

Central Intelligence Agency



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DIRECTORATE OF INTELLIGENCE

20 November 1984

**Australia's Economic Recovery:
Hawke's Election Trump Card**

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Summary

Australia's popular Prime Minister Bob Hawke is relying upon a resurgent economy to guarantee his party's victory on 1 December. As the opposition struggles to find a campaign issue, the Prime Minister points to:

- o The role of the expansionary fiscal and monetary policies of his first budget in spurring the recovery.
- o A thus far successful wage indexation scheme.
- o A new national health insurance program.
- o Recent tax cuts for lower and middle income earners as reasons to retain his economic management.

At the same time, Hawke is reminding business leaders of reduced inflation, lower interest rates, extended deadlines for tax deductions on business investments, and the deregulation of the banking and brokerage industries.

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The polls now show that Hawke is preferred as the country's leader by more than 65 percent of the population. We see no problem on the economic front before the election, but economic challenges to Hawke after the election will be tougher. Australia's structural economic problems do not lend themselves to easy solution and Hawke's own party may impede further policy reform. [redacted]

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Labor's Track Record

Since the Labor Government was elected in March 1983, the Australian economy has done well by any standard.

- o Inflation has been reduced by half, with declining import prices, to about 6 percent.
- o Unemployment has fallen from a near record 11 percent to below 9 percent.
- o Real output growth this year, 5.7 percent, is the greatest one-year improvement Australians have seen in a decade.
- o Farmers have had a bumper crop, as the four-year drought has ended.
- o Australia's energy and resource sector has boomed again with economic recoveries in industrial nations, especially the United States.

Although nonpolitical events have sparked the recovery, praise for his government's role in stimulating and sustaining it is being heaped on Hawke by both business and labor. [redacted]

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One of Hawke's greatest achievements was forging a consensus on economic policy among Australia's disparate economic interest groups by calling an economic summit in 1983 among government, labor, and business leaders. Proclaiming the need for slower wage growth to improve Australia's international competitiveness, Hawke convinced the Australian Conciliation and Arbitration Commission, which usually leans toward labor, of the need for a long-term wage indexation. As a result, the number of man-hours lost to industrial disputes this year has been lower than in any year since 1967. At the same time, real wages fell last year and rose only slightly in 1984, allowing company profits to surge to their highest level as a share of GDP since 1973. [redacted]

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Hawke and Treasurer Paul Keating have also engineered an unprecedented deregulation of both the banking system and the securities industry designed to encourage private business investment. At least ten foreign banks, including one or two US banks, will probably win Australian banking licences in the coming year. On the domestic financial scene, Keating has

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increased the scope of both banks and nonbanking institutions; since their functions now overlap, a wave of mergers is under way.

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The Election Budget--Something for Everyone

Media cynicism about the government's attempt to please everyone, including business, has not dampened the generally favorable response to Hawke's 1985 budget, which was presented in



Prime Minister Hawke, left, quizzes Treasurer Keating about anticipated budget effects.

August.* Keating boasted in his budget presentation that the government would keep a threefold commitment for 1984-85: to cut the personal income tax, to reduce the deficit by more than US\$1.0 billion**, and to increase social spending, particularly for those in greatest need.

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*Hawke's 1985 budget covers the fiscal year 1 July 1984 through 30 June 1985.

**Australian dollars converted to US dollars at the prevailing (Oct. 1984) rate of A\$1.00=US\$0.83.

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On the tax front, Keating delivered to the majority of workers most of the US\$9.60 per week tax cut demanded by the Australian Council of Trade Unions (ACTU). In line with Labor Party principles, the cuts are directed to low and middle income earners--traditional Labor Party voters. Business leaders, meanwhile, are pleased with the provisions of the budget that increase tax incentives for investment in buildings, equipment, and oil exploration and allow the losses of one subsidiary to be deducted from the profits of another for tax purposes. [REDACTED]

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Hawke's social spending moves also are directed at some important political constituencies. Welfare and unemployment assistance increases aim at young people and single adults. The dollar amount of the welfare increment is the same for pensioners, but they were already receiving the equivalent of Medicare so their real benefit is less. Pensioners' complaints are being partially offset by rent supplements for the neediest. [REDACTED]

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The budget's critics argue that it is unnecessarily expansionary, although this year's deficit will be lower than last year's. Revenue from personal income taxes will increase dramatically and government spending as a proportion of GDP will rise as well. Because the increase in revenue is primarily a result of the recovery, critics say the government should use it to trim another US\$2.1 billion from the deficit rather than to extend social spending. Part of the problem for Hawke, however, is that many spending items do not lend themselves to economy moves. For example, interest payments on the national debt consume about 10 percent of total receipts. [REDACTED]

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Prospects Look Bright Through Early 1985

Although no one expects next year's economic performance to outdistance that of 1984, economic growth should remain above the growth rates familiar to Australians who weathered the final years of Prime Minister Malcolm Fraser. Real GDP is rising at an annual rate of about 4 percent. For its part, the ACTU is strictly enforcing its pact with the Hawke government by revoking some of the privileges of the more rebellious unions. In fact, strikes by some of the more radical unions have in recent months brought threats of expulsion from the ACTU. [REDACTED]

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Australia's external accounts, which have held up reasonably well during the expansion, are now weakening--the one dark spot in the overall economic picture. Exports continue apace, but are expected to be moderated by a fall from the mid-1984 peak in agricultural output. With consumption expenditures and capital purchases increasing steadily, imports are expanding more than last year, creating a small merchandise trade deficit and widening the current account deficit. [REDACTED]

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Nevertheless, the only economic issue for the opposition to seize on thus far has been the government's post-election tax

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plans. Hawke proclaims the need for tax reform, but has exercised great care about disclosing specifics because Labor's natural constituency opposes the most obvious reform route, a broadly based consumption tax. Opposition Leader Andrew Peacock warns that not only a capital gains tax but also a wealth tax and a pensioners' assets test loom on the post-election horizon if Labor wins. Australians, however, are inclined to believe that Keating will block any attempt to legislate a wealth tax, and more people than expected seem to favor some kind of capital gains tax to restrict the scope of tax evasion and to direct funds into more productive investments than tax shelters. [redacted]

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Economic Challenges Beyond the Election

With the Prime Minister's popularity rating holding its position above 65 percent for over a year and Peacock's rating falling below 20 percent, Australian observers are treating a Hawke election victory as a foregone conclusion. The only questions are how large a majority Labor will achieve in the House of Representatives, and how strong Hawke's right wing will be in the party caucus.* Hawke undoubtedly hopes to use the election mandate he will receive to advantage in his most formidable challenge--improving Australia's international competitiveness and sustaining long-term growth by restructuring the economy. [redacted]

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Australian analysts agree that continued high growth depends on buoyant private investment and wage moderation with relative industrial peace. Although tax cuts have satisfied labor demands for now, media reports suggest that strikes will reappear next year if new union demands--in the form of productivity-based wage increases or national superannuation (pension) schemes--are not met. Increased union demands are feared partly because inflation, wage indexation, and consequent advances into higher tax brackets are predicted to wipe out all benefit from the August tax cuts by mid 1985. Answering widespread calls for reform and for a broadening of the tax base, the government's post-election tax package will surely include a capital gains tax and probably a value-added or a sales tax covering some services and all goods except essentials. [redacted]

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*The race between the parties is a bit closer than the one between leaders and Embassy observers believe that the new House will have roughly the same make-up as the old: about 60 percent Labor and 40 percent Liberal-National. Although the left wing of Hawke's party mounted a strong campaign to secure more seats for its sympathizers, the Embassy believes that Hawke's countermeasures were at least partially successful and that his faction will again hold about a third of Labor's seats. Hawke's challenge will not be keeping right-wing votes but maintaining the support of Labor's center left, Bill Hayden's faction. [redacted]

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[REDACTED]

One of the problems that threatens to confound Hawke's efforts is slow private business investment, which remains weaker than expected--in spite of higher company profits, higher retained cash flow, budget incentives to private business investment, and government deregulation of the banking and stockbroking industries. Industry leaders stress that capital expenditure decisions are based on need rather than on capacity to pay and claim that the rate of return to investment remains below that of the 1960s and 1970s. They suggest that the bulk of the recovery in the nonfarm sector comes from cutting costs, including laying off workers and closing factories. [REDACTED]

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Much of the economic outlook rests on Hawke's ability to maintain the prices and incomes accord. Business seems incapable of uniting on policy, so few observers expect successful opposition to a national superannuation scheme (pension plan), the top priority on the ACTU's list of demands for the next wage negotiation phase. Labor costs are thus expected to rise even if wage indexation remains intact. If so, business investment will probably continue to lag. [REDACTED]

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Also on the negative side, the unemployment rate is unlikely to be lowered much further soon. Optimistic reports announce that, because of increased labor force participation and natural labor force growth, recorded unemployment will not fall unless 3.5 percent per year GDP growth is sustained for several years. Pessimistic reports, such as one by Bill Kelty, secretary of the ACTU, advance the figure to 5.0 percent. In view of structural problems in the Australian economy and the tenuous nature of the prices and incomes accord, such an extended period of high growth seems unlikely. [REDACTED]

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On the other hand, inflation is unlikely to return to its former high levels if wage pressures can be stemmed. Floating exchange rates, instituted in December 1983, allow Canberra to control more closely the money supply without worrying about a substantial deterioration in the balance of payments. Keating, announcing the Government's 1984-85 target for money supply (M3) growth to be 8 to 10 percent, has said that monetary policy will be neutral. [REDACTED]

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Long Term Outlook

Observers in the press predict that when the economy slows toward the end of 1985, Hawke will lose some of his popularity, and Australia will lose the prices and incomes accord and many of the government's other achievements. We agree that Hawke will not be able to enact all the reforms he has placed on his second-term agenda, primarily because he is challenging long-standing traditions of economic policy making. Still, slower economic growth will probably be seen as insufficient cause to abandon Hawke's leadership. And in our judgment, Australian economic prospects will be fundamentally improved for his and Keating's efforts. [REDACTED]

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