1996-97: A Review of Economic Developments

This article provides an overview of developments in the Australian economy in 1996-97 and compares the outcome with what was forecast at the time of the 1996-97 Budget and the 1996-97 Mid Year Economic and Fiscal Outlook (MYEFO).

The Australian economy grew in 1996-97 for the sixth year in a row since the recession of the early 1990s. Activity in 1996-97 was supported by favourable international conditions, low inflation and an environment where interest rates were declining and wage pressures moderating. Such conditions were conducive to improvements in the balance sheets of the household and corporate sectors.

However, the preliminary outcome for 1996-97 indicates that growth in activity in 1996-97 was lower than expected at the time of the 1996-97 Budget and also lower than the revised forecasts included in the 1996-97 MYEFO. In terms of the profile of activity over the course of the year, growth eased in the second half of 1996 but was followed by a step up in activity in the first half of 1997. The main reasons for Gross Domestic Product (GDP) growth being lower than expected were lower than forecast contributions from private consumption, public final demand and non-farm stocks. Employment growth was also lower than expected, particularly in the latter half of 1996-97, reflecting the lower GDP growth in the first half of the financial year.[1]

COMPARING ECONOMIC FORECASTS WITH PRELIMINARY OUTCOMES

Prior to considering the performance of the economy in 1996-97 and comparing that with the 1996-97 Budget and MYEFO forecasts, it is worth first noting the assumptions underpinning the forecasts and highlighting that at this stage the Australian Bureau of Statistics (ABS) has produced its first preliminary estimate for growth in 1996-97.

As always, the 1996-97 Budget forecasts were based on key assumptions, historical relations between economic variables and judgements about likely

1 The Economic Overview to the Winter 1997 *Economic Roundup* contains a detailed feature on the causes of the weakness in employment growth in the first half of 1997 and the relationship between employment and output and employment and real wages.

outcomes.[2] One such key assumption is that policy will remain unchanged throughout the forecasting period. Such an assumption facilitates policy analysis and, in particular, the consideration of the appropriateness of current settings. This is one area which distinguishes the official forecasts from those undertaken by the private sector.

The forecasting process also includes several key technical assumptions which may also differ from the approach taken in the private sector. These assumptions include that nominal interest rates and the exchange rate will be unchanged from their levels around the time of the forecasts. The latter reflects the difficulties in accurately forecasting short-run movements in exchange rates.

The June quarter 1997 National Accounts is the initial estimate for 1996-97 and provides the first opportunity to compare forecasts with outcomes. However, the first estimate is very preliminary and will be successively revised over time as the ABS incorporates more comprehensive and complete information into the National Accounts. Such revisions can be made over a number of years. Experience indicates that there is no set pattern to such revisions, although they can be significant. Accordingly, it is premature to make judgements about the relative 'accuracy' of forecasts on the basis of first estimates. Taking the budget forecasts from a few years ago to illustrate this point, the budget forecast for GDP growth in 1994-95 was 4½ per cent. In August 1995, the ABS published the first estimate of growth for that year, being 4.8 per cent. In the June quarter 1996 National Accounts, the ABS had revised its estimate for growth in 1994-95 to 4.1 per cent. A year and four National Accounts later (that is, June 1997), the estimate of growth in 1994-95 had been revised to 4.4 per cent. Thus, over time, the budget forecast had both under and over estimated growth, depending on the set of National Accounts used for the basis of assessment.

1996-97 OUTCOME

The August 1996 Budget and January 1997 MYEFO forecasts for GDP growth in 1996-97 of 3½ per cent compares with the preliminary estimate contained in the June quarter National Accounts of 2.5 per cent. Through the year growth to the June quarter 1997 was forecast in the Budget at 3¾ per cent and compares with the preliminary estimate of 3.2 per cent growth. The pattern of growth across the year indicated that activity slowed in the second half of 1996 before picking up in the first half of 1997.

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2 A detailed discussion of the purpose and methodology underpinning macroeconomic forecasts is contained in the Autumn 1996 *Economic Roundup*.

Appropriateness of Forecasting Assumptions

As mentioned previously, the 1996-97 Budget forecasts were prepared on the basis of technical assumptions that nominal interest rates and the nominal exchange rate would be constant during 1996-97. There were four reductions in official **nominal interest rates** totalling 2.0 percentage points during 1996-97. Of these, only one had occurred prior to the Budget being released in August 1996, while three had occurred by the time of the MYEFO in January 1997. A fifth rate cut late in July 1997 brought the cash rate down to 5 per cent. The fall in interest rates reflected continued improvements in Australia's inflation outlook. The improvement in the inflation outlook also saw Australian nominal long-term interest rates fall over the course of the year, from over 8.8 per cent to around 7 per cent. Over the same period real interest rates also declined, though not by as much as the reduction in nominal rates. The profile of the reduction in real rates was also different to that of nominal rates, with most of the reduction in real rates occurring in the latter part of the year. Given the lags involved in the operation of monetary policy, the bulk of the impact of the interest rate reductions during 1996-97 are likely to be felt in 1997-98.

The **Australian dollar**, on a trade weighted (TWI) basis, was slightly higher than that assumed at the time of the 1996 Budget, averaging around 58.75 over 1996-97 (compared with an assumed TWI of 58). It is unlikely that this difference would have had a significant impact on activity during 1996-97, particularly given that the profile of the TWI was such that it was around 58.25 in the first half of the year, then rose on the back of strong commodity prices to a peak of 61.5 in March, before falling back to around 57 by the end of the year.

As expected at the time of the 1996-97 Budget, the **international economy** was supportive of growth in the domestic economy over 1996-97. Real GDP in Australia's major trading partners is estimated to have grown at 4½ per cent in the year (compared with the 4¼ per cent assumed at the time of the 1996-97 Budget). This outcome was driven by continued strong growth in the United States and East Asia and stronger growth in Japan's private sector.

Domestic Activity

Table 1 compares the August 1996 Budget and January 1997 MYEFO forecasts with the preliminary outcome for 1996-97. The composition of GDP growth in 1996-97 was affected by significant one-off transactions, such as the sale of the Loy Yang B power station by the Victorian Government and the sale of gold by the Reserve Bank of Australia (RBA). These transactions involved a transfer from one component of activity to another component and thus did not have any net impact on aggregate GDP. Abstracting from these, the main reasons for GDP growth being lower than expected were lower than forecast contributions from private consumption (though this was partly offset by stronger activity in the dwelling sector), public final demand (the outcome being less than that budgeted for) and non-farm stocks (see Chart 1).

Table 1: 1996-97 Budget and MYEFO Forecasts and Outcomes

	1996-97 Year Average Budget Forecast	1996-97 Year Average MYEFO Forecast	1996-97 Year Average Outcomes	1996-97 Year Average Outcomes adjusted (a)
Demand and Output				
Private consumption	3	2 1/2	2.3	
Private investment				
Dwellings	-3	-5	0.2	
Total business investment	14	17	15.9	13.5
Non-dwelling construction	15	20	16.9	na
Plant and equipment	14	16	15.5	na
Private final demand	4 1/2	4	4.2	3.9
Public final demand	3 1/4	3 1/4	0	1.4
Total final demand	4 1/4	4	3.3	
Increase in stocks (b)				
Private non-farm	0	0	-0.3	
Farm and public authority	0	0	-0.7	-0.1
GNE	4 1/4	4	2.2	
Exports	8	-	9.5	6.8
Imports	11	-	10.3	
Net exports (b)	- 3/4	- 1/4	-0.1	-0.7
GDP (A)	3 1/2	3 1/2	2.5	
Non-farm product	3 1/2	-	2.1	
Farm product	6	-	14.4	
Other Selected Economic Measures				
Prices and wages				
Consumer Price Index - Headline (c)	2	1	0.3	
Consumer Price Index - Underlying (c)	2 3/4	2	1.7	
Average earnings	5	4 1/2	5	
Non-farm nominal unit labour costs	2 1/2	-	3.3	
Labour market				
Employment (Labour Force Survey)	1 1/2	1 1/2	1.1	
Unemployment rate (per cent) (d)	8 1/4	8 1/2	8.7	
Participation rate (per cent) (d)	63 3/4	63 3/4	63.2	
Household income and saving				
Real household disposable income	2 3/4	-	3.25	
Household saving ratio (per cent)	2 1/2	-	5	
Current account balance ($b)	-20	-20	-16.5	

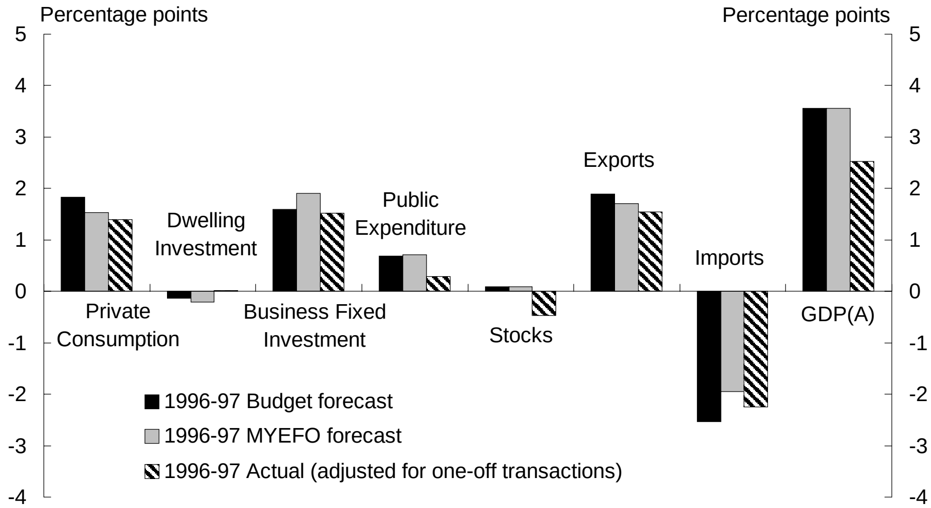
(a) The adjustments reflect negating the impact of: the sale of the Loy Yang B power station by the Victorian Government to the private sector; the sale of gold by the RBA; and the sale of an ANZAC frigate.

(b) Percentage point contribution to growth in GDP (A).

(c) Through the year to June quarter.

(d) Estimate for the June quarter.

Chart 1: Contributions to GDP(A) Growth[(a)]



(a) Year-average growth.

Growth in **consumer spending** was lower than both the 1996-97 Budget and MYEFO forecasts for 1996-97, mainly reflecting weakness in the retail sales component of private consumption. Private consumption normally moves very closely with household disposable income, although in 1996-97 the latter grew at a faster rate than forecast. This discrepancy may suggest a weakening of consumer confidence in 1996-97, which led to a more cautious approach to spending. This would appear to be the case, as evident in the measures of consumer confidence and unemployment expectations produced by the Westpac-Melbourne Institute which were at very low levels in the September quarter 1996 — a quarter in which private consumption fell. The fall in consumption in the September quarter was reflected in the downward revision to the forecast for consumption growth for 1996-97 contained in the MYEFO. Given the strength in household disposable income and the weaker consumption growth, there was a larger than expected offsetting increase in the household saving ratio in 1996-97 to 5.0 per cent, which is the highest yearly level since 1990-91.

The recovery in the **housing** sector became apparent from the December quarter 1996 National Accounts (released in March 1997) onwards, with growth in dwelling investment exceeding both the Budget and MYEFO forecasts. This pick-up was driven by a significant improvement in housing affordability, which rose to an historically high level. The rise in housing affordability was due in large part to the reductions in mortgage interest rates flowing from the reduction in official interest rates and increased competition in the home lending mortgage market.

Private **business investment** (abstracting from the Loy Yang B transaction) continued to grow rapidly in 1996-97, though at a slightly lower rate of growth than forecast in both the 1996-97 Budget and MYEFO. While both sets of forecasts were based on around average realisation ratios for private new capital expenditure, in the case of non-residential construction, expectations proved to be significantly stronger than the actual outcomes in 1996-97. Even so, very strong growth was experienced in both the non-residential construction and plant and equipment components of investment. On an industry basis, particularly large increases were experienced in mining, property and business services and the finance and insurance sectors. The strong growth overall was supported by the absence of price pressures throughout 1996-97 and the high levels of capacity utilisation and corporate profit share. While the reduction in real interest rates through 1996-97 would have added to this supportive environment, as noted above, the bulk of the impact of the interest rate reductions is likely to be felt in 1997-98.

Abstracting from the sale of the Loy Yang B power station, growth in **public final demand** in 1996-97 was around 1.7 per cent, compared with a forecast of 3¼ per cent in the 1996-97 Budget and MYEFO.[3] Significant factors that led to this outcome included: commercial decisions made by major public trading enterprises that resulted in lower than expected investment; and differences in the timing between the payment and delivery of military hardware (the transaction being recorded in the National Accounts when ownership passes rather than when payments are made). These factors are consistent with the background noted in the 1996-97 MYEFO that estimates of public final demand tend to be highly volatile from quarter to quarter, which can alter year average estimates significantly.

A large run-down in farm and public authority **stocks,** together with the sharp slow down in the accumulation of private non-farm stocks resulted in a much larger overall detraction by stocks from output growth than that incorporated in the 1996-97 Budget and MYEFO. However, the large fall in public authority stocks was due to the sale of gold by the RBA and the export of an ANZAC frigate, both of which took place in the last quarter of 1996-97 and were fully offset by a corresponding increase in exports. Setting these aside, stocks detracted 0.5 percentage points from GDP growth in 1996-97. This was still a significantly bigger detraction than included in the forecasts and in large part reflects the unexpected large run-down in private non-farm stocks in the first half of 1997, which resulted in the stocks-sales ratio falling to an historically low level. These events contrasted with the experience over the previous three years or so — when the stocks-sales ratio was relatively flat — and suggests that in 1996-97 firms cleared any excess stocks.

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3 The National Accounts concept of public final demand does not cover the bulk of Commonwealth outlays (such as transfer payments) nor does it include the impact of changes in Commonwealth revenue. In addition, the National Accounts concept of public demand includes not only the Commonwealth budget sector, but also the non-budget sector, Commonwealth public trading enterprises and the State and local government sectors — the latter being the largest component of public final demand

As anticipated at the time of the 1996-97 MYEFO, net exports detracted less from GDP growth in 1996-97 than forecast at the time of the 1996-97 Budget. **Imports** of goods and services grew by 10 per cent in 1996-97, broadly in line with the 1996-97 Budget forecast of 11 per cent. Despite slower overall growth in consumption expenditure, imports of consumption goods rose solidly, while strong business investment resulted in an increase of over 14 per cent in the constant price value of capital imports. **Exports** of goods and services rose by around 7 per cent in 1996-97 (abstracting from the one-off sales), compared with the 1996-97 Budget forecast of 8 per cent. The slightly lower outcome for export growth reflected lower than expected exports of elaborately transformed manufactures and some weakness in exports of non-rural commodities, which more than offset the boost to exports from the record wheat crop in 1996-97.

The **current account deficit** was $16.5 billion in 1996-97, around 20 per cent lower than the previous year. This outcome was well below the 1996-97 Budget and MYEFO forecasts of $20 billion, a result largely attributable to the impact of the RBA gold sales, which as noted above took place in the June quarter of 1996-97.

Labour Market

Following solid growth in the first half of 1996-97, **employment** growth was broadly flat in the second half of the year. Employment grew by 1 per cent through the year to the June quarter. Weak employment growth in the first half of 1997 appears to have been largely a lagged response to the moderation in output growth in the second half of 1996, combined with a pick-up in real wages during 1996; the latter primarily due to falling inflation rather than rising nominal wages.[4]

The **unemployment** rate was largely unchanged through most of 1996-97, remaining around 8.7 per cent in the June quarter 1997, higher than the 1996-97 Budget forecast of 8¼ per cent and 1996-97 MYEFO forecast of 8½ per cent. This outcome reflects the lower than forecast employment growth and a fall in the participation rate over the course of 1996-97 (with the slower employment growth likely to have discouraged workers from remaining in the work force).

Wages and Prices

In 1996-97, growth in the National Accounts measure of **average earnings** (AENA) was consistent with the 1996-97 Budget forecast, while growth in average weekly ordinary time earnings (AWOTE) for full-time adults was weaker than expected. AWOTE is an indicator often used to examine wage pressures because it is less affected by changes in the composition of the labour

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4 The Winter 1997 *Economic Roundup* contains a comprehensive analysis of recent labour market conditions.

force between full-time and part-time employees. The weaker than expected growth in AWOTE in 1996-97 reflected a number of factors, including lower than anticipated inflation and a moderation of inflationary expectations, and lower than expected output and employment growth. Non-farm nominal unit labour costs were higher than the Budget forecast largely due to lower than expected total hours worked, which increased average hourly labour costs.

Underlying **inflation** moderated throughout 1996-97, to be 1.7 per cent in the year to the June quarter, below both the 1996-97 Budget forecast of 2¾ per cent and 1996-97 MYEFO forecast of 2 per cent. This low outcome largely reflected the influence of lower import prices, together with an easing in demand pressures, which continued throughout the year.

Headline inflation was 0.3 per cent through the year to the June quarter 1997, considerably lower than the 1996-97 Budget forecast of 2 per cent and 1996-97 MYEFO forecast of 1 per cent. The low headline outcome was mainly due to a lower than expected underlying inflation rate, and reductions in mortgage interest rates during 1996-97 following the Budget.