

**POTENTIAL GROWTH AND INFLATION:
ESTIMATES FOR AUSTRALIA, THE US AND CANADA**

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13 December 2001

Australian Business Economists

2001 Forecasting Conference

The Economy and Markets: Next Year, Next Decade

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Few economists would disagree with the proposition that if an economy grows too fast (slowly) its inflation rate will rise (fall). What this implies is that the growth rate that defines potential growth is determined by whether or not that rate is compatible with steady inflation. In turn this suggests that changes in inflation can arise from the economy growing too fast or too slowly. Such a theory of inflation has it responding to goods market conditions, which would seem altogether appropriate. This contrasts with the conventional theory of inflation which sees it as arising in the labour market and being transmitted in some way, often not made explicit, to the goods market. The critical parameter in this approach is the non-accelerating inflation rate of unemployment, or NAIRU. However, the estimates that have been made of the NAIRU suggest that it has varied widely. In any case, its application to the goods market must be indirect, so that it affects factors pertinent to that market which in their turn affect prices.

In this paper we want to report on and discuss the implications of recent results obtained from testing this view of inflation and potential growth.¹ In particular, we present our estimates of potential growth for Australia, the US and Canada and use them to consider whether potential growth rates in these countries have increased in the nineties, why our estimate of Australia's potential growth rate is higher than those we find for Canada and the US and to examine the implications for policy.²

Briefly, the conclusions are that, with just two exceptions, for each of the three countries our estimates of potential growth have been steady over decades from the 60s. For Australia the figure has been a little over 4% pa, while it has been a little over 3% for the other two countries. The exceptions are Canada in the 90s when potential growth was 2.5% and Australia in the sixties which yielded 5%. The estimates do not support the view that potential growth rates rose in the nineties. There are other data which suggest that perhaps, when more information is available to estimate future potential growth rates containing late 90s data, they could be found higher for the US and Canada and perhaps lower for Australia. Some possible reasons why Australia's growth rate has not averaged near its potential level are discussed.

¹ See Dungey and Pitchford [1998, 2000, 2001]. The discussion paper [no 843, 2001] which contains results referred to in this paper is obtainable on the web from: econrsss.anu.edu.au

² Other ways of estimating potential growth are to build it up from propositions about the growth rate of inputs, their productivity and technical change. Our method subsumes these issues in the behaviour of GDP growth.