Economic Overview

Chris Caton*

2003 in review

The Australian economy came through 2003 remarkably well.

The Australian economy had a lot to contend with in 2003. At various stages it was buffeted by concern about the war on Iraq, by SARS, by drought and by the weak state of the rest of the world. It also had to deal with the rampaging Australian dollar, which appreciated by some 30 per cent against the US dollar over the course of the year.

It came through all of this remarkably well, mainly because of the strength of domestic demand (consumer spending, business investment and government spending).

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The effects on confidence of the war on Iraq were short-lived. SARS had a clear effect on inbound tourism, and a more subtle effect on other exports because it weakened the economies of many of our major trading partners.

The drought had the biggest effect on growth. For the financial (and agricultural) year 2002/03 it held back overall growth by close to 1 per cent, a remarkable result considering that farming activity now represents only about 3 per cent of the economy. Rural exports were considerably reduced, falling by 21 per cent in the year to October.

Weakness in the rest of the world also held back demand for Australian exports. At the same time, an ongoing capital spending boom pushed up imports, with the result that the current account deficit rose to a record high.

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For the year as a whole, total output (GDP) probably grew by about 2.7 per cent. Net exports (exports minus imports) constituted a huge drag, but domestic demand was strong. For the year, consumer spending probably rose by an estimated 4.3 per cent. Business capital spending rose by 11 per cent, and public spending by 3.5 per cent, with defence spending up by more than 10 per cent. Residential construction was also strong, in case you hadn't noticed. It grew by about 7 per cent. Total domestic demand increased by 4.9 per cent.

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Unemployment began 2003 at 6.1 per cent, and had improved to 5.6 per cent in November. In the year to November, employment rose by 2.2 per cent. Importantly, the composition of this growth was favourable; full-time employment rose by 2.6 per cent. The performance of the labour market was significantly better than expected at the beginning of the year. The last time unemployment was below 6 per cent was in early 1990, and it was commonly believed that getting it below that level would lead to undesirable wage pressures. That hasn't happened to date.

Inflation remained a non-issue. The CPI for the year rose by an estimated 2.8 per cent, pushed up somewhat by drought-related effects.

Most of the concerns listed above had been alleviated by the end of the year. In particular, the international outlook had improved enormously. The US economy, which had been mired in its weakest recovery ever (so weak that employment continued to fall), suddenly snapped into top gear

* The author wishes to acknowledge the assistance of Tracey McNaughton, Senior Economist, BT Financial Group.

in the second half of 2003. This was no accident. It reflected the cumulative stimulatory effect of very low interest rates, three large tax cuts, a declining currency and, not to be underestimated, the passage of time. There are still those who are sceptical about the renewed vigour of the US economy; they will be converts in the near future.

It's not just the United States that has improved. Japan is looking better than at any time in the past decade. Its burst of growth in 2003, unlike other pickups in recent years, was due primarily to a stronger private sector. China bounced back to double-digit growth after the SARS scare. If anything, China's problem is that growth is too rapid. And Europe is about to join the recovery party; GDP growth resumed in the Euro zone in the third quarter.

All in all, world economic growth in the third quarter of last year took place at the strongest rate in 20 years. This must be good for the Australian economy, which has always had a strong relationship with the US economy, in particular.

In addition, the drought has broken. There is still argument in some quarters about this, and it will take some time before all water catchments are restored to their former glory, but there will be strong growth in farm output in the current agricultural year. The ABS estimates that farm output will grow by 27.4 per cent, which will still leave it 9.2 per cent below its 2001/02 level.

Late in 2003, the Reserve Bank (RBA) began to raise interest rates, after having left them unchanged since mid-2002. This reflected the fact that the RBA believes the Australian economy is doing well enough that it no longer needs accommodative, or easy, money. The improving rest of the world also means that rates don't have to be kept low as a form of insurance against Australia being dragged down by foreign weakness. Also importantly, the RBA is clearly concerned about the rate of growth of lending, particularly for investors to purchase housing. The latest figures shows this rising at about 35 per cent annually, and this is clearly driving the excessive rate of house price inflation. The RBA figures that this continued growth in lending probably has something to do with low interest rates.

Outlook for 2004

So the Australian economy enters the new year with a reasonable head of steam. It should continue to grow at a moderate rate, at least in 2004, although there are risks. As long as the labour market is reasonably well-behaved, consumer spending is likely to be a source of strength. However, the latest capital spending expectations data suggest that the outlook for business fixed investment is not as rosy as it appeared earlier. And a significant fall in residential construction is likely over the course of the year. The improvement in the rest of the world should lead to a better performance by net exports.

While one can never be sure about timing, it appears that 2004 will begin strongly and finish with the economy growing only moderately. Year-to growth may peak at close to 4 per cent in mid-2004, but recede to 3 per cent by the end of the year. This is somewhat weaker view than that published recently by both the RBA, in Governor Macfarlane's December testimony, and the Government, in its Mid-Year Outlook.

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US ECONOMY

BOX 1

More about the US economic outlook

According to the official score-keepers, the United States has been in recovery from its mild 2001 recession since late in that year. However, until mid-2003 it was the weakest recovery on record. Output grew at only 2.6 per cent annual rate over that period, less than half the usual recovery pace. Productivity growth has also been surprisingly strong (5 per cent per year in its latest reading), with the result that employment continued to fall. The number of Americans with jobs fell in each month from February to July 2003, an unprecedented string during an economic expansion. Thus it certainly didn't feel like a recovery to most observers. Since George Bush became President, the US economy has lost some 2.3 million jobs, and 'Dubya' runs the risk of being the first president since Herbert Hoover to oversee a net loss of jobs during his term of office.

The very poor labour market outcomes led many to question the sustainability of the US recovery. Sooner or later, it was argued, these outcomes would drag down consumer and business confidence, and hence spending, and the output recovery would sputter out.

Everything changed around mid-2003. Output growth kicked up to an annualised rate of 8.2 per cent in the third quarter. This was no fluke. It came about because of the cumulative effects of low interest rates, three large tax cuts, a depreciating exchange rate and the passage of time, which eventually forced some resumption in capital spending.

The United States is now in conventional business cycle mode. The acceleration of output growth has now led to four successive months of employment growth, and a decline in unemployment of 0.5 percentage points. Recoveries once begun usually continue, just as a rising tide lifts all the boats. The current consensus view is for 4.4 per cent growth in US GDP in 2004. This may be too low.

There are still sceptics. They point to ongoing imbalances in the US economy, such as the large Federal deficit, the large current account deficit, and very low personal saving. Each of these may eventually have negative effects on US economic growth, but in the short run they are likely to be overwhelmed by the cyclical story.

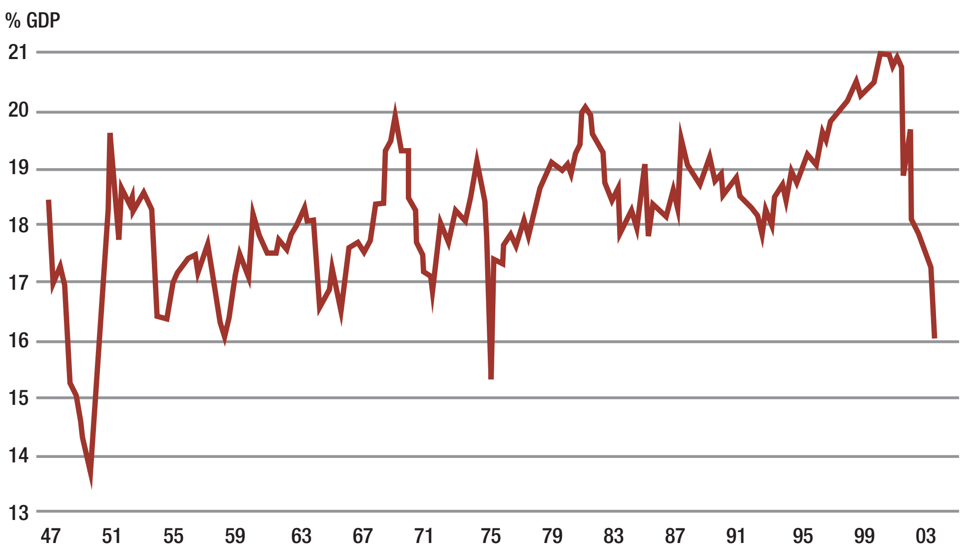
The turnaround in US fiscal policy has been striking. In the last fiscal year of the Clinton presidency, the United States ran a surplus of $237 billion. This fiscal year it will run a deficit of about $480 billion. The turnaround has come about because of the effect of the weak economy and the declining stock market on tax revenues, because of significant increases in spending, particularly on defence and homeland security, and because of George Bush's three large tax cuts.

Primarily because of these tax cuts, US Federal revenues have been slashed to a near 40-year low as a share of GDP.

This turnaround in the deficit is probably justified, given the weakness of the US economy in recent years. The concern is that there is no exit strategy. All reasonable projections of economic growth and the likely increase in spending suggest that the deficit will remain large for many years to come. Among other things, this will require the selling of large numbers of government securities, with some eventual upward effect on market-determined interest rates, which will, in turn, hold down private-sector growth.

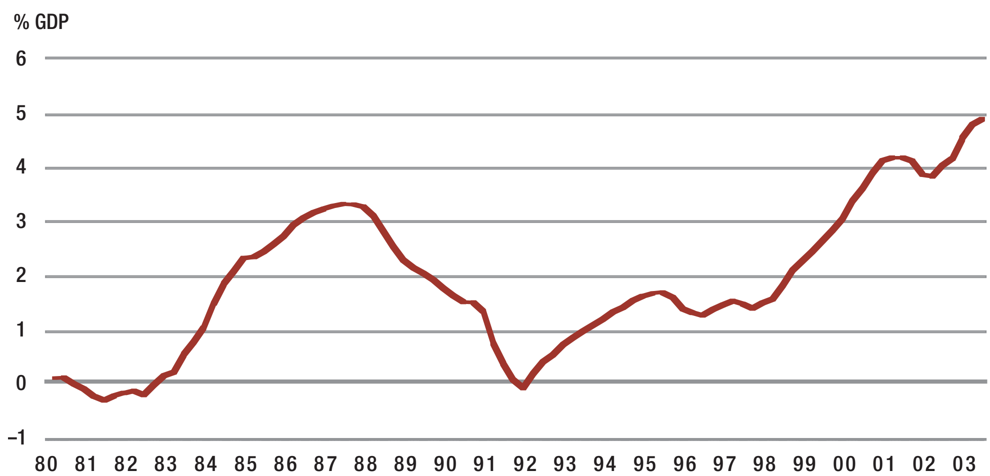
The current account deficit appears to be equally intractable. As Figure 2 shows, it has been in a persistent upward trend relative to GDP for many years. The problem going forward is that the United States appears likely to outgrow its major trading partners on average, and its income elasticity of demand for imports exceeds its partners' elasticity of demand for US exports. Once again, it is difficult to do arithmetic that suggests the gap will close (or even remain where it is) unless something drastic happens. For many, that something is a significant further decline of the US dollar. But this, in turn, appears unlikely, given the absence of other currencies willing or able to sustain significant appreciation against the US dollar.

FIGURE 1: US Federal Government receipts % GDP



Source: Bureau of Economic Analysis

FIGURE 2: US current account deficit



Source: Data Stream

The current account deficit should decline to about $40 billion, from an estimated $46 billion in 2003.

Such a growth outlook is consistent with some further improvement in unemployment, but with little upward pressure on inflation. The current account deficit, which is already showing tentative signs of falling, should decline to about $40 billion, from an estimated $46 billion in 2003.

TABLE 1: Australian economic outlook

	Calendar years (year average, per cent change)				
	2001	2002	2003	2004	2005
GDP	2.6	3.6	2.7	3.5	3.5
Non-farm GDP	2.6	4.0	3.4	2.9	3.5
Farm product	2.7	–12.3	–12.9	25.5	5.2
Private consumption	2.8	4.2	4.3	4.8	4.0
Dwelling investment	–10.8	24.6	7.2	–3.8	–0.9
Business investment	0.1	13.3	11.1	7.0	7.8
Private final demand	1.6	7.1	5.5	4.5	4.4
Public final demand	0.6	4.2	2.9	5.5	3.0
GNE	1.3	6.4	6.0	4.8	4.4
Exports	1.6	0.3	–2.3	5.5	7.9
Imports	–4.2	11.5	11.2	11.3	9.8
Unemployment rate	6.7	6.3	5.9	5.9	6.1
CPI inflation	4.4	3.0	2.8	2.3	2.5
Current account defecit ($bn)	16.6	31.4	46.2	40.6	35.0
Exchange rate (USD/AUD)	0.51	0.55	0.66	0.74	0.70

Source: ABS, BT Financial Group

If this growth outlook comes to pass, interest rates are not likely to rise much further.

If this growth outlook comes to pass, it is unlikely that interest rates will rise much further. The plan appears to be to implement a further increase of 25 basis points in February, and then to stop to assess the effects of the rate hikes to date. This can be likened to taking the foot all the way off the accelerator, and leaving until later any decision to tap the brakes.

Some of the pressure may come off the currency, which has, however, probably not yet finished its rise.

Australia may thus be in the position of having finished its monetary tightening before most other countries have got around to starting theirs. As a result, some of the pressure may come off the currency, which has, however, probably not yet finished its rise. Exporters who are already feeling pain may therefore have more to get used to. That said, the Australian dollar is not particularly overvalued right now. If it were to rise significantly further, this would probably be in the context of a collapse in the US dollar, which would certainly mean higher commodity prices (in US dollar terms). Commodity price rises would mitigate the effect of a higher Australian dollar for exporters.

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Meanwhile, it is an election year, so there is always the risk of a tax cut. The recent Mid-Year Outlook significantly raised the estimate of the forecast surplus for 2003/04, mainly because of higher profits taxes, thus leaving room for a tax cut.

Australia's performance in a longer term context

The Australian economy has been growing since mid-1991. Any economist who had forecast then that there would be no recession for the next 12 years would probably have found themselves quickly out of a job. But it has happened. In a speech in late 2003, RBA Governor Macfarlane presented a table showing shares of world economic output. Between 1982 and 2002, Australia was one of only two OECD nations to have increased its share (most developed countries lost share because of gains made by non-Japan Asia, and particularly by China). Australia's share went from 1.08 per cent to 1.11 per cent. Over the same interval, China's share went from 4 per cent to 12 per cent.

The 30 per cent appreciation of the Australian dollar over 2003 has served as a headwind, offsetting the rise in world commodity prices.

A recession in 2004 is certainly not a realistic baseline forecast, and the probability of one happening this year must be very small (about 10 per cent). There will be another recession in Australia, and when it occurs it will be forecast by very few, if any, mainstream economists. So how can you tell when and if one is coming? Be afraid when economists begin to talk about a 'soft landing'.

Despite the opportunities presented by China (See Box 2), Australian commodity producers are still held hostage by movements in the Australian dollar. The recent 30 per cent appreciation in the Australia dollar since the start of the year has served as a headwind, offsetting the rise in world commodity prices. In Australian dollars, non-rural commodity prices are down 10.5 per cent over the year while non-rural base metal prices are up just 0.4 per cent.

Inflation, deflation and all that

There is a short-term risk of lower inflation in Australia, caused mainly by the flow-on effects of the stronger exchange rate. However, given the relatively high level of utilisation of the economy, it is likely that domestic pressures will eventually lead to rising inflation.

In early 1991, when then Prime Minister Bob Hawke was asked what achievements he would like to see in his remaining term of office, he nominated '4 per cent inflation'. This was quickly followed by a clarification from his office to the effect he meant 'first figure 4 per cent inflation'; that is, inflation of less than 5 per cent.

Mainly because of the depth of the early 1990s recession, he got his wish, and inflation improved rapidly to less than 3 per cent. Around this time, the RBA began talk of 2–3 per cent underlying inflation as a target, and this became a formal target in 1996. Inflation eventually dropped below 2 per cent in the late 1990s.

Australia is not alone in having brought inflation down. Indeed, many countries have recently struggled with inflation that is perceived to be too low. In recent years, Japan, China and Hong Kong have actually experienced falling prices, or deflation. Deflation has several undesirable effects. In particular, it limits the ability of the monetary authorities to reduce real interest rates to a low enough level. It also persuades both investors and consumers, when in doubt, to postpone spending.

Even in the United States, perhaps for the first time in recorded history, the Federal Reserve's biggest worry is that inflation, currently about 1–1.5 per cent, is too low. If it can happen to the United States, there must be a chance it can happen here. But we're a long way from deflation, and recent trends in service inflation, particularly for health and education, make it unlikely that deflation will become a significant concern. And if it does become so, we will have much to learn from the experiences of others!

There is a short-term risk of lower inflation in Australia, caused mainly by the flow-on effects of the stronger exchange rate. However, given the relatively high level of utilisation of the economy, it is likely that domestic pressures will eventually lead to rising inflation. Indeed, the RBA has recently highlighted just such a risk.

CHINESE ECONOMY

BOX 2

China: Friend or foe?

China's role in the world economy has grown significantly in the past couple of decades. In 1982, China's share of world output was just under 4 per cent. By 2002, that share had risen to nearly 13 per cent. China alone accounted for one-quarter of the expansion in world trade last year. This ascendancy in the importance of China to world growth reflects a substantial increase in its openness as an economy, which is largely responsible for the strength at which the Chinese economy has recently been growing. China grew by 8 per cent in 2002 and has averaged 9.9 per cent growth over the past 20 years.

Reflecting this rapid growth, China's external trade position with the rest of the world has swung from a small deficit of $0.2 billion in 1981 to a large surplus of $55 billion in 2001. Manufacturers all around the world have taken advantage of China's sizeable population, and cheap labour, to establish a base from which to export to the rest of the world. As was the case with Japan in the 1980s, such developments have left China open to international criticism. Many industrialised nations, in particular the United States, blame China for diminishing the size of their own manufacturing base.

Such criticism appears unjustified. Certainly from Australia's perspective, while the size of the manufacturing sector has diminished relative to the rest of the economy, a movement of resources to more productive uses has been a key factor in lifting the productivity of the Australian economy and its subsequent potential to grow without igniting inflation.

Far from being a threat, China, with its insatiable appetite for the commodities needed to fuel its growth, represents a key opportunity for Australia. China is the world's second-largest consumer of energy, its biggest importer of steel and iron ore, and the biggest producer of aluminium. China has recently overtaken Japan as Australia's largest buyer of our mineral and energy exports. Outside of minerals and energy, China is Australia's largest export market for wool and barley. This has elevated China to our fourth largest export market. It is estimated that by 2012 China will displace Japan as our number one trading partner.

The effect on the Australian economy of the growth in Chinese demand has been substantial. Business investment in the mining sector is up almost 30 per cent on the September quarter last year while expenditure on mineral exploration is up over 20 per cent compared to the June quarter last year. Commodity prices, too, have responded to the imbalance between supply and demand. In US dollar terms, non-rural commodity prices, as measured by the RBA, are up 13 per cent in the year to date. The increase is even greater for non-rural base metal commodity prices, up 27 per cent.

The rise and rise of the Australian dollar

Over the course of 2003, the Australian dollar rose from 56 US cents to 74 US cents (in mid-December). Late in the year, it rose in every one of 13 successive weeks, something it had never done before in the 20 years that Australia has had a floating exchange rate.

A rising currency is good if you are planning an overseas holiday; it's not so great if you have invested money overseas or if you are an exporter.

So what is the outlook for the dollar? Is it artificially strong, and likely to fall back to 65 cents? Or is it in an upward trend that will lead to 80 cents in the near future?

There is an awful lot of rubbish written about the currency, where it's going and why. I know this because I have written quite a bit myself. Currencies are notoriously difficult to forecast, and even after the fact, analysts rarely agree on why they have done what they've done.

Back in 2000, when the Australian dollar dropped like a stone (it began the year at 65 cents and eventually hit 48 cents in early 2001), all sorts of explanations were trotted out, including, most laughably, that our currency was being sold aggressively because Australia was 'not new economy enough'. In fact, it fell in 2000 mainly (but not only) because the US dollar was going up. This isn't just a semantic point; it means that the dollar fell far less against other major currencies. It also means that the reasons for its fall were more likely to be found in the United States than in Australia.

Figures 3 and 4 illustrate this point. Both show the Australian dollar as conventionally measured, in US cents. The other line in the first chart is the Australian dollar against a weighted basket of the currencies of our other trading partners. As can be seen, the fall in 2000 against everybody else was far less pronounced, and the same can be said for the rise in 2003. The other line in the second chart is the trade-weighted index of the US dollar, inverted (so the line goes down when the US dollar is strengthening against other currencies in general) and appropriately scaled. This suggests that most of the fall (say to 55 cents) in the Australian dollar was simply a reflection of the strength of the big buck.

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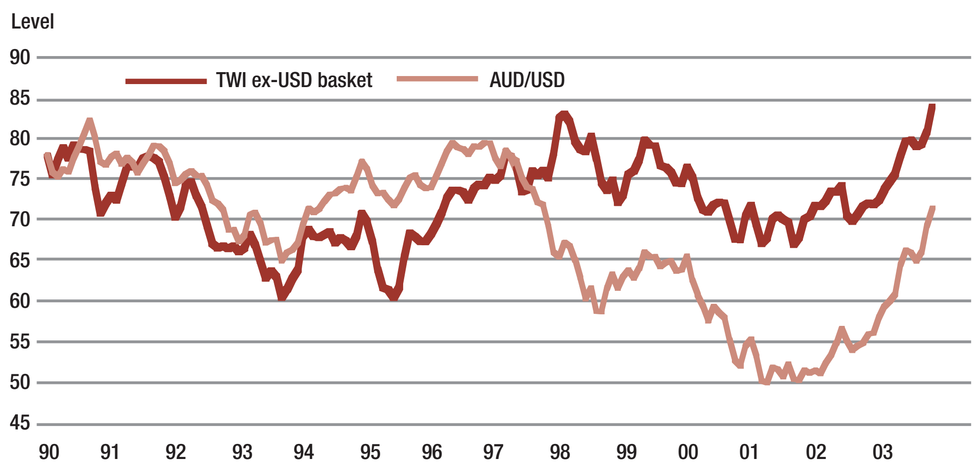
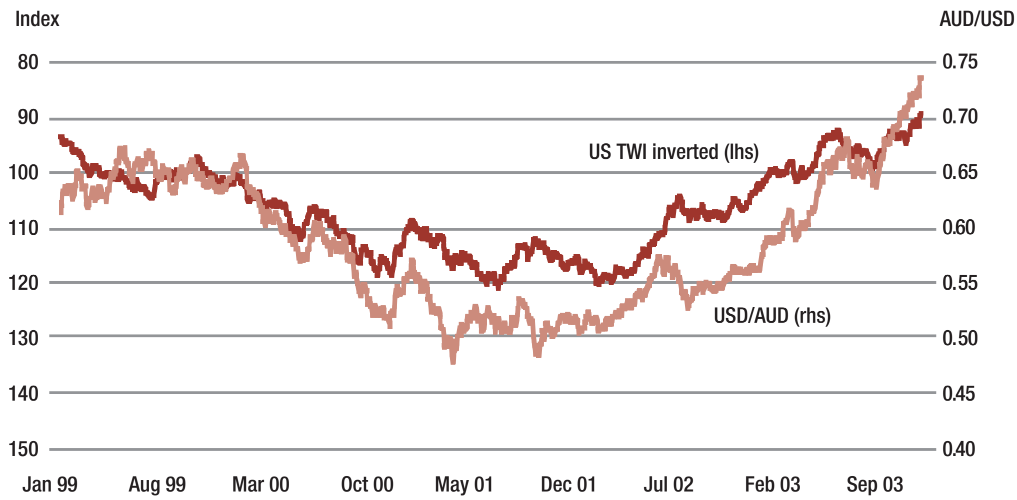
FIGURE 3: AUD/USD and trade weighted index ex-USD



Source: Data Stream

The fall (say to 55 cents) in the Australian dollar was simply a reflection of the strength of the big buck … That process is now reversing. The Australian dollar has gone up mainly because the US dollar has come down … Whether or not we continue to go up depends on what happens to the US dollar.

FIGURE 4: The Australian dollar and the US trade weighted index



Source: Bloomberg

Lately something else has been propelling the Australian dollar upwards. This might be partly because of an improved global economic outlook, but it certainly owes a lot to interest rates. While these are low in Australia, they are higher than elsewhere.

What else do the charts show? That the process is now reversing. The Australian dollar has gone up mainly because the US dollar has come down. Once again, our movement against everybody else has been a lot less.

This has two implications. First, whether or not we continue to go up depends on what happens to the US dollar. The general view is that the latter will continue to weaken, primarily because the US is running such a large current account deficit. My guess (and that's all it is) is that we could hit 75–77 cents some time in 2004, but we may not go very much higher. Second, if recent trends continue, then there is more exchange-rate risk for Australian investors in the US market than there is elsewhere. Of course, some of this risk can be managed by means of hedging, but hedging is like insurance in that it costs something even if you never get to use it.

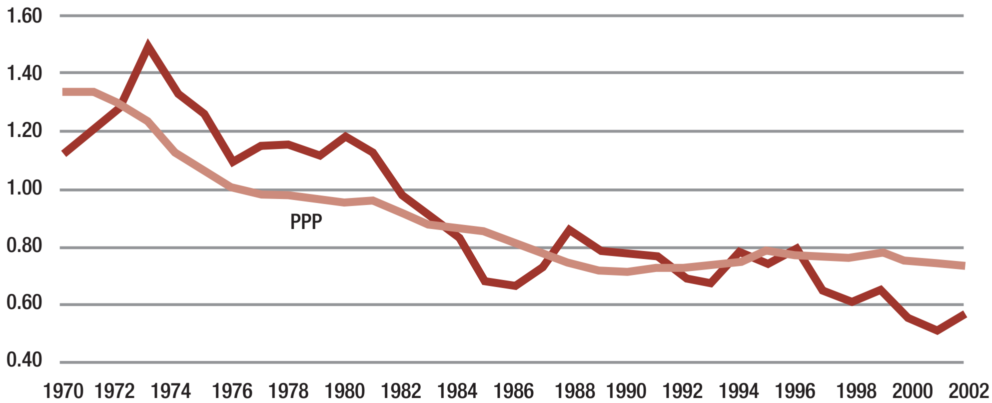
Note that in recent months the gap between the two lines in the second chart has closed. What this means is that lately something else in addition to the falling US dollar has been propelling the Australian dollar upwards. This might be partly because of an improved global economic outlook (the RBA's favourite) but it certainly owes a lot to interest rates. While these are still low in Australia, they are higher than elsewhere.

Money seeking a higher return tends to flow to countries with relatively high interest rates, bidding up the currency on the way. Note that the currency went up by more than 1.5 cents in the week after the early November rate rise. Rates are likely to rise further in Australia, but they will also be going up 'all over the world' in 2004, so this effect may be close to being played out.

What about the long run? Many people remember the halcyon days in the mid-1970s when, briefly, one Australian dollar bought more than US$1.40. The Australian currency has been in long-term trend decline since then, a fact that many pessimists seize upon as evidence that God's own country is a pretty hopeless place.

In fact, the long-term trend decline is due mainly to the fact that for much of the past 30 years Australian inflation has been higher than in the United States. When inflation is higher, over time a dollar will buy less of everything, including less of some other currency. Figure 5 shows the Australian

FIGURE 5: The Australian dollar—purchasing power parity and actual value



Source: UBS

Higher Australian inflation has been responsible for most, but not all of the long-run decline in the value of the currency. Since we no longer have higher inflation than the United States, it would be a mistake to assume that the long-run downward trend in the value of our currency will continue.

dollar and the so-called purchasing power parity measure. This measure takes into account the different inflation rates. As can be seen, higher Australian inflation has been responsible for most, but not all of the long-run decline in the value of the currency. Since we no longer have higher inflation than the United States, it would be a mistake to assume that the long-run downward trend in the value of our currency will continue—48 cents will be the record low for a long time to come.

Other contributing factors include the fact that we have significantly reduced tariff rates over the past 30 years (high tariffs artificially push up the value of the currency, thus acting as a tax on exports), and the fact that commodity prices (particularly non-rural) have been in long-run downward trend. For a long time, the Australian dollar tracked these prices fairly closely, which meant that resource exporters had something of a natural hedge. When the world price of our minerals rose, the Australian dollar tended to go up, so exporters didn't fully benefit, and conversely they did benefit when the world price fell.

The Australian dollar does not appear to be hugely overvalued right now, and it is only likely to rise significantly from here if the US dollar weakens significantly.

As Figure 6 shows, the currency was, for some time, quite low relative to commodity prices, which explains the happy smiles of exporters in recent years. This gap has now closed, which is why their facial expressions have changed.

It is worthwhile pointing out that the Australian dollar does not appear to be hugely overvalued right now, and that it is only likely to rise significantly from here if the US dollar weakens significantly, in which case commodity prices expressed in US dollars will also rise.

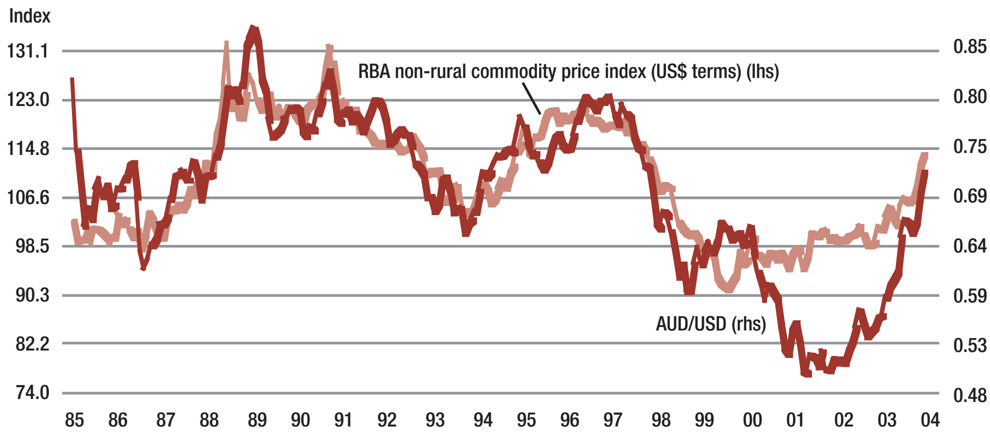
Australia's terms of trade

A country's terms of trade measure the ratio between the prices that it receives for its exports and those it pays for its imports. When the terms of trade are rising, the national income of the country grows faster than its GDP, and conversely when its terms of trade are falling.

It is generally considered that, for a country specialising in the export

Since December 1998 our export prices have risen by 17.3 per cent relative to our import prices. This is mainly because high-tech goods have become increasingly commoditised, and Australia exports few of these and imports many.

FIGURE 6: RBA non-rural commodity price index and the AUD/USD



Source: Datastream

of commodities, as Australia does, the terms of trade will tend to decline over time. For various reasons, commodity prices tend to rise less rapidly in the long term than, for example, the price of manufactures or services. And that was the case for many years for Australia. As Figure 7 shows, however, it has not been the case in recent years. Since December 1998 our export prices have risen by 17.3 per cent relative to our import prices. This is mainly because high-tech goods have become increasingly commoditised, and Australia exports few of these and imports many. Some years ago our lack of new economy industry was bemoaned; now it can be seen as a virtue. The upward trend in our terms of trade will probably continue through 2004.

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The outlook for housing

While one is not allowed to say it in polite company, it is difficult to avoid the conclusion that housing is currently in a 'bubble'. That is, its price has been dragged significantly away from any justifiable, underlying, funda-

FIGURE 7: Terms of trade

Source: ABS

mental value. The single biggest piece of evidence in this regard is the rental yield (market rent as a percentage of price), which has plummeted to about 3 per cent from a more normal 5 per cent. And yet investors have still been piling in, presumably attracted by the expectation of 15 per cent or higher capital gains (Figure 8). However, these expectations are based on simple extrapolation of what has happened recently.

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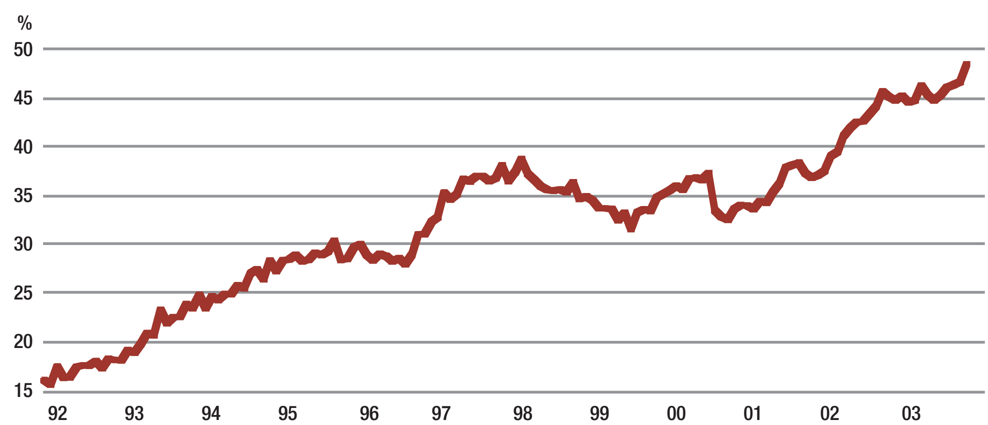
Figure 9 shows the ratio between the median house price series and nominal GDP, or the size of Australia's economic output. It has been indexed to average 100, merely for the ease of interpretation. Despite the prevalent view that 'house prices never fall', there is a clear cycle and by this very crude measure the average house price (and it is a house price, as opposed to a CBD unit) is 'too high' by more than 25 per cent.

The average house price is 'too high' by more than 25 per cent.

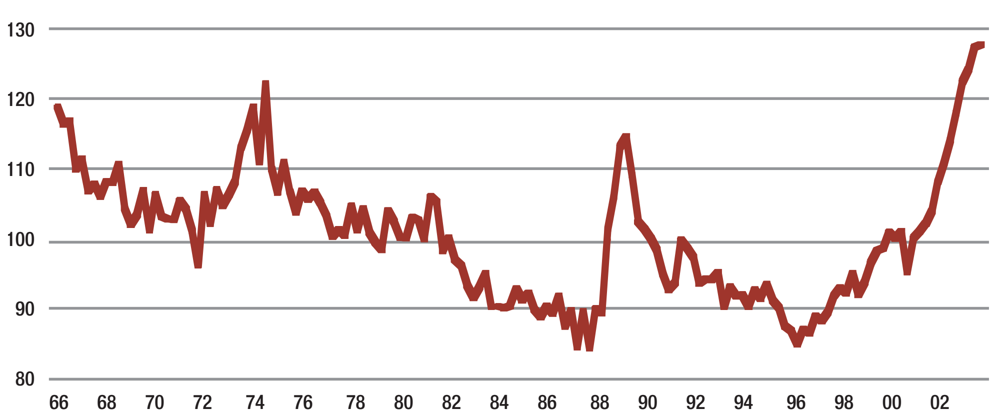
Some of this may be a genuine shift in trend, caused by the willingness and ability of Australian households to carry more debt. Since the early 1990s, the average ratio of debt to income has approximately doubled. To a large extent, this is just rational consumer behaviour. Debt is no different

FIGURE 8: Investors' share of housing finance



Source: ABS

FIGURE 9: Ratio of Australian house prices and GDP



Source: UBS

The housing story seems set to change, possibly dramatically, in 2004.

from other consumer purchases. If it becomes cheaper, buy more. And it is the willingness of consumers to carry more debt that is the single biggest reason why the price of the asset that they use such debt to purchase has risen so strongly. But debt is no longer getting cheaper, and households appear to be close to their limit of debt to income. If debt in the future grows no faster than income, it will literally be impossible for house prices to continue to grow at anywhere close to their recent rate. And once the capital gains dry up, investor sentiment towards property may change rapidly.

There is one thing economists know about bubbles; they always burst. And there's one thing they don't know, and that is when. But the housing story seems set to change, possibly dramatically, in 2004.

Australia's personal saving rate

The personal saving rate in Australia is now negative, and has been since June 2002.

According to the recently released September quarter 2003 national accounts, the personal saving rate in Australia is now negative, and has been since June 2002. This compares with a saving rate of 11 per cent as recently as March 1990. Australian households on average are spending more than their income. At first glance, this is an extraordinary result in an era of compulsory superannuation, which is a form of saving and, you would think, would at least hold total saving above zero. But Australians have obviously decided that the future will take care of itself, and they have all those capital gains (which are not included in income from current production) from the increased value of their real estate to spend.

A low or negative saving rate is a matter of some concern. While personal saving is not the only form, if we as a nation do not save enough it means that either investment in capital is held down or we must rely increasingly on foreigners to finance such investment.

It may be a little early to write us off as a bunch of no-hopers. First, the national accounts saving figures are derived as a residual from separate estimates of income and spending. The ratio of noise to signal in the saving rate estimate is thus quite high, and the saving figures are subject to significant revision. In addition, Australia's saving is measured in net terms. This means that the figures are net of depreciation of the physical assets held by the personal sector. These physical assets are almost solely housing. An estimate of the value of the physical depreciation of the housing stock (which is, nevertheless, an appreciating asset) is subtracted from gross saving. If one were to measure gross rather than net saving, the saving rate would look like the higher line in Figure 10.

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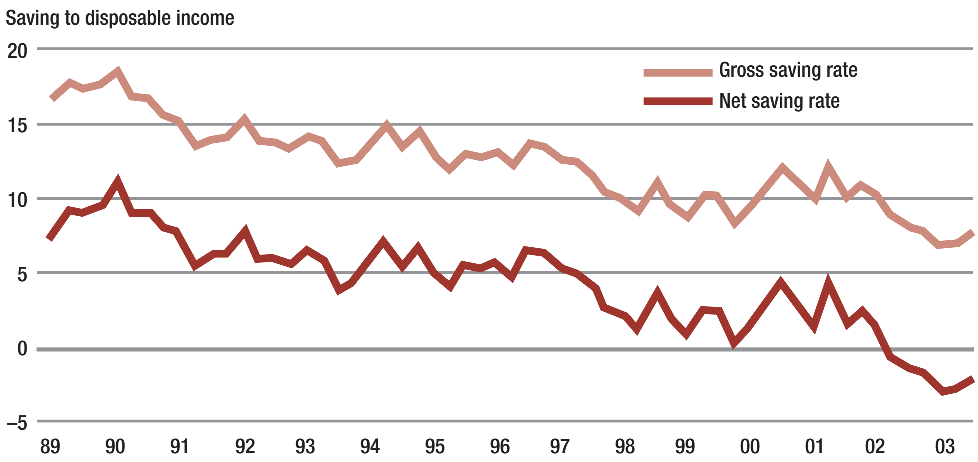
Fiscal policy in an election year

Two thousand and four will almost certainly be the year of a Federal election, and many think, probably correctly, this has implications for fiscal policy. In its recently released Mid-Year Economic and Fiscal Outlook, the Government upgraded its estimate of the prospective surplus in 2003/04 from $2.2 billion to $4.6 billion. Further significant surpluses are projected for future fiscal years. This certainly leaves enough scope for an election year tax cut. But is this sensible fiscal policy?

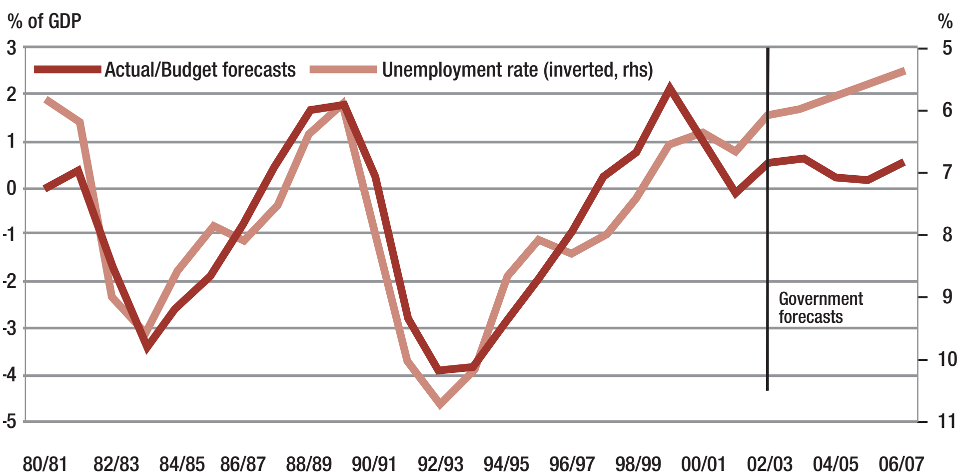
Figure 11 shows the history of the Federal Budget position, expressed as a share of GDP, compared with the unemployment rate. The latter, inverted in

FIGURE 10: Household saving ratio



Source: ABS

FIGURE 11: Underlying Budget balance and the unemployment rate



Source: Federal Government

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The Government has judged that there is no strong constituency for running a large cyclical surplus. As a consequence, it has presided over a counter-cyclical loosening of fiscal policy in recent years.

the chart, is a good summary measure of the state of the Australian business cycle. What the chart shows, therefore, is that most of the variation in the Budget position over the past 23 years can be ascribed to the cyclical position of the Australian economy.

If that's the reason for the variation, then it can't be discretionary fiscal policy. The Beazley black hole, and the apparent return to fiscal responsibility under the present government, both primarily reflect the state of the Australian economy. The widening gap between the two lines in recent years suggests that as the Australian economy has moved close to full utilisation (with the unemployment rate now at a 14-year low) the Government has judged that there is no strong constituency for running a large cyclical surplus. As a consequence, it has presided over a counter-cyclical loosening of fiscal policy in recent years, culminating in last year's 'sandwich and a milkshake' tax cut.

Is it necessarily better to 'return' the surplus in the form of tax cuts rather than in the form of increased spending?

This may be politically expedient, and it is not massively reprehensible from an economic point of view, but it raises two questions:

- If it has been decided that it is best to run a small surplus at all times, rather than to let the Budget result move with the economic cycle, is it necessarily better to 'return' the surplus in the form of tax cuts rather than in the form of increased spending?
- What will the fiscal response be when the economy moves into recession? (One hopes that the Budget position would be allowed to move into deficit.)

There is also a medium-term consideration for fiscal policy, which is becoming progressively more important. As in many other countries, the demographic structure of the Australian population is shifting quickly, with the ratio of the aged to workers increasing sharply. Over time, this means proportionately fewer tax payers, and proportionately greater demands on public funding of health spending in particular. Some of these issues were raised in the Government's own Intergenerational Report, published with the 2002/03 Budget, and the current Treasury Secretary, Dr Ken Henry, has made further speeches addressing the issue.

What will the fiscal response be when the economy moves into recession?

This is all about extrapolating trends, which is always a dangerous game, but it comes down to this. In the absence of action, it is likely that federal spending as a share of the economy will grow significantly over the coming decades. Appropriate action includes weaning the elderly and others, not from dependence on publicly-funded health spending but from continued rapid increases in this dependence. It also includes keeping the growth of revenue high, not by raising tax rates but by doing whatever is possible to raise both productivity and workforce participation, particularly among the late middle-aged, who I define for present purposes as those aged 57 and over. Expect to hear more of this debate.

– *December 2003*