THE AUSTRALIAN ECONOMY

by David Love

(Mr. David Love is Principal of H.D. Love and Associates, publishers of Syntec. This luncheon address was delivered at Macquarie University on May 13, 1974 on the occasion of the Open Session held on the first working day of the Second Portfolio Management Seminar. The Seminar was sponsored jointly by the N.S.W. Branch of the Society and Macquarie University Graduate Studies in Business Administration.)

I have been invited to talk to you about the Australian economy - about where it is now and where it could be going in the short term. On the eve of what is likely to be a closely run election, acceptance of such a brief may seem to be bordering on the foolhardy. In the short term, however, I don't think the name of the Government is going to make all that much difference. At key points the die has been cast already.

For this kind of exercise, a good starting point may be the final months of 1973. You may recall that a strongly held conventional wisdom of that time ran broadly as follows: Australia would be in recession by around the middle of 1974, largely by way of importing the "international oil crisis" recession from the northern hemisphere. International commodity prices were about to collapse and Australian corporate decision-makers simply were not going to go ahead with expansion of inventory and fixed capital equipment spending plans.

Less than six months later prevailing conventional wisdom had swumg around almost 180 degrees. In press commentary and elsewhere, one of the principal points of issue so far in this election campaign has been the question of which side is more irresponsible than the other in its policies towards what most now assume will be a more-or-less continuously overheating boom economy.

The corporate decision-maker who, six months ago, was not going to spend another cent on capital expansion (due to "international uncertainty" and a Labor Government) by this time had changed his tune. The Commonwealth Statistician reported last month that private businesses in Australia anticipated raising their outlay on capital expenditure in the six months to the end of June next at a rate equivalent to 45 percent above the same six months in 1973.

In brief, to say the least, the prevailing climate of opinion on where the economy was going in April was in ironic contrast to that of November. The change about, in fact, was almost sufficient to prompt a cynical fellow like myself to suggest a new kind of Murphy's law for broad measurement of the direction of the economy; that is, take the opposite view to that which is prevailing as conventional wisdom in the market place at any given time.

But of course, we can do much better than that. With the application of a little work, comprehensive analysis and coordinated economic logic and perhaps, most important, a special effort to keep as far away from the emotive and the political as possible, we can grope uncertainly towards a possibility of truth.

Let's begin with the question of why the conventional wisdom of late 1973 - i.e. a mid-1974 real activity slump - turned out to be so wrong. We can turn to ask whether the popular current view - that of a future of untrammelled inflationary boom (irritated somewhat, it is true, by seasonal plunge into very tight money and very high short term interest rates) - is right. Is it more likely to be the correct interpretation of where the economy is heading than the prevailing scare of late 1973?

Briefly put, the Australian economy did not turn into the kind of recession widely feared for mid-1974 because the Australian business cycle is significantly out of synchronisation with the business cycles of the major northern hemisphere capitalist economies. Even if the northern hemisphere industrial recession had been as bad as was so widely feared in those pre-Christmas weeks, Australia would have imported the slump only after a substantial lag.

At a time when most of the northern hemisphere economies had clearly peaked in the middle months of 1973, the Australian business cycle was swinging strongly upwards. There were factors operating in the Australian cycle that would ensure that any tendency towards downward fluctuation in the local economy that did occur in late 1973 - early 1974 (and in fact some such fluctuation did occur), should be short term and shallow; that it should be occurring well above the underlying base trend line for the Australian cycle. I won't attempt to identify all these factors. I shall dwell briefly upon one. And that is the state of investment in what the Statistician calls non-farm inventory.

A brief interpolation here first: Investment in stocks is one of the several areas of Australian official statistics which are woefully inadequate for a modern economy - so inadequate as to be a positive danger to sound economic management. The statistics we have got in this area are in the most general form in the national accounts. They are not only quite insufficient in scope, precision and detail; they are also terribly late. The last national income statistics we have are for the December quarter.

The statistics we have got in this area suggest that throughout 1973 commercial and non-farm industrial investment in inventory played the opposite to the role that normally can be expected from such investment as a fundamental economic dynamic in our system. Throughout the decade of the sixties and into the early seventies, net change in the level of non-farm inventories in Australia contributed as much as a positive 1.2 percentage points per annum out of Australia's 5 percent per annum average real growth. (That is, stock building contributed more than a fifth of average total real growth over this period.)

Through 1972-73 however, change in the level of non-farm stocks operated in quite the opposite way - as a slight negative subtraction from Australia's real domestic product growth. In 1970-71 change in the level of non-farm stocks in Australia had contributed a positive $460 million to total GDP. For 1972-73 this had changed to a negative contribution of $36 million. Australian commercial and industrial enterprises were involuntary disinvestors in stocks through most of 1973.

Before the Australian business cycle can substantially turn from upswing to definite downswing, those enterprises in some must have swung all the way around to becoming involuntary investors in stocks: Stocks have to begin piling up because sales have begun to run below production. The turnabout which this would represent must be fairly massive.

We don't really know what is happening right now. But in most areas of commerce and industry through 1973 and into 1974, enterprises have been frustrated in their endeavours to re-build stock-to-sales-ratios to desired and pre-existing norms - let alone to lift these levels somewhat, as sensible hedge against inflation. While ever wide areas of commerce and industry remained frustrated investors in stocks, a local internal recession was not logical - as an immediate occurrence at least.

The rebuilding from the enforced, abnormal run down in stocks-to-sales ratios that had occurred through 1973 would provide a dynamic in the economy which would have kept the Australian economy running strongly for months - even if the international trade cycle downturn and its impetus upon Australia had turned out to have been as severe as many in the West were predicting. (In fact, the international trade cycle has been propped up by special factors which require a lunch time speech of their own.)

Suffice it to say, that the latest statistics available on non-farm stock investment in Australia (admittedly as old as the December quarter last) show that in that quarter the overall level of non-farm inventory in the Australian economy had declined slightly from the previous quarter. That this was still the direction at that point was itself a large factor in ensuring that the Australian boom ran on strongly into the Autumn and probably Winter, and perhaps Spring of 1974.

So that we are, right now, in the midst of real activity boom as well as inflationary boom. But no boom is static and the real question now for people like yourselves is where this boom is going. Has it longer and further to go upwards? or is it even now peaking for a downslide? A great deal depends where that inventory cycle is at. We really don't know whether the Australian inventory cycle has begun to turn (that is, whether companies throughout the non-farm economy have started succeeding in getting their stocks to required norms, and perhaps even beyond required norms). We don't know because statistics in this vital "lead" area of change are, as I have said, both inadequate and badly out of date.

But ill-equipped as we are with dynamic forward indicators, the time has come nevertheless to raise the question of whether the real boom in products that is now all around us may be at a foreseeable turning point. Does it really require, more than anything else, stringent restraint measures to prevent the demand side of the inflation from getting significantly worse than it is already?

My own assessment is that it does not; that the current trauma at the short end of the money market is but the visible part of a monetary iceberg drifting into our course. Right now I think we have something of a choice: If current trends now under way in Australian external balances and in the Federal Budget were left to run on unadjusted and uncompensated, then we could move on towards a liquidity crunch that would if left to go deep enough, produce first a period of unemployment and continuing inflation (stagflation if you like) and then finally a crack in chronic cost-push inflation.

If - as the election posters tell us - the Australian community's first priority is really the ending of inflation - or at least the ending of an "unacceptable level of inflation" - then I believe it can fulfill its choice right now. It can do this by simply letting existing basic monetary trends run on uncompensated. Of course, one must interpose the question here: How close to reality is the cliché that the Australian community is prepared to give first priority to a cracking of inflation? I shall turn to this question subsequently. But let us assume that it is, so that I can pursue my assertion that the current money trauma is something much more than seasonal - something which would if left unadjusted, bring about a quite significant change in the direction of the economy.

The size and pace of change in Australia's money supply, however you like to define money supply, depends fundamentally upon the size of the Australian monetary base. This latter I define as "liquid assets and cash held by the trading bank system plus bank loans at call in the short-term money market".

In 1972-73, Australia's monetary base grew in leaps and bounds - under the influence of a huge surplus on external account and large deficits in the Commonwealth Budget. Taking a simple quarter on previous corresponding quarter approach: In the March and June quarters of 1972 the country's monetary base was growing at roughly 20 percent per annum. In the September quarter of that year it began to take off: 46 percent September quarter 1972; 43 percent per annum December quarter; 51 percent March quarter 1973; 39 percent June quarter 1973. This allowed the kind of growth in the various versions of money supply with which we are now familiar - both the M_1 and M_2 versions of money supply were growing through calendar 1973 at rates above 25 percent per annum. This in turn allowed double figure inflation to take hold and sustain itself.

From the September quarter of 1973 onwards, however, the monetary base began to change direction fairly drastically. Again taking the simple quarter on previous corresponding quarter approach, the monetary base rose by 10 percent in the September quarter. It began to fall by 1.6 percent in the December quarter and 8.8 percent in the March quarter just past.

This change from massive expansion to an actual annual rate of decline has been severe indeed. And against the background of the money base statistics I have just outlined, the events of April in the money market are not so surprising. Three factors lie behind the money base change to this point: The turn from expansion to contraction on external account; the very successful programme of Commonwealth bond sales to the non-bank public in the first nine months of 1972-73 and, in recent months, the inability of the Commonwealth to match its revenue growth with outlay.

Of these three factors, two would grow in severity if existing trends were left unadjusted. Projecting existing merchandise trade trends suggest a $1,000 million loss to the liquidity base fron external current account in the course of calendar 1974. Projecting existing revenue trends in the Commonwealth Budget, and making the assumption for the moment that expenditure would do no more than run on at its currently scheduled rate of growth of 19 percent per annum, produces a swing towards surplus (and thus a further subtraction from liquidity base) of $350 million in a 12 months period.

Left to themselves, these two major sources of basic liquidity change would force and sustain a severely reduced growth rate in money stock - a rate well below national product growth in current price terms. After a lag, the results of this really quite superb exercise in back-door monetarism would show out clearly enough in the product market. Left on an existing course, the next 12 months would be a scenario worthy of a place in Milton Friedman's scrap book. One could almost trace the process of transposition from the monetary to the "real".

It would be seen in the sub-division ventures that folded because finance companies were not able to continue discounting developers' sales contracts. It could be seen in the working capital expansion plans that failed to get that extra overdraft approval; in the fixed capital spending plans that failed to go ahead because their arithmetic was based on a 10 percent debenture rate; in the car that would have been built at GMH, but wasn't - because, at the margin, consumer credit failed to materialize.

I suggest that in the light of what is happening now in the money base and the money stock, the Statistician's boom survey of anticipated capital spending growth for the June half year in Australia will turn out to have been less than accurate, to say the least.

Having said this, however, one must hasten to adjust. Hundreds of clichés notwithstanding, the Australian community's first priority is not the harsh cracking of inflation. Clearly the trends in the main aggregates are not going to go unaltered. Whichever group takes power next week, the seams of the Budget are going to be let out later in 1974 - by the Coalition on the receipts side; by Labor on the expenditure side.

Under the Coalition, the blockade on debt capital inflow is going to be at least eased and there is the considerable possiblity under the Coalition of change downward in the $A - $US parity - a step that would have internal liquidity expansion implications. Under Labor, although nothing has been foreshadowed, I would not be surprised to see a substantial lifting of blockade on capital inflow before the end of 1974.

So these factors will soften the impact of collision between sharply decelerating growth in money stocks and the high-flying business cycle. I think, nevertheless, that the basic liquidity shrink already in motion will not be offset enough or sufficiently soon to cancel out some real activity crunch in late 1974, early 1975.

In the next financial year one can foresee a period of slack and under-employment and I think this broadly holds under either Government. GDP growth will drop significantly below its current 19 percent growth rate. But of this 19 percent, the 6 percent real growth part of it will, I think, tend to drop much more than proportionately. Initially, at least, the "pure inflation" element of GDP (currently running at about 13 percent per annum) will resist under-employment as an antibiotic.

The nature of the Australian inflation is changing and becoming tougher and more resilient. Our inflation can no longer be fobbed off as "largely imported inflation". The underlying strain now is a 16 percent internal wage push factor which is not going to react initially to money-squeeze deflation. Initially, therefore, a period of under-employment likely in 1974-75 will result in stagflation. Under either Government it is unlikely to be let to go deep enough or long enough to substantially crack this kind of inflation.

Finally, let me try briefly and broadly to focus all this in upon your area - security analysis. What does an outlook such as I have suggested mean for securities - an outlook in which an economy goes some way towards taking the cure and backs off perhaps less than half way through? What does this suggest for the yields required from securities?

Let's first indulge in a little of the game of "what might have been". If the cost-push inflation factor now operating was neither so high nor so resilient, one could see the period of mild economic slackening I have suggested, as but the prelude to a significant turn downward in interest rates - first official rates, then private. In fact, official interest rate downturn would be a substantial part of the policy of getting the monetary base growing again. This would have its effect, of course, throughout the securities market.

That is nice thought. But we must return to what is. Apart from what I think are some notable exceptions (such as certain first-grade areas of the mining market) I think it has to be said that, from an underlying interest rate aspect, the securities market may be headed for the worst of both worlds; that is, slack, without the underlying bonus relief that would come from the interest rate change downward otherwise accompanying such circumstances. Slow down and economic shake-out are not likely to be prolonged enough or deep enough to allow underlying cost-push inflation to crack. But unless inflation does crack substantially and soon, a new and so far mercifully repressed factor will slither into the process of yield determination - the inflationary expectations factor.

Until now, savers and savings institutions have been prepared to accept nominal yields largely unadjusted for inflation. To the extent that logic has applied in this acceptance, it has been founded on the surmise that inflation at current levels is a very temporary phenomenon - soon to fall again to the point where interest rates at current levels are at least half positive.

But time is running out on such a basis for our yield structure. Unless the community is prepared to accept a catharsis period severe enough to eliminate demand inflation and cut significantly into what is now the more resilient cost-push inflation, then inflationary expectations, among institutional and individual savers alike, must start to take over as the new momentum behind upward pressure on security yields, both official and private sector.

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EVERYBODY OUTPERFORMS THE INDEX

by D.C. Pike and G.D. Ratcliffe

At the recent seminar on Security Analysis held at the University of New England a number of analysts were asked how their funds had performed against the Index. It was not stated which Index, but everybody outperformed it - with one exception.

As most of the major life offices were represented it seemed a little puzzling, at first, why this should be so.