Economic Overview

This article provides an overview of economic conditions since the 1997-98 Budget.

The June quarter 1997 National Accounts confirmed that a step up in growth occurred in the first half of 1997, following a temporary slowing over the last three quarters of 1996. Gross Domestic Product (GDP) growth in the June quarter 1997 was driven by solid growth in private consumption, dwelling investment and a substantial contribution from non-farm stocks.

At the time of the 1997-98 Budget, faster economic growth was expected to result from stronger growth in private final demand combined with continued modest growth in public demand and a small detraction from growth from net exports. The recent indicators: are consistent with continued solid growth in business investment; point to a continuation of the housing recovery, underpinned by historically high levels of home affordability; and confirm a firming of employment growth, which will support household incomes and consumption. Lower than average rainfall across much of southern and eastern Australia during the winter months raised the risk that farm production may be lower than expected, however this risk appears to have been reduced for the time being with good September rains. Nevertheless, an El Nino event is still being predicted to March 1998, highlighting that uncertainty continues to surround the outlook for next year's winter crop.

The positive economic fundamentals which underpinned the step up in growth in the first half of 1997 have continued into the second half of the year: inflation at its lowest level since the 1960s; the impact of easier monetary conditions continuing to be felt; and both the household and corporate sectors in structurally sound positions. In particular, the recent interest rate reductions and the depreciation in the exchange rate since the Budget was handed down in May should provide a sizeable stimulus to activity in 1997-98. These influences will help to offset any emerging risk to activity from developments in Asia.

Recent financial market instability in East Asia has increased the degree of uncertainty surrounding the assumption for growth in that region. While it is too early to gauge the impact of recent financial market instability on economic activity in the region, it is likely that economic growth in East Asia will be lower than assumed at budget time. Outside East Asia, economic growth in the United States remains strong and growth continues to pick up in Europe.

Box 1 provides a summary of recent developments in the world economy.

Box 1: Recent Developments in the World Economy

Economic growth in the **United States** has averaged 4¼ per cent (annualised) over the past three quarters, well above the long-term trend. As a result, the unemployment rate has fallen further. At the same time, underlying inflation has continued to fall and there has not been any clear acceleration in labour costs. Recent indicators of activity have been somewhat mixed. Employment growth and consumer spending are expected to moderate and inventory investment to slow. Growth overall is expected to return to a more sustainable level in the year ahead. Should signs of inflationary pressures emerge, any tightening in domestic policy settings is likely to be moderate and any upturn in inflation is likely to be gradual.

The economic outlook for the **East Asian region** has weakened over the past few months with several countries in South East Asia experiencing large currency depreciations and weakening equity markets. Thailand, Indonesia, Malaysia and the Philippines (the ASEAN 4) have been most affected. Together these economies account for around 10 per cent of Australia's merchandise exports and one fifth of the growth in exports over recent years. Our major trading partners in the region are in North Asia — Japan, Korea and Taiwan. A marked slowing in growth in these economies would have a greater impact on Australia. Weaker domestic demand can be expected in the ASEAN 4 in the short term as a result of lower levels of confidence, higher interest rates, exchange rate losses, strains on the financial system, and lower capital inflows. The prospects for these economies over the year ahead will be contingent upon measures to consolidate financial sector liberalisation and to tackle underlying structural problems. The effectiveness of policies to contain the inflationary impact of the currency depreciations will also be critical in the year ahead. Success on this front would help lock in competitiveness gains and underpin a rebound in exports and growth.

The underlying strength of the **Japanese** economy remains difficult to gauge because of the one-off impact of the 1 April increase in the value added tax rate. While growth in the first half of the year was less than expected, domestic demand is expected to rebound in the second half of the year. Policy settings are supportive with interest rates low, the impacts of fiscal consolidation easing and external demand likely to remain a positive force for growth. That said, downside risks remain, highlighting the importance of the domestic structural reform agenda.

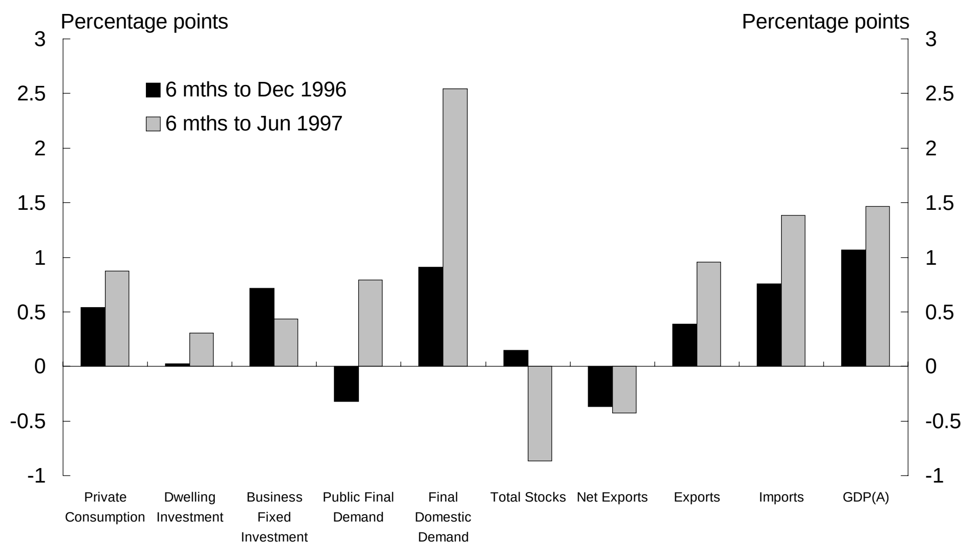
The economic outlook for **Western Europe** is for growth to gain momentum — the solid growth in the United Kingdom and some of the smaller regional economies is expected to broaden to include the larger economies, most importantly Germany. This outlook should be underpinned by a strengthening in domestic demand, supported by still accommodative monetary policy, and a lessening of the impact of fiscal consolidation in many countries. The existence of significant spare capacity across Continental Western Europe suggests that inflationary pressures are likely to remain subdued. In the UK interest rate rises and the appreciation of the exchange rate will work to mitigate against any significant pick-up in inflationary pressures.

DOMESTIC ECONOMIC CONDITIONS

Economic Activity

As evident in Chart 1, a step up in growth occurred in the first half of 1997. This followed a temporary slowing in the economy over the last three quarters of 1996. The pick-up is even more apparent in terms of non-farm activity. The composition of growth in the June quarter was affected significantly by a small number of large one-off transactions, including the sale of gold by the Reserve Bank of Australia (RBA) and the sale of the Loy Yang B power station by the Victorian Government to the private sector. These transactions involved a transfer between components of the expenditure measure of GDP and as such did not have any net impact on aggregate GDP. Abstracting from these transactions, GDP growth in the June quarter 1997 was driven by solid growth in private consumption, dwelling investment and a substantial contribution to growth from non-farm stocks.

Chart 1: Contributions to GDP(A) Growth (seasonally adjusted, adjusted for one-off transactions)



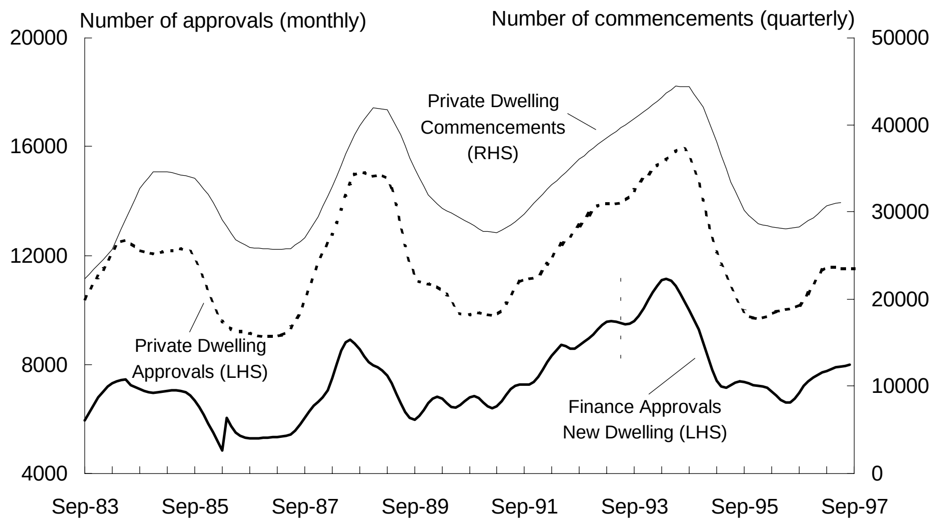
The step up in activity over the first half of 1997 was also evident in the major **business surveys.** These surveys reported an expected slight acceleration in activity over the second half of 1997 with trading conditions, sales and output all expected to improve further, which is also reflected in business confidence being at a relatively high level.

Private Investment

Growth in private investment in the June quarter 1997 was affected by the purchase of the Loy Yang B power station. New private investment, which abstracts from the effect of this purchase, was flat in the quarter. While there were downward revisions to non-dwelling building investment expectations for 1997-98 in the most recent Australian Bureau of Statistics (ABS) Private New Capital Expenditure (CAPEX) survey, these results are at odds with other indicators for investment in the sector. In particular, the value of work yet to be done for non-residential buildings and engineering construction is very high and the value of non-residential building approvals is also high. Recent business surveys also reported an expectation of solid growth in capital expenditure over the next twelve months. In contrast, **equipment investment** intentions were revised up significantly in the CAPEX survey and are consistent with the forecast of moderate growth in constant price investment in 1997-98. Other indicators which also suggest strong growth in equipment investment include: commercial finance commitments and leasing finance for equipment related activities remaining at very high levels in recent months; weak growth in equipment prices; and business credit growth continuing its upward trend. In addition, the positive environment that existed at the time of 1997-98 Budget that was supportive of a continuation in strong growth in business investment remains in place — interest rates are at very low levels, there is a continued absence of price pressures and capacity utilisation and the corporate profit share are at high levels.

The recovery in the dwelling sector has become more apparent since the Budget, with an additional two quarters of solid growth in **dwelling investment.** Dwelling commencements have also continued to trend upwards through 1997 (see Chart 2). While there was some weakness in the sector in the middle of 1997, this appears to have been temporary with more recent building approvals and housing finance data suggesting that the underlying conditions are firm. There remains, nevertheless, monthly volatility in the data. The favourable fundamental influences on the sector remain: the oversupply of housing created in the previous upturn is being eroded rapidly; vacancy rates in some areas are low; and housing affordability is expected to remain very high with low mortgage interest rates (which are at their lowest levels since 1973), rising household income and low house price inflation.

Chart 2: Trend Housing Indicators

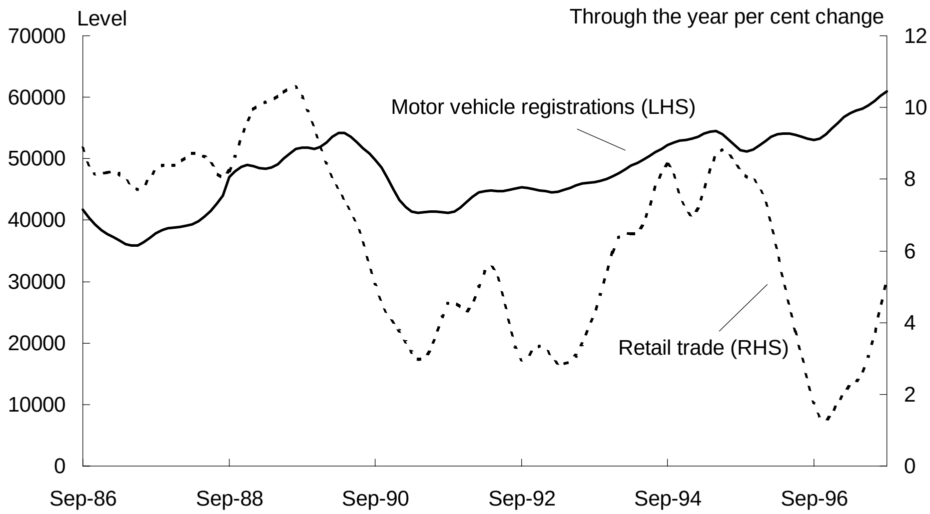


Note: There is a series break in finance approvals for new dwellings in July 1993.

Private Consumption

Consumer spending continues to grow strongly with the recovery in retail spending and strong growth in motor vehicle registrations evident in Chart 3. This is consistent with recent improvements in measures of consumer confidence with the Westpac-Melbourne Institute consumer sentiment index showing rises in each of the past four months. There has also been a pick-up in optimism regarding the future of the labour market with the unemployment expectations index well above the long-term historical average. The strength of the recovery in the labour market will impact on household decisions to continue to spend, both directly in terms of increasing household incomes and indirectly through improved consumer confidence. Businesses are also expecting trading conditions to improve, with the September quarter Australian Business Expectations survey recording a strong rise in expected growth in sales across all industries.

Chart 3: Partial Indicators of Consumption (trend data)



Changes in Stocks

There was a large fall in public authority **stocks** in the June quarter 1997, however this was due to the sale of gold by the RBA and the export of an ANZAC frigate, both of which were fully offset by a corresponding increase in exports. While there was a solid increase in private non-farm stocks, this only slightly exceeded sales growth (adjusted for the impact of the one-off transactions) and, as a result, the stocks-sales ratio was close to the historically low level recorded in the March quarter. The low level of the private non-farm stock-sales ratio suggests that firms are well placed to continue to increase production to match ongoing sales growth. Recent business surveys also indicate an anticipated build-up in private non-farm stocks in line with an outlook for strong sales growth, with the September quarter Australian Business Expectations survey indicating the largest expected increase in stocks over the coming year since that recorded in the June quarter 1994 survey.

Public Final Demand

Growth in public final demand was flat in the June quarter 1997, after abstracting from the sale of the Loy Yang B power station. Public final demand should pick up substantially in 1997-98, partly reflecting the base effects of the Loy Yang B sale in 1996-97 and information in the State Budgets released since May indicating strong growth from the State sector.

Imports and Exports of Goods and Services

Reflecting continuing strength in underlying demand and some increase in prices, the value of **imports** rose solidly in the September quarter. Implied volume outcomes to date appear consistent with budget expectations. **Exports,** excluding the effect of the sale of gold by the RBA and an ANZAC frigate, in the September quarter look to have shown continued modest growth in volume terms, complemented by a rise in prices partly associated with exchange rate movements in the quarter.

In terms of the outlook for rural exports, the widespread rain over much of the grain belt during the month of September helped to alleviate concerns that the lower-than-average rainfall recorded in previous months would continue and cause wheat yields in 1997 to be severely limited. Yields of the harvestable area of wheat in most southern and eastern regions are now expected to be at least around average levels. The Bureau of Meteorology is still forecasting an El Nino event to March 1998 and this is often associated with drier than normal conditions in eastern Australia. This could have some impact on planting conditions for next year's winter crop — although this is particularly uncertain at this stage.

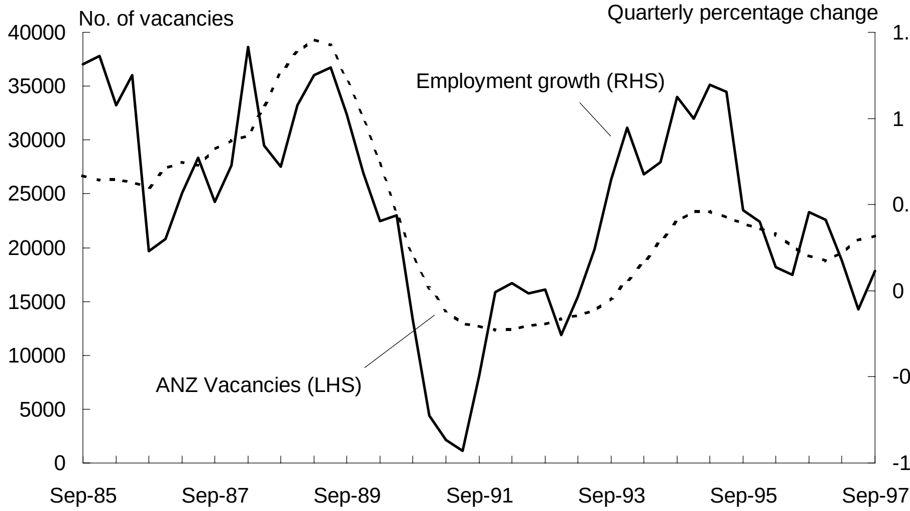
The monthly balance on goods and services has been in surplus for the past six months. The monthly outcomes to date in value terms indicate that strong growth in the volume of imports in the September quarter and a fall in merchandise exports (mainly reflecting the base effects of gold exports in the June quarter) has been offset by growth in service exports which will result in trade in goods and services being roughly in balance. With imports expected to grow more strongly than exports (which will be lower due to the base effect of the gold sales), the **current account deficit** should increase both in dollar terms and as a share of GDP in 1997-98.

Labour Market

Employment has grown solidly on average in 1997-98 to date. While monthly employment outcomes have been volatile recently, employment growth has averaged around 14 400 per month over the last four months.

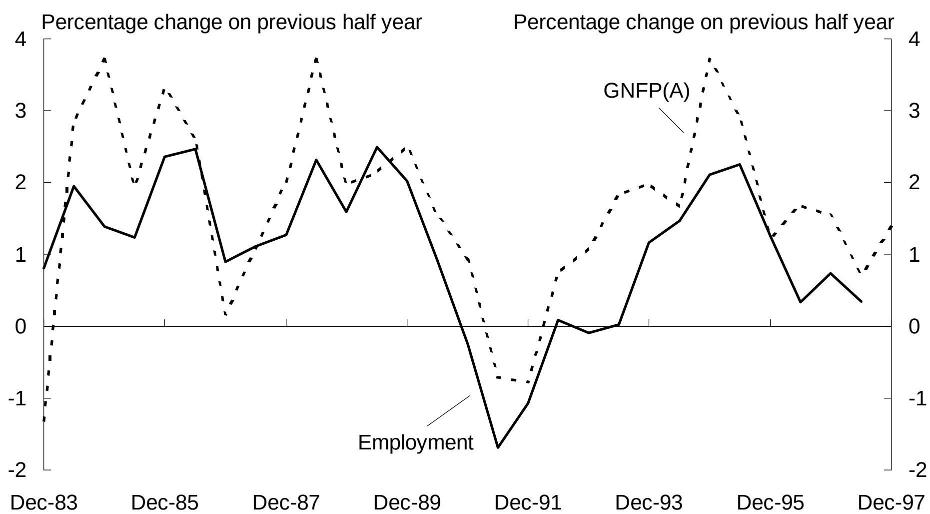
These outcomes appear consistent with the major job vacancy series, which have suggested solid employment growth in recent months. Both the ANZ Bank job advertisements series and DEETYA skilled vacancies index are at high levels. Despite falling slightly in the September quarter, the ABS vacancy series — which is the broadest measure of vacancies — remains at above average levels.

Chart 4: Trend Job Vacancies and Employment Growth



Supporting the outlook for strengthening employment growth is the step up in output growth in the first half of 1997 and the expectation that this momentum will continue through 1997-98.[1] Since most of the impact on employment from changes in activity occur in the three quarters following the change in activity, it would appear that short-term employment prospects remain positive.

Chart 5: Lagged Output Growth and Employment Growth



Note: GNFP(A) growth is brought forward six months, ie June 1997 half year growth appears as December 1997 half year growth, to illustrate the lag between growth in GNFP and employment.

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1 The Economic Overview to the Winter 1997 *Economic Roundup* contains a detailed feature on the relationship between employment and output.

Major business surveys are indicating some improvement in employment in the near term. The latest ACCI Westpac survey reported that firms are expecting a strengthening in employment in the December quarter, with expectations at their highest level since June 1995. The National Australia Bank survey also reported a firming in employment expectations for the December quarter. Expectations are now slightly above the levels recorded for the previous two years.

While vacancy data and expectations surveys point to a continuation of solid employment growth over the coming months, overtime and average hours worked — generally considered leading indicators of changes in labour demand — have not showed any discernible pick-up. However, given the expansion of enterprise bargaining leading to employers cashing-out overtime payments and the ongoing volatility of the hours worked series, these series appear to be less reliable indicators of underlying labour market pressures.

The **unemployment** rate is expected to continue to fall over the near term, after falling in September and October. However, the impact on the unemployment rate of faster employment growth is likely to be partly offset by an increase in the participation rate as more people are encouraged to look for a job.

Wages and Prices

The forecast in the 1997-98 Budget was for some further moderation in **wage** pressures, with growth in average earnings on a national accounts basis being 4 per cent in 1997-98. Consistent with this outlook, the June quarter 1997 and preliminary September quarter 1997 data for average weekly ordinary time earnings for full-time adults show average quarterly growth of around 1 per cent. There is the prospect, however, that nominal wage growth may moderate further in line with low inflation and inflation expectations.

Inflationary pressures have continued to remain subdued, with an **underlying inflation** outcome in the September quarter of 1.5 per cent in through the year terms — the lowest outcome recorded since the series began in 1972. This low outcome reflects the favourable movement in nominal unit labour costs, the lagged impact of lower import prices, and ongoing competitive pressures.

The **headline Consumer Price Index (CPI)** fell again in the September quarter, with the annual inflation rate now at its lowest level since 1962. The declines in the headline CPI since the Budget largely reflect the fall in mortgage interest related charges, a decline in the cost of hospital and medical services (related to the introduction of the Government's Private Health Insurance Incentive Scheme on 1 July 1997) and low underlying inflation.