

Keating and the Consequences of Austerity

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It was Max Planck, a modern-day secular saint of German science, who said that new ideas advance with funerals; that is, old ideas die with the those who hold to them. It was Planck's discovery of the quantal nature of energy that was a foundation stone of quantum mechanics - a driver of our digital world. Albert Einstein, who immediately grasped the significance of Planck's work, said that when he read Planck's 1900 paper he felt the earth move beneath him. Yet it was ironic that the deeply conservative yet brilliant Planck refused to accept the reality of his discovery, believing it to be a mathematical contrivance to explain his observations. Indeed, Planck's conservative views died with him.

Paul Keating's career in Australian government outlined in two of the more recent biographies by O'Brien and by Bramston respectively reveal the economic consequences of adhering to outdated assumptions against contrary evidence. One may stare for years at the obvious, mired in theory that is nothing less than back to front to the reality that stares back. One cannot blame Keating, undeniably our most influential leader since Federation, because first of all he was not trained in economics - not that that has been of help to many others - and secondly, on taking the job of Treasurer in 1983, he was dropped into the views held by highly regarded Treasury Department economists. Like the leap from traditional thinking that Planck could not make even given his brilliance, many economists trained in traditional economic schools appear unable to make the turnaround from "gold-standard", monetarist thinking to the realities offered by an independently floating currency. As in science, it seems economics may only advance with funerals.

Kerry O'Brien's "Keating" is a remarkable insight into the history of the Hawke/Keating era, not only because O'Brien lived and breathed the whole episode as political reporter, but because Keating was allowed unedited space to respond to some quite hard questions put by O'Brien. The book provides a sweeping review of the period as seen through the lens that both O'Brien and Keating saw events. For better or worse the Hawke/Keating era was one of profound economic change that brought about the modernisation of the Australian economy - the dollar was floated, the financial sector deregulated, banks exposed to foreign competition, significant taxation reform, the Incomes and Prices Accord enacted, enterprise bargaining introduced, tariffs removed, superannuation enacted, and very significantly, Mabo in Keating's last term in office.

The more recently released Keating biography by Troy Bramston is an equally remarkable though more objective companion to the personal insights of O'Brien and Keating, taking into account existing biographies and interviews with those whose political and public service careers intersected with Keating's.

Between the lines, both volumes reveal how neoliberalism and its monetarist consequences, once the preserve of the conservative side of politics, have become a fortress of group thinking across the whole spectrum of politics, business and the press - every night on TV we hear comment on "balancing the budget" - the dogma has been normalised and anything contra is now heresy. The Hawke/Keating leadership certainly pushed Labor against the concerns and occasional outrage from the caucus left to where it stands today.

O'Brien's book is also a page-turner insight into Keating's powerful influence over cabinet, caucus and the Lower House - YouTube clips of Keating's parliamentary performance confirm the powerful theatre he used to cow the opposition into submission. There is no doubt then that the power of his energy and personality steered the Labor government in the direction he believed to be the right path - and in budgetary terms, the monetarist path that Treasury Department believed to be the only path.

Labor won office in March 1983 in the midst of a recession that had run from October 1981. As O'Brien put it, the new Treasurer was faced with double-digit unemployment, inflation and interest rates, a serious decline in the balance of trade and a fifty-percent larger than expected budget deficit - "the country was in a mess". There had been a significant decline in the gross domestic product and as put by Keating, there was a wages explosion and investment was "falling through the floor". Early in the period Bob Hawke and Ralph Willis had brought the Prices and Incomes Accord from the Australian Council of Trade Unions (ACTU) into cabinet - a mechanism to bring wages growth under control - "business profits had been shot to pieces and the country was massively uncompetitive". The Accord itself together with the suite of complementary reforms that it brought was revolutionary in its success in bringing industrial harmony, stability and growth to the economy.

Although the US had decoupled its currency from the gold standard in 1971, other currencies including Australia's, that were previously "pegged" to the gold standard via the US dollar, remained to stay in line with the value of the US currency that then floated against the price of gold. Significantly, after the US dollar was floated the tonnes of gold hoarded at Fort Knox were no longer needed to support US currency. For those currencies remaining pegged to the US dollar, their solvency depended on maintaining sufficient foreign currency reserves, like the gold needed to back the US dollar before 1971. Both the Soviet Union and Argentina were two examples of the catastrophic failures that can befall pegged currencies under severe current account deficits, not to forget the current plight of Greece, Italy, Spain, Portugal and Ireland that all deal in someone else's currency - the Euro; unlike others that retained their own independent floating currencies. In Australia's case, the new Labor government had to significantly devalue the Aus dollar almost immediately after taking government in 1983 - the "crawling peg", as Keating put it, was moving too slowly to cope with speculative pressure brought on by ongoing trade deficits. In contrast, in compliance with IMF advice Russia had attempted to defend its pegged currency against all comers before taking the decision to float too late only after it had defaulted on domestic and foreign debt.

It was not long after achieving government that Keating's most significant moment of realisation came to him when reading the previously shelved Campbell Report, prompting him to question the validity of the pegged currency - the inability of the "crawling peg" to effectively adjust the dollar against speculative pressures. Although Treasury totally opposed such an initiative Keating went on to float the dollar¹ enlisting senior Reserve Bank officials who were willing to prepare for and implement such a change.

Throughout his job as Treasurer Keating's undying mission beyond economic and structural reform was the goal of budgetary surplus - unless government expenditure is matched by tax revenues and foreign trade provides a surplus, then "we are living beyond our means". As a consequence, the pursuit of the holy grail of surplus became an annual round-the-clock grind in the Economic Review Committee preparing for May Statements and annual budgets. The quest for savings in a "line-by-

¹ There are conflicting claims between Hawke and Keating as to who initiated what over several policy areas.

line search" through every departmental budget over time added to the physical and mental burden on both Keating and his senior colleagues, all with their own portfolios to worry about. Ultimately, Keating ended up burned out and others departed in a state of exhaustion. Indeed O'Brien's book contributes in part Keating's mental and physical exhaustion to the ultimate defeat of Labor.

Treasury's view unflinchingly rested on monetarist macroeconomics that unnecessarily generates a suit of complementary dogmas that were and are not at all appropriate to a sovereign currency. Because bond sales by policy or necessity are coupled to deficit budgets, the belief follows that bond sales are debt mechanisms necessary to finance deficits. The reasoning therefore follows that deficit spending creates a future burden - both bonds and interest paid on bonds - usually claimed in parliamentary debates to be a debt to be paid off by later generations. Also, as a consequence of deficit spending, bond sales are said to saturate loan markets and therefore "crowd out" private investment. Then there is the "twin deficits" theory that posits budget deficits and current accounts track together in unison.

The "quantum leap" that would turn economic thinking around is evident within the unedited statistics to be observed when national sectoral balances (these being government, private and foreign sectors) for any country running a sovereign currency are graphed out over time. A surplus in any one sector is invariably reflected as a mirror-image deficit in another sector and vice versa, regardless of economic theory or beliefs. This is impersonal currency karma - it just happens. The concept does take more explanation as to why "it just happens". However, the intention here is not to provide a primer for alternative macroeconomic thinking, but an examination of the consequences brought by a combination of neoliberal policies and budget austerity during the Hawke/Keating era.

Unless governments and those who advise them can come to grasp the realities of sectoral balances, they will continue to swim against an economic tide that is beyond their control - somewhat akin those who believe that nature can either be ignored or controlled - the environment just fights back. Once sectoral balances are understood it becomes clear that the tenets of monetarist macroeconomics actually happen to work in reverse when applied to a sovereign currency - deficits are a necessary function of government if full employment is to be achieved; bond sales do not "finance" deficits - rather, the necessary function of bond sales is to mop up excess liquidity consequent to government spending. In explanation, government spending has to end up somewhere - mostly in bank accounts. Without an option for higher returns on excess liquidity, there would be no demand for interbank lending and no avenue for the Reserve to defend its target rate that would consequently sink to zero. Bond sales are therefore nothing more than swapping of excess cash accounts for interest-earning term deposits. Furthermore, bond sales do not "crowd out" investment because the stability of the interbank lending rate is both determined and defended by the Reserve Bank; private sector lenders will set rates at whatever the market will support or the Government may tolerate. And the "twin-deficits theory" is baseless because it contradicts the evidenced of sectoral balances.

By 1986 the impacts of the Hawke/Keating structural and economic reforms had taken hold with an "alarming" rise in the negative balance of trade and the value of the Aus dollar was plunging; all seen by Keating to be signs of a looming disaster prompting his infamous "banana republic" statement - that "we are living beyond our means". In response to the "looming disaster" the Reserve Bank incrementally pushed interest rates to exorbitant levels to attract foreign investment, promised tax

cuts were deferred and a decision for severe expenditure restraints in the 1986 budget was agreed to by cabinet. The dominating view across politics, Treasury and the media being that national prosperity, no matter how contradictory this may sound, depended on a current account surplus that had to be achieved at whatever cost to the country. Both government and the Reserve Bank began pulling all the wrong economic levers - disrupting the economy and creating discontent and misery for burgeoning jobless numbers, home owners and small business. Government spending into the private sector was progressively strangled resulting in rising unemployment and interest rates distressing those dependant on debt to finance homes and businesses - eventually seeing the flight of Labor's heartland to "Howard's battlers". The sense of crisis that Keating unleashed created another crisis that was later to see the end of the Keating-Hawke relationship - a relationship that had created the most successful reforming government since Federation. Going into the 1986 budget, \$3.5 billion was cut out of the deficit - Keating "wanted ultimately to reach the point where the call on Australia's savings was zero at worst, or better still, in surplus". One may well ask, "what savings, or whose savings or, where are these savings?"; in truth, just a fiction no-one seems to question.

Again, the 1987 May statement according to O'Brien delivered the biggest ever public-sector spending cutback in health, education, welfare and jobs programs - estimated by Keating to have a current value of between \$15 to \$20 billion at the time of O'Brien's interviews. A consequent \$27 million deficit was delivered - almost a balanced budget that delighted conservative commentators even though interest rates were around a shocking 14%. Keating boasted a "24-carat budget in a golden age of economic change." Later in '87 the Reserve Bank lowered interest rates and growth began to pick up - seen as a triumph for budgetary austerity - more likely a consequence of the Accord.

Outside of Labor government control a stock-market crash followed in late 1987 - O'Brien notes that this held back the Reserve Bank from pushing up interest rates to mitigate signs that "the economy was at serious risk of overheating". Well, what does that mean? It means that private sector borrowing was booming. Keating's austerity measures were certainly mirrored by private sector debt - then blown out of all measure when the deregulated banks saw unrestrained lending as an opportunity not to be missed - the "big four" banks determined not to allow a foothold to the foreign competition organised by Keating. O'Brien quotes a senior Reserve Bank economist who at the time said "Never before in Australian history had so much money been channelled by so many people incompetent to lend it into the hands of people incompetent to manage it." Keating remarked to O'Brien that "after 1986 we lost control of the economy"; no wonder, because despite the consequences of deregulation and austerity so terrifyingly on show, neither Government, Treasury or the Reserve Bank had any idea of the opportunities that the now floating currency offered. Regardless, Treasury continued to cheer on the holy grail of surplus that together with deregulation soon ran the country into "the recession we had to have"; a comment Keating later regretted considering the damage and hurt that the recession did to the country.

The 1988 budget delivered the first government surplus (at \$5.5 billion) since 1953 at the cost of cutting funding to everything that had made Australia a liveable country. By November 1988 the Reserve Bank had pushed interest rates to 18% in an attempt to stem borrowing but "by 1989 borrowing was still increasing at 25% per annum, gearing ratios had doubled and share prices went up at 18% per annum". Again, all the wrong economic levers were being pulled building chaos on chaos that had gone before. In 1990 the government recorded another surplus, this time of \$9

billion. Despite the private sector disaster now evident, Keating again proudly stated that the surpluses were the achievement of six years of heavy work in the ERC. Despite all the "heavy work", the country soon fell into a recession that ran on for two years from 1990.

The dominating neoliberal dogma that demanding both deregulation and relentless budget austerity had unleashed an economic storm on the Australian economy. Dodgy entrepreneurs left insolvencies in the billions, Victoria's Pyramid Building Society collapsed in 1990 and the State Bank of South Australia followed in 1991 with Western Australia wracked by dodgy financial scandals. By November 1992 unemployment had reached 11.3% - the worst since the great depression. In comparison, the damage caused by Keating was a picnic compared to the global financial crises eventually unleashed on the world via Bill Clinton - who like Keating deregulated financial institutions and achieved four surplus budgets in a row.

Apart from Treasury later acknowledging the consequences of deregulation, what were the lessons to be learned? Absolutely none within the political parties. In the end Keating came to the realisation that all the hard work and austerity advised by Treasury had absolutely no effect on the current account balance and he had been "sold a pup" on the "twin deficit theory". On the consequences of austerity, "Treasury's advice not to run deficits because they could never be repaid represented very poor judgement". Regardless of these comments some twenty years later, Keating still held the view that eventually and somehow, deficits must be repaid. By 1991, Keating no longer trusted Treasury - Keating's *One Nation* policy delivered early 1992 was developed in the Prime Minister's Office without Treasury input. Keating's *One Nation* policy saw a return to deficit spending to repair the damage previously wrought by austerity with \$2.3 billion for infrastructure and technical education and \$8.6 billion promised in tax cuts. Yet again a return to surplus was promised - assumed to funded by economic growth.

The irony of course is that Treasury continues to provide governments with flawed advice. And a greater irony that Keating is now somewhat of an economic hero to the right of politics - a super-hero of government austerity.