AUSTRALIAN INDUSTRY GROUP

ECONOMIC AND FISCAL OVERVIEW

- ***Early this year the key global economic question stopped being whether recovery was underway. Rather it is what sort of recovery — vibrant or grudging?***

- ***A powerful turn in the stock cycle is happening, most notably in the US, but evident in Asia and Europe also. This alone is sufficient to set up a strong start to 2002 for the global economy.***

- ***But the positive phases of the stock cycle invariably provide a short ride of just a few quarters. The issue is what comes next — the traditional cyclical acceleration that comes as growth in housing and consumer durables spending takes over from inventories, or a pause in the recovery?***

- ***There are many aspects to this global recovery that suggest cyclical recovery business as usual is not assured. In the recent words of Dr Greenspan, "an array of influences unique to this business cycle seems likely to moderate the speed of the anticipated recovery."***

- ***There is also the risk that black holes in Japanese banking balance sheets might suck in global financial conditions. The authorities continue to aim to muddle through the problems, but time is no longer on their side.***

- ***Against this backdrop the Australian economy has once again done well to withstand global recession. The outlook remains reasonable, short of global financial calamities. Strong mining investment intentions look like shoring up the GDP bottom line for the fiscal year ahead without disturbing the relatively quiescent general unit labour costs picture.***

- ***But there remain significant untapped opportunities for the key areas of productivity, exports and business investment (outside the latter's lop-sided current strength in mining). The budget interest in these is primarily microeconomic rather than macroeconomic.***

- ***On present indications it is sensible for the fiscal policy expansion of the last two years to cease. But the outlook is sufficiently unclear to render imprudent this far ahead any shift of stance to contraction. Ai Group therefore advises an overall neutral stance for the upcoming budget. Large sections of the domestic economy remain relatively subdued, whilst the main expected growth area (mining) typically does little damage to inflation.***

Economic Overview

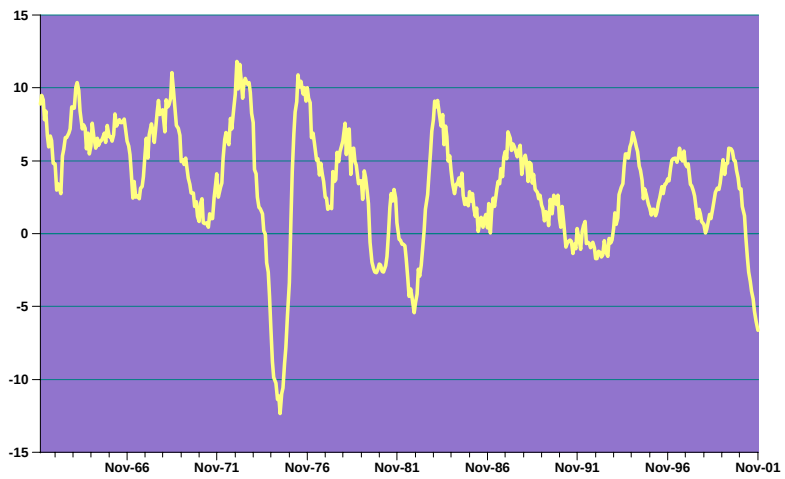
The global recovery now underway should help Australia sustain its recent impressive growth resilience through late 2002 and into 2003. Competitiveness provided by the low dollar will become more evident as external markets reactivate, facilitating a baton switch between household and business and export sources of demand needed later this year. But sustained competitiveness is more a matter of continuing productivity and investment growth than exchange rates. Even though untapped opportunities exist for exports, productivity and investment, there are doubts over whether enough is being done to achieve them. For sustainable results microeconomic policies matter as much as their macroeconomic counterparts.

Global Economic Outlook

In the early months of 2002 the key question stopped being whether the global economy will recover this year. Rather it is what sort of recovery — vibrant or somewhat grudging? There are clear signs, from European and Asian data and especially the American counterparts, that the economic cycle has either bottomed or is very close to doing so. The inventory cycle, both for "old" and "new" economy goods, dominates immediate fortunes, with substantial stocks' liquidations in the second half of 2001 now coming to an end. Even with unchanged final sales, production (GDP) must lift to satisfy demand once the option disappears of running down inventories. Indeed, there is some evidence that US auto and appliances' inventories were run down too far in late 2001 due to the runaway success of zero financing sales deals. Stocks liquidation is more complete in the US than elsewhere, but European business surveys suggest the process to be well advanced there also in early 2002.

Starting from the base of strong inventory reductions recorded in the December quarter national accounts the current turn in the inventory cycle should add 1¼ to 2 percentage points to US growth (at annual rates), most likely over the first two quarters of this year. This strong impact will be reflected in more subdued fashion elsewhere, but the synchronised turn will get global recovery in industrial production and trade off to a good start in most places. The question is what comes next? Here the debate is sharply divided into the two camps of those who think that recovery will adopt its normal shape and strength and those who think it is going to be different this time.

Chart 1
G7 INDUSTRIAL PRODUCTION
Annual % change



Source: OECD MEI database

Every cyclical recovery has had its sceptics claiming unique circumstances would get in the way of a robust regeneration. Mostly they have been wrong, as chart 1 (G7 economies' industrial production growth) shows a history of brief but strongly V-shaped cycles. So it is tempting fate as well as history to suggest this time will be one of the rare exceptions. But that has become a popular view amongst economists, though strategists and others in equity markets are more likely to reckon that the cycle will turn out again to be business as usual. In US GDP terms the difference in outlook is between growth over the course of 2002 just reaching underlying potential in the low 3 percent range and a more robust 4 to 5 percent expansion. Both camps now see US growth reviving quickly in first half 2002, but differ over whether the GDP acceleration will kick on in the second half. Exhibit A for the optimists is the range of 2001 policy rate cuts (table) supported by fiscal expansion in some countries.

POLICY RATE CUTS
Since December 2000 (bp)

Global average	**-234**
US	**-475**
Canada	**-375**
Euro rate	**-150**
UK	**-200**
Sweden	**-25**
Switzerland	**-175**
Japan	**-25**
Korea	**-125**
Indonesia	**+244**
India	**-150**
Philippines	**-625**
Thailand	**+50**
Taiwan	**-250**
NZ	**-175**
Australia	**-200**

Source: J.P.Morgan

The sceptics' case for a slower-than-normal global recovery is based on five main points:

- Unusual strength of US housing and consumer durables through the recession leaves less room than usual for a normal cyclical kick under rate-cutting influences.

- In any event US households have higher-than-usual debt repayment obligations and a saving ratio that is low by reference to their wealth – income positions. Both factors might operate to reduce future consumption growth.

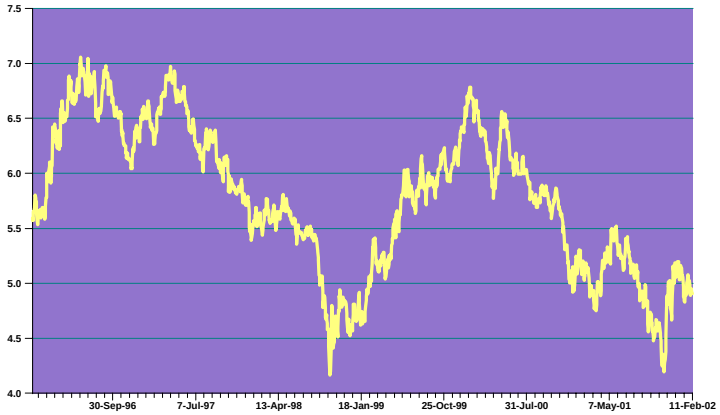
- Business investment expansion is hindered by low capacity utilisation in the US and Japan, by resistance to cost-reducing "competitiveness" or replacement investment after recent "new economy" hype, and by needs to conserve cash in the changed accounting atmosphere following the Enron debacle.

- The US is again being called upon to be the locomotive of global growth but with a high dollar now greasing the wheels. To the extent successful there will be a net exports drain from US production and demand.

- Japan and some others are exporting deflation, thus crimping the profit expansion needed to encourage investment.

Against this it is argued both that US policy expansion is unusually strong and determined <u>and</u> that capital now has a shorter life so that replacement investment is more necessary than hitherto. Despite European policy complacency and deep Japanese problems, the issue is largely one of timing. The global economy is in the recovery stages, a view endorsed by US government bond markets (chart 2). The issue is how promptly and fully that process will occur? Share markets seem more optimistic than bond investors, the former pricing in a strong earnings recovery while 10-year US Treasury notes yielding around 5 percent do not yet exhibit any of the usual market fears of strong growth.

Chart 2
US BONDS SIGNAL RECOVERED GROWTH FAITH

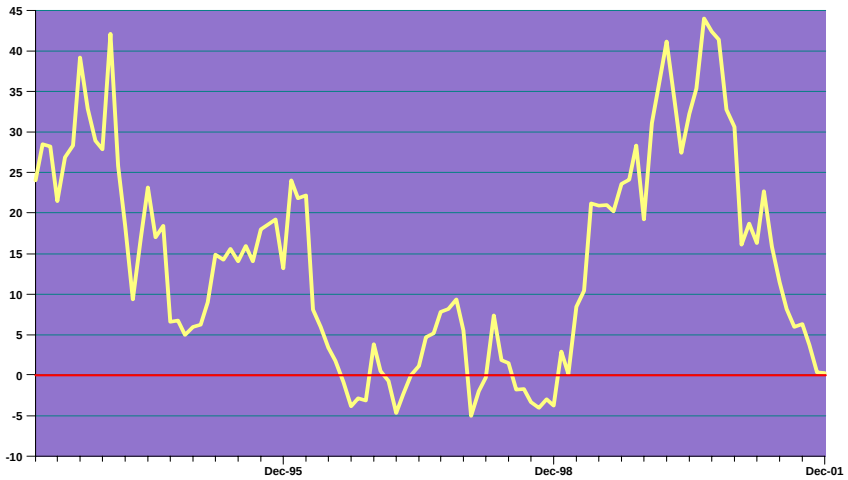


Source: Bloomberg
(US 10-year Treasury yields daily)

Asian Outlook

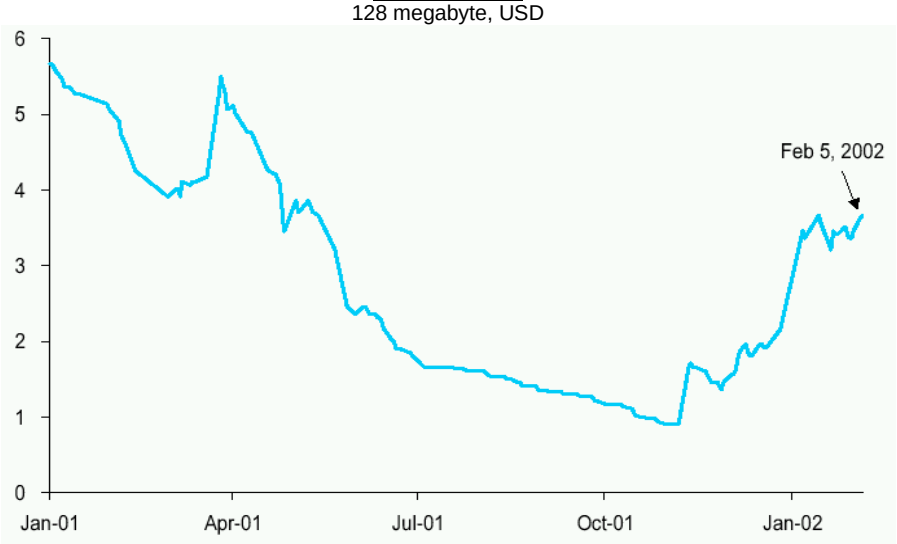
Global growth influences Australian exports by moderating the tone of markets in general, but doubles up in Australia's prime Asian markets as their own export-led vitality hinges on the same global outcomes. Asia suffered badly through 2001. Japan was again in crisis, the electronics specialists (Taiwan, Hong Kong, Singapore and Malaysia as well as Japan) were rattled by plunging chip prices and malaise throughout the global new economy, while global recession stunted economic growth everywhere. ASEAN in particular went backwards. Amongst the majors, only Chinese growth held up, but as the year progressed even her exports and imports bore witness to the global downturn (chart 3). It is no surprise that Australian manufactured and services exports, acutely sensitive to major trading partner growth, were checked in consequence.

Chart 3
CHINESE IMPORTS
Annual % change (3mma)



Source: OECD

Chart 4
DRAM PRICES
128 megabyte, USD



Source: CSFB

All boats lift on the incoming tide, including those like Japan with obvious leaks in parts. Fortunately, 2002 is starting on such an incoming tide:

- A range of indicators suggests in aggregate the worst to be over for the new economy. Inventory to sales ratios in tech production have fallen considerably, US tech real capital expenditure grew in the December quarter (computing hardware growth outweighing continuing declines in software and communications equipment) and DRAM prices have recovered sharply (chart 4). Tech-oriented Asian economies will benefit.

- Better global growth in general will improve markets for most Asian economies.

- Asian domestic demand should not be forgotten, especially with lower interest rates and fiscal stimulus in some economies. The medium-sized Korean economy is a good example, withstanding the worst effects of the global downturn quite well thanks to domestic demand remaining resilient. In turn this outcome is due to good results from both sides of construction and consumption.

- Excluding Japan, the key Asian economy is China. Despite continuing firm GDP results import growth tailed away sharply late in 2001 (so that annual growth virtually disappeared by the three months to December – chart 3). But domestic demand has been stimulated again, and helped also by stronger regional trade, 2002 should see a resumption of China's thirst for foreign goods.

- The main disappointment remains Japan. Financial system reform again appears bogged down in political difficulties, with apprehension over announced lifting of government guarantees on bank deposits at end-March. Yen depreciation is consistent with an economy under-achieving on both inflation and output, but global growth would be the surer short-term remedy for Japanese ills. The latest "anti-deflation" package was greeted with similar derision to earlier efforts.

THE MAIN RISK
Japanese Banking

Japan has been moving in and out of recession for nearly a decade. Chronic underperformance from more than a tenth of the world economy has imposed a continuing drag on global growth, felt more keenly here due to Japan's status as Australia's leading export market. There is virtually no reason to expect a return to vibrant growth any time soon, so that restraints on global growth possibilities should continue as in previous years. But the passage of time, continuing domestic deflation and the recent recession mean that Japanese banking's chronic non-performing or "bad" loan problem could intrude as a new crisis for global financial markets at any time. One possible near-term trigger could be outflows ahead of the end-March removal of government guarantees on bank deposits over ¥10 million.

While various estimates circulate of the size of the bad loan problems, it is clear that they are so large as to require major public funding. But electoral popularity of the Japanese banks is so low that a public bail-out is likely to be greeted with nearly the same reception that would have greeted any suggestion of an Australian taxpayer revival of Christopher Skase's corporate fortunes in the 1990s. Some banking crisis in the headlines seen widely to be imperilling the broad Japanese economy appears a necessary condition for any viable political action. The twofold risks are obvious:

- having allowed (and perhaps even encouraged) a crisis to develop, self-protecting action might lead to the crisis spinning out of control on Japanese and global financial markets;

- electoral constraints may mean that public funding is inadequate, so that the crisis is only partially solved, thus to linger to later dates.

As well as contagion producing widened spreads in global financial markets, Japanese external investments (permitted by the continuing series of current account surpluses) are so large as to be capable of creating short-term havoc should bankruptcies trigger their liquidation. The global issue for 2002 is whether an overdue tackling of the Japanese financial rot will turn out to be injurious to the global economy. Prime Minister Koizumi's declining popularity and associated falling status with the political elites does not bode well for the sure touch of power that is required for such a delicate task. Nevertheless, most observers (including the economists whose global forecasts are canvassed beneath) expect there to be another muddle-through in the fashion pioneered by the earlier economy Japan is increasingly beginning to resemble — Britain.

MEAN GDP FORECASTS OF GLOBAL INVESTMENT BANKS

	Quarterly % change					*Year average % change*		
	Q401	**Q102**	**Q202**	**Q302**	**Q402**	**2001**	**2002**	**2003**
US	0.05	0.5	0.7	0.9	0.9	1.2	1.6	3.7
EU12	-0.1 (e)	0.2	0.5	0.7	0.7	1.5 (e)	1.1	2.8
Japan	-0.4 (e)	-0.5	-0.2	-0.2	0.4	-0.5 (e)	-1.5	-1.1

Forecasts are the means of current predictions from 8 major global investment banks.

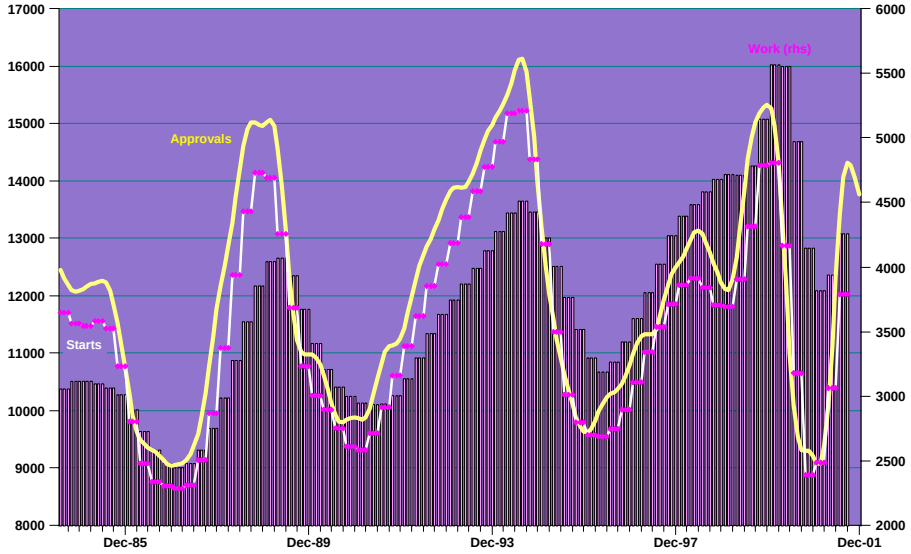
DOMESTIC ECONOMIC OUTLOOK

With annual GDP growth currently at 4.1% in seasonally adjusted terms (end 2001), a pace likely to be continued approximately into the early part of 2002, the Australian economy withstood global recession in fine style. The issue is whether this strong performance can be sustained into the emerging global upturn? The question is often explored through a detailed analysis of prospects for individual expenditure sectors, with revived business investment and exports seen as necessary to replace the passing of housing contributions to growth later this year. But in a more fundamental sense it will be the vitality of productive investment and productivity growth and the unlocking of untapped export opportunities that will determine Australia's future performance. This section takes a brief look at the expenditure components before concentrating on the fundamentals.

The Components

For the second time in four years Australia has withstood major weakness in our most important global trading partners. The economic triumph is again the result of a resilient consumer aided this time by a very strong housing revival. However, there are question marks over the shelf life of both contributions to growth. The strength of the housing upturn emerges graphically in chart 5, but so too does the recent turn in the tide of new approvals. While low mortgage rates and the recent history of capital gains are likely to sustain demand for some time yet (and a little longer for work done), a developing excess supply of units in some markets (associated with rising unfilled vacancy rates) is now a common topic of industry discussion. While activity is expected generally to be in retreat by end-2002, it is the disappearance of the contribution to growth that is arithmetically most important for the coming GDP pace.

Chart 5
HOUSING TRENDS

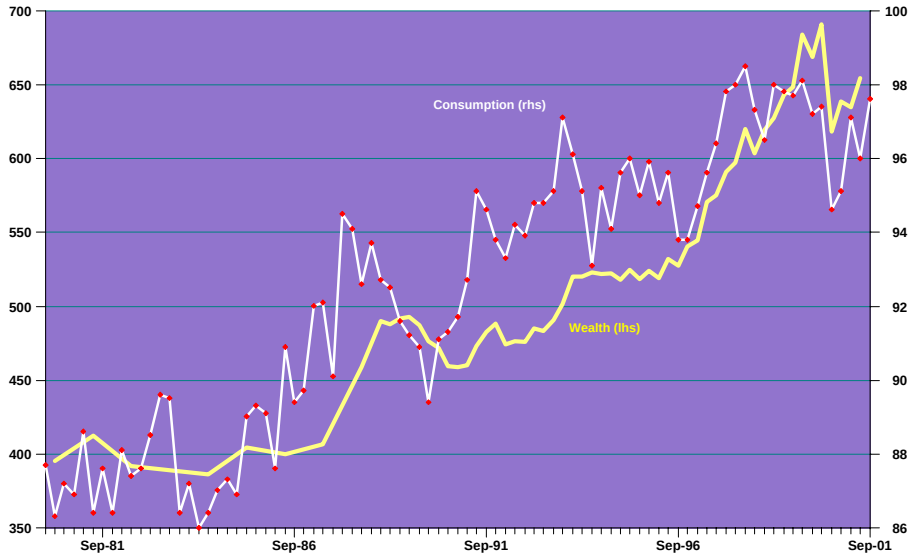


Source: ABS, monthly private approvals and starts (lhs) and quarterly new dwelling work (99/00 $m – rhs).

But it was consumption that provided the mainstay of growth resilience, especially in the first half of 2001. That in turn came from a further raid on the saving ratio, in part inspired by strong housing capital gains and in part by the surge in health insurance coverage following increased public subsidy. Gains from the net tax cuts associated with the new tax package set up a pipeline of demand late in 2000, but employment contributions were dismal throughout 2001. Chart 6 shows Reserve Bank estimates of the developing ratio of household wealth to disposable incomes alongside the consumption ratio (i.e. one hundred minus the commonly-cited household saving ratio). Over the past two decades both have risen more or less in tandem, an outcome replicating experience in the United States.

Chart 6

HOUSEHOLD WEALTH AND CONSUMPTION AS % OF DISPOSABLE INCOMES

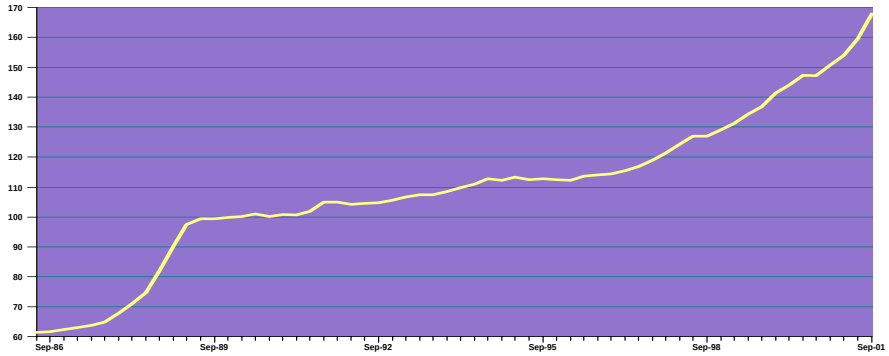


Sources: ABS, RBA

Chart 7

ESTABLISHED HOUSES

Prices, 1989-90 = 100



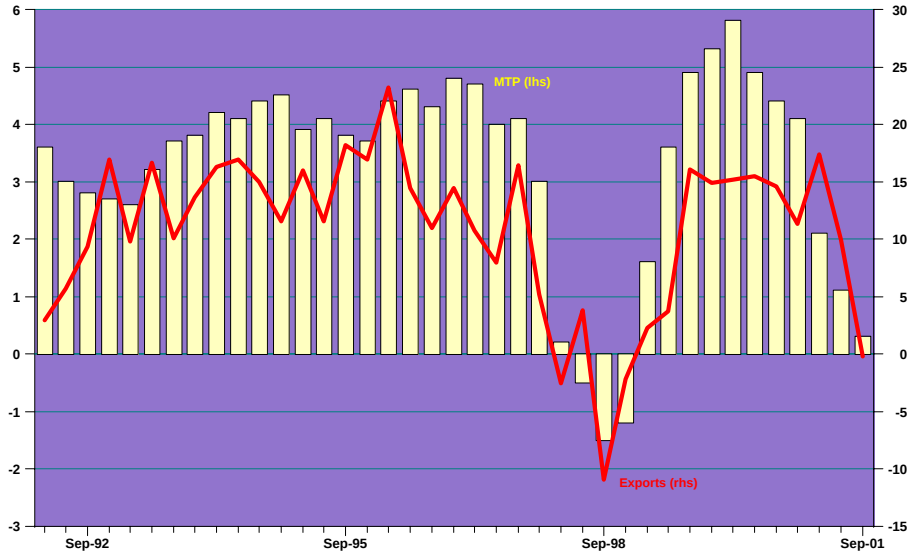
Source: ABS

Lurking behind the gains in household wealth have been strong rises in house prices (chart 7), reflecting demand stirred by lower interest rates and the attractions of the additional first home owners grant. Moreover, the current widespread availability of mortgage equity products allowed unrealised gains on existing houses to be tapped for support of consumption in general. But these fresh sources of fuel for demand may now be in the process of drying up. Fortunately, the high wealth – income ratios should stay in the system supporting consumption for some time (barring an unexpected collapse of general house prices). And there are signs, discussed more fully beneath in the section on productivity, that

incomes expansion might be sustained by the resumption of jobs growth in delayed reaction to last year's good GDP gains.

But, if consumer spending is capable of tooling along, to keep growth buoyant something needs to replace the contribution from housing. The chief candidates are exports and business investment. Much has been written about the impact of the cheap dollar (especially against the greenback) on export competitiveness, but its role in preserving the profitability of resources activity and providing a spur to mining investment should not be neglected.

Chart 8
MANUFACTURED EXPORTS AND MAJOR TRADING PARTNER GROWTH
Annual % change



Source: ABS and RBA. Manufactured exports are ETMs minus frigates.

In the short term export volumes respond much more obviously to variations in the growth of markets within our major trading partners than to exchange rate changes. Chart 8 is the Reserve Bank's demonstration for manufactured exports of the strong links to partner growth rates. Also sensitive to overseas incomes conditions is the vitality of export services growth. Solid growth of volumes was hurt by the late 1990s Asian crisis and again by the 2001 global recession, with a brief revival (Olympics effects aside) in between. Much will depend on continuing Asian recovery. By contrast, resource export volumes are influenced in the short term primarily by supply factors, with demand variations influencing mainly prices received rather than volumes. Fortunately supply conditions have been mainly favourable, and the low dollar (where not rigidly hedged) has preserved profitability against low base metals prices and amplified returns from better prices in other resource areas.

Not surprisingly in view of the shocks to the domestic economy and the gloomy international outlook prevailing throughout 2001, business investment has been weak. Only engineering construction went forward over the year to September quarter, posting three successive growth quarters after a lean trot. With mining investment buoyant, plus some major road and rail transportation projects, there is good reason to expect the sector to continue to support GDP growth. However, building for the commercial sectors might continue to languish. Equipment intentions have also been sluggish (especially outside the mining sector), but very recent marked rises in business confidence might improve the position. However, since most of this equipment is imported, the short-term impact of any change will be felt more by the balance of payments than GDP.

Extracting reliable forecasts from these shifting global and domestic currents is more than usually difficult. Consensus forecasts see moderate recovery ahead (table), but the best reason for medium-term optimism is the large remaining reserve of firepower possessed by the Reserve Bank. Should the domestic recovery fall victim to insipid global growth, the Reserve is well placed to cut the cash rate by the order of another 100 to 200 points. Should, contrary to current market expectations, the Reserve find it necessary to take this step, activity might pause later this year when the housing boost expires. But that would only set up 2003 for strong growth from the possible additional monetary stimulus.

Over recent decades the Reserve has never copied its overseas counterparts (including the Bundesbank as well as the Fed) in setting zero real policy rates during recessions. Until well into the 1990s it was preoccupied with removing (or preventing the prompt return of) excess inflation from the system. More recently the domestic economy has proved not to need such strong stimulus. But should the occasion arise neither of the traditional bugbears of current account and inflation difficulties stand opposed presently. It is true that inflation is currently above target, but this is due to a series of temporary influences (currency, food and other factors) expected to clear away well within the policy horizon. The Bank itself expects inflation to return well within its target range. Most importantly, endogenous inflation, or unit labour costs growth, remains well behaved. Wage Cost Index growth has subsided gently, to be only 3.4 percent over the course of 2001.

CONSENSUS AUSTRALIAN GDP GROWTH FORECASTS

Source	2001	2001/02	2002	2002/03	2003
Investment Banks		3.2		3.7	
Consensus Economics	2.3		3.2		3.6
Treasury – October 2001		3		3½	

Sources: Current forecasts from 7 leading global investment banks; Consensus Economics survey February 2002, and Treasury Mid-Year Economic Outlook, October 2001. All growth rates refer to the change from one calendar (fiscal) year total GDP to the next.

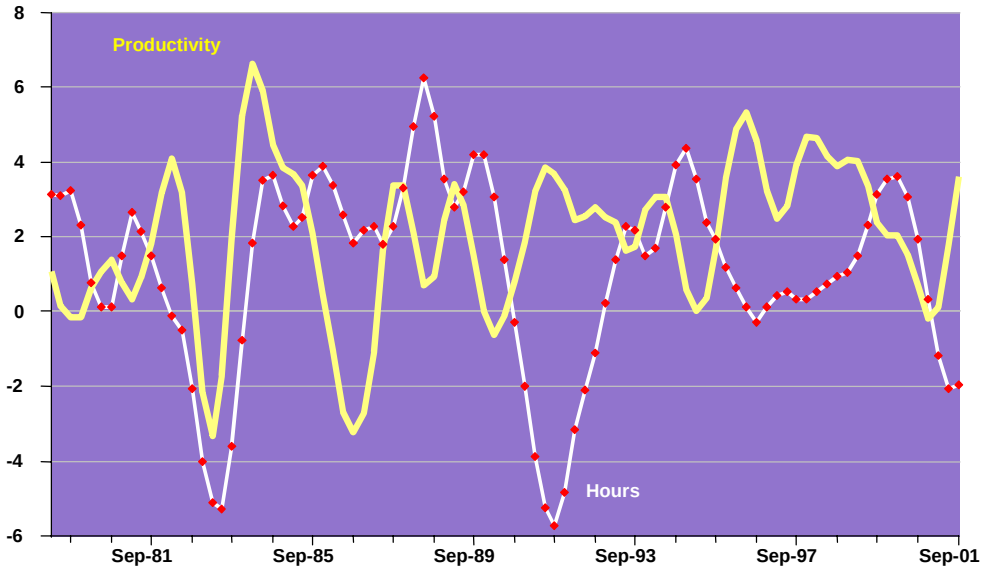
The Fundamentals: Untapped Opportunities

Moving beyond the short-term evolution of the current cycle, three matters stand out as most important for Australia's long-term development — productive investment and productivity growth and the fulfillment of the country's export potential. Without strong investment productivity growth will not remain vibrant for long, and without productivity growth Australia's potential GDP path will be crimped by the evolving slowdown in population growth. A strong export performance promotes and permits growth dynamism. As well as providing markets for domestic productive energy, exports will provide the foreign exchange receipts needed to service unhindered the expanding import bills flowing from realising that growth potential. In each of these three areas there are opportunities that remain untapped. Favourable cyclical conditions are a necessary condition for achieving strong growth, but resting on macroeconomic and external help alone is not sufficient. For achievement of full growth potential policy needs to seize the untapped opportunities available with microeconomic policy support as well as appropriate macroeconomics.

Just over a year ago Ai Group published a detailed discussion paper (*How Fast Can We Grow: Mark 2?* December 2000), which concluded, *inter alia*, that, unless the reform effort were to continue undiminished, the best of Australia's excellent ***productivity*** acceleration of the mid-1990s might be behind us. On the face of it the 3.6 percent trend "market sector" productivity growth in the year to September 2001 suggests the higher pace to have

continued unabated. But the extra productivity was derived in a very unusual fashion seemingly incapable of being sustained for long. As chart 9 depicts the gains came primarily from slashing aggregate hours of work. "Market" sector GDP was up 1.6 percent over the year, while aggregate hours fell 2 percent.

Chart 9
ANNUAL % GROWTH IN MARKET SECTOR PRODUCTIVITY AND HOURS WORKED



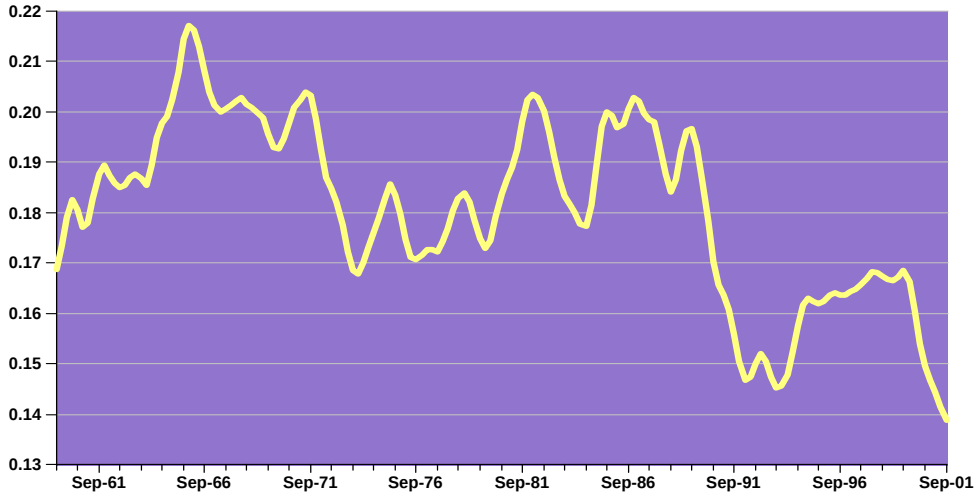
Source: ABS National Accounts

Discordant combinations of rising productivity and falling hours can be signs of a major shake-out. Thus the early 1990s witnessed sharp falls in aggregate hours worked with strong productivity growth for the remainder as industry underwent profound restructuring. This time, however, the unusual combination seems as likely to be a mere timing accident. The usual positive movements of both elements of the productivity ratio (output per hour worked) arise normally from simultaneous adjustments. If the cycle eventuates broadly as expected changes in both GDP and hours will be made in the same direction. But the past two years has been full of surprises for business. The second-half 2000 output downturn was unexpected, resulting in delays to the labour adjustment and reductions in the output – hours ratio. As the belated hours adjustment occurred in 2001 the productivity ratio recovered somewhat. But a "hope for the best, prepare for the worst" outlook seemed to overtake local and international business in mid-2001 as global prospects weakened. The stand-out recovery of Australian GDP took local business, still expecting no need to increase labour inputs, by surprise. The result from a varying numerator (GDP) against an unadjusted denominator (aggregate hours worked) was a sharp productivity surge that will last only as long as it takes to recognise better times and to make the belated adjustment. While the trends remain very new, lifting Australian business confidence and higher January newspaper job vacancies and employment fit well this view of developments. We might add that strong December quarter US productivity (gained overwhelmingly from hours reductions) also adds credibility to the hypothesis.

Underlying productivity trends remain unclear. It is possible to argue that another in the 1990s series of shake-outs or reforms has been underway over the past year. On the other hand the surprise recovery of Australian productivity might be a temporary consequence of forecasting failures. If this latter view is correct the employment implications for 2002 are quite encouraging (thus to sustain consumer spending). But productivity growth would settle back to lower levels. How much lower, assuming the latter hypothesis to be correct, remains to be seen. Until the dynamics of the present cycle unwind it is unclear which of the two

hypotheses has been in operation so that all that can be concluded is that it is unsafe to assume that the higher productivity growth path of the 1990s continued into the new century.

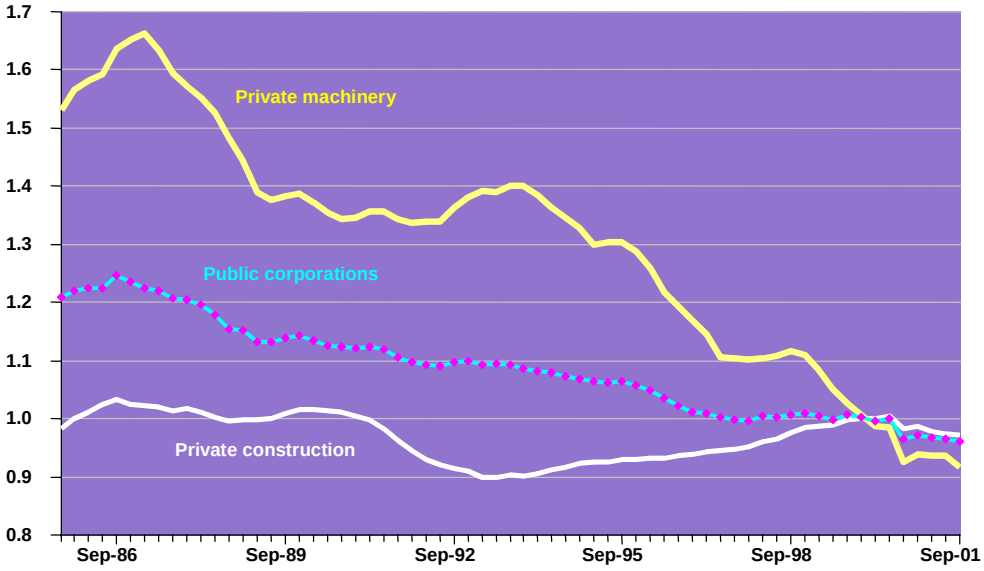
Chart 10
NON-DWELLING INVESTMENT SHARE OF THE GDP DOLLAR
Current prices, trend data



Source: ABS National Accounts. Non-dwelling investment includes private expenditures on other buildings and structures, machinery and equipment and intangible assets plus public investment from public corporations and general government.

Non-dwelling investment declined in real terms in 2001. It is also taking a lower share of the nominal GDP dollar than at any time since the quarterly national accounts series started in 1959 (chart 10). Less than 14 cents of the GDP dollar was invested this way by the last September quarter. Unlike corresponding charts of business investment the present account is uninfluenced by privatisations and the associated classification switch from public to private investment.

Chart 11
RELATIVE PRICE CHANGES OF INVESTMENT GOODS
Chain price indices relative to GDP, 1999 – 2000 = 1



The trends are so dramatic as to require explanation. One is that the sharply improved capital productivity performance of the 1990s now requires less investment to produce output than hitherto. Another, of greater import, is that the prices of some investment goods, especially those involving computing equipment, have dropped sharply relative to goods and services in general (chart 11). In this relative sense investment in machinery and equipment is now nearly 40 percent cheaper than in the mid-1980s. However, construction costs do not seem to have varied much. Since the index for public corporations does not separate equipment and construction spending, it is unsurprising that relative deflation here falls in between its two companions.

The prime reason for the decline in the non-dwelling investment share of the GDP dollar is that it is cheaper now to do the same physical things. Indeed, the real, or inflation-adjusted version of these data show recent investment as a share of GDP to be a little above the 40-year average. However, it is disappointing that the opportunities for improving the real capital stock provided by cheapness have largely not been taken. In the jargon of economists, the apparent price elasticity of capital investment has been quite low. Put in more simple terms, without straining elsewhere for decades Australia found itself quite capable of devoting five cents more of the GDP dollar to investment than it is now. The opportunities for productive growth represented by those five cents are there. They must not be squandered.

Export growth should revive this coming year as major trading partner growth recovers (chart 8), improving opportunities to capitalise from a dollar that is low on average and against many currencies (but especially the US dollar). However, a major fleshing out of the composition of Australia's exporting population being conducted by Austrade finds that it is sub-optimal to rely on macroeconomics alone as the keys to export success. There are many opportunities that will go untapped if left alone by microeconomic or industry policymakers.

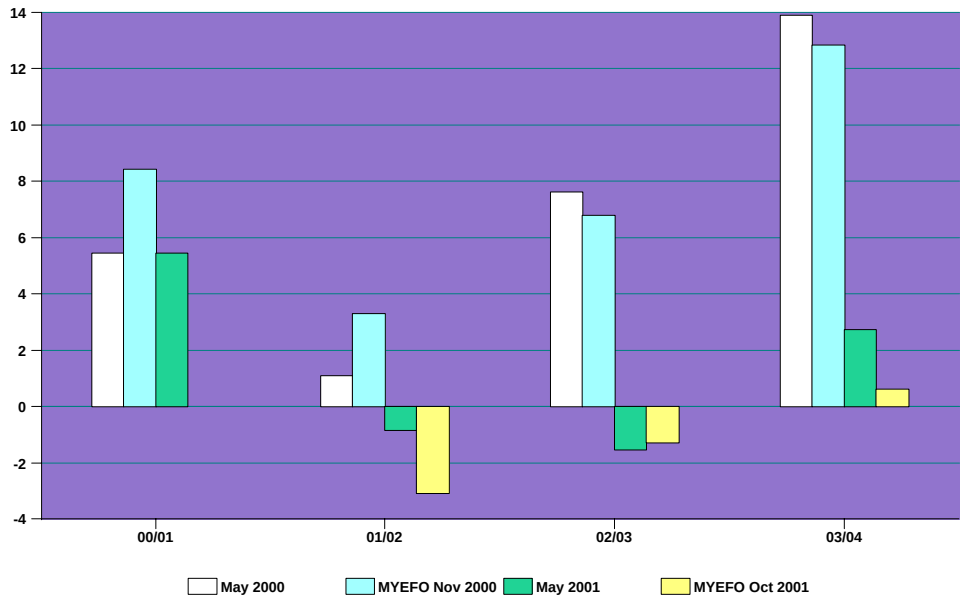
The Austrade analysis of ABS longitudinal survey data (i.e., following up the same firms over time) finds that in any one year only about 4 percent of Australian firms are exporters. This is sharply below the rate of comparable industrial countries. Some firms are regular exporters, these markets being core components of their business. Others are 'irregulars' whose exporting experience is intermittent. Austrade finds that "just under half of Australian exporters drop in and out of exporting over time. The research suggests that a large proportion of these 'irregulars' could become regular exporters with some form of assistance — sometimes at a very basic level".

Outside the 4 percent of businesses, 25,000 in all, who are regular or irregular exporters, the survey information finds another 2 percent of businesses who "intend" to export, but have not yet done so. That is also low by comparable international standards, a worrying trend aggravated by historical data suggesting that less than a quarter of these intentions have been realised in an actual export sale within three years. There are, of course, difficulties in the way of securing export markets, especially for small firms. Yet the Austrade report is full of success stories for metropolitan and regional small firms, some of them from "accidental" opportunities. Minister Vaile pledged to achieve a doubling of the number of Australian exporting firms by 2006. That is a commendable interim objective. But just as man cannot live by bread alone, exports will not flourish on an exclusive diet of the macroeconomic gruel of exchange rates, partner growth and headline budget balances. As with productivity and investment, export opportunities exist in abundance. To tap them requires ongoing support from microeconomic policy.

Macro Fiscal Outlook

A return of global and domestic growth should allow fiscal policy to shed the burden of activity support borne over the past 18 months. But whether it is advisable merely to shift the fiscal levers to neutral or to place them in reverse (through net contractionary measures) depends upon the strength of upcoming activity. With the Commonwealth's balance sheet being one of the strongest in the world, there is no urgency to 'reload the budgetary cannon'. The only decent economic argument for a contractionary turn to fiscal policy would be the emergence of growth pressures straining capacity, and of that there is little sign as yet. When these pressures emerge, as they will at some stage in coming years, fiscal policy will need to be tightened to shoulder some of the restraining task that would otherwise need to be taken by interest rates. The common case advanced for tightening action in the upcoming budget is political rather than economic, this being the first year of the electoral cycle. But that policy risks economic needs becoming hostages to fortune if the aim is merely to build a war chest to finance future election spending. An election cycle would then be incorporated into all the other economic cycles that distract business progress. Fiscal policy is a valuable economic tool, which should neither be neglected nor used perversely.

Chart 12
EVOLVING OFFICIAL FISCAL BALANCE ESTIMATES FOR FISCAL YEARS TO 2003-2004
May 2000 Budget – October 2001 MYEFO, $billion



Source: Commonwealth Budget, May 2000 and MYEFO, October 2001.

Fiscal policy has been strongly supportive of domestic activity so far this decade. The expansionary thrust of the new tax package contained in the 2000-01 budget was followed by a series of further policy measures over the next 18 months. Of the $13.3 billion decline in the 2003-04 fiscal surplus projected between the May 2000 budget and the October 2001 Mid-Year Economic and Fiscal Outlook (chart 12), $7.5 billion (or more than a percentage point of GDP) arose from new policy changes. The smaller part constituting the remainder resulted from a kick back of the weaker 2000-2001 economy on budgetary receipts and expenditures of existing policy (so-called 'parameter variations').[1]

[1] Chart 12 presents the so-called fiscal budget balance using standard accrual accounting concepts. Prominence has been given to an alternative, so-called underlying cash budget balance, which differs from the fiscal balance mainly in terms of timing of receipts and some payments. The cash balance is forecast and projected to remain in (small) surplus throughout the four fiscal years covered.

There is no virtue in maintaining a budget surplus at all times. As former Treasury Secretary, Ted Evans, said in his September 2001 Shann Lecture, "a downturn in the economy could certainly see the budget move into temporary deficit but that, in itself, would not be a worry. It is the essence of the [medium-term fiscal] framework, and the improved [Commonwealth] balance sheet position that has been achieved, that such cyclical shifts can now be accommodated without concern". Evans is reflecting the current global macroeconomic policy consensus that, provided they are temporary, purely cyclical budget deficits should be allowed. Attempts to eliminate them through conscious reductions of government expenditure and increased taxation run the risk of aggravating activity downturns. But, by the same macroeconomic canons, budget balances should be allowed to return to surplus in the ensuing cyclical upturn. One version of this thinking is the rule suggested (originally by US Republican Party economists 50 years ago) that the budget should be balanced over the economic cycle rather than in each and every year.

Evans goes further. Noting that "Australia's fiscal position, measured in a balance sheet sense, is one of the world's strongest", he suggests "there is now once again scope for discretionary fiscal policy should that be required". In essence, the fiscal cannon having been reloaded through the late 1990s, it was in a position to be used in the early years of the new century. There can be little doubt that the aggressive fiscal expansion of the past two years played a part in supporting Australia's defences against the global recession.

Following this philosophy what needs to be done to overall aggregates in the upcoming 2002-03 budget is a matter of judgement rather than doctrinal purity. Barring some unexpected relapse in global recovery (which should be monitored closely nonetheless), the fiscal canon does not need to be fired yet again. In a structural, or cyclically-adjusted, sense fiscal policy should be kept in at least neutral mode, so that cyclical recovery gains can flow to the bottom-line balance. The more timely issue appears to be whether some modest reloading of the cannon ought to occur without delay?

The existing strength of the Commonwealth's balance sheet means that the cannon could be fired again if events turn unexpectedly sour. But undoubtedly the extent and duration of any future firing could be accommodated better with an even stronger fiscal position. Should conscious reloading (or fiscal tightening) start immediately? There is no clear answer at present. Should the global and economic recovery strongly gather pace over the quarters ahead as some are forecasting, an early and modest start to tightening might be justified. It needs to be borne in mind that monetary policy would also be undergoing tightening in these circumstances, so that any fiscal restraint might need to be modest initially. A simultaneous double restriction from fiscal *and* monetary policy is not advisable unless the expansion turns out to be very strongly based.

Mitigating somewhat the upside risks of neutrality with respect to both policies is the fact that the brightest prospect for continuing domestic growth later this year is in a lopsided investment outlook. The first ABS survey of business investment spending intentions for 2002-2003 (conducted earlier this year) yielded indications of strong growth, but in very lop-sided fashion. The bulk of the growth was in mining, assisted by structural projects in transportation. The remaining industrial sectors yielded a subdued outlook. An obvious point is that these projects are primarily undertaken in remote locations. Traditionally there has been little feedback from any excess demand here to the large city labour markets. The lack of such linkages negates most inflationary concerns stemming from strong growth.

Moreover, the earlier economic section drew attention to risks that the pace of both global and domestic advance could falter in second half 2002, by remaining relatively subdued though positive. Even investment intentions could wither in such a changed environment. In this

event policymakers, both monetary and fiscal, would have been ill advised to adopt a restrictive cast. It is simply too early to make a strong call one way or the other based on economic forecasts that have been unusually unreliable in recent times. Unless the outlook clarifies dramatically in the weeks ahead, it is too risky to lock in fiscal policy for circumstances that might never eventuate. Fiscal policy is not easily changed quickly, monetary policy having by far the advantage for purposes of trimming and tacking according to shifts in the prevailing winds. ***Uncertainty therefore points to the advisability of maintaining the status quo (i.e., adopting a neutral budget) this year.***