FINANCIAL INNOVATION AND LABOUR REFORM IN THE POST-INDUSTRIAL AGE

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Upon the election of the new government in South Korea, one of the country's leading newspapers, *Chosun Ilbo*, asked a group of international leaders to share their experiences in the quest for reform. Paul Keating's address, albeit made in another country, is more revealing than perhaps any he has given in Australia. The address makes transparent his social and political philosophy. He says social democratic states should commit to wage justice, including legislated minimums for the low paid; that policy should never be about buttressing top-end wealth off the back of a working poor; and that the most vulnerable must be protected. He says decisive Cabinet government with a competent bureaucracy is the highway to change. In the address Paul Keating claims 'there is nothing more noble than lifting the great body of a population into higher levels of income and employment'.

Chosun Ilbo has asked me to address the subject of financial and labour market reform. I have been asked to draw upon my experience of introducing reforms to those markets in Australia during the period I was Prime Minister and Treasurer of Australia.

In particular, I have been asked to reflect upon similar changes made in Australia 25 years ago and more recently, fifteen years ago, to provide some clue as to the importance of these reforms and how they might work in a South Korean context.

Perhaps I should make the overarching and key point first: any country has a right and can choose the economic pathway of economic nationalism and protectionism. But supporters of that policy have to know that such a pathway, while having some popular appeal, carries with it the choice of sub-optimal or lower rates of economic growth coupled with lower and slower rates of income growth.

Perhaps I could paraphrase it this way: open markets provide more opportunities, more growth and faster income growth. But they present greater challenges from the ensuing adjustments and put a greater requirement on the political system to respond to the need for those adjustments.

Open markets also do something else: by allowing competitive pricing, they make clear which parts of the economy are true profit centres and which, by contrast, are the parts which perform sub-optimally.

These outcomes inform investment choices such that capital is drawn to those parts of the economy where enhanced profitability lifts returns and with these returns, GDP growth. In other words, open markets identify the more likely and natural parts of the economy where scarce capital is best employed.

Impediments to trade, such as tariffs and quotas, financial regulation and labour-market rigidities falsely pump up particular sectors and industries, making them appear more attractive and profitable than they really are. Whereas those nominal attractions can only exist at the expense of the broader community by way of diminished incomes and lower GDP growth.

We have a choice. But if we have the option and the power, why would we take the low-income road over the high-income one, simply to satisfy entrenched interest groups or keep the political system free from trouble?

There is no revelation in this. But the fact that these truths are so often ignored or obscured makes their recital worthwhile.

Politicians and political parties exist for one purpose and one purpose only: to safeguard the people while improving their living standards, making the required changes to the fabric of their economies and their societies.

Politicians who are in the business of politics but not in the business of change let their communities down, and badly. The political game is about, and only about, getting the changes through. Bureaucracies are more than capable of running an existing system, but bureaucrats do not have the authority or generally the instinct to promote change.

The great curse of modern political life is incrementalism. Moving along, millimetre by millimetre, taking few political risks while pretending to be the elector's friend.

Mandates for paradigm shifts in an economy or society belong only to politicians and to the political system; they can never belong to bureaucracies. Bureaucracies have no political power on which to draw; what they do, sometimes well, is to filch morsels of power which they use to incrementally move along their own agendas.

It is no accident that in countries where bureaucracies have been in the ascendancy we find generally slower rates of economic growth and slower rates of income growth.

A decisive Cabinet government, aided and abetted by a competent bureaucracy, is the key to change.

With that in mind, your hosts have asked me to say something about the financial system and financial-market reform.

When I first began opening the financial markets in Australia in 1983 I used to speak in terms of a sclerosis which inhabited the Australian financial system. And I used apply the analogy that we needed to 'clear the financial arteries to get blood to the muscle of the economy'. That remark is as true today of unreformed financial systems as it was of Australia then. Open and porous financial markets bring financial resources to parts of the economy that were undreamt of even 30 years ago. Financial deregulation allows financial engineering and packaging of a kind which the old regulated and traditional financial system was unable to provide. And, more importantly, unwilling to try.

Most financial systems built around deposit-taking institutions were characterised as high-margin businesses, offering a relatively limited range of services. Institutions of this kind serve a society particularly badly by making people pay too high a margin for financial resources while limiting the size of the group who qualify to enjoy those resources. Low margin, big volume, fungible financial services are able to help the great body of the community into assets and services they require. In doing so, they promote higher GDP growth.

The absence of unnecessary financial regulation also underwrites the more rapid development of capital markets, those places where financial resources are available to industry and commerce other than through the intermediation of traditional banks. For instance, Japan is the model of a top-down, bank-intermediated financial economy whereas the United States has been the model of a much more horizontal financial structure where corporations and individuals have access to capital through a vibrant capital market. Where banks do what banks should do: look after the consumer, the householder and the small business entrepreneur.

Of its essence, financial regulation represents a set of structures most valuable to the already wealthy while deregulation, openness and fungibility present avenues which are most valuable to the clever and the imaginative. When a society leaves the door shut to the clever and the imaginative while leaving it open to those of established wealth, that society is heading for second-best outcomes.

That said, financial innovation also carries with it ongoing adjustment problems and distortions as we have seen in the United States more recently.

A sustained period of economic expansion like the one we have experienced since 1982 will generate an ever growing role for the financial economy in world economic affairs. A 25-year expansion characterised by low inflation and with less circumscribed financial markets will inevitably underwrite an expanding role for financial services in our economic life. Indeed, we have seen a proliferation of institutions and services of a kind never before witnessed. And this period, at least for half of it, has also been characterised by accommodating monetary conditions and high levels of liquidity induced, in the main, by central banks.

The outcome has been a *pot au feu*: a financial milieu without precedence in financial history. Financial innovation in this period has led to all sorts of financial engineering and packaging to get financial resources into every crack and crevice of the economy; while on the asset side, ownership of those resources has been spread to the four corners of the earth under every instrument imaginable. Each new instrument brings another new name: collateralised debt obligations or CDOs, derivatives, hedges, swaps, securitised bonds and all manner of financial units, be they in listed trusts or private portfolios.

The fact is, for the first time in modern history, we now have a financial system whose affairs and influences are beyond the reach and remedy of central banks.

However true this is, would we have turned our back on the financial innovation which has lubricated the last 25-year expansion, or would we have opted for the safe house of bank-intermediated economies run in clubby cabals by central banks, commercial banks and finance ministries?

The answer has to be that we should have preferred innovation over regulation, notwithstanding the problems that too often accompany innovation. The current sub-prime crisis in the United States teaches us, again, that no amount of financial slicing and dicing can turn a bad credit into a good credit.

If sub-prime loans were bad to begin with they remained bad even as they were sliced and diced into a collateralised security held by unsuspecting investors. And, let me add, that none of these tendencies have been helped by central banks who feel it is their bounden duty to underwrite the financial adventurism of investment banks and private equity funds, by putting onto the state the contingent cost of financial miscalculation.

I do not think it is too much to claim that as a consequence of the behaviour of central banks and their opportunistic clients, that 'moral hazard' has become the leitmotif of financial services.

This has to be a worry for all governments and all prudential supervisors. But it is a worry that we have to work our way through so that we can enjoy the advantageous aspects of financial innovation while seeking to limit the fallout to investors and the state alike.

North Asia, especially China and South Korea, have an enormous stake in getting the design of their financial systems right. With economies growing in the order of 8 to 11 per cent a year, the ongoing resourcing of these economies will not be possible unless their financial systems move in tandem, or are allowed to move in tandem, with economic expansion.

And what is true of financial markets is just as true of labour markets.

Policy toward labour markets should be such as to encourage labour to go to the most productive places in the economy to secure the greatest increments to income. Productivity-based wage adjustments therefore represent the best way of lifting incomes while holding down inflation. And this is best accomplished by labour-market mobility with workers free to switch to the best jobs.

Social democratic states very properly have another objective: to guarantee that working people are able to enjoy a living wage, one that lifts them and their families above the poverty line. This can take the form of a legislated minimum or a basic award but, in whatever form, it provides the foundation of a civil society. We should always remember that the point of economic policy is economic wealth and social progress. It should never be about top-end wealth provided off the back of an army of working poor, denied the kind of wages and conditions that are conducive to the sustenance of families.

We ought remember that in that great cauldron of opportunity, the United States, real wages have not risen since the early 1980s. That is, the huge increments to productivity from the late 1990s on have gone solely to profits and to those lucky individuals at the uppermost reaches of the corporate and financial system. This represents a massive indictment of the United States as the country of the fair society. This is not a model which will suit rising societies, particularly of the Asian variety, which rely upon the family unit, family cohesion and family income as their nation's basic building block.

What a country needs is wage justice with full employment, had by directing national financial resources to the appropriate and best parts of the economy, unfettered by the distortions of protection. Investment of the kind which, through productivity, is able to lift wages and profits simultaneously. Any fool can run a low-wage economy in the quest for low prices and competitiveness; what we need are clever people to run systems which are productivity-inducing, where real wages rise with GDP and where competitiveness is not had unfairly from the sweat of the low paid.

There will always be groups in the labour market whose positions are so weak that they are unable to bargain their way into higher wages, to garner a share of the productivity. This is invariably true for women and young people and the broadly unskilled. Policy has to work at protecting these vulnerable people from exploitation while the better off are able to reasonably enjoy their economic rewards.

There is a real challenge here: we want flexible and mobile labour markets with earnings related to productivity but decency demands that we should have this only in the context of safety nets for the disadvantaged.

Education provides the great springboard of opportunity, including into higher incomes. This is why an economy becoming more urbanised, with greater service orientation, has to have a premium on education. Education is the conduit through which higher levels of productivity are had.

Education has been a notable and strong trend in South Korea; it knows the way forward in the post-industrial age. A country like South Korea must continue to lift itself up the international division of labour and not be left behind to compete with low-wage countries.

There is nothing more noble than lifting the great body of a population to higher levels of income and employment: indeed, there can be nothing more noble for a political system than lifting the great body of a community. But this can only be done by governments competent in the ways of the world: knowing about the economy, knowing about business, knowing about the financial system, knowing about the workforce. Guiding policies with a kind and thoughtful hand.

Financial, product and labour market deregulation have brought much wealth to countries which have promoted these policies. Australia, as a case in point, has now experienced a continuous seventeen-year expansion averaging nearly 4 per cent

GDP growth per annum with inflation at 2.5 per cent. In the 25 years since 1983, real incomes in Australia have risen by one third, over 30 per cent, the largest increment to incomes at any time in the twentieth century. These policies will work just as well for South Korea as they have worked for Australia.

Given that all societies are different, the variations on the theme in South Korea will of course have to be South Korean. But the underlying efficiency of the changes is guaranteed to lift people more rapidly up the income scale and to boost South Korean GDP more obviously on the international totem pole.

It is a very encouraging development indeed, that one of this country's premier newspapers, *Chosun Ilbo*, is committed to these kinds of outcomes and is prepared to meet the organisational responsibility of promoting a conference of this kind in pursuit of those outcomes.