

4. Economic Conditions and Prospects

- 4.1 The Australian economy can sustain a moderate but significant increase in award rates of pay. The recent performance of the economy has been good and our overall prospects are encouraging. Last year's safety net review proceedings were conducted against a backdrop of the (then) recently released December 2000 quarter National Accounts data. That data showed a seasonally adjusted contraction of 0.6 per cent in the economy (later revised to 0.5%). Since that time economic growth has recovered strongly, and Australia's economic performance throughout 2002 is forecast to outpace most of the developed world.

Current Economic Conditions⁴

- 4.2 This section of the submission considers the recent developments in the Australian economy and presents a summary of the current economic conditions. A complete summary of each of the matters presented below is contained in Tag 1 of the Composite Exhibit.

Economic Growth

- 4.3 The Australian economy has recovered strongly from its GST-induced slump in late 2000. The current economic expansion is now

⁴ The economic data presented throughout this section, as with the tables of the Composite Exhibit, have been expressed, unless otherwise noted, in trend terms. Whilst seasonally adjusted estimates may provide a clearer focus on adjustments in the real economy, they still include factors of volatility and irregularity, which can make interpretation difficult or inaccurate. The trend estimates presented smooth out these irregularities, to provide a more reliable guide to the underlying directions of the data.

more than 10 years old, with a total of 40 consecutive quarters of positive growth in trend terms.⁵ While the later half of 2000 and early part of 2001 saw GDP growth fall below its recent levels of above 4 per cent, the most recent data for June and September quarters 2001 suggest a return to these levels once again, and at rates far outpacing most other major economies. In trend terms, GDP rose 1.1 per cent in the September quarter 2001, following an increase of 0.9 per cent in June 2001.

4.4 Following the release of the September quarter 2001 National Accounts figures, the Treasurer, Mr Costello commented:

“In the face of an ailing world economy with synchronised downturns in North America, Europe and Japan, the Australian economy has maintained a very strong growth momentum through 2001. In seasonally adjusted terms, GDP grew by a robust 1.1 per cent in the September quarter of 2001, building on the strong growth of 1.8 per cent recorded over the March and June quarters.

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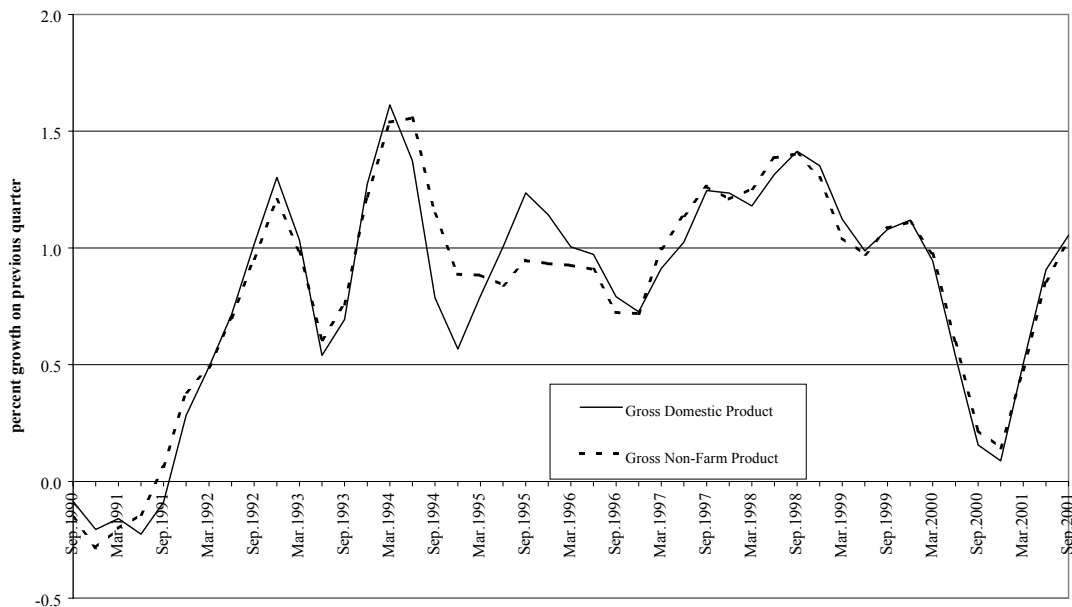
The Australian economy remains well on track to markedly outperform most of the developed economies in 2001. Over the first three quarters of 2001, Australia’s growth was around five times higher than the average growth for the G7 economies.”

[Costello, P. Press Release: National Accounts: September Quarter 2001,
5 December 2001]

⁵ The seasonally adjusted data for December 2000 showed a contraction of 0.5 per cent in that

4.5 Figure 4.1, below, presents the recent movements in Gross Domestic Product (GDP) and Gross Non-Farm Product (GNFP) over the past decade⁶. The graph clearly shows a sharp moderation in growth occurring during September and December 2000, following the introduction of the GST, followed by the strong recovery during the later half of 2001, to pre-GST levels once again.

Figure 4.1: Growth in GDP and GNFP, Australia – 1990 to 2001



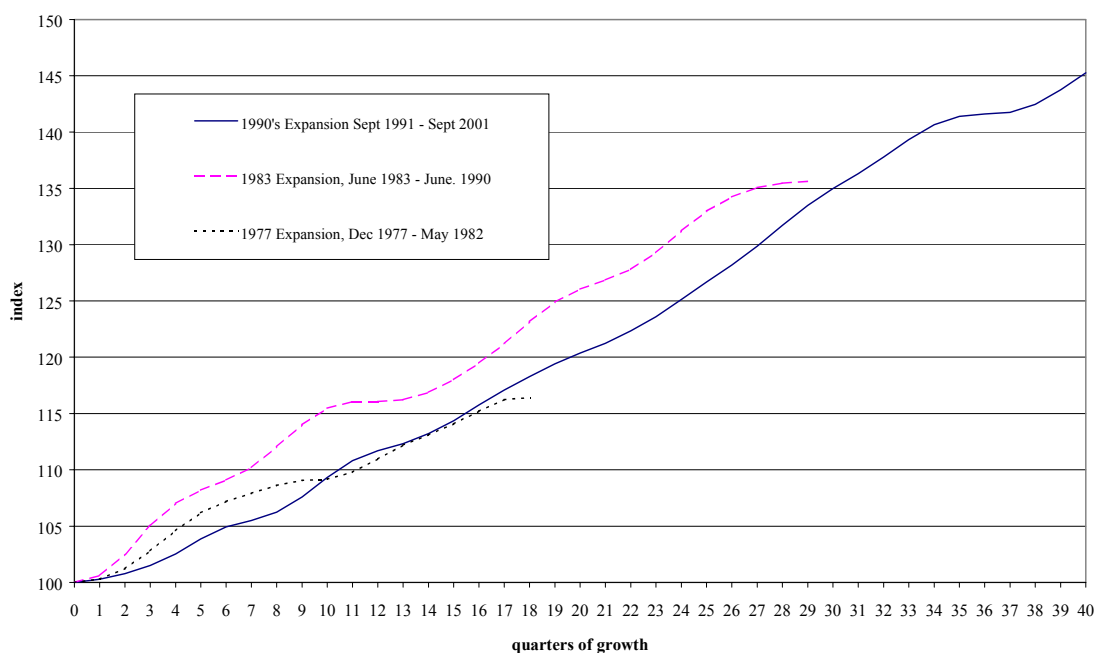
Source: ABS Cat No. 5206.0

4.6 Figure 4.2 charts Australia’s last three economic expansions. The current expansion which began in the September quarter 1991, and now in its 40th consecutive quarter of growth, is notably the longest expansion of the three. Over this time, the economy has grown at an average rate of around 1 per cent per quarter, or 4 per cent annually.

quarter – but with a strong recovery in the following quarters, this slowdown can be viewed as a temporary phenomenon.

⁶ GNFP abstracts from the farm sector to remove the inherent volatility present in this sector

Figure 4.2: Comparison of last three economic expansions



Source: ABS Cat No. 5206.0

- 4.7 While the current expansion has a rate of growth slightly below that during the mid-late 1980's, it has clearly continued far longer than the 1980's expansion, and appears to show little sign of ending in the near future. With the exception of the GST-induced slowdown in the later half of 2000, the current expansion also appears to be relatively more stable, with few fluctuations during the whole 40 quarter period. As the Reserve Bank Governor, Ian Macfarlane, commented in an address to economists in December:

“What the graph shows is that the current expansion is a good deal longer and smoother than its predecessors.

...

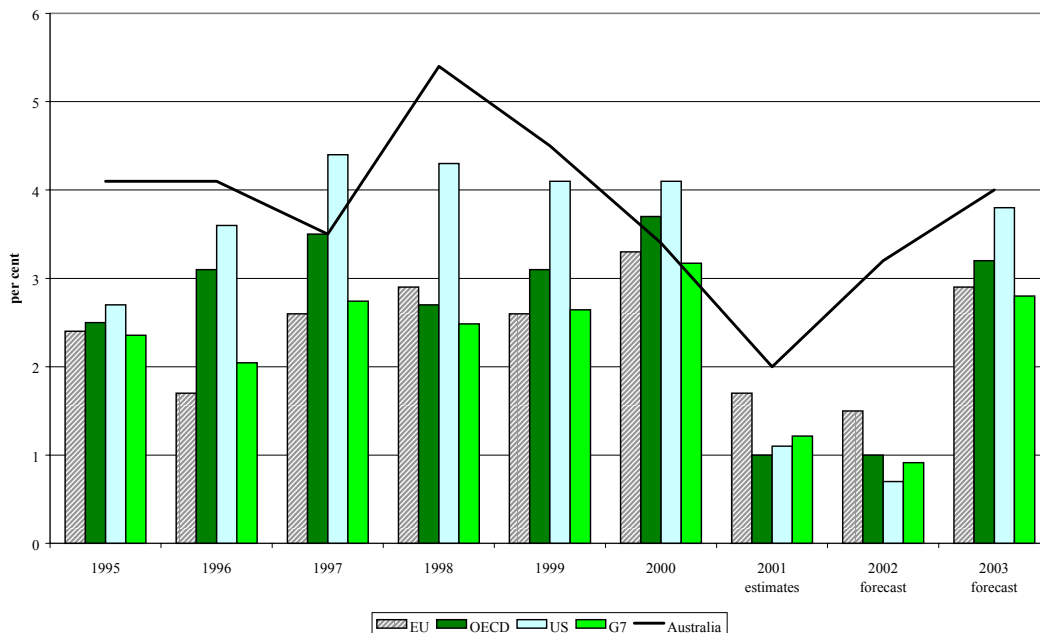
For most of the period of the current expansion, the international background has been benign. The exception until recently was the period between mid 1997 and the beginning of 1999, when the Asian crisis confronted us with a pronounced fall in the demand for our exports and some

pretty skittish international capital markets. We survived – indeed, prospered – in that period, much better than any of us thought likely at the time.”

[RBA Governor, Ian Macfarlane, *Australia and the International Cycle*, Address to Australian Business Economists/Economic Society of Australia (NSW Branch) Forecasting Conference Dinner – Sydney – 6 December 2001, at **Tag 7 of Composite Exhibit**]

4.8 The recent growth in Australia’s GDP continues to outpace other major industrial countries, as shown in Figure 4.3. The OECD’s *Economic Outlook* for December 2001, suggests despite an expected slower growth rate of 2.0% over the 2001 calendar year, Australia continues to outperform the G7 average of 1.2 per cent, the European Union (1.7 per cent), and the total OECD which is expected to have grown by 1.0 per cent over the same period.

Figure 4.3: International comparison of Real GDP growth (1995 – 2003)

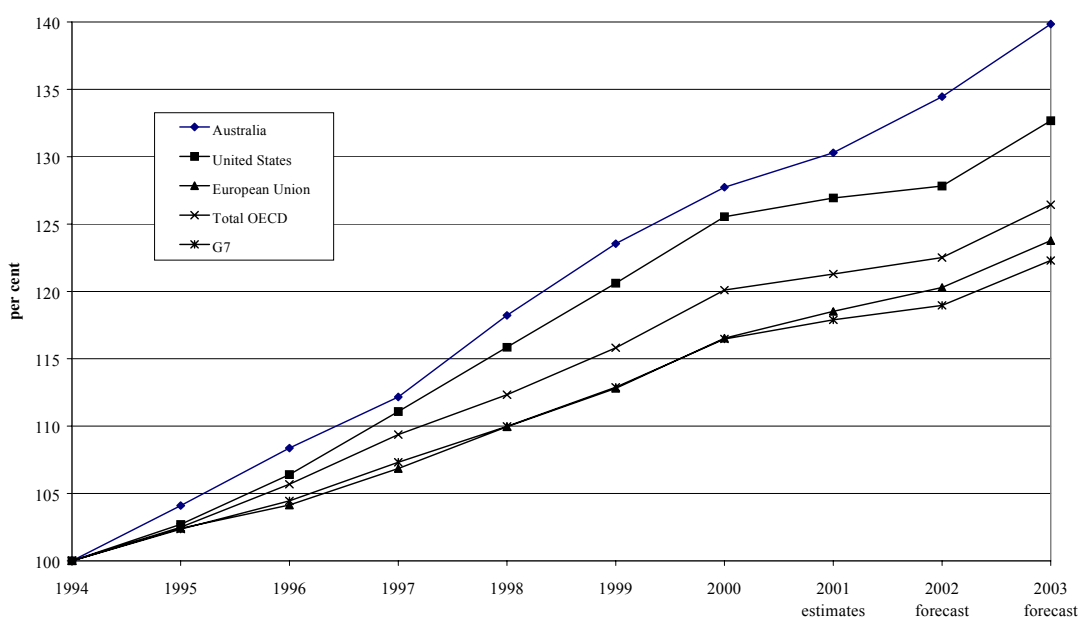


Source: OECD Economic Outlook – December 2001

4.9 Australia’s GDP growth has also continued to outperform that of the United States, which is expected to have grown by only 1.1 per cent

in 2001. The OECD forecasts for the years ahead continue to look favourably upon Australia, with the current 2002 calendar year seeing probably the largest gap between Australian economic growth and that in the rest of the developed world. Figure 4.4 below, further illustrates how well Australia has performed over recent years, showing the cumulative increases in real GDP growth over the past seven years.

Figure 4.4: International comparison of Real GDP growth - cumulative



Source: OECD Economic Outlook – December 2001

Aggregate Demand

4.10 A full assessment of the current trends in overall economic growth requires a consideration of the underlying components of domestic demand. Private final domestic demand in Australia has recovered strongly from the impacts of the introduction of the GST during the later half of 2000, which hit the construction sector particularly hard. Analysis of the components of private final domestic demand (private consumption and investment), reveals that most of its decline was as a result of a fall in investment in dwelling and non-

dwelling construction, with consumption moderating only slightly – see below.

- 4.11 Private final domestic demand increased 1.4 per cent during the September quarter 2001, to be 2.5 per cent higher than a year earlier, on the back of a 1.0 per cent increase during the June 2001 quarter. This represents a return to quarterly growth levels recorded before the GST-induced slump, with the September 2001 quarter itself being the highest recorded increase in the series since June 1999.

Private Consumption

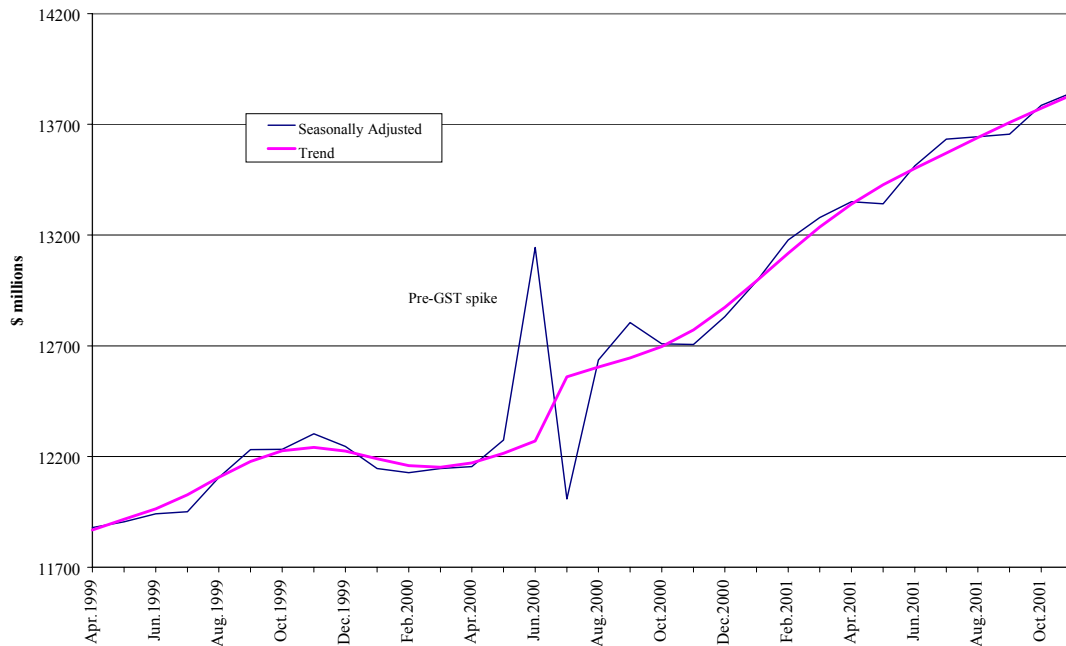
- 4.12 Private consumption has remained quite solid despite a temporary moderation as a result of the introduction of the GST in July 2000. Private consumption expenditure fell to lows of 0.3 per cent and 0.4 per cent in the March and June quarters 2000, but has since returned to quarterly growth rates of at least 1 per cent since March 2001.
- 4.13 The most recent data for September 2001 reveals that private consumption grew by 1.0 per cent during the quarter to be 3.8 per cent higher than a year earlier. This represents the third such quarter of consumption growth of around 1 per cent. Should this trend continue in December 2001, which seems quite possible considering the other indicators available (see below), annual growth would be expected to return to above 4 per cent levels.
- 4.14 By international comparison, Australia's consumption growth remains well above the G7 average of 2.0 per cent over 2001, the

European Union (2.1 per cent), and the OECD (1.9 per cent).
[OECD, Economic Outlook, December 2001]

Retail Trade and New Motor Vehicle Registrations

- 4.15 Movement in two of the major indicators of private consumption – Retail Turnover, and New Motor Vehicle Registrations – experienced a great deal of volatility over the period surrounding the implementation of the GST, mostly due to changes in timing of consumption. These indicators are presented in greater detail in Table 6 of Tag 1 of the Composite Exhibit.
- 4.16 In trend terms (thus ironing out some of this volatility surrounding the GST period), retail turnover has continued to grow at an increasing rate. Over the 2000-01 financial year, retail turnover was 6.6 per cent higher than at the same time a year earlier. Considering the most recent data for the month of November 2001 reveals that retail turnover has now grown at a monthly rate in excess of 0.5 per cent in each of the past 13 months, with the value of retail turnover 8.3 per cent higher in November 2001 than at the same time a year earlier. Figure 4.5 below, clearly shows that the declines in the seasonally adjusted retail turnover figures occurring following the introduction of the GST are a reversal of the previous spike, with both the trend and seasonally adjusted measures recovering strongly since this time.

Figure 4.5: Value of retail turnover – 1999 to 2001



Source: ABS Cat No. 8501.0

- 4.17 Similar volatility also occurred around the GST's introduction with respect to new motor vehicle registrations. Whilst the number of new motor vehicle registrations fell in the period leading up to the GST (as people put off purchase to wait for the cheaper prices), there was a corresponding jump in registrations in the September quarter of 12.5 per cent. Since this time registrations have settled down to be closer in line with their recent longer term growth levels.

Consumer Sentiment

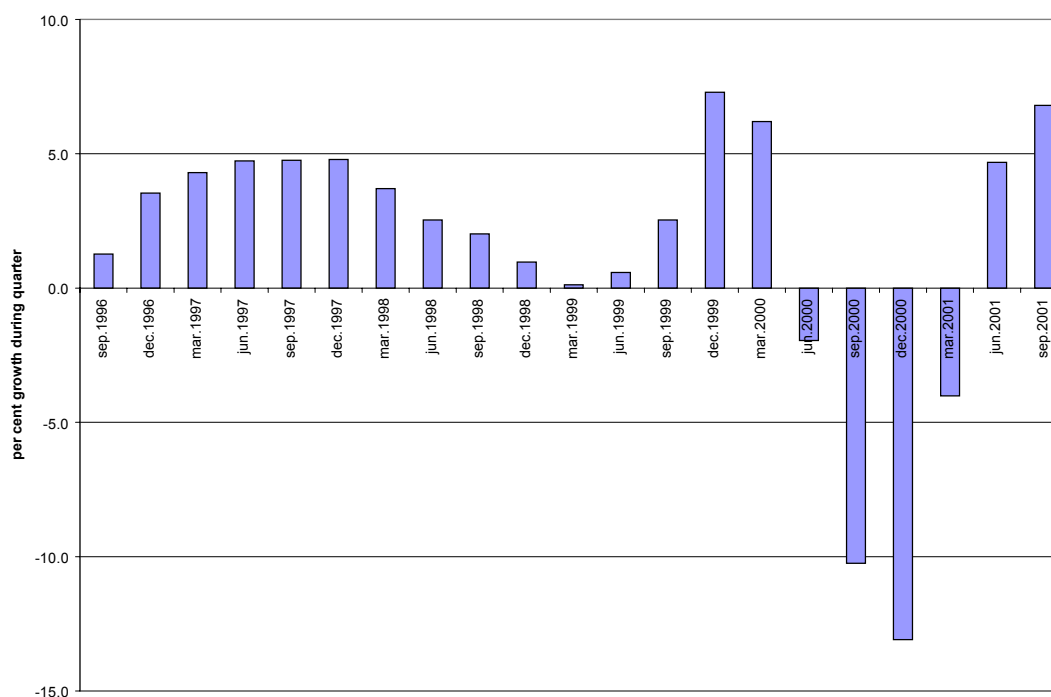
- 4.18 The most recent Westpac-Melbourne Institute Index of Consumer Sentiment – which measures spending plans and confidence about the economy amongst householders, rose 3.3 per cent in January. This represents the third successive increase in the index since it fell following the September 11 attacks (now up 12.9 per cent since this

time), and means that consumer sentiment is now well above its long term average.

The Housing Sector

- 4.19 The recent performance of the housing sector is discussed in more detail in Table 8, at Tag 1 of the Composite Exhibit. The housing sector experienced considerable volatility during the 2000 calendar year resulting from the introduction of the Government's GST. As was outlined in greater detail during last year's submission, the effect of the introduction of the GST on the sector was to bring-forward expenditure on construction into the period before the new tax, and a large reduction in construction following its introduction. This has largely been recognised by commentators as the reason behind the contraction in overall GDP growth, in seasonally adjusted terms, during the December 2000 quarter.
- 4.20 Since this time, private dwelling expenditure has rebounded strongly during 2001, as the GST bring-forward effects were unwound in combination with large reductions by the Reserve Bank in official interest rates, and an increase in the Government's First Home Owners Scheme (FHOS). Private dwelling expenditure rose 4.7 per cent and 6.8 per cent during each of the June and September 2001 quarters. The recent pattern in growth in private dwelling investment expenditure can be seen clearly in Figure 4.6 below.

Figure 4.6: Growth in Private Dwelling Investment Expenditure Australia – September 1996 to 2001



Source: ABS Cat No. 5206.0

4.21 The most recent ABS housing approvals and finance data for November 2001, show signs of even stronger growth in private dwelling investment likely over the December quarter and beyond. The number of new dwelling approvals increased 23.7 per cent in the September 2001 quarter alone, with the value of lendings by financial institutions for the purpose of new dwellings also up 13.7 per cent during September.

Business Investment

4.22 Investment in new plant and machinery increased slightly by 0.4 per cent in trend terms (1.5 per cent seasonally adjusted) during the September quarter 2000, following three quarters of moderate contraction from its recent high levels. New investment in non-

dwelling construction has recovered even faster, growing by 1.7 per cent and 1.4 per cent in the June and September 2001 quarters, following the contractions recorded immediately following the introduction of the GST. For more detail of recent movements in business investment see Table 9 at Tag 1 of the Composite Exhibit.

The Business Sector

4.23 Conditions and confidence and in the business sector have improved strongly in recent months, as reported in the various business surveys.

4.24 The *Dun & Bradstreet Business Expectations Survey* released on 15 January 2002, showed sales expectations reached a 20 month high in December 2001. Christine Christian, CEO of Dun & Bradstreet Australia & New Zealand, said the increase in expectations across the board indicated a 'great start to 2002 for many businesses':

"Australia is starting the new calendar year in a far stronger position than it entered 2001. In spite of negative growth in the US, Japan and some other trading partners, the unexpectedly quick success in the war on terrorism in Afghanistan have helped improve the business outlook"

[Dun & Bradstreet, *Media Release – The New Monthly D&B Business Expectations Survey – January 2002*, 15 January 2002]

4.25 Further, the survey found that the outlook in the distribution sectors was particularly strong:

"Wholesale executives in particular have shown an extremely strong outlook for growth in sales, with a net 68

per cent now expecting an increase in the March quarter. This is the best wholesale sales outlook in two years. The profits for the wholesalers is also very strong, the best in 20 months.

In the distribution sectors, wholesalers and retailers both expect strong growth in employment during the March quarter”

[Dun & Bradstreet, *Media Release – The New Monthly D&B Business Expectations Survey – January 2002*, 15 January 2002]

- 4.26 The most recent National Australia Bank’s business surveys have shown similar results. Following the release of its *National Quarterly Business Survey – December 2001*, NAB Chief Economist Alan Olster, made the following comments:

“The Survey’s results can only be described as robust and further underlie the ongoing strength of the Australian economy in a period of global downturn. Overall, the results were consistent with annual growth in non-farm GDP of around 3.5 per cent during 2001.

...

Business confidence was significantly weaker in the December quarter. ... That said, the quarterly result represents a marked improvement on confidence levels at the end of the September month (-9.7 points), following the events of September 11.

...

The partial recovery of business confidence has undoubtedly been influenced by evidence of continued resilience, some signs that the deterioration in the global environment may be abating (or at least past its worst

stages), and positive developments on the 'war against terrorism'."

[National Australia Bank, *Media Release – National Quarterly Business Survey – December 2001, January 2002*]

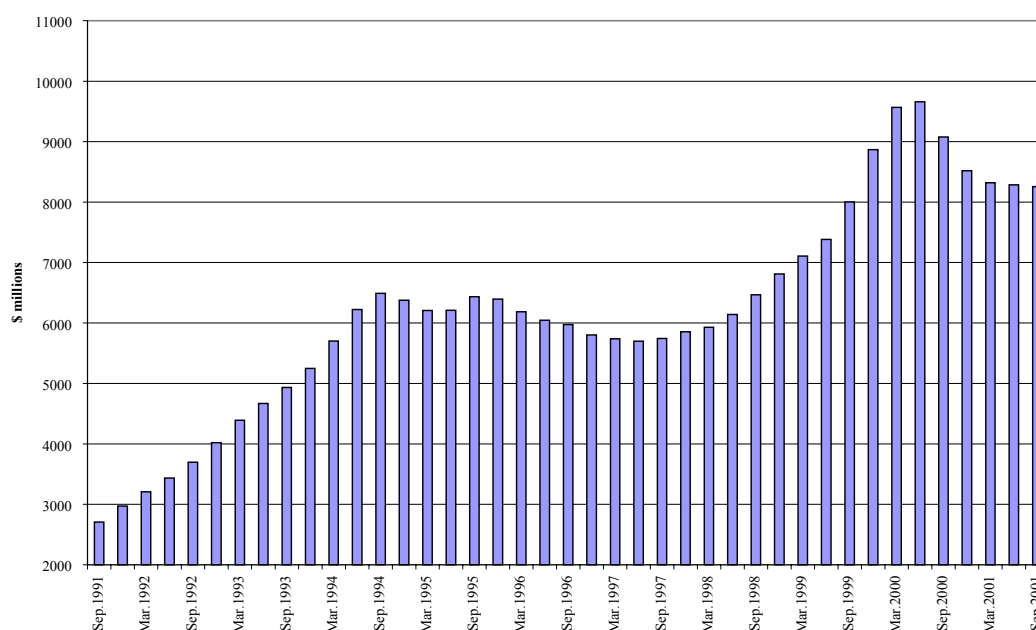
Manufacturing Production

4.27 Following a decline in manufacturing production, growth in the sector has since began to recover. The value of manufacturing output as measured by the National Accounts, grew 0.8 per cent and 1.4 per cent in the June and September quarters 2001.

Company Profits

4.28 Following record high levels between 1998 and 2000, company profits before tax moderated slightly during 2000-01 as seen in Figure 4.7 below. The most recent September 2001 quarter data shows that profits declined slightly by 0.4 per cent, following astronomical growth of 17.3 per cent and 30.0 per cent during 1998-99 and 1999-2000 respectively.

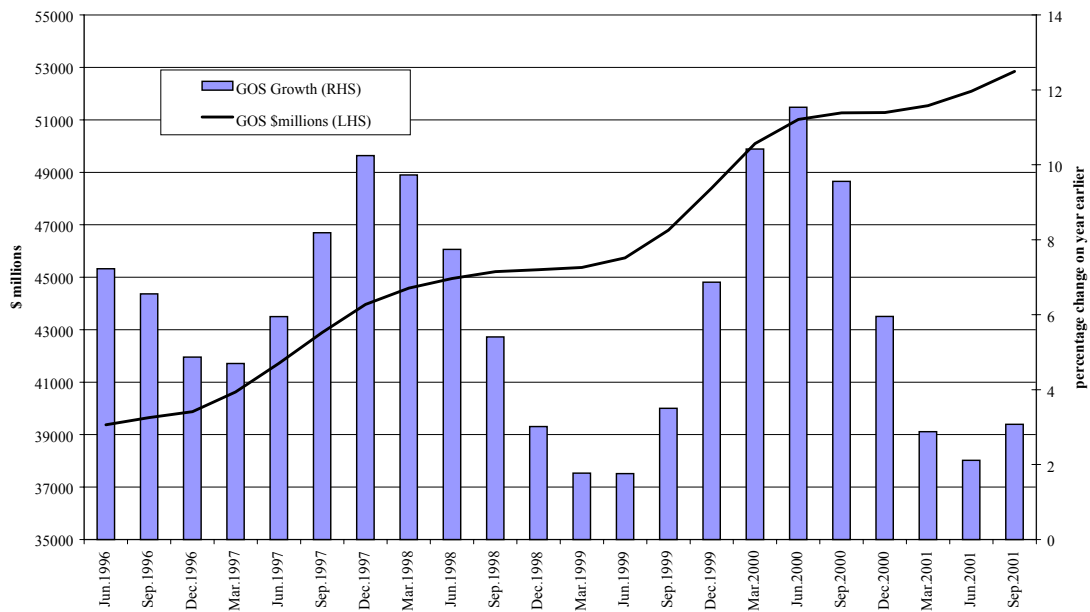
Figure 4.7: Company profits before income tax – 1991 to 2001



Source: ABS Cat No. 5651.0

4.29 The Gross Operating Surplus (GOS) measure of company profits as reported in the ABS's National Accounts publication has exhibited further growth over recent quarters. GOS increased 5.0 per cent in year average terms during the 2000-01 financial year on the back of very strong 8.1 per cent growth in 1999-2000. The June and September 2001 quarters recorded GOS growth of 1.1 per cent and 1.4 per cent respectively. Figure 4.8 plots the recent GOS data to September 2001.

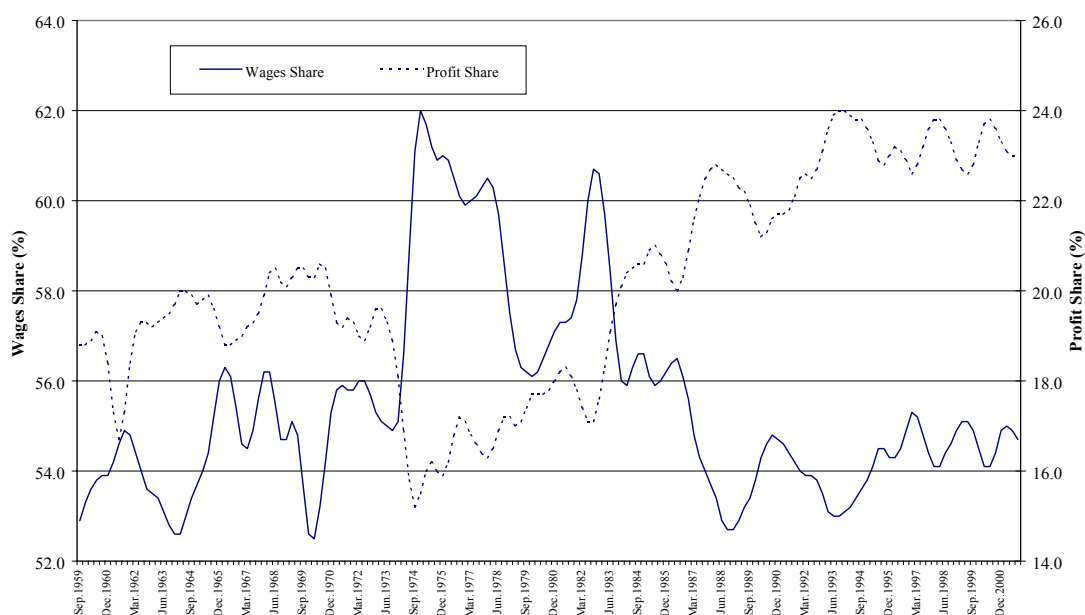
Figure 4.8: Gross Operating Surplus – Australia – 1996 to 2001



Source: ABS Cat No. 5206.0

4.30 Figure 4.9 below, presents the wage and profit shares of total factor income since September 1959. The profit share of national income continues to fluctuate around its recent historical highs of around 23 to 24 per cent. The wages share of total factor incomes, comparatively, remains at near record low levels.

Figure 4.9: Wage and Profit share of total factor income – 1959 to 2001



Source: ABS Cat No. 5206.0

Wages

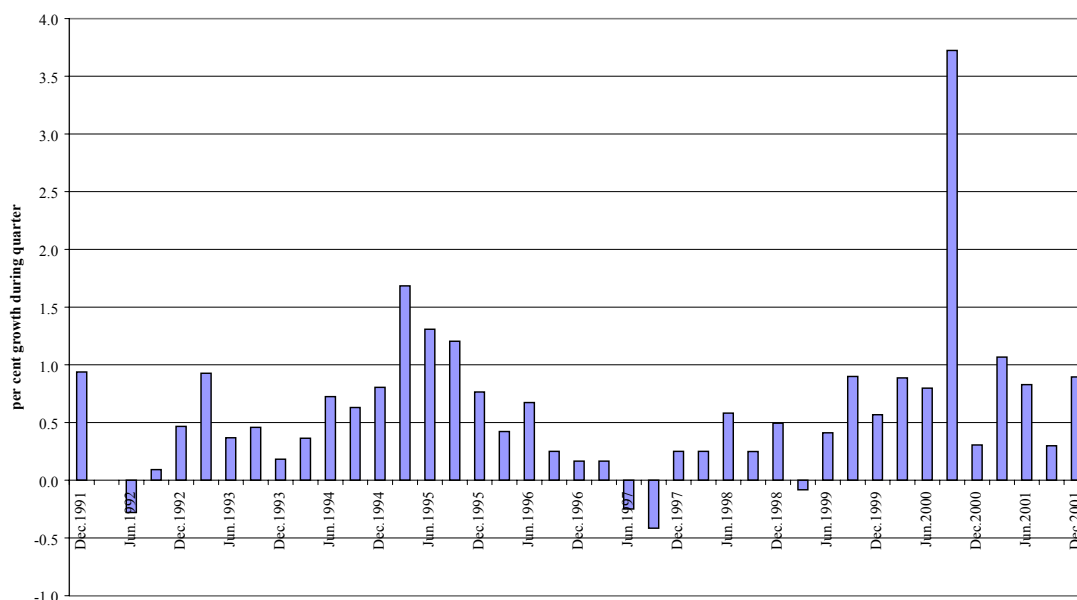
- 4.31 Wages growth has been dealt with in greater detail in Chapter 2 and Appendix A of this submission, and at Tables 12 and 13 of Tag 1 of the Composite Exhibit. Wage growth remains moderate with no evidence of wages causing pressure on inflation.

Prices

- 4.32 The Consumer Price Index (CPI), increased 6.0 per cent in year-average terms during 2000-01, compared with 2.4 per cent during 1999-2000. The headline rate over this time was largely affected by the introduction of the GST, which saw CPI in the September quarter 2000 alone increase by 3.7 per cent.
- 4.33 A year on from the introduction of the tax suggests that most of these pressures have now passed through, with the September 2001 quarter rising by 0.3 per cent during the quarter to be 2.5 per

cent higher than at the same time a year earlier. The December quarter 2001 saw a slightly higher than expected quarterly increase on 0.9 per cent, taking inflation over the year to 3.1 per cent. Most commentators since the release of this data have put this down to one-off effects such as rising air-travel costs arising from the Ansett collapse, rather than any large increase in underlying price pressures. Figure 4.10 below shows the quarterly growth in the headline CPI over the past decade.

Figure 4.10: Quarterly CPI growth – December 1991 to 2001



Source: ABS Cat No. 6401.0

4.34 In terms of underlying inflation the Reserve Bank recently made the following assessment:

“The various measures of underlying inflation were around 0.7 per cent in the September quarter, down from rates of around 0.9 per cent in the March and June quarters. Thus, year-ended underlying inflation has risen from 2½ per cent in mid-2000 to around 3 per cent currently. This pick-up

largely reflects some flow-through of accumulated upstream price pressures relating to the fall in the exchange rate over the past couple of years and increases in world prices which have flowed through to items such as food.

...

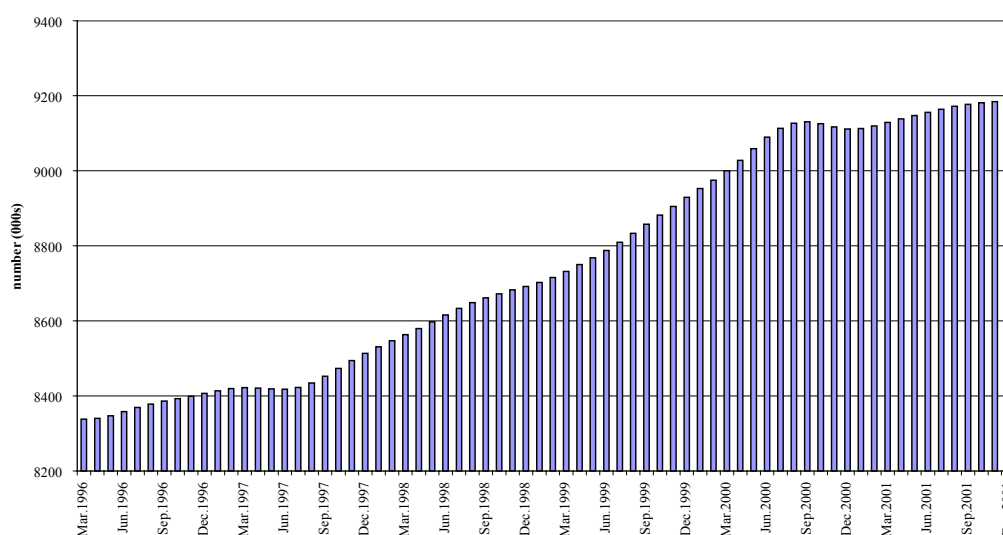
In the latest quarter, however, there are signs that some of this pressure may be abating.”

[RBA, *Statement on Monetary Policy*, 12 November 2001, page 61-62]

Labour Market

- 4.35 Figure 4.11, below shows that employment growth moderated over the past year, largely as a result of the post-GST induced slowdown. Employment grew 2.1 per cent during 2000-01, in line with the 2 per cent average annual growth recorded in recent years.

Figure 4.11: Total Employment – Australia – 1996 to 2001

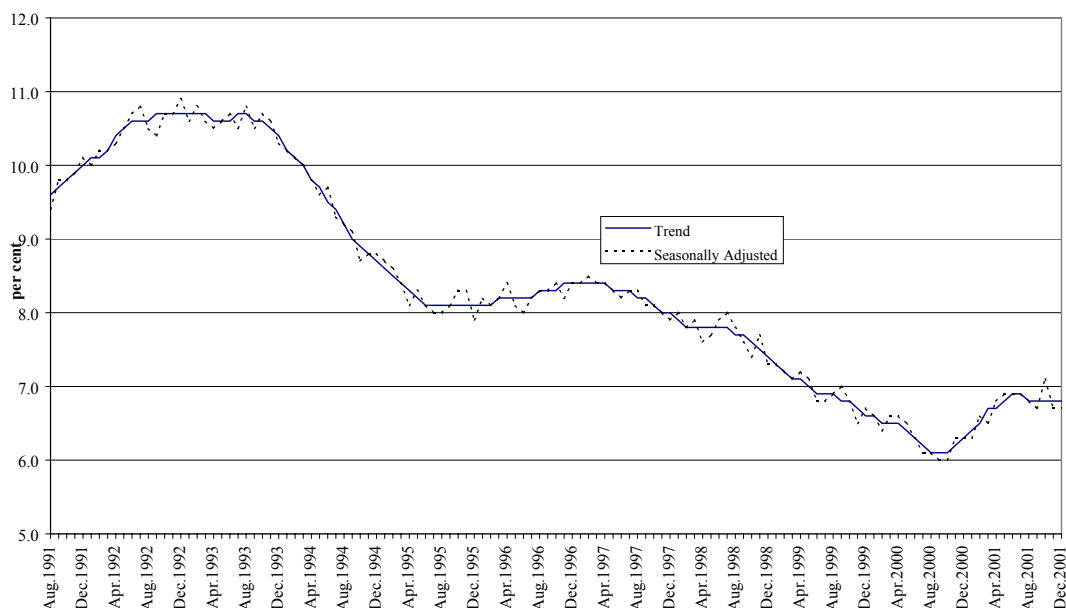


Source: ABS Cat. No. 6202.0

- 4.36 The unemployment rate rose slightly during the later part of 2000 and early 2001 after bottoming out at 6.1 per cent in

September/October 2000 (6.0 per cent in seasonally adjusted terms). Since this time the unemployment rate has remained quite steady over the past year at around 6.8 per cent in trend terms.

Figure 4.12: Unemployment Rate – Australia – 1991 to 2000



Source: ABS Cat No. 6202.0

4.37 Following the release of the latest ABS labour force figures for December 2001, Federal Employment and Workplace Relations Minister, Tony Abbot commented that:

“I think that we can be cautiously optimistic about the future because the ANZ job series is going up, the Westpac consumer sentiment series is going up, the Dun and Bradstreet measure is looking up, and so I think we can be reasonably optimistic about strong employment growth in the months ahead”

[Abbott, T (Minister for Employment and Workplace Relations), ABC Radio, 17 January 2002]

4.38 The latest results from ANZ Monthly Job Advertisements survey saw the number of Job Ads in January rise 12.5 per cent, the largest monthly increase since April 1997. ANZ Chief Economist Saul Eslake commented at the release of the survey:

“The sharp increase in the number of newspaper job advertisements in January potentially represents a major turning point in the outlook for employment.

...

The fact that January’s large increase follows a small increase in December, rather than a fall which has typically preceded large increases at this time of year, suggests that this increase may genuinely signal a significant improvement in employers’ hiring intentions.

...

Moreover, an improvement in the labour market would be consistent with the more optimistic tone suggested by other surveys of business confidence.

...

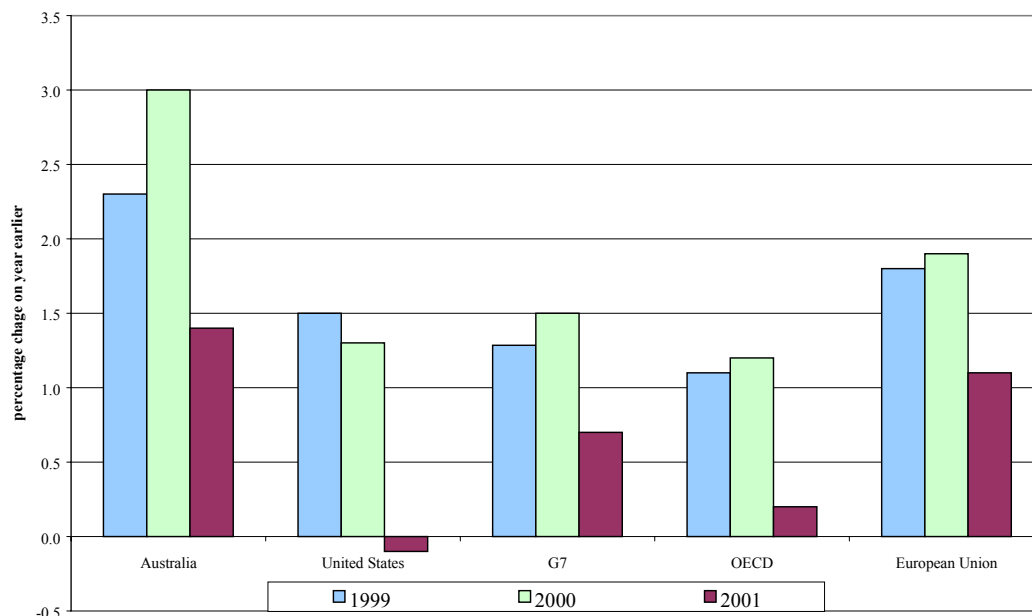
If this latest jump in job advertising is validated by next month’s results, then there would be solid grounds for expecting better labour market outcomes than those forecast in the Government’s Mid-Year Economic and Fiscal Outlook”

[Eslake, Saul. Media Release – Newspaper job advertisements up 12.5% in January, ANZ Job Vacancies series, 4 February 2002.]

4.39 Figure 4.13 below compares Australia’s recent employment growth performance with that of other developed nations. It can be seen that, while employment growth in Australia has moderated from its

previous highs, it continues to outperform other OECD countries. In 2001 the OECD estimates that employment growth in Australia grew by 1.4 per cent, compared with 0.2 per cent for the total OECD, an average of 0.7 per cent for G7 countries, and 1.1 per cent for the European Union. The United States over the same period recorded a 0.1 per cent decline in employment.

Figure 4.13: International Comparisons of employment growth 1999 to 2001

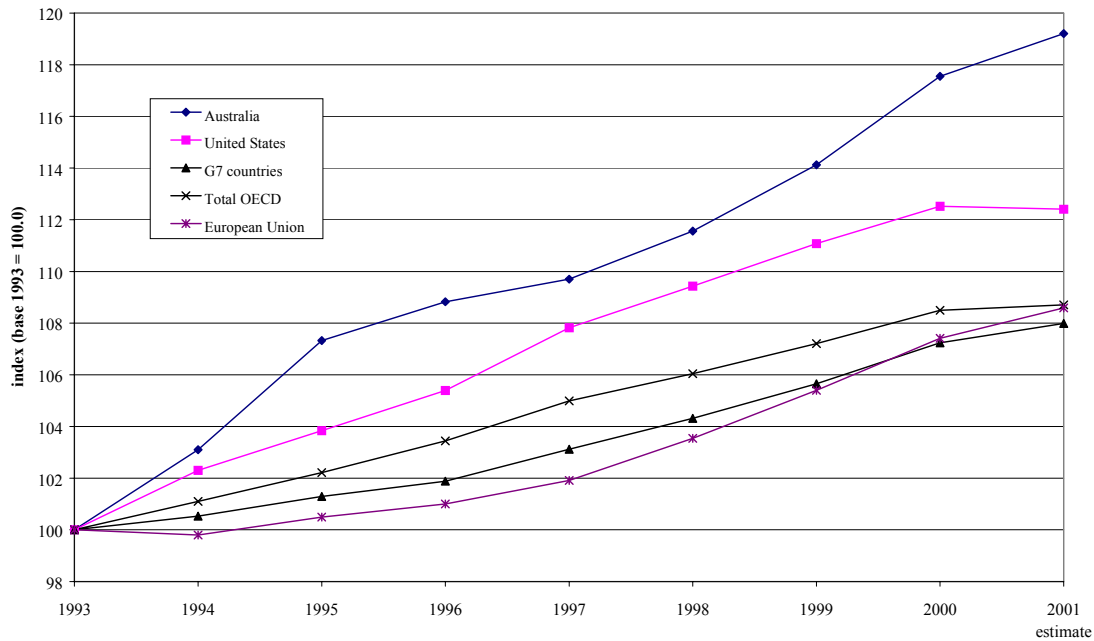


Source: OECD Economic Outlook, December, 2001.

4.40 Figure 4.14 shows an international comparison of the cumulative performance in employment growth since 1993. Australia continues to well outpace the European Union, G7, and Total OECD, as well as growing notably faster than the United States. Since 1993, employment has grown by 19.2 per cent in Australia compared with 12.4 per cent in the United States, 8.6 per cent in the European Union, 8.0 per cent in G7 countries and 8.7 per cent for the OECD as a whole.

4.41 Australia's employment growth figures are also forecast to outpace those of most of the industrialised world in the two years ahead (see section on labour market prospects below).

Figure 4.15: Cumulative employment growth International comparisons (1993 – 2001)

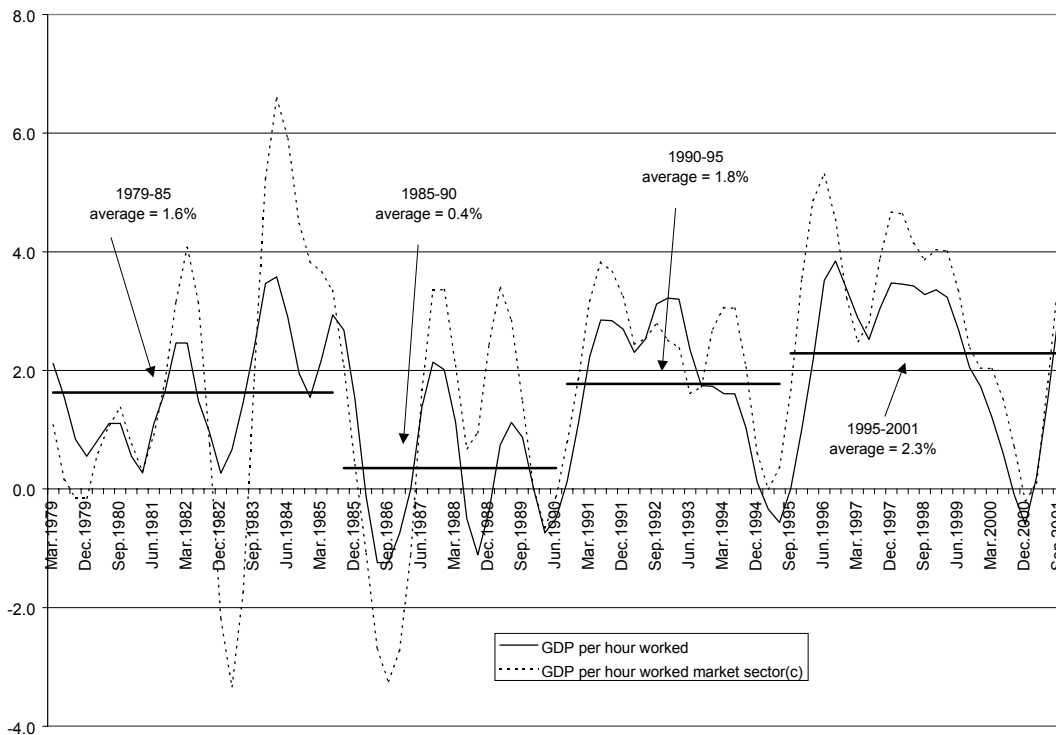


Source: OECD Economic Outlook – December 2001

Productivity

4.42 Labour productivity increased markedly during 2001, with the GDP per hour worked measure having increased 3.0 per cent over the year to September 2001. The past six years have seen a faster increase in labour productivity growth than in any similar period in Australia's recorded history, increasing at an annual average rate of 2.3 per cent since June 1995 (see Figure 4.16).

Figure 4.16: Labour productivity growth – Australia - 1979-2001



Source: ABS Cat No. 5206.0

External Accounts

4.43 Australia's Current Account Deficit (CAD) has continued to decline over the past year on the back of strong export growth. As of September 2001, the CAD had fallen to 1.7 per cent as a proportion of GDP, down from its recent high of 6.1 per cent of GDP in September 1999.

Domestic Economic Outlook and Prospects

- 4.44 This section of the submission deals with the economic outlook and prospects for Australia economy over the period ahead.
- 4.45 As in past submissions, we have relied heavily upon the ‘official’ economic forecasts published by Commonwealth Treasury and the Reserve Bank of Australia (RBA, or ‘the Bank’).
- 4.46 The Commonwealth Treasury’s *Mid-Year Economic and Fiscal Outlook* (MYEFO) for 2001-02, was released on 17 October 2001 last year, somewhat earlier than is normally the case. An extract is provided at Tag 6 of the Composite Exhibit. This was due to a request from the Treasurer to have the publication ready for release during the recent federal election campaign. The publication still, however, provides the most authoritative official outlook available, despite being generally formulated with data from the June quarter 2001.⁷ The RBA *Statement on Monetary Policy*, provides a more up to date look at the situation prevailing in the economy, being released on 12 November 2001, after the Bank had had some time to consider the economic implications the terrorist attacks in the US on 11 September.

⁷ At paragraph PN1740-1 of transcript from last year’s case, Mr Downes appearing on behalf of the Joint Coalition Governments told the Commission that, owing to the time involved in producing the MYEFO document, figures used are generally derived from the June quarter national accounts.

4.47 Evidence has also been presented from private economic forecasters and international economic agencies such as the OECD where appropriate.

The outlook for the Australian Economy – an Overview

4.48 The official forecasts paint a very favourable picture of the Australian economy over the foreseeable future, in contrast with the weak economic performance expected through most of the rest of the world's major economic regions (see below a more detailed discussion of the world economic outlook).

4.49 The Australian economy has recovered strongly from its GST induced slump around the end of 2000 and early 2001, following a strong pick-up in exports, housing construction and most areas of private consumption.

4.50 As the Reserve Bank points out, any major impediments to growth in the Australian economy over the period ahead are likely to come from abroad. However, despite the relatively poor short-term outlook internationally, most forecasters expect Australia to weather the storm quite well.

Uncertainties in the forecasts

4.51 Given this analysis, Treasury note that the international outlook poses the main uncertainty to their MYEFO forecasts. Should the world downturn gather momentum and last longer than expected, this would put added tension on the domestic forecasts.

- 4.52 Conversely, growth in the US and elsewhere could rebound sooner, and at a faster pace, supported by the fiscal and monetary policy stimulus now in train and a restoration of business and consumer confidence (recent data and commentary from the US suggests that this may now be a more likely scenario).
- 4.53 Under these circumstances, given Australia's supportive exchange rate, exports would be stronger than forecast and, with very low interest rates and a recovery in confidence, consumption and investment in Australia could rebound rapidly. The result would be substantially stronger domestic economic growth on average across 2001-02 and 2002-03 than the forecasts presented below.

Economic Growth

- 4.54 Since Treasury last published its economic forecasts at Budget time, domestic demand is now expected to grow more quickly than previously forecast, partially ameliorating the impact of world events on overall economic growth in Australia. In particular, dwelling investment and public demand are both now expected to grow much stronger than earlier anticipated. Combined with the strong fundamentals underlying the economy, and favourable monetary and fiscal policy settings, Australia is expected to perform much stronger than most other world economies over the period ahead.
- 4.55 The Commonwealth Treasury expect the Australian economy to continue to grow strongly at around 3 per cent in year-average terms over 2001-02, up from around 2 per cent during 2000-01. The Treasury forecast for 2001-02 has been revised down slightly from 3¼ per cent at Budget time, owing largely to a weaker than expected global economic environment than that previously

forecast. In through-the-year terms, Treasury expect the Australian economy to grow by robust 3¼ per cent to the June quarter 2002.

- 4.56 Since the time of these forecasts, the Reserve Bank has again lowered official interest rates, adding a further stimulatory effect on economic growth.
- 4.57 The initial forecasts for 2002-03 show a further strengthening in economic growth in Australia to around 3½ per cent in year-average terms and a strong 4¼ per cent in through-the-year term, following an expected recovery in world economic growth as 2002 progresses. It is during this period that the Commission's decision in this case will take effect.
- 4.58 Under the revised Mid-Year outlook, domestic demand is forecast to grow by a solid 3¾ per cent in 2001-02, with net exports, reflecting the weaker global environment, expected to detract around ¾ of a Percentage point from overall domestic economic growth.
- 4.59 The Treasury's assessment of the economy over the year ahead has seen broad support from the Reserve Bank, which recently gave the following statement on the outlook for the economy:

“The significant expansion in the housing sector that is currently in train should continue through much of this financial year, and will have flow-on effects to construction-related sectors. While the confidence of the household sector was adversely affected by the events of mid-September, up until that time consumer confidence had been reasonably positive, supported by the ongoing growth in household incomes and assets and the reductions in interest rates since the beginning of the year. Continued

strong growth in household credit should provide support for consumer spending in the period ahead.”

[RBA, *Statement on Monetary Policy*, 12 November 2001, page 23]

Table 4.1: MYEFO economy forecasts^(a)

	Outcomes(b)	2001-02 Budget	2001-02 MYEFO
	2000-01 Year average	Forecasts Year average	Forecasts Year average
Panel A - Demand and output(c)			
Household consumption	2.7	3	3 1/4
Private investment			
Dwellings	-20.5	5	20
Total business investment(d)	-2.6	5	-1
Other buildings and structures(d)	-19.8	6	5
Machinery and equipment(d)	1.3	3	-5
Private final demand(d)	0.0	3 1/2	4
Public final demand(d)	1.1	2 1/4	3 1/2
Total final demand	0.3	3 1/4	3 3/4
Change in inventories(e)			
Private non-farm	0.0	- 1/4	- 1/4
Farm and public authorities	-0.1	0	0
Gross national expenditure	0.2	3	3 3/4
Exports of goods and services	7.1	5	0
Imports of goods and services	-1.4	4	3
Net exports(e)	1.7	1/4	- 3/4
Gross domestic product	1.9	3 1/4	3
Non-farm product	2.1	3	3
Farm product(f)	-4.8	7	3
Panel B - Other selected economic measures			
External accounts			
Terms of trade	3.1	- 3/4	-1 1/4
Current account balance			
\$billion	-18.7	-20	-26
Percentage of GDP	-2.8	-3	-3 3/4
Labour market			
Employment (Labour Force Survey basis)	2.1	1	3/4
Unemployment rate (per cent)	6.4	7	7
Unemployment rate (per cent)(g)	6.9	7	7
Participation rate (per cent)	63.7	63 3/4	63 3/4
Prices and wages			
Consumer Price Index - headline	6.0	2	2 3/4
Gross non-farm product deflator	4.3	1 1/2	1 3/4
Average earnings(h)	3.9	3 3/4	4 1/4

(a) Percentage change on preceding year unless otherwise indicated.

(b) Calculated using original data.

(c) Chain volume measure.

(d) Excluding transfers of second-hand asset sales from the public sector to the private sector.

(e) Percentage point contribution to growth in GDP.

(f) Calculated at basic prices.

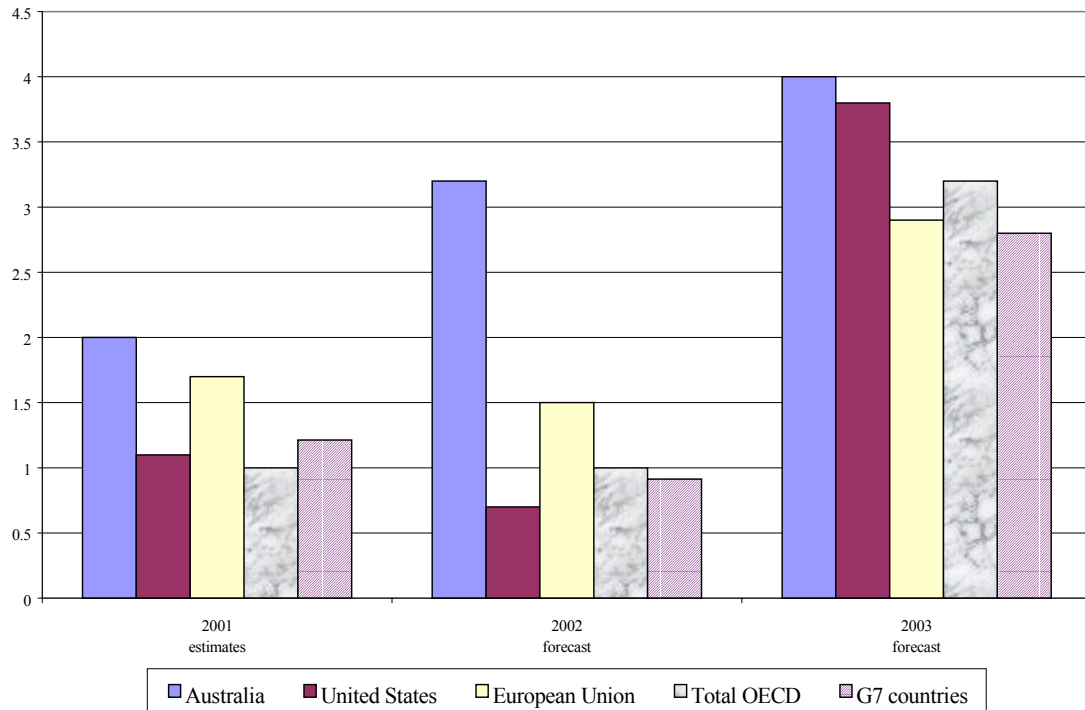
(g) The level in the June quarter of each year, seasonally adjusted.

(h) Average non-farm compensation of employees (national accounts basis).

4.60 A summary of the Treasury's forecasts is presented in Table 4.1 above, with a discussion on each of the major items presented below. The full extract of the economic outlook from the MYEFO presented at Tag 6 of the Composite Exhibit.

4.61 Figure 4.17 below shows that Australia's GDP growth is forecast to well outpace that of other industrial economies, over both 2002 and 2003. In 2002, Australia is expected to grow at over 3 times the OECD and G7 averages, and over 4 times the rate of the US economy.

Figure 4.17: International Growth Forecasts



Source: OECD Economic Outlook, December 2001.

Private consumption

4.62 Private consumption growth is expected by Treasury to be around 3¼ per cent in year-average terms over 2001-02, a little below the long-term average. In through-the-year terms, consumption growth has been revised down slightly from 3¼ per cent at Budget time to 3 per cent in MYEFO. The more subdued outlook for private consumption growth incorporates an expected decline in consumer confidence in response to international developments.

- 4.63 However, recent data on consumer sentiment suggests that the expected decline may be less than anticipated in the immediate aftermath of September 11.
- 4.64 Over the second half of this year and into 2002-03, private consumption is expected to increase more in line with longer-term trend rates, supported in broad terms by firmer growth in employment, the lagged effects of recent falls in interest rates and continuing flow-on effects from the forecast recovery in the dwellings sector, particularly with respect to spending on consumer durables.

Dwelling Investment

- 4.65 Dwelling investment is expected to rebound sharply from the large GST-induced slump recorded in the second half of 2000, discussed at length during last year's submission. Rather than detracting from overall economic growth, dwelling investment is expected instead to strongly contribute to positive growth in 2001-02.
- 4.66 Treasury now expect dwelling investment to grow by 20 per cent during 2001-02 – much stronger than the 5 per cent growth expected at Budget. This sharp rebound from the last year's decline reflects a combination of the correction since the GST-induced slump, and the stimulus to the sector from the lower level of prevailing housing interest rates, and the Government's First Home Owners Scheme (FHOS) .
- 4.67 It is expected that there will be a significant bring-forward of dwelling investment into the first half of 2001-02 which will unwind late in 2001-02 and into 2002-03 as FHOS-related building is completed. The building of new dwellings for existing home owners, and

alterations and additions, are both expected to grow strongly in 2001-02, aided by low interest rates. Recent volatility in share markets may also encourage some switching of investment funds out of the share market into the dwellings sector.

- 4.68 The most recent reduction in official interest rates by the Reserve since the time the MYEFO forecasts were published would be expected to contribute further to growth in this sector.

Private Business Investment

- 4.69 Treasury expect private business investment (abstracting from the purchase of second hand assets from the public sector) to be weaker than forecast at Budget time. The downward revision reflects the impact of the much weaker world outlook and an allowance for some decline in business confidence in Australia arising from recent terrorist attacks in the United States. Total private business investment is now predicted to decline by around 1 per cent in 2001-02. Most of this fall is expected to come from a decline in investment in new machinery and equipment, which is forecast to fall by around 5 per cent in 2001-02.
- 4.70 In contrast, the outlook for non-residential construction appears to have consolidated. Private engineering construction is expected to lead the recovery in non-residential construction, with investment intentions also remaining very strong in the mining sector.
- 4.71 If the anticipated investment intentions for 2001-02 in the mining industry are fully realised, Treasury suggest that private business investment could be stronger than forecast. Business investment should also be supported by low interest rates, and by the bringing

forward of the commencement date for full GST input tax credits on motor vehicles.

- 4.72 Business investment is forecast to return to solid growth in 2002-03, driven by a rebound in machinery and equipment investment, and supported by continued growth in non-residential investment. The improved Treasury forecast for 2002-03 predominantly reflects the low interest rate environment, combined with a pick-up in global economic growth and a restoration in business confidence by the second half of this year.

Inventories

- 4.73 Reduced investment in private non-farm inventories is expected to subtract around $\frac{1}{4}$ of a Percentage point from total GDP growth in 2001-02.
- 4.74 Despite a modest run-down in non-farm inventories in the first half of 2001, stock-to-sales ratios remain a little above trend levels, especially in the retail sector. Treasury suggest that it is possible that firms may adopt a more cautious approach to inventory investment over the coming year, particularly in the retail and wholesale sectors, in response to global uncertainties. That aside, recent solid growth in sales since the MYEFO forecasts (and over the Christmas period) could be expected to see inventories run-down further, with a potential pick-up in inventory investment relative to the MYEFO forecasts prepared by Treasury in September/October 2001.

Public final demand

- 4.75 Public final demand (after adjusting for second-hand asset sales) is now expected by Treasury to grow by a solid 3½ per cent in year-average terms in 2001-02, following modest growth in the previous year. Stronger expected growth in 2001-02 partly reflects increases in defence expenditure related to the development of Australia's armed forces announced in the Defence White Paper, and increased spending on other public infrastructure projects. Growth in public final demand is expected to slow during 2002-03, reflecting the winding down of various investment projects at the State and local level.

Net Exports

- 4.76 Following a large 1.7 Percentage point contribution to economic growth during 2000-01, expected net export growth for 2001-02 has been revised down since Budget by Treasury. Net exports are now expected to detract about ¾ of a Percentage point from total GDP growth in 2001-02, following a large 1.7 Percentage point contribution in 2000-01.
- 4.77 Notwithstanding a supportive exchange rate, growth in export volumes is forecast to be around zero over 2001-02, down from the 5 per cent growth expected at Budget time, and on the back of two years of strong growth. This downward revision is as a result of the anticipated impacts recent world events and of the now much weaker outlook for the world economy.
- 4.78 The subdued outlook for export volumes largely reflects a significant expected fall in services exports and very muted growth in exports of

elaborately transformed manufactures (ETMs), both of which are very sensitive to economic conditions in the importing country and are more difficult to divert to other (stronger) markets than are commodity exports, in times of downturn. With Asia being an important destination for both ETMs and services, the weaker outlook for that region will put sharp downward pressure on exports.

- 4.79 In contrast to services and ETM exports, commodity export volumes are much less affected by international conditions in the short term. In Australian dollar terms, most rural and non-rural commodity prices remain relatively profitable. Modest growth is forecast by Treasury in export volumes of non-rural commodities, with rural export volumes largely unchanged relative to 2000-01.
- 4.80 The Treasury has also revised down its forecasts for growth in import volumes, to 3 per cent in 2001-02, reflecting the effect of a lower exchange rate in increasing the price of imported goods, and the downward revision in the forecast for machinery and equipment investment over the same period.
- 4.81 Following large rises over the past two years in the terms of trade, it is now expected by Treasury to decline by 1¼ per cent in 2001-02, but to remain above pre-Asian crisis levels.
- 4.82 The relatively small overall decline in the terms of trade reflects the net impact of continuing strong world prices for several of Australia's key export items such as beef, grains and bulk commodities, combined with substantial falls in world prices of base metals.
- 4.83 With the weaker outlook for world growth, subdued world prices for some imports and very competitive market conditions should also help to minimise the fall in Australia's terms of trade.

4.84 Consistent with lower net exports and lower terms of trade, the current account deficit (CAD) as a share of GDP is expected to increase to around 3¾ per cent in 2001-02, after reaching the lowest annual level in 20 years in the last year. Nevertheless, Treasury still expect the CAD as a share of GDP to remain significantly below its long-term average.

Prices

4.85 The headline Consumer Price Index (CPI) is forecast to rise by around 2¾ per cent in year-average terms in 2001-02 (compared with 2 per cent forecast at Budget time) and by 2½ per cent through-the-year to the June quarter 2002.

4.86 The upward revision by Treasury largely reflects the expected impact of a number of one-off factors, including higher insurance premiums, electricity prices, meat prices, and domestic airfares, rather than any significant increase in ongoing inflationary pressures.

4.87 Treasury suggest that the modest decline in the exchange rate recently, if sustained, could also increase the CPI slightly over coming quarters. On the other hand, weak world growth and subdued domestic demand is expected to help contain inflationary pressures. Present volatility in exchange rates and world oil prices are identified by Treasury as amongst key uncertainties for the forecasts outlook in 2001-02.

4.88 The headline CPI is forecast by Treasury to increase by 2½ per cent in 2002-03 in year-average terms, comfortably within the Reserve Bank's medium-term target band of 2-3 per cent.

The Reserve Bank's Inflation Outlook

- 4.89 The Reserve Bank assessment of the inflation outlook continues to be broadly in line of that of Treasury. The Bank's outlook as published in the November quarter's *Statement on Monetary Policy*, is for underlying inflation as measured on a year-ended basis, to reach a little over 3 per cent in the next couple of quarters, before declining to around 2½ per cent through 2002. The Bank suggests that in the near term, CPI inflation (or Headline inflation) is likely to remain below underlying inflation due to recent declines in petrol prices.
- 4.90 The RBA identifies risks to the forecasts in both directions. Firstly, inflation could be higher than forecast should the world economy recover faster than is currently foreseen by lessening the assumed downward pressure on world prices. The Bank also suggests that the possibility of higher oil prices, given the current military tensions, could pose another upside risk to the outlook for domestic inflation.
- 4.91 Conversely, inflation could be lower than forecast should the downturn in the global economy turn out to be deeper or more protracted than currently assumed. In addition to causing larger declines in world prices, a weaker than expected world economy could translate into slower demand growth in Australia and hence, in time, further constrain domestic wage and price increases. The Bank currently considers these risks to the central forecast for inflation, over a one to two year horizon to be slightly weighted towards the downside.

Inflation expectations

- 4.92 In its most recent *Statement on Monetary Policy*, the Reserve Bank reported that the inflation expectations of consumers have been relatively steady over recent quarters following strong rises over the year prior to the introduction of the GST.

“The Melbourne Institute indicates that consumers’ median expectation for inflation over the coming year was 4.5 per cent in October, unchanged from September; this series has exceeded the actual rate of inflation for most of the past decade. Business expectations for inflation have also remained steady. The NAB business survey indicates that retailers expect to increase prices by 0.7 per cent in the December quarter. Over the medium term, less than one in ten respondents expect inflation to average more than 4 per cent, while one-third of respondents expect inflation to be below 3 per cent. Longer term inflationary expectations of investors, as measured by the difference between nominal and indexed 10 year bond yields, have fallen over the past three months and are back around the low levels recorded in late 1997 and 1998.”

[RBA, *Statement on Monetary Policy*, 12 November 2001, page 65]

- 4.93 In its surveys of financial market economists, the Bank found that most had revised down their forecasts following the release of the September quarter CPI. The median inflation forecast of financial economists surveyed by the Bank declined from 2.3 per cent in its August Survey, to 2.0 per cent in its latest (November) survey, while the median inflation forecast for the year to June 2003 was 2.2 per cent.

Wages

- 4.94 Treasury forecast wages growth, as measured on an *Average Earnings on a National Accounts* basis (AENA), to be marginally higher than the outcome for 2000-01. As reported in MYEFO, the AENA measure of wages is expected to grow by a moderate 4¼ per cent in 2001-02, and remain at around the same rate into 2002-03. This analysis of future wages growth would also appear to be consistent with that of the Reserve Bank:

“...growth in labour costs should remain well contained and may slow. Together with the general easing in cost pressures, this increases the scope for some margin re-building without strong pressure on consumer prices.”

[RBA, *Statement on Monetary Policy*, 12 November 2001, page 67]

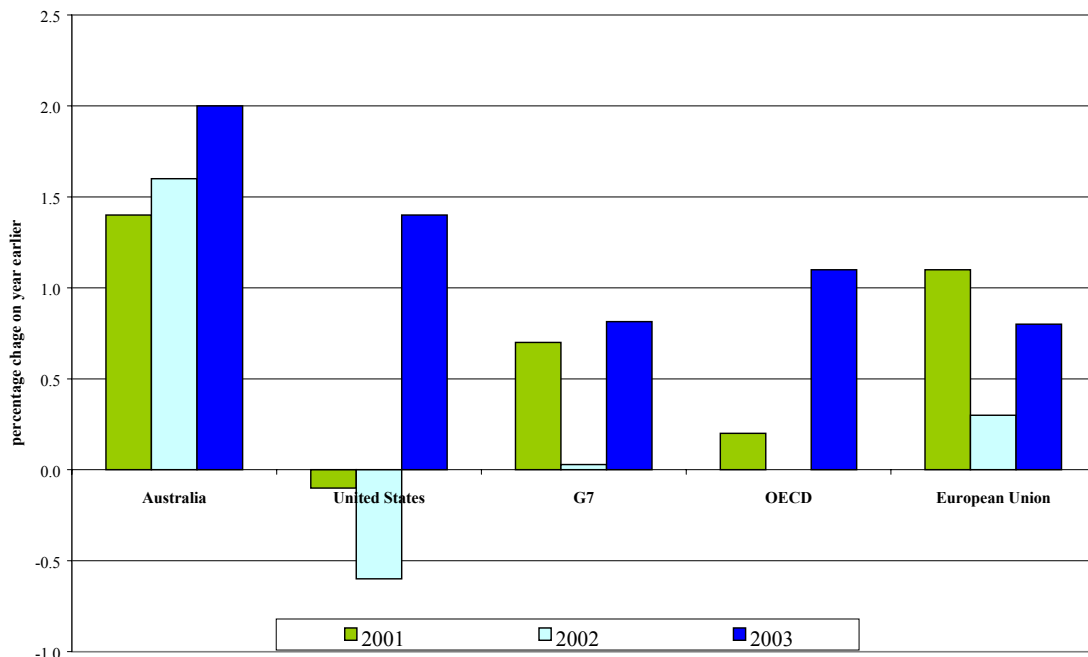
Labour Market

- 4.95 Following strong growth of around 2.1 per cent during 2000-01, Treasury expect employment growth to moderate to around ¾ of one per cent in 2001-02 in year average terms, reflecting the weaker overall economic growth. The strong recovery anticipated in the labour-intensive construction sector is likely to be reflected in increasing employment growth during the second half of 2001-02, particularly in male full-time employment, the component in the labour market that has experienced the most marked weakness over the past 12 months. As a result, Treasury anticipate that the unemployment rate will average around the 7 per cent mark during 2001-02 and in the June quarter 2002.

4.96 With the improved outlook for the domestic economy in the second half of this year, the rate of employment growth is expected to double to 1¼ per cent in year-average terms throughout 2002-03, with the unemployment rate expected to decline slightly by the June quarter 2003. This would appear to be backed up by recent data on job vacancies, as reported in the section on current conditions.

4.97 Figure 4.18 below, compares Australia’s forecast employment growth over the next two years with the forecasts for the other major developed economies. Australia’s forecast employment growth of 1.6 per cent in 2002 is expected to outpace each of the OECD and G7 Averages (predicted to stay flat during the year), and the European Union (which is expected to grow by only 0.3 per cent). Employment in the United States is expected to decline by 0.6 per cent in 2002. Over 2003, Australia is expected to continue to well outpace the other countries presented.

Figure 4.18: International Employment growth comparisons



Source: OECD Economic Outlook, December 2001

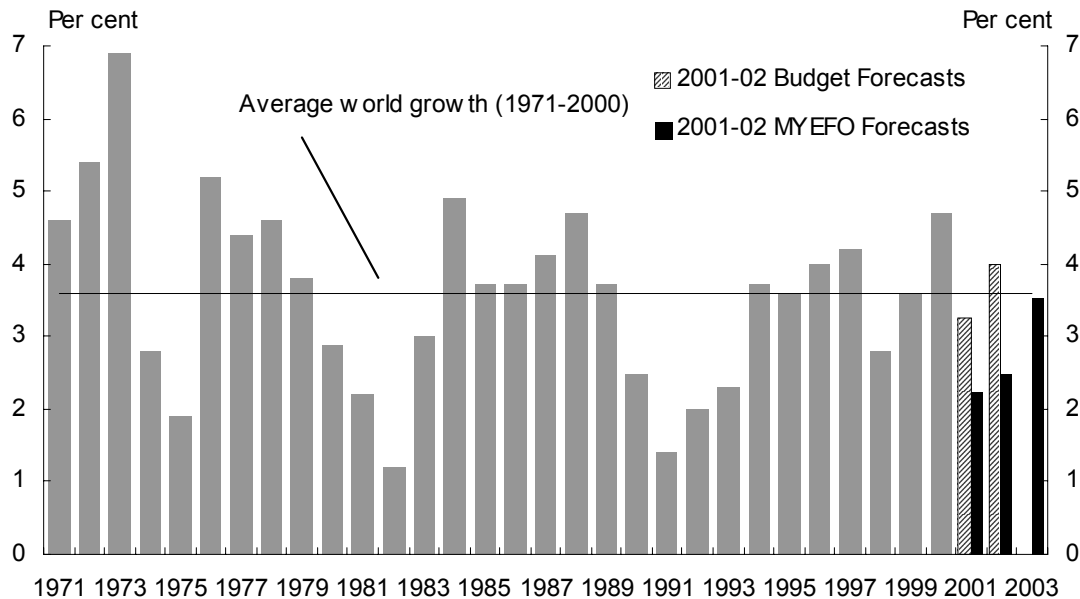
Overview of recent international economic events and implications for Australia

- 4.98 There has been considerable discussion of recent events in the world economy, particularly following the slowdown in growth in the United States and the subsequent terrorist attacks in that country on 11 September 2001.
- 4.99 This section of the submission gives an overview of the general outlook for the world economy, and addresses the possible implications for Australia.

The outlook for the world economy

- 4.100 In its MYEFO forecasts published in October 2001, the Australian Treasury revised expectations for world growth to 2¼ per cent for 2001, the lowest rate since the early 1990s. The latest forecast has been revised down about one Percentage point lower than at Budget, reflecting a more pronounced slowing in the US, and gathering weakness in European and East Asian economies. The Treasury's estimates for world growth are presented in Figure 4.19 below.

Figure 4.19: World GDP growth forecasts^(a)



(a) World GDP growth rates are calculated using GDP weights based on purchasing power parity.
 Source: Various national statistical publications, International Monetary Fund (IMF) and Treasury.

- 4.101 With uncertainty remaining high over the latter part of 2001, global economic growth is anticipated to have remained weak over this period, and remain subdued in early 2002.
- 4.102 Economic recovery in the United States, however, is expected to gather momentum by the latter half of 2002 (when the Commission’s next safety net adjustment will take effect) as the current inventory adjustment is completed and excess capacity is worked off. Recent data from the US Department of Commerce suggests that recovery in the US economy may be occurring earlier than anticipated.
- 4.103 Treasury note that as the substantial stimulus in many countries from monetary and fiscal policies take effect *“the medium term outlook for world growth remains favourable, with economic fundamentals remaining generally sound”* [MYEFO, page 3], with growth expected to return to around long-run average levels in 2003.

- 4.104 The Treasury MYEFO forecasts for the world economy in 2002, while down on the Budget forecasts, reflect this pattern of recovery. World growth is expected by Treasury to rise to 2½ per cent in 2002, up slightly from the anticipated 2¼ per cent for 2001. Treasury expect world growth to climb strongly by the end of 2002 with an increase of 3½ per cent forecast for 2003.
- 4.105 Treasury acknowledge that there exist a number of uncertainties surrounding the world outlook, on both the downside and upside of the equation.

Implications for the Australian economy

- 4.106 Despite the recent slowdown in the global economy and the subdued outlook for the period immediately ahead, the Australian economy continued growing faster than most other industrialised economies over the 2001 period, and is expected to continue growing faster than these economies into the future.
- 4.107 The Reserve Bank of Australia had the following to say on this subject in its latest *Statement on Monetary Policy*:

“The period ahead is shaping up as a particularly testing time for the global economy and Australia cannot hope to be unaffected by these events. But Australia can reasonably hope to fare better than most other economies in the current episode. Because exposure to the production side of the ‘new economy’ was limited, a major contractionary force at work in the US and Asia is not affecting Australia to the same extent. In fact, as an importer of high-tech manufactured goods, Australia’s

terms of trade, and hence national income, are improved by a decline in prices of a wide range of such goods.”

[RBA, *Statement on Monetary Policy*, 12 November 2001, page 4]

4.108 This issue was discussed further in recent speech by the Reserve Bank Governor, Ian Macfarlane, to a gathering of economists in December 2001.

4.109 As part of this discussion, Mr Macfarlane raised the question of whether Australia would necessarily follow the US and Japan into recession because it had done so a number of times in the past. Mr Macfarlane described this sort of hypothesising as ‘historical determinism’, and added that before such a conclusion should be drawn, it should be challenged by a close examination of the circumstances in the past and currently.

“What such an examination reveals is that present domestic circumstances are very different to those prevailing in the earlier episodes. To put it bluntly, we brought a lot of the problems on ourselves in the previous episodes, whereas this time we have not done so. On the previous occasions, we could not in all honesty make the claim that it was mainly the fault of the rest of the world – much of the fault was clearly of our own making. In other words, Australia had a lot of serious domestic imbalances that contributed to the downturns.”

[RBA Governor, Ian Macfarlane, *Australia and the International Cycle*, Address to Australian Business Economists/Economic Society of Australia (NSW Branch) Forecasting Conference Dinner – Sydney – 6 December 2001, at **Tag 7 of Composite Exhibit**]

4.110 Mr Macfarlane identifies the following factors which have contributed to economic difficulty in the past which are not present now:

- Australia's recent sustained low levels of inflation, accompanied by the stimulatory monetary policy setting afforded by that low inflation, not seen during the 1970s, 80s or early 1990s;
- Large rises in real wages in the 1970s and 80s, this time wage cost pressures have grown at a reasonably steady 3½ per cent per annum over the past year or two;
- There was an investment boom that led to over-capacity during the early 1980s, whereas it has been quite subdued over the past couple of years, and is due for a pick-up;
- During the early 1990s the exchange rate appreciated sharply ahead of the downturn, on this occasion it has depreciated significantly, exerting an expansionary influence on the economy;
- On each earlier occasion, the Current Account Deficit widened by an amount that alarmed many people, on this occasion it has fallen to a level not seen in more than 20 years.

4.111 Besides the differences which exist between the Australian economy in the past with those of today, considerable underlying differences exist between the situation in the United States and Australia which suggest that the problems there are not present in the Australian economy.

4.112 In general terms these refer to developments which occurred in the later stages of the US expansion which can loosely be regarded as due to the 'bubble' arising in the US from the earlier euphoria associated with the pouring of resources into the 'high tech' sector:

- The US stock market, particularly the technology sector (measured by the NASDAQ), rose to exceptional and unsustainable heights towards the end of the US expansion, and has since fallen dramatically. The broad indices such as the S&P 500 are down around 25 per cent from their peak. In comparison Australian shares have outperformed global equity markets by 25% in 2001.

[HSBC, Australian and New Zealand Weekly: The quiet achiever – ASX the best performing major share market in 2001, 7 November 2001]

- There was a large increase in physical investment towards the end of the US expansion, particularly in high technology equipment which has led to consequent excess capacity now, and consequently sharp falls in investment. This pattern is absent from Australia, which has not suffered excess capacity from over-investment, and is in fact due for some growth in this area over the near future.
- The US dollar has appreciated markedly over recent years, and despite lowering interest rates faster than any other country during 2001, the currency remains at a very high level. In comparison, the Australian dollar remains very competitive.

4.113 Whilst a fall, or even a pronounced slowdown, in the world economy and world trade would have a potential contractionary effect on export volumes and possibly lower terms of trade, the Reserve Bank Governor made the following comments:

“It is true that during world recessions, the volume of Australian exports usually falls ... (but the negative contributions to GDP in any one year are not large; the

biggest we can identify is the 1.4 percentage points in the year to March 1974). Clearly, if the rest of the economy was growing at a reasonable rate, this would not be enough to induce recession ... even if we add the export volume effects and the terms of trade effects together (noting that they would usually cover different, but roughly adjacent, periods), the combined effect in any one year would not be enough to turn a reasonable positive growth rate into a negative one.”

[RBA Governor, Ian Macfarlane, *Australia and the International Cycle*, Address to Australian Business Economists/Economic Society of Australia (NSW Branch) Forecasting Conference Dinner – Sydney – 6 December 2001, at **Tag 7 of Composite Exhibit**]

Conclusion

- 4.114 The Australian economy has showed remarkable resilience over the past year, recovering strongly and quickly from the GST-induced slowdown during the latter part of 2000 and early 2001. Since this time, the Australian economy has well outperformed most other major industrialised countries in almost all areas, often by an order of magnitude.
- 4.115 The outlook for the period ahead is also very encouraging. Notwithstanding the recent developments overseas, Australia is expected to ride out the current world downturn better than most, being largely shielded by the international events by strong growth domestically, and by the stimulatory effects from the expansionary stance in both fiscal and monetary policy.

