

Revisiting the policy requirements of the terms-of-trade boom

Address to the Australian Business Economists, Sydney, 20 May 2008

Ken Henry, Secretary to the Treasury

The global increase in food and energy prices is best thought of as a positive demand shock rather than a negative supply shock for the Australian economy. This is evident in a substantial increase in our terms-of-trade through large rises in export prices. This positive shock is contributing to strong domestic demand growth in an economy operating at close to full capacity. This income effect is being offset to a significant, but not complete, extent by an appreciating Australian dollar. The appreciation is also putting downward pressure on import prices, contributing to a moderation in consumer prices. That is, the exchange rate appreciation is helping to dampen the inflationary consequences of the higher terms-of-trade. The effects of this positive demand shock to the Australian economy can be accommodated by the sensible implementation of our inflation targeting framework, combined with allowing the automatic fiscal stabilisers to work.

Introduction

A couple of years ago in addressing this group I spoke at some length about the macroeconomic and structural adjustments that might confront the Australian economy if the terms-of-trade boom we were then observing turned out to be sustained for some meaningful period of time.

Today, I think we can agree that the period of time over which we have been experiencing heightened terms-of-trade is meaningful in both a macroeconomic and structural sense. Moreover, the terms-of-trade are considerably higher today than they were when I addressed that topic a couple of years ago.

Today, I want to return to a discussion of the policy requirements of our terms-of-trade boom. While I will have something to say about structural, or microeconomic, policy requirements, I will spend most of my time today on macroeconomic policy, and quite a lot of that on monetary policy.

One reason for this focus is that there has been some questioning in recent times of the appropriateness of the inflation targeting regime for monetary policy that was adopted by the Reserve Bank in the early 1990s; that is, the policy rule that targets inflation of two to three per cent on average over the cycle. Given the significant contribution that the conduct of monetary policy has made to our relatively strong macroeconomic performance in the period since the adoption of that particular monetary policy framework, the fact of this questioning is quite peculiar. And today I want to explain why it is seriously misguided.

1. Imported inflation

Those arguing that the inflation targeting regime has outlived its usefulness draw attention to what is often called 'imported inflation': strong increases in global food, energy and minerals prices are contributing to inflationary pressures in all countries; there is little that the Reserve Bank of Australia can do to reduce global inflationary pressures; and efforts to reduce domestic demand to 'compensate' for imported inflation, and so achieve the inflation target, will simply drive the domestic economy into recession. That language puts the argument in rather stark terms, but I don't think it does it any injustice.¹

1 A confusion about policy rules has appeared in some recent press commentary on inflation targeting. Our framework is a framework of constrained discretion. It is not an instrument rule; it is not a Taylor rule, or indeed any other sort of instrument rule. In implementing the target, there is no attempt to derive, in a mechanical way, an optimal setting for the policy interest rate.

Indeed, some commentators and analysts are speculating that the world might currently be experiencing precisely the sort of supply-shock that will not only put an end to the relatively benign period of low inflation and strong growth that has characterised the period since emergence from the recession of the early 1990s, but also put an end to inflation targeting.

This somewhat iconoclastic speculation is a serious matter for macro policy people.

In a very readable overview of the state of inflation targeting presented to the August 2004 RBA conference, Ken Kuttner² referred to Olivier Blanchard's observation³ that the intellectual basis for inflation targeting 'rests on the "divine coincidence" that stabilising inflation is equivalent to stabilising output around its natural level'. Thus, inflation targeting is valuable not simply because it encourages a focus on price stability, but because macroeconomic price stability is associated with desirable real economy outcomes, notably in respect of output and employment.

In pondering the future of inflation targeting, Kuttner had this to say: '(Inflation targeters) have ... been lucky. Aside from the occasional financial panic, the 1990s were a relatively quiescent decade, more or less free of supply-side disturbances such as the persistent oil price shocks and productivity slowdowns of the 1970s. Moreover, to the extent there *have* been supply shifts, they have generally been favourable, combining higher growth and lower inflation. Thus, a benign economic environment has allowed (inflation targeters) to finesse the more difficult policy issues. Reality has obeyed Blanchard's 'divine coincidence', in other words. The good luck will inevitably run out, however, and adverse cost-push shocks are sure to appear at some point.'⁴

Is that what the world is now experiencing? Is the developed world looking at a 1970s style supply shock? And is this the sort of shock that will put an end to the efficacy of inflation targeting?

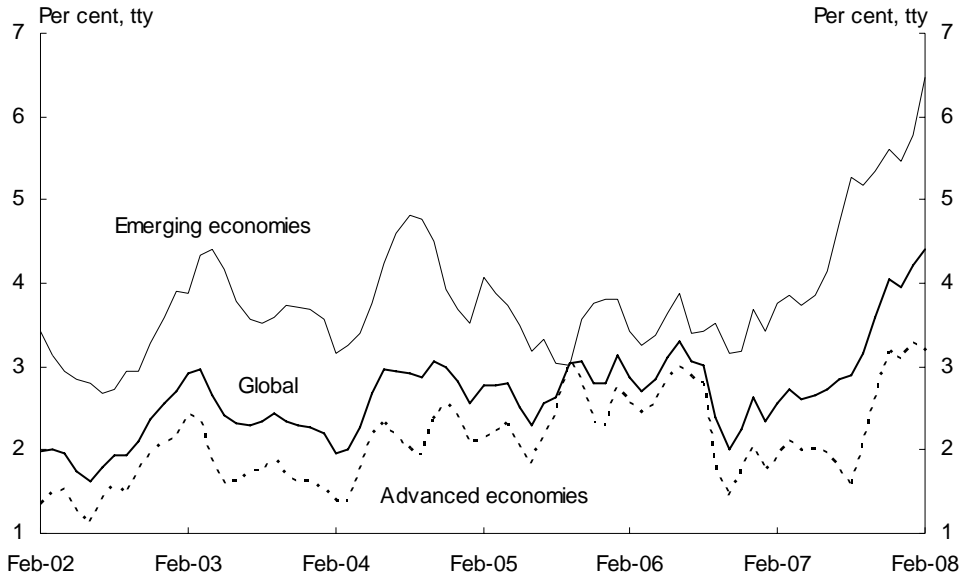
Well, it is certainly true that global prices have been rising quite strongly, as Chart 1 shows.

2 Kenneth N Kuttner (2004), 'A snapshot of inflation targeting in its adolescence', *Proceedings of a Conference on The Future of Inflation Targeting*, Economic Group, Reserve Bank of Australia, Sydney, pp.6-42.

3 Olivier Blanchard (2003), 'Comments on Jiri Jonas and Frederic Mishkin's "Inflation targeting in transition economies: experience and prospects"', paper presented at the NBER Conference on Inflation Targeting, Florida, 25 January. Cited in Kuttner (2004), op. cit.

4 Kuttner (2004), p. 38.

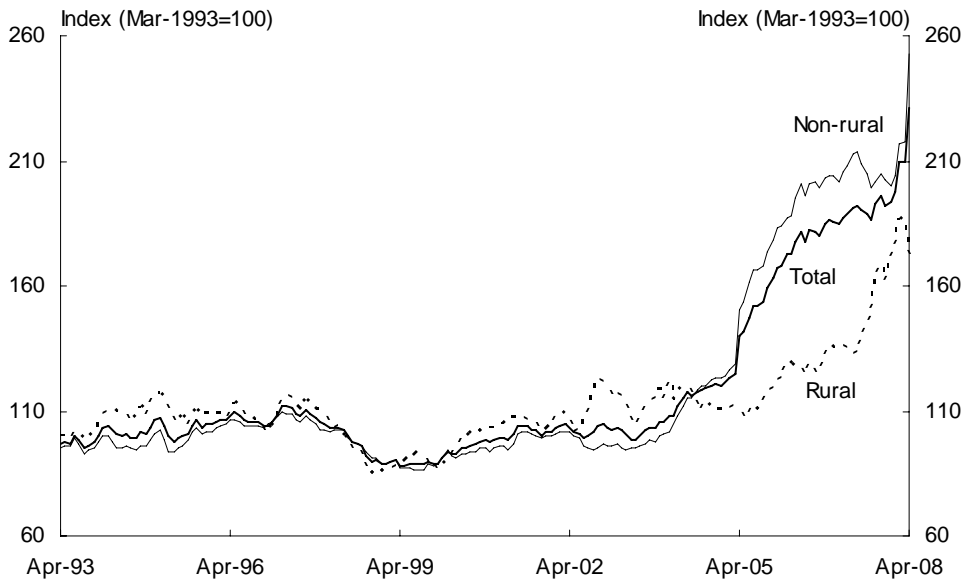
Chart 1: Global inflation



Source: IMF World Economic Outlook, April 2008.

Global increases in the prices of food, energy and minerals, in particular, have been reflected in strong growth in the foreign currency prices of our commodity exports (see Chart 2, which records the average price of our commodity exports in SDR units).

Chart 2: Commodity price inflation

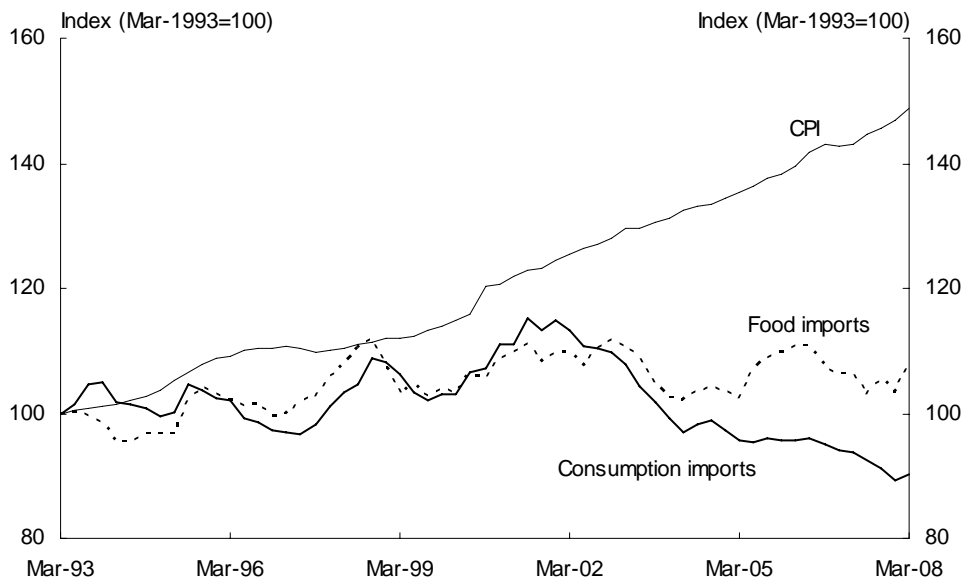


Source: Reserve Bank of Australia.

To state a tautology, those price increases are the consequence of global demand growth outstripping global supply growth at prevailing prices. Principal among the various demand factors is the continuing rapid growth of China and India. Among the more important supply factors, one could list our own prolonged drought and the United States' biofuel subsidies affecting global grain supplies; and, perversely, flooding in a number of countries, including our own, affecting global coal supplies. My guess is that the supply side factors at play here are rather less structural – that is, rather less permanent – than the demand side factors, although the United States biofuel program has some worrying signs of structural policy misadventure. If that is the case, then the present global price pressure is more the consequence of strong growth than, as in the 1970s, a negative, growth-destroying, shock to the cost base of the developed world.

But the iconoclasts certainly are correct to note that global prices are rising. And it may also be true that these global price increases are exerting upward pressure on Australian prices. That effect does not appear to be coming through strongly in import prices, however. Chart 3 presents, for the period from the March Quarter 1993 to the March Quarter 2008, the CPI and the \$A import price indices for food and beverages and for consumption goods. In the last quarter, the prices of food imports have increased strongly, but that has not been the experience of imports of consumption goods in general. Clearly, the behaviour of the CPI cannot be explained by higher prices of consumption goods imports.

Chart 3: Prices of consumer imports and the CPI

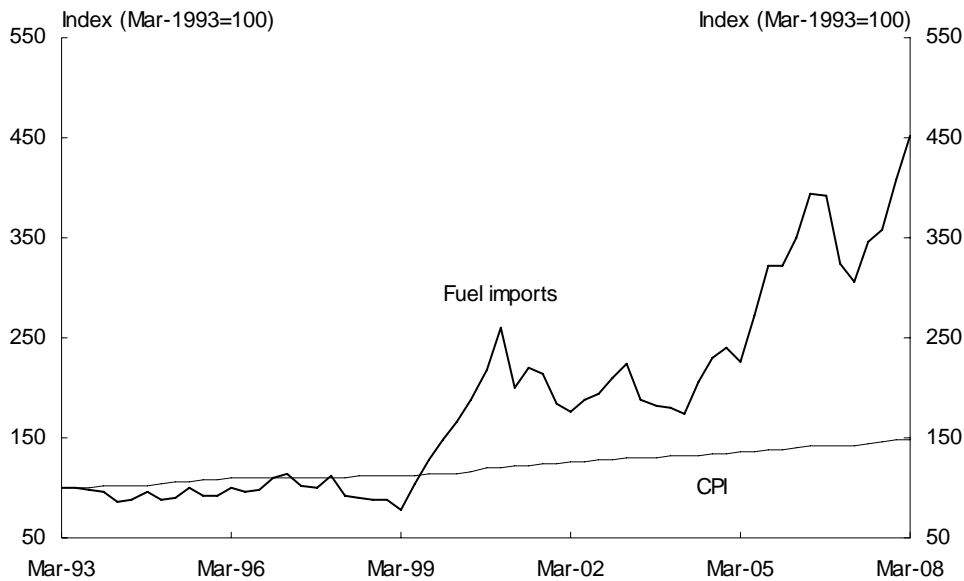


Note: Import price data are implicit price deflators from the Balance of Payments. March quarter 2008 import price data are estimates based on the International Trade Price Indexes.
 Source: ABS cat. nos. 5302.0, 6401.0, 6457.0 and Treasury.

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Of course, higher global prices are feeding through into domestic consumer prices in other ways. For example, the prices of fuels and lubricants affect just about all consumer prices indirectly. And, as Chart 4 shows, the prices of imported fuels and lubricants have been growing at a much faster rate than the CPI in recent years. I'll say more about these effects in a moment.

Chart 4: Prices of fuel imports and the CPI



Note: Import price data are implicit price deflators from the Balance of Payments. March quarter 2008 import price data are estimates based on the International Trade Price Indexes.
Source: ABS cat. nos. 5302.0, 6401.0, 6457.0 and Treasury.

Finally, those questioning the appropriateness of our inflation targeting regime are right in saying that there is very little that the RBA could do to address the various demand and supply factors that are affecting global prices.

In summary then, it is that case that commodity prices globally are increasing, those price increases may be feeding into domestic consumer prices (though the evidence for this is weak), and there is nothing the RBA can do to affect global demand and supply.

But those observations do not constitute a case for discarding our inflation targeting regime.

2. The case for having an inflation target

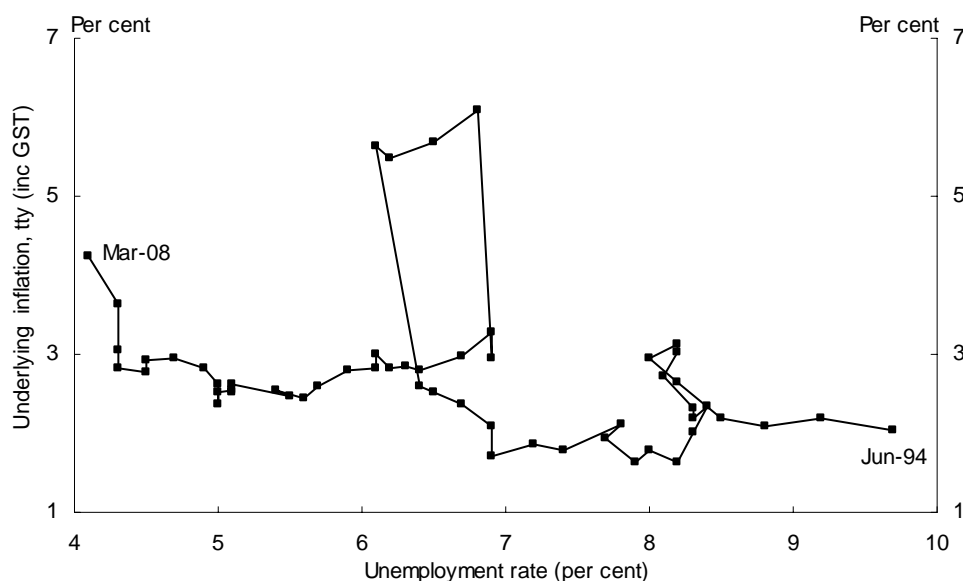
Our inflation target permits non-negligible prices growth over time, it allows for cyclical variability, and it has 'soft edges'. These design features are deliberate. They were not adopted lightly. Australian authorities recognised that the Australian

economy would, from time to time, be subject to external shocks that could, over time, undermine the value of tighter, harder edged targets. It is undoubtedly the case that the current acceleration in global commodity prices is out in the tail of the distributions of probable shocks that were in the minds of those authorities in the early 1990s. But it is also true, I would suggest, that the inflation targeting regime has handled, far better than they might have imagined, other external shocks, including the Asian financial crisis and a pronounced economic downturn in the early years of this decade in much of the industrialised northern hemisphere.

The case for having a medium-term monetary policy target is that it helps to anchor inflation expectations. Anchoring inflation expectations is especially important when the economy is growing strongly and when it is being hit by external shocks to domestic prices. Without a secure anchor, an increase in the level of consumer prices, for whatever reason, might feed into wage claims and generate a costly wage-price spiral; we've seen such things before.

The benefit of having well anchored inflation expectations is illustrated in Chart 5, which presents a naïve Phillips Curve for the period from the June quarter 1994 to the March quarter 2008. The recovery from the early 1990s recession was slow to emerge, but by 1994 the economy was growing strongly. And that strong growth was fuelling inflation. The acceleration in consumer prices evident from the June quarter 1994 was halted by a monetary tightening that saw the cash rate lifted from 4.75 per cent to 7.5 per cent by December 1994; by 275 basis points in four months. The extent to which that decisive action helped to anchor inflation expectations is illustrated by the fact that the increase in consumer prices associated with the introduction of the GST in mid-2000 was only temporary. As this decade has unfolded, the unemployment rate has continued to fall without the inflationary consequences of earlier decades.

Chart 5: Phillips curve



Source: ABS cat. nos. 6202.0, 6401.0, Reserve Bank of Australia and Treasury.

Our inflation targeting regime has served us well.

It is possible that its critics would concede this much: the history is pretty good; it's the future we should be worried about. And there is a bit to be worried about. Present macroeconomic circumstances are as testing as anything we've seen since the mid to late 1980s. But frameworks designed to anchor expectations will not be successful if they are put aside the moment they are tested. It is in testing times that they do their work. That much should be self-evident.

So the argument for discarding our inflation targeting regime can't just be that things are getting tough; it must be that, in present circumstances, the framework prescribes the wrong monetary policy settings.

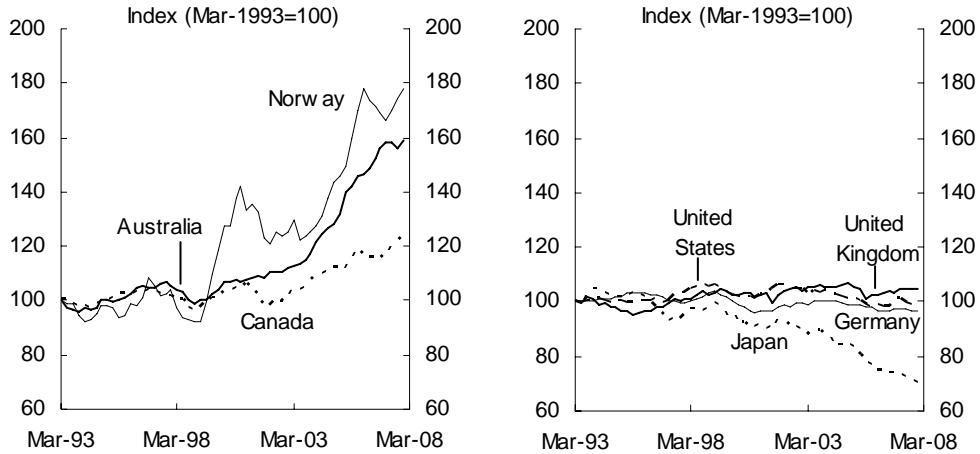
This argument should be rejected.

3. The shock hitting the Australian economy

It is somewhat misleading to describe as 'imported inflation' the impact on Australian prices of higher global prices for cereal grains, coal and iron ore. Were that a natural description of the impact of those higher prices, we would be experiencing a worsening of our terms-of-trade. Certainly, as Chart 6 shows, that has been the experience of most industrial economies. But as Chart 6 also shows, Australia, like

Norway, and to a much lesser extent Canada, is living with an extraordinary terms-of-trade boom.

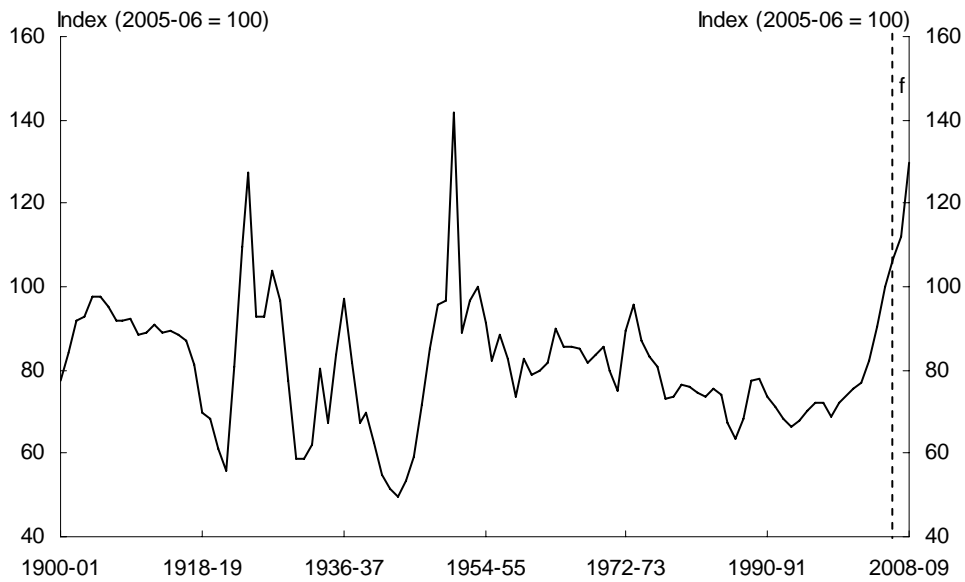
Chart 6: Terms of trade: selected industrialised economies



Note: December quarter 2007 data are forecasts.
Source: OECD Economic Outlook No. 82.

Indeed, as Chart 7 shows, it is a boom that is beginning to rival that associated with the Korean War when wool prices almost tripled in two years.

Chart 7: Terms of trade (Australia)



Source: ABS cat. no. 5302.0, Reserve Bank of Australia and Treasury.

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In the case of most industrial economies, cereal grains, energy and minerals are net imports and therefore feature in the *denominator* of their terms-of-trade. In Australia's case, however, these things are largely net exports, and therefore feature in the *numerator* of our terms-of-trade. Now, ignoring for the moment any change in the exchange rate and any impact of induced changes in domestic supply and demand conditions, an increase in the global prices of these products, whether they appear in the numerator or denominator of the terms-of-trade, will generally have an autonomous positive impact on domestic prices. But in respect of the risks posed for inflation, it matters quite a lot whether the price increases are coming through the numerator or denominator of the terms-of-trade.

4. Direct price impacts

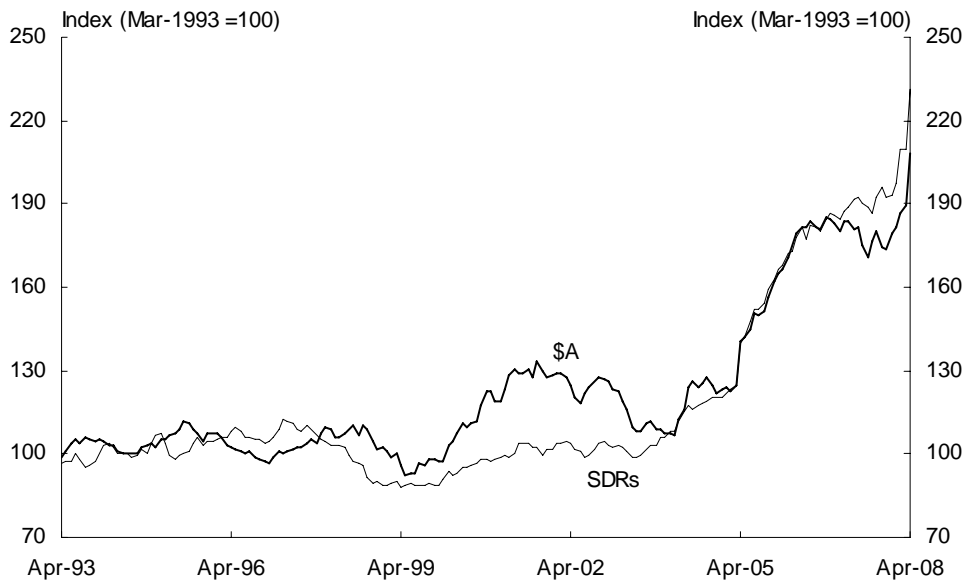
In national accounting terms, imports enter into consumption directly and they feed into the consumer prices of domestically produced goods and services to the extent they are used as intermediate inputs. By definition, exports can do neither of these things. But 'exportables' can. And, in the absence of export taxes and similar interventions, the domestic prices of exportables (that is, goods and services of which at least part of the output is exported) will match their global prices expressed in the same currency. Hence, ignoring exchange rate and other induced effects, to the extent these goods and services are used as intermediate inputs to domestic production, an increase in their global prices will also raise the consumer prices of domestically produced goods and services.

These price effects are fairly mechanical. There are other, less mechanical, but no less important, effects that need also to be considered. These effects relate to the exchange rate, the rewards to the primary factors of production, especially labour, and the impact on domestic final demand.

5. Exchange rate adjustment

When global prices of our imports rise, the nominal exchange rate might normally be expected to depreciate, amplifying the impact on domestic prices. But when the global prices of our exports rise, the capital account of the balance of payments will usually strengthen on an expectation of a higher yield on \$A denominated assets. The nominal exchange rate will appreciate. And that exchange rate appreciation will attenuate the domestic price impact of the higher export prices referred to above. This has been our experience (see Chart 8): especially in the last two years, the gap between global commodity prices and commodity prices in \$A terms has been widening. Even so, the exchange rate appreciation has not been nearly large enough to prevent the \$A price of our commodity exports from increasing strongly.

Chart 8: Commodity prices in international and domestic prices



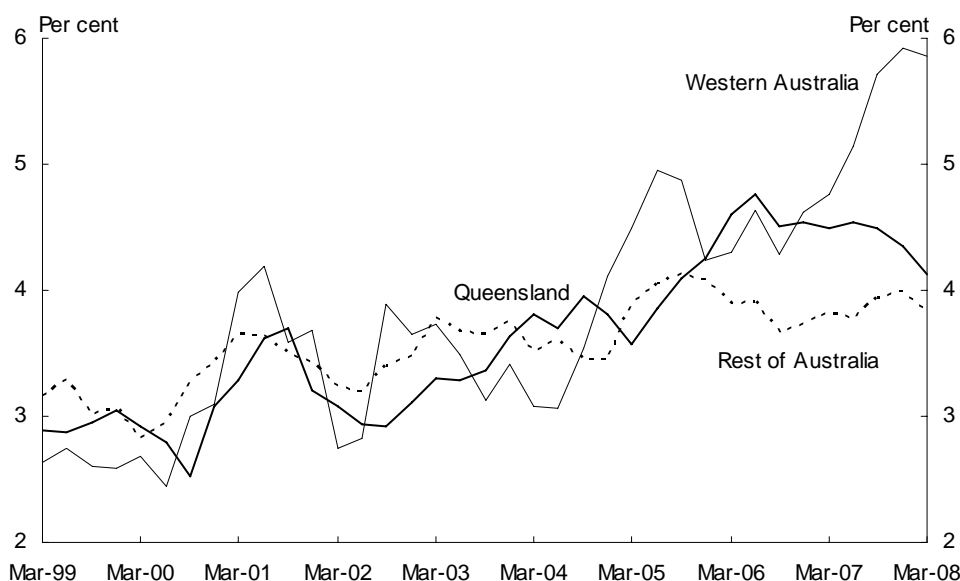
Source: Reserve Bank of Australia.

The appreciation of the \$A has, however, put downward pressure on the price of imports, including (as Chart 3 illustrated) imports of consumption goods. This is one way in which a floating currency redistributes, from shareholders in resource companies to Australian households, some of the real income effect of higher export prices. I'll come to those real income effects in a moment.

6. Labour market adjustments

The increase in the \$A price of commodity exports permits higher wages to be offered in the commodity exporting sectors of the economy, and also in sectors complementary with commodity exporting; principally mining construction, mining services and mining-related manufacturing. Given that our resource endowments are not uniformly distributed across the Australian continent, there will be a geographic dimension to wages growth. Chart 9 shows that, over the period in which commodity prices have grown strongly, the resource-rich states of Queensland and Western Australia have experienced considerably stronger wages growth.

Chart 9: Wage price index growth



Source: ABS cat. no. 6345.0.

Wage increases for labour that is of value to enterprises in the mining and construction sectors help facilitate the sectoral reallocation of labour: these sectors, having benefited from output price increases, can afford to pay the higher wage rate, and they draw labour away from those sectors that have not had output price increases.⁵ This is a straightforward instance of the price mechanism allocating a scarce resource. On this topic, it's worth recalling the 1929 comment of Professor Edward Shann, then of the University of Western Australia, who said that '... the higgling of the market is a sanction of economic wisdom more prompt, delicate and potent in its operation than any rewards or penalties that are within the slow reach of an over-burdened judge or commission.'⁶ Shann was, of course, taking a less than subtle swipe at the decisions of the Commonwealth Court of Conciliation and Arbitration which had laid the groundwork for Australia's highly centralised wage setting system, but his point that flexible relative wages are a necessary ingredient in an economy's ability to adjust successfully to shocks is correct.

As a general rule, macroeconomic policy should not compromise the price mechanism, including in labour markets, playing such a role. But large structural adjustments can pose risks for macroeconomic policy. This was especially the case when we had

5 Employment in those other sectors has to fall in order that the marginal product of labour increases to match the higher real wage rate (assuming a diminishing marginal product of labour, of course). For simplicity, this discussion ignores the general equilibrium impacts on capital intensities that act to reduce labour's marginal product in all sectors.

6 Edward Shann (1930), 'Economic control', *Bond or Free?*, Angus & Robertson, Sydney, p 36.

significant structural rigidities in our labour markets. The most problematic labour market rigidities were those that pre-dated enterprise bargaining, operating through judicial or administrative mechanisms to spread wage increases generally across the economy, to occupational categories for which aggregate demand had not increased (more accurately, for which there had been no increase in the value of marginal product), and to regions from which labour was slow to move. The consequence was not only inflation, but also unemployment.

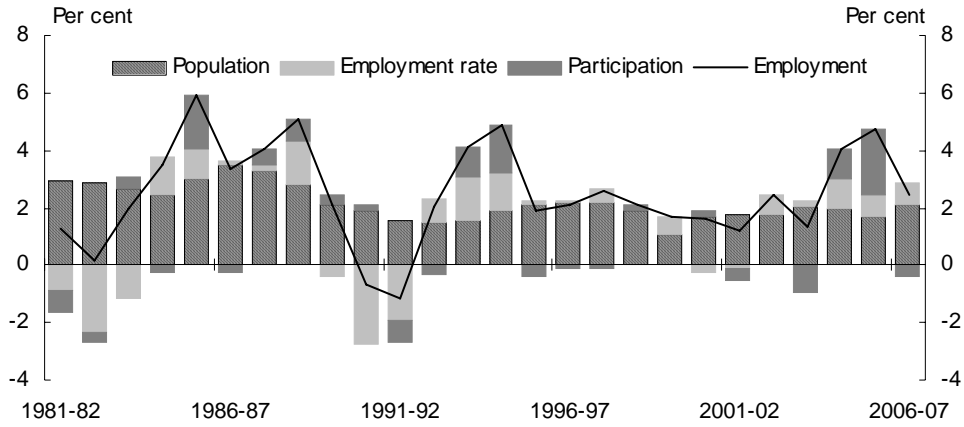
It might seem perverse that a positive demand shock can produce unemployment. If the labour market is highly flexible, and labour is highly mobile geographically, it shouldn't. But we know that it can happen if wage setting arrangements are overly centralised, as they were in the 1970s when we last had a significant increase in our terms-of-trade.

Fortunately, the Australian labour market today is very different from that of the 1970s. But the poor macroeconomic outcomes of that earlier period provide a potent reminder of the importance of maintaining flexible, enterprise-based bargaining arrangements that are sensitive to occupational and regional differences in labour demand.

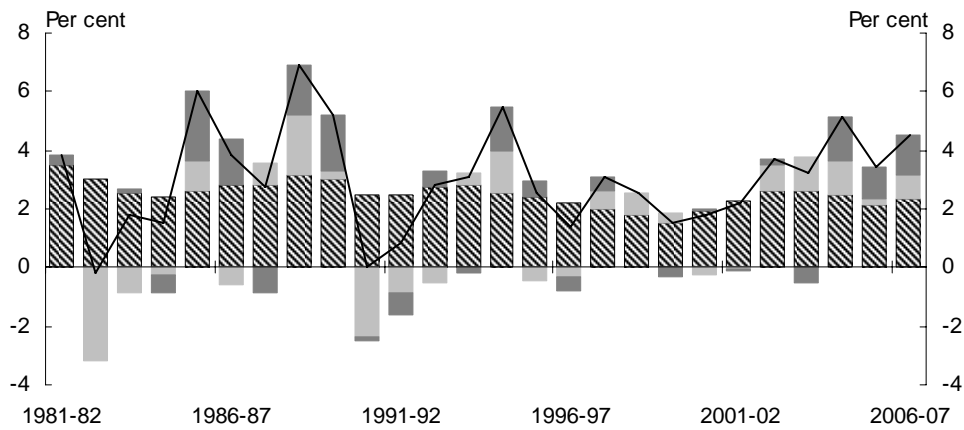
The importance of relative wage flexibility among occupational groups is well accepted these days. But what about regional wage differentials? What matters here, as I have noted already, is the degree of labour mobility. Eventually, labour of a particular quality that is inter-sectorally mobile should command the same reward in all places – with appropriate adjustment for sector-specific 'disutilities', of course. But there is some evidence that Australian labour is not sufficiently mobile to compress regional wage differentials within a period of several years.

Chart 10 shows that much of the pick-up in average rates of employment growth in Western Australia and Queensland over the past three years has come from higher rates of labour force participation and lower unemployment rates, rather than from faster growth in state populations.

Chart 10: Sources of employment growth
Western Australia



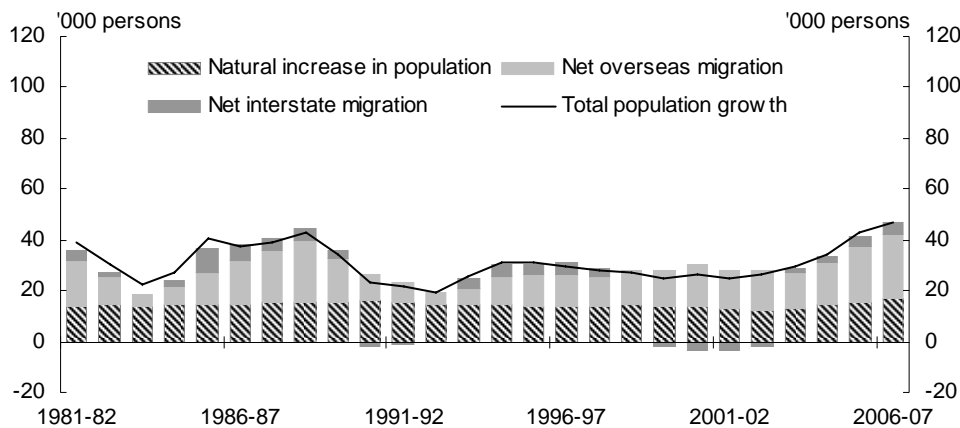
Queensland



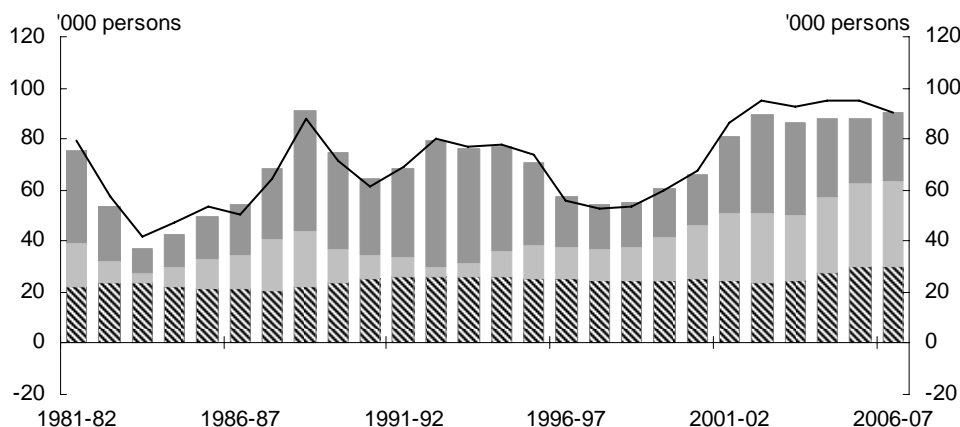
Source: ABS cat. no. 6202.0 and Treasury.

Chart 11 looks closer at the sources of population growth in the resource-rich states.

Chart 11: Sources of population growth
Western Australia



Queensland



Note: These Net Overseas Migration estimates contain a break in time series. Estimates for September quarter 2006 onwards use an improved methodology and are not comparable with Net Overseas Migration estimates from earlier periods. Differences between total growth and the sum of natural increase and net migration between census years are due to intercensal discrepancy.
Source: ABS cat. no. 3101.0.

Natural population increase, as you would expect, has not changed significantly in recent years, although there may be some upward drift observable in Queensland. The other two components – net interstate migration and net overseas migration – are more interesting. In Western Australia, the net inflow of people from other states appears to have increased, but it is still only a small component of total population growth. In Queensland, which traditionally has had a higher net interstate migration inflow, there has been no step-up in growth in recent years. For both Western Australia and Queensland, the net overseas migration inflow, however, does appear to have increased in recent years. This trend is also evident in other states.

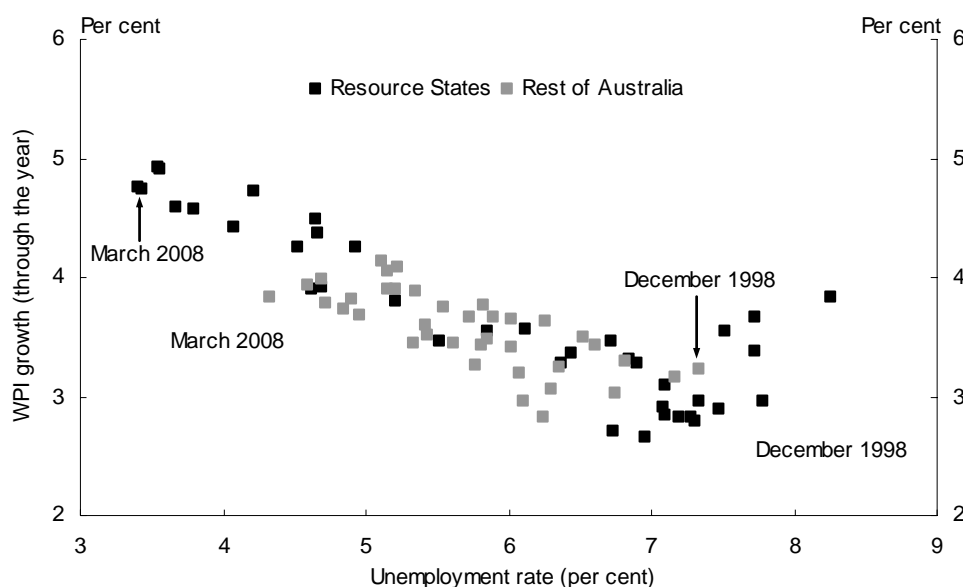
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The low sensitivity of interstate migration flows to the wage growth that we have seen in Western Australia and Queensland might seem surprising. But the decision to move interstate is based on many factors, of which the remuneration opportunity is only one.

To date, net overseas migration seems able to respond more quickly to employment opportunities. The immigration programme provides mechanisms by which particular skills can be targeted. And it might be easier to encourage immigrants to consider settling in areas where labour is needed than it is to induce an established Australian resident to move interstate.

Labour market outcomes in the various states are summarised in Chart 12 which shows combinations of wage price inflation and unemployment rates for the resource states of Queensland and Western Australia and for the rest of the country. The former are now experiencing higher wage growth and lower unemployment rates than the rest of the country, a reversal of the situation a decade ago.

Chart 12: Wage inflation and unemployment



Source: ABS cat. nos. 6202.0 and 6345.0.

Labour market flexibility, then, is quite important to the operation of monetary policy when the economy is hit by a large terms-of-trade shock. But even when labour markets are very flexible, there remains a significant risk for monetary policy; specifically, that a large increase in wages hoists the anchor on inflation expectations.

Before moving on from a consideration of labour market matters, it is worth noting that labour market impacts would be equally challenging for macro-policy if global price increases were reflected in the \$A prices of our imports rather than our exports.

As we saw in the mid-1980s, in this case, it is import-competing producers – encouraged by a depreciating nominal exchange rate – who have the capacity to pay higher wages to attract labour. Many of you will recall that the Government of the time was concerned to ensure – through both fiscal policy and the prices and incomes Accord with the trade union movement – that the *nominal* exchange rate depreciation was also a *real* exchange rate depreciation.

In the case of an increase in export prices, the induced increase in \$A wages adds to the real exchange rate appreciation, of which the nominal appreciation is also a part. The real exchange rate appreciation is an important shock absorber, attenuating both the macroeconomic and structural consequences of the terms-of-trade improvement.⁷ Monetary policy plays an important role here in determining, at least in the short run, how much of the real exchange rate appreciation occurs through the nominal exchange rate, and how much occurs through an increase in the domestic primary factor cost base.

7. Real income and substitution effects

There are also complex income and substitution effects to consider. And these can be, from a macroeconomic policy perspective, by far the most important.

When \$A export prices increase there is an addition to national income. The associated exchange rate appreciation also reduces the price of imports relative to domestically produced goods and services, encouraging demand substitution away from domestic product. As discussed in my presentation to this group three years ago, these attenuating exchange rate effects can be quite substantial. Even so, it will generally be the case that the net impact on domestic demand of an increase in the global prices of our exports is positive.

When import prices increase, there are both income and substitution effects impacting on the demand for domestic product also. Two income effects – one positive and the other negative – need to be considered. First, producers of import-competing product benefit from an increase in real income. And second, consumers of imports suffer a real income reduction. It is necessarily the case that the second effect is the larger; that is, overall, there is a negative real income effect. On the other hand, there is a positive substitution effect: as the relative price of imports rise, consumers switch to domestic

⁷ Gruen and Dwyer (1995) show that, if the real exchange rate appreciation is sufficiently large, the net impact of an increase in the terms of trade on domestic inflation (especially after taking account of the lower prices of imports and 'importables' included in the consumption basket) is negative. Gruen, D. and Dwyer, J. (1995), *Are terms of trade inflationary?*, Reserve Bank of Australia, Research Discussion Paper (RDP 9508), November.

product. It is conceivable that this positive substitution effect dominates the negative real income effect. However, when the imports that are increasing in price are things like food and energy, I would say that such an outcome is extremely improbable.⁸ Thus, economies that are large net importers of these products are experiencing strongly negative real income shocks that should be expected to have a negative impact on the demand for domestic product, notwithstanding some degree of positive demand substitution.

This is why some analysts suggest that an increase in import prices should be treated as a 'negative supply shock', and argue that it would be inappropriate to tighten monetary policy in response: in such circumstances, the real macroeconomic consequences of achieving price stabilization in some short-term time period will be unacceptably high.

But when it is export prices that are increasing, we do not have a negative supply shock; rather, we have a positive demand shock. The implications for macroeconomic policy are quite different.

8. Is it time to ditch our inflation targeting regime?

In summary, from an Australian economy perspective, the global increase in food and energy prices is best thought of as an export price shock, evident in a substantial increase in our terms-of-trade. That shock is producing an increase in income that is contributing to strong domestic demand growth in an economy operating at close to full capacity. The size of the income effect is being offset to a significant, but not complete, extent by an appreciating \$A. This appreciation is also putting downward pressure on import prices, contributing directly and, through substitution effects, indirectly to a moderation in consumer prices. In these three ways, the exchange rate appreciation is helping to dampen the inflationary consequences of the higher terms-of-trade. What remains should not be thought of as the consequence of a negative supply shock; instead, it reflects a positive demand shock to the Australian economy. But there is no reason to think that it is the sort of shock that cannot be accommodated by the sensible implementation of our inflation targeting framework.

9. The role for fiscal policy

Fiscal policy can play a supportive role. Indeed, the *Charter of Budget Honesty Act 1998* mandates that it do so. The second of the 'principles of sound fiscal management' says

⁸ Note that in Slutsky-Hicks terms, what matters here is the degree of (compensated) substitutability between the imports that are increasing strongly in price and 'aggregate' domestic product.

that 'the Government is to ensure that its fiscal policy contributes to achieving adequate national saving and to moderating cyclical fluctuations in economic activity, as appropriate, taking account of the economic risks facing the nation and the impact of those risks on the Government's fiscal position'.

As I have observed previously⁹, ill disciplined fiscal policy can set up problems for monetary policy in two ways: by impacting the trajectory of consumer prices in a way that forces a monetary response or tests monetary policy credibility; or by generating destabilising volatility in the real economy through which the monetary transmission process operates. Disciplined fiscal policy, on the other hand, relaxes constraints on the effective operation of monetary policy. A credible, medium-term fiscal strategy, in particular, provides room for an effective monetary policy.

On that earlier occasion, I noted that activist counter-cyclical fiscal policy might be frustrated by lags of recognition, implementation and transmission. And its effectiveness might be compromised by Ricardian equivalence, the permanent income hypothesis or import leakages. I noted that these lags and questions of effectiveness pose real challenges for the use of counter-cyclical fiscal policy. But I also noted that they do not rule out such use.

And, obviously, they do not rule out allowing the so-called automatic stabilisers to work. That's probably how the fiscal stance contained in this budget should be interpreted. With respect to the current year, 2007-08, the *Pre-Election Economic and Fiscal Outlook* (PEFO) published in the November 2007 election period estimated an underlying cash surplus of 1.3 per cent of GDP. Last week's budget reveals parameter and other variations since PEFO that would have added \$5.2 billion, or about 0.5 per cent of GDP, to the underlying cash balance. Of this, more than 0.3 per cent of GDP is additional tax revenue. Most of that upward revision to tax revenue has been 'saved', to achieve a 2007-08 surplus estimated now to be 1.5 per cent of GDP. For the budget year, 2008-09, the government has targeted an underlying cash balance excluding tax revenue revisions of the same proportion of GDP – that is, 1.5 per cent. Adding the revisions to tax revenue since PEFO, the estimated surplus for 2008-09 is 1.8 per cent of GDP.

As all of you would know, that figure of 1.8 per cent of GDP does not include Future Fund earnings. If those were included, in order to obtain a consistent historical series, the forecast cash surplus would be 2.1 per cent of GDP – the largest budget surplus as a proportion of GDP since 1970-71.

9 Henry (2003), Fiscal policy in Australia, Address to the Australian Conference of Economists Business Symposium, Canberra, 2 October 2003, available at: <http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=699>.

10. Structural policy requirements

I will conclude with some remarks on structural policy requirements. I've already emphasised the critical importance of labour market flexibility in present macroeconomic circumstances. But, important as that is, it is only one element of a much larger set of structural policy requirements if this terms-of-trade boom, unlike several that have preceded it, is to have a happy ending. And while our current labour market arrangements are in pretty good shape, it is unfortunately the case that in many other areas the structural reform task is still in front of us.

In presenting the Ian Little Memorial Lecture in Melbourne in March I emphasised the need for policy makers to develop institutional arrangements to support the operation of efficient markets and, in particular, to allow the price mechanism to determine the allocation of our scarce resources. I illustrated the argument with some observations about the Soviet-style arrangements presently operating to allocate water in this driest inhabited continent on earth. And, as on other occasions, I noted that the most significant obstacle to structural policy reform is a political sensitivity – intolerance even – to the logic of markets.

With the extraordinarily rich COAG agenda being developed by Australian governments this calendar year there is cause for being optimistic that this will be a relatively enlightened period for microeconomic reform.

But consider this.

In 1992, COAG agreed to a notional road user charge for heavy vehicles. The charge was struck at an initial level of 18 cents per litre of diesel and collected as a notional component of the diesel excise, which was then around 26 cents a litre and subject to periodic indexation in line with the CPI. COAG agreed that the charge would be reviewed periodically by the National Road Transport Commission (NRTC), now the National Transport Commission (NTC). By 2000, the diesel fuel excise had been indexed to 44 cents a litre. With the introduction of the GST in that year, the Howard Government decided that the notional road user charge should be the total effective excise payable by heavy vehicle operators. Acting on the NRTC's second determination, the Government increased the notional road user charge to 20 cents a litre. And it then introduced arrangements so that the difference between the 44 cents a litre excise and the notional road user charge was refunded.

Thus, in 2000 the effective diesel excise payable by heavy vehicle operators was cut from around 44 cents a litre to 20 cents a litre, all of which represented a notional road user charge. In March 2001, automatic fuel excise indexation was terminated, the fuel excise rates were cut by 1.5 cents per litre, and the road-user charge was cut from 20 cents a litre to 19.633 cents per litre.

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In 2005, the NTC completed its third determination. It found that the road user charge should be increased (from 19.633 cents a litre to 22.1 cents a litre). That recommendation was not endorsed by the former Government.

Instead, in 2007 COAG directed the NTC to undertake a new determination. The NTC recommended that the road user charge be increased to 21 cents per litre, along with a range of changes to registration charges.

On 29 February 2008, the Australian Transport Council (comprising State, Territory and Commonwealth Transport Ministers) endorsed the NTC recommendations. And on 13 March 2008, the Rudd Government tabled a regulation in the Parliament to implement the increase in the road user charge with effect from 1 January 2009.

But on Wednesday of last week, following the Budget, and before the Leader of the Opposition had delivered his speech in reply, Opposition Senators disallowed the regulation.

This should have been front page news. But it wasn't. In fact, I have been able to find only one reference to it in the nation's print media: a tiny side-bar piece of 52 words with an AAP by-line buried on page 26 of Friday's *Australian Financial Review*.

The road user charge for heavy vehicles is not the most important structural policy matter likely to confront the nation's parliaments this year. But it would be one of the easiest. And it is a pre-condition for other, more important, land transport reforms.

If this terms-of-trade boom is going to have a happy ending, we are going to have to do better than this – a lot better.

