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Why Keynesian Policy was More Successful in the Fifties and Sixties than in the Last Twenty Years

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Abstract

In the 1950s and 1960s unemployment averaged about 2 per cent. The lowest level of unemployment in the last twenty years was double that and long term unemployment, virtually unknown in the 1950s and 1960s, has been a severe problem. In each period there were two major slumps. We examine the progress of each slump and macroeconomic policy responses in each case, in order to search for reasons for this contrast. The priority given to minimising unemployment rather than restraining inflation is the most important difference between the two periods. Other major principles stand out, the most important of which are that in response to a downturn a fiscal policy stimulus is essential and must play the major part of any response; and that implementation must be swift and then followed up by further measures if necessary.

JEL codes: E12, E32, E62

Keywords

Fiscal policy; economic recovery; economic slump; economic stimulus policy; full employment; inflation; macroeconomic policy.

1. Introduction

The focus of this paper is firmly on unemployment. Underemployment, which is people working fewer hours a week than they would wish, is also a problem but generally is well correlated with unemployment. As is documented below, in the nineteen fifties and sixties even in periods when there was a major downturn in economic activity policy, unemployment was much lower than was the case in the last twenty years. In the 1950s and 1960s unemployment averaged about 2 per cent. The lowest level of unemployment in the last twenty years was more than double that figure. Moreover, long term unemployment was virtually unknown in the 1950s and1960s but has been a severe problem in the last 20 years. In each period there were two major slumps. This paper examines the

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macroeconomic policy responses to each of the four slumps in order to search for reasons for the contrast.

The major conclusion is that the priority given to minimising unemployment, rather than restraining inflation, is the most important difference between the two periods. In the first period maintaining full employment was normally the priority in aggregate demand policy: in the second with few exceptions 'fighting inflation first' was the priority. The clear cut commitment to maintaining full employment in the first period was associated with greater optimism about future prospects among entrepreneurs. Surveys of business expectations are not available for this period, but the results of the optimistic outlook can be seen in the behaviour of entrepreneurs. In addition to this overriding finding, other principles emerge from mistakes as well as successes in each period.

Both 20 year periods[1] contained one very large slump and another slump which although smaller was still very significant. Section 2 describes the two biggest slumps and the policy responses they evoked and Section 3 does the same for the two smaller slumps.

Fighting inflation first was originally adopted when inflation was at a relatively high level due to supply side shocks culminating in the first oil price shocks, and continued with the invalid justification that if inflation was any higher than the current level, it would cause increased unemployment, though why this should occur was never clearly explained. The effect of inflation on unemployment is one of two issues that emerge when the policy implications of the different approaches are examined. This effect is discussed in Section 4 of the paper. The second issue is the importance, or otherwise, of an increasing public debt. This is examined in Section 5 of the paper. Finally, a concluding section draws the threads together.

2. The Slumps of 1951–53 and 2008–10

The 1951–53 slump occurred against a background in which there was a widespread belief that the government both could and would keep departures from full employment brief. At the end of the Second World War memories of the depression of the 1930s were still strong and there were fears that, unless policy measures were taken to prevent it, large scale unemployment might reappear. However, at least in English speaking countries there was confidence that economists now knew what to do to prevent this (Colander and Landreff 1996). A belief both in the importance of full employment and the ability to keep departures from it brief was manifest in the White Paper in Australia in 1945 (Commonwealth of Australia 1945). Unlike both the United Kingdom and the United States, Australia had no dip in real gross national product when the economy changed from producing for fighting a war to producing for peace, though there was a small blip in unemployment in 1946–47.[2] This uninterrupted growth in the Australian economy no doubt helped entrepreneurs and Australians in general to accept the view that the government could and would keep brief any departures from full employment.

The slump that occurred in 1951–53 was caused by an external shock to the Australian economy. It followed a very strong rise in the price of wool. The price of wool in 1950–51 was double the price in 1949–50. Since the exchange rate was fixed to the pound sterling and other major currencies under the Bretton Woods arrangements, this produced an important increase in national income in Australia. The value of wool exports rose by 347 million pounds in 1950–51 compared to a National Income of 3129 million pounds. The next year the value of wool exports fell by 314 million pounds, precipitating a major slump. There are no official quarterly national income and expenditure accounts for this period but judging by the (lagged) changes in unemployment and other data with a cyclical pattern, the fall in economic activity started around the middle of 1951 and continued until at least the end of 1952. On an annual basis current value gross national product deflated by the Consumer Price Index (CPI) fell by 14 per cent in 1951/52 and was virtually unchanged in 1952/53. If composite indexes are used the story is much the same. It is exactly the same, if the most popular of such indexes, a combination of the CPI and the food and basic materials wholesale price index, is used.

As is typical, the change in the unemployment rate lagged behind changes in deflated national income and product. The number of persons receiving unemployment benefits is shown in Table 1. The unemployment rate started to rise slowly in the first half of 1952 then rose rapidly to peak at the end of that year and started to decline in 1953. The Conservative Federal Government acted promptly as soon as there was a significant rise in unemployment, mainly through fiscal policy but also through aggressive relaxation of monetary policy. Tax rates were cut in 1952–53 but the main weapon of fiscal policy was government expenditure. Including special grants to the states to support public works, total Federal Government expenditure increased by virtually one third in 1952–53.[3] This was in current value terms but the rate of inflation though still high had fallen to around 10 per cent.

The stance of monetary policy changed even before that of fiscal policy. Under the institutional arrangements current at the time the central bank required commercial banks to lodge money in Special Accounts with the Commonwealth Bank (a special section of the Commonwealth Bank acted as the central bank until 1960). Money in these accounts was in effect frozen and could not be used to support lending. Over the financial year 1951–52 the amount in Special Accounts was more than halved. This was the first time the value of the holdings in Special Accounts had declined in any year. The central bank also purchased government securities on the open market and relaxed the directions it could give to private banks, under the *Banking Act* (1945–1953), about the general nature of their lending. Further relaxations were made in October 1952. There were also further, fairly modest, reductions in the amount held in Special Accounts and the Commonwealth Bank increased its lending to local government and semi-governmental authorities.

One further point should be made about the use of monetary policy. The boom in 1950–51 was accompanied by a very high rate of inflation. When the stance of monetary policy started to be relaxed, inflation was still over 20 per cent (as measured by the CPI). The central bank moved very early when it would have had good reason to worry about inflation. Yet despite easy monetary policy and explosive fiscal policy the CPI was only 3.9 per cent (or 0.54 percentage points) higher in June 1953 than its value in June 1952. This followed an increase of 20 per cent from June 1951 to June 1952.

The aggressive fiscal and monetary policy kept the rise in the unemployment rate small and remarkably brief. Over the 20 year period as a whole the unemployment rate averaged about 2 per cent. At its peak at the end of 1952 it was probably barely 1 percentage point above that and then fell rapidly, so that in 1953–54 it was below its average value. Entrepreneurs did reduce expenditure on fixed capital equipment a little, but not by much. The big falls were in export income, in1951–52, and inventory investment in 1952–53. It appears that a belief that departures from full employment would be brief was a self fulfilling prophecy.

The slump of 2008–2010 was also the result of events external to the Australian economy. In view of the 2010 election campaigns waged by those on both sides of the political fence it is worth reminding ourselves that the crisis in the global financial sector did cause a major world-wide slump of a magnitude not seen since the 1930s and that there is the strong possibility that it will cause a large ongoing increase in structural unemployment.

The cause of the slump can be epitomised in a comment by Krugman (2009) that the financial sector had forgotten the old truth that markets can stay irrational longer than many financial institutions can stay solvent. Global financial crises follow a typical pattern. They are preceded by a period of increasing asset prices. Business balance sheets improve as a result of the increased value of their assets. This improved business confidence encourages investment. Banks, at the same time, are increasingly happy to lend money for these investments.

Financial crises are often precipitated by banks reassessing their liabilities, and requiring repayment of large loans. Businesses, in order to meet those demands, start selling assets, reducing their prices. This leads to re-evaluation of the balance sheets of companies, with many more being driven into serious debt problems, leading to further sales of assets, and to significant asset price falls (Minsky 1985).

The current crisis followed the same basic pattern with two important differences. First, households, as well as firms, went into significant debt; and secondly there is the role of so called 'toxic assets', in particular those associated with subprime mortgages. The role of credit rating agencies exacerbated the second factor. The new and very complex instruments were given triple A ratings, although in fact they were anything but triple A. Credit rating agencies are paid by those seeking to have assets rated. Credit rating agencies often provide other services for such clients. Either the relevant firewalls were not as good as they might have been or the credit rating agencies were remarkably bad at making rating judgements. In any case, the crisis was triggered by an evaluation that the assets held by many enterprises were, in fact, worth substantially less than their current valuation.

In Australia, the crisis has not only been associated with a substantial rise in unemployment rates, from 4.2 per cent in April 2008 to 5.8 per cent in August 2009, but a significant part of this was long term unemployment. This increased by 50 per cent in the year following its trough in June and July 2008. The following year it was higher again. This contrasts greatly with 1951–53, when total unemployment rose by just over half as much and long term unemployment was virtually unknown.

Substantial falls in GDP occurred too, though not in successive quarters. Prices especially of staples also fell, for example the CPI fell by 0.3 per cent in the December 2008 quarter rising in the quarter to March 2009 by only 0.1 per cent. The annual rise in the CPI was 2.5 per cent for the year to March 2009, compared to an annual rise of 3.7 per cent to December 2008.

The Rudd Government's response to this was timely and at first exemplary, but needs to be set in context. In Australia the effects of the global financial crisis were much less serious than in most developed counties. This is largely due to two reasons. First, both the Government and the Reserve Bank acted quickly to stimulate the economy. The speed and size of the increase in government expenditure was the most important part of the stimulus, but the large rapid cut in interest rates also helped. Secondly, our banks were much better supervised than were the banks in many other countries. The high quality level of bank supervision is many decades old but the establishment of the Australian Prudential Regulation Authority in 1998 improved the supervision of other financial companies. Also, the strength both in volume and price of our exports due to the continuing demand for minerals, especially from China, was helpful in containing the recession, though not as important in our judgment as the first two reasons. In short, although increased government expenditure was the most important single thing leading to Australia's excellent record in moderating the recession, a number of other factors made the government's task easier.

Moreover, in 2008 and 2009 the Rudd Government did all the right things in using government expenditure to counter the recession. It started with a \$10.4 billion package, 85 per cent of which flowed to low income families. Virtually all of the rest was a grant to first home buyers which started immediately and finished on a date which was included in the announcement of the grant. Then only a year later almost all the extra government expenditure was switched to a range of investment projects which increased potential output as well as increasing demand. The total package for the first half of 2008 was roughly equal to 1 per cent of GDP.

In a very useful paper, Gruen (2009) both details the size and the nature (personal transfers or investment) of expenditure and of planned expenditure till the first half of 2012, and also gives the Treasury estimates of the multiplier effects. The Treasury concluded that if it were not for discretionary fiscal policy real GDP would have continued to fall in the first and second quarters of 2009 and the peak unemployment rate would have been 1.5 percentage points higher. Although himself a senior Treasury officer, Gruen thinks this an underestimate because conservative values for multiplier effects were used to estimate it and also because it ignored the feedback effects of better macroeconomic outcomes on business and consumer confidence.

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Table 1: Unemployment in the two bigger slumps

Quarter	Persons receiving unemployment benefits (000)
1950–51	
September	0.6
December	0.7
March	0.9
June	0.6
1951–52	
September	0.5
December	1.1
March	3.2
June	5.7
1952–53	
September	21.9
December	36.2
March	35.4
June	26.7
1953–54	
September	21.8
December	12.7
March	11.4
June	6.8
1954–55	
September	4.6
December	3.3
March	4.0
June	3.0
	Unemployment rate (%)
2008–09	
September	4.0
December	4.3
March	5.8
June	5.7
2009–10	
September	5.5
December	5.3
March	5.8
June	5.3
2010–11	
September	5.0
December	4.9
March	5.4

Note: For various reasons not all the unemployed received benefits but two reasons dwarfed the rest. Eligibility for benefits was subject to an income test and benefits were not normally paid to married women. Despite this, changes in the number of persons receiving benefits is a good indicator of changes in unemployment. Data is not seasonably adjusted.

Sources: Quarterly Summary of Australian Statistics and ABS 6202.0 Labour Force, Australia

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Table 2: Unemployment in the two smaller slumps

Quarter	Persons receiving unemployment benefits (000)
1960	
March	20.7
June	16.9
1960–61	
September	11.9
December	12.0
March	20.9
June	39.9
1961–62	
September	60.5
December	50.2
March	53.0
June	47.5
1962–63	
September	43.2
December	35.5
March	42.5
June	37.6
1963–64	
September	34.0
December	23.7
March	26.5
June	19.5
1964–65	
September	16.0
December	11.9
March	14.5
June	12.6
	Unemployment rate (%)
1989–90	
September	5.9
December	5.6
March	6.8
June	6.4
1990–91	
September	7.0
December	7.5
March	9.4
June	9.5
1991–92	
September	9.7
December	9.9
March	11.2
June	10.6
1992–93	
September	10.6
December	10.7
March	11.8
June	10.7
1993–94	
September	10.6
December	10.5
March	11.2
June	9.8
1994–95	
September	9.2
December	8.8
March	9.6
June	8.2

Note: See note for table 1

Sources: Quarterly Summary of Australian Statistics, and ABS 6202.0 Labour Force, Australia

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As we noted above, not only did overall unemployment increase substantially in Australia, but much of the increase was structural unemployment, measured as unemployment lasting more than one year. An OECD report (2009) contains valuable empirical material on the extent to which recessions cause long term unemployment.

> The limited empirical literature examining the long-run implications of recessions suggest that they result in permanent output losses, and that losses from recessions associated with financial crises are even larger. For example, Kim *et al.* (2005) consider the output response to recessions in Australia, Canada, the United Kingdom, and the United States, and estimate that permanent losses to output range from 1¼ to 5¼ per cent. … Recent OECD research also finds evidence of persistent output losses from financial crises. Furceri and Mourougane (2009) estimate that financial crises permanently lower potential output by 1½ to 2½ per cent on average, and by up to 4 per cent for severe crises. (OECD 2009*:* 234)

Of course not all of this output loss is due to structural unemployment, but the OECD notes that a 'particular concern is that much of the substantial increase in unemployment is transformed into higher structural unemployment' (OECD 2009: 239). This was certainly true in Australia. Moreover, the present government's plans to start the process of restoring the federal government budget to a surplus now the economy has started to grow, will help entrench structural unemployment. When healthy growth in economic activity is restored is when the least employable, in the eyes of employers, have the best chance of getting a job. Every effort should be made to help them at this time, particularly through active labour market policies, rather than putting priority on beginning the process of restoring the budget to a surplus.

3. The Slumps of 1960–62 and 1990–92

The 1960–62 slump was, at the time, the biggest slump since the 1930s if the size of a slump is measured by the peak value of the unemployment rate. Many would say that it was a self inflicted disaster, but the original decisions to tighten monetary and fiscal policy, which precipitated the slump, do not appear all that inexcusable given the information available at the time. The fault was the tardiness to recognise the effect of these decisions and to take prompt action to correct them.

In February 1960 the government removed nearly all the import restrictions still in place. This seemed a sensible move designed to reduce inflation. Export prices were rising (or so it was thought). Unemployment was falling and the economy was growing at a satisfactory rate. However, export prices actually fell by 4 per cent in February 1960 and continued to fall for another 11 months. On the other hand, imports in current value terms rose more than expected. Most of this was due to a record increase in the volume of imports, which was even higher than expected, but there was also a modest growth in import prices.

When the budget was brought down in August 1960, unemployment was still falling as shown in Table 2, inflation was a little high (around 4 per cent) and was accompanied by a speculative boom. In the June quarter preceding the budget (then in August) the economy was growing rapidly. The budget was a very tight one. Unusually small increases in expenditure were combined with a rise of 5 per cent in the rate of personal income taxation. This tight budget was made tighter by supplementary measures in November, the most important of which were an increase in the sales tax on cars from 30 per cent to 40 per cent and associated changes to tax laws. These measures had the effect of increasing monetary tightness especially in the case of hire purchase companies. It was later realised that the boom had peaked a little before November 1960 and that month passed into mythology as a byword for government incompetence. The tax increase on cars was also particularly unfortunate from the point of view of household expenditure, since many people believed the increase could not be permanent and postponed buying a car. In the event the increase only lasted three months and was reversed in February 1961. The budget for 1961–62 gave a substantial boost to the economy, but not a dramatic one despite the high levels of unemployment. It was made much more expansionary by supplementary measures taken in February 1962, which cut both personal income tax rates and indirect taxes and authorised additional government expenditure. Monetary policy was relaxed in 1961–62 but, despite the consequent fall in interest rates, this had no effect until the following year. This was largely due to uncertain expectations about the future.

The boom had reached its peak in June 1960. In the September quarter real GDP barely rose. Seasonally adjusted, it fell by 1 per cent in the December quarter (i.e. close to 4 per cent at an annual rate) and did not begin steady growth again until the December quarter of the following year. However on a year by year basis output did not fall, it only suffered a sharp decline in the rate of growth which fell in both the years 1960–61 and 1961–62. Gross private fixed capital formation did fall by 3.3 per cent in 1961–62 but bounced back to rise by 8.1 per cent in the following year. Unemployment was still low in the middle of 1961 but then rose rapidly and subsequently fell slowly. The unemployment rate peaked in 1962 somewhere between 3 and 3.5 per cent but did not fall to an acceptable rate by the standards of the time until the middle of 1964. There was a very widespread belief that the Federal Government had failed badly in its conduct of macroeconomic policy. Menzies only just scraped home in the 1961 election and felt it necessary to set up a Committee of Economic Enquiry (the Vernon Committee) to placate the voters.

There was a large slump in 1982–83 in the 30 years between our two twenty year periods, but more important from the perspective of this paper was the reversal of the priorities given to minimising unemployment and fighting inflation. 'Fighting inflation first' became the policy mantra of the Conservative Fraser government which took office in 1975. Its Treasurer, Philip Lynch, explicitly rejected 'Keynesianism' and argued for expenditure cuts. Not surprisingly unemployment increased substantially even before the recession mentioned above. However, inflation also remained a problem. After an initial fall from a very high rate, inflation started rising again in 1979–80 and by the end of Fraser's term of office was much the same as in 1976–77. The implicit deflator for gross national expenditure increased by 11.1 per cent in 1976–77 and 10.6 per cent in 1981–82. 'Fighting inflation first' was not a success, partly because contractionary fiscal policy had relied to a substantial extent on raising indirect tax rates and cutting subsidies. Nevertheless, the reversal in policy priorities remained.

The Hawke/Keating economic strategy gave an important role to the Accord, as part of a corporatist model which was meant to deliver to the economy similar benefits to those that corporatism had delivered in the Scandinavian countries. However, there was a fundamental problem in that the business sector did not actively participate in the agreement. This meant that while the Accord delivered short run benefits in terms of lower inflation and unemployment, and at the same time increased the profit share, this did not result in increased investment in real capacity. The overall result was a serious deterioration in Australia's current account balance during the late 1980s.[4] The problem of the deteriorating current account deficit was compounded by significant increases in foreign borrowing as a result of the Hawke government's 1983 deregulation of the financial sector and of the exchange rate. As a result, Australia's net foreign debt rose from 6.2 per cent of GDP in 1980 to 34 per cent in 1990 (Kryger 2003). Already in 1986 the trend rise in foreign debt had caused Keating to warn that Australia was in danger of becoming a 'banana republic'. It was the net income outflows associated with the foreign debt that were driving the current account deficits. Towards the end of the 1980s these contributed to record current account deficits.

The Reserve Bank, with the encouragement of Treasurer Keating, responded to this by significantly tightening monetary policy. The cash rate reached 18 per cent in the second half of 1989, the mortgage rate rose to 17 per cent and many loans to businesses were well in excess of 20 per cent. The result was a significant increase in the size of the recession at the beginning of the 1990s[5], culminating in an unemployment rate in 1992 of 10.9 per cent, which was (and still is) the highest since the depression of the 1930s. The depth of the slump was in large part because The Reserve Bank and bureaucrats in Canberra took the opportunity to squeeze inflation out of the economy. The consumer price index was 99.2 in December 1989 and only 110.0 in December 1993.

The size of the government deficit is not a good measure of the stance of fiscal policy. Automatic stabilisers, especially the decline in tax revenues as income falls, have a significant ameliorating effect on the decline in economic activity. If the effects of automatic stabilizers are subtracted from the total deficit, the resulting deficit called the structural deficit (or surplus) indicates the stance of discretionary fiscal policy. For Australia[6] there was a structural surplus in 1990–91, virtually the same size as in the previous year. The next year there was a small structural deficit but it was not until 1992–93 that there was a large structural deficit (Nevile 1999). Thus, it was two years before fiscal policy gave a significant boost to economic activity.

Changes in monetary policy occurred much more promptly. The (nominal) cash rate began declining in the first half of 1990 and fell rapidly until it levelled out at around 5 per cent in 1993–94. This overstates the effect since it is the real rate (the nominal rate less the expected rate of inflation) that is important in making investment decisions. As we noted above the actual rate of inflation measured by the rise in the consumer price index was less than 2 per cent a year over the period compared to 7.8 per cent in 1989. However, there is evidence that the expected rate of inflation did not fall as much as this, levelling out at around 4 per cent at the end of 1992 (Junor 1999). Many believe that private sector investment is not interest elastic, however the interest rate is measured. In any case, it takes about 18 months before changes in the cash rate are reflected in the level of economic activity (Milbourne and Crosby 1999). Thus, in the absence of aggressive fiscal policy in the first two years, the slump was not only deep, as noted above, but prolonged. Unemployment was still around 8 per cent in the mid 1990s.

4. The Effects of Inflation on Unemployment

Partly because of the growth in the financial sector, in the last 25 years or so, more emphasis has been put on keeping inflation low compared with keeping unemployment low. In a speech to the National Press Club, just before his retirement as Governor of the Reserve Bank of Australia, Bernie Fraser said that monetary policy was becoming the hostage of influential financial markets with a vested interest in making the Reserve Bank give greater weight to inflation than employment. He was quite explicit about the reason for this.

> Most financial market participants rate low inflation ahead of the Reserve Bank's other objectives. This reflects a number of factors but the financial harm that is done to the holders of bonds when inflation and interest rates rise is the main one. (Fraser 1996: 19)

In Australia, and many other countries, Governments have defended a concentration on keeping inflation at a very low rate with the claim that high rates of inflation adversely affect longer run growth in output and employment. There is no doubt that this is true for very high rates of inflation, but there is substantial evidence that this is not the case when the rate of inflation is below, say, 10 per cent. Those who support fighting inflation as the over-riding goal of macroeconomic policy claim the support of the current dominant neoclassical school of thought in economics. Professor Robert Barro is one of the most respected members of this school. In a study of the experience of more than a hundred countries over thirty years, Barro found that there was evidence of 'causation from higher long-term inflation to reduced growth and investment' but immediately commented that 'it should be stressed that the clear evidence for the adverse effects of inflation comes from the experience of high inflation'(Barro 1996: 168). The general tenor of Barro's article suggests that he had inflation rates above 20 per cent a year in mind when he used the term high, although anyone less sympathetic to the argument that inflation has adverse effects on growth might maintain that his empirical work shows that 'high' should be taken to mean more than 50 per cent a year. Barro's general result has been supported by numerous other studies.[7]

Many media commentators and some academics have countered the argument for a reduction in the priority given to fighting inflation with the claim that such a reduction runs the risk of making inflation harder to contain whereas pre-emptive interest rate rises add credibility to policy which lessens the risk of an increase in inflation. This is true but the argument is completely symmetrical with respect to unemployment. Pre-emptive increases in policy to expand employment equally lessen the risk of an increase in unemployment.

In any case, there is serious doubt about the association of higher employment levels with inflation, at least at levels of capacity utilisation below full capacity of the labour force or of the capital stock. Most contemporary arguments about the dangers of inflation associated with low levels of unemployment are based on the neoclassical model with its emphasis on the non-accelerating rate of inflation or NAIRU. However, heterodox economists have questioned the usefulness of this concept, arguing that levels of unemployment well below current estimates of the NAIRU are possible with little if any inflationary implications — see for example Kriesler and Lavoie (2005, 2007). In this case, unemployment can fall significantly below current levels before inflation becomes a potential cost of reducing unemployment further. Moreover, other policies, especially incomes policies, may reduce the extent of any rise in inflation.

5. The Debt Issue

How important is ratio of public debt to GDP? A strong case can be made for borrowing, in response to substantial rises in unemployment, in order to finance improvements in physical and human capital and especially for 'borrowing' from the Reserve Bank. This will increase the productivity of employed workers in the future. This will also reduce the numbers of unemployed. Both these things will increase the productivity of the economy and raise living standards. They will also increase the capacity to pay taxes, and hence the ability to reduce the public debt if that is thought desirable.

How important is it to pay off the public debt or at least to prevent it from rising? In the case of Australia not at all. A large public debt can, in certain circumstances, limit government policy options, but this not a relevant consideration in Australia. Apart from that of Luxemburg, Australian public debt is the lowest in the OECD. In 2008 it was less than 10 per cent of GDP, or total production. Compare this, for example, with the case of Canada, another Western country where commodity exports are a high proportion of total exports. In Canada the ratio of public debt to GDP was 60 per cent in 2008. Because Australia has such a low level of public debt, it has more ability than the large majority of Western economies to use deficit financing to fund desirable educational and physical infrastructure with no need ever to pay back any borrowing involved, though this may be desirable to reduce aggregate demand in a situation of over full employment. Not only are the claims that this will place a burden on future generations false, but exactly the opposite is true. If the federal government finances desirable infrastructure from taxation, this puts a burden on the present generation who will be paying now to finance completely expenditure which will benefit future generations. Moreover, expenditure on improvements in physical and human capital will increase the future productivity of workers employed as a result by maintaining or even increasing their skills. It will also reduce the numbers of unemployed. Both these things will increase the productivity of the economy and raise living standards. The consequent increase in GDP will raise taxation revenue even if rates remain unchanged, and hence the ability to reduce the public debt if that is thought desirable.

6. Conclusions

The dominant lesson to be drawn from our historical comparisons is the major thesis of the paper as set out in the introduction. The fifties and sixties as a whole were marked by active fiscal policy, often tight to restrain strong inflationary pressures, but generally very quick to change its stance when unemployment increased significantly. Monetary policy also had an important but subsidiary role. Overall, the widespread belief that the Federal Government's overriding priority was to keep any departures from full employment brief was a major factor in helping to achieve this and it is notable that slumps in private fixed capital formation were brief as well as rises in unemployment. In short, the more the government can create a belief that it will ensure that any slump will be of short duration, the more successful it will be in achieving that aim.

The historical comparisons also point to major principles which should always underlie counter cyclical policy and guide the selection of the detailed measures whose exact nature will depend on the character of a slump and on the state of the economy before that slump.

These underlying principles are:

- in response to any downturn a fiscal policy stimulus is essential and must play the major part;
- fiscal policy measures at least must be implemented quickly and then followed up promptly by further measures if necessary;
- not only in response to downturns, but in good times as well the government must convey the impression that it will act decisively to minimise any decline in economic activity below the full employment level or rise in unemployment above its full employment level;
- it is possible to devise policies which will reduce both unemployment and inflation in the longer run as well as in the short run.[8]

Overall, the key is to minimise any decline in 'animal spirits' by effective policy measures and the first two principles are the most important in this respect.

Although it is not so obvious as these principles, the allocation of increased government expenditure is also significant. Usually, personal transfers, which can be implemented quickly, are important at the start of a slump. Then the emphasis should shift to investment. Investment in physical and human capital is valuable on both the demand and supply side. The need to increase aggregate demand during slumps is obvious, but until we reach a sustained period of genuine full employment there will be a need for supply side policies to stop structural unemployment rising and to incorporate more securely into the labour market those on its fringes.

Data Sources

Except where otherwise referenced, data for the more recent period is taken from the Excel spreadsheets on the Australian Bureau of Statistics web site, especially from tables in catalogue items 5204, 5206, 6202 and 6401. For periods before this data became available, data are taken from the Quarterly Summary of Australian Statistics, and the White Papers on National Income and Expenditure, the annual reports of the Commonwealth Bank and later the Reserve Bank and the Commonwealth Year Book. There are now quasi-official data for the earlier period, for example in Foster and Stewart (1991), but if one is comparing the success of policy making at disparate periods of time it is better only to use the data available to policy makers at the time their decisions are made.

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Notes

1. The last 20 years should be interpreted to include the slump of the early 1990s, which actually started at the very end of 1989.
2. See the note on data sources before the list of references for the information on the sources of data used throughout this paper. In fact, in 1946–47 there were no estimates of real gross national product but nominal gross national product increased by 9.5 per cent, the C series measure of retail prices by 2.3 per cent and the food and basic materials index of wholesale prices by 1.4 per cent.
3. Not all the money in the special grants to the states for public works was necessarily spent in 1952–53, but the knowledge of its existence would have increased the confidence of businessmen in maintaining their own spending on fixed capital.
4. See Kriesler and Halevi (1995, 1997).
5. The recession itself was triggered by events overseas.
6. That is combining all three levels of government and removing any consequent double counting.
7. For example, see Ericsson, Irons and Tryon (2001) and Kyriakopoulos (1991).
8. This should not be taken to mean that what worked so well in 1952–53 will work now, nor that the task is not harder now.

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