

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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THIRTY YEARS ON: THE INDUSTRY POLICY AGENDA

Thirty years ago this month, the Australian government announced that it would cut all tariffs by 25%. The scars would remain for many years but it proved a seminal step in giving Australia a more open economy. Importantly, industry policy was moved to centre stage.

The 25% tariff cut made in July 1973 by the Whitlam government was, by many standards, a genuinely poor policy decision. However, opportunities for a more prosperous Australia in subsequent years were created through the reforms and policy adjustments which had to follow.

The policy making culture in the 1960s and 1970s was very different from today's. It was widely believed that industry could be fostered with assistance from government. In Australia, that assistance had come largely, but not exclusively, through the tariff.

The tariff on manufactured imports permitted domestic producers to raise their prices up to the limit allowed by the landed price of imported goods plus the tariff. If those purchasing the goods could recoup the higher cost from others, the cost of the tariff could be passed on. Otherwise, the cost had to be absorbed by the buyer.

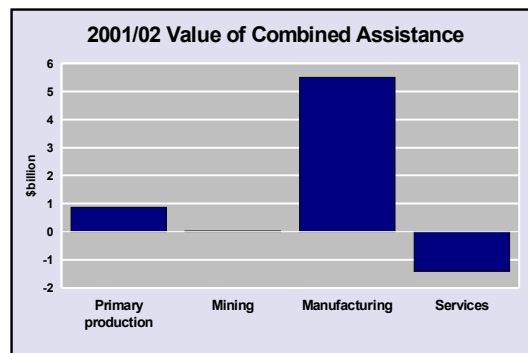
A debate had been raging for years between the manufacturing lobby and those who thought that the support being given was too costly to justify the benefits.

The Tariff Board, which had been leading the opposition, had estimated that measures supporting manufacturing were equivalent to an effective rate of assistance of 35% of the sector's value added. There was little evidence that manufacturers were weaning themselves from the benefit as they were supposed to do as a sign of greater maturity.

Generally speaking, the conservative side of politics supported the tariff arrangements which were seen to be good for their business relations. A minority dissented but made little headway. The union movement, too, was supportive. For the unions, the tariff was seen as supporting job numbers and membership.

Then came the shock: the Whitlam government decided without warning to cut all tariffs across the board by 25%. Even those who opposed using the tariff as an industry development tool regarded this as extraordinarily bad policy.

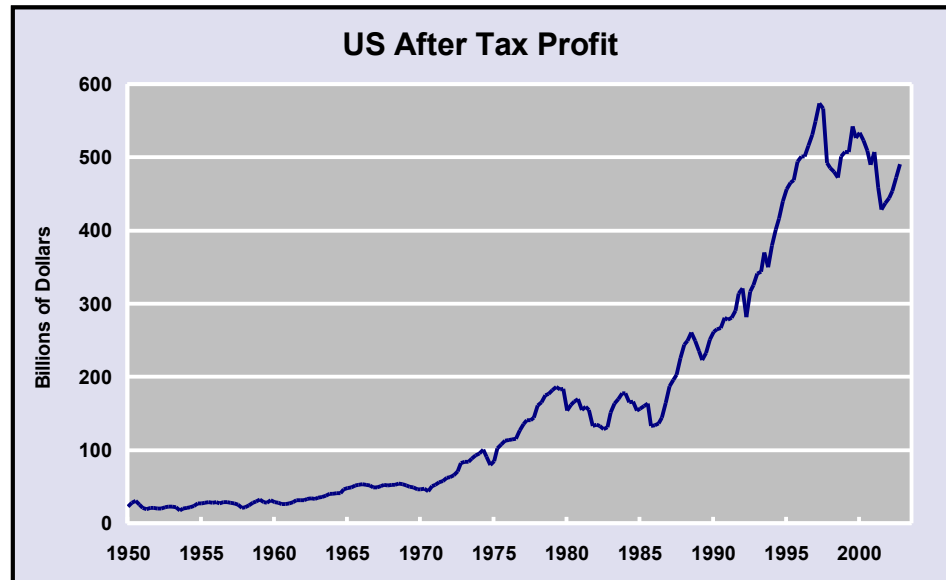
- The social impact was largely unplanned. Subsequently, policies had to be cobbled together quickly to meet the needs of the many thousands who were affected by the change, some in regional centres which were disproportionately reliant on manufacturing industry.
- The burden of adjustment was uneven. Businesses fully utilizing the available protection were more likely to be damaged than those for whom the tariff was excessive and unnecessary.
- This was a government decision from which key advisers (such as Treasury offi-



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THE WEEKLY CHART SPOT

A recovery in US corporate profitability is happening. After tax profits rose by 3.7% in the latest March quarter to be 12.2% higher than a year earlier. The recovery still leaves them 15% short of their peak in the fourth quarter of 1997.



Source: US Bureau of Economic Analysis

ASSET MARKETS: LET THEM RUN? CONT'D

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that these were likely to so change the relationship between consumers and suppliers and amongst businesses that a large slab of the profits of traditional companies would be shifted to the new economy companies. Their values shot up in anticipation of the change.

By the peak of the market, in the third quarter of 2000, there was some objective evidence that the re-pricing process had gone too far. Many of the prices implied rates of growth on a continuing basis which were unrealistic in just about any circumstances.

At what point, if any, in this sequence should the Federal Reserve have stepped in? Arguably, it discerned that the market was overvalued only when the rest of the market was coming to the same conclusion. Clarity of vision only came with hindsight.

A NASDAQ at 5500 was clearly too high. But at 3000, more than twice the current level, there was still over 80% to go. Given the momentum, how much would the Fed have had to hike interest rates to bring the price momentum to a halt? Who knows? But a considerable effort might have been required. And the cost might have been widespread economic hardship as interest rates were used to target lower asset prices just as activity was already slowing.

The Reserve Bank is in a similar position

with the housing market. Housing prices have increased by some 45% in Sydney and 35% in Melbourne over the last two years according to the Australian Bureau of Statistics. A \$700,000 house in inner city Melbourne is now commonplace. Should this be a matter of concern when a house similarly positioned in Sydney (albeit closer to one of the world's great harbours) could sell for four times as much?

Recognizing that only a small number of people are paying such prices, should this be of concern, even if they subsequently lose money?

In fact, speculating about turning points in asset prices is no role for a central bank. It is no better equipped than the global funds management industry, all of whose analytical resources are directed to picking asset market turning points.

Central banks, too, will be captured by the momentum of the market or will cut short legitimate price adjustments.

That does not mean that they should be oblivious to asset values. If high house prices are likely to push general price inflation beyond the 3% barrier there might be cause for action. If declining equity prices are having a detrimental effect on buying power leading to weaker growth, there might be an argument for some offsetting policy action. Failing this, however, it might be preferable for the central bank to simply watch.

ASSET MARKETS: LET THEM RUN?

Should the Reserve Bank (or any other central bank) be concerned with asset prices or should it allow individual markets to run their course?

Rising Australian real estate values have been cited as the principal argument for higher interest rates in Australia. Against that are five factors:

- a slowing Australian domestic economy;
- uncertainty about the US economy, clear weakness in Japan and sluggish European activity;
- US policy interest rates which have been reduced to near historical lows
- domestic inflation which appears to be well contained; and,
- a relatively strong Australian dollar which is helping to control inflation as well as weaken the penetration of overseas markets by Australian exporters.

Looked at objectively, the balance of the argument appears to be clear-cut: the Reserve Bank should reduce interest rates.

And yet, history suggests that residential housing and unit developers need the heavy hand of a tighter monetary policy to prevent periodic bouts of uncontrolled

speculation. Some of the commercial banks appear to have been persuaded that the risks of lending for inner city units have risen to the point that they should curtail further lending activity for such assets. That being so, the balance of risks seems to have already shifted toward prices moving lower since liquidity is a necessary ingredient for the speculative end of the building development market to sustain itself.

For the banks, prudence requires ongoing risk management. Unfortunately, irrationality is too often in eye of the beholder.

Rising asset prices can often be justified. During the ten years after 1986, the average rate of profit growth in the USA was 14% a year compared with a long term average annual increase of 4.5% prior to that. At the same time, inflation was falling delivering lower interest rates which justified a reduction in target rates of return. On both fronts, there was scope for the market to undergo a significant reappraisal of value.

Meanwhile, there was considerable speculation about the changes likely to be wrought by developments in the information technology industry. Many thought

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THIRTY YEARS ON: THE INDUSTRY POLICY AGENDA CONT'D

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need for a planned approach implemented with ample warning is the only means of achieving sustainable assistance reductions.

There is now widespread agreement that reduced tariffs have helped deliver a more robust industrial base and, with more emphasis on productivity growth to sustain its competitive position, industry has become less reliant on government decisions and more reliant on its own skills and innovation.

Thirty years on, industry policy is focused at two levels:

- sectoral policies based around relatively low tariffs and budgetary assistance; and,
- opening new markets for Australian businesses through
 - ~ multilateral trade negotiations under the auspices of the WTO, and
 - ~ bilateral trade negotiations under

so-called free trade agreements

Large welfare benefits can no longer be obtained from withdrawing assistance from local industry. Further gains from trade will have to come from other countries accepting what Australia has already learned and opening their markets to stimulate greater competition and productivity.

The multilateral route is proving to be frustratingly slow. While bilateral negotiations with the USA have begun speedily enough, the Australian trade minister in the past week has suggested that the US team's offer falls short of what Australia had expected.

Meanwhile, it seems from the Prime Minister's recent visit to Japan that bilateral openings there are also limited. And, of course, hopes that the Europeans will have a change of heart on their agricultural subsidies is beyond even the USA, let alone the more modest influence of Australia.

THIRTY YEARS ON: THE INDUSTRY POLICY AGENDA CONT'D

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cial) were excluded so that many of the implications of the change had not been canvassed fully. Their exclusion engendered mistrust which lingered for many years after.

- The unilateral initiative reduced the scope for reciprocity in trade negotiations with other countries.
- A public backlash stalled further attempts to reduce industry assistance and even helped promote some restoration of previous levels.

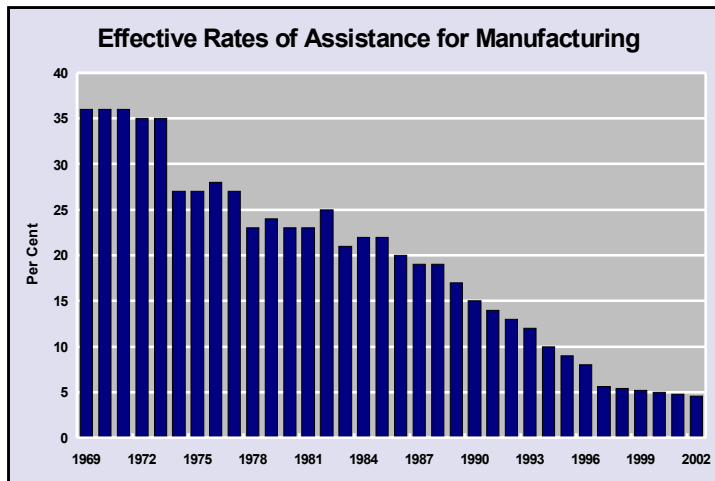
The silver lining in a chaotic policy environment was that industry policy was brought to the forefront of the national debate. Economic policy was no longer simply about interest rates, taxation, expenditure and the occasional centralized wage case decision.

Even so, the immediate aftermath of the tariff cut required much attention. The timing was appalling. Australia was slipping into a recession as the cut was occurring. Unemployment more than doubled in the subsequent 12 months, kept rising and would never again be so low. Economic conditions became entwined in the minds of many with the tariff changes.

Industry policy became part of the political debate. A young John Howard, campaigning in Tasmania in the 1977 election, promised unemployed workers that they should have the protection they needed. By this he meant to convey that previous protection levels would be reinstated. Only years later when the political climate changed did he make his reputation for opposing interventionist industry policies.

Meanwhile, the charter of the Industries Assistance Commission was broadened and its review role greatly expanded.

While it consistently advocated lower protection levels, each of its many reports offered the chance for governments to



review and provide more than the recommended level of assistance which they did frequently. The level of manufacturing industry assistance was little changed until the mid 1980s.

Nonetheless, considerable analytical work followed and the experience with structural adjustment policies in the 1970s evolved into the motor vehicle plans and other industry specific initiatives in the 1980s and 1990s which have helped to boost the international competitiveness of Australian manufacturing.

The Productivity Commission estimated that in 2001/02, manufacturing received total assistance from tariffs and budgetary measures of some \$5.5 billion. Another \$874 million went to primary production. The services sector actually suffered a net subtraction in value of \$1.4 billion as a consequence of the assistance flows. However, the effective tariff rates had fallen to under 5% - one eighth of what they had been at the time of the 25% tariff cut.

Further cuts have been foreshadowed. The argument now is whether they are any longer significant. If assistance is so low, why bother? On the other hand, if assistance is so low why not clean it up once and for all? But the 1970s experience still looms and with it the key lesson: the

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