

STATEMENT No. 2—THE BUDGET AND THE ECONOMY

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STATEMENT No. 2—THE BUDGET AND THE ECONOMY

Overview

The economy sank deep into recession in 1982-83 as the forces instrumental in bringing the earlier expansion to a halt—principally large increases in domestic costs, international recession and high domestic and overseas interest rates—exerted a continuing influence, and as widespread drought took its toll.

Private investment fell sharply and private consumption spending weakened. In response, imports fell and stocks were reduced markedly. Fiscal policy became much more stimulative but the impact of this was not felt until the second half of the fiscal year. As business responded to high labour costs, a slump in profitability and weakening demand, employment contracted sharply and unemployment spiralled to rates not experienced since the 1930s.

Finance was readily available over most of the year as reflected in the relatively high growth of most of the financial aggregates. Despite falls in overseas interest rates and the depth of the domestic recession, domestic interest rates remained relatively high under the influence of continuing inflation and large and rapidly increasing public sector borrowings.

Wage increases slowed as the labour market deteriorated and the 'wages pause' took effect in the second half of the year. Inflation continued at a high rate and by the second half of the year was more than double the average of our major OECD trading partners. Increased productivity and a slowing in wages growth brought only a partial unwinding of past increases in real unit labour costs and business profitability and cash flow continued to be depressed. Reflecting these pressures the value of the Australian dollar declined substantially over the year.

A continuing application of fiscal stimulus, the breaking of the drought, inventory cycle effects and a strengthening in the economies of some of our major trading partners indicate an improved outlook for domestic economic activity during 1983-84. However, with uncertainties regarding the durability of the pick-up and the level of labour costs still constraining employers' reactions, and with the labour force continuing to grow, some further rise in unemployment during the year can be expected.

The task ahead is to ensure that the pick-up in domestic economic activity in prospect for 1983-84 is sustained and transformed into lasting recovery. For that to occur it will be essential that the cost and price moderation which began in 1982-83 should continue and be supported by appropriate, and consistently applied, economic policies.

This Statement discusses those issues in four Parts. Part I reviews domestic economic developments during 1982-83 while Part II looks briefly at recent and prospective developments in the world economy. Part III discusses aspects of the Government's policy approach. Part IV assesses economic prospects for 1983-84 and beyond. Unless otherwise noted, values of goods and services are expressed in constant price (real) terms, with growth rates for half years based on seasonally adjusted data and expressed as annual rates.

PART I: REVIEW OF DOMESTIC ECONOMIC DEVELOPMENTS
IN 1982-83

Production and Demand

National accounts data indicate that the pace of activity in the non-farm sector of the economy expanded relatively strongly in 1980-81 and into the first half of 1981-82. Gross non-farm product declined in the second half of 1981-82, picked up a little in the first half of 1982-83 but then declined sharply in the second half of the year to about 2 per cent below its peak (see Table 1 and Chart 1). However, undue weight should not be attached to the precise pattern or timing of the more recent movements in these preliminary national accounts aggregates which are subject to revision.⁽¹⁾

Table 1: Gross Domestic Product (Average 1979-80 prices)

	Gross non-farm product			Gross domestic product	
	Income-based estimate(a)	Expenditure-based estimate(b)	Gross farm product	Income-based estimate(a)	Expenditure-based estimate(b)
	Change on previous period (per cent)				
Year—					
1973-74	4.3	2.3	6.4	4.4	2.5
1974-75	0.9	2.2	11.4	1.6	2.7
1975-76	2.1	3.6	8.1	2.5	3.9
1976-77	2.7	3.0	2.5	2.7	2.9
1977-78	1.1	0.7	-2.0	0.9	0.5
1978-79	3.9	4.8	19.6	4.9	5.7
1979-80	2.2	2.7	-11.4	1.2	1.7
1980-81	4.7	3.7	-11.2	3.6	2.8
1981-82	1.7	2.0	16.1	2.5	2.8
1982-83	-1.0	-0.8	-17.7	-2.0	-1.8
Half year(c)—					
1981-82 I	1.8	3.8	35.1	3.5	5.4
1981-82 II	-1.9	-2.8	7.7	-1.3	-2.1
1982-83 I	1.5	2.0	-29.9	-0.7	-0.2
1982-83 II	-3.9	-3.4	-18.5	-4.8	-4.2

(a) Income-based estimate as published.

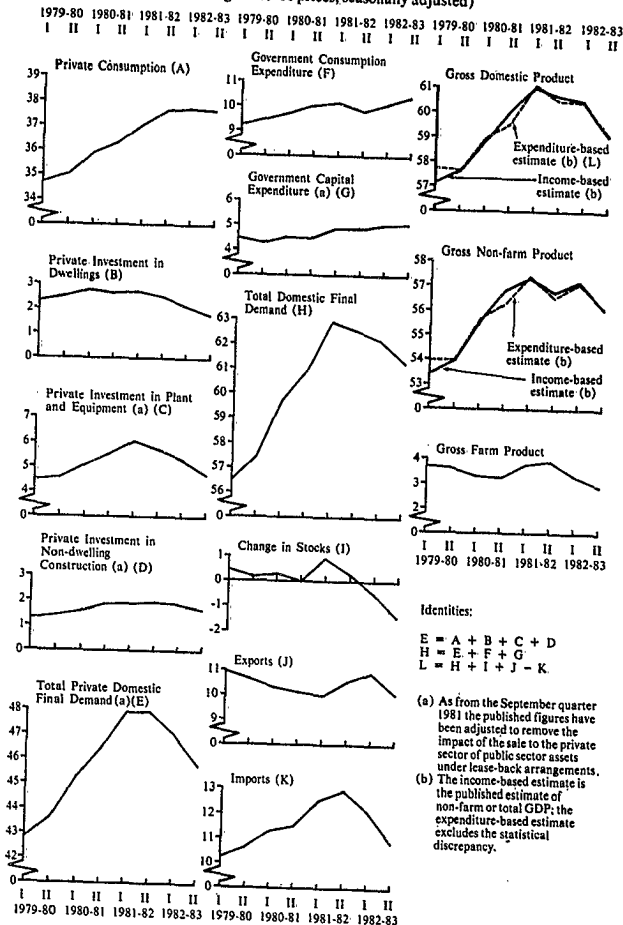
(b) Expenditure-based estimate derived by the subtraction of the statistical discrepancy from (a).

(c) Seasonally adjusted, annual rates.

Within the non-farm sector there were some especially large declines in particular areas of private activity in 1982-83. There was a very sharp fall in manufacturing gross product—of the order of 11 per cent—which far exceeded the dimensions of the contraction in manufacturing activity in 1974-75. Private investment in dwelling construction declined by around 25 per cent. In contrast, in the non-dwelling construction industry growth in government construction activity helped to support activity levels in the face of a fall in private non-dwelling construction activity.

⁽¹⁾ There is a possibility that revisions to the preliminary estimates may be more marked in periods of rapid change, such as the recent past; for instance, the initial estimate (at average 1966-67 prices) of a decline of 2.6 per cent in non-farm GDP in 1974-75 was subsequently revised to an increase of 0.5 per cent with the latest estimate showing an increase of 0.9 per cent in average 1979-80 prices. Over recent years there does not appear to be any pattern in the direction of revisions.

Chart 1: Levels of the Main Economic Aggregates
(\$'000 m, average 1979.80 prices, seasonally adjusted)



Identities:

$$E = A + B + C + D$$

$$H = E + F + G$$

$$L = H + I + J - K$$

- (a) As from the September quarter 1981 the published figures have been adjusted to remove the impact of the sale to the private sector of public sector assets under lease-back arrangements.
- (b) The income-based estimate is the published estimate of non-farm or total GDP; the expenditure-based estimate excludes the statistical discrepancy.

The recession in the non-farm sector coincided with a sharp contraction in farm output and incomes. As a result, both the income and expenditure-based estimates of gross domestic product declined by about 2 per cent in 1982-83, the first financial-year decline recorded in either estimate since 1952-53 and the largest since 1946-47.

The decline in gross farm product reflected the effects of the worst drought on record in many parts of eastern and southern Australia. Widespread rains in the first half of 1983 eventually broke the drought in most areas but major flooding then occurred in southern Queensland and northern New South Wales.

The drought severely affected cereals production, with the national wheat crop in 1982-83 estimated at 8.8 million tonnes, 7.5 million tonnes (or 46 per cent) lower than in 1981-82, notwithstanding a record crop in Western Australia. As the drought encouraged higher slaughter rates, the output of meat initially rose and herd sizes were reduced. It is estimated that cattle numbers declined by around 7 per cent over the year to March 1983 and sheep numbers by around 3 per cent. Calvings and lambings in 1983-84 will be adversely affected.

Taken together, these various influences led to a large, though not unprecedented, decline in gross farm product in 1982-83. At the same time, farm product prices, which had fallen the year before mainly because of a continuation of subdued demand on world markets for Australian rural products, remained depressed. Combined with increased prices for material inputs and labour, this resulted in a decline in farmers' 'terms of trade'. Overall, farm incomes deflated by the price deflator for private consumption expenditure fell by 53 per cent in 1982-83, much the largest percentage fall recorded in the last 30 years.

As shown in Chart 1 and Table 2, the weakness in activity over the past eighteen months reflected a decline in private final domestic demand and stock decumulation, only partly offset by a rise in public final demand, moderate growth in exports and a fall in imports.

The major component of the decline in private final domestic demand in 1982-83 was the continuing contraction in *private investment in plant and equipment and non-dwelling construction*¹⁵ which began in 1981-82 under the influence of rising domestic labour costs, and higher interest rates, which reduced international competitiveness and profitability against the background of severe international recession and the softening of international energy prices. By the second half of 1982-83 private investment in plant and equipment was about 22 per cent lower and private investment in non-dwelling construction about 16 per cent lower than their respective pre-recession peak levels, representing a fall in total business fixed investment equivalent to some 2.6 per cent of GDP. Investment in manufacturing—particularly in the basic metal products industries—was the most hard hit. Mining investment continued to grow relatively strongly

¹⁵ The national accounts estimates for recent years adjust the components of new fixed capital expenditure for major sales of capital assets by the public sector to the private sector, mainly under lease-back arrangements. The Statistician treats such transactions as additions to private fixed capital expenditure and reductions in public fixed capital expenditure at the time of sale. To provide a better indication of underlying trends the discussion in this section is based on figures adjusted, for the last two financial years, to remove the impact of such sales from the estimates of both public and private sector fixed capital expenditure (and of public and private final domestic demand).

Table 2: Contributions to Changes in Demand and Supply (Average 1979-80 prices)

Year	Final domestic demand					Supply						
	Private investment in non-dwelling construction and equipment (e)		Private investment in dwellings		Private consumption		Change in stocks		Exports		Total supply	
	Private investment in non-dwelling construction and equipment (e)	Private investment in dwellings	Private consumption	Private final demand (e)	Public final demand (e)	Private non-farm authority	Farm and public authority	Statistical discrepancy	Total demand	GDP		Imports
1979-80	0.9	0.4	0.0	1.1	0.1	0.5	-1.3	1.1	-0.4	1.1	1.0	1.1
1980-81	1.3	0.1	1.7	1.9	0.9	-0.5	-0.9	0.7	0.7	4.5	3.1	4.5
1981-82	1.3	-0.1	1.7	2.9	0.6	0.1	0.6	-0.1	-0.2	4.0	2.1	1.9
1982-83	0.4	-0.9	-1.5	-2.1	0.7	-1.6	-0.5	0.2	-0.2	-3.5	-1.7	-3.5
Half-year (e)												
1981-82 I	1.2	0.1	0.7	2.0	0.7	0.6	0.7	-0.4	-0.8	2.9	1.4	2.9
1981-82 II	0.7	-0.3	-0.3	1.1	-0.5	-0.4	0.5	0.9	0.3	1.1	-0.5	0.5
1982-83 I	0.1	-0.5	-0.8	1.2	0.6	-0.7	-0.4	0.4	-0.2	-1.5	-0.3	-1.2
1982-83 II	-0.1	-0.5	-1.1	-1.7	0.5	-1.4	0.1	-1.1	-0.2	-3.8	-2.0	-3.8

(a) As from the September quarter 1981, the published figures have been adjusted to remove the impact of the sale to the private sector of public sector assets under lease-back arrangements. In this adjustment, estimates of the value of such sales are subtracted from the published estimates of private investment in non-dwelling construction and equipment and added back to the published estimates of public investment expenditure.

(b) Calculated according to the formula $x_t = (y_t - y_{t-1}) \times 100 / D_{t-1}$, where x_t is the estimate appearing in the table for period t , y_t is the constant price value of the aggregate concerned in period t and D_{t-1} is total demand or supply in period $t-1$.

(c) Seasonally adjusted, not at annual rates.

in 1982-83, largely reflecting the 'pipeline' of investment that results from the long lead times involved in such projects, but its pace slowed sharply in the second half of the year. Survey data of expectations suggest that private investment will decline in all major sectors surveyed in 1983-84 (see Table 3).

Table 3: New Fixed Capital Expenditure by Private Enterprises in Selected Industries (Current prices)

Year	Manufacturing			Finance	Other selected industries	Total
	Mining	Basic metal products	Other manufacturing			
1979-80	4.5	61.8	-4.5	4.5	15.1	-1.5
1980-81	71.8	118.5	27.3	46.4	25.9	26.1
1981-82	50.2	52.2	6.1	20.5	18.6	29.4
1982-83	24.8	-21.4	-7.0	-12.7	(b)8.2	-7.3
1983-84(c)	-25.4	-56.7	-12.4	-29.5	(b)-8.8	-18.7
Half-year						
1981-82 I	60.5	58.3	5.8	20.8	19.4	41.5
1981-82 II	42.4	47.2	6.5	20.3	17.9	18.1
1982-83 I	46.9	7.4	-2.3	1.3	(b)10.9	-9.3
1982-83 II	6.2	-46.3	-11.7	-26.1	(b)1.8	-5.1

(a) Finance, insurance, real estate and business services (includes leasing to other sectors).

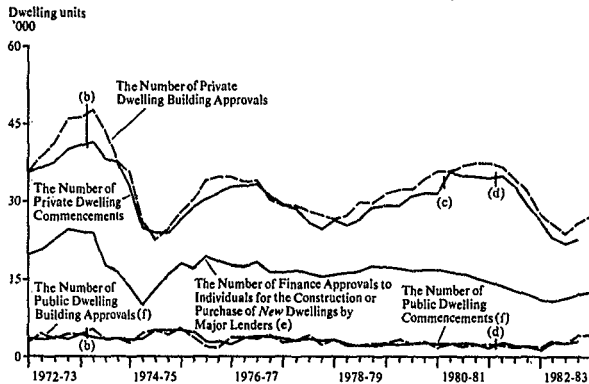
(b) Growth rates shown have been adjusted approximately for a change to the treatment of unsold speculatively built construction projects.

(c) Based on expectations data from the Statistician's July/August surveys for 1982 and 1983.

Another contributor to the weakening in private final domestic demand—though of lesser magnitude in its direct impact—was the slump in *private investment in dwellings*. This began in 1981-82 and persisted through 1982-83, although by the end of the year the forward indicators of dwelling construction activity suggested that a pick-up in housing construction was underway in both the private and public sectors.

As shown in Chart 2, since about 1975-76 the relationship between lending for new dwellings by the main housing finance institutions and total dwelling construction activity has weakened, due in part to a surge in dwelling investment in areas less reliant on traditional sources of finance such as retirement housing, accommodation in resort areas and, for a time, housing associated with resource projects. This surge appears to have passed for the moment and the lift in dwelling building approvals in the second half of 1982-83 mainly reflects an increase in lending by the major housing finance institutions. That increase includes a very large increase in lending for the purchase of established dwellings, which contributes indirectly to increased dwelling construction activity through its effect on relative prices of new and established dwellings and as a source of funds to sellers of established dwellings for the purchase of new dwellings. Factors behind the increased lending for housing include an improved deposit intake of housing finance institutions, particularly savings banks, as a result of a decline in the general interest rate structure and a consequent improvement in their competitive position as borrowers.

Chart 2: Forward Indicators of Dwelling Construction Activity (a)

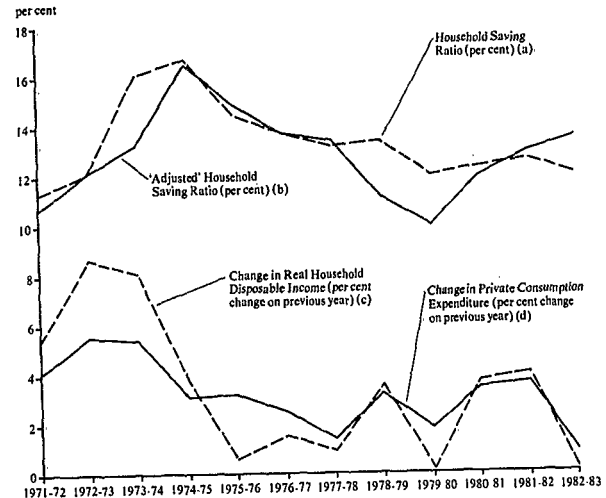


- (a) Quarterly data; seasonally adjusted, thousands of dwelling units.
 (b) Break in commencements and building approvals series due to changes in the definition of non-house dwellings from the September quarter 1973.
 (c) Break in commencements series due to the change from a census to a survey collection method from the September quarter 1980.
 (d) Break in commencements series due to changes in the method of processing of survey returns from the September quarter 1981.
 (e) Major lenders are defined as savings banks, trading banks and permanent building societies; these finance approvals relate only to loan for owner occupation.
 (f) Derived as the difference between the seasonally adjusted number of dwelling commencements (or approvals) and the seasonally adjusted number of private sector dwelling commencements (or approvals).

After growing relatively strongly in 1980-81 and in 1981-82, the rate of increase in private consumption expenditure slowed markedly in 1982-83 and expenditure fell in the second half of the year. One influence on this trend was a slowing in the growth of real household disposable income in 1982-83 (with a slight decline recorded in the second half of the year). In turn, this reflected the slowing in the growth of real average wage earnings, the fall in the number of persons employed and the slump in farm incomes—factors partly offset by strong growth in unemployment benefit payments (and cash benefits generally) and by the reduction in personal income tax rates from 1: November 1982. Heightened uncertainty in the face of rising unemployment and deteriorating economic conditions apparently offset any tendency for consumption to be maintained by drawing down savings, so that the aggregate household saving propensity increased, after adjusting for the effect on that aggregate of the sharp fall in income in the farm sector (see Chart 3).

Taken together, the decline in private investment and the weakening in the growth of private final consumption expenditure contributed to a marked (3.2 per cent) fall in private final domestic demand in 1982-83. This was partly offset by a rise in government consumption expenditure, by both Commonwealth and State and local govern-

Chart 3: Changes in Real Household Disposable Income and Private Consumption and the Household Saving Ratio



- (a) Ratio of household saving to household disposable income.
 (b) The 'adjusted' household saving ratio is derived from the ratio of private consumption to adjusted household disposable income in which farm income is replaced by its sixteen quarter moving average so as to reduce the effect of year to year swings in farm income. The 'adjusted' saving ratio seeks to abstract from the volatility in farm income which tends not to be reflected to nearly the same degree in farm consumption.
 (c) Change in household disposable income deflated by the implicit price deflator of private final consumption expenditure.
 (d) Change in private final consumption expenditure in average 1979-80 prices.

ment authorities, and strong growth in capital expenditure by State and local government authorities. Growth in exports of goods and services also worked to offset, to some extent, the decline in private final domestic demand in 1982-83; this reflected strong growth in non-rural exports which outweighed a decline in rural exports.

The effect of the decline in final demand in 1982-83 on domestic production was exacerbated by a large run-down in private non-farm stocks particularly in the second half of 1982-83 as businesses, faced by a squeeze on cash flows and profitability and continuing high interest rates, moved quickly to reduce inventories. The reduction in non-farm stocks following the rise in 1981-82 contributed nearly half of the decline in total demand in 1982-83, slightly more than contributed by the fall in private business fixed investment. Farm stocks also declined due to the effects of drought.

In marked contrast to the previous year, when there was a surge in imports, *imports of goods and services fell sharply in 1982-83* due to the weakening in final demand—particularly the decline in import-intensive investment in plant and equipment—the decumulation of private non-farm stocks and some improvement in Australia's relative competitiveness as a result of continuing depreciation of the exchange rate. The resulting fall in import penetration reduced the impact on domestic production of the full effects of the decline in demand. The fall in the volume of imports in the year was equivalent to about 2.2 per cent of gross domestic product.

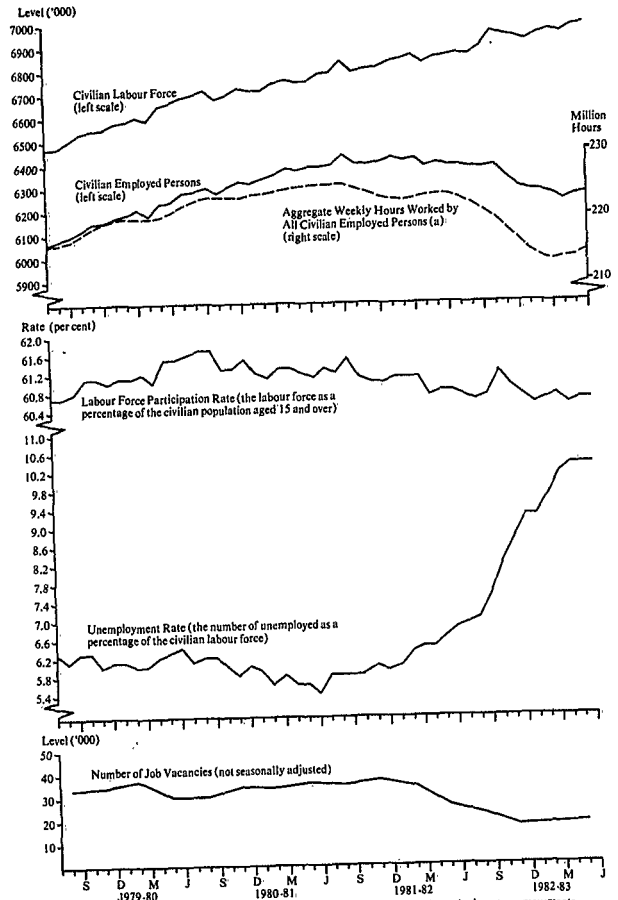
The Labour Market and Labour Productivity

The total number of persons employed in the non-farm sector (measured consistently with the national accounts) fell by 1.6 per cent in 1982-83—a somewhat larger fall than the decline in non-farm product—while the corresponding measure of aggregate hours worked fell by 2.5 per cent. The total number of persons in civilian employment in 1982-83 fell by 1.4 per cent, the largest fall for 30 years.

Hence 'labour shedding' took the form of reductions both in numbers employed and in hours worked by those in employment—through greater use of part-time employees, reduced overtime and short-time work arrangements. Average labour productivity (per hour worked) in the non-farm sector increased substantially in the first half of the year, when there was a small increase in non-farm product, and remained at around this level in the second half of the year, when non-farm product fell sharply. The overall result was thus somewhat similar to the experience in 1974-75 when rapid growth in labour costs also played a large role in bringing on the recession and when labour productivity growth increased relative to the change in non-farm product. These developments appear to have reflected, in large part, strong efforts by employers—conditioned by a belief that there would be no early recovery in profits and by the experience of 1974-75—to rationalise their labour requirements in response to increased labour costs and consequently reduced profits and cash flows. The completion of construction and coming on stream of some resource projects may have contributed to the rise in productivity, although the decline in manufacturing output has probably been such that the change in the industry composition of output has detracted from growth in measured productivity in 1982-83. Some of these employment responses are purely cyclical (e.g. reduced overtime and short-time arrangements) and should be reversed when demand picks up. But the trend towards economising in labour use—with on-going implications for employment—may continue for some time until a better relationship between labour costs and profits can be firmly re-established.

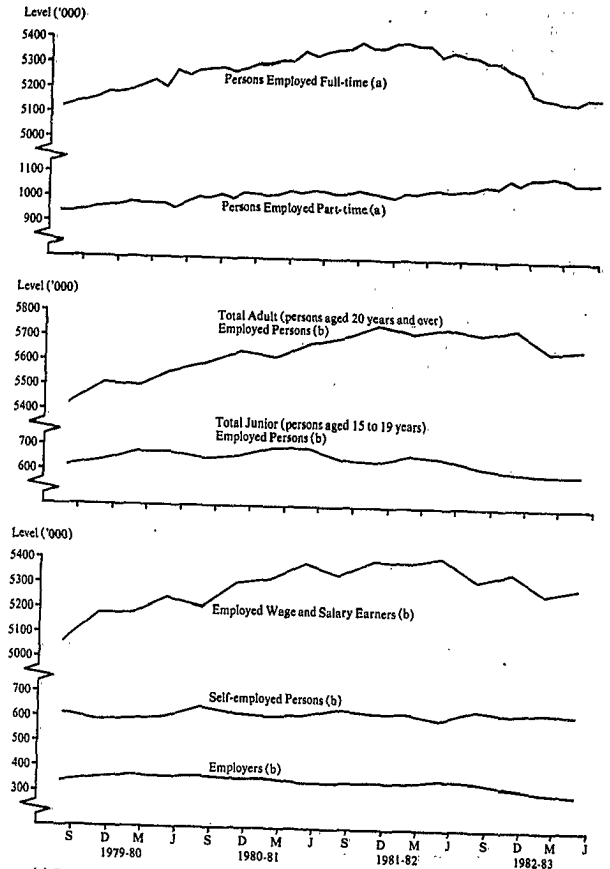
The decline in employment, which began in the second half of 1981-82, gathered momentum in 1982-83 (see Chart 4). The number of persons employed in the private sector contracted by around 3.3 per cent over the course of 1982-83 but this was offset to some degree by an increase in employment in the public sector. Overall, a continued rise in part-time employment was more than offset by a substantial decline in full-time employment (see Chart 5). The numbers of employees and employers both fell, but the number of self-employed remained broadly unchanged. Data on employment, vacancies and overtime suggest that the decline in the demand for labour levelled off towards the end of 1982-83.

Chart 4: Labour Market Aggregates (seasonally adjusted)



(a) The series shown has been smoothed by Treasury to minimise seasonal and erratic short-term movements.

Chart 5: Selected Components of Civilian Employment



(a) Seasonally adjusted, monthly data.
 (b) Data for February, May, August and November of each year; not seasonally adjusted.

The decline in employment in 1982-83 was particularly evident in the manufacturing and construction industries. By contrast, employment continued to rise in some service industries. Reflecting these trends, the employment of males, particularly tradesmen and other manual workers, was especially adversely affected. As well, for the second successive year, there was a large contraction in the number of juniors in employment, partly reflecting a longer-term decline in the junior labour force but mainly due to the higher susceptibility of juniors to deteriorating labour market conditions—the latter largely a result of junior wage rates which have evidently been set above the relative work value of the employees concerned.

The impact of the decline in employment on recorded unemployment in 1982-83 was cushioned to a small extent by an associated decline in the labour force participation rate, particularly for juniors and older males, which was reflected in a rise in the number of discouraged job-seekers who are classified as being outside the labour force. Despite the deterioration in employment during the year, the labour force grew at the same rate as in 1981-82. Recorded unemployment thus rose dramatically over the year; the seasonally adjusted number of persons unemployed increased by 266 100 over the year to the June quarter 1983 to 719 300 persons and the unemployment rate rose from 6.6 per cent to 10.3 per cent. Reflecting the changes in the structure of employment already noted, almost the entire rise in unemployment over the last year was in persons seeking full-time work, with adult males accounting for around two-thirds of this increase. Unemployment of juniors also rose sharply to take the seasonally adjusted unemployment rate for juniors seeking full-time work to 26.9 per cent in the June quarter 1983 (see Table 4).

Table 4: Labour Market

Year (a) —	The number of employed persons			Unemployment			Junior labour market	
	Full-time	Part-time	Total	Persons seeking full-time work	Persons seeking part-time work	Total unemployment	Persons employed (a)	Full-time unemployment rate (b)
	Change on a year earlier (per cent)	Change on a year earlier (per cent)	Change on a year earlier (per cent)	('000s)	('000s)	(per cent)	Change on a year earlier (per cent)	(per cent)
1979-80	2.0	3.8	2.3	336.0	67.9	6.1	2.1	18.6
1980-81	2.2	5.7	2.7	327.5	65.3	5.9	4.5	17.2
1981-82	1.2	1.2	1.2	349.8	69.9	6.2	-3.3	17.5
1982-83	-2.6	4.7	-1.4	538.3	83.8	9.0	-7.9	23.6
Quarter (c) (d) —								
1981-82 —								
Sept.	1.8	2.3	1.9	333.6	63.4	5.8	..	16.2
Dec.	1.7	0.6	1.6	334.5	66.5	5.9	-2.6	16.9
Mar.	1.4	1.0	1.3	352.8	73.2	6.2	-4.0	18.0
June	..	0.9	0.2	376.9	76.2	6.6	-6.3	19.1
1982-83 —								
Sept.	-0.8	2.5	-0.3	408.1	82.2	7.1	-5.1	19.5
Dec.	-2.3	6.4	-0.9	521.1	81.8	8.7	-6.5	22.3
Mar.	-4.0	6.6	-2.4	587.9	82.4	9.6	-10.8	26.1
June	-3.3	3.4	-2.2	631.3	88.0	10.3	-9.1	26.9

(a) Persons employed aged 15-19 years.
 (b) The number of juniors (those aged 15-19 years) seeking full-time work as a percentage of the junior full-time labour force.
 (c) Based on the average of the monthly observations for the period.
 (d) Seasonally unadjusted except for the measures of unemployment and the full-time unemployment rate for juniors.

Incomes and Labour Costs

The marked deterioration in the labour market, reinforced by the adoption of the 'wages pause' from December 1982, led to a sharp slowing in increases in award wage rates and earnings during 1982-83 (see Table 5).

Award rates of pay grew strongly in the second half of 1981-82 and the early months of 1982-83. In part, this reflected increases in individual awards following the May 1982 National Wage Case decision which, while ostensibly not recognising the 1981 metal industry agreement as establishing a 'community standard', facilitated the ratification of agreements that were in accordance with it. As a result, wage increases comparable to those under the metal industry agreement spread rapidly to most areas of employment covered by industrial awards. A survey⁴⁹ of 60 major Federal awards estimated that about 83 per cent of employees covered by these awards received award wage increases in the three months from June to August 1982, with a further 15 per cent receiving increases in the following three months.

Table 5: Award Rates of Pay and Earnings.

Year—	Award rates of pay: adult wage and salary earners ^(b)	Average weekly earnings (survey basis)			Average earnings (national accounts basis) ^(a)	
		Full-time adult ordinary time earnings ^(c)	Total earnings ^(d)	Total earnings in real terms ^(e)	In nominal terms	In real terms ^(e)
1979-80	8.8	9.4	9.9	-0.2	9.5	-0.6
1980-81	11.7	14.2	13.5	3.8	13.2	3.5
1981-82	12.2	(f)13.3	(f)13.6	(f)3.9	13.7	4.0
1982-83	10.8	14.2	11.2	-0.1	11.9	0.5
Half year (g)—						
1981-82 I	10.4	(f)12.9	(f)12.2	(f)2.9	12.1	2.9
II	16.7	16.8	18.5	7.4	17.3	6.3
1982-83 I	12.0	16.8	10.5	-1.8	15.9	3.0
II	3.3	7.1	6.0	-3.4	1.4	-7.6

(a) Non-farm wages, salaries and supplements per non-farm wage and salary earner.

(b) Growth rates are based on weighted average figures centred on the middle of the period.

(c) For the June quarter 1981 and earlier periods the figures are based on estimates of full-time non-managerial adult male average weekly ordinary time earnings derived from payroll tax and other returns for the whole quarter. From the September quarter 1981 the estimates are based on a new survey of private and government employers and relate to average weekly ordinary time earnings of all adult full-time employees for a pay period around the middle of each quarter.

(d) For the June quarter 1981 and earlier periods the total average weekly earnings figures are based on the former payroll tax based series on a so-called 'male units' basis. From the September quarter 1981 the estimates are based on the new survey and relate to total average weekly earnings for all employees.

(e) Deflated by the implicit price deflator of private final consumption expenditure.

(f) Based on links to the former payroll tax based series at the September quarter 1981.

(g) Growth rates are at annual rates and use seasonally adjusted data for the 'old' average weekly earnings series, the 'old' average weekly ordinary time earnings series and the average earnings series on a national accounts basis; the award rates of pay series, the 'new' average weekly ordinary time earnings series and the 'new' average weekly earnings series are not seasonally adjusted.

Developments in various measures of wage rates and earnings are shown in Chart 6. The slowing in the rate of increase in award rates of pay apparent from September 1982 was not reflected in a corresponding slowing in average weekly ordinary time earnings of adult full-time employees until the second half of 1982-83 despite the introduction of short-time work arrangements in some areas. This lag appears to have reflected, *inter alia*, delays in the payment of award wage increases, the timing of the earnings surveys and differences in the coverage of the series. Changes in the composition of full-time employment may also have played a part⁴⁹. In the case of average weekly earnings, these factors were partly offset by reductions in overtime and the continuing shift to part-time employment.

Following a special Premiers' Conference held on 7 December 1982 the Commonwealth, State and Northern Territory Governments initiated a pause in wage and salary increases and in hours reductions for both public and private sector employees. This took the form of interventions in support of a pause before the relevant industrial tribunals and, in some cases, legislation to freeze the wages of public sector employees. The Australian Conciliation and Arbitration Commission agreed to apply a pause in wages and conditions from 23 December 1982 until at least 30 June 1983 and each of the State industrial tribunals agreed to similar pauses in their respective jurisdictions. Legislative arrangements extended the 'pause' to twelve months for employees of the Commonwealth and Western Australian Governments.

On 29 June 1983 a full bench of the Australian Conciliation and Arbitration Commission began hearing a National Wage Case on claims by the ACTU for the introduction of a centralised system of wage determination based on quarterly indexation of all award and over-award wage rates, commencing with the increase in the CPI from the March quarter 1983. Pending a decision in that case, the guidelines that applied under the 'wages pause' remain in effect.

Average award rates of pay increased only marginally—by 0.3 per cent—between January 1983 and June 1983, which suggests that the 'wages pause' was effective during this period. Earnings growth for the same period remained somewhat higher, but nevertheless also slowed considerably in the second half of 1982-83.

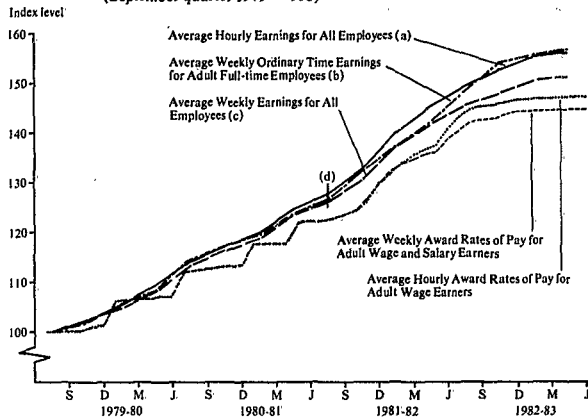
For 1982-83 as a whole, average weekly earnings for all employees rose by 11.2 per cent, and average weekly ordinary time earnings for adult full-time employees by 14.2 per cent. After deflation for movements in the consumer price index, real average weekly earnings fell over the course of 1982-83; by the June quarter 1983 they were comparable to their level in the December quarter 1981 but real average weekly ordinary time earnings remained 2.5 per cent above that level (see Chart 7). Over the three years to the June quarter 1983, real average weekly earnings increased by 4.4 per cent; for real ordinary time earnings the increase was 8.0 per cent.

The sharp falls in employment and the slowing in earnings growth during 1982-83 led to a slowing in the growth of wages, salaries and supplements and in the second half of the year that aggregate declined. However, this was partly offset by reductions in income tax scales in November 1982 and large increases in transfer payments from the

⁴⁹ Commonwealth Government Submission, Exhibit 9, to the June 1983 National Wage Case.

⁴⁹ This is discussed in a technical note on pages 88-95 of the *Information Paper on the Economy* submitted to the National Economic Summit Conference, April 1983.

Chart 6: Indexes of Wage Rates and Earnings
(September quarter 1979 = 100)

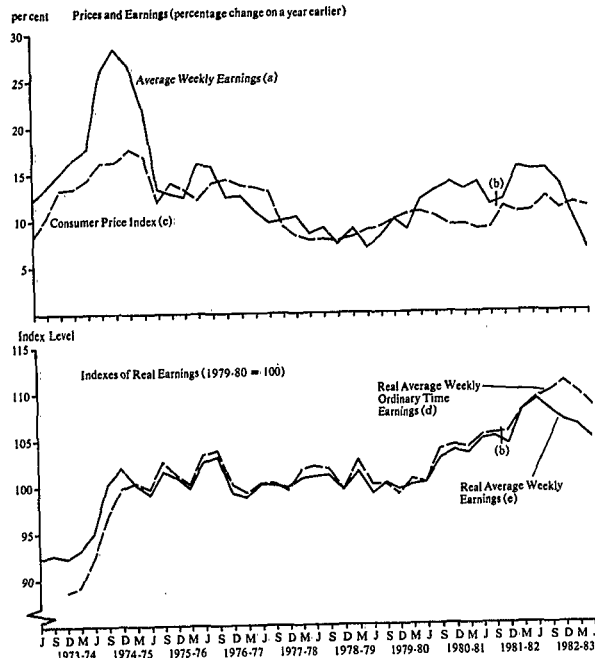


- (a) Average weekly earnings for all employees (linked to the 'old' seasonally adjusted male units series at the September quarter 1981) divided by average weekly hours worked by all employees. The latter series has been smoothed by Treasury to minimise seasonal and erratic short-term movements.
- (b) Average weekly ordinary time earnings for all adult full-time employees linked to the 'old' seasonally adjusted average weekly ordinary time earnings series for full-time non-managerial adult male employees at the September quarter 1981.
- (c) Average weekly earnings for all employees linked to the 'old' seasonally adjusted male units series at the September quarter 1981.
- (d) Break in series associated with change from payroll tax based earnings series to survey based earnings series. Further details provided in footnotes (a) to (c).

Commonwealth so that, after allowance for price increases, real household disposable income remained virtually unchanged in 1982-83. Details of some of the major components of household disposable income are shown in Table 6.

Real unit labour costs, which rose in 1981-82 as increases in hourly labour costs outstripped increases in prices and productivity, appear to have remained at a high level in 1982-83 but to have fallen in the second half of the year as wage increases slowed. Table 7 shows two measures of real unit labour costs. One is an estimate of such costs in the non-farm sector; this shows a decline in the second half of the year. However, this measure may be affected by shifts in the composition of output between the public, dwellings and unincorporated sectors and the private corporate sector. The second measure shows real unit labour costs in the private non-farm corporate sector and avoids possible distortions due to such shifts, but is available only on a financial year basis. Over recent years it shows a slightly stronger rise in real unit labour costs than the first measure.

Chart 7: Prices, Earnings and Real Earnings



- (a) Average weekly earnings for all employees linked to the 'old' seasonally adjusted male units series at the September quarter 1981.
- (b) Break in series associated with change from payroll tax based earnings series to survey based earnings series. Further details are provided in footnotes (a) and (d).
- (c) Based on six State capital cities consumer price index up to and including the June quarter 1981 and on the eight capital cities index thereafter.
- (d) Average weekly ordinary time earnings for all adult full-time employees linked to the 'old' seasonally adjusted average weekly ordinary time earnings series for full-time non-managerial adult male employees at the September quarter 1981, deflated by the six State capital cities consumer price index in the period up to and including the June quarter 1980 and by the eight capital cities index thereafter.
- (e) Average weekly earnings series described in footnote (a), deflated by the six State capital cities consumer price index in the period up to and including the June quarter 1980 and by the eight capital cities index thereafter.

Table 6: Household Incomes (Including Incomes of Unincorporated Enterprises)

Year	Wages, salaries and supplements	Income of farm unincorporated enterprises	Income of other unincorporated enterprises and from dwellings and dividends	Personal benefit payments to residents (a)	Household income	Income tax paid	Household disposable income	Real household disposable income (b)
Change on previous period (per cent)								
1979-80	11.3	13.8	10.1	8.7	11.1	17.5	10.2	0.1
1980-81	16.2	-15.3	14.0	12.9	14.0	16.6	13.4	3.1
1981-82	15.3	-7.7	18.0	16.3	15.1	21.0	13.7	4.0
1982-83	10.4	-48.7	15.2	22.0	11.0	8.2	11.4	0.1
Half year (c)—								
1981-82 I	13.9	26.2	25.3	15.2	16.6	16.2	16.2	6.6
II	17.3	-26.8	12.7	16.6	14.8	29.4	11.8	1.2
1982-83 I	14.5	-65.6	16.7	22.2	13.0	9.1	13.8	1.2
II	-1.5	-32.4	16.9	32.6	5.4	-14.4	9.5	-0.2

- (a) Includes unemployment and sickness benefits, family allowances, widows' age, invalid and repatriation pensions and other transfers to persons from general government.
 (b) Household disposable income deflated by the implicit price deflator for private final consumption expenditure.
 (c) Seasonally adjusted annual rates.

Table 7: Indexes of Average Real Unit Labour Costs (Average 1966-67 to 1972-73=100)

Year	Average real unit labour costs (a)—non-farm sector	Average real unit labour costs (b)—private non-farm corporate sector
1971-72	102	101
1972-73	101	100
1973-74	105	105
1974-75	110	109
1975-76	108	107
1976-77	108	106
1977-78	108	107
1978-79	105	104
1979-80	105	103
1980-81	105	102
1981-82	107	105
1982-83	107	107
Half year (c)—		
1981-82 I	105	n.a.
II	109	n.a.
1982-83 I	109	n.a.
II	106	n.a.

- (a) Ratio of non-farm wages, salaries and supplements and payroll tax, deflated by the implicit price deflator of gross non-farm product, per hour worked by non-farm wage and salary earners to gross non-farm product at average 1979-80 prices, per hour worked by all persons employed in the non-farm sector.
 (b) Ratio of wages, salaries and supplements and imputed payroll tax (less employment subsidies) paid by the private non-farm corporate sector to private non-farm corporate sector gross product at factor cost plus imputed payroll tax (less employment subsidies).
 (c) Seasonally adjusted.
 n.a. not available.

The downturn in economic activity and increased labour costs had a severe effect on business profits in 1982. The gross operating surplus of trading enterprise companies declined by 6 per cent in nominal terms in 1982 or by 17 per cent in real terms (relative to the price deflator for gross non-farm product); there was a partial recovery in the second half of 1982-83 by about 5 per cent in real terms.

A number of other guides to trends in profitability and cash flows are shown in Chart 8. The top two lines of the chart show the share of the gross operating surplus of the non-farm private corporate sector (both before and after stock valuation adjustment) in that sector's gross product at factor cost. Both shares declined in 1981-82 and 1982-83 to near historically low levels.

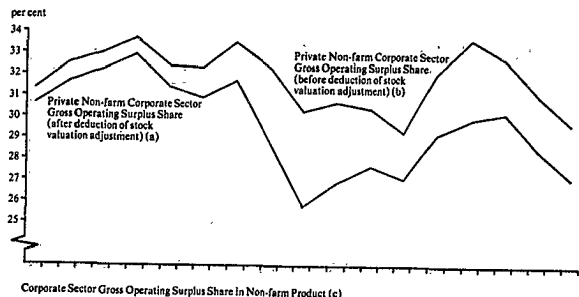
Gross operating surplus includes, *inter alia*, interest payments and direct taxes as well as profits. In view of the high levels of interest rates in recent years and the rising indebtedness of the corporate sector, the decline in profits is likely to have been greater than the recorded decline in the gross operating surplus shares. Cash flows would have been even further constrained because of the lag in tax payments which are made in respect of the previous year's taxable income. An approximate guide to within-year trends in profitability and cash flows is provided by the bottom line of Chart 8; it suggests that in the second half of 1982-83 profitability and cash flows may have recovered somewhat from the very low level established in the first half of the year, but remained well below historical levels. This more traditional measure may, however, be affected by distortions due to the shifts in the composition of output.

Prices

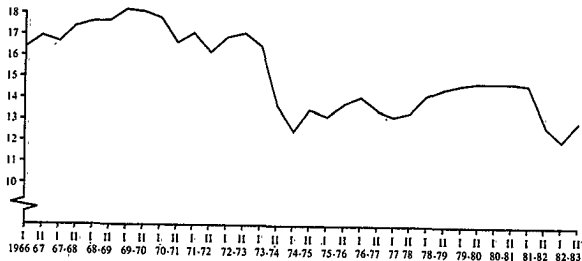
The rate of inflation continued unabated in the first half of 1982-83 mainly as a result of the earlier strong growth in labour costs and relatively large increases in a range of government charges and taxes. Price increases eased during the second half of the year, reflecting the slowing in the growth of labour costs partly offset by the impact on some meat prices of the breaking of the drought and possibly by some recovery in profit margins. Domestic prices also benefitted from a slowing in inflation overseas, despite the depreciation of the exchange rate over the course of the year. By the second half of the year the rate of price increase in Australia was more than twice as high as in our major trading partners.

The deflator for gross non-farm product—a broad measure of the domestic component of inflation—rose by 11.4 per cent in 1982-83 following an increase of 11.8 per cent in 1981-82. However, as shown in Chart 9, growth in this deflator slowed sharply in the second half of the year (though this slowing may be somewhat over-stated in the estimates because of suspected problems with seasonal adjustment) reflecting the effects of the deceleration in labour costs and continued sluggishness in demand. Growth of expenditure prices also slowed in the second half of the year, when the deflator for total domestic final demand increased at an annual rate of 8.4 per cent (see Table 8).

Chart 8: Shares of Gross Operating Surplus in Gross Product at Factor Cost.



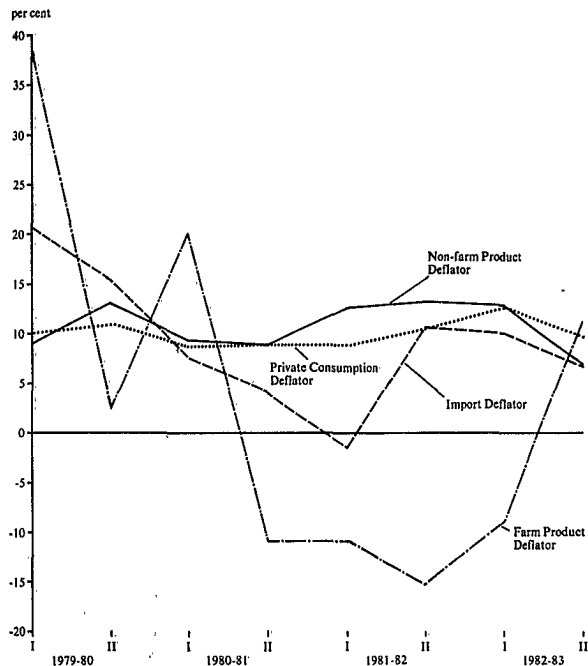
Corporate Sector Gross Operating Surplus Share In Non-farm Product (c)



- (a) The ratio of the gross operating surplus of the private non-farm corporate sector (after deduction of this sector's stock valuation adjustment) to the gross product at factor cost of the private non-farm corporate sector. The gross operating surplus of the private non-farm corporate sector is defined as the gross operating surplus of non-farm trading enterprise companies and private financial enterprises (less imputed bank service charge).
- (b) The ratio of the gross operating surplus of the private non-farm corporate sector (before deduction of the stock valuation adjustment for the private corporate sector) to the gross product at factor cost of the private non-farm corporate sector before deduction of the stock valuation adjustment for the private corporate sector.
- (c) The ratio of the gross operating surplus of trading enterprise companies and financial enterprises (less imputed bank service charge) to gross non-farm product at factor cost; seasonally adjusted.

The drought had a noticeable effect on meat prices during 1982-83. As feeding became more difficult, beasts were brought to market early. This led to a fall in livestock prices and helped to restrain growth in the prices of material inputs to manufacturing and in consumption prices in the first half of 1982-83. In the final quarter of the year livestock prices increased sharply as stock were withheld from markets as the drought came to an end.

Chart 9: Implicit Price Deflators (percentage changes at annual rates) (a)



(a) Based on seasonally adjusted data.

Table 8: Prices

	Year						Half year(e)	
	1979-80		1980-81		1981-82		1982-83	
	1979-80	1980-81	1981-82	1982-83	I	II	I	II
Consumer price index (f)—								
All groups	10.1	9.4	10.4	11.5	10.9	10.4	12.9	9.8
Food (weight of 21.3%) (g)	14.0	10.3	8.6	9.1	10.5	5.0	10.3	10.9
Non-food	10.3	9.4	8.6	10.7	10.0	5.0	12.2	9.3
State government rates and charges	n.a.	n.a.	25.4	20.8	26.6	31.6	22.4	9.0
Implicit price deflators (h)—								
Private final consumption expenditure	10.1	9.3	9.3	11.3	8.9	10.5	12.5	9.8
Private gross fixed capital expenditure	9.3	10.9	10.0	11.6	7.6	15.5	11.4	8.2
Total domestic final demand	10.0	10.2	10.3	11.2	9.6	12.7	12.1	8.4
Non-farm exports of goods and services (i)	20.8	6.5	9.8	10.2	3.6	15.4	5.8	5.8
Imports of goods and services	17.5	8.5	2.9	9.2	1.4	10.7	10.1	6.7
Gross farm output	29.5	7.2	11.8	16.1	10.6	15.2	11.0	9.0
Gross farm product	29.5	7.2	-11.8	-6.1	-10.6	-15.2	-8.9	11.2
Gross domestic product	11.0	10.0	10.4	11.0	11.0	11.4	12.6	7.4
Sectoral Indices—								
Manufacturing industry								
Materials used in	29.3	9.8	0.74	0.74	-0.7	4.3	6.5	(p)12.6
Articles produced by	15.8	11.0	7.8	0.95	6.8	9.3	10.4	(p)8.1
Building								
Materials used in house building	13.0	13.6	9.9	10.0	8.9	13.0	9.9	7.4
Materials used in other building	(h)12.9	12.9	11.1	12.1	9.8	15.3	13.2	7.1

(e) Annual rates.
(f) Weighted average of six capital cities for 1979-80 and 1980-81, eight capital cities data used thereafter.

(g) Weights shown are those used in the tenth series of the CPI.
(h) Early-year calculations are based on seasonally adjusted data.
(i) Excludes exports of goods and services.
(j) Average of twelve months to May on preceding twelve months.
(k) Average of six months to May on preceding six months.
(l) Based on linkage to old series at July 1979.
n.a. not available.

Fiscal Conditions

The Commonwealth Budget deficit in 1982-83 was \$4473m, equivalent to 2.8 per cent of GDP. This compared with a deficit of \$548m or 0.4 per cent of GDP in 1981-82 and represented a sharp departure from the sustained downward trend in the deficit as a proportion of GDP between 1977-78 and 1981-82.

The 1982-83 Budget deficit outcome was \$2799m above the Budget-time estimate. The deficit overrun was attributable primarily to the effects of the unexpected severity of the weakness in the labour market on receipts and outlays, particularly social security outlays, and to post-Budget decisions, mainly on the expenditure side (see Statement No. 5).

In 1982-83, Commonwealth budget outlays increased by 18.5 per cent. This represented an increase of 6.3 per cent in real terms, the largest such increase since 1974-75 and well above the average annual increase of around 2 per cent recorded during the seven intervening years. Budget outlays were equivalent to 30.4 per cent of GDP in 1982-83, exceeding the previous peak of 30.0 per cent in 1975-76.

Commonwealth budget receipts increased by 9.1 per cent in 1982-83 compared with an increase of 15.9 per cent in 1981-82. In real terms, budget receipts fell by 2.1 per cent in 1982-83, compared with growth of 3.7 per cent in 1981-82 and an annual average real increase of around 4.4 per cent over the decade to 1981-82. The decline in real budget receipts in 1982-83 was the first since 1972-73 (when payroll tax was transferred to the States), and the largest since at least the mid-1950s. Nominal GDP grew even more slowly in 1982-83 than budget receipts, with the result that, as a proportion of estimated GDP, budget receipts increased marginally in 1982-83 to reach a new record high of 27.7 per cent.

Current outlays and receipts of the Commonwealth non-budget sector are relatively small. Some details of developments in the sector are given in Statement No. 6 and in Table 10 attached to that Statement.

State and local sector outlays also increased strongly in 1982-83. As a proportion of GDP, State and local sector outlays increased to 22.2 per cent from 20.2 per cent in 1981-82 (see Table 9). Abstracting from the effects of sale and lease-back transactions with the private sector, these outlays are estimated to have increased by 6 per cent in real terms compared with 4 per cent in 1981-82. A major component of the increase in 1982-83 was in fixed capital expenditure which is estimated to have increased by around 8 per cent in real terms reflecting, in particular, large increases in capital works undertaken by electricity authorities.

State and local government revenues from own sources are estimated on a preliminary basis to have increased by 17 per cent (or 5 per cent in real terms) in 1982-83. Commonwealth payments to the State and local sector increased by \$413m above Budget-time estimates (principally reflecting 'wages pause savings' transfers and assistance in respect of drought and bushfires). Total State and local sector revenues (including transfers and advances from the Commonwealth) are estimated to have increased by 17 per cent in 1982-83, or by 5 per cent in real terms.

The overall State and local sector deficit (net of Commonwealth advances) in 1982-83 is estimated to have been \$5182m; as a proportion of GDP it was 3.2 per cent, up from 2.5 per cent in 1981-82. There was thus a continuation of the trend, evident since the mid-1970s, of increased resort to borrowing by State and local authorities.

The major part of the increase in State and local government borrowing in 1982-83 represented borrowings of State electricity authorities, following the agreement at the June 1982 Loan Council meeting to remove the controls over the amount and terms of their domestic borrowings. Conventional longer term borrowings by these authorities rose to \$2612m in 1982-83, some 122 per cent above their level in 1981-82. These figures do not cover off-program financing techniques employed by these authorities, specifically leasing, trade credit and short term borrowings. Following the June 1982 decision, electricity authorities reduced their recourse to such techniques.

Total public sector outlays are estimated to have increased by 19 per cent in 1982-83 or by 7 per cent in real terms; as a proportion of GDP they rose to 42.6 per cent which was well above the previous high point of 39.6 per cent reached by this ratio in the mid-1970s (see Table 9 and also Statement No. 6).

As a percentage of GDP, the Public Sector Borrowing Requirement (PSBR) is estimated to have almost doubled from 3.3 per cent in 1981-82 to 6.4 per cent in 1982-83, with both the Commonwealth and the State and local government sectors contributing to the increase (see Table 10).

Table 9: Public Sector Outlays as a Percentage of Gross Domestic Product

Year—	State and Local Government Sector					
	Commonwealth sector outlays(a)(b) (per cent) (1)	Financed by:			Total(b) (per cent) (4)	Total(b)(d) (per cent) (5)
		Commonwealth assistance(c) (per cent) (2)	Own funds (per cent) (3)	Total(b) (per cent) (4)		
1973-74	24.6	8.1	8.4	16.6	31.6	
1974-75	29.4	10.4	9.0	19.4	37.1	
1975-76	30.6	11.6	8.5	20.1	37.9	
1976-77	30.2	10.7	9.2	20.0	38.2	
1977-78	31.1	11.1	9.9	20.9	39.6	
1978-79	29.5	10.5	9.7	20.3	38.0	
1979-80	28.9	10.1	9.9	20.0	37.7	
1980-81	28.9	9.9	10.5	20.3	38.1	
1981-82	29.3	9.5	10.7	20.2	38.8	
1982-83	31.8	10.2	12.0	22.2	42.6	

(a) Budget and non-budget sector. The latter comprises mainly capital expenditure.

(b) If adjustment is made for sale and lease-back transactions with the private sector, the estimates for 1981-82 and 1982-83, the years principally affected, are increased by the following amounts: for the Commonwealth sector by approximately 0.2 and 0.1 percentage points respectively; for the State and local government sector by approximately 0.7 and 0.5 percentage points respectively; and for the total public sector by approximately 0.9 and 0.6 percentage points respectively.

(c) Direct assistance from the Commonwealth budget.

(d) Net of all transfers between Commonwealth and State and local government sectors. Column (5) is equal to column (1) plus column (3) less interest payments between these sectors.

Table 10: Public Sector Borrowing Requirement(a)(b)

Year—	Commonwealth sector		State and local government sector(c)		Total	
	\$m	Percentage of GDP	\$m	Percentage of GDP	\$m	Percentage of GDP
1973-74	353	0.7	457	0.9	812	1.6
1974-75	2 516	4.1	925	1.5	3 440	5.6
1975-76	3 530	4.8	450	0.6	3 979	5.5
1976-77	3 029	3.6	1 022	1.2	4 052	4.9
1977-78	3 851	4.3	1 616	1.8	5 467	6.1
1978-79	3 618	3.5	1 926	1.9	5 545	5.4
1979-80	2 457	2.1	2 248	2.0	4 704	4.1
1980-81	1 470	1.1	3 175	2.4	4 645	3.6
1981-82	1 087	0.7	3 769	2.5	4 856	3.3
1982-83	5 188	3.2	5 182	3.2	10 370	6.4

(a) Total public sector outlays less receipts; net advances to other sectors by the public sector are treated as outlays. This measure differs from the measure of net borrowing by the public sector used in Chart 11, in which net advances are treated as lending.

(b) If adjustment is made for sale and lease-back transactions with the private sector, the estimates as a percentage of GDP for 1981-82 and 1982-83, the years principally affected, are increased by the following amounts: for the Commonwealth sector by approximately 0.2 and 0.1 percentage points respectively; for the State and local government sector by approximately 0.7 and 0.5 percentage points respectively; and for the total public sector by approximately 0.9 and 0.6 percentage points respectively.

(c) The figures for the deficit of the State and local government sector shown here do not include advances from the Commonwealth budget; they therefore indicate the residual borrowing requirement of the sector.

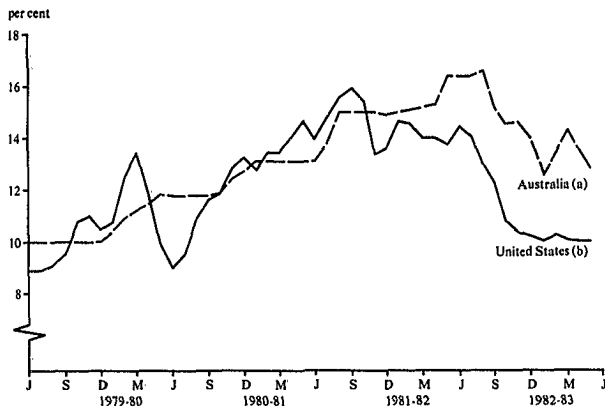
Monetary Conditions

Monetary conditions are influenced by developments in the domestic economy, (e.g. changes in the level of economic activity, changes in net borrowing and lending by different sectors and changes in economic policies) and by developments in overseas financial markets.

Overseas financial conditions have been an increasingly important influence on domestic financial developments as the Australian financial system has become more closely linked with world financial markets. During 1982-83, substantial falls in overseas interest rates and more liquid financial conditions abroad were accompanied by similar trends in Australian financial markets, just as relatively high interest rates and tighter financial conditions had been experienced both overseas and at home in 1981-82. Chart 10 depicts movements in United States and Australian medium term bond yields over the period 1979-80 to 1982-83. Both rates fell over the course of 1982-83, although with a wider margin developing than in previous years, reflecting, *inter alia*, the independent influence on interest rates in the two countries of the demand for and supply of finance, and exchange rate and inflationary expectations.

Underlying the developments in domestic financial markets in 1982-83 were substantial changes in the net lending and borrowing positions of the major sectors of the economy. In particular, corporate sector net borrowing had risen to a very high proportion of GDP in 1981-82, partly reflecting increased corporate investment in resource-related projects. In 1982-83, however, corporate net borrowing fell sharply, despite reduced corporate profitability and cash flow, as fixed investment slumped and inventories fell substantially.

Chart 10: Medium-term Government Bond Yields in Australia and the United States



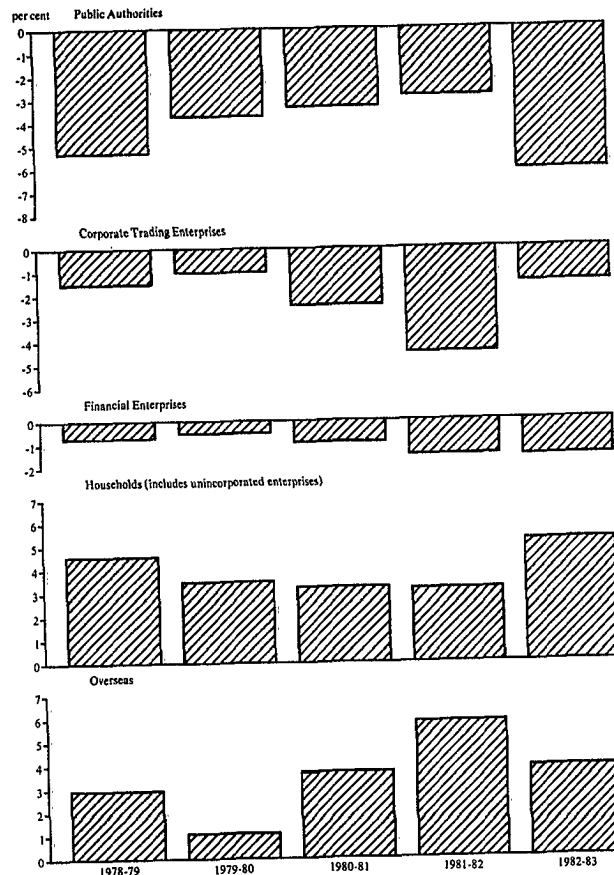
(a) Theoretical yield on five-year Treasury bonds.

(b) Yield on five-year government securities. Prior to April 1980, yield on three to five-year securities.

The fall in corporate net borrowing in 1982-83 was offset by a more than two-fold increase in public sector net borrowing, from about \$4600m in 1981-82 to about \$9800m in 1982-83. While net lending to Australia from the external sector decreased, net lending by the household sector increased substantially, the latter arising from a moderate rise in household savings and a marked fall in investment by the household sector, particularly dwelling investment. The public sector was thus able to finance the large increase in its deficit in an environment of falling nominal domestic interest rates. This occurred partly because of the fall in overseas interest rates; partly because of an apparent developing expectation that our inflation rate would fall in the short term (if for no other reason than the very depressed state of economic activity); and partly because of the increase in household net lending and reduced competition for funds from the corporate sector.

Chart 11 illustrates developments in the net lending and borrowing positions of the major sectors of the Australian economy as a proportion of GDP over the last five years. As is evident from the chart and the discussion above, the deterioration of the economy in 1982-83 resulted in a redirection of net borrowing and the associated financial flows but not in any reduction in the overall levels of real borrowing and lending undertaken.

Chart 11: Net Lending and Borrowing by Sector (per cent of Gross Domestic Product) (a)



(a) Based on National Accounts data and Treasury estimates. Positive (upward) bars on these charts represent net lending while negative (downward) bars represent net borrowing.

Primary Liquidity Formation

There was a large increase (\$5979m) during 1982-83 in the non-official sector's holdings of liquid assets and Commonwealth Government securities (LGS assets), consisting of an increase in currency and deposits with the Reserve Bank (\$336m) and Commonwealth Government securities (\$5643m). This reflected the marked increase in the Commonwealth domestic budget deficit in the year and very large surpluses on private sector foreign exchange transactions (PSFET) in several months of the financial year, particularly in the period September to December 1982 and again in April 1983, which contributed to a record PSFET surplus of \$3871m for the year as a whole. The net outcome was that, even though sales of Government securities to the non-financial sector were high, there was for much of the year a comparatively ready availability of LGS assets to the financial sector.

A little under half of the aggregate take-up of Commonwealth Government securities in 1982-83—some \$2390m—was in Australian Savings Bonds (ASBs). This instrument gives the Commonwealth direct access to household sector savings, thereby reducing the extent to which the deficit is financed through the process of intermediation—that is by the household sector depositing funds in financial institutions which are then enabled to purchase Government securities. ASBs can thereby be particularly effective in constraining growth in the monetary aggregates. The large sales of ASBs in 1982-83 can in this sense be regarded as one of the more successful aspects of monetary policy; without them the increase in household deposits with financial institutions and in the monetary aggregates would have been much greater. In another sense, the relatively high dependence in the deficit financing task upon high sales of ASBs was, potentially at least, a cause for concern. The ASB is a very liquid instrument, being redeemable at one month's notice. In past periods (e.g. 1981-82) when the ASB rate has not been kept competitive, redemptions have been high.

Secondary Credit Formation

Secondary sources of credit growth contributed substantially less to the overall growth of the monetary aggregates during 1982-83 than in earlier recent years. In particular, with the corporate sector's demand for credit considerably weakened by the recession, the growth in major trading bank advances during the year was much reduced, from 12.1 per cent in the twelve months to June 1982 to 8.1 per cent in the twelve months to June 1983.

Among the groups of major financial intermediaries only the savings banks increased the growth of their advances in 1982-83. Savings bank loans outstanding increased by 20.1 per cent over the twelve months to June 1983 compared with 11.0 per cent over the twelve months to June 1982. Of the \$2960m increase in savings bank advances outstanding during 1982-83, some \$1688m went to housing loans—compared with \$1061m in 1981-82—with another \$872m directed to commercial bills. The latter figure meant that the savings banks were much more significant participants in the commercial finance market during 1982-83 than previously.

The growth rate of advances by finance companies, building societies and merchant banks fell substantially during the year from 18.3 per cent over the twelve months to June 1982 to 9.6 per cent last year. Advances by merchant banks showed the sharpest

deceleration on this comparison—from almost 40 per cent to around 10 per cent, although their lending was still strong by comparison with, say, finance companies whose advances outstanding rose by only 4.6 per cent during the year (15.6 per cent in 1981-82).

The downward slide of lending by the institutions that lend primarily to the commercial sector was amplified by sizeable private sector borrowings off-shore and by the continued relatively strong growth of the various forms of commercial bill financing taking place outside financial institutions' balance sheets. This latter development was encouraged by a shift during the year of interest rate differentials in favour of bill financing.

The Monetary Aggregates

The volume of money measure, M3, increased by 12.5 per cent over the twelve months to June 1983, or by 11.1 per cent for 1982-83 in average year-on-year terms. This latter increase was only slightly above the projected range of 9 to 11 per cent annual average growth announced in last year's Budget Speech, but there was a marked acceleration in M3 growth during the later months of the financial year. The underlying influences on M3 growth during 1982-83 are shown in Table 11.

As shown in Table 12, there were marked differences in the growth rates of the various financial aggregates in 1982-83. This largely reflected the very high growth rate of savings bank deposits, which increased by 19.2 per cent, the strongest such growth since 1972-73. M2 (which excludes savings bank deposits) thereby grew substantially less quickly than M3. Deposits of non-bank financial institutions included in M6 grew in aggregate at a similar rate to trading bank deposits, so that the rate of growth in this measure was a little lower than that in M3. This pattern of growth rates presented a considerable contrast to the experience of earlier years.

One development which appears to have influenced these differences in monetary growth rates was the liberalisation of the banking regulations in recent times. This may have led to banks becoming more competitive relative to non-banks and thus to reintermediation of funds to banks from non-banks.

Constraints on the deposit rates which can be offered by both trading and savings banks were removed in December 1980. Further, in March 1982, the 30 day notice of withdrawal requirement for savings banks' savings investment accounts was removed, and trading banks were allowed to borrow large deposits for terms as short as fourteen days, instead of the previous minimum of thirty days. In August 1982, there were amendments to the regulations under the Banking Act relating to assets in which savings banks may invest depositors' funds. However, the 'reintermediation' that did occur during 1982-83 was, as indicated earlier, not predominantly from non-bank financial institutions to banks in general, but rather from non-bank financial institutions and the trading banks to the savings banks.

It seems that much of the explanation for the differing monetary growth rates may lie in cyclical rather than structural influences. In particular, the decline in net borrowing by the corporate sector, the increase in household savings and in public sector borrowing, and the reduced rate of overseas borrowing would have tended to stimulate the growth of financial institutions intermediating household savings, including savings banks, and dampen that of the institutions lending to the corporate sector, such as

Table 11: Formation of Movements in the Volume of Money (₹) (₹m)

	Half-year--								
	Year--			1981-82			1982-83		
	1980-81	1981-82	1982-83(p)	I	II	II(p)	I	II	II(p)
Budget deficit (+) or surplus (-)	1 109	548	4 473	4 373	3 824	4 737	4 737	4 737	-766
Less Budget excess deficit	1 556	1 468	2 022	2 022	733	733	733	733	1 184
Budget contribution to private sector LGS assets (b)	447	920	2 451	3 640	-4 559	3 899	3 899	3 899	-1 450
Private sector foreign exchange transactions (c)	2 802	2 454	3 871	-927	3 382	2 357	2 357	2 357	1 514
Change in SRD accounts of all trading banks (increase (-))	-467	-260	-125	-119	-141	-85	-85	-85	-40
Change in Rural Credit advances	114	3	65	32	35	31	31	31	-96
Other factors (d)	435	313	-591	-20	333	-282	-282	-282	298
Less Change in Government and inter-bank deposits	106	118	538	1 174	454	1 174	454	454	1 174
CHANGE IN PRIVATE SECTOR LGS ASSETS (e)	2 391	672	5 975	628	-156	5 028	5 028	5 028	951
Plus Change in loans and advances--									
Major trading banks	2 167	2 381	1 800	1 342	1 039	747	747	747	1 033
Other trading banks	445	761	639	639	287	474	214	214	425
Savings banks	1 474	1 458	2 960	1 022	436	1 382	1 382	1 382	1 579
Less Change in Government and inter-bank deposits	534	1 155	4 124	69	224	3 230	3 230	3 230	895
Less Change in non-bank public holdings of currency, deposits with Reserve Bank and Commonwealth Government securities	-42	145	90	714	32	52	52	52	112
Less Change in non-bank public holdings of currency, deposits with Reserve Bank and Commonwealth Government securities	24	1 146	582	714	434	411	411	411	411
CHANGE IN VOLUME OF MONEY (M3) (h)	6 228	6 266	7 726	4 171	2 095	4 314	4 314	4 314	3 412

(e) Average weekly figures based on private sector foreign exchange transactions, budget deficit, budget overseas deficit, budget contribution to private sector LGS assets, and change in non-bank holdings of Commonwealth Government securities which are on a last day basis, and change in private sector LGS assets which is partly last day. Not seasonally adjusted.

(f) Equate budget domestic deficit.

(g) Defined as net official monetary movements adjusted to exclude Commonwealth Government, Treasury, and semi-government authorities. It is defined as net official monetary movements adjusted to exclude Commonwealth Government, Treasury, and semi-government authorities.

(h) This item is largely due to the different time bases used.

(i) Defined as change in banking sector LGS assets (the sum of its holdings of notes, coin, cash with Reserve Bank, Treasury Notes and other Commonwealth Government securities).

(j) Plus change in non-bank public holdings of currency, deposits with Reserve Bank and Commonwealth Government securities.

(k) Plus change in other assets and liabilities of banks / less change in other banking institutions' LGS assets.

(l) Defined as change in holdings of the non-bank public of notes and coin plus change in deposits of the non-bank public with banks (including deposits with the Reserve Bank).

(m) Preliminary.

Table 12: Growth Rates of Selected Financial Aggregates (a)
(per cent)

	1978-79	1979-80	1980-81	1981-82	1982-83
M1 (b)	16.7	12.9	12.0	1.6	5.9
M2 (c)	13.3	16.5	15.2	13.9	8.1
M3 (d)	11.8	12.5	12.7	11.3	12.5
M6 (e)	14.2	15.7	15.7	13.8	10.7(p)

(a) Over the twelve months to June in the year shown.

(b) Defined as the non-bank sector's holdings of notes and coin, deposits with the Reserve Bank and current deposits with trading banks. Current deposits with trading banks held by Commonwealth and State Governments and by other banks are excluded.

(c) Defined as M1 plus the non-bank sector's non-current deposits with trading banks. Trading bank deposits held by Commonwealth and State Governments and by other banks are excluded.

(d) Defined as M2 plus the non-bank sector's deposits with all savings banks.

(e) Defined as M3 plus the non-bank sector's deposits with building societies, finance companies, general financiers and money market corporations. Cash holdings and bank deposits of these latter institutions are excluded.

(p) Preliminary.

finance companies, merchant banks and, to a lesser degree, trading banks. Cyclical movements in the economy also affect the relative competitive positions of the controlled and uncontrolled financial institutions. During an upturn in the economy, when interest rates are tending to rise, institutions subject to below-market ceilings on their lending rates—and thus, for profitability reasons, unable to compete effectively for deposit funds—tend to be relatively disadvantaged. Conversely, during a cyclical downturn as in 1982-83 market rates fall relative to the more 'sticky' lending rate ceilings under which controlled institutions are operating. These controls are then less binding and the affected institutions can attempt to make up lost ground by maintaining relatively attractive deposit rates. The savings banks, being the financial institutions most directly affected by lending rate ceilings, find their deposit performance especially prone to counter-cyclical variation. Moreover, a downturn in economic activity, by increasing uncertainty, promotes a higher premium on security and liquidity; in 1982-83 this also could have added to the relative attractiveness of depositing with banks.

With the growth rate of M3 increasing slightly through the year, and nominal GDP growth declining, the M3 velocity declined sharply (by about 31 per cent between the first halves of 1982 and of 1983), in contrast to its longer term annual trend rate of growth of around 1.6 per cent. As the growth rate of M6 fell by 3.2 percentage points between the two half years, the decline in the M6 velocity was not as pronounced.

Overall, however, there was a fall during 1982-83 in the velocity of circulation of each of the financial aggregates broader than M2. This would be consistent with a view that monetary policy, in itself, did little to restrain inflation and inflationary expectations during 1982-83. Given the lags involved, however, the continued high rate of monetary growth relative to the very depressed level of activity may not have had much impact on the inflation process during 1982-83 itself, but rather raises a question as to the future consequences for inflation.

Balance of Payments

An overall balance of payments surplus of \$2435m was recorded in 1982-83. The pattern of the previous two years of strong capital inflows exceeding the current account deficit was again evident. Table 13 and Chart 12 show the main balance of payments aggregates for recent years.

Table 13: Balance of Payments: Main Aggregates
(\$m, not seasonally adjusted)

	1980-81		1981-82		1982-83	
	Year	Year	Year	Year	First half	Second half
Current Account—						
Exports	18 718	19 089	20 697	10 430	10 267	
Imports	-19 169	-22 374	-21 528	-11 290	-10 238	
Trade balance	-451	-3 285	-831	-860	-29	
Net invisibles	-5 004	-5 575	-5 637	-2 787	-2 850	
Current account balance	-5 455	-8 860	-6 468	-3 647	-2 821	
Capital Account—						
Government securities	-80	558	788	895	-107	
Securities domiciled overseas	-101	368	575	701	-126	
Securities domiciled in Australia	21	190	213	194	19	
Other government	11	-53	-262	-144	-117	
Total government capital	-69	505	526	751	-225	
Trade credit net	-41	223	-257	-1	-254	
Foreign investment in enterprises in Australia—						
Undistributed income	830	330	380	190	190	
Other	5 195	9 083	8 201	4 367	3 835	
Other private capital and balancing item	689	73	53	365	-515	
Net apparent private capital inflow	6 673	9 709	8 377	5 121	3 256	
Net apparent capital inflow	6 604	10 214	8 903	5 872	3 031	
Net official monetary movements	1 149	1 354	2 435	2 225	210	
Private sector foreign exchange transactions(a)	2 802	2 454	3 871	2 357	1 514	

(a) This item represents the direct contribution to private sector LGS assets and the volume of money from overseas sources, including borrowings by semi-government authorities. It is defined as net official monetary movements adjusted to exclude Commonwealth Government budgetary and financing transactions (see Table 11).

A notable development in the external accounts in 1982-83 was the substantial reduction in the current account deficit to 4 per cent of GDP from 6 per cent in 1981-82. This reflected the effects of declining demand on imports and relatively buoyant exports of some non-farm products. Summary details of changes in the commodity structure of imports and exports are shown in Table 14.

The total value of imports declined by about 4 per cent in 1982-83, reflecting a fall in volume of about 12 per cent (discussed in the production and demand section) and a rise in import prices, underpinned by the depreciation of the Australian dollar, of 9 per cent.

Chart 12: Recent Trends in Australia's Balance of Payments
(\$ m per quarter)

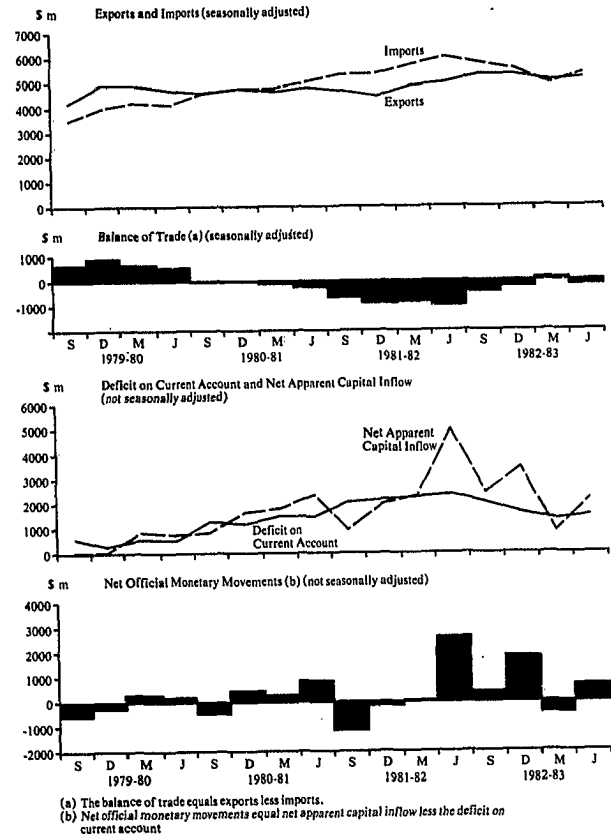


Table 14: Balance on Current Account

	1980-81	1981-82	1982-83	1982-83	
	Year	Year	Year	First half	Second half
Current account deficit to GDP (per cent)	4.2	6.0	4.0	4.4	3.6
Change on previous period (per cent)(a)					
<i>Volumes</i>					
Rural exports	-10.6	0.6	-4.8	4.4	-35.8
of which: Meat	-4.3	-3.5	11.7	32.3	-34.0
Cereals	-31.0	9.2	-28.3	-26.4	-76.3
Non-rural exports	-2.0	1.4	6.9	9.7	3.4
of which: Coal	8.2	-1.5	13.9	26.3	36.5
Metals and metal manufactures	-9.1	6.0	12.8	15.0	22.5
Other manufactures	1.8	-0.2	4.7	-6.4	11.8
Total exports of goods	-6.1	1.0	1.6	5.9	-14.4
Total imports of goods	11.5	13.4	-11.6	-15.1	-21.7
of which: Fuels	-4.0	0.3	-5.7	9.4	-45.6
Metals and metal manufactures	18.8	13.5	-16.7	-25.4	-36.4
Machinery and transport equipment	26.7	19.3	-14.8	-8.3	-18.7
<i>Implicit price deflators</i>					
Exports of goods and services	7.2	2.0	6.9	7.4	10.6
Imports of goods and services	8.6	2.9	3.2	10.0	6.8
<i>Terms of Trade(b)</i>	-0.6	-1.0	-2.0	-2.5	3.6

(a) Half yearly changes are expressed as seasonally adjusted annual rates.

(b) Defined as the implicit price deflator for exports of goods and services divided by the implicit price deflator for imports of goods and services.

Export receipts increased by about 8 per cent in 1982-83, reflecting an increase in volume of about 2 per cent and an increase in prices of about 7 per cent. The drought had a marked effect on rural exports. Although meat export volumes increased up to the breaking of the drought, cereal export volumes declined and, overall, the volume of rural exports fell. The average rural export price did not change much as increases in Australian dollar prices of meat and cereals were offset by lower sugar prices. Non-rural export receipts grew strongly as additional production capacity in, or associated with, the resources sector came on stream, with notable increases in the volume of coal, uranium and aluminium exports. The volume of manufactured exports also increased, largely it seems, due to some improvement in competitiveness. Exports were not subject to the same degree of disruption as in the previous year by industrial disputes and inadequate port facilities. Increases in contract prices for coking coal and iron ore and the depreciation of the Australian dollar boosted non-rural export receipts, even though prices for many other commodities were depressed.

The net invisibles deficit of \$5637m was similar to that in 1981-82. Interest payments on higher levels of private sector offshore borrowing added to the deficit, while lower freight payments on imports, reduced profits accruing on foreign investment in Australia and increased interest earned on Australia's international reserves were offsetting factors.

Total net apparent capital inflow was \$8.9 billion in 1982-83, not far short of the record \$10.2 billion in 1981-82. There were three main factors contributing to this relatively buoyant outcome. First, uncovered interest rate differentials favoured both investment in Australian securities by foreigners and overseas financing by local

enterprises, though this effect was sometimes partially or fully negated by adverse exchange rate expectations and, related to that, by high forward hedge premiums for cover against foreign exchange risk. Secondly, inflows were also influenced by some carry over of the heavy financing requirements of the energy and resource sector investment projects. Finally, uncertainties which intensified during the year about the credit-worthiness of some countries facing debt-servicing difficulties seem to have increased the relative attractiveness of Australia in the eyes of foreign investors.

Chart 12 shows that the time profile of net apparent capital inflow in 1982-83 was markedly different from that experienced in 1981-82. In 1981-82 private capital inflows were concentrated in the second half of the year, a time of seasonal drain on liquidity and when uncovered interest differentials favoured overseas financing. In contrast, private capital inflows in 1982-83 were particularly strong in the first half of the financial year following significant reductions in nominal interest rates overseas. This, and the greatly increased budget deficit (or, in the case of the June quarter, the much reduced surplus) provided the basis for relatively easy liquidity conditions in the second half of the year, except for the weeks leading up to the 10 per cent devaluation on 8 March when large capital outflows occurred.

Government capital transactions resulted in a net inflow of \$526m, little changed from the 1981-82 result. Gross overseas borrowings by the Commonwealth added \$1150m to reserves while a net identified inflow by overseas investors in domestically-issued Commonwealth securities added a further \$213m.

At end-June 1983 official reserves stood at \$10 748m, an increase of \$4231m from the level at the end of 1981-82. Balance of payments transactions increased reserves by \$2460m while revaluations arising from depreciation of the Australian dollar and increases in the price of gold increased reserves by a further \$1771m. Foreign exchange reserves stood at \$6900m at end-June 1983 compared with \$4065m at end-June 1982.

The Exchange Rate

Volatility and uncertainty characterised international financial markets in 1982-83, leading to large shifts in interest rates and exchange rates and exerting an influence on the Australian dollar. In the latter regard, the most significant influences included marked reductions in nominal interest rates in some major industrial economies in the first half of 1982-83 and fluctuations in the United States dollar throughout the year.

At the outset of 1982-83, the competitive position of Australian producers had been eroded by the wage cost surge of 1980-81 and 1981-82. Competitiveness was also adversely affected in 1980-81 by an appreciation of the trade-weighted index over the course of that year, though that effect was largely unwound by the subsequent depreciation of the trade-weighted index over the course of 1981-82. This loss of competitiveness, reinforced by Australia's widening adverse inflation differential in 1982-83 itself, placed some further downward pressures on the Australian dollar. The strength of capital inflow—seemingly impervious to the fundamentals—and the resultant additions to reserves worked in the opposite direction.

Between end-June 1982 and end-June 1983 the trade-weighted index (TWI) of the value of the \$A declined by 12 per cent, bringing the cumulative depreciation in the TWI since its August 1981 peak to 18 per cent. This lowering was not uniform over time; for example, there was a period of relative stability from September to January.

Following the calling of the general election, expectations gathered that the value of the Australian dollar might fall and this led to substantial capital outflows and a 10 per cent devaluation on 8 March. Between that date and 30 June, the TWI appreciated by 6 per cent.

Table 15 and Chart 13 provide details of changes in the trade-weighted index of the value of the \$A and its value against major foreign currencies.

Table 15: Bilateral Exchange Rates and the Trade Weighted Index (TWI)(a)

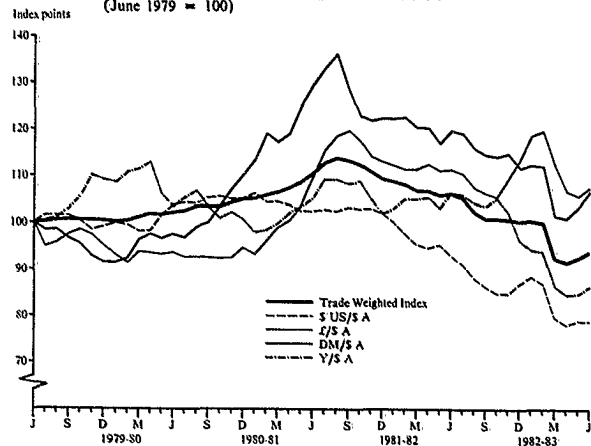
	June			Change over year to—	
	1981	1982	1983	June 1982 (per cent)	June 1983 (per cent)
\$US/\$A	1.14	1.03	0.88	-9.4	-15.1
Yen/\$A	256	260	211	1.5	-18.9
DM/\$A	2.71	2.51	2.24	-7.5	-10.9
Pound Stg/\$A	0.58	0.59	0.57	1.6	-3.5
TWI	91.9	88.2	77.9	(b) -4.0	(c) -11.7

(a) Monthly averages.

(b) Between 30 June 1981 and 30 June 1982 the TWI fell by 5.1 per cent.

(c) Between 30 June 1982 and 30 June 1983 the TWI fell by 11.9 per cent.

Chart 13: Movements of the Australian Dollar Against Selected Currencies and in the Trade Weighted Index (a) (b) (June 1979 = 100)



(a) Upward (downward) movements represent appreciation (depreciation) of the \$A against other currencies.

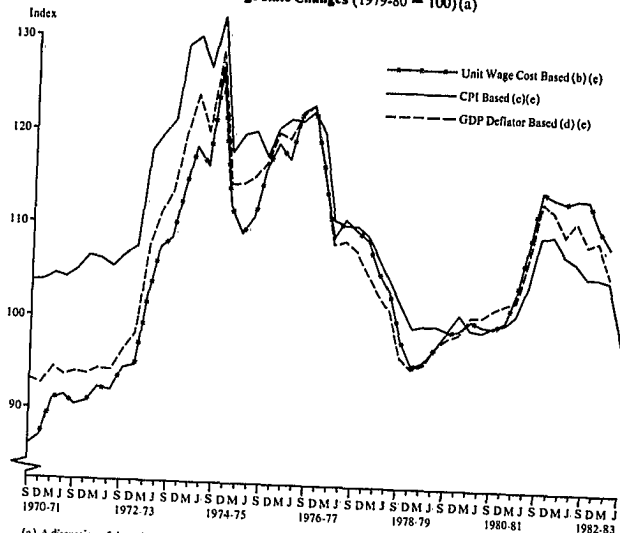
(b) Rates calculated as monthly averages.

International Comparisons of Relative Price and Cost Levels

Three key measures of price and cost movements in Australia relative to changes in prices and costs in Australia's four major trading partners, adjusted for changes in exchange rates, are provided in Chart 14. Movements in these indexes, which are based on unit wage costs, consumer prices and GDP deflators, reflect changes in the ability of Australian producers to compete with overseas producers in domestic and international markets on the basis of price.

All measures show a marked deterioration in relative exchange rate adjusted price and cost levels in Australia over the course of 1981 and some winding back of this gap since that time. Although wage and price increases during 1982-83 were more than double those of our major trading partners, this was outweighed by the depreciation of the exchange rate during the year. Although the wage and GDP deflator based indexes cannot yet be calculated for the June quarter 1983, it is likely—taking account of recent exchange rate movements and known movements in domestic wages and prices—that both indexes fell broadly in line with the decline in the CPI-based index.

Chart 14: Indexes of Unit Wage Costs and Prices in Australia Relative to Major Trading Partner Countries— Adjusted for Exchange Rate Changes (1979-80 = 100) (a)



- (a) A discussion of these indexes and detailed figures covering the period from the September quarter 1970 to the March quarter 1983 may be found in a Supplement to the *Round-up of Economic Statistics for July 1983* titled "International Comparisons of Relative Price and Cost Levels".
- (b) The unit wage cost based index is the ratio of unit wage costs in the non-farm sector of the Australian economy (calculated as the ratio of non-farm wages, salaries and supplements to gross non-farm product) to the weighted average of the exchange rate adjusted unit wage cost indexes estimated for the manufacturing sectors of Australia's major four trading partners.
- (c) The CPI based index is the ratio of the Australian consumer price index to the weighted average of the exchange rate adjusted consumer price indexes of Australia's major four trading partners.
- (d) The GDP deflator based index is the ratio of the GDP deflator for Australia to the weighted average of the exchange rate adjusted GDP deflators of Australia's major four trading partners.
- (e) The weights used are based on the average share of Australia's imports from the US, Japan, UK and West Germany from 1974-75 to 1979-80. The four countries are the source for about 55 per cent of Australia's imports. Observations are quarterly averages. A rise (fall) on this graph implies a deterioration (improvement) in Australian costs and prices relative to our major four trading partners after adjusting for exchange rate changes.

PART II: INTERNATIONAL ECONOMIC CONDITIONS AND PROSPECTS

Declining inflation and falling interest rates have contributed to the emergence of a recovery in economic activity in the major industrial countries in the course of 1983. Real GNP in the seven major industrial countries, which fell by about 4 per cent in 1982, is estimated to have expanded at an annual rate of about 2 per cent in the first half of 1983, with the strengthening in activity most evident in the United States and Canada.

In the United States, real GNP is estimated to have increased at an annual rate of about 3 per cent in the first half of 1983, reflecting a marked slowdown in the rate of stock decumulation, increasing fiscal stimulus and a resurgence in consumer demand and residential investment.

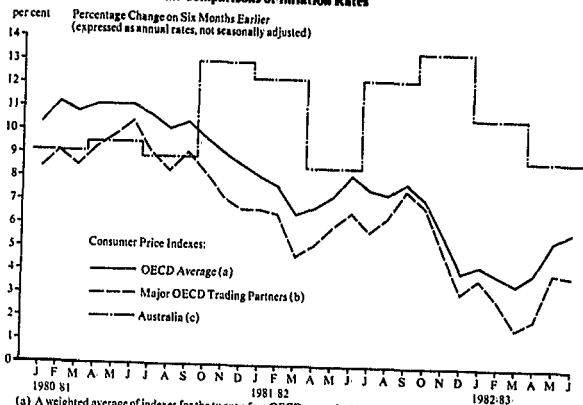
Elsewhere the recovery is, as yet, less evident. Activity in the major European economies was sluggish in 1982-83 although modest growth has re-emerged in the United Kingdom and West Germany. The Japanese economy again grew by over 3 per cent in 1982-83 but growth slowed significantly during the year. The smaller industrial countries appear to have experienced little if any growth.

A number of developing countries suffered severe economic and financial strains in 1982-83 and in some of them per capita output appears to have fallen. Concern about the capacity of some developing countries to continue to service heavy external borrowing in the face of slowing export growth (including, in the case of certain oil producers, falling oil prices) has led to a reduction in new lending to these countries from banks and other private sources. This reduced flow of finance has necessitated action to renegotiate debt arrangements and, more fundamentally, undertake adjustment programs to cut back net imports. Although the liquidity position of the largest debtor countries has so far been preserved, debt payment arrears have risen sharply and a number of international banks remain exposed to risks of default.

Inflation continued to fall in almost all OECD countries in 1982-83 although the progress made by individual countries varied considerably. For the OECD as a whole, consumer prices increased by 5.0 per cent over the twelve months to June 1983 compared to 8.4 per cent during the previous year. Much of this deceleration can be traced to developments in a few major economies—particularly the United States, West Germany and the United Kingdom. In a number of other industrial countries progress was less satisfactory and this has impeded their capacity to share in the emerging recovery. Countries which have been most successful in reducing inflation loom large in our trading relationship; as shown in Chart 15, consumer prices in our major OECD trading partners increased at an annual rate of only 4.0 per cent over the six months to June 1983. By comparison, the consumer price index in Australia increased at an annual rate of 8.9 per cent over the six months to the June quarter 1983.

Some of the improvement in inflation overseas stems from factors which may prove to be temporary; the squeeze on profit margins, reduced prices for oil and other commodities and currency appreciation in the United States are examples. At the same time, a substantial degree of wage moderation has been achieved in a number of countries. In 1982, hourly earnings in manufacturing rose by around 6½ per cent in the United States, 4½ per cent in Japan and 5 per cent in West Germany. Average wage settlements in each of these three economies appear to have run at an annual rate of less

Chart 15: International Comparisons of Inflation Rates



- (a) A weighted average of indexes for the twenty-four OECD countries based on 1981 consumption levels and exchange rates.
 (b) Australia's eight major OECD trading partners comprise the United States, Japan, West Germany, France, the United Kingdom, Italy, Canada and New Zealand. Percentage changes are weighted by 1981-82 import and export weights.
 (c) Quarterly data. Based on the six capitals consumer price index up to and including the June quarter 1981 and on the eight capital cities index thereafter.

than 5 per cent in the first half of 1983 and the OECD has forecast an increase of hourly earnings in manufacturing of 4-4½ per cent in these countries in 1983. For the OECD area as a whole, hourly earnings in manufacturing are expected to rise by about 6 per cent in 1983, compared to 8½ per cent in 1982.

Notwithstanding these clear signs of wage moderation over the past year, the concurrent slowing in inflation has offset the effects of that on real wage movements and, in the absence of any significant productivity growth, there has been broadly no change in the share of non-wage incomes in GNP. Corporate profit margins remain severely squeezed in the OECD area as a whole notwithstanding a recent pick up in the United States; the OECD has estimated that realised rates of return on capital in the major industrial countries reached a post-war low in 1982.

Labour market conditions in the industrial countries continued to deteriorate in 1982-83. Employment declined during the year in all major economies except Japan and the United States. Although the rate of growth in the labour force slowed, partly due to reduced participation rates, unemployment rates in the OECD area continued to rise, reaching about 9½ per cent of the labour force in the second half of the year, notwithstanding a noticeable improvement in the United States and Canada in this period.

Central government budget deficits, expressed as a proportion of GNP, increased in 1982 in all major industrial countries except Japan and the United Kingdom. Discretionary policies in Europe and Japan have generally been directed to containing or reducing already sizeable structural deficits, but there was a marked shift towards a

more stimulatory fiscal stance in the United States and Canada. Although interpretation of monetary aggregates has been made difficult by innovation in financial markets and other factors, monetary conditions in most major industrial countries appear to have eased in 1982-83 relative to the two preceding years. Monetary aggregates have generally run near to or in excess of the upper bounds of announced targets and, in combination with declining inflation, this has permitted an increase in real credit availability.

Nominal interest rates declined substantially during 1982-83 but remained well above concurrent inflation rates. In doing so, they appeared to reflect concerns that large fiscal deficits will persist as activity picks up, particularly in the United States, with consequent effects on borrowing requirements, risk premia and inflationary expectations. In such an environment, expected inflation may well be above current (i.e. immediate past period) inflation so that comparisons of nominal interest rates with the latter are likely to overstate the level of 'real' interest rates.

World trade has been severely affected by the recession, growing protectionism and the problems of developing countries. The volume of world trade fell by 2½ per cent in 1982—the first such decline since 1975. The average price of internationally traded crude oil weakened further in 1982-83 to be about 20 per cent below the peak reached in early 1981. This reflected falling consumption and pressures on producers arising from a heavy liquidation of inventories built up in earlier periods. The IMF estimates that non-oil commodity prices fell by a further 12 per cent in 1982 after a fall of nearly 15 per cent in 1981; an increase of about 5 per cent has been forecast for 1983.

The emergence of a large statistical discrepancy in global estimates of current account balances has underlined the need for caution in interpreting trends in the external positions of the major groups of countries. Available data suggest that since 1980 the surplus of the oil exporting countries has fallen (it may have disappeared altogether in 1982) while the deficit of the non-oil developing countries peaked in 1981 and fell significantly in 1982 in the face of severe funding constraints. The current account position of industrial countries remained in near balance overall in 1982 but the United States, the United Kingdom and France experienced a weakening in their current accounts, while most other countries had stable or strengthening positions.

The international economic context is likely to be more favourable for Australia in 1983-84 than last year. Growth in the OECD countries is now accelerating to an annual rate of more than 3 per cent and that momentum seems likely to be maintained in the rest of 1983-84. The major international economic institutions are forecasting that inflation will not accelerate substantially in the major industrial countries over the coming year, although scepticism in capital markets that this outlook will continue into the medium term appears to be an important factor in keeping interest rates high. The growth in world trade in 1983-84 is likely to be modest, although there should be a significant quickening during the course of the year and, in terms of composition, growth in trade volumes is likely to be relatively more pronounced for Australia's major trading partners.

Looking further ahead, there are several uncertainties surrounding the sustainability beyond 1983-84 of the international recovery, including possible increases in

PART III: ECONOMIC POLICY AND RECOVERY

The Economic Policy Context

In its review of economic developments in 1981-82 and the prospects, as seen then, for 1982-83, last year's Statement No. 2 made reference to the 'natural economic forces' operating both in individual markets and in the overall economy. Following disturbances of one kind or another, such forces, or adjustment processes, were seen as acting to re-establish some sort of equilibrium. It was suggested that, in the absence of policies effective in modifying those processes, the new equilibrium might not be a preferred one from a social or economic perspective; the question was raised 'whether these "natural" responses are the best that industrialised economies—and societies—can offer'.⁵⁹

Adjustment processes of these kinds were central to economic developments during 1982-83.

- In labour markets, employers responded to the earlier real wage hike and associated decline in demand by shedding labour; employment fell and unemployment climbed. Those reactions contributed to a marked slowing of wage increases which in turn facilitated the putting in place of the 'wages pause'. Real wages turned down and, eventually, the decline in employment began to ease and the economy moved towards a new 'equilibrium' at a much higher level of unemployment. A particular sub-set of those processes was evident in the labour market for juniors where the effects were even sharper.
- In capital markets, the sharp interest rate increases in 1981-82 brought forth increased savings from households and from abroad while contributing to the downturn in private investment and hence to reduced borrowings by the corporate sector. For this and other reasons already noted on page 36 (including declining interest rates abroad), the sharply increased public sector borrowing in 1982-83 could be met in a climate of declining domestic interest rates. Capital markets moved towards a new 'equilibrium' involving lower business investment and higher public sector expenditure (both consumption and investment).
- In goods markets, the adjustment processes were more complex, involving increased household savings (magnifying the effects upon final demand of slower growth in real incomes), substantial stock decumulation (magnifying the final demand effects upon production), and falling imports (ameliorating demand effects upon domestic production). The net effect was to restrain demand and domestic production which, in turn, began to contribute to an easing of domestic wage and price pressures. In time, this latter development could, if it were to continue, be expected to generate greater confidence and higher spending propensities.

In total, these various adjustment processes saw unemployment climb in 1982-83 to its highest rate in half a century and, while inflation began to ease back in the second half of the year, it remained high. The newly-elected Government's policy approach is an attempt to modify the raw economic forces in order to achieve a more speedy improvement in both unemployment and inflation; in that sense, it might be characterised as a response to the question posed in last year's Statement No. 2 and quoted in the opening paragraph of this Part.

interest rates, particularly in the United States (as private sector demands for credit increase against a background of large budget deficits), a possible resurgence of inflationary expectations, and lingering concerns as to the stability of the international financial system.

Of the major countries, only Japan and West Germany appear to have inflationary pressures firmly under control. While the United States, United Kingdom and, to a lesser extent, Canada have made progress in reducing inflation, it is too early to judge whether lasting gains have yet been achieved. In France, Italy and a number of smaller industrial countries, progress in reducing inflation has been much less satisfactory.

Monetary aggregates have been growing strongly in a number of major industrial countries in 1983 and, in the United States and Canada, the stance of fiscal policy has become markedly more stimulatory. These developments appear to be continuing despite a much stronger recovery in the United States than was earlier expected by most commentators. In this environment, there is growing concern that inflationary pressures might re-emerge, undermining the hard-won progress made to date against inflation and placing sustained recovery at risk.

Although the problem of large fiscal deficits affects many industrial countries, it is of particular significance in the United States given the importance of that country to international capital markets. United States interest rates can have a major influence on activity levels and inflationary pressures in other countries via their effects on those countries' interest rates and exchange rates. In addition, the strengthening of the U.S. dollar over recent years has acted to reinforce the already strong pressures for protectionism in the United States which have been associated with the world recession. There appears to be a growing consensus in the United States on the need for action to reduce the budget deficit but views differ as to the expenditure areas which need to be cut back and what, if any, taxation measures are called for. The working out of these issues in the political process seems likely to take some time.

Prospects for a sustained recovery also depend importantly on the willingness of governments to create an environment which is conducive to rapid growth through, for example, the reduction of trade barriers, correction of domestic pricing distortions and labour market rigidities and the removal of unnecessary regulation. The need for such measures has been repeatedly recognised by policy makers meeting in international forums but so far action has been limited and, in some cases, even perverse.

⁵⁹ 1982-83 Budget Paper No. 1, Statement No. 2, Part II, page 54.

The Government's approach centres upon a prices and incomes policy and, in particular, the Prices and Incomes Accord agreed between the Government and the ACTU. That Accord recognises the nexus between wage moderation, inflation and employment growth and represents an attempt to establish, by mutual agreement, income (including price) settlement arrangements which might modify the inherent adjustment processes in order to reduce their cost in terms of unemployment and production forgone.

It should be emphasised, however, that those adjustment processes still have some way to run.

The sheer magnitude of the deterioration in the labour market, assisted by the 'wages pause', has brought some respite from the hitherto continuing increase in real labour costs. Given time, further wage moderation would be reflected in better profitability and slowing inflation, and in more jobs. But while some progress was made on that score in 1982-83, particularly in the second half, other notable imbalances remain, suggesting that sustained recovery remains a hope for the future rather than a present reality. In particular:

- corporate profitability remains heavily depressed;
- our inflation rate, unlike those of our major trading partners, remains persistently high;
- monetary growth is excessive, with monetary objectives having again been exceeded in 1982-83 for the fifth year running; and
- public sector borrowing is continuing to rise.

Australia was of course not alone among OECD countries in the difficulties it faced during 1982-83. By the end of the year, however, the severity of Australia's problems was distinctly greater than the average for the OECD area as a whole. This was particularly so for inflation, with Australia's rate more than double that of our major trading partners. Uncertainty continued to surround our economic prospects even though the immediate outlook abroad, and in the United States in particular, had improved.

Because 1982-83 represented a period of adjustment in response to the disturbances of the preceding years, the remaining imbalances should be considered in a longer term perspective—not only to understand the nature and extent of the economy's present problems, but also to formulate realistic expectations as to the speed with which they can be solved and to pursue economic policies appropriate to doing so.

To take the example of unemployment, a high rate of output growth will be needed over a sustained period to bring the bulk of the unemployed—including discouraged workers—back into employment and to absorb the growth in the labour force. If, as expected, productivity growth is relatively high and participation rates rise in the course of the upswing, an improvement in unemployment will take some time to emerge—and whether, given time, it does emerge will depend upon the re-establishment of an adequate level of business profitability.

Inflation persisted stubbornly in 1982-83. In only one of the past ten years has the rise in the CPI fallen below 9 per cent, so that expectations of inflation have become increasingly entrenched in the community. As a result, a sustained slowing in prices may be required before economic behaviour and decisions come to be based on markedly different inflationary expectations. This is not to say that inflation cannot be

reduced decisively and quickly—the recent evidence in several of our major trading partners demonstrates that it can be—but it does indicate the magnitude of the barriers to be overcome.

The simultaneous reduction in unemployment and inflation which the Government is seeking needs to be achieved over the medium term. In the shorter run, policy settings need to pay regard to the nature of the adjustment processes and the extent to which they have yet to work their way through the economy, as well as the inherent risks to sustained recovery.

Prices and Incomes Policy

For success in the Government's efforts to stimulate employment and reduce inflation at the same time, it is crucial that wage and price developments be constrained within the broad guidelines set by the Prices and Incomes Accord. The severity of the declines in both profitability and employment and the associated rise in unemployment during the downturn suggest that labour cost moderation must play a key role in any sustained reduction in inflation and any sustained improvement in competitiveness and in profitability, investment and employment.

The Prices and Incomes Accord stresses the relationship between non-inflationary wage and price setting behaviour and the scope which that is seen as giving for pursuing an expansionary fiscal policy. Reinforcing the relationship between the Accord and macroeconomic policy, the setting of monetary objectives rests upon the *desirable* growth in incomes flowing from the Accord. To cement that relationship, however, the monetary stance will need to be such as to limit the potential for wage settlements outside the centralised wage process. This will become of increasing importance through 1984.

The focus on 1984 arises from the conjunction of an expected pick up in economic activity and restraint in centralised wage increases from the one-off impact of the introduction of Medicare on the CPI. These circumstances could well give rise to increased pressures for sectional wage increases outside the spirit of the Accord (and perhaps even its strict letter). If monetary policy were not sufficiently firm, the ability of employers to concede to such sectional claims and to pass them on in higher prices would be enhanced and this could feed back, through indexation, into the centralised wage settlement processes themselves.

There are two elements to the relationship between fiscal policy and the Accord. First and most fundamentally, expansionary fiscal policy is predicated on the assumption that the Accord will be successful in combating inflation. If that assumption is not realised, the viability of that approach to fiscal policy will be immediately called into question.

Secondly, as demonstrated by the measures contained in the May Economic Statement and in this Budget, there has been a significant switch in the composition of outlays towards programs such as community works and housing which are seen as having substantial direct effects upon employment. There have also been substantial moves towards meeting the equity objectives of the Government's fiscal policy, including with respect to the introduction of an income and assets test on pension entitlements, income testing over 70's age pensions, superannuation and housing interest tax rebates. On both

sides of the budget, the changes thus set in train have moved fiscal policy in directions envisaged in the Accord.

Fiscal Policy

Against the background outlined above, a stimulatory cast to fiscal policy in 1983-84 is taken as given with other policies being required to adapt to that fiscal policy setting.

In one sense, any budget deficit is directly expansionary in that it puts more money into the economy than it takes out. While some qualifications might be made to that general proposition—most notably in respect of the distinction between domestic and external transactions—such qualifications do not substantially affect the basic point. There is no doubt that, in this sense, the Budget for 1983-84 is very highly expansionary indeed. The deficit of \$8361m represents 4.7 per cent of forecast GDP (as compared with a deficit of 2.8 per cent of GDP in 1982-83).

Clearly, no single summary statistic can be an adequate indicator of the appropriateness of the stance of fiscal policy, such summary indicators as those just quoted can be no more than illustrative of certain limited relationships. Some would wish to draw what they see as a more fundamental distinction between the effects of the budget upon the economy and the effects of the economy upon the budget. The former effects are seen as related to the so-called 'structural' elements of the budget deficit and the latter to its 'cyclical' components.

Broadly, the methodology for disentangling the cyclical and structural components for a particular fiscal year involves estimating what the budget would have been, given the existing set of taxation and government expenditure policies, had there not been a downturn in activity and employment. This provides an estimate of the structural deficit (or surplus), which differs from the actual deficit in being calculated on the assumption of a different level of aggregate economic activity. In practice, this is not as straightforward as it might seem, since numerous alternative approaches to such calculations are possible.

On the basis of various calculations that have been made, within the Treasury and elsewhere, the structural component of the 1983-84 Budget deficit will increase substantially, both relative to the overall deficit and to GDP. Within a perspective which focusses solely on the direct income/expenditure effects of a budget, the larger the structural deficit, the more stimulatory the stance of fiscal policy. From such a perspective, the 1983-84 Budget is clearly highly stimulatory.

Structural budget deficits have another significance: they provide an indication of the prospective size of future deficits after the economy has emerged from recession. They thus suggest the magnitude of discretionary taxation-raising or budgetary expenditure-cutting measures that, as the economy recovers, will be required to bring about a fiscal stance appropriate to those improved economic conditions.

Structural/cyclical budget deficit analysis, however, is essentially static. Moreover, that analysis—like other static analyses of the stimulatory effects of fiscal policy adjustments—can have nothing to say on how the structural deficit calculated within such a framework could assist in moving the economy back to the high-employment condition which is assumed for the purposes of the analysis. It seems, in short, to be of little relevance to economies beset not just by underutilisation of real resources—the

classical problem to which Keynes is generally thought to have been principally addressing himself—but by more fundamental imbalances, such as high inflation, distorted wages/profits relationships and structural rigidities in the markets for goods and labour. Nothing—or at least nothing desired—will be achieved by treating unemployment and the other manifestations of underutilisation of real resources as if they were problems to be solved in isolation from underlying economic disjunctures.

In reality, fiscal policy can affect the economy through a variety of channels in addition to direct income/expenditure effects. It can influence interest rates, exchange rates, the money supply, the balance of payments, expectations—notably, inflationary expectations—confidence and uncertainty. These additional transmission mechanisms are, for the most part, extremely inconvenient to handle analytically and often impossible to quantify. They are, however, no less real for being empirically and often even theoretically intractable.

To take an example, the cyclical/structural approach to fiscal policy is of no assistance in considering the monetary policy ramifications of the budgetary outcome, whatever it may be. It is the *total* deficit that is relevant to the relationships between fiscal policy, money and interest rates—for it is the *total* deficit that must be financed. The cyclical component of the deficit adds to private sector liquidity—and needs to be offset by sales of Government securities to the non-bank sector—in just the same way as the structural component does.

It is true that an increase in the budget deficit arising from cyclical influences will generally coincide with lower private sector borrowing demands. However, private demands upon capital markets are likely to increase relatively early in the recovery process, as businesses start to increase production levels and rebuild inventories. The cyclical deficit is related mainly to labour market developments, through reduced PAYE receipts and increased unemployment benefit payments, and recovery in the labour market tends to lag behind recovery in business activity. Hence, the cyclical deficit will still be high as the private sector's demand for funds gathers pace, and this conjuncture will tend to put upward pressure on interest rates during the crucial early stages of economic recovery.

As well as directly reducing private spending, higher domestic interest rates are likely to attract additional overseas funds into Australian capital markets. Although such capital movements tend partially to mitigate rises in interest rates, they also have the effect of putting upward pressure on the exchange rate. This reduces the competitiveness of Australian industry on world markets, dampens exports, and encourages imports. The consequent decline in expenditure on Australian goods provides another offset—in some circumstances perhaps more directly important than the interest rate effects—to the direct expenditure-creating effects of the budget deficit.

By increasing pressures on interest rates and the exchange rate, large budget deficits also pose—publicly—the risk that pressures for a loosening of monetary policy will become stronger and eventually prevail. Those who are involved in financial markets—that is to say, the myriad of lenders and borrowers in such markets as well as the financial institutions which make them up—have come to know that excessive monetary growth does, over time, result in increased inflation; thus the mere threat of increased monetary growth can rekindle inflationary expectations and drive nominal interest rates higher.

Once allowance is made for all these indirect effects of budget deficits on the economy, it cannot simply be assumed that successive increases in budget deficits will provide continuing stimulus to economic activity.

Monetary Policy

In the context of an expansionary fiscal policy, much of the burden of creating an environment conducive to prices and incomes moderation necessarily falls upon monetary policy.

The Government's approach to monetary policy is to provide just sufficient monetary growth to finance the prospective increase in nominal output considered desirable and feasible in the circumstances. That is, sufficient money supply growth will be provided to accommodate the expected increase in real output plus what is considered to be a desirable and feasible increase in prices, with the latter being determined on the basis of the operation of the centralised wage system under conditions consistent with the Prices and Incomes Accord. The relationship between monetary policy and the Accord is, therefore, a close and important one.

The attainment of this objective has probably been made more difficult by previous failures to achieve stated monetary projections. In each of the past five years, monetary growth has exceeded the Budget-time projection; the discrepancy in 1982-83 was not particularly large but the 'average for the year' nature of that projection conceals the marked acceleration over the latter part of the year. The action already taken by the Government to expand the scale of bond tenders should help to re-establish the credibility of monetary projections, but the response will not be immediate. Markets five times bitten are likely to be at least twice shy.

Two further aspects of monetary conditions in recent years assume particular importance for the period immediately ahead. One is the acceleration of innovation in financial markets; the other (perhaps partly related) concerns the large changes in monetary velocity that have occurred and seem likely to continue.

Some concern has been expressed recently both in Australia and overseas, particularly in the United States, that financial innovation has made the conduct of monetary policy more difficult and perhaps even substantially reduced its overall effectiveness. Recent innovations in Australia include the rapid development of the commercial bill and promissory note market, the development of cash management trusts and greater emphasis on liability management by financial institutions, involving a greater reliance on standby credit lines (particularly from overseas). The acceleration of the innovation process, both here and overseas, stems importantly from the high nominal interest rates that have accompanied the high inflation of recent years and from increased awareness of relative rates of return on different financial assets. In many respects, such developments betoken markets living (and evolving) in troubled times.

While the effect of these innovations on monetary conditions can be overdrawn, they have undoubtedly contributed to the differing relative growth rates of various financial aggregates and, more speculatively, may have changed the relationship between particular monetary and financial aggregates and other economic variables such as nominal and real income growth. If so, this would have important consequences for monetary policy—though not ones that raise basic doubts about its efficacy.

One obvious consequence is that assessments of monetary policy should be based on a variety of indicators and not rely on a single aggregate; there is of course nothing new in that and recent financial innovation merely emphasises the point. More fundamentally, particularly when inflation is high, monetary policy needs to be conducted by market-oriented instruments which aim to control the liquidity or monetary base of the financial system rather than by instruments which rely on direct controls on one or more categories of financial intermediaries. Whereas virtually all forms of financial intermediation rest to a greater or lesser extent on the liquidity or monetary base, it is an obvious lesson of history that direct controls only invite innovation to evade them.

The current recession in Australia has been marked by a much sharper fall in real and nominal output growth than in monetary growth, so that monetary velocity has declined sharply. In Part I of this Statement, the judgment was reached that this sharp decline in velocity seems to have been primarily related to cyclical factors. Some unwinding of that process can be expected to be reflected, as the pick-up in activity proceeds, in a marked increase in velocity during 1983-84. In turn, this implies a requirement for growth in the monetary aggregates noticeably below the desired growth in nominal product.

The lags with which monetary policy affects the economy are lengthy and variable and argue against attempts to 'fine tune' monetary growth to short-term swings in the growth of real output. Rather, monetary growth needs to be set on a more stable path consistent with medium term objectives for reductions in inflation and inflationary expectations and growth in real output. Stable does not, however, mean unchanged and the need for stability cannot be invoked to support continuing monetary drift. Avoiding such drift—achieving an appropriate monetary outcome—in the context of a very large budget deficit requires very large sales of Commonwealth Government securities to the non-bank sector.

External Policy

Although there has been much debate about the nature of the channels through which domestic and external policies interact, there is general acceptance that the task of economic management is easier if policies are mutually supportive. While external economic policy must primarily be directed to maintaining external balance, it can also have an important role in the achievement of domestic objectives. It cannot, however, be expected to operate independently of domestic policy or compensate for inadequacies in domestic policy.

The 12 per cent depreciation of the trade-weighted value of the \$A over the course of 1982-83 both provided an immediate and substantial improvement in Australia's international competitiveness and assisted in improving the current account deficit. Depreciation also, however, resulted in higher priced imports thereby adding to underlying domestic price and cost pressures.

With the budget adding substantially to primary liquidity in 1983-84, the achievement of monetary objectives would be facilitated by a reduced injection from external sources. Given the present relatively high level of external reserves, there is scope for the private sector foreign exchange transactions surplus to decline in 1983-84 from its high 1982-83 level. Other things being equal, however, the required bond-selling effort

and its effects on interest rates would tend to attract inwards flows across the exchanges. External policy will need to do what it can to ensure that any such tendency does not substantially offset the domestic effects of the bond-selling effort.

There is a fine line to tread here. If sufficient securities were not sold to the non-bank sector there would be a substantial risk that the liquidity being pumped into the private sector from the budget would result in a large fall in net foreign borrowing. What was intended to be a modest surplus in private sector foreign exchange transactions could thus develop into a substantial deficit.

The implication of those considerations for external policy in 1983-84 is not easily assessed. The exchange rate will, as usual, be influenced by many factors including cost and price pressures in Australia relative to those of our trading partners, developments on the current and capital accounts, movements in exchange rates and interest rates abroad, the course of economic policies, and Australia's growth prospects. It suffices to say that the exchange rate will need to be managed flexibly if external policy is to pull in tandem with domestic economic policies.

Risks to Sustained Recovery

There are four major—and closely inter-related—risks to achievement of sustained recovery in the domestic economy in the period ahead. These relate to interest rates, inflation, the balance of payments and high uncertainty linked with low private sector confidence. (This is to say nothing of the uncertainties surrounding the sustainability of the *international* recovery, including the possibility of further increases in interest rates, particularly in the United States, a resurgence of inflationary expectations internationally and lingering concerns as to the stability of the international financial system.)

To take these risks in turn, interest rate outcomes may potentially provide major barriers to the emergence of a basis for sustained recovery during 1983-84. The fundamental issue is not, however, whether interest rates will rise or fall in 1983-84; rather it is whether, given the configuration of other economic variables, they will be at a level which is conducive to or inhibits a durable revival in private sector spending.

Net borrowing by the public sector as a proportion of GDP more than doubled in 1982-83 and a further sharp increase is in prospect for 1983-84. Even with a further fall in corporate net borrowing in 1983-84, the combined borrowing of the public and corporate sectors is projected to rise to the highest level relative to GDP for at least the past twenty-five years. Certainly, in 1982-83 it proved possible to finance a sharply increased public sector borrowing requirement in a climate of declining interest rates. There were, however, some particular elements of the economic scene in 1982-83 which were relevant to that achievement and which cannot be counted on to continue—or at least not to the same extent—in the year ahead. These were:

- a very sharp fall in corporate sector borrowing and relatively high household savings;
- very significant falls in overseas interest rates and exchange rate expectations that, for a good part of the year, favoured capital inflows; and
- apparently, some growing expectation that inflation would fall in the short run, with consequences for the inflation premium built into medium-term nominal interest rates.

In 1983-84 the financing of the very large Commonwealth budget deficit in a way consistent with the overall thrust of policy will require very large volumes of Government securities to be placed with the non-bank sector. This involves a transfer of income to investment in financial assets and/or increases in holdings of public sector securities relative to other financial assets. It cannot be expected that these portfolio shifts will be achieved without a change—at least in the short-term—in the relative real rate of return on public sector securities. In particular, these shifts will require that public sector securities become relatively more attractive than other financial assets, at least for a time.

To put the task into some perspective, it might be noted that sales of Government securities to the non-bank sector in 1982-83 alone—\$4100m—were greater in real terms than total sales to the non-bank sector during the whole of the 1970s.

The prospect of a similar—perhaps larger—real increase in non-bank holdings of Government paper in 1983-84 carries with it the risk of pressures on the price (i.e., the interest rate) of that paper. This risk would be substantially heightened over future years if large budget deficits—and a consequent high rate of growth of Government paper outstanding—were permitted to continue.

It should be noted that the increase in non-bank holdings of Government securities in 1982-83 was from a relatively low base level. Although the nominal stock of Government debt in non-bank hands more than doubled over the decade to June 1982, the real value of that debt actually declined by 29 per cent over that period. By the end of 1982-83, however, real non-bank holdings of Government debt had risen again to their highest June level since 1972-73. Additional increases in 1983-84 and *a fortiori* beyond run an increasing risk that bonds may have to be sold onto a market already saturated with that product. If so, investors would be likely to shorten further the maturity of the debt they hold and demand very full interest rate premia to cover the risks of a resurgence of inflation.

The risks of all this to interest rates are compounded by the likelihood that, at the same time as the Commonwealth will be increasing its call on the savings of the non-bank sector, and more specifically the household sector, other elements of the public sector will also be increasing their demands on the same savings.

Inflation is another potential barrier to the transformation of the present pick-up in economic activity into durable economic recovery. The lagged effects of recession over the past 18 months and the slowing of wages should be sufficient to deliver a somewhat lower price outcome in 1983-84 than last year within a higher profit environment. The central issue, however, is whether that decline in wage and price inflation can be furthered so as to permit sustained economic recovery. Continued incomes restraint and substantial declines in inflation would assist recovery through promoting an environment conducive to improved international competitiveness, the financing of the very large bond-selling task facing the government already referred to, the lowering of uncertainty, reduction in speculative investment and the encouragement of private spending decisions, particularly longer-term investment decisions.

As for the balance of payments, the events of March 1983 provided a graphic reminder—if one were needed—of the inherent volatility of external capital flows. The dramatic swings in market sentiment, and the speed and size of transfers of funds in and out of the country, provided an example of the need for flexibility in monetary and

external management. But no amount of flexibility can remove the potential for the external account to impose severe constraints on domestic economic performance if that performance is not seen to be conditioned by adequate domestic policies.

Probably the most readily recognised balance of payments constraint derives from the link between the rate of domestic economic expansion and the rate of importing. With the current account deficit now declining strongly (temporary drought effects on exports aside), there is no suggestion that this source of difficulty is operative, or close to being operative, in Australia at present. Nevertheless, it does serve as a reminder of the limits to the pace of economic recovery, particularly should the recent gains in international competitiveness not be sustained.

Related to that point is the constraint that domestic cost and price performance places on the balance of payments and on exchange rate policy. The forecast recovery in international activity should provide a boost to world trade volumes, at least among Australia's principal trading partners, and to commodity prices; this will provide the opportunity for a further improvement in Australia's balance of trade. At present, though, the Australian economy is not well positioned to improve its share of world trade. In particular, our inflation rate is currently more than twice that of our major trading partners. Prospects for 1983-84 are for no more than some narrowing of that gap.

In principle, continual exchange rate depreciation can avoid a loss of international competitiveness resulting from relatively high inflation. The reality is more complex, particularly in the context of an inflexible domestic cost structure. For a devaluation to be effective, there must be a lasting improvement in the cost/price structure of the traded goods sector. If the higher prices caused by devaluation are reflected in higher wages and other costs, nothing will have been achieved—except a further boost to the high inflation which necessitated the devaluation in the first place. It would therefore be a dangerous fallacy to suppose that exchange rate flexibility frees us from the necessity of bringing down our inflation rate.

The balance of payments also has potential to disrupt the management of domestic monetary policy. Ultimately, external stability depends on domestic financial stability, including a macroeconomic policy framework which is—and is seen to be—stable, predictable and workable. A sceptical public—including financial market participants—may require some clear 'runs on the board' before uncertainties are lessened. In the meantime, financial markets, and flows of funds across the exchanges, could remain quite volatile.

Risks of the type just described deserve specific attention at this time because of the unprecedented scale of public sector demands on financial markets. Most discussion of this issue—including in this Statement—has emphasised the inherent interest rate (i.e. price) risks. But there are also quantity risks. If interest rate pressures approach the unacceptable, or if expectations develop that they are likely to do so, excess money balances can build up very quickly—and with equal speed spill across the exchanges via a haemorrhage on the capital account of the balance of payments.

The general point in the foregoing is that if there are domestic policy deficiencies, external policy is not itself capable of restoring a stable external position; in the end, external balance is above all a function of domestic policy settings.

PART IV—THE ECONOMIC OUTLOOK

Background

The Australian economy has emerged from 1982-83 with mixed prospects. The deep recession and the associated wage moderation over a period of six months or so have seen labour costs being brought more into line with productivity and the underlying rate of inflation beginning to fall in the wake of that. Fiscal policy has become decidedly stimulatory. The drought has broken and economic prospects abroad have brightened. At the same time the exceptionally heavy stock run-down which depressed production in 1982-83 is likely to level out as 1983-84 progresses, with positive consequences for production.

The concurrence of those favourable factors should see economic activity pick-up as 1983-84 proceeds. That pick-up, however, is expected to be narrowly based and policy must now focus upon creating conditions which might broaden the pick-up to include private sector spending.

The Forecasting Framework

Preparation of budget estimates requires detailed forecasts of various economic parameters in the form of single point estimates. This suggests a degree of precision which is quite unwarranted given the uncertainties of the economic environment, and each estimate should more accurately be regarded as no more than the mid-point of a range of plausible possibilities. The economic upheavals of the past decade, the increased swiftness of the response of economic agents to changes in their perceptions of the economic situation and to their expectations of prospective developments, as well as the movement, in some important respects, of the current performance of the economy to an area that is outside the domain of post-war experience, all heighten the uncertainty surrounding the outlook for the year ahead.

Those difficulties for the forecaster are compounded when, as at present, a turnaround in economic activity is expected within the forecasting horizon. The long-heralded but much delayed turnaround in the U.S. economy bears witness to the difficulty of successfully predicting the turning point in an economic cycle. Even if the forecasts herein correctly embody the rate at which activity rises once the turnaround commences—and there is, of course, no guarantee of that—an error in the projected time profile of the upturn could dramatically alter forecast year-average growth rates. For example, a delay of only one quarter in the commencement of the projected pick-up would detract over one percentage point from the forecast growth of non-farm product in 1983-84.

The forecasts are, as always, conditional on an underlying framework of assumptions which form an interrelated and (it is hoped) consistent whole. Other things being equal, a change during the course of the year in the setting of a policy instrument necessarily entails offsetting shifts in other policy settings if the same objectives are to be achieved. For example, the forecast slowing in the rate of inflation is conditional on the assumption that wage increases outside the assumed increases in award wages under National Wage Case hearings are only minimal. Fiscal and monetary policy settings have been adopted having regard to that assumption. To the extent that sectional wage claims increase above that minimal level, the slowing in inflation could only be achieved

through a firmer stance of other policies. On the other hand, a more favourable outlook for inflation and an easing of inflationary expectations—and hence for private demand and the growth of employment—would obtain if the increase in award rates were, in the event, lower than has been assumed.

In addition to all the caveats just mentioned, there is the usual problem that the forecasts must necessarily be based on currently available statistical data, which can subsequently be subjected to substantial revision and then be seen to have provided an erroneous stepping off point for the forecasts.

Forecasting Assumptions

The main components of the Budget estimates, as used for forecasting purposes, are as follows (figures in parenthesis represent corresponding increases in real terms, where appropriate):

- an overall budget deficit of \$8361m, comprising an estimated domestic deficit of \$5744m and an overseas deficit of \$2617m;
- an estimated increase in total outlays of 15.8 per cent (about 7½ per cent) comprising:
 - an increase of 15.4 per cent (about 8 per cent) in current expenditure on goods and services (partly deriving from an estimated increase of 4.4 per cent in public service staffing, approximately one-half of which represents the full year effects of increases during 1982-83);
 - an increase of 20.9 per cent (about 11½ per cent) in gross fixed capital expenditure, including sharp increases in building and construction expenditures and extensive outlays on computing equipment;
 - an increase of 14.0 per cent (about 5½ per cent) in payments to the States, the Northern Territory and local government, including large additions to special employment programs and for road construction; and
 - an increase of 19.5 per cent (about 10½ per cent) in cash benefit payments to individuals;
- an estimated increase of 8.6 per cent (about ½ per cent) in total receipts, including:
 - an increase of 5.4 per cent in direct taxation; and
 - an increase of 14.4 per cent in indirect taxation.

The other assumptions underpinning the detailed projections are:

- a moderate recovery in international economic activity over the course of 1983-84. Real GNP in industrial countries as a group could grow by around 2½ per cent in 1983-84, including a stronger rise in the United States;
- only slight growth in the volume of world trade in 1983-84 although the trade of Australia's major trading partners could fare significantly better than average;
- lower price inflation in all major industrial countries in 1983-84 than in 1982-83, though there could well be some upward pressure on prices later in the year as activity recovers and commodity prices rise. World oil prices, however, are assumed to remain around their current levels over the forecast period;

- adjustments in domestic and external policy instruments with sufficient flexibility to ensure growth in financial aggregates consistent with an increase in M3 in the range of 9 to 11 per cent over the year to the June quarter 1984;
- more normal seasonal conditions, following the recent rains, allowing the sharp decline in farm production that occurred in 1982-83 to be reversed; and
- six-monthly wage indexation and strictly limited sectional claims.

General Outlook

Based on those forecasting assumptions, the outlook for 1983-84, in summary, is as follows:

Activity and output

- continued strong growth in public sector final demand;
- continued weak private sector final demand, with a further marked fall in private business fixed investment more than offsetting weak growth in private consumption and strong growth through the year in private dwelling construction;
- a marked slowing in non-farm stock decumulation and a rise in farm stocks;
- a modest pick-up in exports and another significant decline in imports; and
- moderate growth in real non-farm product (but strong growth through the course of the year) and, reflecting a rebound in farm output, somewhat faster growth in GDP.

Labour market

- moderate growth in employment during the course of the year; and
- an edging up in the rate of unemployment.

Prices and incomes

- some slowing in the rate of domestic inflation;
- a resumption of growth in real household disposable income; and
- some improvement in business cash flows and profits.

Balance of payments

- a further fall in the current account deficit;
- a rather larger fall in capital inflows; and
- as a consequence, a modest fall in international reserves from their present high level.

Financial markets

- a further fall in corporate borrowing and an increase in household lending;
- a marked increase in public sector borrowing; and
- continued pressure on interest rates.

Further notes on the major components of the forecasts are set out below. Expenditure estimates are in real terms.

Activity and Output

Private consumption expenditure is projected to increase by around 1½ per cent in 1983-84, somewhat faster than in 1982-83. However, as recorded in the national accounts, consumption growth is likely to be only slightly stronger than in 1982-83 because of the reclassification of certain health expenditures from the private to the public sector, reflecting increased hospital payments to the States under Medicare. Real household disposable income is projected to grow by about 3 per cent, following no growth in 1982-83. The forecasts imply little change in the 'adjusted' saving ratio (following the ½ percentage point increase in 1982-83), reflecting an assumption that the effects of continued high unemployment and uncertainties about future inflation (with consequential effects for interest rates) will be countered by the favourable effects on confidence of economic recovery and a slowing in recorded inflation. Consistent with the projected strong growth in farm income, the aggregate saving ratio is expected to increase markedly in 1983-84.

Private dwelling investment is projected to increase by about 3 per cent in 1983-84 (following the decline of 25 per cent in 1982-83). The rebound over the course of the year could be of the order of 20 per cent. This projection is conditional upon deposit rates of the major mortgage lenders remaining competitive within the interest rate structure.

*Business fixed investment*¹⁰ is projected to fall again in 1983-84 at about the same rate as the very sharp decline of 14 per cent recorded in 1982-83. The forecast reflects the view that, given current low levels of capacity utilisation, business will be cautious in responding to the pick-up in activity and improved profitability in the face of high real rates of interest and uncertainties about wage moderation, international competitiveness and the durability of the recovery.

The major influences on the level of public sector activity in 1983-84 include the Commonwealth Budget and the apparent continued willingness and ability of governmental authorities at all levels to finance growing capital expenditures in an environment of high real interest rates. *Total public sector final expenditures* on a national accounts basis are projected to increase by about 4½ per cent following the rise of about 3½ per cent in 1982-83. This assumes accelerated growth in public *current expenditures* (possibly to around 6 per cent) roughly offset by a slowing in the rate of growth in public *capital expenditure* from about 4 per cent in 1982-83 to around 2 per cent in 1983-84.

Commonwealth current expenditure on a national accounts (deliveries) basis is expected to increase strongly in 1983-84 (by around 10 per cent) while Commonwealth capital expenditures are projected to increase by about 3½ per cent after declining by around 10½ per cent in 1982-83. Very strong growth in budget-financed civil works is expected in 1983-84, with lesser growth in capital spending by Commonwealth authorities. State and local government authorities' capital expenditures are assumed to increase by around 2 per cent, compared with very strong growth of about 8 per cent in 1982-83.

¹⁰ The following discussion of the outlook for business fixed investment and public authority investment abstracts from the impact on the published national accounts estimates of certain sale/leaseback transactions between the public and private sectors, based on Treasury estimates of these transactions.

Following very heavy decumulation of *non-farm stocks* during 1982-83, the rate of run down is expected to slow substantially during the course of 1983-84. Within 1983-84, *farm stocks* are likely to experience a turnaround equivalent to about half of the increase in farm product.

Non-farm product is forecast to increase by about 2 per cent in 1983-84, embodying considerably more rapid growth—5 per cent or so—over the course of the year. With a sharp rebound of about 20 per cent in farm product, total *gross domestic product* could grow by 3 per cent or so for 1983-84 as a whole.

The Rural Recovery

The severe drought which afflicted much of eastern Australia in 1982-83 had a devastating effect on the rural sector and led to a fall in gross farm product of 18 per cent. With farmers' costs rising more rapidly than the prices received for their produce, farm income, measured in real terms, recorded much the largest percentage decline in the last 30 years.

Following the drought-breaking rains over recent months, a significant recovery in the rural sector is likely in 1983-84. Gross farm product could rise by around 20 per cent. A firming of commodity prices on international markets and the strong rise in livestock prices in Australia following the breaking of the drought, together with a moderation in the rate of increase of farm costs, should lead to an approximate doubling of nominal farm incomes in 1983-84.

Autumn plantings suggest that wheat production could double the 1982-83 crop. Record plantings are expected for most other grain crops. Production of livestock and livestock products could decline by about 4 per cent in 1983-84, as farmers start rebuilding herd and flock sizes following the breaking of the drought. However, in conjunction with the US recovery, this lower production has put upward pressure on livestock (and hence meat) prices. Sugar production is expected to fall in 1983-84 following unseasonably low rains during the growing period, although the impact on the value of production is likely to be muted by an expected improvement in world sugar prices.

The large increase expected in grain production would result in a build-up of farm stocks (following the drought-induced fall in 1982-83), more than offsetting an expected depletion of wool stocks associated with the projected small decline in wool production.

Balance of Payments

Exports of goods and services are likely to increase moderately in 1983-84 as in 1982-83. Some farm exports will still be affected by the earlier decline in farm production and there is expected to be a modest fall in overall farm export volumes; non-rural exports should record better growth, reflecting improving world demand and increased production capacity in some parts of the resource sector.

Imports of goods and services seem set for another decline in 1983-84 consistent with the weak outlook for private domestic demand, particularly in the business investment area, and the lagged effects on competitiveness of the depreciation of the Australian dollar through 1982-83. However, the expected pick-up in the domestic economy is likely to induce some expansion of import volumes over the course of 1983-84.

As always, the likely *balance on the current account* is surrounded by considerable uncertainty. The trade deficit, which declined significantly in 1982-83, should turn to surplus in 1983-84, more than offsetting some further edging up in the net invisibles deficit. As a result, the current account deficit could narrow further in 1983-84, although by less than the major reduction in 1982-83.

The extent of private capital inflow will depend heavily on monetary and short-term external policy settings. It is assumed that in 1983-84 these settings will be conducive to a level of private capital inflow markedly lower than in 1982-83 and consistent, having regard to the reduction in the deficit on private current account, with a smaller external contribution to domestic liquidity than in 1982-83. With continued moderate Commonwealth Government borrowing abroad, this would indicate some modest reduction in Australia's foreign exchange reserves from the high level at which they stood at 30 June 1983.

Labour Market

There is considerable uncertainty as to how far the pick-up in activity will be transmitted to the labour market. The shake-out in employment in the present recession has been particularly severe as firms have responded to the combination of higher real wage costs and reduced demand. The severity of the labour-shedding response has worked to raise non-farm labour 'productivity' (per person employed) in 1982-83 and it may well be that this trend will continue into the upturn in the face of the depressed corporate profit share and high labour costs. Employers may require firm evidence of improved profitability and a sustained increase in demand before fully reversing the labour shedding that took place in 1982-83.

On that basis, the greater part of the projected increase in product in 1983-84 is expected to be accounted for by an increase in 'productivity' (as measured) rather than increased employment. A substantial part of that 'productivity' increase would represent merely an increase in weekly hours worked as short-time arrangements are unwound and employers make greater resort to overtime working.

Partly reflecting the impact of the Government's public sector employment-generating initiatives, employment could grow by about 1½ per cent over the course of 1983-84, bringing average employment in 1983-84 up to around the average for 1982-83.

In view of the resilience of the labour force participation rate in the face of the shake-out in the labour market during 1982-83, the forecasts for 1983-84 assume little change in the participation rate from its recent level. In conjunction with expected growth in the working age population of about 2 per cent, this would imply that labour force growth would continue to exceed employment growth and hence that average unemployment would be higher in 1983-84. For the purpose of the Budget estimates, this has been translated into an average level of unemployment benefit recipients of around 680 000 in 1983-84 compared with an average of 540 000 in 1982-83 and a level in July 1983 of 634 000.

Prices and Incomes

For 1983-84 as a whole, *average weekly earnings* are assumed to be about 7 per cent above their average level in 1982-83, representing a marked slowing from the increase of 11½ per cent last year.

For the purpose of preparing the Budget estimates, it has been assumed that National Wage Case decisions are based on half-yearly indexation commencing with the increase in the consumer price index for the March and June quarters of 1983; a sizeable allowance is made for increases in hours worked but minimal allowance for sectional claims. An alternative assumption—leading to much the same outcome—would be for less than full indexation to be awarded but for sectional claims to be somewhat higher.

However, much of the slowing in earnings growth that the year-on-year increase of 7 per cent implies would reflect the effects of the wages pause in the second half of 1982-83; the growth in earnings through the course of 1983-84 would be considerably faster than that.

The slowing in wage increases during 1982-83 and the early part of 1983-84 is in turn the main influence contributing to some slowing in underlying inflation in 1983-84. Other influences expected to affect prices in 1983-84 include: the lagged effects of the exchange rate depreciation over the course of 1982-83 (which are likely to offset the beneficial effects on domestic inflation of the very low inflation projected for our major trading partners); some further increase in food prices; and increases in public authority taxes and charges including those announced in this Budget. The introduction of Medicare from 1 February 1984 is expected to diminish substantially the increase in the CPI in the second half of the year, but national accounts price deflators will, of course, be unaffected.

On that basis, the CPI could increase by about 7½ per cent in 1983-84 as a whole, with more broadly based expenditure deflators rising rather more than that.

Taken in conjunction with the projected strong pick-up in 'productivity', these movements in wages and prices would be consistent with some increase in profitability, from its current extremely depressed level, over the course of 1983-84.

Financial Markets

As indicated in the Budget Speech, the Government will be seeking to restrain growth in all monetary aggregates, consistent with growth of M3 in the range of 9 to 11 per cent over the year to the June quarter 1984.

This implies a fairly sharp increase in the income velocity of circulation of M3 through the course of the year. However, as discussed in Part III of this Statement, a cyclical increase in velocity is normal during an upswing and, on this occasion, velocity starts from a point well below trend. The projection has been based on the judgment that, accordingly, there is room for a substantial increase in velocity before the slack presently in the system is taken up.

Net borrowing by the public sector in 1983-84 could increase by around 2 percentage points of GDP, to about 8 per cent, more than offsetting a likely further decline in net corporate borrowing. Even with a further rise in household net lending, such large shifts in sectoral funds flows might not be achievable without some pressure on interest rates. Developments in overseas financial markets, however—particularly interest-rate movements—will as usual have a significant influence on domestic financial markets and hence on domestic interest rates.

STATEMENT NO. 3—ESTIMATES OF OUTLAYS, 1983-84

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Further Ahead

As the forecasting horizon is extended the uncertainties and risks attaching to the durability of the upturn greatly increase. Stripped down to its essentials, the task of maintaining the momentum of the pick-up in activity beyond 1983-84 hinges on the creation of an economic environment conducive to sustained growth in the private sector. Of those factors not directly subject to policy control, wage settlements in the year ahead have the greatest potential for influencing the outcomes for inflation, interest rates and corporate profitability—and hence private sector activity in the period beyond that.

A wages outcome higher than currently assumed would have an especially damaging impact on business confidence and private sector spending propensities. The renewal of pressures on corporate profitability, together with a consequent slackening in private demand, would be likely to manifest itself in a further round of labour shedding and another sharp ratcheting up in the rate of unemployment.

Those risks are sufficiently grave in the economic context presently foreseen. They would be magnified, however, should the outlook for demand prove even stronger than presently expected while public sector demands were still growing strongly. For example, an even stronger upturn in the world economy than now foreseen could aggravate the risks within Australia of a renewed wage surge, higher inflation and higher interest rates. Unless these possible consequences were contained, the potential advantages to Australia of the world upturn could then be lost and the prospects of sustained recovery further imperilled.

The current fiscal stimulus is large by any standards. The forecasts assume that, in 1983-84 at least, it will be possible to finance the resultant public sector borrowing requirement without significant increases in the general level of interest rates. This assumption rests largely upon the forecast, comfortable in the reasoning which underlies it, of very weak projected demand for finance by the private corporate sector. At the same time it is recognised that developments in capital markets abroad, particularly in the United States, are highly unlikely to be as 'favourable' for domestic interest rate trends as they were in 1982-83. Clearly, additional pressures on interest rates would result if, from one viewpoint happily, the demand for private finance were stronger than envisaged. In that case, rising interest rates could act seriously to inhibit, if not choke off, the tendency for recovery in private sector activity. The risk of that would be much enhanced if budget deficits and borrowing requirements were not seen as likely to be reduced once an upturn in private sector activity gathered momentum.

A further point of concern for a sustainable recovery relates to the current inflation outlook which, even given a favourable wages outcome, is likely to remain substantially above inflation levels in our major trading partner countries.

These possibilities are highlighted not to engender any feelings of gloom but to emphasise the serious nature of the problems still to be overcome and the central elements of the necessary policy response. They tend to reinforce the view that a durable recovery will require, as essential pre-requisites, both continuing wage moderation in the period immediately ahead and an on-going effort to reduce structural public sector deficits and borrowing requirements as recovery proceeds. If those pre-requisites were met recovery would proceed and, as it did so, growth in activity would be reflected more fully in strong employment growth.