COMPETITION, PRODUCTIVITY, ECONOMIC GROWTH AND LIVING STANDARDS

Address to the Adjudication Branch of the Australian Competition and Consumer Commission

Mollymook Shores, New South Wales South Coast

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* *Note:* the opinions expressed in this paper are the personal views of the author and should not be interpreted as representing the official position of the Australia and New Zealand Banking Group Limited or any of its executives or officers.

Thank you for the opportunity to speak to your conference this afternoon. Your invitation was an unusual request, but it was one I was delighted to accept, because – and I'm not saying this in order to curry any kind of favour with you either for me or my employer – I think the role that you play is absolutely vital to the functioning of a market economy in a democratic society.

My intellectual starting point is almost, to paraphrase the fictional character Gordon Gecko from Oliver Stone's 1987 film *Wall Street*, "Competition is good. Competition works; competition is right. Competition clarifies, cuts through, and captures the essence of the evolutionary spirit. Competition in all its forms … has marked the upward surge of mankind … and competition, mark my words, has saved the previously malfunctioning corporation called Australia"[1].

I said my intellectual starting point was *almost* that paraphrase, because I would want to qualify my endorsement of it by noting that competition is not an end in itself, but rather a means to an end; and that, as the Productivity Commission's Chairman Gary Banks pointed out in a speech in July 2001, "there are circumstances in which restraints on competition can be justified from a community-wide perspective"[2].

I would also add that although competition is in most circumstances beneficial to consumers, consumers (including this one) are sometimes bewildered by the array of choices with which they may be confronted in some situations, and that they may incur a variety of costs, and make costly mistakes, in navigating their way through those choices.

Nonetheless, at least since Adam Smith pointed out more than 230 years ago that "people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or some contrivance to raise prices"[3], most economists have accepted and recognized the importance of having and enforcing competition laws, even though – as Smith went on to say in the less-frequently-quoted next sentence – "it would be impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice".

As Simon Domberger, Professor of Management at Sydney University observed nearly a decade ago, the word 'competition' derives from the same Latin root as 'competence' – from *com petere* which means 'together to strive for' or 'together to achieve'.[4]

And there is now a considerable body of empirical evidence, stemming from what were initially ambiguous theoretical results and complicated by difficulties of measurement and calibration, which shows that competition does indeed boost productivity growth and, hence, average living standards, in most situations.

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[1] The monologue delivered by Gordon Gecko in *Wall Street* to stockholders in the company Teldar Paper, for which Gecko was making a takeover bid, drew heavily on a commencement address given by the real-life arbitrageur Ivan Boesky to students at the University of California, Berkeley, in 1985. Boesky pleaded guilty to insider trading in 1989, and turned State's evidence against Michael Milken (among others), for which he received a 3½-year jail sentence and a US$100mn fine.

[2] Gary Banks, 'Competition and the Public Interest', Paper prepared for the National Competition Council Workshop, *The Public Interest Test under National Competition Policy*, Melbourne, 12 July 2001, p. 6.

[3] Adam Smith, *The Wealth of Nations* (1776; Penguin 1985), Volume 1, Book 1, pp. 232-3.

[4] Simon Domberger, 'Competition: reject it at our peril', *Australian Financial Review*, 1st December 1995, p. 46.

Productivity growth – which, as Paul Krugman has pithily observed, "isn't everything, but in the long run it's almost everything"[5] – essentially stems from three sources – innovation in the commonly-understood sense of that word; technical efficiency gains (in the sense used by economists, that is, reducing the extent to which more resources and factor inputs than required by a particular technology are used, or to which resources and factor inputs are put to sub-optimal uses); and technological diffusion or imitation (that is, applying processes and products developed elsewhere).

Research by academic economists over the past decade supports the proposition that all three sources of productivity growth are enhanced by competition.

Summarizing this research, a 2002 paper from the OECD concludes that "competition has pervasive and long-lasting effects on economic performance by affecting economic actors' incentive structure, by encouraging their innovative activities, and by selecting more efficient ones from less efficient ones over time". It goes on to show that "the link between product market competition and productivity growth is positive and robust", and that "there exist considerable interactions between product market competition and competition in labour and capital markets"[6].

Australia's experience exemplifies the conclusions of this academic research. The principal purpose of most of what has fallen under the heading of 'micro-economic reform' over the past two decades has been to increase the exposure of Australian economic agents – businesses, workers and government instrumentalities – to greater competition, both from abroad (through, for example, reductions in barriers to imports and to foreign investment) and from within (through, for example, de-regulation, privatization, and competition policy). And the result has been a significant improvement in Australia's productivity performance, relative both to our own (rather unimpressive) history, and relative to other countries at comparable stages of economic development.

Australia's *labour* productivity growth rate has accelerated to 2.8% per annum over the decade ended 2003-04, from an average of 2.2% per annum over the preceding three decades. That might not sound a lot, but it means that it takes 26 years to double our output per hour worked at the growth rate of the past decade, compared with 33 years at the growth rate of the preceding 30 years.

Our *multi-factor* productivity growth rate – which, at the risk of over-simplifying, measures the efficiency with which labour *and* capital are combined to produce output – has stepped up from an average of 1.1% per annum over the three decades ended 1993-94 to 1.5% per annum over the past decade. Again that might not sound much, but the difference is enough to cut the time required to double our output per unit of labour and capital inputs by 17 years.

Gary Banks, in the 3½-year old paper I cited earlier, asserted that if Australia's productivity had grown in the 1990s at its previous trend rate, annual income in 2000 would have averaged around $2,700 less per person, or roughly $7,000 less per household[7].

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[5] Paul Krugman, *The Age of Diminished Expectations* (MIT Press, Cambridge, 1994), p. 13.

[6] Sanghoon Ahn, "Competition, Innovation and Productivity Growth: A Review of Theory and Evidence", OECD Economics Department Working Paper No. 317 (OECD, Paris, 2002), pp. 5-6. See also Dirk Pilat, "Competition, Productivity and Efficiency", *OECD Economic Studies*, No. 27 (November 1996), pp. 107-146.

[7] Banks, *op. cit.*, p. 4.

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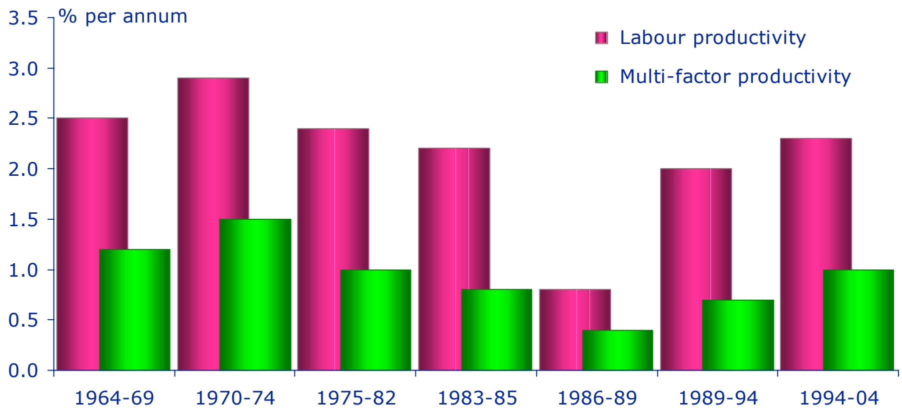
Australian productivity growth has accelerated substantially over the past decade

Productivity growth

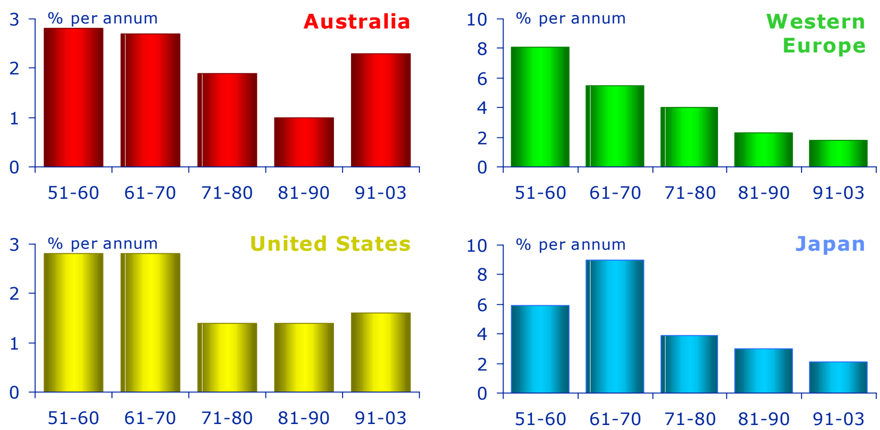


Note: This chart shows productivity growth between what the ABS identifies as 'multi-factor productivity' peaks, so as to abstract from cyclical influences on productivity growth. Data are for the 'market sectors' only. *Source:* ABS, *National Accounts 2003-04* (5204.0), Tables 22 and 23.

3

Australia is one of only a few Western countries where productivity growth picked up in the 1990s

Labour productivity growth, 1950-2003



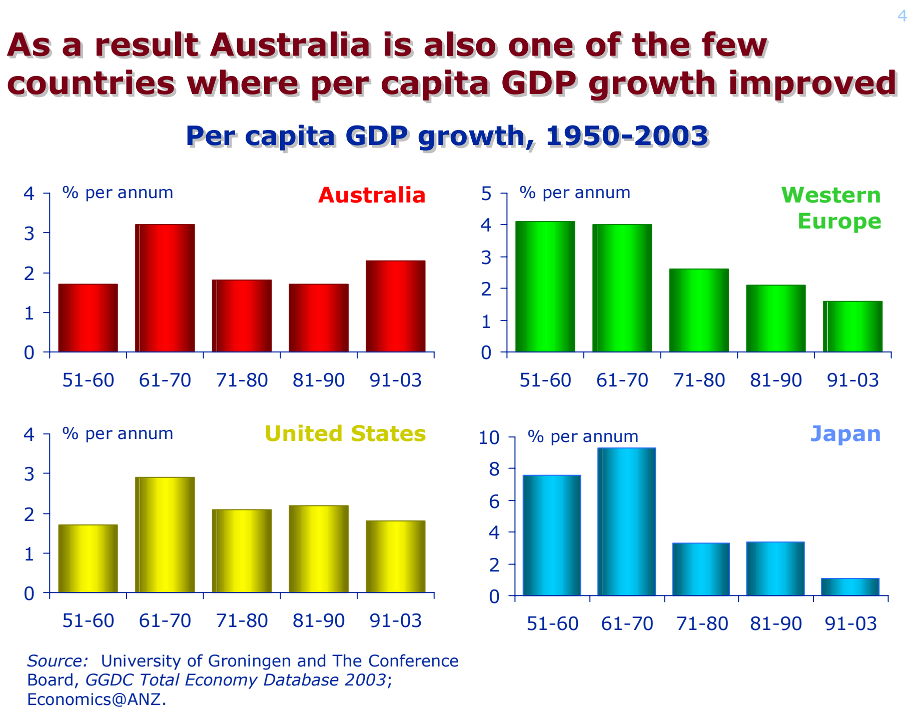
Note: Labour productivity is here defined as real GDP per hour worked in all sectors of the economy, not just the 'non-farm market' sectors. *Source:* University of Groningen and The Conference Board, *GGDC Total Economy Database 2003*; Economics@ANZ.

Australia is one of a handful of OECD countries which have been able to reverse the substantial decline in productivity growth which set in after the first oil shock of the 1970s. The US is another; but Australia's performance in lifting productivity growth over the past decade is much more impressive than that of the US.

Moreover, as the Productivity Commission's Dean Parham et al point out, "the fact that Australia's productivity surge pre-dated that of the US has been a principal reason to attribute Australia's surge to … non-ICT (information and communications technology) factors – at least in the initial stages of the productivity uplift. Micro-economic reforms are now widely seen to have played an important part in raising Australia's productivity performance"[8].

This conclusion has been endorsed by Charlie Bean, the Chief Economist of the Bank of England[9]. Similarly, Peter Forsyth of Monash University concludes that "both the magnitude and timing are consistent with the view that microeconomic reform has been a primary contributor to the productivity boom".[10]

Largely as a result of this improved productivity performance, Australia has also been one of the few Western countries in which growth in per capita GDP – the broadest commonly available measure (albeit an incomplete and imperfect one) of improvements in average living standards - has trended upwards since the 1980s.



And that has in turn meant that over the past 15 years Australia has reversed most of the decline in its ranking among OECD countries in terms of per capita GDP that took place between 1950, when we ranked 5th, and 1989, by which time we had fallen to 18th. By 2003, we had recovered to 9th.

To those who might object, with some justice, that per capita GDP is an inadequate measure of living standards, I would note that Australia's ranking on the United Nations' Human Development Index, which adds measures of educational and health outcomes to per capita GDP, Australia has improved its ranking from 14th to 2nd over the same period.

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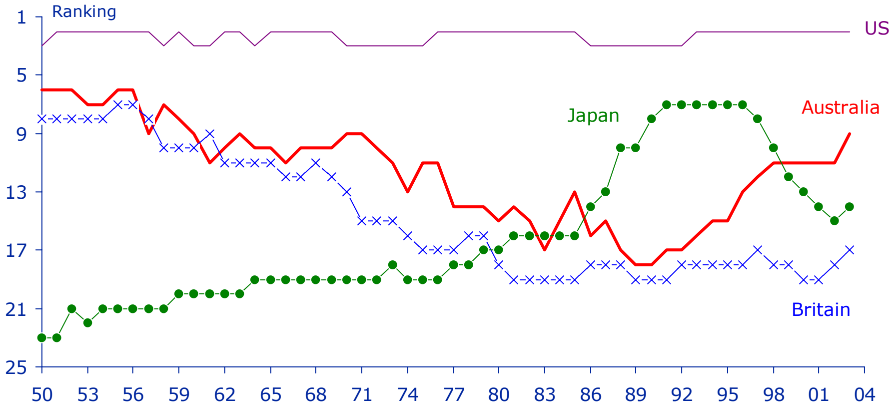
[8] Dean Parham, Paul Roberts and Haishun Sun, *Information Technology and Australia's Productivity Surge*, Productivity Commission Staff Research Paper (Ausinfo, Canberra, 2001), p. xiii.

[9] Charles Bean, "The Australian Economic 'Miracle': A View from the North", in David Gruen and Sona Shrestha (eds.), *The Australian Economy in the 1990s* (Reserve Bank of Australia, Sydney, 2000), p. 93.

[10] Peter Forsyth, "Microeconomic Policies and Structural Change", in Gruen and Shrestha, *op. cit.* p. 236.

Australia's living standards 'ranking' among Western countries has thus risen significantly

Australia's ranking among OECD countries in terms of GDP per capita



Note: GDP is in 1999 US$ at PPP exchange rates.
Source: GGDC *Total Economy Database 2003*.
Economics@ANZ.

I would argue that enhanced domestic and international competition within Australian product and labour markets has contributed to this result, not only by whatever impact it has had on boosting productivity growth, but also by enabling the economy to operate at higher rates of resource utilization (that is, at lower rates of unemployment, among other things), without generating the sort of cost and price pressures which in previous cycles would have prompted the Reserve Bank to curtail the economic expansion through aggressive increases in interest rates. It has done that by providing an additional source of discipline on the capacity of firms to raise prices, and of labour to extract wage increases over and above what can be justified by improvements in labour productivity, in the face of increased demand and tighter supply.

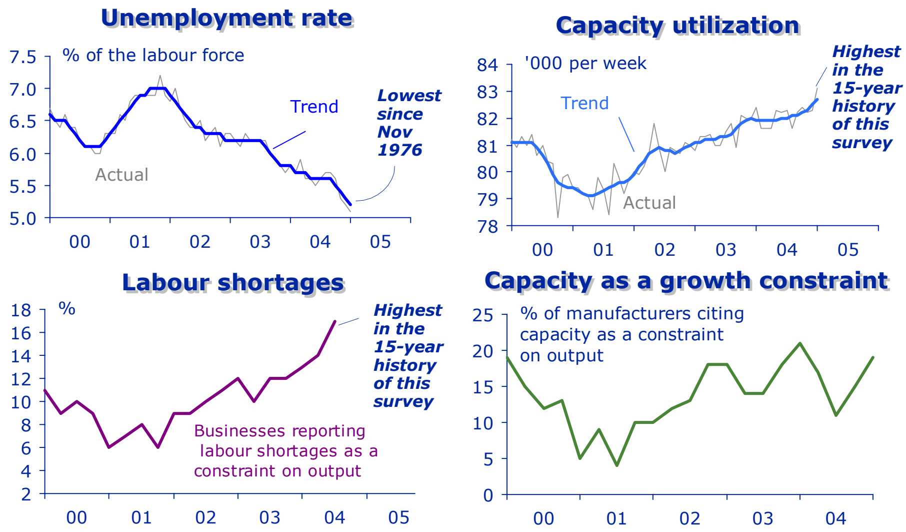
The pervasiveness of that enhanced discipline will face an important test this year as the Australian economy approaches levels of resource utilization not seen in at least 16 – and by some benchmarks as much as 28 – years.

The Australian economy enters 2005 with unemployment at its lowest level since November 1976, and with a higher proportion of firms encountering shortages of labour than at any time since our friends at the National Australia Bank began surveying that question in 1989. Likewise, capacity utilization and the proportion of businesses citing capacity as a major constraint on increases in output are at their highest levels in 16 years. In the past, these have been precisely the circumstances in which cost and price pressures have begun to escalate, and which in turn have ultimately ended in recession.

Fortunately, although there are plenty of what economists call 'anecdotal evidence' of pressures of this nature beginning to emerge, there is as yet very little hard evidence of the sort that would justify recession-inducing increases in interest rates. And if the Australian dollar continues to rise – or, more accurately, the US dollar continues to fall, as I expect it will, thereby generating further appreciation of the A$ against the US$ if not against other floating exchange rates – then those pressures may be at least partially offset by falling import prices, both directly and via their effect on competing Australian-made goods and services.

6

The Australian economy is running into capacity constraints for the first time in 16 years



Sources: ABS; National Australia Bank; Westpac/ACCI; Economics@ANZ.

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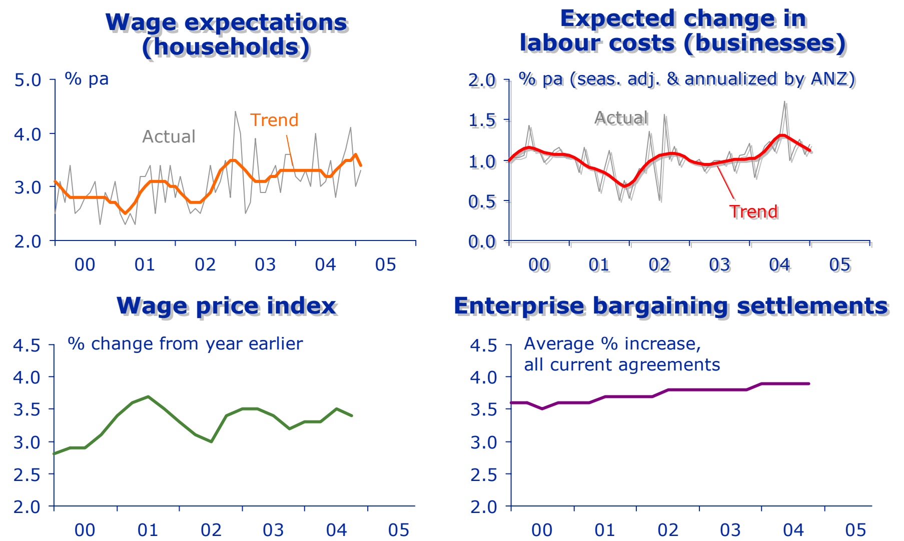
To date there's no sign of any pick-up in wage pressures, despite the tight labour market …



Sources: Melbourne Institute; National Australia Bank; ABS; Dept of Employment & Workplace Relations.

Nonetheless, I expect that some further rises in interest rates are inevitable, though perhaps not until this time next year.

Even then, our forecasts anticipate that the cost and price pressures which will eventually prompt further increases in interest rates will not be of sufficient magnitude to warrant those rate increases being large enough to result in a material or long-lived slowdown in economic activity.

And I put that down, in part, to the greater interplay of competitive forces in the Australian economy.

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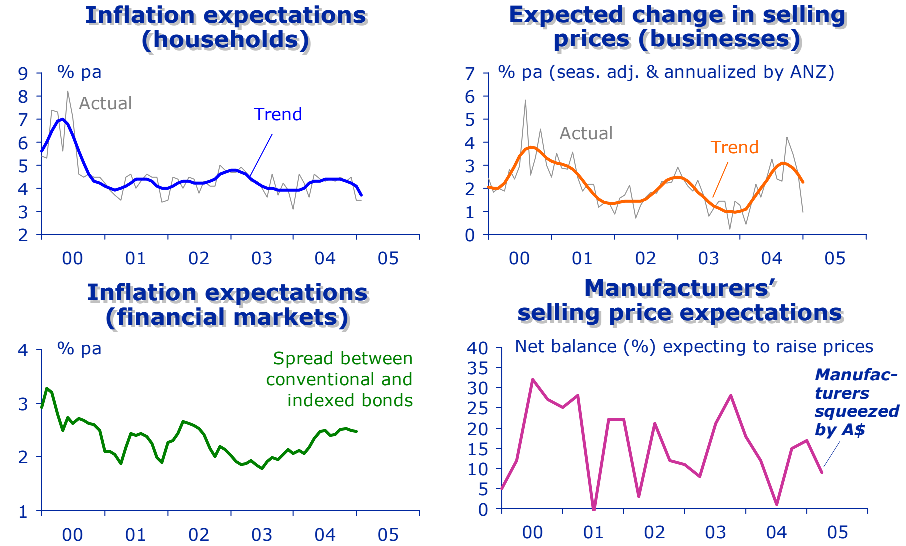
... and little evidence of rising inflationary expectations elsewhere in the economy



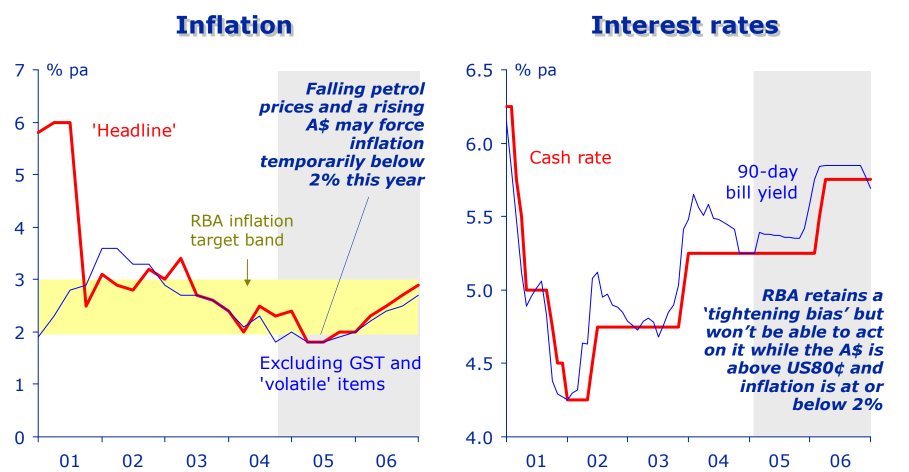
Sources: Melbourne Institute; National Australia Bank; Reuters; Westpac/ACCI;

This will provide a testing environment for many Australian businesses. Most sectors of the Australian economy have been able to improve their profit margins over the past few years, not by raising prices but rather by holding down costs and improving productivity or, in some cases, by retaining some of the benefits of exchange rate appreciation and low interest rates.

Manufacturers' pre-tax profit margins, for example, were higher in 2004 than at any time since at least 1986, when the ABS first began publishing the data from which one can derive such measures; while wholesalers' margins are higher than at any time since 1989 (also a period when the A$ was strong, and growth in domestic demand and imports were robust).

11

The RBA has a 'bias towards tightening' but in our view won't actually raise rates until next year



Sources: ABS; RBA; Economics@ANZ.

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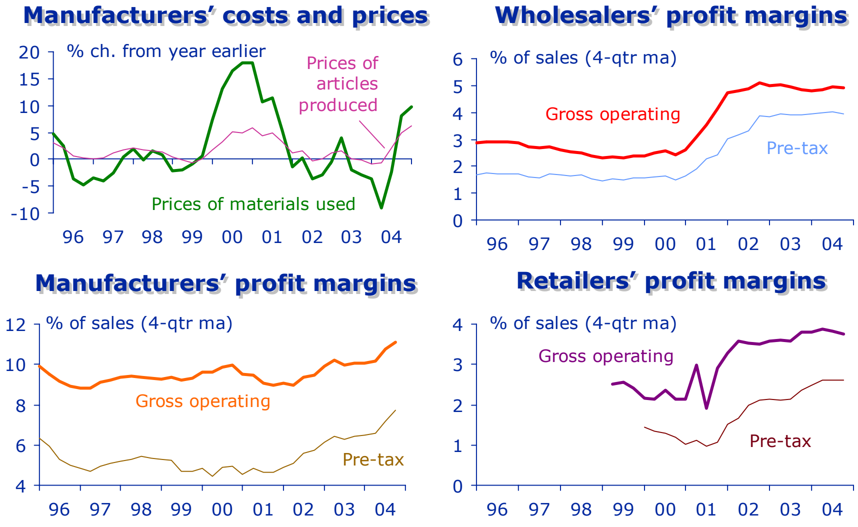
Currently very strong profit margins may come under some pressure this year



Sources: ABS; Economics@ANZ.

Profit margins in the retail, transport and storage, and property and business services sectors – for which the run of data is much more recent – have also improved substantially over the past three years. Yet this has occurred during a period in which consumer price inflation has been well-contained.

However for the reasons I've just mentioned – that is, rising wage and materials costs and a stronger A$ – profit margins are likely to come under some downward pressure this year.

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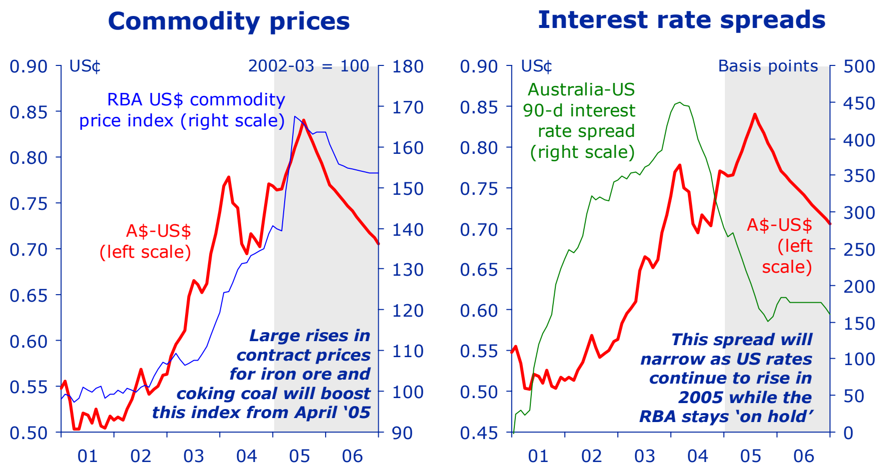
Slower world growth and a narrowing interest rate differential will eventually cap the A$'s rise

Traditional 'fundamentals' and the A$



Sources: Datastream; Economics@ANZ.

A test of a slightly different nature may come when the Australian dollar reverses course – as on our forecasts it will later this year once commodity prices have peaked, the interest rate differential between Australia and the US has narrowed further (as a result of on-going increases in US interest rates) and, perhaps, as markets become more wary of our persistently large current account deficits.

Despite what I've argued, and most other economists would agree, are the significant benefits for the Australian economy and for Australian consumers of the greater role played by competition in the Australian economy over the past two decades, Australians – both consumers and businesses – retain a curiously ambivalent attitude towards competition.

As in so many aspects of Australian life and culture, many Australians apply different standards to sport from those which they apply in other areas. Just as high incomes, luxury lifestyles, and high levels of taxpayer-funded support are considered acceptable for successful sportspeople, but not for those who find success in other walks of life, so do many Australians seem to regard competition – albeit within well-defined and (usually) strictly-enforced rules – as something to be applauded on the football field, the running track, the cricket pitch, the swimming pool and the tennis court, but by contrast see it as something to be regarded elsewhere with a mixture of fear and loathing[11].

Australians readily acknowledge that competition is a spur to greater achievement in sport – and are willing to tolerate our leading sportspeople living overseas (in tax havens if necessary, a tolerance which they don't extend to business people) – and for our tax dollars to be used to assist them to participate in international competition. But a surprisingly large number of them (including enough members of the Federal Opposition before the last election to have a discernible influence on their policy platform) seem still to regard international competition as something from which governments should shelter them (or their employers), even though to do so would add to the cost of their clothes and their cars. And the introduction of greater competition into domestic markets such as local government contracting and (for enough members of the Federal Government to have a discernible influence on their policy position) pharmacies, newsagents and the professions – seems to be regarded as more of a threat than an opportunity.

In much the same way, many business people – who, it has to be said, are more likely to extol the virtues of competition as a general proposition – tend to be rather less enthusiastic about the idea of greater competition in their own industry. Mercifully, it's far less common to hear captains of industry calling for 'protection' against international competition – at least in those quarters, the intellectual battle has been won – but it's far from uncommon to hear or read of business people and or their representatives objecting to Sunday trading, the removal of laws restricting entry into particular industries, or calling for legislation preserving their share of particular markets. These people appear to be under the impression – although they never *quite* put it this way – that consumers exist to serve the interests of business people, rather than the other way round.

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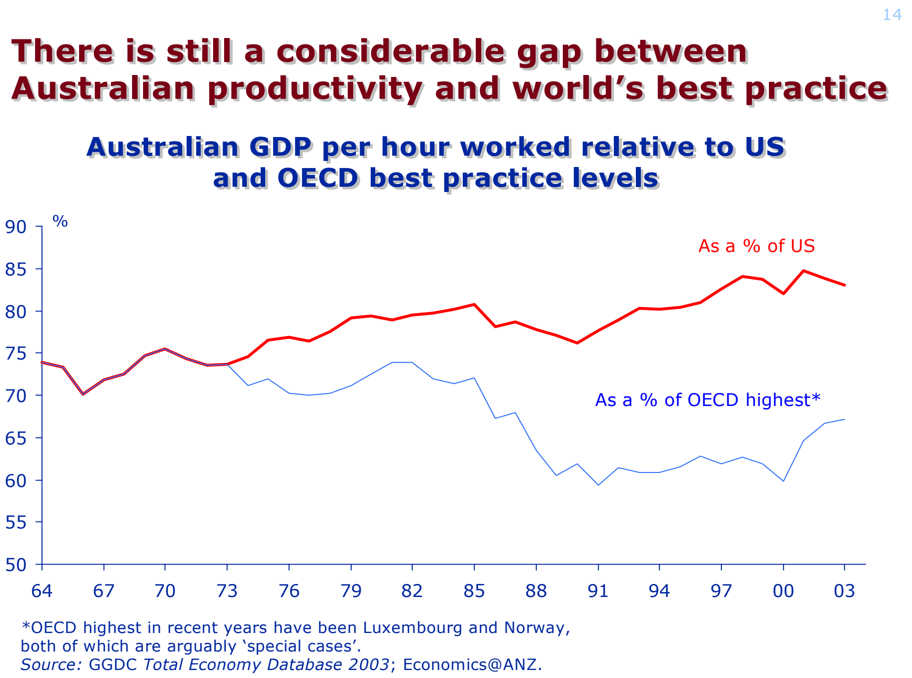
[11] I readily admit that this is one of my personal hobby-horses; see, for example, my 'Remarks to Melbourne Media Club lunch' of 15 March 2001, available on ANZ's website at http://www.anz.com/Business/info centre/economic commentary/Melbourne Media Club talk.pdf. This was intended to be at least partly tongue-in-cheek; but it drew an extraordinary response from Collingwood Football Club President, TV commentator and quiz-show host and all-round 'A-list' celebrity Eddie McGuire.

None of which is to say, as I acknowledged earlier, that competition is an end in itself, or that there are not some circumstances where other considerations might warrant some restrictions on competition.

As Simon Domberger observed in the article I quoted from earlier, "competition is no panacea for our social ills. It may even make some of our problems worse" (I would insert here, especially those who emerge from our education systems or from our less well-serviced suburbs and regions ill-equipped to survive and prosper in more competitive labour and product markets); but, as Domberger goes on, "the benefits it creates allow for the social infrastructure to help people cope with the pressures of reduced job security, part-time employment and other pressures of modern life"[12].

And in that respect, as the OECD's annual survey of the Australian economy released last night reminds us, there is still more work to be done to "promote higher growth by further strengthening competitive pressures in the economy via: completion of unfinished business of the National Competition Policy (NCP) agenda and the adoption of an extended reform agenda, following the Productivity Commission inquiry into the future of NCP"[13]. Australia still ranks only 17th among OECD countries in terms of GDP per hour worked, 17% below the comparable figure for the United States (at out lowest point, in 1990, Australia was nearly 24% below the US on this measure).



There may be reasons stemming from our geography, scale and distance from other major economic centres as to why we cannot aspire to close the gap entirely[14]; but there can be little doubt that there is still considerable potential to

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[12] Domberger, *op. cit.*
[13] OECD, *Survey of Australia 2004*, 2nd February 2004; available via the OECD website at http://www.oecd.org/document/29/0,2340,en_2649_201185_34037213_1_1_1_1,00.html
[14] See, for example, The Treasury, 'Budget Statement No. 4: Sustaining Growth in Australian Living Standards', in *Budget Strategy and Outlook 2003-04* (Commonwealth of Australia 2003), pp. 4-19 to 4-23.

improve Australians' standard of living through further pro-competitive and productivity-enhancing reforms.

It seems to me that as the economy becomes less regulated in the traditional sense of that term, as government-owned instrumentalities cease to exist or become less important, and as globalization puts more activities actually or potentially beyond the reach of national governments and regulatory agencies, the importance of competition as a discipline on business behaviour increases – and with it the importance of effective enforcement of competition laws.

Thus, for example, I think it's entirely right and proper that the Government is proposing to take a tougher legislative approach towards anti-competitive cartels – as indeed the ACCC has already begun to do on its own initiative – and to prescribe tougher penalties for breaches of laws pertaining to cartel behaviour.

Similarly I think the Commission should take a tough line, unless persuaded to the contrary, in relation to mergers which appear, at least on the surface, to result in a substantial lessening of competition. I'm happy to leave precise definitions of what that means to the lawyers. But one specific example that I do want to discuss is the so-called 'national champions' argument, which is trotted out from time to time to justify proposed mergers on the grounds that they enable Australian firms better to withstand the rigours of international competition and to survive in the global market place.

I should emphasize here that on this particular point I am speaking solely for myself, and that there are others in ANZ – specifically others who are higher up, and better paid, than I am and who actually have some experience running a business – who take a different view. That said, I think the 'national champions' argument is, as the British would say, bollocks.

I am not aware of any evidence which demonstrates that size, or the absence of domestic rivals, is a necessary – let alone a sufficient - condition for success in international markets. To the contrary, my interpretation of the evidence of researchers like Harvard's Michael Porter is that strong domestic rivalry, rather than local monopoly, best fits firms to succeed in foreign markets[15].

Contrast the success of Japanese firms – all of which face strong competition in their home market (albeit that it usually doesn't take the form of lower prices) – or the more successful US firms (which do compete strongly on price) – in establishing themselves in foreign markets with, for example, the track record of many (though not all) French firms who all too often enjoy State support for their foreign ventures and protection from competition at home. Rather, I see the 'national champions' argument in all its various guises as little more than a plea to be allowed to extract monopoly rents from Australian consumers in order to subsidize offshore adventures – and that it should be rejected wherever it is encountered.

As I said at the outset, the role which you play is vital to the operation of a market economy in a democratic society, and I want to conclude by wishing you well in discharging your responsibilities in what may well be a testing year.

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[15] Michael Porter, *The Competitive Advantage of Nations* (The Free Press, New York, 1990).

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