1. Australia: Outcomes and Outlook

Lei Lei Song, Peter Summers and Anne Leahy

1.1 Outcomes

The Australian economy achieved very favourable outcomes in calendar year 2001, particularly in the second half of the year. The growth rate of real GDP in the year ended the December quarter 2001 was a higher than expected 4.1 per cent—much better than the growth performance in other OECD countries. While compared to the previous calendar year the 2001 growth rate of 2.4 per cent was not so spectacular, it was nevertheless achieved in the context of difficult domestic and international environments. In 2001 the annual growth rate of the US economy fell to 1.2 per cent, from above 4 per cent in the previous three years.

The recent performance of the Australian economy is summarised in Table 2. While private consumption remained strong in the December quarter 2001, it was private investment, in particular new business investment, that underpinned strong growth. After almost two years of decline, new business investment growth turned positive in the December quarter. Of overall GDP growth of 4.1 per cent in the December quarter, private consumption accounted for 2.5 percentage points and, importantly, total private investment accounted for 1.8 percentage points (a third of came which from business investment).

For the first time since mid 2000 net exports contributed negatively to GDP growth in the December quarter. This was mainly due to a decline in exports, reflecting the weak world economy. In the past year or so, net exports provided strong support to the Australian economy, which helped underpin growth in the aftermath of GST's introduction and the Sydney Olympic Games.

From an historical low of 46.4 in late September 2001, the trade-weighted index of the Australian dollar (TWI) has risen by 10 per cent. The exchange rate against the US dollar, however, has not recovered by as much. The Australian dollar has been very stable in the past three months which could reflect, and also be a factor in attracting, net capital inflows into Australia.

The headline rate of consumer price inflation rose to 3.1 per cent in the year to the December quarter 2001 from 2.5 per cent in the year to September. However, underlying inflation[1] rose only slightly from 3 per cent in the year to the September quarter to 3.2 per cent in the year to December, both of which are at the top end of the Reserve Bank's target band.

[1] As measured by the Reserve Bank's weighted median price index. The 'weighted median' is calculated using the quarterly price changes of all CPI components, with the annual rates based on compounded quarterly calculations. From the September quarter 2000, this series is calculated using the previous quarter's CPI expenditure weights; prior to this period, the calculations used base-period CPI expenditure weights. As reported in the 4.00 issue of the *Quarterly Bulletin*, our forecasts assume that underlying inflation net of transitional GST effects was 2.5 per cent in the September quarter 2000.

Though the participation rate jumped half of a percentage point to a record of 64.1 per cent in January 2002, the unemployment rate increased only slightly to 7 per cent, due to strong growth in employment. The unemployment rate was steady at 6.8 per cent for most of 2001. The preliminary figures show that the unemployment rate fell to 6.6 per cent in February 2002.

A 25 basis point cut in the official cash rate by the Reserve Bank in early December 2001 brought the total cut in official rates during the year to 200 basis points. At 4.25 per cent the cash rate is currently at its lowest level in almost 30 years. Monetary policy settings are now clearly expansionary and with an expectation of a solid global recovery in near future, the Reserve Bank left the official interest rate unchanged in the recent meetings.

Table 2. Australian economic activity

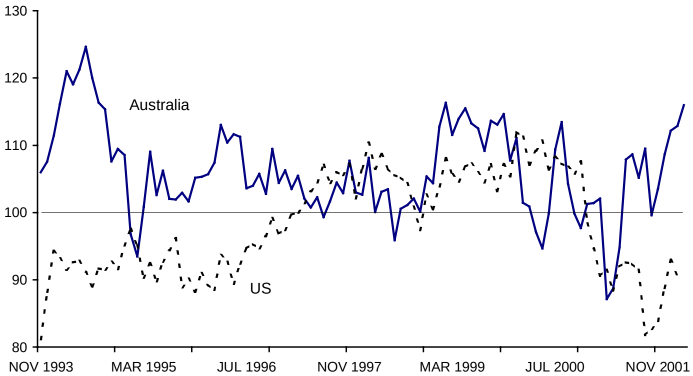
	2000	*2001*			
	Dec	*Mar*	*Jun*	*Sep*	*Dec*
Activity and inflation					
GDP(A)[a]	1.5	1.6	1.6	2.4	4.1
Inflation[a,i]	2.3	2.4	3	3	3.2
Investment[a,b]	-20.7	-6.5	-10.7	-9.9	5.1
Consumption[a]	1.4	2.6	2.8	3	4.2
Labour market					
Unemployment[c]	6.2	6.5	6.9	6.8	6.8
Participation Rate[d]	63.7	63.4	63.8	63.7	63.7
Employment[a,e]	2.2	1.6	1.1	0.3	0.9
Finance					
90-day bill rate[f]	6.3	5.5	4.9	4.9	4.3
Exchange rate[g]	49.5	50	49.7	49.4	49.6
Real Share Price[a,h]	5.8	1.9	5.7	-3.6	2.8

Since October 2001, the Westpac – Melbourne Institute Consumer Sentiment Index has recovered to and exceeded its pre-September 11 levels. The latest March reading of the Index is the highest level in three years. Improving consumer sentiment certainly contributed to strong growth in household consumption in the December quarter and will

[a] Per cent change from same quarter in previous year.
[b] Business investment, measured as machinery plus other buildings and structures, excluding net 2nd hand purchases.
[c] Unemployment rate, per cent of labour force, average for quarter.
[d] Participation rate, labour force as per cent of population aged 15 and over; mid-year population forecasts from ABS linearly interpolated.
[e] Growth rate in employed persons, per cent change from previous year.
[f] Per cent per annum, average for quarter.
[g] Trade weighted index of exchange rates, May 1970 = 100.0.
[h] All Ordinaries Index deflated by weighted average of implicit price deflators for machinery and other buildings and structures, (weights given by shares of these components in business investment) 1996/97=1.0.
[i] RBA weighted median inflation rate adjusted to remove the transitional effects of the GST.

continue to do so in the near future. Household consumption grew by 4.2 per cent in the year to the December quarter, which is the highest growth rate since late 1999. The Westpac—Melbourne Institute Consumer Sentiment Index is shown in Figure 1.

Figure 1. Westpac - Melbourne Institute and University of Michigan Consumer Sentiment Indices, seasonally adjusted



1.2 Outlook[2]

The latest Melbourne Institute forecasts for the next two years are summarised in Table 3. The forecasts suggest that, in the near term, the momentum of the Australian economy in late 2001will continue, though at a more moderate pace. The forecast GDP growth rates for next two years are much higher than those reported in the previous issue of this Bulletin. The results suggest that a renewed period of economic expansion, although possibly not as strong as that which was experienced in the late 1990s, will get under way in the next two years.

The main driving force of strong economic growth is buoyant domestic demand. Private consumption is forecast to remain strong, growing at rates more than 4 per cent. The momentum of business investment should be strengthened at least in the first half of 2002. While business investment is forecast to moderate from the second half of 2002, improved international conditions will help the Australian economy to grow at rates above the average rate of the past three decades.

In line with the Reserve Bank view, our forecasts show that inflation will decline in the first half of this year and thereafter will stabilise in the middle of the RBA target band. Well contained inflation and the gap between Australian and US interest rates suggest that the case for early increases in the cash rate is not as strong as some in the financial markets expect.

Our forecasts for the 90-day bill rate suggest no change in the forecast period. This may seem contradictory to the consensus view that as the economy expands, inflation will rise and interest rates will go up sooner rather than later. However, our forecasts for interest rates are consistent with the inflation outlook in both Australia and the United States. If the Reserve Bank knew with certainty that the inflation rate, employment, unemployment, etc. would all be as we predict over the next several quarters, an unchanged interest rate would be perfectly sensible. It is also important to note that our inflation rate forecasts imply a rising *real* interest rate, even though the *nominal* rate stays steady. Finally, we believe that there is still enough uncertainty in the strength and breadth of the nascent expansion in the US to warrant leaving interest rates unchanged for longer than might otherwise be the case.

Having said all this, we do not expect interest rates to remain unchanged until mid-2003. On the contrary, we think that the RBA will act so as to err on the side of caution, which in this case means being more worried about inflation being higher than forecast here. Viewed in this way, we expect at least one rise of 25 basis points in official interest rates over the coming months.

In line with a relatively strong economic expansion in the coming quarters, the outlook for the labour market is encouraging. Employment is forecast to grow strongly and unemployment to fall gradually in the next two years, though the participation rate will remain high.

While future developments in the Australian economy may not turn out to be as bright as suggested here, one thing that is certain is that the economy has held up extremely well in the face of international weakness and it should continue to do so.

Table 3. Melbourne Institute forecasts of Australian economic activity, March quarter 2002 to December quarter 2003[3]

	2002				*2003*			
	Mar	*Jun*	*Sep*	*Dec*	*Mar*	*Jun*	*Sep*	*Dec*
Activity and inflation								
GDP(A)[a]	4.6	4.5	4.2	3.8	3.6	3.6	3.6	3.6
Inflation[a]	2.9	2.6	2.6	2.6	2.7	2.6	2.6	2.6
Investment[a,b]	5.8	11.1	5.4	3.2	1.9	1.9	1.8	1.7
Consumption[a]	3.9	4.1	4.6	4.3	4.2	4.2	4.2	4.2
Labour market								
Unemployment[c]	**6.8**	6.7	6.7	6.6	6.6	6.5	6.4	6.4
Participation[d]	**64**	63.6	63.7	63.8	63.9	63.9	64	64.1
Employment[a,e]	**1.7**	1.8	2.2	2.4	2	2	2	2.1
Finance								
90-day bill rate[f]	**4.3**	4.3	4.3	4.3	4.3	4.3	4.4	4.4
Exchange rate[g]	**50.8**	50.9	51	51.1	51.2	51.3	51.4	51.5
Real Share Price[a,h]	6.4	4.2	8.9	5.6	2.5	2	1.5	1

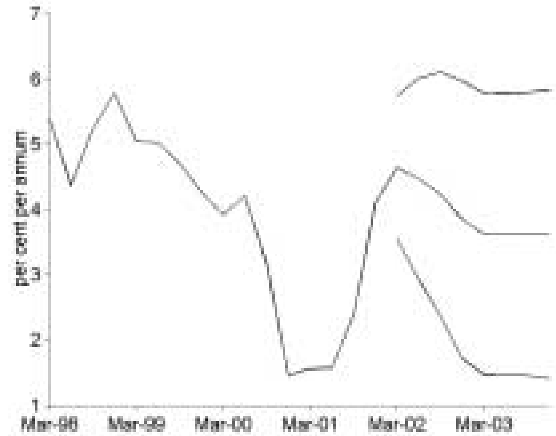
1.2.1 Detail of Melbourne Institute Forecasts

Turning to the detail of the Melbourne Institute forecasts, GDP growth rates in the first two quarters of 2002 are forecast at 4.6 per cent and 4.5 per cent respectively in year-end terms (both at about 1 per cent on a quarterly basis). From late this year, the pace of economic expansion will moderate to around 3.6 per cent in year-end terms, although this rate is still very high compared to an average growth rate of 3.2 per cent in the past three decades. A renewed period of economic expansion may be truly under way. Forecasts for GDP growth are shown in Figure 2.

[2] Appendix 2A contains a discussion of the data on which the forecasts are conditioned.

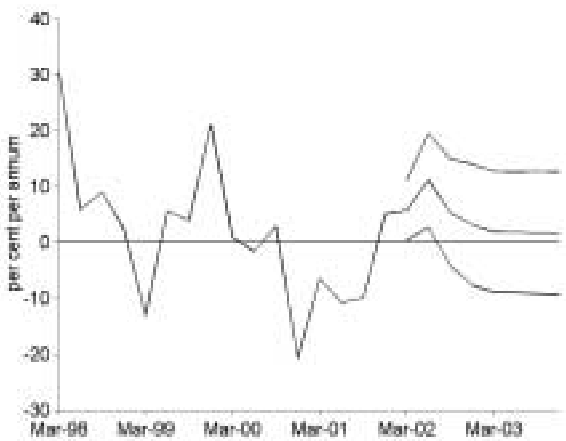
[3] See notes to Table 2. Bold figures are actual data.

Figure 2. GDP, actual and forecast (year-end percentage change)



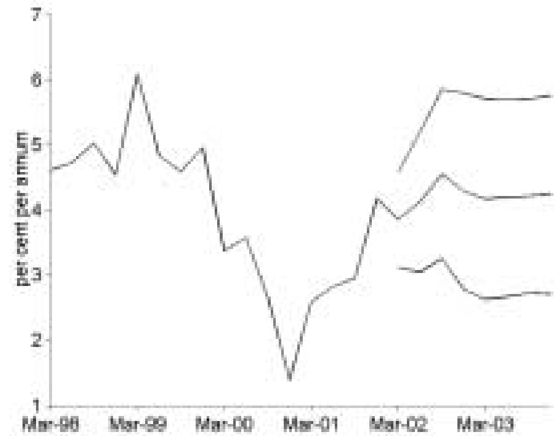
Before the December quarter 2001, new business investment (measured as machinery plus buildings and structures, excluding net 2nd hand purchases) had contracted for four consecutive quarters. Expansionary monetary policy and restored business confidence are the two key factors that contributed to a dramatic turnaround in the last quarter of 2001. Business investment growth is predicted to be strong for most of 2002, before slowing down to about 2 per cent at the end of 2002 and for the whole of 2003, as shown in Figure 3.

Figure 3. Business investment, actual and forecast (year-end percentage change)



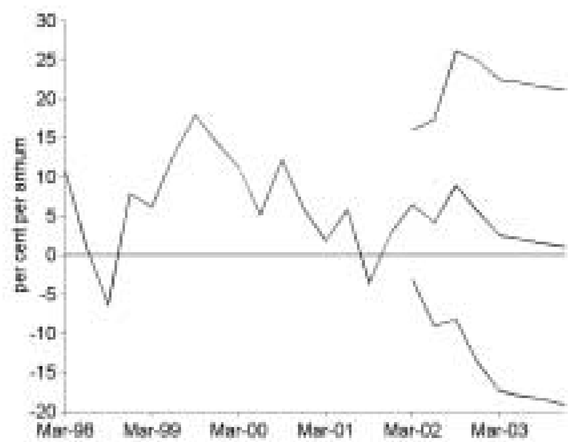
In contrast to business investment, household consumption in Australia will remain buoyant. A high degree of optimism among consumers underpins strong consumption growth, which is forecast to average a healthy 4.2 per cent through to December 2003 (see Figure 4). Robust household consumption expenditure should be a major driving force of economic growth in Australia, contributing to the bulk of GDP growth over the forecast period.

Figure 4. Household consumption expenditure, actual and forecast (year-end percentage change)



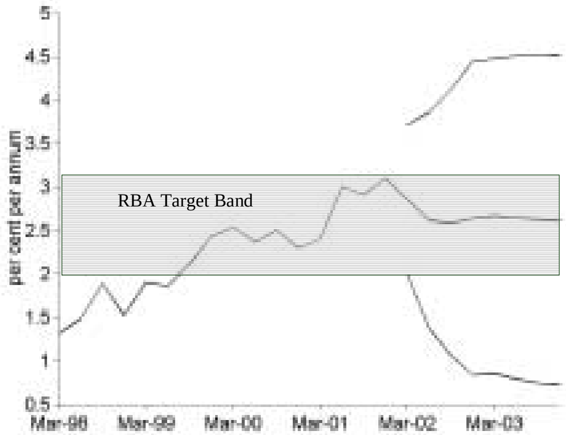
In our forecasting model, real share prices act as an indicator for future investment. The higher the level of real share prices, the higher is the expected return from investment, and therefore the more investment is encouraged. With the exception of negative growth in the September quarter 2001 (which followed the terrorist attacks in the United States) real share prices have been growing continuously for the past four years. The forecasts presented in Figure 5 suggest that real share prices are more likely to rise than fall over the forecast period. It should be borne in mind that real share prices are very volatile and are difficult to forecast, as illustrated by the wide forecast error bands in the figure.

Figure 5. Real share price, actual and forecast (year-end percentage change)



Underlying inflation as measured by the weighted median of consumer prices is forecast to fall in the first half of 2002 to the middle of the Reserve Bank's target band of 2-3 per cent. From the second quarter of 2002 to the end of 2003, the inflation rate is forecast to be around 2.6 per cent. These forecasts are supported by recent developments in both the Westpac – Melbourne Institute leading index of inflation and the Westpac – Melbourne Institute consumer inflationary expectations data. The inflation outlook seems to reaffirm a renewed period of economic expansion with well-contained inflation over the forecast period.

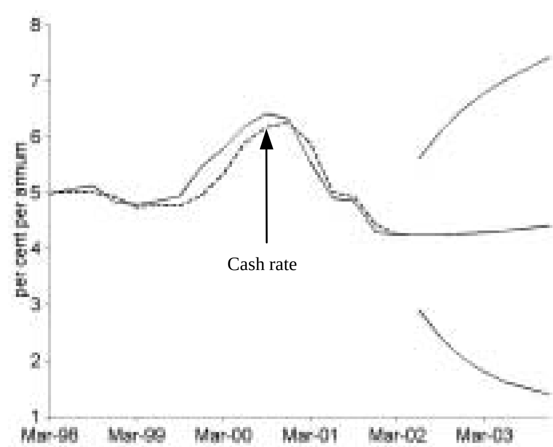
Figure 6. Weighted median inflation, actual and forecast[a]



a. Excludes the effect of GST on prices from September quarter 2000 to June quarter 2001. Forecasts assume 2.5 per cent underlying inflation for September quarter 2000.

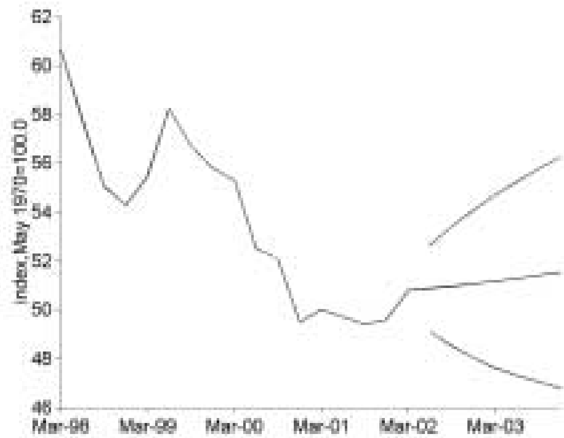
With well-contained inflation in the forecast period and healthy economic growth, there is not yet a compelling case for the Reserve Bank to change official interest rates. The nearly constant level of the cash rate in Figure 7 reflects an implicit symmetry between the costs of inflation turning out to be higher or lower than forecast. As mentioned in the Economic Update, we believe that the Reserve Bank will act as if these costs are asymmetric: higher-than-expected inflation would be worse than lower-than-expected inflation. Therefore, even though the forecasts in Figure 7 do not yet point to a rate rise, we expect at least one increase of 25 basis points before the year is out. At the same time, we do not believe that there is a particular danger of the economy overheating during our forecast horizon.

Figure 7. 90-day bank bill and cash market interest rates, actual and forecast



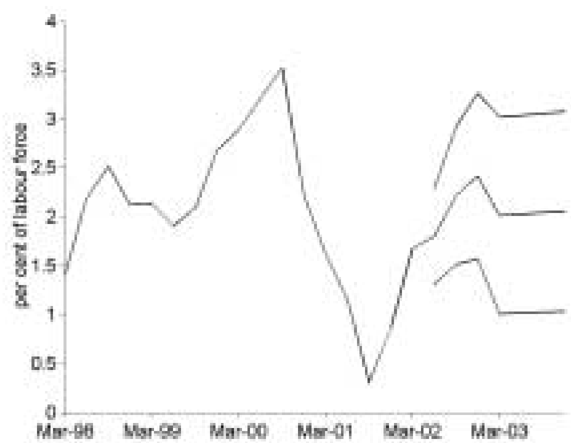
Actual and forecast movements in the trade-weighted index of the Australian dollar are shown in Figure 8. The index is expected to remain at around 51, albeit on a slowly increasing trend, throughout the forecast period. As international economic conditions improve, a stable and low exchange rate will help Australian exports and capital inflows, which are important for future economic growth in Australia.

Figure 8. Trade-weighted exchange rate, actual and forecast



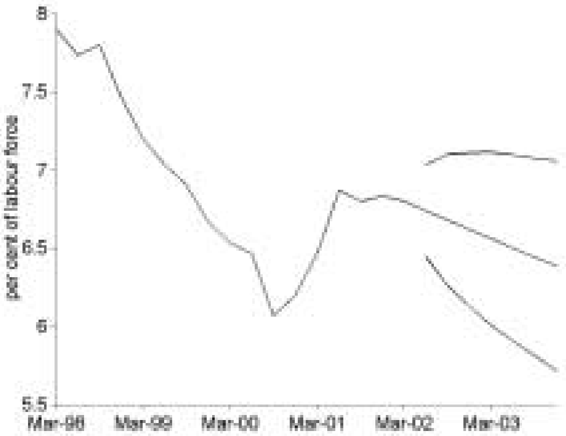
In line with a renewed period of economic expansion, prospects for the labour market should improve over the forecast period, as shown in Figure 9. In 2002, employment is forecast to grow at an accelerating pace after strengthening in late 2001 and early 2002. The forecasts suggest that employment growth will be back to the trend established in the late 1990s, after a decline in 2001.

Figure 9. Employment, actual and forecast (year-ended percentage change)



With strong growth in employment, unemployment is forecast to fall gradually in 2002 and the decline is expected to continue in mid 2003 (see Figure 10).

Figure 10. Unemployment rate, actual and forecast



Appendix 1A: Precision of Melbourne Institute Forecasts for Australia

Measures of precision for the various forecasts for Australia are reported below. Table 4 gives the standard deviation of the indicated forecast, based on 1,000 simulations of the Institute's forecasting model.

Table 4. Precision of Melbourne Institute forecasts of Australian economic activity for 2001 and 2003* (percentage points)

	2002				*2003*			
	Mar	*Jun*	*Sep*	*Dec*	*Mar*	*Jun*	*Sep*	*Dec*
Activity and inflation								
GDP[a]	1.1	1.5	1.9	2.1	2.2	2.2	2.2	2.2
Inflation[a]	0.9	1.2	1.5	1.8	1.8	1.9	1.9	1.9
Investment[a,b]	5.4	8.4	9.6	10.8	10.8	10.8	10.9	11
Consumption[a]	0.7	1.1	1.3	1.5	1.5	1.5	1.5	1.5
Labour market								
Unemployment[c]		0.3	0.4	0.5	0.6	0.6	0.6	0.7
Participation[d]		0.2	0.3	0.4	0.4	0.5	0.6	0.6
Employment[a,e]		0.5	0.7	0.8	1	1	1	1
Finance								
90-day bill rate[f]		1.4	1.9	2.2	2.5	2.7	2.9	3
Exchange rate[g]		1.8	2.5	3	3.5	4	4.4	4.7
Real Share Price[a,h]	9.6	13.2	17.2	19.3	19.9	20.1	20	20.2

* *See notes to Table 2*

Appendix 2A: Data

The forecasts presented in this publication are conditional on ABS National Accounts data through to the December quarter 2001; the December quarter 2001 Consumer Price Index (weighted median); monthly data to January 2002 for total employed and unemployed persons; and monthly data to February for the 90-day bank bill rate and the trade-weighted index of the Australian dollar. The 90-day bill rate for the March quarter this year is the average rate over the quarter.

The forecasts use data through December 2001 for US GDP; through January 2002 for consumer prices, M2 money supply and commodity prices; through February for the unemployment rate and the effective Federal Funds rate. US GDP, consumer prices, Federal Funds rate, M2 and unemployment rate data were obtained from the Federal Reserve Economics Databank (FRED) at the Federal Reserve Bank of St. Louis (www.stls.frb.org/fred/). All other data were obtained from *Datastream*. The commodity price index is the Commodity Research Bureau (CRB) spot raw industrial index (www.crbindex.com). Seasonally adjusted data are used where available.

2. United States

Lei Lei Song, Peter Summers and Anne Leahy

2.1 Outcomes

Over the past few months there have been a number of indications of a more positive outlook for the US economy, having been officially declared (by the National Bureau of Economic Research) in November 2001 to have been in a period of recession[1] since March 2001. The US National Accounts showed marginally positive growth in the December quarter, stronger than most had expected. Data in the first two months of this year suggest that unemployment may have peaked, after a jump of up to 1.8 percentage points in 2001. The Institute of Supply Management (formerly NAPM) measure of manufacturing activity (PMI) indicated positive growth in February, ending 18 consecutive months of decline. Consumer confidence, measured by University of Michigan Index of Consumer Sentiment, shown in Figure 1, has recovered to the pre-September 11 levels, though it is still some way from its peaks in 2000.

Perhaps more significantly, the Federal Reserve left its interest rates unchanged at its January meeting for the first time since January 3, 2001, when it started a series of interest rate cuts amounting to 4.75 percentage points in total. The current Federal Funds rate of 1.75 per cent is at its lowest level since the early 1960s. Expansionary monetary policy and massive fiscal stimulus after September 11 suggest that the US economy could well begin a new expansion soon. The recent performance of the US economy is summarised in Table 5.

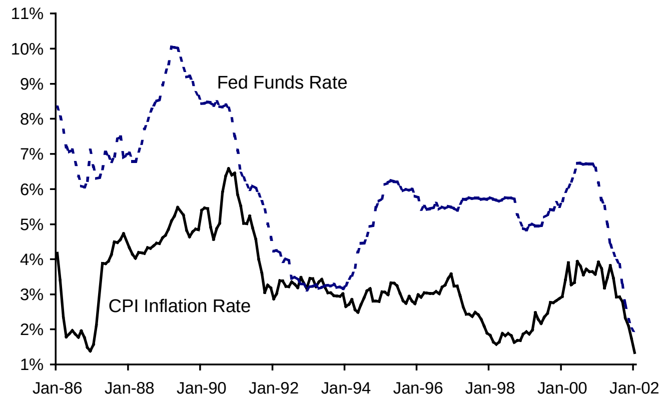
Table 5. United States economic activity

	2000	2001			
	Dec	*Mar*	*Jun*	*Sep*	*Dec*
GDP	2.8	2.5	1.2	0.5	0.4
Inflation	3.4	3.4	3.4	2.7	1.9
Commodity Prices[2]	-5.8	-5.4	-5.9	-9	-13.9
Unemployment[3]	4	4.2	4.5	4.8	5.6
Federal Funds	6.5	5.6	4.3	3.5	2.1

It should be noted that in January 2002, consumer price inflation reached its lowest level since 1964. In the past eight months, the inflation rate has declined drastically from 3.6 per cent to 1.1 per cent. Figure 11 plots the US inflation rate over the past sixteen years, as well as the Fed Funds rate. The decline in inflation is mainly due to weak demand and lower energy prices. Higher government spending after September 11 may be able to keep the US economy away from the deflation spiral being experienced by Japan and parts of Asia.

The figure also implies that monetary conditions in the US are highly expansionary at present with real short-term interest rates similar to the levels in the early 1990s.

Figure 11 US Inflation and Interest Rate: Jan 1986 to Jan 2002



2.2 Outlook

Melbourne Institute forecasts for the US economy, reported in Table 6, suggest that economic activity will continue to pick up in the first half of 2002 and will then return to the trend of the past ten years. As a result, unemployment will fall, but inflation will rise only slightly over the forecast period. The forecast V-shape strong recovery represents an optimistic outlook for the US economy in the near future.

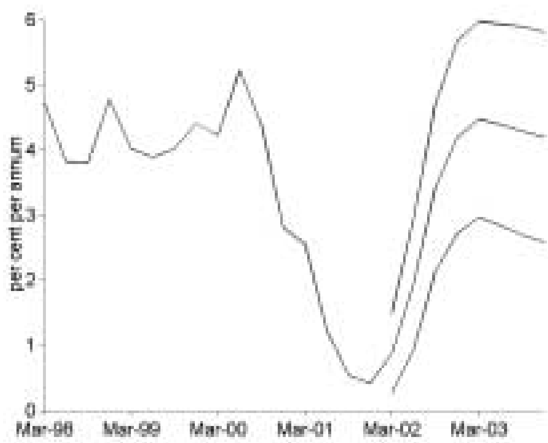
Table 6. Melbourne Institute forecasts of United States activity

	2002				2003			
	Mar	*Jun*	*Sep*	*Dec*	*Mar*	*Jun*	*Sep*	*Dec*
GDP	0.9	1.9	3.4	4.2	4.5	4.4	4.3	4.2
Inflation	**1**	0.6	0.9	1.4	1.8	1.9	2	2
Commodity Prices	**-9.5**	-8.1	-2.6	5.5	4.5	4.4	4.3	4.1
Unemployment	**5.6**	5.4	5.2	5.1	4.9	4.8	4.6	4.5
Federal Funds	**1.7**	1.9	2	2.2	2.3	2.5	2.6	2.8

As Figure 12 shows, US GDP growth is expected to have bottomed in the December quarter of 2001. While still a risk, negative economic growth in the first half of 2002 looks unlikely. GDP growth is forecast to accelerate to above 4 per cent by the end of 2002. Nevertheless, the predicted high growth rates could still prove to be too optimistic, as indicated by the big error bands in the Figure.

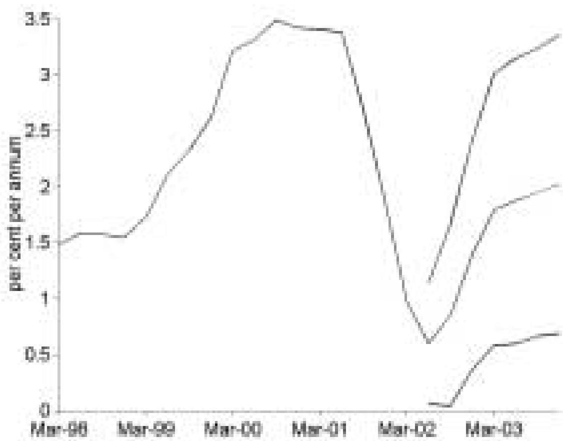
[1] Defined by the NBER as a "significant decline in activity spread across the economy, lasting more than a few months, visible in industrial production, employment, real income, and wholesale-retail trade".
[2] Spot raw industrial sub index, Commodity Research Bureau.
[3] Unemployment rate as per cent of labour force, average for the quarter.

Figure 12. United States GDP growth, actual and forecast (year-ended percentage change)



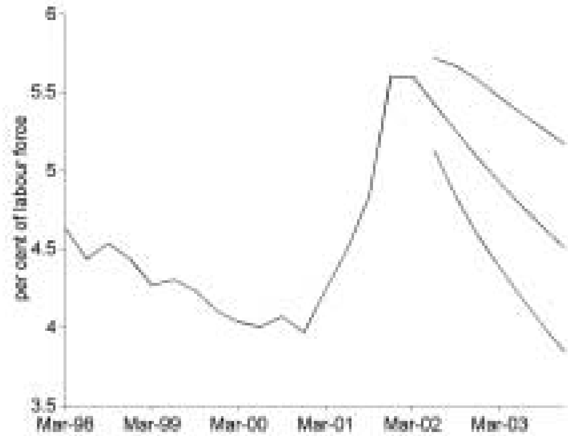
The forecasts for the US Fed Funds rate suggest that after one year of interest rate cuts, monetary tightening may occur late this year. However, it is more likely that the Federal Reserve will keep the Funds rate at the current level, as in the early 1990s when the rate was kept at 3 per cent for more than sixteen months.[4] The future outcome will depend on the inflation outlook of the US economy.

Figure 13. United States Inflation, actual and forecast (year-ended percentage change)



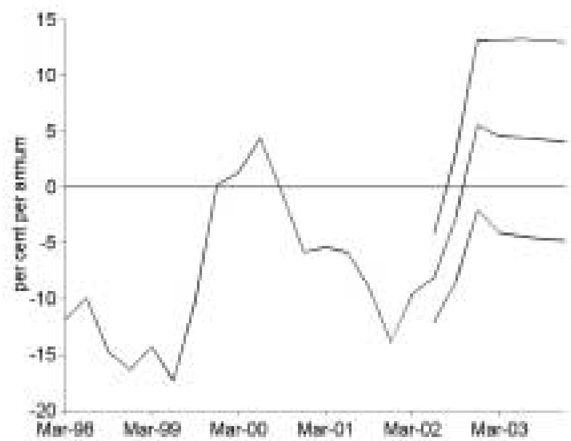
US inflation is forecast to gradually rise over the forecast period after a fall in the first half of 2002, as shown in Figure 13. It is expected that in 2003, inflation will be about 2 per cent. Such an outcome would prove to be a very unusual situation for the US after 1964. The only period longer than one year and with sustained inflation lower than 2 per cent, was from late 1997 to mid 1999 when the Asian financial crisis occurred. Ongoing low inflation suggests that the Federal Reserve may not begin to tighten monetary policy in the next two years.

Figure 14. United States unemployment rate, actual and forecast



As the economy picks up, the unemployment rate is forecast to decline from its peak of 5.8 per cent in late 2001. Figure 14 shows that a renewed period of economic expansion should see the unemployment rate fall to about 4.5 per cent by the end of 2003.

Figure 15. CRB commodity price index, actual and forecast (year-ended percentage change)



While the CRB industrial commodity price index is forecast to weaken further in the first half of this year, the expected economic recovery should drag it higher in late 2002, a dramatic turnaround from the decline over the past two years. As the economy accelerates, the commodity price index will rise substantially in 2003.

[4] From mid 1992 to mid 1993, US inflation was also about 3 per cent.

Appendix 2A: Precision of Melbourne Institute Forecasts for the United States

Measures of precision for the various forecasts for the United States are reported below. Each of the tables in this section gives the standard deviation of the indicated forecast, based on 2,000 simulations of the Institute's forecasting model.

Table 7. Precision of Melbourne Institute forecasts of United States activity (percentage points)

	2002				*2003*			
	Mar	*Jun*	*Sep*	*Dec*	*Mar*	*Jun*	*Sep*	*Dec*
GDP	0.6	1	1.3	1.5	1.5	1.5	1.6	1.6
Inflation		0.5	0.8	1	1.2	1.3	1.3	1.3
Commodity Prices		3.9	5.8	7.6	8.6	8.8	8.9	8.9
Unemployment		0.3	0.4	0.5	0.5	0.6	0.6	0.7
Federal Funds		1	1.5	1.8	2	2.2	2.4	2.5