Assessments of the Economic Outlook
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Assessments of the Economic Outlook

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Executive Summary

- The signs of Australia's economic recovery are now unambiguous. But recovery is uneven with some sectors such as non-residential construction and heavy industry investment lagging. There are signs that Australia is riding on the coat-tails of the US recovery, possibly 'getting a better ride' than it deserves relative to our economic fundamentals.

- Despite upbeat assessments of our commodity outlook, markets for our bulk minerals and metals have only bottomed. There are large stockholdings around the world which will keep price improvement and market prospects limited for at least the next two or three years.

- The present international recovery is patchy, with the US and the other Anglo-Saxon economies performing well and the newly industrialising nations of Asia maintaining rapid growth, but with the German and Japanese economies expected to remain in the doldrums for the next year or two. The latter situation will be a drag on the rate of recovery of the global economy.

- The Australian housing and equity markets are pointers to the high level of confidence and optimism prevailing in the Australian economy. There are indications that they are possibly overshooting relative to our economic fundamentals, echoing Australia's traditional proneness to 'boom-bust' volatility in our economic circumstances.

- The public sector budget outlook is improving on the strength of the recovering economy, but initiatives to enhance public savings levels should not be at the expense of further declines in public investment. In the long term, such strategies are counter-productive, reducing the scope for the economy to raise national income and savings potential over the longer term.

- The durability of the Australian recovery will be heavily dependent on how our balance of payments on current account performs which in turn is a reflection of our national savings and investment performance. Fitzgerald's calls to raise national savings remains valid and significant in this regard.

- The medium term outlook for inflation and interest rates in Australia is conducive to an improving economic performance. Nevertheless, if the recovery in investment is patchy or delayed, this is likely to lead to supply bottlenecks which will spill over into
imports, with a potential for a blow-out in the current account deficit.

- The disturbingly high levels of unemployment forecast for the remainder of this decade will impose not only major social costs on the community, but also represent massive economic costs and inefficiency in the economic system as reflected in lost production and income earning opportunities for Australians.
1. Background

The purpose of this paper is to report the proceedings of a Conference convened on 17 February 1994 in Melbourne by the Economic Society of Australia to address the domestic and international economic outlook\(^1\). This Paper synthesises the major assessments highlighted at the Conference and concludes with some interpretative comment from this writer. The statistics, forecasts, schedules and tabulations contained in this Paper are drawn from the presentations of the respective speakers at the Conference listed in the footnote below.

The Conference speakers were generally concerned about the intermediate terms outlook - ie. over the next two to three years. Of course, it can be expected that there will be short term aberrations which will disrupt the intermediate term outlook from time to time, and by its very nature, economic forecasting is an uncertain discipline - constantly subject to review and revision.

2. The International Economic Outlook

2.1 The Setting

1991 and 1992 were periods of generally very weak growth on the international scene, most notably, among the 'locomotive economies'. Of these major economies, Japan and Germany were in recession while the US was undergoing an uncharacteristically slow recovery. Most economic forecasters expected 1993 to be little better, but in the event, the US economy picked up speed faster than many forecasters expected. However Japan remained in the doldrums and Germany contracted seriously, with real GDP in western Germany falling on average 2 per cent below the 1992 figure, this being the largest contraction in its economy since the Second World War.

2.2 Outlook for the Big Three

Despite the recoveries and relatively buoyant outlook in the Anglo-Saxon economies, particularly in the world's major 'locomotive

\(^{1}\) The Conference speakers and their topics were as follows; Glenn Stevens, Reserve Bank of Australia. *The World Economy*; Michael Kirby, McIntosh & Company Limited. *Commodity Outlook*; John Fraser, SBC Australia Limited. *Australian Economic Outlook*; Graham Hodges, ANZ Banking Group. *Australian Financial Outlook*; Brett Alexander, Schroders Australia Limited. *Budget and Savings Outlook*. 
economy, the US, economic activity in Germany and Japan remains very subdued for the present; forecasters do not offer more than a slow recovery for Germany and Japan in 1994 but with a noticeable pick-up likely in 1995. Real GDP growth forecasts for the big three are as follows:

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>1994</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>2.8</td>
<td>3.1</td>
<td>2.7</td>
</tr>
<tr>
<td>Germany</td>
<td>-2.1</td>
<td>0.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Japan</td>
<td>0.0</td>
<td>0.5</td>
<td>2.3</td>
</tr>
</tbody>
</table>

Recognising that the US, Japan and Germany account for about 60 per cent of the OECD's output between them, the sluggish state of the economies of Japan and Germany\(^2\) is a sobering consideration in a view of the more up-beat economic outlook assessments prevailing in Australia.

### 2.3 The Outlook Elsewhere

In contrast to Germany and Japan, the outlook for real GDP growth in the newly industrialising economies, and the overall OECD area, is noticeably better, as is evident in Table 2;

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>1994</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD</td>
<td>1.1</td>
<td>2.1</td>
<td>2.7</td>
</tr>
<tr>
<td>Newly Industrialising Economies</td>
<td>5.3</td>
<td>5.7</td>
<td>6.0</td>
</tr>
<tr>
<td>Australia's Trading Partners</td>
<td>2.5</td>
<td>3.5</td>
<td>4.5</td>
</tr>
</tbody>
</table>

\(^2\) The sobering assessment of the German economic outlook is reinforced (in this writer's view) by the challenges Germany faces in coping with, on the one hand, the reconstruction of the economy of the old East Germany, and on the other hand, the likely upward pressures on German interest rates flowing on from the US Federal Reserve's policy of easing up US interest rates to facilitate non-inflationary growth in that country.
The growing share of Australia's trade stemming from the newly industrialising economies of South East Asia is a cause for Australian optimism about our economic outlook.\(^3\)

Reasons for global optimism about continued improvement include:-

- **the nature of the US expansion**: the US recovery has become 'durable' over the past year and has picked up speed, with a notable cut in US unemployment. The so called 'jobless recovery' in the US has actually created about 2 million new jobs in the year to December, which is a growth rate in employment of 1.8 per cent. The only OECD economy which recorded faster growth in employment was Australia - about 2.5 per cent. Business investment in the US is strong, while the wind-back of the debt burden of the corporate sector has boosted confidence.

- **the consolidation of the US recovery and accommodating policy settings have raised confidence about the recovery prospects of other countries**: The debt and balance sheet impediments to growth inherited from the 1980's have gradually been wound back in other economies while policy settings, in particular monetary policy, have remained 'fairly accommodative' to growth. For example, real interest rates in the US have been around zero.

- **The Bank of Japan's discount rate is at its lowest level ever.** The large fiscal stimulus recently initiated by the Diet is equivalent to over 3 per cent of GDP, large in any terms, but its impact will take a while to be felt, as the new package is to take effect in mid year. Germany's interest rates have come down significantly from their 1991 high point. The cut in the UK's link to the European Exchange Rate (ERM) Mechanism has enabled interest rate reductions in the UK which have spurred the British recovery ahead of Germany.

### 2.4 The Pace of the Recovery

The resurgence in the global economy is likely to be slow relative to other recoveries; the over-indebtedness which has plagued the Anglo-Saxon economies and Japan will continue to constrain growth in these countries as will the political turmoil in Japan and the high Yen. Structural problems remain in the economies of the major countries and these will hamper growth.

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\(^3\) Australia's relatively high penetration into Asian markets is highlighted in the Reserve Bank article included with this Paper at Appendix 2.
Of concern to Australia is the weak state of the Japanese economy. This reflected in the low and falling contract prices for coal and iron ore, but overall our index of commodity prices has at least bottomed out. Nevertheless, the weakness in the commodity outlook will be a constraining force on the pace of Australia's economic recovery for at least the next few years. However, the overall international outlook, while not sensational, is moving in a more supportive direction for the Australian economy.

2.5 The Asian Economic Situation

The newly industrialising economies of Asia are likely to experience growth of 6 per cent per annum - about three times the rate of the OECD. These countries, together with NZ, account for about one quarter of Australia's exports. China's development also will become an ever increasing force in regional growth. China is already expanding at a phenomenal rate with double digit rates of growth in real GDP and imports. The greater strength of the Asian region over the OECD countries is reflected in the forecast growth rate of Australia's Asian trading partners of 3.5 per cent in 1994 compared with the OECD area's 2 per cent.

2.6 The International Unemployment Outlook

There is a noteworthy divergence in the unemployment situation and outlook between the US and Europe. At its worst, unemployment in the US did not reach more than 8 per cent during the recent recession\(^4\); the US's fairly flexible labour markets have facilitated a subsequent drop in the unemployment level to around 6.5 per cent. In contrast, when Europe entered the recession, its average unemployment was already at 8 per cent and at double digit levels in some countries. Structural problems in some European economies suggest that unemployment may move even higher over the next few years.

Stevens offered the following sobering assessment of the European unemployment outlook, hinting at its potentially far reaching socio-political implications;

> In Europe, structural causes of unemployment are endemic, and compound the effects of cyclical factors. Labour markets are inflexible, regional disparities in unemployment are big and policy responses, on the whole, not very effective.

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\(^4\) Some observers may dispute the apparent low rates of US unemployment arguing that this reflects the higher propensity for US citizens to drop out of the workforce altogether (due to the institutional barriers to 'staying on the dole' in that country, rather than a reflection of more flexible and efficient labour markets. In other words, the US may have much higher 'hidden unemployment' than other western economies.
Unemployment is a complex problem, and one where no single, simple solution is available. The search for solutions is on, however, because even if growth resumes, and even if it is a bit faster than forecast, unemployment in Europe seems likely to remain high. This will continue to exert all kinds of pressures on European society and its policy makers over coming years. I am not going to try to predict the outcome of those pressures, but they could potentially be quite profound.\(^5\)

Australia is seen as an intermediate case; like the US, Australia outperformed Europe in getting unemployment down in the 1980s, but our 1990s recession was more protracted than that of the US and we went into recession ahead of the Europeans. However, our unemployment situation over the coming years will compare quite favourably to Europe.

### 2.7 Government Budgets and Inflation Issues

All major countries excepting Japan have big deficits, as illustrated by the ratio of gross debt of the general government sector to national income. In some European countries (e.g. Belgium), this is over 100 per cent; most other countries have a ratio of around 40 to 60 per cent. Contrary to popular perceptions, Australia has a relatively low ratio of around 35 per cent\(^6\) (1993 figure). Several countries face significant constraints on the freedom of action of their governments because of past budget profligacy. For example, in Canada, one tenth of general government expenditure goes to finance interest payments; in Italy and Belgium, the proportion is around 20 per cent compared with about 5 per cent for Australia. Such situations impose binding requirements and constraints over long periods and may well affect growth potential.

A remarkable feature of the present international environment is that inflation is very low virtually everywhere. The median rate for twenty one OECD countries is around 3 per cent and this is forecast to fall to 2.75 per cent or less next year. In Europe, many countries are still in disinflationary mode. Even if the cyclical factors pushing down Australia's inflation are largely spent, there are few signs on the horizon suggesting upward pressures on inflation. The expansion of low cost producers in Asia may have profound, beneficial, effects on prices for internationally traded goods and services over the coming years.

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\(^6\) Contrary to popular impressions promoted by the media, Australia has one of the lowest ratios of gross public debt to GDP in the OECD. Source: OECD Economic Outlook, June 1993.
3. The Commodity Outlook

The medium term commodity outlook can usefully be interpreted with reference to the refined metals price index as depicted in Appendix 1, Chart 1.1; it is evident that the index has only just recently begun to show tentative signs of revival after a general trend decline since mid 1990. This is in marked contrast with the pronounced bullish trends evident on world stock markets over the past year. The sluggishness in the recovery in metal prices is hardly surprising in view of the continuing poor state of the German and Japanese economies, as reflected in industrial production trends depicted in Chart 1.2. Large stockholdings of refined metals will continue to act as a major dampener on world refined metal market for some years to come (refer Chart 1.3).

The refined metals price index is forecast to turn up only modestly over the coming year (Chart 1.4) concurrently with an easing in stockholdings as reflected in the trend decline in the stock/consumption ratio illustrated in Chart 1.4. Similarly, the bulk commodities price index forecasts suggest only a bottoming out over the next two years of the downward trend in prices evident since mid 1990.

Of interest for Australia is the trends in crude steel production among our Asian trading partners. Charts 1.5 and 1.6 illustrate the continued depressed situation in Japan, contrasting markedly with the energetic growth in crude steel production among our other Asian trading partners. Japan still accounts for nearly half of our coal exports, with other Asian nations accounting for around 25 per cent. Accordingly, coal contract prices are forecast to show only a very modest recovery through to 1995 (Chart 1.7).

Overall, the perception sometimes reflected in reports from some sections of the Australian financial media that the mineral and metals commodity outlook has taken a strong upswing over the past six months appears to be an overstatement of reality. At best, all that can be said is that the worst appears to be over; but there is a massive stock overhang which will take several years at least to clear before commodity markets can look forward to signs of any pronounced upswing in its prospects. This prognosis needs to temper the financial media’s more robust economic predictions for the Australian economy.

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7 The longer term outlook for Australian minerals and energy commodities is discussed in the Parliamentary Research Service Current Issues Brief No 2 1994, Report: Outlook 94 Conference (Minerals and Energy) by Paul Kay.
4. The Australian Economic Outlook

There is widespread acceptance that the Australian economic outlook has improved markedly over the past two quarters supported by a series of promising economic indicators. Investment and savings are seen as crucial to a durable and a sustainable recovery. Business investment has been gathering pace since the December 1993 quarter, in part supported by the Government's strong expansionary fiscal stance, the relatively low real interest rate structure and a favourable Australian dollar exchange rate which has worked to the considerable advantage of the exporting sectors over the past year.

The current account deficit is considered to have been 'well behaved' in recent times, but nevertheless, the overall size of Australia's external debt is considered to be a 'worry' for the rest of the world; any marked increase in the level of interest rates would leave Australia particularly exposed because of the short term maturity structure of our external debt. However, such a marked escalation in interest rates is not considered likely. Further, the Federal Government's long term fiscal stance of reducing the Federal deficit to 1 per cent of GDP by 1996/97 is seen as a signal to the rest of the world that we are serious about reducing our current account deficit.

Notwithstanding this, there is an important requirement to boost private sector savings levels if our recovery is to become sustainable; this was reinforced by the Fitzgerald report and should remain a priority for government policy.

The commodity outlook will continue to shape the strength of the Australian recovery; in view of the relatively modest recovery in commodity markets expected over the next few years, the dramatic appreciation of the Australian dollar exchange rate over recent times seems surprising. To some extent, this appears to reflect the traditional pattern of Australia 'riding on the coat-tails' of the US recovery and this is reinforced in practice by the massive inflow of US Mutual Fund investment in Australian equities combined with

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10 There are indications that US investors do not always distinguish the fundamental differences between the US and Australian economic situations; Australia can get 'tarred with the same brush of optimism' regardless of realities. It is curious to observe that whereas real interest rates in the US are between zero and 0.5, in Australia, they still remain comparatively high at approximately 3 per cent.
strong Japanese interest in our bond market. Nevertheless, there are indications that the Australian exchange rate is overshooting a little relative to our economy's 'fundamentals', so some market correction is possible at some stage.\footnote{11}

The overall outlook for the Australian economy is positive.\footnote{12} Our strong trading performance, excellent inflation outcomes and indications of a disciplined Budgetary policies being adopted at the Federal level are promising signs. In addition, the restoration of State budget outcomes (particularly in the south-eastern 'rust belt' states) and the perseverence of Federal and State/Territory Governments in microeconomic reforms programs are seen as further encouraging signs. The fact that Australia weathered a marked depreciation in the $A during 1993 without an offsetting bout of inflation suggests significant growth in our productivity performance. Further enhancements in productivity remain to be tapped via a greater spread of the enterprise bargaining process in labour markets.

Forecasting through to 1996/97, a relatively promising prognosis for most economic indicators is revealed (see Table below) excepting for unemployment, which is forecast to remain at a disturbingly high level.

<table>
<thead>
<tr>
<th>Real GDP growth (%)</th>
<th>2.7</th>
<th>3.5</th>
<th>3.7</th>
<th>3.3</th>
<th>3.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployment rate (%)</td>
<td>11.0</td>
<td>10.8</td>
<td>10.0</td>
<td>9.3</td>
<td>8.7</td>
</tr>
<tr>
<td>Consumer Price Index (Annual % rate)</td>
<td>1.0</td>
<td>1.9</td>
<td>2.7</td>
<td>3.2</td>
<td>3.0</td>
</tr>
<tr>
<td>Current Account Deficit (as % GDP)</td>
<td>3.8</td>
<td>3.7</td>
<td>3.9</td>
<td>4.2</td>
<td>4.1</td>
</tr>
</tbody>
</table>

\footnote{11} The easing of upward pressure on the $A in late February and March in the wake of the breakdown in US/Japan trade negotiations has possibly restored some degree of 'reality' to the level of the $A.

\footnote{12} The grounds for optimism and for pessimism about Australia's longer term economic future have recently been discussed in an address by Mr I J Macfarlane, Deputy Governor of the Reserve Bank of Australia, titled 'Pessimism and Optimism, About Australia's Future', a copy of which is reproduced at Appendix 2 to this Paper.
5. **The Financial Outlook**

The financial outlook is to some extent coloured by the unsynchronised recovery at the international level, with Japan and Germany still in the doldrums, while the US and the newly industrialising economies (NIEs) of Asia are charging ahead. In the commodities area, the scene is patchy also, with minerals and metals not looking particularly healthy but with wool and wheat looking somewhat better.

The financial market recovery in Australia is most evident with the big jump in interest in equities but also in the surprisingly strong and sustained in interest in housing. There has been an expectation that the heat would come off the housing market but there is no sign of this yet. However, housing investment is seen as a 'potentially troublesome' area, with many investors maintaining possibly unrealistic expectations of 1980s style returns.

The exchange rate is forecast to appreciate progressively through to 1995, factors relevant being illustrated in Schedule 1. Schedule 2 illustrates the main market influences considered relevant to equities markets over 1992/93 to 1995. It is noteworthy that a continued moderate inflation outcome is forecast combined with a 'subdued' interest rate cycle, factors which auger well for a durable and realistic recovery and expansion. Nevertheless, as Schedule 1 suggests, the deficit on current account and the Government deficit 'problem' will continue to be a 'worry' and a negative force for financial markets.

6. **The Budget and National Savings**

The medium term outlook for the Federal Budget is one of improvement, supported by a strengthening domestic economy which is assisting in the reduction of the 'cyclical deficit', notwithstanding projected falls in revenues from Reserve Bank profits, company taxes (due to rate cuts) and Fringe Benefit Tax raisings.

A $12 billion Commonwealth deficit for 1994/95 is considered feasible, but this constrains new spending options. The targeted reduction of the Federal deficit to 1 per cent of GDP by 1996/97 is considered achievable although it is heavily dependent on the underlying economic growth assumptions. The overall Public Sector Budgetary situation is being rapidly enhanced by the quickly strengthening state of public finances in Victoria and Queensland.

Nevertheless there is a concern that increased public savings should not be achieved by reducing public investment. A run down in public
infrastructure reduces the long term growth potential of the economy and ultimately, the economy's capacity to generate increased incomes and therefore, increased savings\textsuperscript{13}. Initiatives to encourage greater private sector involvement in infrastructure provision have so far proved largely ineffective.

### SCHEDULE 1

#### EXCHANGE RATE PROSPECTS

<table>
<thead>
<tr>
<th>USD/AUD</th>
<th>Mid 94</th>
<th>End 94</th>
<th>Mid 95</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fundamentals</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Rates</td>
<td>Neutral</td>
<td>+</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Commodity Prices</td>
<td>Neutral</td>
<td>+</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>Investment Flows</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>RBA Intervention</td>
<td>Neutral</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Budget/Debt/BOP</td>
<td>Neutral</td>
<td>-</td>
<td>-</td>
<td>*</td>
</tr>
<tr>
<td>Growth</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td><strong>Forecast</strong></td>
<td>0.70-0.72</td>
<td>0.73-0.75</td>
<td>0.75-0.77</td>
<td></td>
</tr>
</tbody>
</table>

### SCHEDULE 2

#### EQUITIES

**Support from:**
- Earnings up (better than expectations)
- Growth accelerating 4% + in 1995
- Inflation pressures moderate
- Interest rate cycle more subdued

**Main market influences**
- **92-93**
  - low interest rates
  - corporate cost cutting
  - productivity gains
  - weak demand

- **93-94**
  - low interest rates
  - growth in sales volumes
  - little margin creep
  - costs contained

- **1995**
  - stronger sales
  - margin gains
  - interest rates edge up
7. Author’s Concluding Comments: The Longer Term Perspective

Mind you, I’ve never been down...  
But this bloody recession, mate -  
Its really hit people bad!  
This bloody ratbag boom-bust economy!  
(Observations on Australia’s experience of the recent recession).14

All economies are subject to bouts of economic growth and recession. But Australia’s economic history since British settlement suggests that, just as our natural environment is one of extremes, so our economic circumstances are prone to relatively high levels of volatility and uncertainty. This is true of recent years as is illustrated in Figure 1.

Whether this volatility reflects our international exposure by virtue of our primary commodity export dependence15, or boom-bust outcomes arising from Australians' cultural inclinations towards speculative investment waves or simply poor performance by successive governments 'in pulling the economic levers' are moot points. But there seems little doubt that Australia's taxation system contains some inherent inducements to speculative investment.16

FIGURE 1  
Economic Growth  
Australia and OECD  
Quarterly Real GDP - Percent per annum

--- AUSTRALIA ---- OECD

14 Transcript from an episode of 'Minder in Australia', ABC Television 1993.

15 As exemplified by the old catch cry, 'When Britain/America gets a cold, Australia catches pneumonia'!

16 For example, provisions allowing business to write off interest on borrowing as a business expense, the retention of negative gearing for investment housing, the absence of any capital gains taxation on owner-occupied housing and the non-accountability for tax purposes of imputed rental on owner-occupied homes.
Economists might have entertained the hope that the greater integration of Australia into the global economy in the aftermath of financial deregulation and tariff reductions in the 1980s could have reduced our susceptibility to this volatility. But the experiences of the past decade suggest otherwise. Australia's recession of the early 1990s was deeper and more protracted than that of the major western economies and many comparable OECD nations and its toll on unemployment proportionately heavier; this is illustrated in Figure 2 below. In some respects, this experience echoed the relatively severe adverse impacts on Australia of the depressions of the 1890s and the 1930s. Likewise Australia's Korean War boom of the 1950s and its economic booms of the early 1970s and the mid 1980s significantly outpaced those of many other western economies.

FIGURE 2
Unemployment Rates
Australia, European Union and OECD
1989 - 1994

It remains to be seen whether the severity of the early 1990s recession is likely to have left a lasting impact on the Australian psyche. In this respect, there are promising signs in the present recovery, with a greater emphasis on equities rather than debt instruments in raising new finance. But there are also signs of possibly excessive optimism (relative to our apparent economic fundamentals) evident in the protracted buoyancy of the investor housing market over the past eighteen months and the rapid rise in the Australian stock market since the second half of 1993 - notwithstanding our relatively high real
interest rates by US standards and the subdued minerals and metals commodity outlook for the next two or three years\(^{17}\).

In this respect, it is possibly reassuring to note the decline in the rate of appreciation of the Australian dollar in recent weeks as well as the easing off in the upward surge of the All-Ordinaries Index in the face of the current US/Japan trade negotiation difficulties.

The durability of Australia's current economic recovery in the longer term will depend on a sustained rise in new investment in the traded goods and services sectors and the avoidance of excessive blow-outs in the current account deficit relative to GDP (with accompanying interest rate escalations and potential inflationary pressures). It seems too early to determine how constraining the investment and current account situation will be on the strength and scope of the recovery, but in the end, they are dependent on Australia substantially improving its savings performance - the fundamental call of the recent Fitzgerald report.

While the Federal Government is employing Budgetary strategies directed at enhancing the level of public sector savings, there seems to be scope for further Government initiatives to raise private sector saving levels. While the latter remain at quite low levels, economic policy makers will necessarily be concerned about Australia's capacity to sustain protracted periods of buoyant growth. This constraint should be a real source of concern to governments in the light of our disturbingly high level of forecast unemployment over the next decade, (particularly among our youth), with all its attendant social costs as well as its massive economic costs as reflected in lost production and income earning opportunities for Australians.

\(^{17}\) Some economists believe that the stock market may be over-optimistic about Australia's commodity export outlook because it is basing its assessments on international commodity index movements (such as the New York Futures Exchange's Commodity Research Bureau (CRB) index) which use a commodity weighting basket which is not actually relevant to Australian circumstances. Compared with what's important to Australia, the CRB index gives roughly twice the weight it should to rural commodities and roughly half the weight it should to mineral commodities. The Reserve Bank of Australia's Commodity Price Index is seen as a more reliable indicator. Refer R. Gittens, 'Beware the US Way With Figures', *The Sydney Morning Herald*, 12 March 1994.
8. References

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Hodges, Graham. ANZ Banking Group. *Australian Financial Outlook*.


Stevens, Glenn. Reserve Bank of Australia. *The World Economy*;


Transcript from an episode of 'Minder in Australia', ABC Television 1993.
Chart 1.4

METALS
STOCK/CONSUMPTION RATIO

(Stocks/Consumption Ratio (%))

Refined Metals
Price Index

Weighted
Average

Forecast

McIntosh Baring
JAPANESE CRUDE STEEL PRODUCTION

Chart 1.5

McIntosh Baring
Chart 1.6

ASIAN CRUDE STEEL PRODUCTION

(m tonnes)

75 77 79 81 83 85 87 89 91 93
PESSIMISM AND OPTIMISM ABOUT AUSTRALIA'S FUTURE


When I agreed to talk to this forum three months ago and nominated as my subject 'Pessimism and Optimism about Australia's Future', I did not realise how topical it would become in the intervening period. There has recently been a remarkable improvement in confidence, which is as sharp as any I can recall. More importantly, it appears to be based on more than cyclical factors, and seems to reflect a favourable reassessment of Australia's medium-term potential. My earlier intention, which was to counter the prevailing pessimism by drawing attention to some neglected factors in Australia's favour, has been overtaken by events. Perhaps I should be trying instead to calm down over-exuberant expectations.

When I talk about Australia's future, I am referring to its economic future. This is the only aspect I feel qualified to comment on, and it seems to be the aspect most people are interested in. There is no country in the world that is as obsessed with economic issues as Australia. In other countries, the front pages of their newspapers are full of stories about civil wars, riots, racial tension, constitutional crises, etc. Ours are filled with balance of payments statistics, unemployment statistics, Budgets, etc. This is not an original observation - I have heard it again and again from overseas visitors.

As well as being obsessed with economics, we have usually been quite pessimistic about it. Certainly this has been the predominant mood over the past decade, not just the past few years. While a lot of businesses were often optimistic, or even overly optimistic, in their own commercial decisions, particularly during the asset price boom, general opinions on the economic predicament of the country tended to be pessimistic. This was certainly true of the bulk of economic commentators, and of businessmen when addressing public policy issues. Indeed, if you wished to be regarded as a sophisticated economic observer, a degree of pessimism was de rigueur.

There was a lot to be said for this period of introspection and self-criticism. The fear of economic oblivion it engendered helped the country to face up to some painful and politically-unpopular decisions. Governments at Federal and State level have found it easier to rein in expenditure, introduce competition, reduce protection, and privatisate or corporatise public utilities in this environment; it also provided a spur to wage restraint. In short, pessimism was useful, but too much could become counter-productive. We were in danger of losing confidence in our ability to improve our position, which in turn was having adverse consequences for Australian investment.
THE PESSIMISTIC APPROACH

There were some longstanding and quite deep-seated reasons for the predominantly pessimistic outlook, and others which were based mainly on the experience of the mid 1980s. I will start with the former.

The long-run decline argument

A feeling that we have declined relative to other countries has pervaded a lot of our thinking. The most common form of this argument is based on long-run comparisons of income per head among developed countries, which showed Australia at number one at the turn of the century, but now back in the middle of the field. There is a feeling of disappointment that 'we used to be number one, but look how far we have slipped'.

The immediate response to this line of argument is to ask whether we were really that good, or was there a large element of luck. It does not take a great deal of historical knowledge to realise that there is more substance in the latter explanation than the former. In a sense, we were the Kuwait of the 1890s in that we had a lot of land and a small number of people, and we were able to produce commodities that were relatively highly valued.

We were able to stay in a high position on the ladder for quite a while, but again we were helped by the accidents of history. The fact that most of the countries close to us in the rankings blew away their capital bases and a large part of their population in two world wars kept us near to the top of the ladder for the first half of the century. We were bound to slip back for two reasons.

- First, there is a tendency among developed countries towards convergence. Countries with high income/output per head tend to achieve lower productivity growth than those with lower income/output per head. The countries near the bottom 'catch up' by importing the technology of the more advanced countries (Graph 1).

- Second, as the scarcity value (or economic rent) of what we exported fell, it constrained the rate at which national income could grow. The graph below from the IMF measures the price of commodities relative to the price of manufactured goods at the broadest level. It shows that there has been a noticeable downward trend in the relative price of commodities, which has been more pronounced since the mid 1970s. Countries, like Australia, who owed their former high ranking to a large resource sector have tended to slip in the rankings, particularly over the past two decades.

GRAPH 1
PRODUCTIVITY GROWTH & INITIAL INCOME
1960-90

Second, as the scarcity value (or economic rent) of what we exported fell, it constrained the rate at which national income could grow. The graph below from the IMF measures the price of commodities relative to the price of manufactured goods at the broadest level. It shows that there has been a noticeable downward trend in the relative price of commodities, which has been more pronounced since the mid 1970s. Countries, like Australia, who owed their former high ranking to a large resource sector have tended to slip in the rankings, particularly over the past two decades.

GRAPH 2
Relative Price of Commodities, 1854 - 1993
(1980 = 100)

The recent decline argument

There is also a version of the theme that we are not as good as we used to be which is based on post-war experience. People point to the good economic performance of the 1950s and 1960s and ask why are we not doing as well as that now? Isn’t this evidence that we are not as good as we used to be?

We certainly did well in terms of economic growth, low inflation and low unemployment in the 1950s and 1960s, but so did everyone. Angus Maddison, who is the main compiler of long-run, income-per-head rankings going back a century and a half, refers to the 1950s and 1960s as the Golden Age — a set of historical circumstances for most countries which gave rise to an economic performance not seen before or since.

It is not widely known, but during the 1950s and 1960s, although in absolute terms our performance was good, it did not keep up with the OECD average. Our growth in income per head averaged a per cent per annum lower than the OECD average, a bigger shortfall than over the past two decades (see Table 1).

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<tr>
<th>TABLE 1: GROWTH RATE OF REAL GDP PER CAPITA</th>
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<td>1950-73</td>
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<td>Australia</td>
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<td>Average of 16 OECD countries</td>
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The re-assessment of the mid 1980s

The fullest recognition that our performance was wanting came in the mid 1980s, and was heavily influenced by perceptions about the balance of payments and the growth of external debt. It was brought to everyone’s attention by the 40 per cent fall in the exchange rate (which incidentally also pushed up our external debt to GDP ratio and caused us to fall a few rungs in the international GDP per head rankings). This pessimism dominated most commentary on the Australian economy until very recently. It tended to reinforce the view that our economic performance was getting progressively worse. For example, it implied that the most recent decade’s performance was worse than the one that preceded it.

I think you can make a pretty good argument that this was not the case. While economic pessimism reached its peak in the 1980s, it was a lagged reaction to our economic performance, which had its most serious period of deterioration in the 1970s.

For example, if we look at the balance of payments, it is now clear that the period of deteriorating performance (i.e. increasing deficits) was from about the early 1970s to the mid 1980s (Graph 3). Since then, there has been a slight upward trend in the trade position and a stabilisation in the current account position. Since debt is, to a large extent, the summation of past current account deficits, it is not surprising that this ratio lagged behind and did not begin to rise sharply until the mid 1980s.

Similarly if we look at inflation, it is clear that the damage was done in the 1970s and early 1980s. The average rate of inflation between 1973 and 1983 was 11.3 per cent, whereas in the most recent decade it has been about half that, and over the most recent three years has been less than 2 per cent. More importantly, the trend over the past decade has definitely been downwards (lower panel of Graph 4).
Even unemployment shows the same picture of major deterioration between 1973 and 1983, followed by a much smaller deterioration in the past decade. In the 1960s, the unemployment rate reached a peak of about 3½ per cent early in the decade. First in 1975 and then in 1983, the peak was pushed up to about 10½ per cent (upper panel of Graph 4). In the following decade, the unemployment rate fell and then rose in 1993 to a peak of 11.3 per cent. It is true that this represented a higher rate than the previous peak, but the shift up was small compared to what had occurred in the previous decade.

Overall, I think that on the basis of these three key variables - the rate of inflation, the balance of payments and the unemployment rate - the period of deteriorating performance was the 1970s rather than the 1980s. What is disappointing about the 1980s, I suppose, is that we did not make as much progress in correcting the imbalances of the 1970s as we might have hoped for. We eventually had success on inflation, made only small gains on the balance of payments but none, in net terms, on the unemployment rate. But it is misplaced to blame the policies of the past decade for creating the problem.

Where does that leave us?

The first thing to say is that we should not lose too much sleep about small changes in our position in the international rankings of income per head. These rankings are extremely approximate. For example, the two most quoted rankings of recent years give very different results. In the year they overlap - 1988 - one has Australia in 13th place and the other has us in 6th place.1 If you are in the middle of the field, where a number of countries are clustered together, a small change in GDP or the exchange rate can move you up or down four or five places in one year.

I think the best way to view Australia is as a middle-income, middle-sized, developed country that is going to have to work hard to keep its place in the world. The other countries that would fit this description are ones like the Netherlands, Belgium, Austria or Sweden. These are the sorts of countries, by the way, that we regularly change places with in the middle of the field of OECD countries, but which we used to be above in the first half of the twentieth century.

THE OPTIMISTIC APPROACH

The optimistic approach would say that there is not much use focusing on long-term trends that include the distant past. It is the very recent past, and the future, that matters. If you take this approach, there are a number of factors which make for considerable optimism about Australia’s medium-term future.

The first is one for which we can take no credit - we are in the right position. We are closer to Asia than are Europe and North America; we are in the same time zone but a different hemisphere. In many respects, we are the perfect complement to Asia, and close enough to take advantage of it. This has given us enormous opportunities over recent years: opportunities that will no doubt continue to increase. Asian dynamism - which was once confined to Japan - has spread to Hong Kong, Singapore, Taiwan and Korea in the first instance and is now spreading through Thailand, Malaysia, Indonesia and, most important of all, China.

All the countries of the OECD area have recently been through a recession and we have been waiting to see what impact this would have on the dynamic Asian economies. The answer is that it seems to have had almost none; they are still growing at rates higher than the boom rates of OECD countries. It is now reasonable to assume that the dynamic Asian economies will continue to grow on average at 6 to 7 per cent in the future. When I say this I do not include Japan, which has already become a conventional OECD country with a potential growth rate of about 3 per cent.

As I said earlier, we cannot take credit for our position or for the fact that Asian growth is so strong. We can, however, take some credit for the fact that we have taken advantage of the growth opportunities arising from Asia. Two examples illustrate this point:

- we are already much more ‘Asianised’ than any other OECD country in one important respect. The share of our exports going to Asia is much higher than Canada, the United States, New Zealand or even Japan (Graph 5). If an investor wants to put funds into a developed country that has a big exposure to Asia, then Australia is the one;

- the other thing we have going for us is we actually run a balance of payments surplus with Asia and with each of the major Asian regions; our deficit is with the United States and Europe (Table 2). Thus, we have a surplus with a fast-growing region and a deficit with the slower-growing ones. That has to be good for us in the medium term.

These trading patterns are a promising starting point, but whether they are translated into sustainable growth will depend on our flexibility and willingness to innovate. We do not enjoy a great reputation for either of these attributes, but again we have probably underestimated our capacity for adaptation.

The best-known example of our capacity to adapt is the remarkable growth in exports of elaborately-transformed manufactures. These have grown at a rate of 19 per cent per annum for the past seven years, which means they have more than trebled in that time. A few
years back, when these figures were first produced, they were greeted with a good deal of scepticism and it was assumed they must be the result of some special factor. But as the good performance continued year after year and became more widely reported, it gave a boost to the self-confidence of the corporate sector. Now the business magazines are full of success stories and the export culture is becoming more widely accepted and imitated.

THE PRESENT BALANCE

Excessive pessimism is unhelpful because it discourages us, and others, from investing in expanding our capital base. Fortunately, the period of excessive pessimism seems to have passed and been replaced by a general air of optimism. On balance, this must be good for us, but there is a risk that the turnaround in sentiment has been too rapid. There is a risk that we have recently witnessed 'too much of a good thing'.

Some of the recent turnaround is cyclical - we have been through this before in 1976 and 1984 - and we know that the benefits do not last all that long. The other part of the turnaround is structural and is mainly due to our belated recognition of the benefits of Asian growth and our capacity to share in it. We have to be on our guard, however, against taking the benefits for granted. There is a risk that we see this as a gigantic updraught that will automatically lift us onto a higher growth plane. It will if we play our cards right, but not if we think it will solve all our problems.

There will be two forces at work. While overall we will benefit from increased demand for our products from growing Asia, many of our industries will also come under intense pressure from newly-emerging Asian competitors. A lot of adjustment will still be required; some industries will expand quickly, others will have to adopt more productive practices in order to meet best international standard and so survive, and some will inevitably fall by the wayside. We need to ensure that we have enough flexibility to make sure that the expansion of the first two groups outweighs the contraction of the third.

Obviously this will be a big challenge for business, but it will also be a challenge for governments and our institutions more generally. The first requirement is a big increase in physical investment, which is now underway. Another is that we achieve enough flexibility in our labour and goods markets to allow firms to reach best international practice. That will require further moves to increase competition and flexibility of wages and conditions. Governments, too, will have to continue working towards making the delivery of publicly-provided services more efficient and economic.

In other words, the turnaround in our cyclical position and return of optimism about our medium-term future does not mean that we can now afford to stop the process of improving our standards. Perhaps it is more difficult to make the hard decisions in the good times than it is in the bad, but we should guard against this mentality. In principle, it should be less painful to make adjustments in a growing economy than in a stagnating one. While we should welcome the return of optimism, we should also retain our capacity for self-criticism and a distrust of those who think success will quickly and easily fall into our hands.