

Economic Outlook

The following is a reprint of Statement 2, Economic Outlook, from Budget Paper No.1: Budget Strategy and Outlook 1999-2000.

PART I: OVERVIEW

Following very strong growth in excess of 4 per cent in 1997-98 and 1998-99, the Australian economy is expected to grow by a solid 3 per cent in 1999-2000. This growth has occurred in the face of the East Asian financial crisis and the slowdown in the world economy more generally. Fundamental to this resilient performance has been sound fiscal and monetary policy, and the benefits of on-going microeconomic reform.

The expected moderation in growth in 1999-2000 from the previous two years reflects the impact of continued below trend growth in the world economy on the domestic economy, particularly business investment, as well as a slowing in the growth of some other components of domestic demand, including consumption. Nevertheless, the outlook for growth remains very favourable compared with other developed economies and countries in the region. Continued low inflation and further solid growth in employment are expected, with the unemployment rate consolidating recent falls to remain around 7½ per cent over 1999-2000.

The world economy is estimated to have grown by 1¾ per cent in 1998 and is expected to maintain that growth in 1999, before strengthening to around 2½ per cent in 2000. This compares with the long-term average growth rate of around 3 per cent per annum.

The Australian economy performed more strongly than expected in the first half of 1998-99. This, together with evidence of continuing strong consumer demand, solid employment growth and a high level of job vacancies, has resulted in the 1998-99 GDP growth forecast being revised up significantly to 4¼ per cent, a full percentage point above the figure reported in the *1998-99 Mid-Year Economic and Fiscal Outlook* (MYEFO) in December 1998. While the impact of the international downturn is clearly evident in the sharp decline in world commodity prices, well below trend growth in export volumes and a decline in Australia's terms of trade, domestic demand remains strong, supported by favourable domestic policy settings.

GDP growth in 1999-2000 is expected to be around 3 per cent in year-average terms. The moderation in GDP growth compared with the previous year is expected to occur largely in calendar year 1999, with a pick-up in calendar year 2000 as the world economy gradually strengthens. Growth through the

year to the June quarter 2000 is expected to be around 3½ per cent. The moderation in growth largely reflects: more moderate growth in private consumption at rates closer to the longer-term trend, following very strong growth in the two previous years; a reduction in private non-residential construction from recent high levels; relatively stable dwelling investment; and slower growth in public demand. Partially offsetting influences are expected to be a pick-up in export growth, as well as some pick-up in plant and equipment investment growth as the international economy gradually strengthens.

Solid employment growth of around 1¾ per cent is forecast in 1999-2000, following strong growth of around 2¼ per cent in 1998-99. The unemployment rate is forecast to average around 7½ per cent in 1999-2000, down from 8.3 per cent in 1997-98 and around 7¾ per cent in 1998-99. Underlying these forecasts is an assumed small increase in the participation rate from recent levels and a cyclical slowing in average labour productivity growth.

Inflation is expected to remain low, averaging 1¼ per cent in 1998-99 and 2 per cent in 1999-2000. Through the year to the June quarter 2000, inflation is expected to be around 2¼ per cent. Nominal unit labour costs are expected to grow a little more quickly in 1999-2000 in response to a cyclical slowing in average labour productivity growth from recent very high rates, although slower growth in domestic demand will limit the flow-through into retail prices. International deflationary pressures may also become less marked as the effects of falling world commodity prices run their course and as the troubled East Asian economies begin to recover.

The current account deficit (CAD) is forecast to average around 5½ per cent of GDP in 1998-99, compared with a little over 4 per cent in 1997-98. This widening of the CAD reflects the impact of the slower world economy on both net exports and Australia's terms of trade. The CAD is expected to decline in 1999-2000 as a share of GDP (to around 5¼ per cent), as exports respond to a gradual strengthening in the world economy and the terms of trade improve slightly. Volatility in the various components of the external accounts could result in the CAD as a percentage of GDP being higher in any one quarter than the expected average for the year.

Major uncertainties continue to surround the outlook for world economic growth, particularly in Japan and some emerging markets. While there are signs of recovery in some East Asian economies, and an improvement in the economic performance of these economies is expected in 1999-2000, continuing structural problems, particularly in the financial and corporate sectors, raise questions about the sustainability of that improvement. Similarly, there remains the possibility of further periods of instability in other emerging market economies. Against this, however, the United States could continue to exceed expectations.

Against the backdrop of these international risks, there are also significant uncertainties about the timing and extent of the expected moderation in growth in the Australian economy. While business investment looks to be slowing after

six years of strong growth, it is by nature volatile and difficult to predict, being subject to both domestic and international influences. There is also some uncertainty around the net impact of rising household debt and rising household asset values on future consumption expenditure. The timing of both business investment expenditures and household consumption expenditures in the latter part of 1999-2000 are also likely to be affected to some extent by the introduction of the Government's tax reform package, *A New Tax System*.

Table 1: Domestic economy forecasts^(a)

	Outcome (b)	Estimates	Forecasts	
	1997-98 Year Average	1998-99 Year Average	1999-00 Year Average	Four Quarters to June 2000
Panel A - Demand and Output(c)				
Household consumption	4.6	4 1/2	3 3/4	4
Private investment				
Dwellings	15.6	2	3	5
Total business investment	10.1	-1	-1	-2
Other buildings and structures	16.7	-2	-10	-8
Machinery and equipment	7.4	-2	1	-1
Private final demand	6.2	3 1/4	2 3/4	3
Public final demand	2.3	7 1/4	3 1/4	4
Total final demand	5.3	4 1/4	3	3 1/4
Change in inventories(d)				
Private non-farm	0.1	1/4	0	- 1/4
Farm and public authorities	0.6	0	- 1/4	- 1/2
Gross national expenditure	6.0	4 1/2	2 3/4	2 3/4
Exports of goods and services	3.8	2	5	9
Imports of goods and services	9.6	5	4	4
Net exports(d)	-1.1	- 1/2	1/4	3/4
Gross domestic product	4.6	4 1/4	3	3 1/2
Non-farm product(e)	4.8	4 1/4	3	3 1/2
Farm product(e)	-2.1	4	1	-3
Panel B - Expenditure Excluding Transfers and One-off Transactions(c)(f)				
Total business investment	9.7	2	0	-1
Other buildings and structures	6.9	9	-9	-6
Machinery and equipment	11.3	-2	3	0
Public final demand	3.4	5 1/4	2 1/2	3 1/2
Change in inventories(d)	0.3	0	0	- 3/4
Gross national expenditure	5.8	4 1/4	2 3/4	2 3/4
Exports of goods and services	5.6	3	5	9
Panel C - Other Selected Economic Measures				
Prices and wages				
Consumer Price Index	0.0	1 1/4	2	2 1/4
Gross non-farm product deflator	1.3	3/4	1 3/4	2 1/4
Average earnings(g)	3.6	4 1/4	3 3/4	4
Labour market				
Employment (Labour Force Survey basis)	1.4	2 1/4	1 3/4	1 1/2
Unemployment rate (per cent)(h)	8.3	7 3/4	7 1/2	7 1/2
Participation rate (per cent)(h)	63.1	63 1/4	63 1/4	63 1/4
Household saving ratio (per cent)	3.0	1 1/4	1	
External accounts				
Terms of trade	0.0	-4 3/4	1/2	1/2
Current account balance				
\$ billion	-23.3	-32 1/2	-32	
Percentage of GDP	-4.1	-5 1/2	-5 1/4	

(a) Percentage change on preceding year unless otherwise indicated.

(b) Calculated using original data.

(c) Chain volume measure. Reference year is 1996-97.

(d) Percentage point contribution to growth in GDP.

(e) 1997-98 outcome calculated at basic prices.

(f) Transfers are net second hand asset sales from the public sector to the private sector. One-off transactions are gold sales by the Reserve Bank, 'lumpy' imports of aircraft, ships and satellites, and the export of ANZAC frigates.

(g) Average non-farm compensation of employees (National Accounts basis).

(h) The estimate in the final column represents the forecast level in the June quarter 2000.

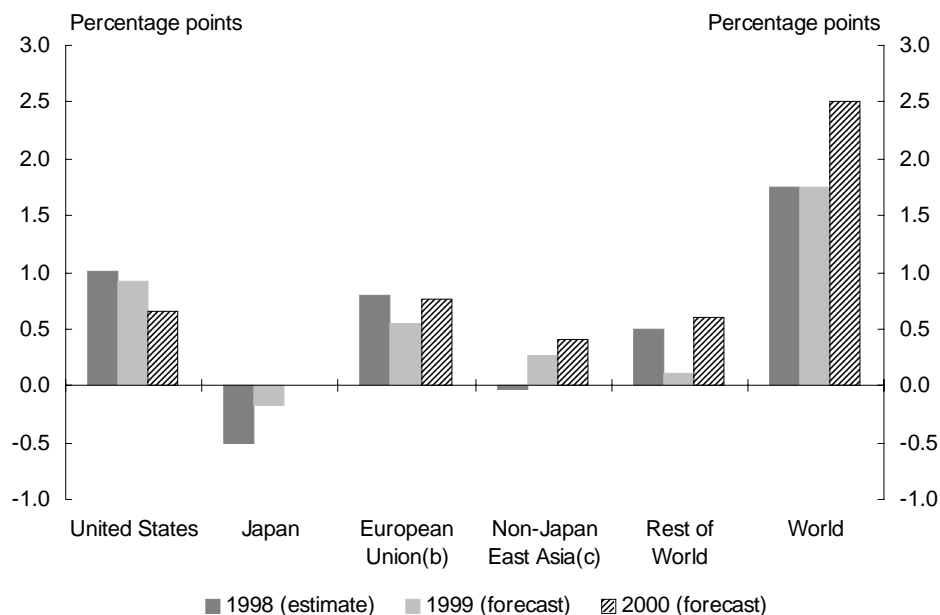
PART II: THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

The severe recession in Japan and the weakness in the East Asian crisis economies detracted significantly from world economic growth in 1998, with growth slowing from 3¼ per cent in 1997 to 1¼ per cent in 1998. Robust growth in the United States economy and solid economic growth in Europe has supported world growth.

Growth in the United States and Europe is expected to be weaker in 1999 and significant contractions are expected in several emerging market economies, in particular Brazil and Russia. Offsetting these are the expected improvement in the troubled economies of East Asia and a moderation in the rate of economic contraction in Japan. On balance, world economic growth should be maintained at its current pace of around 1¼ per cent.

World economic growth is expected to strengthen to around 2½ per cent in 2000, with an anticipated pick-up in growth in the European Union, further improvement in East Asia and recovery in Latin America and Eastern Europe. While growth in the United States could continue to exceed expectations, there remains considerable uncertainty surrounding the outlook for Japan and the strength of recovery in the crisis-affected emerging markets.

Chart 1: Percentage point contributions to world growth rates^(a)



(a) European Union, Non-Japan East Asia, Rest of World and World GDP growth rates are calculated using GDP weights based on market exchange rates.

(b) Germany, France, Italy, the United Kingdom, Belgium, Netherlands, Greece, Denmark, Sweden, Luxembourg, Austria, Spain, Portugal, Finland and Ireland.

(c) Korea, Singapore, Taiwan, Hong Kong, China, Indonesia, Malaysia, Thailand and the Philippines.

Source: Various national statistical publications, IMF and Treasury.

Table 2: GDP growth rates for selected countries and groupings^(a)

	1996	1997	1998(c)	1999(f)	2000(f)
United States	3.4	3.9	3.9	3½	2½
European Union	1.8	2.6	2.8	1¾	2½
Japan	5.0	1.4	-2.8	-1	0
Non-Japan East Asia	7.4	6.2	-0.3	3¼	5
OECD(b)	3.3	3.0	1.9	2	2¼
World	3.5	3.3	1.8	1¾	2½

(a) European Union, Non-Japan East Asia, OECD and World GDP growth rates are calculated using GDP weights based on market exchange rates.

(b) The United States, Japan, Germany, France, Italy, the United Kingdom, Canada, Australia, Austria, Belgium, Czech Republic, Denmark, Finland, Greece, Hungary, Iceland, Ireland, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland and Turkey.

(c) Treasury estimates for European Union, OECD and World.

Source: Various national statistical publications, IMF and Treasury.

The **United States** economy continued to grow strongly in 1998 and into 1999 — its ninth year of continuous economic expansion — providing considerable support to world growth.

In recent years, above-trend economic growth has reflected particularly robust growth in both consumption and investment. This has been supported by strong employment growth, rising real wages, large gains in the value of equity holdings, significant falls in interest rates and high levels of consumer confidence. Household consumption growth has exceeded income growth as conventionally measured (ie excluding capital gains and losses). Inflation and inflation expectations remain subdued, having fallen significantly in recent years despite strong employment growth and very low rates of unemployment.

The continuation of strong economic growth and subdued inflation probably reflects, in some part, a structural improvement in productivity growth flowing from increased competition in product and labour markets, and substantial investment in new technology. However, this low-inflation growth has also been aided by several positive supply-side developments. These include, in particular, the significant declines in world commodity prices — especially energy prices — and in import prices more generally that have resulted from a weakening in world growth and a strengthening US currency.

The relative strength of the US economy has also attracted large amounts of international capital from less stable markets. This inflow has helped to push down domestic bond yields, boost equity prices and increase investment. However, the associated fall in net exports has impacted significantly on manufacturing output.

The outlook for 1999 and 2000 is for growth to moderate towards a more sustainable rate, with a waning in recent positive supply-side developments

expected to provide some direct constraint to growth. Investment should slow with a weaker overall profit outlook, lower capacity utilisation rates and the ongoing impact on industrial production of a strong currency and external weakness. Consumption spending should ease as a result of an expected slowing in employment growth and in the rate of wealth accumulation.

However, US economic growth may continue to exceed expectations. Much of the strength of investment has been in information technology which may distort traditional capacity utilisation measures. If so, investment growth may continue to be strong notwithstanding apparently low capacity utilisation. In the first quarter of 1999, consumption and investment growth has maintained the momentum of 1998 and the stock market has continued to post significant gains supported by indications of continued strong profit performance. That said, there is limited scope for further falls in unemployment and, with some abatement in the factors that have helped offset inflation, the continuation of current growth rates is likely to increase inflationary pressures. In addition, the rapid growth in equity prices in recent years poses concerns about the effects of a possible significant and sustained correction.

Further, while the maintenance of open and competitive markets has helped to cushion the negative impact of external weakness on the US economy, there is a risk that further deterioration in the current account deficit in 1999, as is expected, may give increased voice to protectionist sentiment within the United States.

Growth in the **European Union** maintained the momentum of 1997 into the first half of 1998, with some moderation occurring in the second half of the year. While there was continuing strength in France and the smaller euro economies, weaker growth became evident in Germany, Italy and the United Kingdom. The manufacturing sectors suffered as a result of weakness in the East Asian region and weak business confidence in general, but domestic demand strengthened considerably on the back of productivity increases that boosted household income, along with high levels of consumer confidence and reductions in interest rates.

Stronger growth is expected to resume in the second half of 1999 and continue into 2000. Investment is expected to pick-up steadily during 1999, supported by accommodative monetary conditions including a weaker euro, high capacity utilisation and a gradual improvement in the external sector as world growth strengthens. Consumption strongly supported growth during 1998 and is expected to do the same in 1999. While the external sector is expected to improve through 1999 it is still likely to detract from growth for the year as a whole. The improvement in the external sector is expected to continue in 2000.

Growth in the past two years has been supported by a shift in the balance of macroeconomic policy settings, with significant easings in monetary conditions and substantial improvement in fiscal positions, made in the move toward European Monetary Union (EMU). The operation of EMU, however, will serve

to highlight further the persistent structural impediments to growth in both labour and product markets in Europe. Flexibility in these markets will become more important as governments have relinquished the policy options of nationally-set interest rates and internal exchange rate adjustments and have placed limitations on fiscal policy.

The **Japanese** economy remains in protracted recession. Substantial fiscal stimulus measures and growth in the external sector have been unable to offset contraction in private domestic demand, which has been adversely affected by significant deterioration in business and consumer confidence, constrained credit availability arising from problems in the banking sector and weak profitability within the corporate sector.

The outlook is for a further contraction in activity in 1999 before stabilising in 2000. Continued weakness in private demand is expected in 1999, influenced by the ongoing removal of excess industrial capacity and increased restructuring within the corporate sector and further deterioration in employment and household income prospects. In addition, the strengthening of the currency since August 1998 should temper the positive contribution that the external sector provided in 1998. While fiscal stimulus is anticipated to provide some support for activity in 1999 and 2000, high levels of public debt will constrain the sustainability of this course of action in the longer term.

Reforms aimed at restructuring the financial sector and improving profitability within the corporate sector will provide a stronger base for economic recovery in the medium term. In the short term, these reforms may have a contractionary impact, although effective progress may also provide some positive impact on business and consumer confidence. While significant reforms are occurring in the banking and broader financial sector, there are still many problems to be resolved. Further reforms are necessary within the corporate sector, the labour market and in the provision of access to Japan's domestic market.

Several **emerging market economies**, particularly Brazil and Russia, are expected to experience significant contraction in 1999, following severe financial market instability and capital flight experienced over the latter half of 1998 and early 1999. Significant tightening in monetary policy made in response to the instability and significant moves towards fiscal consolidation, particularly in Brazil, are likely to contribute to the deterioration in the outlook for 1999.

These policy measures have been necessary to restore stability and confidence in financial markets and to address underlying structural and fiscal problems that hinder the return to strong sustainable growth. With reform now in progress in a number of these economies, it is anticipated that there will be an improvement in growth in 2000. However, if the implementation of reform in institutional, structural and macroeconomic policies is not ongoing, recovery is likely to be more delayed as confidence deteriorates, which may weaken the expected improvement in world growth in 2000.

The **non-Japan East Asian region**, in aggregate, contracted over the first half of 1998 — the first recession in at least 30 years — after averaging annual output growth of around 8 per cent in the preceding decade. Output fell dramatically in Indonesia, Thailand, Malaysia and Korea, while Hong Kong was also heavily affected. The contraction in activity seen in Singapore and the Philippines was less severe, while solid growth was achieved in China and Taiwan, albeit at lower rates than experienced over recent years.

The worst of the economic contraction would appear to have passed, with the region in aggregate likely to experience a gradual improvement in growth rates over the next few years. Since the middle of 1998, activity in China has strengthened on the back of increased infrastructure spending, while output growth has resumed in Korea, Malaysia and Singapore. Taiwan has maintained solid output growth, while activity in Thailand and the Philippines is likely to stabilise over coming months. In Indonesia, progress will be heavily influenced by political and social developments. Increased stability in regional financial markets in the second half of 1998 allowed authorities to adopt more expansionary monetary and fiscal policies which assisted in halting the declines in output. However, large divergences in growth performance are likely to remain and many factors could still derail the recovery.

The outlook for exports will be an important factor affecting the recovery prospects of the East Asian economies. The improvement in competitiveness that many regional countries gained from large currency depreciations during the second half of 1997 has, to a large extent, been maintained and has contributed to an increase in exports to the growth economies of the United States and Europe. However, intra-regional exports have remained weak.

The gradual improvement in regional growth rates over the next few years will be a positive for exports within the region. However, the large trade imbalances building between the East Asian region (including Japan) and the growth economies (particularly the United States) have increased trade tensions and calls for trade restrictions. Continued access to the United States and European markets will be an important factor for the outlook for the region over the next few years.

The value of East Asian exports has also been affected by global over-capacity in several key sectors such as textiles and electronics, and the likelihood is that continuing weak global prices in these sectors will constrain export revenue over 1999.

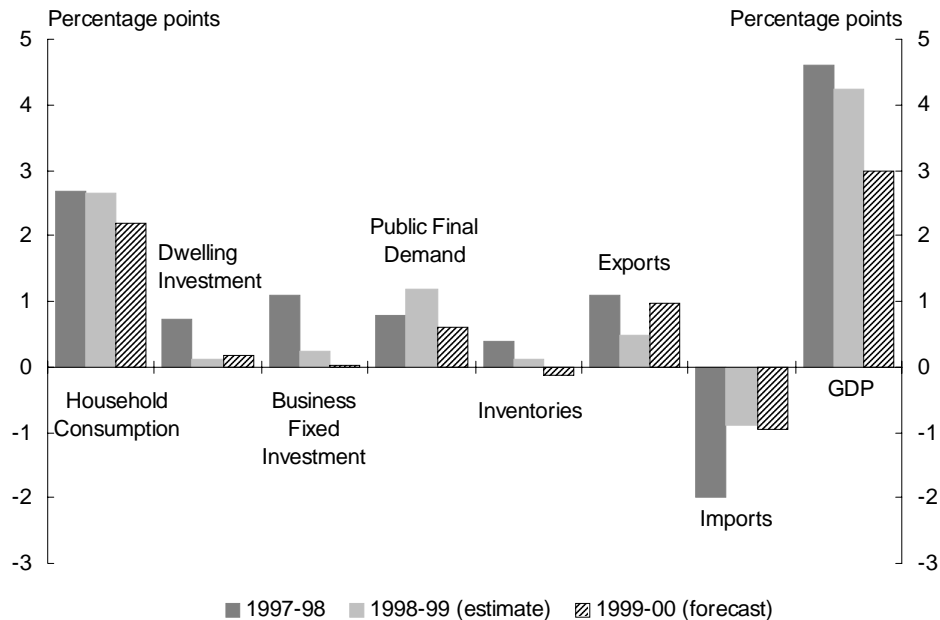
PART III: THE OUTLOOK FOR THE DOMESTIC ECONOMY

The forecasts for the domestic economy have been developed taking account of the international outlook outlined above. In framing the forecasts for the domestic economy, the exchange rate is assumed, as is usual practice, to remain unchanged from the average levels reached in recent months. The farm sector forecasts have been prepared on an assumption of average seasonal conditions over the remainder of 1998-99 and in 1999-2000.

Demand and output

Following very strong growth of more than 4 per cent in both 1997-98 and 1998-99, economic growth is expected to remain solid in 1999-2000 at around 3 per cent. The moderation in GDP growth is expected to occur largely in 1999, before picking up in 2000 as the world economy gradually strengthens. The expected moderation in growth largely reflects: more moderate growth in household consumption, closer to the longer-term trend, following very strong growth in the two previous years; a reduction in private non-residential construction from recent high levels; relatively stable activity levels in dwelling investment; and slower growth in public demand. Partially offsetting influences are expected to be a pick-up in export growth and plant and equipment investment as the international economy gradually strengthens through calendar year 2000.

Chart 2: Contributions to GDP growth^(a)



(a) Adjusted for transfers and one-off transactions as noted in Table 1.
Source: ABS Cat. No. 5204.0 and Treasury.

In 1998-99, GDP is expected to grow by around 4¼ per cent, significantly above the MYEFO forecast of 3¼ per cent. The upward revision largely reflects stronger than expected growth in the December quarter 1998, particularly household consumption, and indications of continuing solid growth in consumer spending and employment in the second half of 1998-99. Measures of business confidence have also rebounded, although these measures are not always a good indicator of future movements in business investment or overall growth.

The overall effects of the Government's taxation reform package on economic activity in 1999-2000 are likely to be muted since the package does not come into effect until the following financial year. While some components of activity are likely to be affected in 1999-2000, the effects on individual components tend to work in offsetting directions. The overall impact is expected to be slightly positive.

Household consumption

Household consumption growth is expected to remain solid in 1999-2000, growing by around 3¾ per cent, following very strong growth of around 4½ per cent in 1997-98 and 1998-99.

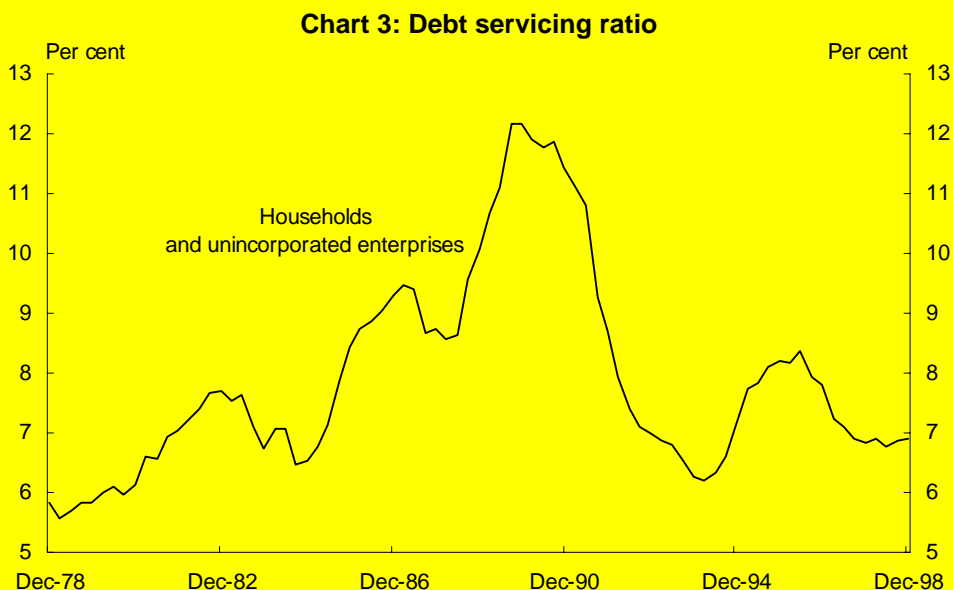
The continuing strength in household consumption in 1998-99 has been underpinned by strong employment growth and ongoing real wage growth, low interest rates and wealth effects associated with rising asset prices and the AMP Society demutualisation. The results of recent consumer confidence surveys indicate that consumer optimism is at high levels with regard to consumers' expectations about their personal financial situation, their stated willingness to purchase major household items and, more recently, their confidence in economic conditions over the next twelve months.

In 1999-2000 more moderate growth in employment and real wages is expected to contribute to some slowing in household consumption expenditure. In addition, much of the impact of the AMP demutualisation on consumer demand, particularly for consumer durables, is likely to have run its course in 1998-99 and hence seems unlikely to contribute to further growth in consumer demand in 1999-2000. As a partial offset recent significant increases in the price of equities, particularly privatised companies such as Telstra and the Commonwealth Bank which are likely to be widely held amongst households, may provide some boost to consumer spending in 1999-2000. There is also likely to be some net increase in household consumption in the latter part of 1999-2000 ahead of the introduction of the *A New Tax System* package. Purchases of currently relatively lightly taxed goods may be brought forward. On the other hand, some spending on items that are currently more highly taxed may be deferred, although this will be softened by transitional arrangements.

Box 1: Households' financial position

Very strong growth in household borrowing has occurred over the past five years. Household debt has increased from around 80 per cent of disposable income in 1994 to around 100 per cent in the December quarter 1998. However, by international standards, Australian households have carried relatively little debt in the past and the recent increase in indebtedness has brought Australia more into line with other developed countries.^(a)

The increase in debt is likely to partly reflect consumers responding to lower interest rates, allowing them to service a higher level of debt. Debt servicing ratios, currently at around 7 per cent of gross disposable income, are much lower than the late 1980s peak of around 12 per cent and have been relatively stable over the past six years.



Source: ABS Cat. No. 5206.0.

In conjunction with rising debt, there has also been strong growth on the asset side of the household balance sheet, with net worth increasing solidly. Net household financial assets (ie excluding dwellings and consumer durables) rose 10 per cent in the year to December 1998 and have risen 40 per cent in the past three years, with much of this growth reflecting rising asset prices, particularly equities.

A broader measure of net worth, which includes dwellings and combines the assets and liabilities of the household and business sectors, rose 5.7 per cent in the year to December 1998, after adjusting for inflation. Over the three years to December 1998, this broader measure of net worth increased by 23 per cent in real terms.

(a) *Reserve Bank of Australia Bulletin*, October 1997, 'Some Observations on Low Inflation and Household Finances'.

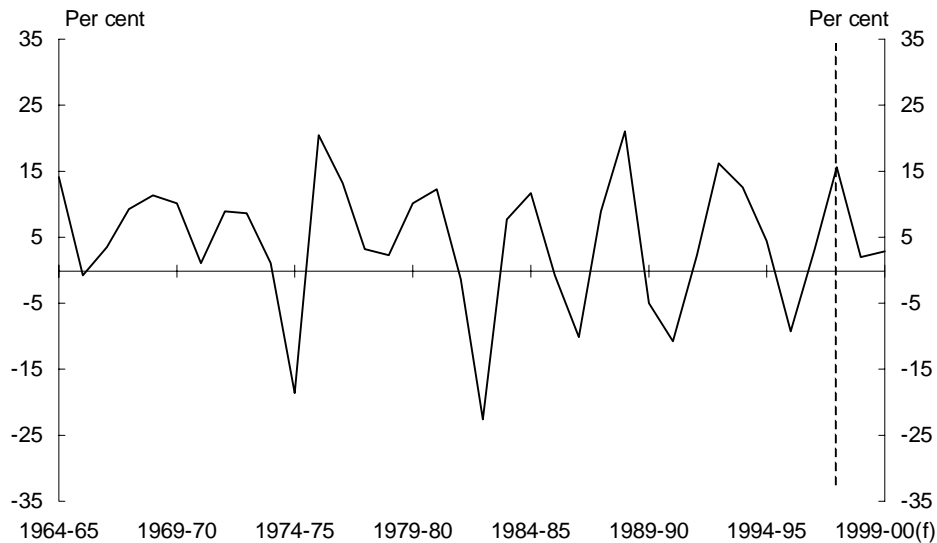
One important uncertainty surrounding the outlook for household consumption is the apparent downward trend in the household saving ratio and rising household debt. If households move to stabilise or increase their saving rates from recent levels and rein in their borrowing, household consumption expenditure could be weaker than forecast. Nevertheless, the household saving ratio as conventionally measured is a rather narrow concept (from an economic perspective) and is likely to give a distorted picture when asset values are changing. Broader measures of households' financial position, such as net worth and debt servicing ratios, remain sound and interest rates are at low levels, suggesting that risks around the outlook for household consumption are relatively evenly balanced (see Box 1).

Dwelling investment

Modest increases in dwelling investment are forecast in both 1998-99 and 1999-2000, following very strong growth in 1997-98.

Partial indicators of activity in the housing sector, such as building approvals, housing finance and dwelling commencements, appear to have peaked around the middle of 1998. Importantly, however, the decline in these indicators since then has been relatively mild. In recent decades, dwelling investment has followed a four to five year cycle, with sharp increases in dwelling investment followed by sharp declines, often associated with significant changes in interest rates and inflation rates. However, with interest rates and inflation now more stable than in the past, dwelling investment is likely to be less volatile. It is noteworthy, for example, that in the 1960s low inflation and relatively stable interest rates were associated with a more muted housing cycle (Chart 4).

Chart 4: Dwelling investment



Source: ABS Cat. No. 5204.0 and Treasury.

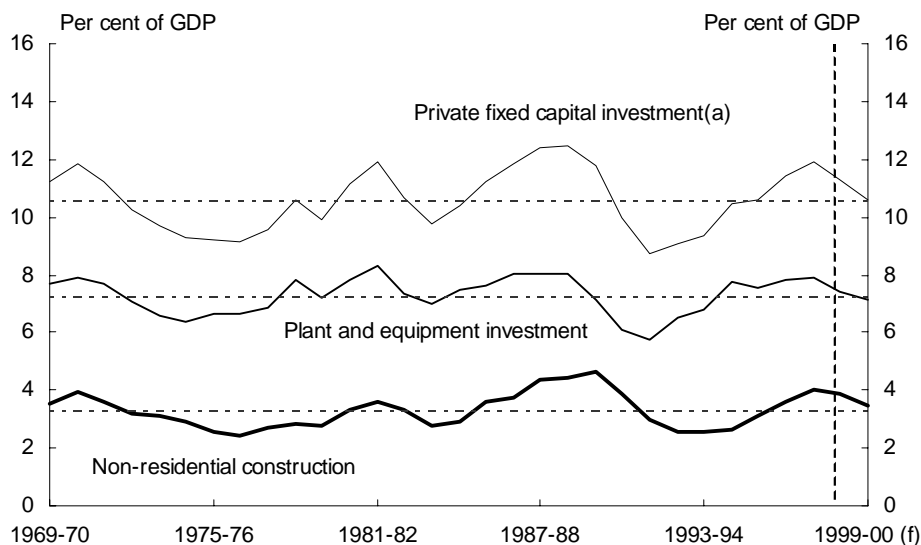
Demand for housing should be supported by continuing high levels of housing affordability and moderately supportive demographic factors. High housing affordability reflects rising household incomes, moderate house price inflation and very low housing interest rates. At the same time, strong demand from 'baby boomers' and the trend to smaller households should cushion the impact of slower population growth across the key household forming age cohorts.

There is also little sign of the overbuilding which has characterised some previous cycles. Supply and demand conditions in the housing sector appear to be broadly in balance, with the current level of housing commencements judged to broadly match the underlying demand for new houses attributable to demographic factors. The long-term structural trend towards larger, more expensive housing and ongoing expenditure on alterations and additions to the existing housing stock is expected to result in dwelling investment growing more strongly than the number of new houses commenced.

Business investment

The sale and purchase of assets between the public and private sectors can have a significant impact on published estimates of business investment and public final demand. This has been the case in recent years, as is evident from a comparison of Panels A and B of Table 1. Such asset sales have no significant impact on aggregate activity, but can provide a misleading view of movements in individual components. For this reason, it is preferable to abstract from such asset sales when assessing underlying economic activity.

Chart 5: Investment as a percentage of GDP

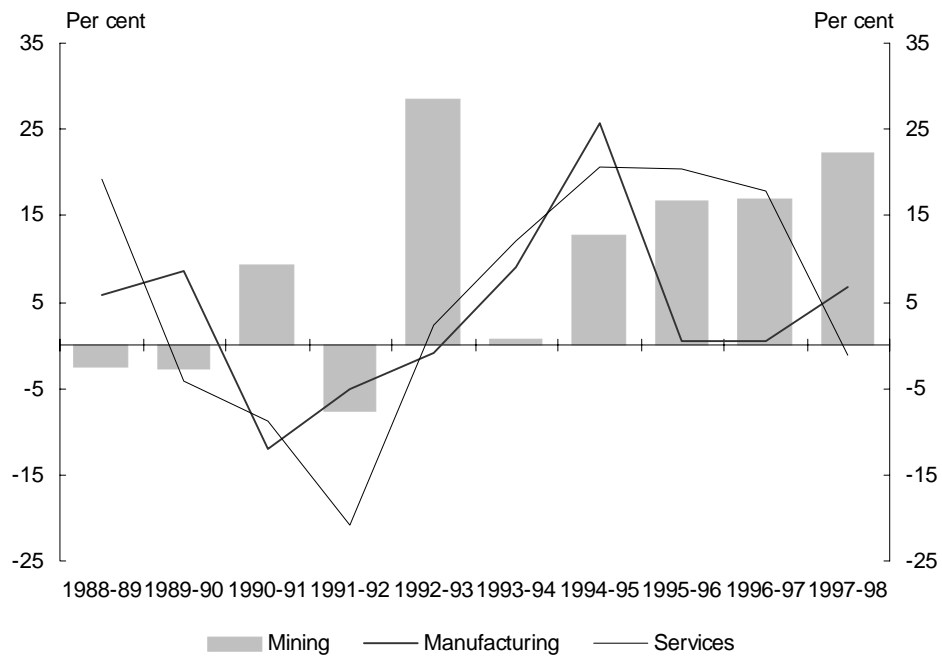


(a) Excludes intangible fixed assets and livestock.
Source: ABS Cat. No. 5204.0 and Treasury.

After six years of strong growth in business investment (abstracting from asset sales), which carried business investment to around historical highs as a share of GDP in 1997-98, only modest growth is expected in 1998-99. In 1999-2000 growth in business investment is forecast to be flat (ie running at the same level as in 1998-99), reflecting the impact of continuing below trend world growth, the maturity of the current investment cycle and some deferral of investment spending ahead of the introduction of the *A New Tax System* package. Nevertheless, business investment is expected to be around its long-run average share of GDP in 1999-2000 (Chart 5).

While the Australian economy has grown very strongly notwithstanding the international downturn, international developments are having a significant impact on some components of business investment. Some firms have responded to the uncertainty surrounding the international outlook and low world commodity prices by deferring investment plans until the outlook becomes clearer. This trend seems to be most marked in the mining sector, although it follows several years of very strong growth in investment in that sector (Chart 6).

Chart 6: Annual growth in business investment



Source: ABS Cat. No. 5646.0.

Acting against these factors, however, is a range of relatively positive fundamental influences: nominal and real interest rates are low; overall capacity utilisation is at above average levels; most measures of business confidence have

returned to pre East Asian crisis levels; and profitability and balance sheets are healthy. The corporate profit share increased to a record level in 1998 and broader measures of profitability, which include unincorporated enterprises, are also at high levels. While gearing ratios have drifted up slightly in recent years, they remain well below the highs experienced in the late 1980s and early 1990s.

On an industry basis, the weakness in business investment intentions is largely concentrated in the mining industry, consistent with current low commodity prices and the subdued outlook for the resources sector. Investment intentions in the manufacturing and, to a lesser degree, services sectors, are relatively strong and more in line with the favourable fundamentals noted above.

In terms of the components of business investment, underlying plant and equipment investment is expected to grow by around 3 per cent in 1999-2000 after declining by around 2 per cent in 1998-99. Key influences are expected to be stronger growth in manufactured exports, in line with a gradually strengthening world economy and the generally favourable investment climate outlined above. As a partial offset, the introduction of the GST on 1 July 2000 and the removal of wholesale sales tax from business inputs will generally reduce the cost of investment and hence is likely to result in some deferral of plant and equipment investment in the latter part of 1999-2000.

Surveyed business investment intentions data also point to a return to growth in plant and equipment investment in 1999-2000. Applying a five-year average realisation ratio to the initial intentions data for 1999-2000 implies growth of around 7 per cent in the value of plant and equipment investment. However, there is always a wide band of uncertainty around estimates based on the first set of investment intentions data for a particular year, with investment plans being firmed up as the year progresses and often sensitive to changing economic trends.

Non-residential construction investment (in underlying terms) is expected to peak in 1998-99 at a relatively high level as a share of GDP, before turning down in 1999-2000. This follows several years of strong growth in investment in projects such as offices, hotels, casinos, sporting arenas and infrastructure, including projects linked to the Sydney 2000 Olympics. Lower mining investment is also expected to dampen non-residential construction activity. Approvals and financing data have been trending down since around mid-1998. While a large stock of work yet to be done should support a high level of activity for some time, it is expected to only partly offset the decline in the flow of new projects. Surveyed business investment intentions also point to a significant fall in non-residential construction in 1999-2000.

Public final demand

Following strong growth in 1998-99, public final demand (abstracting from asset sales) is expected to moderate in 1999-2000, reflecting slower growth in both public investment and consumption.

Growth in investment spending at the Commonwealth, State and local government levels is expected to slow in 1999-2000. This largely reflects slower growth in public trading enterprise investment at the Commonwealth and State levels of government, with the completion of some major investment projects in 1998-99. While general government investment is expected to be underpinned by some infrastructure programmes of State Governments in 1999-2000, the effect of this will be partly offset by the conclusion of Olympic-related spending.

Public consumption growth is expected to slow in 1999-2000, reflecting ongoing fiscal consolidation programmes at both Commonwealth and State government levels.

Non-farm inventories

Private sector non-farm inventories are expected to contribute around $\frac{1}{4}$ percentage point to growth in 1998-99 and detract around $\frac{1}{4}$ percentage point from growth in 1999-2000 (after adjusting for the privatisation of Wool International in the September quarter 1999). The inventories-sales ratio appeared to have fallen below desired levels in 1997-98, reflecting unexpectedly strong sales growth over that period. The increase in inventories in recent quarters has returned stockholding to levels more in line with requirements. A resumption in the structural decline in the inventories-sales ratio associated with improved inventory management practices is expected to more than offset any increase in demand for stockholding stemming from ongoing solid sales growth over the course of 1999-2000.

Farm sector

The level of farm gross domestic product is forecast to remain broadly unchanged in 1999-2000, reflecting the usual assumption of normal seasonal conditions. Of the main components, production of canola and dairy products in particular are expected to rise over the period. These increases are expected to offset a decline in grain and wool production and livestock slaughterings as some rebuilding of the herd takes place.

Net exports and the current account balance

The slower world economy and continued strength in domestic demand is expected to result in net exports detracting from GDP growth in 1998-99, although the detraction is likely to be smaller than in 1997-98. In 1999-2000, net exports are expected to contribute slightly to GDP growth ($\frac{1}{4}$ percentage point),

as exports pick-up in line with the gradual strengthening in the international economy.

The pick-up in export volume growth in 1999-2000 is expected to be to around 5 per cent, with growth across resources, manufactures and service exports. Nevertheless, such an outcome would mean that the growth rate for exports would remain below the longer-term trend rate for the third consecutive year as world economic growth remained below trend. A feature of Australia's export performance in the first year of the economic downturn in East Asia was a significant diversion of exports, particularly commodities, away from the troubled East Asian economies and toward faster growing economies elsewhere. This export diversion may moderate in 1999-2000 as the economies of some of Australia's major trading partners in East Asia stabilise and begin to recover and growth slows in the United States.

The expected pick-up in the volume of resource exports in 1999-2000 primarily reflects additional supply capacity coming on stream, coupled with stronger growth in traditional export markets in East Asia. The volume of elaborately transformed manufactures (ETMs) exports is estimated to have declined in 1998-99, reflecting very weak activity in some of Australia's major ETM trading partners in the region and the relative difficulty in establishing alternative markets for such items in the short term. A return to positive growth in ETM exports is expected in 1999-2000, supported by strengthening activity in key regional markets. The outlook for stronger world growth also points to a return to moderate growth in services exports.

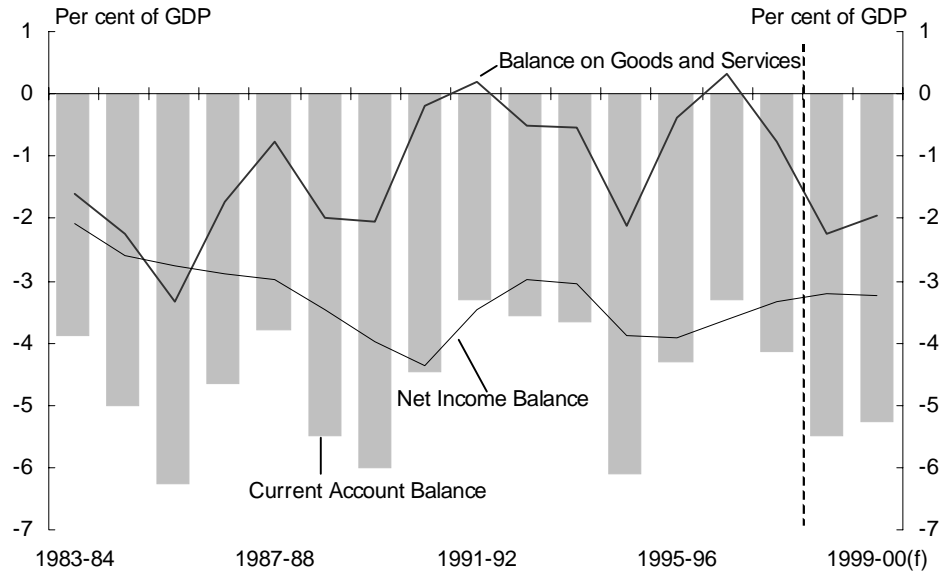
Import volume growth in 1999-2000 is forecast to remain relatively subdued, reflecting the net impact of more moderate growth in domestic demand, against a slight fall in import prices. The outlook for import prices across-the-docks and at the retail level remains uncertain. Strong international and domestic competitive pressures have produced lower than expected outcomes over recent quarters (see discussion in Box 2 and Statement 3).¹

The CAD is forecast to decline slightly relative to GDP (to 5¼ per cent or \$32 billion) in 1999-2000 as compared with a forecast outcome of 5½ per cent of GDP (\$32½ billion) in 1998-99.

The increase in the CAD in 1998-99 primarily reflects a deterioration in the balance of trade (Chart 7), coming from continued weak net exports and weaker terms of trade.

¹ Statement 3 of Budget Paper No. 1 — Budget Strategy and Outlook 1999-2000. Statement 3 is reproduced in this edition of the Roundup.

Chart 7: Contributions to current account deficit



Source: ABS Cat. No. 5302.0 and Treasury.

There has been a decline in the terms of trade since the onset of the crisis in East Asia albeit modest. While export prices on world markets, particularly for commodities, have declined significantly in foreign currency terms, there has also been a significant decline in the foreign currency prices of Australia's imports. The latter reflects various factors including technological and productivity gains, as well as the impact of slow world economic growth and the very competitive world markets for many items, such as motor vehicles and computers, which are important import items for Australia.

The terms of trade is expected to decline by around 4¾ per cent in year-average terms in 1998-99. A slight increase is expected in 1999-2000 as commodity prices stabilise overall and import items remain competitively priced. This outlook hinges on a gradual strengthening in the world economy in 2000 placing a floor under commodity prices.

Unlike previous episodes in Australia when the CAD has increased significantly as a percentage of GDP, growth in the net income deficit is expected to be subdued over the forecast period, reflecting the continuation of a low interest rate environment and the absence of significant exchange rate valuation effects. More detail on the performance of Australia's external sector relative to other periods of slow world economic growth is contained in Statement 3.

The forecast decline in the CAD as a share of GDP in 1999-2000 reflects the outlook for a gradual pick-up in growth in Australia's major export markets and a slight increase in the terms of trade. In keeping with past experience, considerable volatility is likely from quarter to quarter.

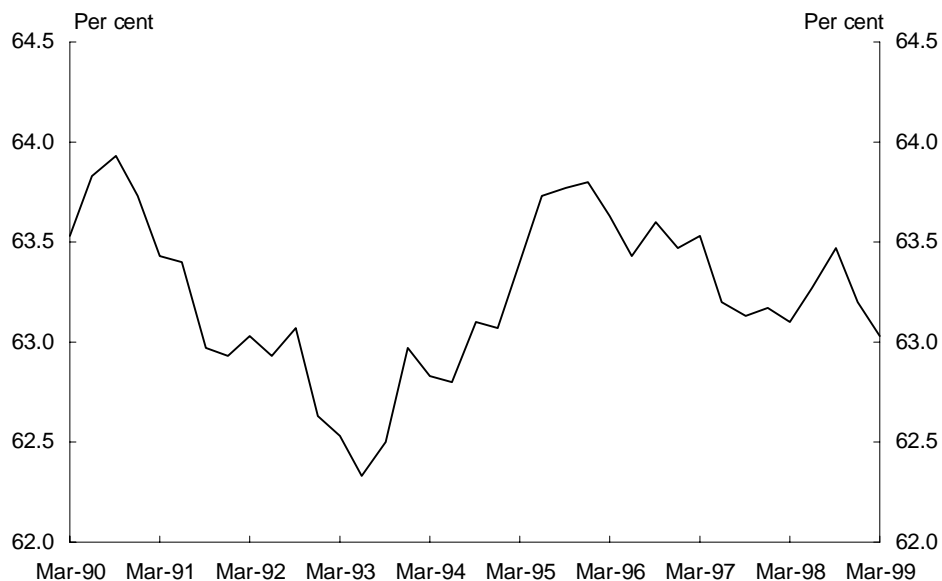
Labour market

Conditions in the labour market are expected to remain firm in 1999-2000, although some moderation in employment growth is expected over the course of the year in response to slower growth in the domestic economy. The unemployment rate is expected to average around 7½ per cent in 1999-2000, consolidating the decline in the unemployment rate since mid-1997.

Employment has grown solidly through 1998-99 to date, underpinned by the strength in overall economic growth. Given the usual lags between output growth and employment, further solid growth is likely in the early part of 1999-2000. This is consistent with the high level of the major job vacancies surveys, with both the ANZ and Skilled Vacancy surveys at their highest levels in over nine years. Some easing in the rate of employment growth is expected later in 1999-2000 as economic growth moderates.

Following very strong average labour productivity growth in recent years, a cyclical slowing in productivity growth is expected in 1999-2000, as employment growth responds with a lag to slower growth in activity. The forecast rate of labour productivity growth is consistent with the experience of the mid-1990s, although average labour productivity has been quite volatile from year to year and is therefore difficult to predict.

Chart 8: The participation rate



Source: ABS Cat. No. 6202.0.

The unemployment rate is forecast to average around 7½ per cent over 1999-2000, with the participation rate drifting up a little from recent levels

to average around 63¼ per cent. There is a larger than normal degree of uncertainty concerning the participation rate at this time. Short-term movements in the participation rate tend to largely reflect changes in employment opportunities, although this does not seem to have been the case during 1998-99.

A range of factors may have contributed to a stable participation rate over recent quarters, notwithstanding the favourable employment outlook. For example, continued high levels of housing affordability and rising household wealth may be creating opportunities for some households to rearrange their work/leisure choices. Further, longer-term demographic factors, such as the ageing of the population and the movement of the 'baby boomer' generation into the lower participation cohorts, are also likely to be exerting a negative influence on the participation rate (as discussed in the Summer 1999 *Economic Roundup* and in Statement 3).

Overall, a modest increase in the participation rate from recent levels is expected over the course of 1999-2000, with the continuing favourable employment outlook assumed to outweigh the various forces which may be working in the opposite direction.

Wages

Wages growth on a National Accounts basis is currently running at around 4 per cent per annum, similar to outcomes in 1997-98. This is somewhat higher than other measures of wages growth. A slight moderation in wages growth generally is expected in 1999-2000, as labour market conditions remain firm but employment growth slows relative to 1998-99. This outlook incorporates the contribution to wages growth flowing from the recent Australian Industrial Relations Commission safety net decision.

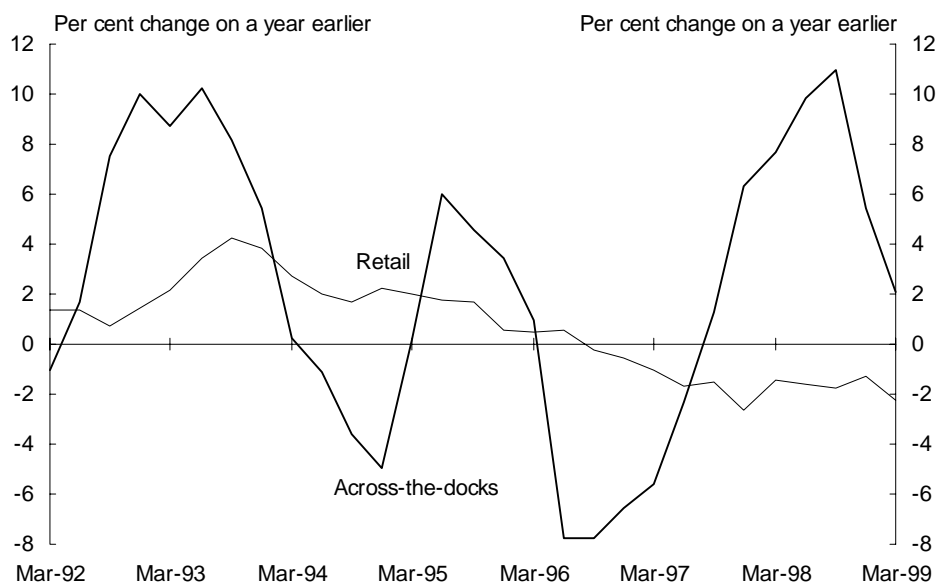
Prices

Inflation is expected to increase modestly from recent low outcomes. In year-average terms, inflation is forecast to be around 2 per cent in 1999-2000, up from around 1¼ per cent in 1998-1999. Through the year to the June quarter 2000, inflation is expected to be around 2¼ per cent.

The forecast slight rise in inflation in 1999-2000 partly reflects faster growth in nominal unit labour costs in response to a cyclical slowing in average labour productivity growth from its recent high rates, more than offsetting a slight moderation in the rate of nominal wage increases. Some lessening in the downward pressure on the world prices of Australia's imports is also expected in 1999-2000, following significant falls in world prices of these items (when expressed in \$US terms) since mid-1997 (see Box 2 and the discussion in Statement 3). There may also be some move on the part of wholesalers and retailers to rebuild profit margins on imported items, following an apparent squeezing of margins over recent quarters (Chart 9). Acting in the opposite

direction will be the moderating effect of some easing in domestic demand pressures as activity slows.

Chart 9: Prices of imported consumption goods



Source: ABS Cat. Nos. 6414.0 and 6444.0.

Box 2: Australia's recent inflation performance

CPI inflation has been well below 2 per cent in through-the-year terms for the past two years, with other measures of inflation, such as underlying inflation and the household consumption deflator, also indicating subdued price pressures. While an improved inflation performance has been a feature of most developed countries, in Australia it has occurred in an environment of strong demand growth and rising import prices across-the-docks.

Australia's low inflation outcomes reflect an improved monetary policy framework and the success of labour and product market reforms, which have resulted in a more dynamic, efficient and competitive economy. The benefits of these reforms are evident in recent productivity outcomes. Growth in average labour productivity (GDP per employed person) has thus far averaged above 2¼ per cent per annum in the 1990s growth period, up from around 1¼ per cent per annum in the 1980s growth cycle. In 1997-98 average labour productivity growth was even stronger at around 3¼ per cent, resulting in historically very low growth in nominal unit labour costs. Taking into account lags between changes in production costs and changes in final retail prices, this has been a key factor keeping inflation at low levels in recent quarters.

Box 2: Australia's recent inflation performance (continued)

Falling world prices for a number of Australia's consumer imports, such as cars and computer equipment, have also contributed to recent low inflation outcomes. While import prices across-the-docks have risen in \$A terms, the increase has been considerably less than might have otherwise been expected, given the sharp decline in the \$A against the major currencies. Import prices have fallen significantly in \$US terms, with falling commodity prices and the East Asian downturn having been important, though not the only, underlying factors (see Statement 3). Falling commodity prices have helped to reduce production costs in many manufacturing industries overseas. In addition, the East Asian downturn has meant that demand for manufactured items has been very weak in many East Asian economies and East Asian manufacturers have benefited from low exchange rates, boosting their competitiveness.

It is expected that some of these downward pressures on world prices of Australia's imports may begin to weaken in 1999-2000 as world commodity prices and the troubled East Asian economies begin to recover. Nevertheless, ongoing low inflation in the major economies, strong productivity growth and technological advances should ensure that world prices of imports remain subdued.

It is also noteworthy that, to date the (relatively modest) increases in import prices across-the-docks in \$A terms have not been reflected in rising prices at the retail level (Chart 9). In part, this probably reflects an increasingly competitive market place putting pressure on businesses' margins. Moreover, retailers review and change prices infrequently, attempting to avoid excessive price volatility so as to maintain stability and customer loyalty. Over the past 15 years or so, greater use of financial instruments to hedge exchange rate risk has also assisted retailers in reducing the volatility of retail prices relative to changes in import prices across-the-docks. In addition, any discounts that may be provided directly from overseas suppliers to domestic wholesalers or retailers may not be captured in measured prices across-the-docks.

The inflation forecasts in both 1998-99 and 1999-2000 also partly reflect the one-off impact on the Consumer Price Index (CPI) of changes in government policy. Inflation in 1998-99 has been reduced by the impact on health insurance costs as a result of the introduction of the 30 per cent health insurance rebate in the March quarter 1999 (which is estimated to have reduced the CPI by around 0.6 percentage points). Conversely, the introduction of the 'per stick' tobacco excise in the December quarter 1999 is expected to increase the CPI by around ¼ percentage point.

PART IV: UNCERTAINTIES SURROUNDING THE OUTLOOK

There continues to be significant uncertainty surrounding the international economic outlook and with that the outlook for Australia's export industries and the terms of trade. Although there are several factors pointing to an improved international economic outlook in calendar year 2000, there are questions about the sustainability of a strong East Asian recovery, and considerable uncertainty is attached to the outlook for Japan and some emerging market economies. Against this, economic growth in the United States could continue to exceed expectations.

The export outlook will, of course, be heavily dependent on the gradual recovery of the international economy and accordingly also remains subject to a high degree of uncertainty. The forecast slight decline in the CAD in 1999-2000 reflects the outlook for a gradual pick-up in growth in Australia's major export markets and a slight increase in the terms of trade. Should the world economy not pick-up as expected in 2000, then the export outlook would be more subdued and the CAD may be a little higher.

Against the backdrop of these international risks, considerable uncertainty remains about the timing and extent of the slowdown in the domestic economy from the very strong growth in 1997-98 and 1998-99. Business investment, which is forecast to slow after six years of strong growth, is by nature quite volatile, with surveys of business investment intentions only providing a broad guide to likely outcomes.

Some uncertainty remains around the extent to which the recent strength in household consumption expenditure will be sustained once the effects of recent increases in household wealth have run their course. A related area of uncertainty is the apparent downward trend in the household saving ratio and rising household debt. If households move to stabilise or increase their saving rates from recent levels and to rein in the growth in household debt, household consumption expenditure could be weaker than forecast. On the other hand, broader measures of households' financial position, such as net worth and debt servicing ratios, remain sound and interest rates are at low levels, suggesting that risks around the outlook for household consumption are relatively evenly balanced.

The timing of business and dwelling investment and household consumption in the latter part of 1999-2000 will also be affected to some extent by the introduction of the GST and the abolition of the wholesale sales tax.

Some increase in spending and business stocks may occur in the December quarter 1999 in response to lingering concerns about Y2K related disruptions. However, it seems likely that such spending and stock building would be largely reversed in the March quarter 2000, with minimal effect on average growth outcomes for 1999-2000 as a whole. There remain uncertainties,

however, in relation to Australia's international trade if Y2K effects disrupt some of our major trading partners.

A modest increase in the labour force participation rate from recent levels is expected over the course of 1999-2000, reflecting the continuing favourable employment outlook. Nevertheless, given recent trends, the participation rate is an important area of uncertainty surrounding the outlook for unemployment. If the participation rate were to remain around current levels then, other things being equal, the unemployment rate would continue its downward trend, despite the moderating economic growth rate.

