Economic Overview

The Australian economy recorded strong economic growth in the June quarter 1998 and most of the recent data suggests ongoing growth in the September quarter. Retail spending has remained firm, loan and building approvals data suggest housing investment will continue at a high level in 1998 and steady employment growth has been maintained. While the pace of activity is expected to moderate over 1998-99, continued solid economic growth is expected notwithstanding the sharp slowdown in Asia. As outlined in the *Pre-Election Economic and Fiscal Outlook* released on 8 September 1998, GDP is forecast to grow by 2¾ per cent in 1998-99, down slightly from the 1998-99 Budget forecast of 3 per cent.

The main reason for the downward revision to the growth forecast is the expected impact of weaker international economic growth prospects since the Budget and the associated instability on world financial markets. Nevertheless, growth of 2¾ per cent in 1998-99 compares favourably with likely outcomes in other developed economies and is consistent with continuing solid growth in employment.

DEVELOPMENTS IN THE WORLD ECONOMY

A marked slowing in world economic activity has occurred in 1998, relating in particular to developments in the Asian region. With more stable levels of activity likely to become apparent in some of the most affected Asian economies, a modest strengthening in world growth is expected in 1999. This, for example, is the outlook portrayed in the IMF's most recent forecasts of world economic activity (Table 1). If this outlook eventuates, the experience of these two years will be quite similar in magnitude to the cycle of the early 1990s. In composition, however, it will be very different; as already noted, the catalyst for weakness on this occasion relates to developments in the Asian economies whereas on the previous occasion it reflected outcomes in the major industrialised economies.

There are, however, considerable uncertainties surrounding the international outlook. One of the more important of these relates to developments in the global financial system and possible implications for aggregate financial liquidity. Developments in Russia — particularly the currency devaluation and debt moratorium — provided a catalyst for a reassessment of emerging markets more generally, resulting in increased risk premia and capital instability for these economies. However, the concerns are broader, reflecting a general reassessment of risk following difficulties encountered by some institutions (primarily hedge funds) and a recognition of the strong financial market interrelationships both between the major industrialised economies and with emerging markets.

Possible developments in emerging markets in Eastern Europe and Latin America are of particular importance to the world outlook, because of trade and financial linkages with the United States and Western Europe, the current pillars of support for the world economy.

The recent financial market instability in Latin America has reflected a reassessment of emerging market risk in general and a growing concern about the size of fiscal and external deficits in the light of large-scale regional indebtedness and falling commodity (particularly oil) prices and terms of trade. To restrain capital flight and avoid the further depletion of foreign reserves, short-term interest rates across the region have risen substantially. While restoring some stability, this increase in interest rates has the longer-term detrimental effect of increasing government outlays on public debt servicing, while also representing a substantial tightening of monetary policy that promises further slowing in domestic activity. Moreover, the implementation of fiscal austerity measures, promised in various Latin American countries to reduce government deficits and shore up market confidence, will also contribute to slower growth.

However, these concerns need to be balanced against the realisation that the **United States** is continuing to experience strong growth. GDP in the September quarter 1998 was 3.4 per cent above the year-earlier level and, despite some signs of softening, growth continues to be well in excess of potential. A slowing of growth is expected to become more apparent during 1999, reflecting both external and domestic factors.

Developments in Asia have adversely affected trade performance and will continue to do so. Moreover, the external environment has further deteriorated in recent months, reflecting the above-mentioned developments in emerging markets. As noted, adverse consequences in Latin America could be of particular relevance because of trade and financial linkages. That said, trade accounts for a relatively small proportion of total US activity, a little less than 12 per cent of GDP; around 37 per cent of total exports in 1997 were directed toward emerging markets, split roughly equally between emerging economies in Asia and Latin America. Moreover, the weakening of the US dollar in recent months, if sustained, would be expected to provide some offsetting benefits to trade outcomes.

The US financial sector does not have a large direct exposure to emerging markets, indeed much less than is the case for either Europe or Japan, however, it is true that the exposure of US banks to Latin America is greater than that to Asia or Russia. Although direct exposure might not be large, recent difficulties encountered by Long-Term Capital Management have nevertheless raised concerns about the domestic financial system and led to a marked tightening of lending criteria and increased borrowing rates for less creditworthy customers.

Until recently, however, liquidity growth has been particularly strong and, at this stage, there is little indication of a systemic problem in the financial sector. But it is impossible to currently make an accurate assessment of the overall exposure of US banks to lending in emerging markets, because of the possibility of significant indirect effects, both through domestic non-bank financial institutions and via linkages with institutions in other countries. The more significant these indirect effects prove to be, the more pronounced become the downside risks to the outlook for both the US and global economies. Further, growth could also be affected to the extent that gathering uncertainties from numerous sources serve to dampen business and consumer sentiment.

Importantly, the US authorities appear to have a considerable degree of policy flexibility at present. Although some further correction of equity markets is possible, recent movements largely unwind the sharp increases in the first half of 1998 which appeared to be out of alignment with other indicators of corporate strength. Moreover, concerns about inflationary pressures seem to be abating, despite continued tightness in the labour market and although a weakening currency implies that the beneficial impact of low import prices may be less significant than has recently be the case. These circumstances enabled recent easings of monetary policy, in the face of financial market uncertainty and the resultant tighter credit conditions, which would have implications for future demand growth.

Economic growth has strengthened in **Continental Europe**. A weaker trade contribution has to date been more than offset by a broadening of domestic demand, and recent indicators point to continuing strength in the latter. The outlook in 1999 is for growth to ease a little from that in 1998 as the effects of the global slowdown further reduce net export earnings. Developments in emerging markets pose an added risk to the outlook for western Europe; in particular, the exposure of European banks to emerging markets in Asia, Russia and Latin America is, in each case, greater than that of either Japanese or US banks. Trade is of relatively greater importance for these European economies than it is for the United States. Exports to countries outside the Euro area account for a little under 16 per cent of total GDP; of this, about a quarter is directed toward emerging markets, with countries in Asia and Eastern Europe roughly of equal significance and of much more importance than Latin America.

Europe’s favourable inflation environment, coupled with concerns about the external environment, could encourage the new European Central Bank (ECB) to favour an initial interest rate environment close to prevailing monetary settings in France and Germany. If so, a relative easing of monetary conditions in Europe as a whole would be implied, with the economies of peripheral Europe easing policy in line with convergence requirements for the launch of EMU. If growth was to weaken further than expected, and inflation was to remain subdued in core Europe, the prospect could emerge of some reduction in interest rates from current core levels. However, the ECB will be aware of the need for it to establish its anti-inflationary credentials, suggesting that considerable uncertainty surrounds its likely approach to monetary policy.

In contrast, growth in the **United Kingdom** is slowing — to around 2½ per cent in the year to the September quarter 1998 — and is expected to slow to well below potential in 1999. Net exports have been detracting from growth in the face of falling demand from Asia and the effects of a strong sterling. Private consumption and investment have been the driving force behind strong domestic demand, but tight monetary conditions are acting to dampen demand. Underlying inflation returned to the Government's target of 2½ per cent in August, providing scope for the easing of monetary policy in October, with further reductions in prospect.

Japan is currently suffering its worst recession in 50 years after recording its third consecutive quarter of negative growth in the June quarter. Industrial production has continued to decline into the September quarter as companies attempt to reduce inventory levels. The September quarter Bank of Japan business survey (Tankan) reported historic lows for business confidence, and increased difficulties in accessing credit as banks attempt to repair their own balance sheets. Corporate bankruptcies are at record levels. The impact on employment has been severe enough to raise unemployment to historic highs, further damaging household confidence and constraining consumer spending.

In an effort to address the slump in economic activity, the Japanese Government has implemented a large program of fiscal stimulus, involving income and corporate tax cuts and public works expenditures. However, the measures do not appear to have had a substantial impact so far. This reflects ongoing consumer uncertainty, weakness in disposable incomes despite the tax cuts, and doubts about the permanency of the tax cuts. In addition, the increases in expenditure are now not expected to become effective until very late in 1998, with problems in local government financing being partly responsible for the delays.

The other important focus of policy is the development and implementation of measures to address structural weaknesses in the financial sector, particularly the deterioration of bank capital and the resultant squeeze on lending. Following extensive parliamentary debate with opposition parties, the Government has recently introduced a new legislative framework for the public management of the banking crisis that surpasses earlier proposed measures in its breadth and promises a substantial increase in the public funds available for the restoration of bank capital. However, there are continuing uncertainties about the operational detail of the scheme and the likely speed of implementation. Given the potential impact on confidence and, eventually, on credit availability, the early announcement of a firm timetable for implementation remains of critical importance.

Several of the other major economies in **East Asia** are also in severe recession. Sharp contractions in output occurred in both the March and June quarters 1998 in Indonesia, Malaysia, Korea, and Hong Kong, while industrial production fell sharply in Thailand. Growth in exports has not been as strong as might have been expected, given improvements in competitiveness resulting from exchange rate depreciations, because of both general demand weakness in the region and some supply constraints.

Singapore also experienced a fall in output in the June quarter 1998, and some easing of growth was apparent in Taiwan and China during the first half of the year, however, stronger growth in China was evident in the third quarter.

However, more stability has been apparent in regional financial markets in recent months. This stability has allowed authorities in the major economies to reduce interest rates from the recent peaks experienced in late 1997; rates have fallen below pre-crisis levels in South Korea and Thailand, while in Hong Kong, Singapore and Malaysia, rates are currently relatively comparable with pre-crisis levels. In some cases, fiscal stimulus has also been introduced. In particular, Taiwan and China have both announced plans to increase infrastructure spending; the impact on actual expenditure is already apparent for the latter and has resulted in an increase in the rate of growth in the third quarter. There has been a relaxation of fiscal targets in those countries with IMF programs. In early September 1998, Malaysia introduced foreign exchange controls and pegged its currency to the US dollar; while this move provided scope for the above-mentioned reduction in interest rates, and thus has some possible short-term stimulatory implications, there may be adverse longer-term consequences in relation, for example, to the availability of capital.

There are some early indications that the rate of contraction in some of the worst affected economies is slowing. Even in Indonesia, which is the worst affected, the third quarter GDP outcome indicates such a slowing in the rate of contraction. The easing of monetary conditions and fiscal settings should further assist the attainment of stability and, in some cases, foster some strengthening of growth. Furthermore once growth resumes, recoveries should be mutually reinforcing due to the extensive inter-linkages between economies in the region. However, a resumption of strong growth on a sustained basis in the crisis economies depends critically on fundamental economic reforms being undertaken, particularly in the financial and corporate sectors. Progress in this regard is uneven across the economies involved; even in Korea and Thailand — where substantial advances have been made — much more needs to be done. The social costs of adjustment are high and are being exacerbated by the severe contractions in output that are occurring, a factor which could potentially weaken governments' commitment to reform.

The **New Zealand** economy has deteriorated markedly over the last year, and is now officially in recession, with GDP having fallen in each of the first two quarters of 1998. Exports have been particularly affected by the weak international environment, consumer and business confidence have fallen, labour market conditions have deteriorated, and there has been considerable volatility in the exchange rate and interest rates. While low consumer and business confidence and weak labour market conditions are expected to continue to constrain activity over coming quarters, the substantial easing in overall monetary conditions that has occurred since mid 1997 and the lower trade-weighted exchange rate should see some recovery in activity in 1999.

Table 1: Overview of the IMF World Economic Outlook Projections, October 1998

			Current Projections	
	1996	**1997**	**1998**	**1999**
World Output	4.2	4.1	2.0	2.5
G7	2.8	2.9	2.1	1.9
United States	3.4	3.9	3.5	2.0
Japan	3.9	0.8	-2.5	0.5
Germany	1.3	2.2	2.6	2.5
France	1.6	2.3	3.1	2.8
Italy	0.7	1.5	2.1	2.5
United Kingdom	2.2	3.4	2.3	1.2
Canada	1.2	3.7	3.0	2.5
European Union	1.7	2.7	2.9	2.5
New Zealand	3.1	2.3	-0.5	1.7
Newly industrialised Asian economies	6.3	6.0	-2.9	0.7
Korea	7.1	5.5	-7.0	-1.0
Taiwan	5.7	6.9	4.0	3.9
Hong Kong	4.6	5.3	-5.0	0.0
Singapore	6.9	7.8	0.0	0.2
Developing countries	6.6	5.8	2.3	3.6
Africa	5.8	3.2	3.7	4.7
Asia	8.2	6.6	1.8	3.9
ASEAN-4	7.1	3.7	-10.4	-0.1
Thailand	5.5	-0.4	-8.0	n.a.
Indonesia	8.0	4.6	-15.0	n.a.
Malaysia	8.6	7.8	-6.4	n.a.
Philippines	5.7	5.1	-0.6	n.a.
China	9.6	8.8	5.5	n.a.
Middle East and Europe	4.7	4.7	2.3	2.7
Western Hemisphere	3.5	5.1	2.8	2.7
Countries in transition	-1.0	2.0	-0.2	-0.2
Central and Eastern Europe	1.6	2.8	3.4	3.6
Russia	-5.0	0.9	-6.0	-6.0
Transcaucasus and Central Asia	1.6	2.1	4.1	3.8

DOMESTIC ECONOMIC ACTIVITY

The June quarter 1998 National Accounts recorded GDP growth of 0.8 per cent. The result reflected continuing growth in domestic demand and a rebound in net exports, partially offset by a modest detraction by stocks.

Growth in domestic demand in the June quarter was driven by robust final consumption growth, due largely to increasing consumption of services and motor vehicle purchases, with support from increasing public final demand. Dwelling investment rose moderately, following a larger increase in the March quarter, while business investment fell, following a rise in the March quarter.

Net exports contributed 0.7 per cent to growth in the June quarter following a large detraction in the previous quarter. Exports of goods and services rose 2.2 per cent after falling in the previous three quarters, while imports of goods and services fell 0.6 per cent.

The composition of growth in the June quarter removed some of the concerns expressed at the time the March quarter Accounts were released. There were also important revisions to the March quarter Accounts. A particular concern that was raised with respect to the initial March quarter estimates was the flat growth in domestic demand and the very strong increase in stocks. As noted above, domestic demand grew in the June quarter and the large run-up in stocks which underpinned growth in the March quarter was revised down and was only slightly reversed in the June quarter.

Private Consumption

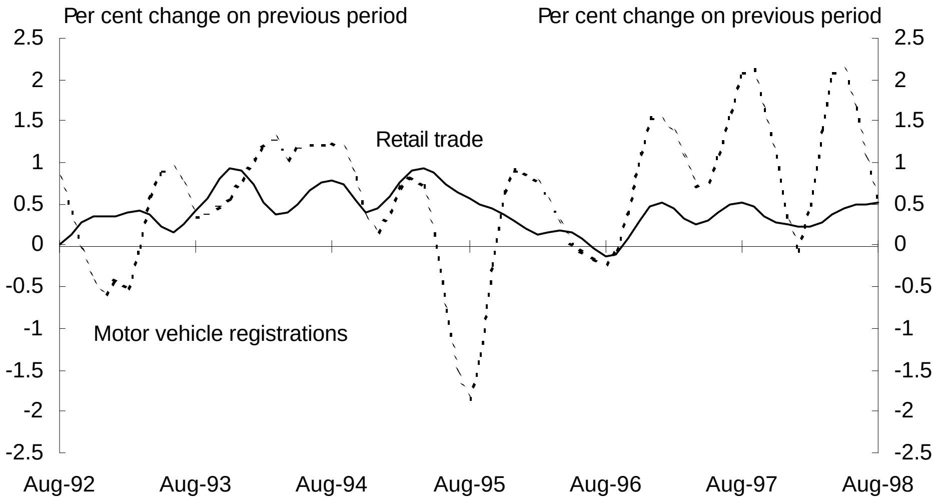
Real *private consumption* expenditure rose 1.3 per cent in the June quarter, following an upwardly revised 0.3 per cent increase in the March quarter. Consumption of other services and motor vehicles each contributed around 0.4 percentage points to growth in total consumption.

The fundamental determinants of consumption continue to support growth. Real household disposable income is set to grow moderately in an environment of continuing employment growth, moderate wage outcomes and low inflation. Low interest rates, growth in established house prices and relatively stable share prices should sustain households' real wealth.

Recent partial indicators are also consistent with continuing growth in private consumption (Chart 1). The value of *retail trade* fell 0.8 per cent in August following a strong 2.6 per cent increase in July. These results largely reflected volatility in department store sales which rose 17.7 per cent in July then fell 10.3 per cent in August. This volatility in the monthly data may be due to changing consumption patterns as mid-year sales are pushed into July, coinciding with school holidays. Over the year to August, current price retail trade grew by a solid 4.5 per cent.

Motor vehicle registrations fell 4.5 per cent in July and 9.7 per cent in August after surging 16.9 per cent in June, seasonally adjusted. However, registrations in August were 9.5 per cent higher than a year earlier. Continued price competition, particularly in the small car market, and the release of new models should provide support for motor vehicle registrations over coming months.

Chart 1: Retail Trade and Motor Vehicle Registrations (trend)



Source: ABS Cat. Nos. 8501.0, 9301.0

Consumer sentiment also has some influence on household spending. The Westpac-Melbourne Institute Consumer Sentiment Index fell slightly in October, and while it has remained above the recent low of June, it is 2.7 per cent below its level of a year earlier. Notably, much of the decline in the measures of consumer sentiment over the past year have reflected more pessimistic responses to questions dealing with general economic conditions over the next twelve months. Responses with respect to both actual and expected personal finances, which are likely to be better indicators of consumers' capacity and willingness to spend, are virtually unchanged over the past year.

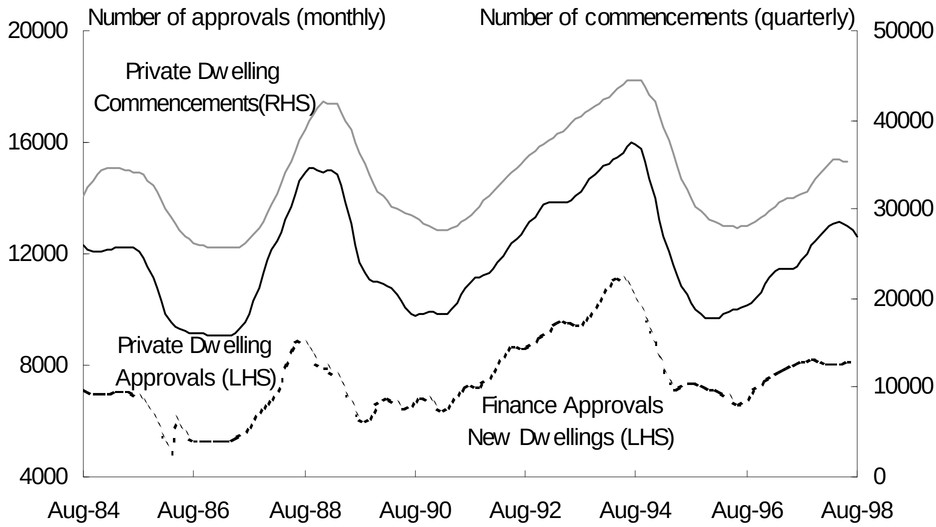
Private investment

Dwelling investment increased by 1.6 per cent in the June quarter, following a 5.9 per cent rise in the March quarter. Recent partial indicators, although exhibiting some month to month volatility, point to solid growth in dwelling investment continuing in 1998-99, although at a more moderate pace than the 15 per cent increase recorded in 1997-98.

Finance approvals for new dwellings increased by 0.4 per cent in the three months to August over the three months to May. *Private building approvals* fell by

4.3 per cent in August and are 4.1 per cent below their level a year earlier[1]. Total *private dwelling commencements* fell by 1.9 per cent in the June quarter following a 0.7 per cent fall in the March quarter. However, these recent declines in commencements follow a very strong rise of 10.5 per cent in the December quarter 1997 so that dwelling commencements remain at a high level. The fall in commencements in the June quarter was particularly pronounced in New South Wales and may have been influenced by heavy rainfall causing a delay in startups. This may point to some rebound in activity in coming quarters.

Chart 2: Partial Indicators of Dwelling Activity



Source: ABS Cat. Nos. 8731.0, 8752.0, 5609.0

Housing affordability, which is a key determinant of housing demand in the short term, has also eased recently but remains at levels consistent with ongoing solid demand. The Commonwealth Bank / Housing Institute of Australia index of housing affordability fell by 5.8 per cent in the June quarter. However, it is still 14.8 per cent higher than two years ago. The Citibank / Real Estate Institute of Australia index of home affordability fell 0.7 per cent in the June quarter but has improved by 2.6 per cent over the past year. The factors underpinning affordability remain positive: the indicator lending rate for standard variable home loans remains at 6.7 per cent, its lowest level since 1970; household income is rising; and house price inflation is moderate.

Private business investment fell 12.8 per cent in the June quarter, reversing the 13.6 per cent rise in the March quarter. The solid March quarter result was

1 There have been a number of changes to building approval procedures in New South Wales. This has meant that the ABS has made an estimate for the backlog of approvals yet to be reported with some councils. As such, the ABS advise that additional care should be taken when interpreting the data.

almost entirely due to the purchase of the Dampier to Bunbury gas pipeline from the public sector.

New private business investment, which abstracts from the effects of purchases of second hand assets from the public sector, fell by 5 per cent in the June quarter, following a 1.1 per cent rise in the March quarter. *New plant and equipment investment* fell by 3.7 per cent in the June quarter, following a fall of 1.8 per cent in the March quarter. However, new plant and equipment investment remains 2.1 per cent above its level in June 1997. *New non-dwelling construction* fell by 8.2 per cent in the June quarter, following a very strong rise of 9.5 per cent in the March quarter. New non-dwelling construction grew by 7.1 per cent through the year to the June quarter.

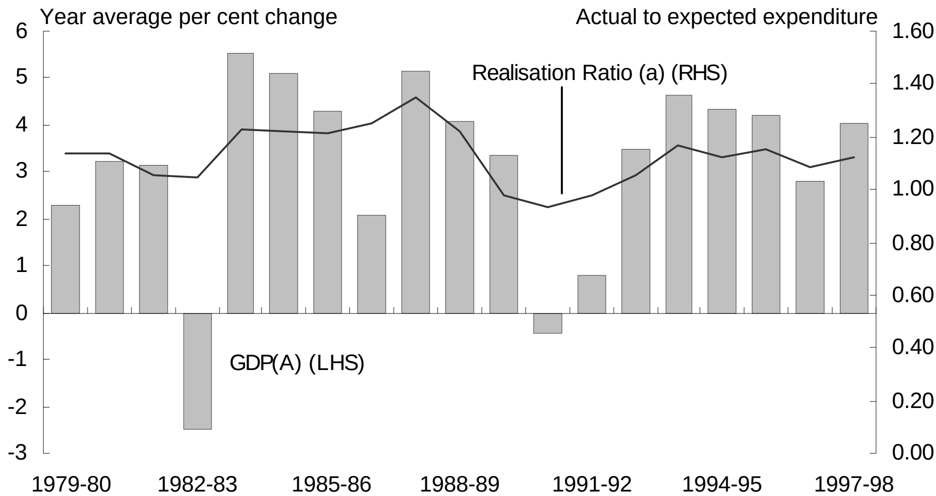
The most recent ABS survey of investment intentions (taken in July / August 1998) suggests solid growth in plant and equipment investment in 1998-99. The third estimate of total investment expenditure for 1998-99 was 11.8 per cent higher than the equivalent estimate for 1997-98. The third estimate of plant and equipment investment was 14 per cent above the equivalent estimate last year and investment intentions for non-residential construction were 7 per cent above the equivalent estimate last year.

The extent to which these expectations are realised is likely to be affected by the slower pace of economic growth in prospect in Australia and heightened uncertainty in the business sector about the world economic outlook. While it is common to use a five year average realisation ratio to convert investment intentions into a likely outcome, a somewhat lower ratio may be more appropriate under current circumstances (Chart 3). In addition, business investment has grown solidly for several years, particularly in mining, and some moderation of growth in line with a maturing of the investment cycle is to be expected.

Partial indicators suggest a solid outlook for non-residential construction. Finance commitments, while volatile on a monthly basis, were at very high levels in the June quarter, as were building approvals. There is a large stock of work-yet-to-be-done, particularly for engineering construction, and business surveys point to strong activity in the construction sector.

Over the latter part of 1997 and the first half of 1998 there were sharp falls in business confidence as measured in both the Australian Chamber of Commerce and Industry (ACCI) / Westpac Survey of Industrial Trends and the National Australia Bank Quarterly Business Survey. Both measures recovered slightly in the September quarter although they remain low by historical standards.

Chart 3: Business Investment Realisation Ratios and GDP growth



(a) Ratio of actual to third estimate of capital expenditure for that year.

Source: ABS Cat. Nos. 5206.0, 5625.0

Public final demand

Abstracting from the impact of second hand asset sales to the private sector (in particular the sale of the Dampier to Bunbury gas pipeline in the March quarter), underlying *public final demand* rose by around 1 per cent in the June quarter, driven by stronger Commonwealth consumption and State and local underlying investment. Underlying public final demand is expected to contribute significantly to growth in demand in 1998-99, with anticipated growth in both public consumption and gross fixed capital expenditure. Solid contributions to public final demand in 1998-99 are expected from both the Commonwealth and State and local sectors, with information in State Budgets released since May suggesting growth in both consumption and investment by the States.

Stocks

The initial March quarter 1998 National Accounts indicated a 1.7 percentage point contribution to growth in GDP(A) from private non-farm stocks. The strong rise in stocks in the quarter led to considerable speculation that there would be a large detraction from growth in the June quarter from unwinding the build-up in non-farm stocks. The rise in stocks in the March quarter was revised down with the release of the June quarter Accounts, such that the contribution to growth in the March quarter from private non-farm stocks is now estimated to be 1.2 percentage points. (The change in stocks is a component of the National Accounts that is subject to frequent and large revisions.) Stocks grew strongly again in the June quarter, although growth was slightly lower than in the previous quarter, so that stocks detracted 0.2 percentage points from GDP(A) growth.

The strong increase in private non-farm stocks in the first half of 1998 resulted in a rise in the current price stocks-to-sales ratio. However, the stocks-to-sales ratio had fallen sharply since late 1996 in the face of strong sales growth, suggesting that some of the recent build-up had been aimed at returning stocks to desired levels.

Farm and public marketing authority stocks detracted slightly from growth in the June quarter, following a significant contribution in the March quarter. This reflects a changed profile for sales of the wheat and barley harvest as sales that would normally be expected to occur in February and March instead occurred in later months. Other public authority stocks contributed to growth in the quarter.

Labour Market

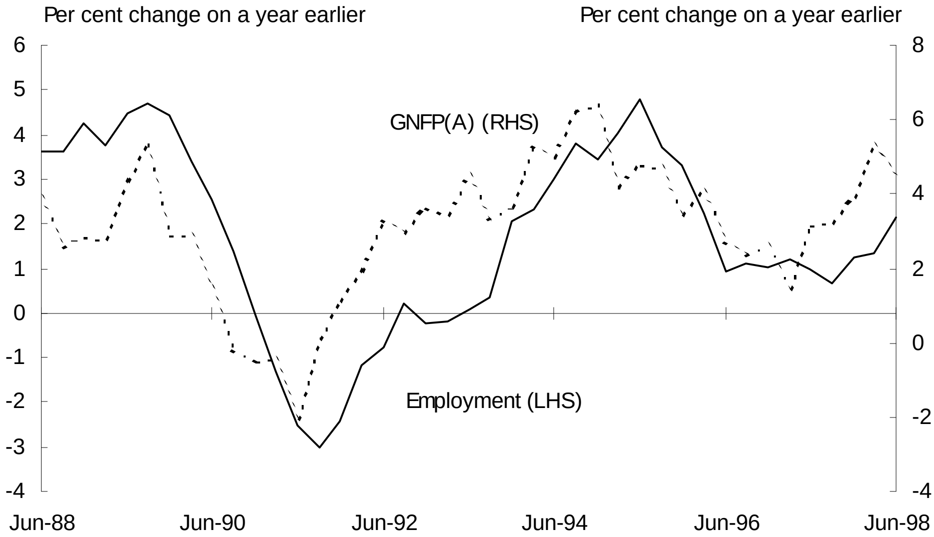
Employment grew 0.5 per cent in the September quarter, following a 0.7 per cent rise in the previous quarter. The unemployment rate was 8.1 per cent in September while the participation rate was 63.6 per cent.

The outlook for the labour market remains positive. As outlined in the *Pre-Election Economic and Fiscal Outlook*, the forecast for year-average employment growth in 1998-99 is 1¾ per cent, unchanged from Budget, but slightly slower growth in non-farm activity is expected to result in an easing in the pace of employment growth through the year to 1½ per cent compared with the Budget forecast of 1¾ per cent (Chart 4).

In the short term, forward-looking indicators of labour demand remain strong. The three major job vacancies series are at high levels. The ANZ series is at its highest level since March 1990, skilled vacancies[2] are at their highest level since December 1989 and, while ABS job vacancies have fallen recently, this fall was from the highest level reached by this series since it began in 1979. While the rate of growth of all three forward-looking labour market series' has slowed slightly in recent months, this easing is consistent with ongoing solid employment growth in 1998-99, albeit at a slower pace than in the previous year.

2 Series compiled by the Department of Employment, Workplace Relations and Small Business.

Chart 4: Growth in Employment and Non-farm Activity



Source: ABS Cat 5206.0, 6202.0

Wages

As outlined in the *Pre-Election Economic and Fiscal Outlook*, average earnings on a National Accounts basis is forecast to grow by 4 per cent in 1998-99. Preliminary September quarter 1998 data for average weekly ordinary time earnings for full-time adults (AWOTE) indicated that growth through the year was 4.1 per cent and that quarterly outcomes continue to average close to 1 per cent. The expected slowing in activity should contribute to some slight easing in wages growth.

Prices

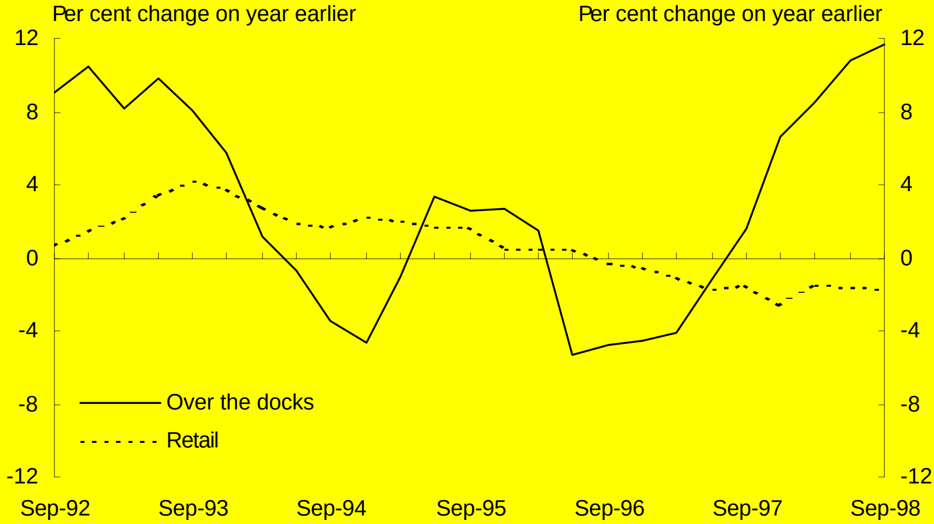
The All Groups Consumer Price Index increased by 1.3 per cent in the year to the September quarter 1998, while underlying inflation remained at 1.6 per cent. Prices of private sector goods increased by 0.2 per cent in the quarter and by 1.2 per cent over the year, while private sector services also increased by 0.2 per cent in the quarter and 2.4 per cent over the year. Prices of wholly or predominantly imported items fell by 0.7 per cent in the September quarter, and have declined considerably since mid 1996 (Box 1). Continuing competitive pressures (reflecting both domestic and international factors) have been an important influence in keeping inflation low.

Box 1: Import Prices and Inflation

Inflation in Australia has in the past been notably affected by movements in the price of imported items. Increases in import penetration over the years have not only increased the proportion of consumer expenditure directed toward imported items and locally produced items sold in competition with imports, but also increased the imported input cost component of many domestically produced retail items. Currently, imported items directly account for over 11 per cent of the CPI.

However, recent declines in the Australian dollar against major trading partners, and significant rises in the price of imported items across the docks, have yet to appear in the retail price of imported items and underlying inflation.

Chart 5: Import Prices, Retail and Over the Docks



Source: ABS Cat. Nos. 6401.0, 6414.0

Traditionally, the pass-through of changes in import prices across the docks to retail prices has been gradual, but appears to be even more so on this occasion. In part, this probably reflects an increasingly competitive market place, with importers' mark-ups being squeezed to allow them to remain competitive. Moreover, retailers tend to review and change prices infrequently, attempting to avoid excessive price volatility so as to maintain a degree of stability and customer loyalty. Instruments such as exchange rate hedging and long-term fixed price contracts also assist in reducing the volatility of retail prices relative to changes in import prices across the docks. The use of hedging has increased over the past fifteen years or so with the result that analysis of past episodes of currency weakness may implicitly overstate the effect and speed of pass-through of the most recent decline in the Australian dollar.

Furthermore, world producer prices are strongly influenced by commodity prices and so the inflationary effects of commodity price related weakness in the exchange rate will be partly offset by lower world producer prices.

A particular factor exerting downward pressure on the CPI are falls in the price of motor vehicles. Motor vehicle prices in the CPI have fallen more than 10 per cent over the past two years, with a 15 per cent fall in the imported motor vehicle component in the CPI over the same period.

The decline in imported motor vehicle prices in the CPI (ie the retail price) contrasts with the substantial increases in the landed price of imported motor vehicles which have risen by 7 per cent over the past two years. The decline in the imported motor vehicle price in the CPI reflects significant price discounting from local distributors and rebates from manufacturers. Industry liaison suggests such pressures will continue to keep prices down over the coming year.

Current Account

The current account deficit (CAD) fell 10.9 per cent to $6.5 billion in the June quarter 1998. For 1997-98 as a whole, the CAD was $23.9 billion or around 4.4 per cent of GDP, somewhat higher than the $17.1 billion recorded in 1996-97. Abstracting from sales of gold by the Reserve Bank[3], the increase in the CAD in 1997-98 was around $5.7 billion or 1 per cent of GDP — a relatively modest increase given the sharp downturn in the Asian region which unfolded during the course of the year, while domestic demand continued to grow strongly.

The June quarter result reflected a 4.9 per cent increase in goods and services exports more than offsetting a 2.6 per cent rise in goods and services imports. The rise in imports was due to increasing (over the docks) import prices as import volumes fell. Import volume growth is expected to be restrained over the year ahead by moderate domestic demand growth and strong competition from domestic supplies in response to the low Australian dollar.

The reduction in the CAD in the June quarter and the relatively favourable outcome for the CAD in 1997-98 as a whole reflects the success of exporters in diverting goods and services away from weaker markets in East Asia to markets in North America, Europe and other parts of Asia. In essence, export diversion away from the countries in Asia experiencing economic difficulties has partially offset the potential impact on exports of the weaker world environment. This has been aided by the lower Australian dollar and the relative strength of the North American and European economies (see the Winter 1998 *Economic Roundup* and *1997-98 In Review: A Resilient Australian Economy* in this edition for

3 Of $1.8 billion in 1996-97 and $0.6 billion in 1997-98.

details). In the three months to August 1998 compared with the same period last year, total merchandise exports increased by 8.4 per cent, reflecting a 19.7 per cent decrease in exports to Korea, Indonesia, Malaysia, the Philippines and Thailand being more than offset by a 15.5 per cent increase in merchandise exports to the rest of the world.

The extent of export diversion continues to differ between commodity and non-commodity exports. In the three months to August 1998 the value of commodity exports was 12.7 per cent higher than the corresponding period twelve months earlier. Exports of commodities to Korea, Indonesia, Malaysia, the Philippines and Thailand have declined over this period by over 13 per cent, while exports to the rest of the world have increased nearly 20 per cent. By contrast, exports of elaborately transformed manufactures (ETMs) have declined 3.7 per cent, with a 45 per cent fall in exports to Korea, Indonesia, Malaysia, the Philippines and Thailand only partially offset by an increase in exports to the rest of the world of 3.9 per cent.

Similarly, the tourism industry has been affected by the downturn in East Asia, with total arrivals falling 3.2 per cent in the three months to August 1998 compared with the same period a year earlier. Visitors from Korea, Indonesia, Malaysia, the Philippines and Thailand fell 51.2 per cent over this period, with visitors from the rest of the world increasing 5.3 per cent (notably from the United Kingdom, United States and Singapore).

There have been suggestions that much of the impressive diversion in Australian exports is accounted for by a single commodity, namely gold. For example, over the three months to August 1998 total exports of non-monetary gold[4] increased by 85 per cent over the same period a year earlier. A significant part of this reflects the importing, processing and re-exporting of gold from Korea and Indonesia following the 'gold donation' campaigns in those countries earlier this year and the subsequent ceasing of the gold re-export trade in Korea. Nevertheless, excluding all gold, total merchandise exports increased by 3.9 per cent in the three months to August 1998 compared with the same period a year earlier, comprising a decline in exports to Korea, Indonesia, Malaysia, the Philippines and Thailand of 19.1 per cent which was more than offset by an 8.9 per cent increase in exports to the rest of the world (Chart 6). In other words, export diversion is not confined to gold and is apparent in a range of export categories, particularly, coal, metal ores and non-ferrous metals (Box 2).

Recent monthly trade data suggests that the balance of trade component of the current account in the September quarter will be slightly weaker than the previous quarter, with imports increasing slightly faster than exports. The improvement in exports in part reflects strong growth in cereals exports, as sales delayed from earlier in the year proceed, offset by weaker ETM exports.

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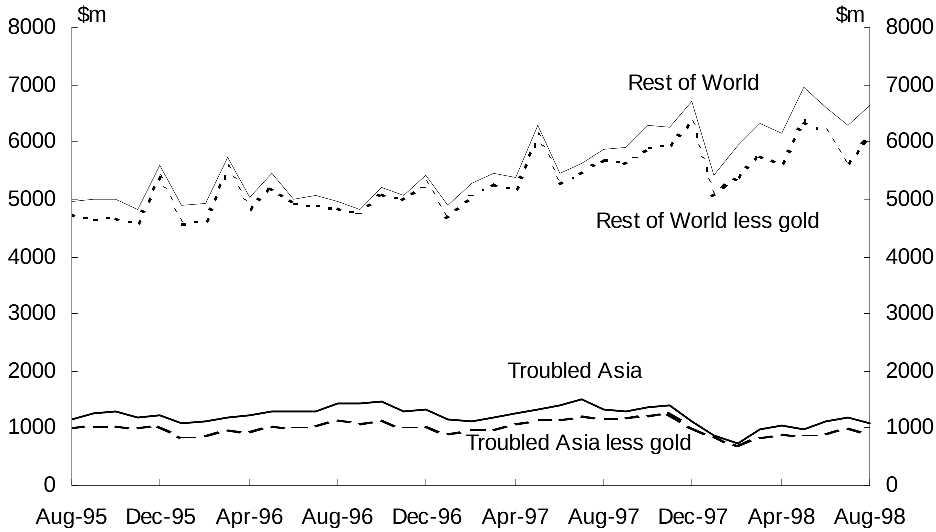
4 Merchandise trade basis, which excludes Reserve Bank gold sales.

Chart 6: Merchandise exports by destination



Source: Unpublished ABS data

Box 2: Export Diversion – Can It Continue?

The ability of Australian exporters to continue to establish and develop new markets will depend upon a number of factors. In particular, a slowing of economic growth in North America and Europe may make it increasingly difficult to divert exports to those regions. On the other hand, the decline in the value of the Australian dollar has boosted Australian exporters' competitiveness, facilitating both the maintenance of markets despite adverse conditions and the development of new markets. It is likely that the full benefits of the depreciation in this regard were not felt in 1997-98. It will take some time for the benefits to fully work through. The lower Australian dollar also shields the incomes of commodity exporters from lower world commodity prices to some extent, providing commodity producers with an ongoing incentive to supply.

A particularly positive sign is the improved export expectations of manufacturers. As outlined in *1997-98 in Review: A Resilient Australian Economy* in this edition and in the Winter 1998 *Economic Roundup*, exports of elaborately transformed manufactures were adversely affected by the crisis in Asia since it was often very difficult to divert sales to alternative markets. However, the ability of exporters of manufactured goods to divert sales from the troubled Asian region to more promising markets has tended to surprise on the upside, with significant increases in exports to the United States, Germany, China and India.

The outlook for manufactured exports is also positive. The September quarter 1998 ACCI/Westpac Survey of Industrial Trends reported a significant turnaround in export deliveries by manufacturers as well as more positive expectations for future growth. The National Australia Bank Quarterly Business Survey reported that exports improved marginally in the September quarter, as did expectations for the December quarter. Other private sector surveys of manufacturers' expectations (for example, the Australian Business Chamber/Colonial State Bank Survey of Manufacturing in New South Wales) have also shown significantly less negative outcomes in the September quarter compared to expectations, and that the proportion of manufacturers seeking to export their products is increasing.