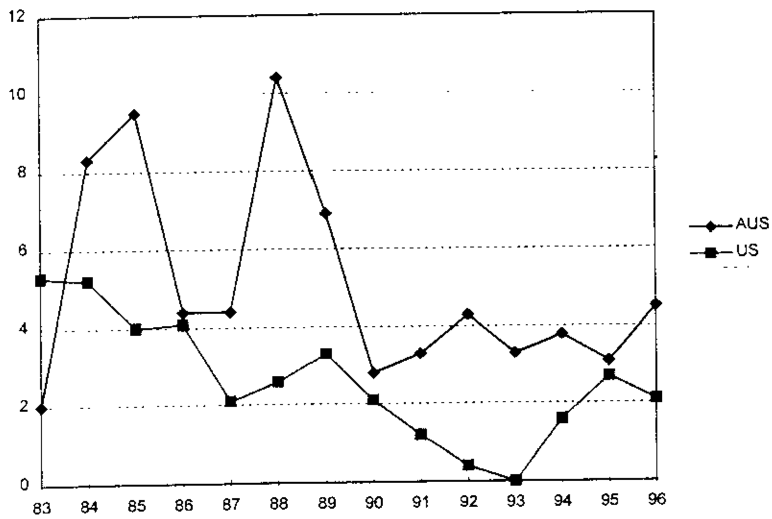
The use of restrictive monetary policies in Australia has basically been the result of three overlapping phenomena: the perennial current account deficit, the deflationary process and the resurgence of the classical school of thought as the new economic orthodoxy.

The first issue - the current account deficit - arises from Australia's growing foreign debt. Between 1984 and 1986 Australia's terms of trade fell by nearly 13 %. The subsequent depreciation of the Australian dollar was largely responsible for more than doubling the net foreign debt (through the 'valuation effect') over the two years, from 15.3% of GDP to 31.4% (ABS, 1993). The corresponding increases in Net Income outflows (mainly comprising interest on this debt) was the major component in the growing current account deficit. The then Treasurer expressed his concern that Australia might become a 'banana republic'. The policy response was to curb the demand for imports, via a contraction of the economy, leading to what the Treasurer called 'the recession we had to have'. Real interest rates rose from 4.4% to 10% (see Figure 2) and fiscal policy was tightened. The increase in nominal interest rates was also aimed at redressing the Australian dollar in order to prevent the imported inflation that the massive depreciation of the dollar in 1985 would have engendered.

Ten years later, the current account deficit is still present, even larger but the issue has subsided somehow in its political priority. In the meantime, the validity of resorting to macroeconomic policy to address what is mainly private foreign debt, and the appropriateness of using monetary policy to target the current account deficit have been seriously questioned (Anderson 1995, Pitchford 1989, 1990).

The second objective of restrictive monetary policy was to control inflation. Inflation, in 1986-87, had climbed to 9.2% per annum. Contractionary policies were then seen as necessary to reduce the inflation rate to what was considered an acceptable level. By 1992-93, Australia's annual inflation rate had declined to just 1%.

Figure 2: Real Interest Rates*- Australia and USA, 1983-1996



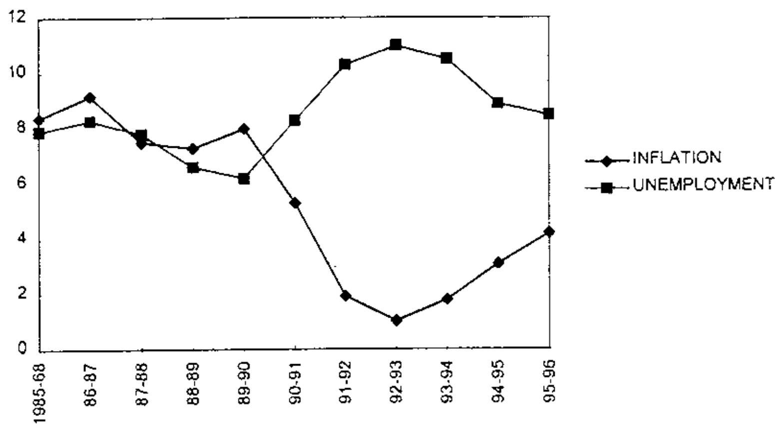
* Real interest rates have been calculated by subtracting the percentage change in the CPI since previous year from nominal rates. Nominal interest rates used are 90-day bank-accepted bills.

Source: OECD (1997). *Economic Outlook*

Reliance on tight monetary policy, however, has had a substantial and prolonged detrimental impact on unemployment. The sharp increase of real interest rates in 1988 (when they reached 10%, the peak level for the period under consideration) was followed by Australia's worst recession since the Great Depression, with unemployment rising from 6% to 11% by 1992. In the words of a former Labor member of Parliament: " This stunning misjudgment ... drove up unemployment faster than in any Western country (other than Finland)" (Langmore, 1994).

In the early 1990s, real interest rates in Australia were still 3 to 4 times higher than the US rates. While the disinflationary process has been successful, it has been at the expense of keeping the unemployment rate high even as the economy moved out of the recession. The Australian experience over the last 12 years indeed indicates a nearly continuous trade-off between inflation and unemployment (Figure 3)

Figure 3: Inflation* and Unemployment in Australia



* Measured as the percentage change in the Consumer Price Index from the previous year

Source: ABS (1997 & previous years). *Australian Economic Indicators*

Fiscal Restraint

Fiscal policy has also been a vehicle for restrictive macroeconomic effects. This policy has an ideological nature, rather than being aimed at correcting short term economic disequilibria. Throughout the Western world, the neo-liberal commitment to smaller governments and freer market forces has come back in force, since the perceived failure of Keynesian economics and policy in the 1970s. Neo-liberals see government intervention in the economy as more detrimental than beneficial, and thus the thrust is now towards reducing the size of public expenditure, even at times of high unemployment. Indeed, the new classical theory postulates that unemployment is best reduced by tightening fiscal policy (in order to achieve a balanced or surplus budget). This fiscal restraint leads to reduction in public borrowing and hence to lower interest rates. These lower interest rates are then expected to stimulate investment which, in turn, would foster increased employment. The theory makes a major assumption: that increased saving will automatically turn into investment, regardless of the state of the economy and therefore of market confidence. If the assumption does not hold in practice, the process of reducing the budget deficit in order to reduce unemployment can actually increase the deficit. This is Vickrey's deficit paradox (Vickrey, 1992), where the short-term effects of cuts in public expenditure aggravate the unemployment problem and result in larger budget deficits.

Of course, fiscal restraint is not a novel idea. Balancing the government budget had been used - with disastrous results - as a policy to reduce unemployment in the USA in a vain attempt to stymie the burgeoning Great Depression in the early 1930s. In more recent times, the trimming of public expenditure has been accompanied by the so-called 'rationalisation process' in the private sector, whereby profits are realised via the pursuit of cost-cutting measures rather than through the pursuit of increased capacity. The outcome of these cost-efficiency measures is often further unemployment.

Increasing saving *per se* (whether public or private) as a way of reducing unemployment is a questionable policy, as Keynesian economics has always emphasised. In the absence of a corresponding increase in investment, increased saving simply leads to a contraction of both the economy and the employment level via the well-known paradox of thrift - increased saving reduces the effective demand for goods and services, which pushes incomes down and therefore undermines savings. This is a recipe for recession.

Conclusion

Traditional explanations for the presence of unemployment, such as the effect of wage rigidities and the structural and frictional aspects of the so-called 'natural rate of unemployment', cannot account for the persistence of relatively high levels of unemployment in Australia. They certainly cannot explain the substantial increase in unemployment which occurred in the early 1990s. The evidence indicates that the real cause of Australia's poor performance in the last decade has been the pursuit of restrictive macroeconomic policies, in a vain attempt to rectify the increasing current account deficit in the late 1980s and, over a longer period of time, also with the objective of reining in inflation. There has been an underlying belief in the power of market forces alone to deliver low unemployment. This adherence to new classical thinking in economics has led the government to gradually reduce its role in the economy, by embracing the concept of fiscal restraint as a panacea for good economic management.

Australia is not alone in that regard. These policies are also pursued in different degrees in both the USA and the EU. In the USA, greater labour market flexibility has masked the problem of unemployment, via a proliferation of part-time jobs leading to greater wage dispersion (see OECD, 1994); whereas the EU experience of a positive relationship between restrictive macroeconomic policies and higher unemployment is not unlike Australia. While restrictive macroeconomic policies alone do not explain the presence of unemployment in Australia or in any other contemporary capitalist economy, they nonetheless have much more to answer for the persistence of unemployment in Australia than any other cause.

Unemployment must be seen as a profound failing of the market, not as a situation that can be cleared by market forces alone (nor as one resulting from choosing idleness). As pointed out by Keynes, market equilibrium in terms of aggregate supply and demand can be achieved even with massive unemployment. As such, unemployment needs to be corrected by government intervention in the economy, just as government intervention is needed to promote competition or reduce negative externalities. As Eisner (1989) pointed out, in reference to the US recession in the early 1980s, "it was the old-fashioned Keynesian stimulus of real budget deficits that has contributed mightily to cutting unemployment in half from its recession high of almost 11%". In the same way, the Australian government, rather than pursuing a policy of budgetary cuts, such as those currently affecting education, should instead embark on a job-creating expenditure programme that would directly address the perennial problem of unemployment.

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