DO COSTS MATTER?

OVER the post-war years there seems to have been a widespread feeling that costs don't matter very much.

Now this is something entirely new in economic thought. With the old classical economists costs were all-important. And in the days when international trade was regulated by the stern discipline of the gold standard, costs did matter—a very great deal. If incomes (and consequently costs) in a particular country rose sharply out of line with incomes and costs in other countries, the disparity led to an outflow of gold. In order to check this movement and to preserve the gold basis of its currency the country in question was forced to resort to deflationary measures such as credit restriction, higher interest rates and sometimes straight-out cuts in incomes. In the environment of the gold standard, costs mattered so much that any rapid increase was looked at askance.

The gold standard thus possessed one great advantage that has been lost to the modern world. It kept the cost structures of the various countries engaged in international trade reasonably in step, and, to that extent, it promoted the classical economists' ideal of maximising trade between the nations. But it had the disadvantage of tying the economy of one country too tightly to those of the countries with which it traded. If, for example, there were a recession in business activity in the United States, the full effects were transmitted to the rest of the world by an automatic process. Other countries were virtually compelled to follow the path of deflation in order to preserve their external balance and thus their stocks of gold.

Under these conditions of trade, individual countries had little control over their own domestic economies. The level of employment was determined largely by the ebb and flow of external economic forces rather than by internal financial policy. It is not surprising that expert and popular opinion rebelled against the tight tyranny of the gold standard and the severe limitations which it imposed on the freedom of countries to manage their own economic and financial affairs.

But now we have jumped to the other extreme. The economic experience of Australia (and other countries) since the end of the war seems to suggest that we believe it to be right and possible to go our own way, and to pursue internal policies regardless almost of their effect on our trading and financial relationships with other countries. Under this philosophy, and now that there is no longer the automatic check on incomes and costs imposed by the gold standard, there has developed a reckless, irresponsible attitude to costs, a feeling that costs can be permitted to go on rising almost indefinitely without any seriously adverse economic effects. It is the philosophy of "costs don't matter"—or, at least, not very much.

Of course there have been a few heretics. Many business men have protested vigorously against the rapid increase in post-war costs in Australia, although, perhaps, more from fears of the effect of rising costs on their competitive position than from any reasoned economic argument. A few economists have registered their forebodings — but only a few. The great majority of modern economists belong to the neo-Keynesian school of thought with its one-sided emphasis on expansionist financial policies and its insistence that any reduction in money incomes under any circumstances will bring about unemployment. **It is undoubtedly the influence of this school of thought that is responsible for the blithe indifference to soaring costs in Australia displayed by governments, industrial tribunals and popular opinion since the end of the war.**

Now the question which this article is primarily concerned to answer is just how far this attitude of indifference to costs is tenable. Is it true that costs don't matter? Is it possible for money costs to snowball year after year without any serious consequences for the economy? And if it is not possible, then at what point do rising costs become a menace to economic stability and better living standards? Has that point yet been reached in Australia?

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A BRIEF digression is necessary to forestall any misunderstanding. The level of money incomes is only one of the two main influences which determine costs of production. The other is the efficiency with which production is carried out, popularly expressed as output per man-hour or man-year. If output per man-hour increases without any changes in wages and other incomes, costs will fall. If productivity increases at the same rate as incomes are increasing, costs will remain constant. But, if wages and other incomes are increasing at a faster rate than improvements in output per man-hour, costs will rise. The last-mentioned case largely explains what has been happening in Australia since the end of the war. The growth in productivity has been far exceeded by the expansion in money incomes with consequent increases in costs.

Those who argue that the way to reduce costs (and selling prices) is to improve efficiency often overlook that productive efficiency can only be raised gradually. Admittedly it is true that spectacular advances in productive efficiency are frequently achieved in particular industries. But, over the whole economy, technical and psychological limitations preclude any major forward jumps in output per man-hour. Even in the dynamic economy of the United States increases in man-hour output average only around 2% to 3% a year.

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WITH the classical economists it was taken for granted that costs of production in a given country could not be permitted to get seriously out of step with cost levels in other countries. If that occurred, other countries would concentrate their purchases on cheaper sources of supply and would undersell the high-cost-of-production country in its own domestic markets. In other words, the exports of the high-cost country would decline and its imports would increase. If this situation remained uncorrected, sooner or later the offending country would be unable to pay for its essential requirements from abroad, its standards of living would be drastically reduced and unemployment would appear.

To meet a situation of this kind the remedy prescribed by the classical economists was simple: reduce costs, expand exports and restore the competitive position of domestic industries producing for the home market. The remedy of the neo-Keynesians is precisely the reverse; cut back imports by quantitative restrictions to the levels which the reduced income from exports will stand, and compensate for any unemployment resulting from the falling off in external demand by expanding demand at home through a policy of credit expansion. In other words, in a situation for which the classical economists prescribed lower costs, the neo-Keynesians prescribe still higher costs.

Now clearly there must be limits to which the neo-Keynesian policy can be carried. For if domestic costs go on increasing regardless of the level of world costs there must come a time when production for export becomes completely unprofitable. Before that point is reached, a government following neo-Keynesian ideas would no doubt endeavour to bolster export production by paying subsidies to export producers. But that device could have only a limited application; for if costs are not restrained, or if export prices fall, the government would eventually be faced with an impossible bill for subsidies. There is no escape from the logic that a country whose costs are far above the level of world costs must face the possibility of a collapse in export production and if that should occur there will be no money to pay for imports. Imports will therefore dwindle to a trickle and the high-cost country will be forced into complete self-sufficiency. **The road of high costs is the road to economic autarchy.**

Now it may be claimed that this is a theoretical reductio ad absurdum and that, in practice, no country, with the possible exception of the United States, could become self-sufficient or near self-sufficient in the modern world without a catastrophic reduction in its standard of living. And long before that reduction had been achieved, public opinion, if not economic horse-sense, would compel a reversal of policy.

The fact that this is true, that is, that no country could embark upon a policy of near self-sufficiency, only goes to prove that there must be limits to the distance to which the doctrine of "costs don't matter" can be pushed.

We are speaking now, of course, of costs in the relative sense. So long as the costs of all countries are rising in roughly the same ratio, the position of one country vis-à-vis the countries with which it trades will remain unaltered. The trouble arises when the costs of one country or a number of countries become much higher than costs in other countries. When this occurs, the normal flow of international trade will be upset. The high-cost countries will resort to various devices to restore their external balance of payments position. These devices may take a variety of forms, such as exchange controls, subsidies, protective tariffs to bolster up those industries feeling the pinch most acutely, and straight-out quantity restrictions on imports. But all these devices have the effect of reducing the volume of international trade. They are therefore highly unfair to those countries that have been behaving themselves by keeping their costs on a tight rein*.

* In its latest Annual Report the Tariff Board rightly points out that "the Tariff can only provide temporary protection. In contributing to the cost-price spiral the Tariff would be hastening the day when it would be sheltering a cost-price structure so high that trade with the rest of the world would be impossible. The Board in framing its recommendations is faced with the choice between an immediate local and temporary dislocation (by refusal to grant tariff protection) or a delayed but widespread and more permanent unemployment."

The plain truth is that any nation that allows its costs to get grossly out of line with overseas cost levels is falling down on its responsibilities to the rest of the world. The various economic and financial institutions set up since the war to promote the maximum of stable trade have no hope of working successfully whilst there are wide disparities between the cost structures of the various nations.

One of the most eminent of British economists, Professor Lionel Robbins, has argued that the intractability of "the dollar gap" is traceable to this cause. While, in the post-war period, prices and incomes in the United States have greatly increased, prices and incomes in the non-dollar countries have in most instances increased a great deal more. The cost divergence on this account has been further aggravated by the much more rapid advance in technical productivity in the United States. Under these circumstances the persistence of the dollar shortage was inevitable. The crux of the dollar problem is thus to be found in the excessive expansion of incomes since the war in the non-dollar countries.

In course of propounding this argument, Professor Robbins states: "It should be clear that the essential condition for balanced trade is an appropriate relation between incomes in the different areas concerned, so that when the value of the product in one country increases relatively to the value of the product elsewhere there is a shift in relative incomes." **This simply means that if the nations of the world are to draw the maximum benefit from trading with one another, and if trade is not to be constantly dislocated by restrictive expedients, costs in the different countries must be kept reasonably in line. This is the essential condition of a balanced and expanding world trading system.**

WHAT is the alternative? If nations insist on pursuing their own domestic policies without regard to their external implications there must result a vicious spiral of contraction in international trade. In order to preserve their financial solvency, the high-cost countries are forced to resort to the use of defensive mechanisms. Those countries for which they previously provided a large market suffer a reduction in their exports. With a declining income from exports they, in turn, are compelled to limit their purchases from abroad. The position of the high-cost countries thus tends to worsen still further leading them to intensify their policy of import restriction. **The original unbalance caused by the failure of a few countries to restrain their costs sets in motion an all-along-the-line retreat to economic isolation.**

Countries, such as the United Kingdom, which are very highly dependent on international trade, would of course suffer most in a trading climate of this kind. As Professor Robbins pregnantly remarks: "A generalization and perpetuation of recent Australian policy would knock us off our perch entirely and keep us permanently from climbing back."†

Keynes, of course, insisted that individual countries, should retain control over their own financial policies and thus over the level of

† This is not quoted to imply criticism of the Australian policy of import cuts. Under the conditions which arose there was no alternative. The criticism should not be directed at the import cuts, but at the policies which made them unavoidable.

employment. The neo-Keynesians remember this. **But they forget, or are unaware, that Keynes also argued that autonomy in domestic economic affairs would only work successfully in an international environment that observed the basic principles of the classical doctrine.** In his last article, published after his death, he declared: "I find myself moved, not for the first time, to remind contemporary economists that the classical teaching embodied some permanent truths of great importance. There are in these matters deep undercurrents at work, natural forces one can call them, or even the invisible hand, which are operating toward equilibrium."

In spite of all the efforts to promote trade in the post-war period, the volume of international trade has failed to respond. While world trade in 1951 was an great as in 1929, the best pre-war year, this was only made possible by the staggering financial assistance provided by the United States, including military aid. It was not the result of a normal and natural flow of trade between the nations. World production has advanced enormously in the last two decades so that the proportion of world trade to production has fallen correspondingly. Only 16% of manufacturing output entered international trade in 1951, compared with 26% in 1929. And in that period substantial reductions in tariffs have been made in the dollar countries.

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UNTIL late in 1951 Australia did not feel any ill-effects from its high cost structure. This was partly because costs in Australia did not begin to rise much more rapidly than overseas costs until about 1948. But it was also due to the combination of two circumstances, fortuitous and temporary in character. The first was the immediate post-war condition of world shortage brought about by the economic dislocation and physical destruction caused by the war. Under these circumstances competition in the home market with the locally produced product was limited. The second was the persistence of extraordinarily favourable export prices. This meant that despite the rising costs of export production, there was a more than profitable margin between costs and selling prices.

The first of these conditions has now vanished. When ample supplies of imports became available, Australia suddenly found itself flooded with imported products which even the buoyant level of export income was insufficient to finance. The drastic import restrictions of early 1952 were the outcome.

The second condition—favourable export prices which have masked the consequences of excessively high costs—continues, but the gap between prices and costs has become much narrower, even in the major export industries, and has disappeared entirely in exports such as canned vegetables and jams and some processed foods.

The prop to high internal costs of abnormally good export prices continues to stand, although it is beginning to look a little shaky. But what if export price levels should recede sharply and the prop be removed entirely? Would anyone seriously suggest that the problem could be met by a wholesale intensification of import restrictions, in other words by a retreat into economic isolation?

Import restriction is not a policy that can be applied year in, year out, or whenever a crisis appears in the external finances. With export prices high and a superfluity of accumulated stocks of goods, it can be introduced without any noticeable ill-effects. But with low export returns and the availability of only normal stocks it would soon occasion acute distress. A sharp fall in export prices would expose the futility of the "costs don't matter" doctrine in all its short-sighted stupidity.

There is, of course, always that weapon of last resort, much beloved of the neo-Keynesians—exchange depreciation. But how effective would this be?

Exchange depreciation is a legitimate weapon for countering an adverse trade balance brought about largely by causes outside of a country's own control such as a more or less permanent worsening of its terms of trade. **But it is a device of highly doubtful value where the external deficit is traceable primarily to the over-exuberant pursuit of internal expansionist policies and thus to a fundamental disparity in costs.** In such a case depreciation would be a beggar-my-neighbour policy giving temporary relief at the expense of greater trouble later on.

Exchange devaluation is itself an inflationary force. It stimulates spending and adds to the cost structure both through loading the price of imported goods and materials and through the protection it provides for high-cost home production. Where the trouble arises primarily from internal inflation, depreciation relieves the external sore only to aggravate the internal seat of the disease.

Those who advocate depreciation as a cure for present economic ills in Australia should sit down and consider where the action they propose is likely to lead. They should ask themselves whether they will not be purchasing a little temporary relief at the cost of further unbalance in the Australian economy.

Under existing conditions of high employment depreciation should be ruled out of court. And even should there occur a serious decline in export prices, while exchange depreciation might prove unavoidable, as an isolated measure it would not correct the basic unbalance caused by an over-loaded internal cost structure. All in all, the prospective advantages to be derived from devaluation have been grossly over-estimated.

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SINCE the war, Australia has hitched its waggon to the star of high wool prices. If the star should plummet to the ground it will take Australia with it.

The only sound and honest path for Australia to follow is to manage its internal finances so that its costs are maintained broadly around overseas levels. The other route is the route of economic isolation, irresponsibility and selfishness, and can eventually lead only to disaster.