

# 1998-99 in Review – Australia’s Strong Growth Exceeds Expectations

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*This article reviews how major international and domestic developments impacted on the Australian economy in 1998-99, and compares the 1998-99 Budget and 1998-99 Mid-Year Economic and Fiscal Outlook (MYEFO) forecasts with actual outcomes.<sup>1</sup>*

Following a sustained period of very strong economic growth over recent years, including Gross Domestic Product (GDP) growth of 4.8 per cent in 1997-98, some moderation in growth was forecast in 1998-99. This was expected to result from a deceleration in the rapid growth of household consumption and business investment, combined with a large detraction from net exports resulting from the Asian financial crisis. The outcomes in 1998-99 of low inflation (1.2 per cent) and strong GDP growth (4.5 per cent) exceeded even the most optimistic private sector expectations.<sup>2</sup> To borrow the words of the IMF Deputy Managing Director Stanley Fischer, Australia has ‘done remarkably well’.

Australia’s higher than expected economic growth in 1998-99 reflected continuing strong household consumption growth and a lower detraction from net exports than earlier expected. Sustained economic growth helped to improve labour market outcomes, with stronger employment growth and a larger reduction in the unemployment rate than forecast. Ongoing productivity growth contributed towards keeping inflation low.

Australia’s strong economic performance continued to reflect the results of a well-developed economic policy framework. Statement 3 of *Budget Strategy and Outlook 1999-2000, Budget Paper No. 1* discussed at length Australia’s policy reforms and its contribution to Australia’s recent economic performance.

Against the backdrop of the Asian financial crisis and heightened financial market instability, the Australian economy recorded its longest period of strong (continuous) economic growth since the early 1970s. This outcome was even more remarkable as it was achieved when many of Australia’s Asian trading partners were experiencing a recession: Australia’s strong growth and low

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1 Changes implemented by the Australian Bureau of Statistics to the national accounts and the Consumer Price Index make some comparisons between forecasts and outcomes misleading.

2 The *Business Review Weekly’s* survey of private sector forecasts reported average GDP forecasts of 2.9 per cent in March 1998 (survey high of 3.9 per cent), 2.2 per cent in June 1998 (high of 3.0 per cent), 2.4 per cent in September 1998 (high of 3.0 per cent) and 3.5 per cent in December 1998 (survey high of 3.9 per cent).

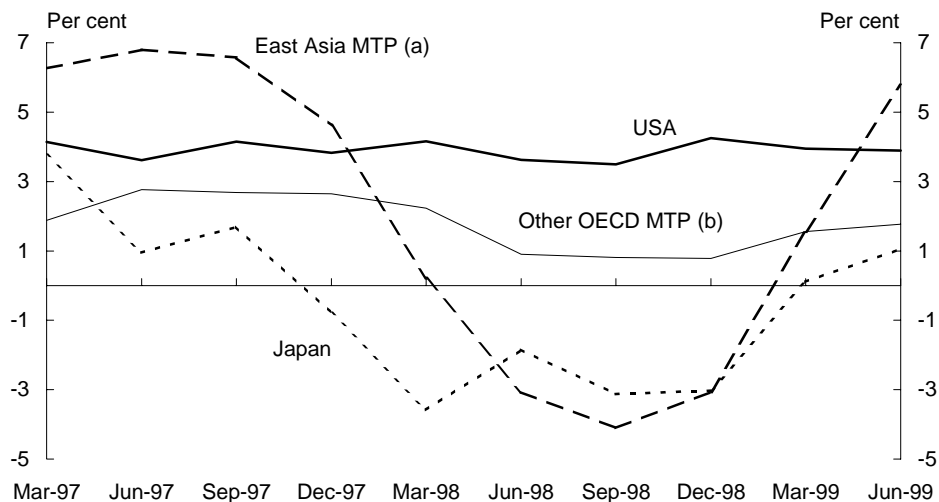
inflation performance continued to compare very favourably with the US and other OECD countries.

Strong international investor confidence in Australia allowed the spread between Australian and US long-term interest rates to remain at historical lows. Confidence in Australia's structural and regulatory reforms, and its sound policy environment was explicitly recognised in Standard and Poor's (S&P) decision to upgrade Australia's long-term foreign currency debt credit rating from AA to AA+. Indeed, Australia was increasingly viewed over the course of 1998-99 as a model for other economies to follow.

## INTERNATIONAL ECONOMY

World GDP growth slowed from 3.3 per cent in 1997 to 1.8 per cent in 1998 (measured on a market exchange rate basis). The main source of this slowdown was the deepening of the recession in Japan, the sharper than expected declines in output in many Asian countries, and the turbulence in Russia and Latin America. Continued strong growth in the United States economy, and sustained growth in Europe provided the main support for world activity in 1998. World growth increased in the first half of 1999, as growth resumed in Asia, including Japan, with strong growth continuing in the US. Chart 1 provides an illustration of GDP growth profiles in 1998-99 for our major trading partners.

**Chart 1: Economic growth in Major Trading Partners (MTP)  
(quarterly, through the year)**



(a) Korea, Singapore, Taiwan, Hong Kong, China, Indonesia, Malaysia, Thailand and the Philippines weighted by merchandise exports.

(b) Germany, France, United Kingdom, Italy, Canada and New Zealand weighted by merchandise exports.

GDP growth of around 4 per cent was recorded in the **United States** in 1998, and much of that momentum was carried into the first half of 1999. While growth slowed to 1.6 per cent in annualised terms in the second quarter, this overstated the reduction in the economy's momentum. In through-the-year terms, growth was 3.9 per cent in the twelve months to end June 1999.<sup>3</sup>

Strong consumption and investment have been the cornerstone of the sustained and higher than expected growth through 1998 and 1999. Some of the strength in consumption was due to the wealth effects created by the rise in the stockmarket and net sales of shares by the household sector. A sharp increase in mortgage refinancing (to take advantage of low interest rates) also supported consumption growth.

The low cost of capital (both debt and equity) underpinned robust plant and equipment investment and the housing sector also remained strong.

The sustained period of solid employment growth kept the unemployment rate very low, at 4.25 per cent. Strong productivity growth helped contain prices, with increases in the core CPI declining over the later half of 1998 and the first half of 1999.

The other significant impact of the stronger than expected domestic demand over 1998 and 1999 has been the increase in the US trade deficit, which widened steadily since the start of the Asian crisis in mid-1997. Imports have increased sharply, especially in consumer goods, automotive products and computers. At the same time, the weakness in economic growth in the rest of the world and the strong US dollar contributed to export volumes falling (although this has begun to reverse more recently).

On the policy front, one third of the 75 basis point easing in official interest rates late in 1998 to address financial markets stresses was reversed (by the end of June 1999), as these pressures receded and in the face of growing concerns about the outlook for inflation going forward. The US fiscal position remained strong with the Budget moving into surplus in 1998, in large part reflecting the strength of economic activity.

The **Japanese** economy returned to growth in the first half of 1999, with activity expanding at an annualised growth rate of 3.3 per cent. Despite this stronger than expected result, Japan still recorded a year-average contraction of 1.3 per cent in 1998–99.

The pick-up in private domestic demand in 1999 (particularly in private consumption and housing) can, in large part, be attributed to the Japanese Government's expansionary fiscal policy and supportive monetary policy. In November 1998, the Government announced its 3<sup>rd</sup> 'Supplementary Budget' for

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3 Subsequent revisions to the US national accounts that were released towards the end of October 1999 have not been taken into account.

the year, involving a fiscal stimulus package totaling ¥23.9 trillion (or 5 per cent of GDP).

Around the same time, to offset a sharp contraction in the availability of bank credit, the Government introduced, from 1 October 1998, a substantial programme of loan guarantees and other funding support for small and medium-sized enterprises and selected larger firms. In an attempt to prevent the Japanese economy from falling into a deflationary spiral, and the economy from deteriorating further, the Bank of Japan lowered its targeted overnight cash rate on 12 February 1999 from 0.25 per cent to around 0.15 per cent.

The **Euro** area was created on 1 January 1999, bringing 11 European countries into a monetary union. The transition to the new exchange rate regime has been smooth. Monetary policy for the region is now set by the European Central Bank System with reference to economic conditions prevailing in the region as a whole.

The pace of economic growth within Europe over 1998 and the first half of 1999 was somewhat mixed with growth remaining strong in some countries while weakening in others. Overall growth in the Euro area increased to 2.9 per cent in 1998, mainly due to stronger growth in Germany (2 per cent), France (3.4 per cent) and the non-core economies. However, activity in Italy remained relatively weak (1.3 per cent). Output slowed over the second half of 1998 and into the first half of 1999 in the core Euro economies (especially in Germany and Italy), which further amplified the divergence of growth rates in the Euro area. GDP growth in 1998-99 was 2.7 per cent in France, 1.1 per cent in Germany and 0.8 per cent in Italy.

The external sector was a substantial drag on growth during the slowdown in the second half of 1998 and the first half of 1999. Exports weakened due to the collapse in demand in Asia and Russia. Germany and Italy were the worst affected, due, in part, to the composition of their exports, which are cyclically sensitive. Production was also negatively affected by a substantial decline in business confidence in Germany and Italy. This decline was an outcome of the turbulence in the global outlook and, in the case of Germany, uncertainty over the direction of government policies.

Consumption was the main factor underpinning growth in Germany and France over 1998 and the first half of 1999. Private consumption growth remained relatively buoyant, benefiting from high consumer confidence, a modest decline in unemployment and low inflation. Accommodative monetary conditions also supported consumer demand. Consumption in Italy, by contrast, was relatively weak over the period due to the continued stagnation of real disposable income and fragile consumer confidence.

Following an extended period of expansion, the **United Kingdom** economy slowed to 1.6 per cent in 1998-99, compared with 3.2 per cent in 1997-98. Similar to the core euro economies, the slowdown in the United Kingdom was greatest in the external sector and also manufacturing production. Net exports fell as a

consequence of weaker international demand and the high sterling exchange rate. On the other hand, sustained employment growth and sound household disposable income supported both consumption and investment and, ultimately, domestic demand.

The economic performance of our **Asian major trading partners** strengthened as 1998-99 progressed. Many of the Asian economies stabilised before commencing their recovery in the second half of 1998-99. The robust pick-up in activity in some economies was impressive, particularly in Korea.

Key to the recovery of the **Korean** economy over 1998-99 were supportive macroeconomic policies, particularly the easing in short-term interest rates. Rates peaked at 30 per cent at the end of 1997, and were held above 20 per cent until mid-1998. Short-term interest rates were steadily reduced to below pre-crisis levels following a stabilisation of the won exchange rate in early 1998-99.

Korea has benefited substantially from the pick-up in the world electronics cycle. After contracting sharply during the crisis, industrial production bottomed in July 1998, and has been on a rising trend since then. By the end of 1998-99, industrial production was 33 per cent above the level at the start of 1998-99, with the electronics sector showing even stronger growth. Also contributing to the turnaround in the Korean economy was a recovery in international and domestic investor confidence — the Korean equity market tripled over 1998-99. Although the economy only recorded 0.3 per cent growth for 1998-99, growth in the first half of 1999 was 6.7 per cent.

**Indonesia's** economic growth contracted by around 11 per cent in 1998-99. Activity stabilised in the latter half of the financial year, with modest, positive growth of around 2 per cent recorded over-the-year to June 1999. Government spending and a recovery in net exports mainly supported this turnaround. While household consumption spending improved, by June 1999 it was still moderately below the levels of June 1998. Capital expenditure remained in a deep slump, reflecting the continuing difficulties in the financial system. The rupiah recovered significantly, doubling its value in US dollar terms from its record low levels in June 1998, although by June 1999 it was still less than half its June 1997 (pre-crisis) value. Inflation eased substantially over the year, from around 70 per cent to less than 25 per cent by June 1999.

After contracting by 6.8 per cent in 1997-98, **Thailand's** economic growth contracted by 4.1 per cent in 1998-99 as it continued to adjust in the wake of the 1997 financial crisis. Nevertheless, by the March quarter of 1999, Thailand's economy was showing signs of emerging from recession as strong growth in manufactured exports underpinned the first quarter of positive growth for two years.

By the end of 1998, the **Malaysian** economy had contracted by 7.4 per cent. Private consumption collapsed and the contraction in investment was particularly severe, with the manufacturing and construction sectors hardest hit.

This reflected lower domestic and external demand, lower levels of foreign investment activity and high interest rates. Import compression on the back of the collapse in domestic demand saw the current account move into surplus, although weak regional activity also led to a decline in exports for most of the year despite the significant depreciation of the ringgit (which was fixed in early September 1998). The recovery in activity has been stronger than anticipated with the economy returning to positive growth in the December quarter 1998 - an important contributor to the turnaround has been the cyclical upturn in the international demand for electronics. In 1998-99, Malaysia's GDP contracted by around 5 per cent.

Unlike most other countries in the region that moved to float their exchange rates, **Hong Kong** maintained its pegged exchange rate to the US dollar throughout 1998-99. This required tight monetary policy, which hit the domestic economy hard and had a significant impact on asset prices. As a result, GDP continued to contract (falling 3.8 per cent in 1998-99) and strong deflation emerged. Although fiscal policy was quite expansionary, it had little apparent impact on reviving the economy and it was not until the second quarter of 1999, following six quarters of contraction, that it emerged from recession (the last economy in the region to do so).

**China** continued to withstand the effects of the Asia crisis, recording economic growth of around 7.5 per cent in 1998-99. China's economic performance was assisted by a strong economy going into the crisis, a sound balance of payments position, low external debt and lack of free convertibility on its capital account. The exchange rate was not altered despite widespread market expectations of a possible devaluation. With both private and public sector activity slowing, the fiscal package introduced in the second half of 1998 sustained growth, but this began to diminish in the first half of 1999. Retail sales grew at slower rates as a result of concerns about job security and deflation. Private investment also grew more slowly as a result of low confidence, saturated markets, and high real interest rates. Foreign direct investment also fell, partly as a result of the regional slowdown. Relatively tight monetary policy had a contractionary effect on growth as deflation throughout the four quarters of 1998-99 kept real interest rates high, despite nominal interest rate reductions.

Despite **Singapore's** sound macroeconomic fundamentals and sound corporate and financial sectors, it experienced a mild recession in 1998 as a result of its strong trade and investment links in the region. However, it rebounded strongly, emerging from recession in the fourth quarter of 1998, leading to GDP growth of around 1 per cent in 1998-99. The rebound was supported by a strong recovery in property and equity markets and in private consumption, with retail sales returning to strong growth. The pick-up in the electronics cycle also had a positive impact, with significant demand from the US and a pick-up in regional conditions returning exports to strong growth. The Government also engaged in a range of expansionary and competitiveness-enhancing measures including tax cuts, wage cuts and a reduction in employer superannuation contributions.

**Taiwan** continued to withstand the effects of the Asia crisis, avoiding recession and recording strong growth of 4.7 per cent in 1998-99 as the region recovered. Prudent macroeconomic management and lower exposure to foreign borrowing were important factors. Expansionary fiscal policy, through public infrastructure investment, supported growth as private consumption and investment growth slowed. An improvement in competitiveness was provided through exchange rate depreciation and a pick-up in the electronics cycle boosted export growth. Expansionary monetary policy, combined with a return to strong growth in the equity market and a return of confidence, underpinned a recovery in private consumption growth, despite moderate deflation being experienced.

The **Philippines** economy weathered the Asian crisis relatively well, with output having contracted by 0.5 per cent over calendar 1998. The contraction was predominantly driven by sharp falls in the agricultural sector, which was badly affected by adverse weather conditions, and falls in investment, particularly in construction and construction-related manufacturing. Consumption, in contrast, remained firm and export growth was supported by strong trade ties with the United States. However, imports declined due to weak demand by industry. The Philippines economy, however, resumed growth in the first half of 1999, joining the broader regional recovery, and grew by 0.6 per cent in 1998-99. The rebound in activity was driven by a turnaround in agricultural activity and stronger export growth.

**Emerging markets**, notably Brazil and Russia, were caught up in severe financial market instability and capital flight over the latter half of 1998 and early 1999. The more pessimistic assessments of some forecasters were, however, proved incorrect, as the contagion effects and severity of the economic slowdowns in these markets were much milder than expected.

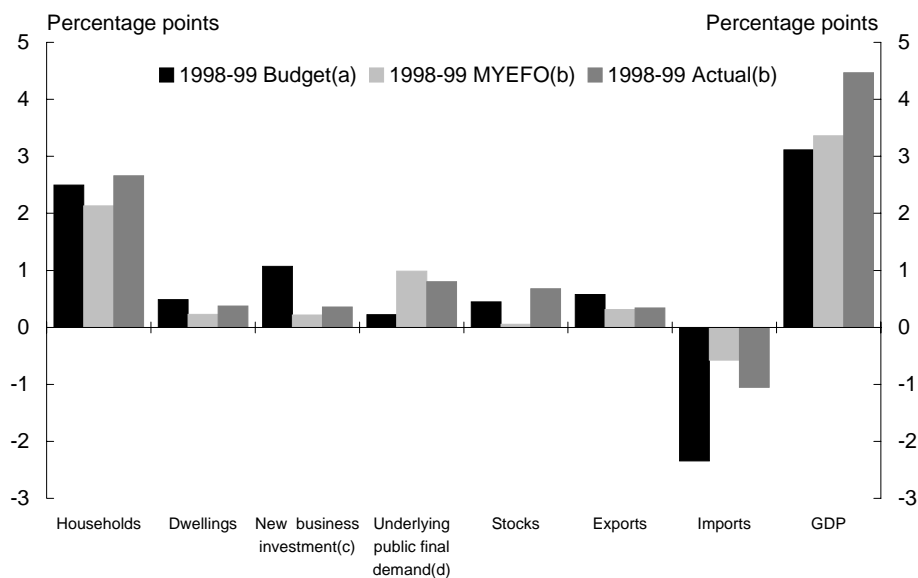
The momentum of the **New Zealand** economic recovery continues after experiencing a short-lived recession in the first half of 1998. Growth returned in the September quarter 1998 and despite a small contraction in the June quarter 1999, GDP increased by 2 per cent through the year to June 1999. This economic pick-up was largely attributed to strong private domestic demand growth on the back of improvements in consumer and business confidence, and supportive monetary conditions.

## 1998-99 OUTCOME COMPARED WITH THE FORECASTS

Australia's GDP growth in 1998-99 was 4.5 per cent, significantly stronger than both the May 1998 Budget growth forecast of 3 per cent and the December 1998 Mid-Year Economic and Fiscal Outlook (MYEFO) growth forecast of 3¼ per cent. Nevertheless, the composition of growth was broadly in line with the MYEFO forecasts, with a strong contribution from domestic demand offsetting weak net exports. Table 1 compares the 1998-99 outcomes with the May 1998 Budget and the MYEFO forecasts.

The higher GDP growth outcome compared with the MYEFO forecasts largely reflected a stronger contribution to growth by household consumption and a larger inventory accumulation (stocks), more than offsetting the higher net export detraction and a lower contribution from public final demand (Chart 2).

**Chart 2: Contributions to GDP Growth 1998-99**



- (a) 1998-99 Budget forecasts were based on constant price estimates.
- (b) 1998-99 MYEFO and actuals were based on chain volume measures.
- (c) New business investment represents headline business investment adjusted for second hand asset purchases.
- (d) Underlying public final demand represents the sum of public consumption and public investment, after abstracting from the impact on the latter of second-hand asset sales to the private sector.



**Table 1: 1998-99 Budget and MYEFO forecasts and outcomes**

	1998-99 Budget	1998-99 MYEFO	1998-99
	Forecasts	Forecasts	Outcomes (a)
	Year Average (b)	Year Average (b)	Year Average (b)
<b>Panel A - Demand and Output (c)</b>			
Household consumption	4	3 1/2	4.5
Private investment			
Dwellings	10	4	7.4
Total business investment	6	-2	0.4
Other buildings and structures	9	-8	-0.9
Machinery and equipment	5	0	-2.7
Private final demand	5	2 3/4	3.9
Public final demand	2 1/4	6 3/4	5.0
Total final demand	4 1/4	3 1/2	4.2
Change in inventories (d)			
Private non-farm	1/4	0	0.7
Farm and public authorities	0	0	0.0
Gross national expenditure	4 3/4	3 1/2	4.8
Exports of goods and services	2 1/2	1 1/2	1.7
Imports of goods and services	9	3	5.0
Net exports (d)	-1 3/4	- 1/4	-0.7
Gross domestic product	3	3 1/4	4.5
Non-farm product	3 1/4	3 1/2	4.3
Farm product (e)	-1	3	8.2
<b>Panel B - Expenditure Excluding Transfers and One-off Transactions (c)(f)</b>			
Total business investment	8	1	2.6
Other buildings and structures	10	n/a	7.8
Machinery and equipment	6	n/a	-3.6
Public final demand	1	4 1/4	3.5
<b>Panel C - Other Selected Economic Measures</b>			
Prices and wages			
Consumer Price Index (g)	2 1/2	2	1.2
Gross non-farm product deflator	3	1 1/4	0.6
Average earnings (non-farm compensation)	4 1/4	4	3.9
Labour market			
Employment (Labour Force Survey basis)	1 3/4	2	2.2
Unemployment rate (per cent)	8	8	7.6
Participation rate (per cent)	63 1/4	63 1/2	63.2
External accounts			
Terms of trade (h)	-1 1/4	-5 1/4	-5.1
Current account balance			
\$billion	-31	-32	-32.4
Percentage of GDP	-5 1/4	-5 1/2	-5.5

(a) Calculated using original data.

(b) All figures refer to the percentage change on preceding year unless otherwise indicated.

(c) The 1998-99 Budget forecasts were based on constant price measures using average 1989-90 prices. The MYEFO forecasts and the outcomes for 1998-99 were based on chain volume measures, with reference years of 1996-97 and 1997-98 respectively.

(d) Percentage point contribution to GDP growth.

(e) 1998-99 outcome calculated at basic prices.

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

(g) The Budget forecast was based on the 12<sup>th</sup> CPI series while the MYEFO forecast and the 1998-99 outcome were both based on the 13<sup>th</sup> series.

(h) The Budget forecast was adjusted to exclude computer import prices, while the MYEFO forecast and the 1998-99 outcome were both unadjusted, as they were based on chain volume measures which are less distorted by movements in computer prices.

## THE DOMESTIC ECONOMY

As in 1997-98, the major contributor to strong GDP growth in 1998-99 was household consumption expenditure. With some moderation in household consumption growth expected over the course of 1998-99, the outcome was stronger than anticipated.

The May 1998 Budget (Statement 2) identified a number of factors that could impact on the Australian economy (in either a positive or negative direction relative to the forecasts) over 1998-99. These included uncertainty surrounding the rate of world economic growth; the size of the stimulus to domestic demand flowing from declines in interest rates over 1997-98; and the consumption behaviour of AMP shareholders following the society's demutualisation and listing on the Australian Stock Exchange in June 1998.

In addition, there were a number of other favourable factors that also supported private demand throughout 1998-99: inflation continued to surprise on the downside, with intense price competition (motor vehicles were a prime example) and robust productivity growth both acting to subdue overall consumer price rises. Rising private sector wealth, relatively strong real wage growth, sustained employment growth and lower unemployment outcomes, and improved consumer confidence, all contributed towards creating an environment conducive to strong consumption growth being sustained in 1998-99.

The success in re-directing Australian exports to more strongly growing regions continued in 1998-99. The depreciation in the Australian dollar over the latter half of 1998 assisted to counterbalance the negative external impact arising from the Asian financial crisis. This assisted in increasing the competitiveness of Australian exports and domestic import-competing industries. In concert, these factors resulted in net exports detracting less from domestic growth than originally forecast at budget time.

In 1998-99, **fiscal policy** continued to build the level of national savings through the Government's ongoing programme of fiscal consolidation. The rise in the underlying general government cash surplus (from \$1.3 billion in 1997-98 to \$4.2 billion in 1998-99<sup>4</sup>), ensured that the Government did not contribute directly to the increase in the current account deficit (CAD). Further, when combined with receipts derived from assets sales, the headline fiscal position provided for a reduction in Commonwealth general government net debt (from 14.7 per cent of GDP in 1997-98 to an estimated 12.1 per cent of GDP in 1998-99).

The Reserve Bank reduced official interest rates (by 25 basis points) to 4.75 per cent on 2 December 1998. Long-term (10-year) bond yields and the

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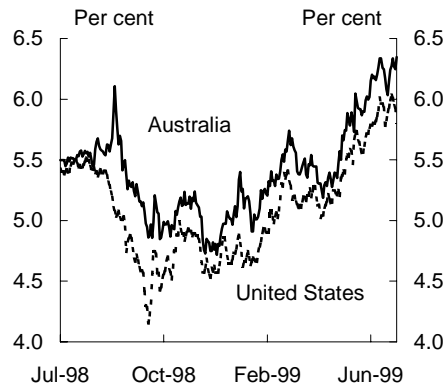
4 Consistent with the treatment applied in the 1999-2000 Budget, the underlying cash balance from 1998-99 onwards includes payments of around \$1¼ billion per annum by the Commonwealth in respect of accumulated public trading enterprises' superannuation liabilities.

exchange rates fell over the first half of 1998-99. Significant falls in long-term bond yields throughout the latter half of 1998 were driven by weaker global economic growth and inflation expectations, 'flight to quality' buying of US Treasury securities and reductions in official interest rates amongst central banks.

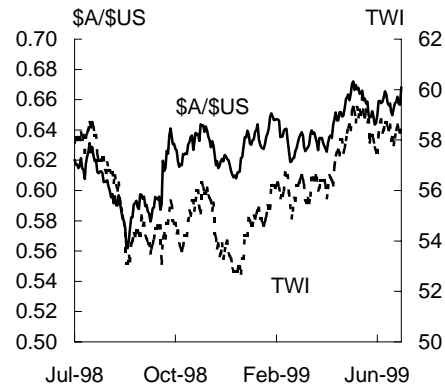
In contrast to the latter half of 1998, upward revisions to global economic growth and inflation expectations prompted a gradual rise in long-term bond yields in the first half of 1999. Rising long-term bond yields occurred alongside a rebound in the \$A/\$US and the TWI, and by the end of 1998-99, the rise in both bond yields and the exchange rate had more than unwound the falls observed over the latter half of 1998. Nevertheless, the exchange rate and Australian long-term bond yields over 1998-99 remained well below the average levels recorded over 1997-98.<sup>5</sup>

As shown in Chart 3, during a period of heightened global financial market instability and investor uncertainty, international investors' confidence in Australia allowed the spread between Australian and US long-term bond yields to remain low (30 basis points over 1998-99).

**Chart 3: 10 year bond yields – Australia and the United States<sup>(a)</sup>**



**Chart 4: \$A/\$US and TWI exchange rates, 1998-99**



(a) Monthly averages of daily rates  
Source: Datastream

<sup>5</sup> In year-average terms, the \$A/\$US was around US 62.8 cents in 1998-99 (compared with US 68.1 cents in 1997-98); the TWI averaged 56.0 in 1998-99 (compared with 58.3 in 1997-98); and Australian 10-year bond yields averaged 5.4 per cent in 1998-99 (compared with 6.0 per cent in 1997-98).

## Supply-side developments<sup>6</sup>

In 1998-99, industries in the Australian economy that benefited from the strength of the household sector contributed solidly to GDP and employment growth.

By industry grouping, Chart 5 shows that private service industries contributed 2.3 percentage points to GDP growth in 1998-99, with solid outcomes for property and business services, finance and insurance, and wholesale trade. Domestic cyclical industries contributed 0.6 percentage points to growth, with a pick-up in manufacturing (as the effects of the Asian crisis unwound) helping to offset the moderation in the contribution by the construction sector (following very strong growth in the previous year). Contributions to output growth in the infrastructure sector continued to be supported by communication services, while output in commodity (external) and general government industries were broadly flat.

Total employment grew 2.2 per cent in 1998-99; this represented a significant strengthening in growth over the previous year. Employment growth was concentrated amongst private service industries. Favourable trading conditions in retail trade and property and business services resulted in private service industries contributing 1.7 percentage points to total employment growth. Growth in general government employment, which contributed 0.5 percentage points to total employment growth in 1998-99, followed two years of flat government employment growth.<sup>7</sup>

With industry gross value added growing at around twice the pace of employment growth in 1998-99, implied labour productivity growth remained robust at 2.3 per cent in 1998-99. This was slightly lower than the high productivity growth of 3.4 per cent recorded in 1997-98.<sup>8</sup>

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6 The various industry groupings are: **Private services** (wholesale trade; retail trade; accommodation, cafes and restaurants; transport and storage; finance and insurance; property and business; cultural and recreational; and personal and other services); **Domestic Cyclical** (manufacturing and construction); **Commodity (External sector)** (agriculture, forestry and fishing; and mining); **Public Enterprise/Infrastructure** (electricity, gas and water; and communication); and **General Government** (government administration and defence, education; and health and community services).

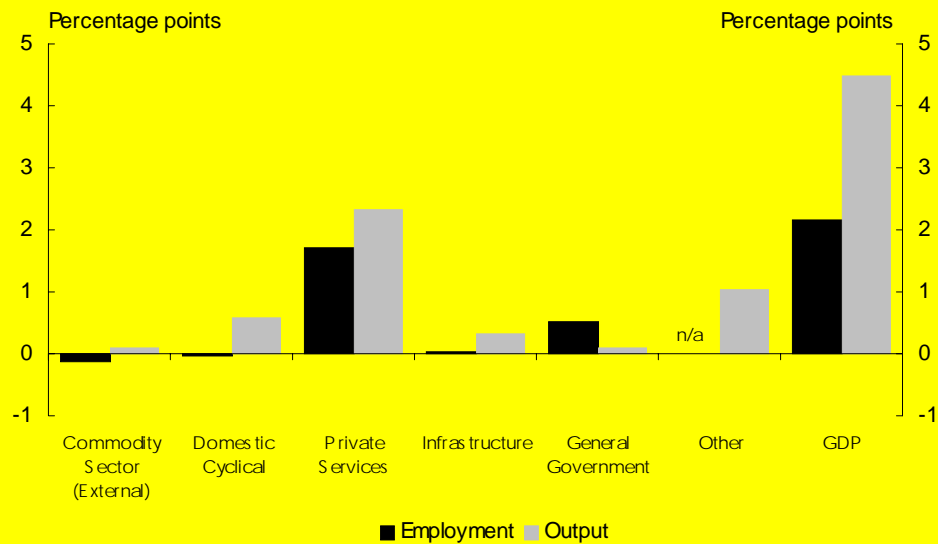
7 The increase in general government employment growth in 1998-99 as implied from the ABS Labour Force Survey (LFS) contrasts with the fall in public sector employment growth reported by the ABS Wage and Salary Earners Survey (SEE). The difference between the two surveys is likely to reflect the share of private sector employment that is captured in the LFS measure of employment in general government industries.

8 The moderation in implied productivity growth in 1998-99 is consistent with developments in other productivity measures. Growth in trend GDP per hour worked eased from 3.6 per cent in 1997-98 to 2.6 per cent in 1998-99, while growth in trend GDP per hour worked in the market sector fell from 4.3 per cent in 1997-98 to 2.9 per cent in 1998-99. Source: ABS Cat. No. 5206.0.

Very high productivity growth continued to be achieved by infrastructure industries (up 4.5 per cent), with the communication sector the key to ongoing productivity growth in this industry. Productivity growth in commodity industries rose sharply (up 3.6 per cent in 1998-99 from 1.8 per cent in 1997-98), with increased productivity in agriculture, forestry and fishing more than offsetting falling productivity in the mining industry. Productivity growth amongst domestic cyclical industries was also strong, rising by 3.3 per cent in 1998-99, with solid productivity growth in manufacturing more than offsetting the productivity decline in construction (which followed two years of high productivity growth).

Robust productivity growth of 2.7 per cent amongst private service industries was strongest for wholesale trade, business and hospitality related services. In contrast, general government productivity contracted by 1.8 per cent in 1998-99 (following two years of above average productivity growth), as a result of both lower recorded output and higher employment.

**Chart 5: Industry contribution to GDP and employment growth, 1998-99<sup>(a)</sup>**



(a) Output refers to gross value added at basic prices.  
 (b) 'Other' captures the contribution to GDP associated with the ownership of dwellings, taxes less subsidies, and the statistical discrepancy.  
 Source: ABS Catalogue No. 5206.0, 6202.0 and 6203.0.

## Domestic Demand

**Total final (domestic) demand** in 1998-99 rose by 4.2 per cent. Despite the increasing contribution of exports to the overall economy (exports of goods and services accounted for around 20 per cent of total GDP in 1998-99), the Australian economy still predominately produces for the domestic market.

In 1998-99, the production of non-tradeables<sup>9</sup> in Australia accounted for around three-quarters of the economy and around 82 per cent of total employment. The production of non-tradeables was the main contributor to GDP growth over the year, contributing around 3.6 percentage points to industry gross value added (measured at basic prices) of 4.0 per cent in 1998-99.

**Private consumption** grew by 4½ per cent in 1998-99: this was ½ percentage point higher than the May 1998 Budget forecast and 1 percentage point higher than the MYEFO forecasts. Higher consumption growth reflected stronger than expected growth across all components of private consumption, with the services and motor vehicles components (record sales of motor vehicles were recorded in 1998) both particularly strong. Growth in retail trade was also solid in 1998-99.

The strength in private consumption continued to be supported by low inflation, low interest rates, robust employment growth and falling unemployment, relatively strong real wage growth, high household borrowing and rising private sector wealth. The growth in private sector wealth in 1998-99 was driven by strong rises in both equity and house prices, which grew by around 5½ and 8 per cent respectively. Given the increase in direct share ownership by households, the rise in equity prices is likely to have flowed through to consumption expenditure more directly than has historically been the case.

The one-off windfall gain to AMP policy holders associated with the AMP demutualisation and, further gains in the share price of the partially privatised Telstra, clearly gave private consumption a considerable boost. The demutualisation of the AMP Society effectively unlocked around \$20 billion (market capitalisation) of wealth available to AMP shareholders, with roughly 80 per cent of this wealth going to domestic shareholders. When combined with stronger employment growth and the rebound in consumer confidence, rising private sector wealth clearly resulted in a stronger impact on consumption than was factored in at the time of the May 1998 Budget.

The favourable conditions that underpinned stronger growth in private consumption were, in part, reflected in the large increase in consumer sentiment

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9 The following industries are assumed to produce non-tradable goods and services: electricity, gas and water supply; construction; wholesale trade; retail trade; accommodation, cafes and restaurants; transport and storage; communication services; finance and insurance; property and business services; government administration and defence; education; health and community services; cultural and recreational services; personal and other services; and ownership of dwellings.

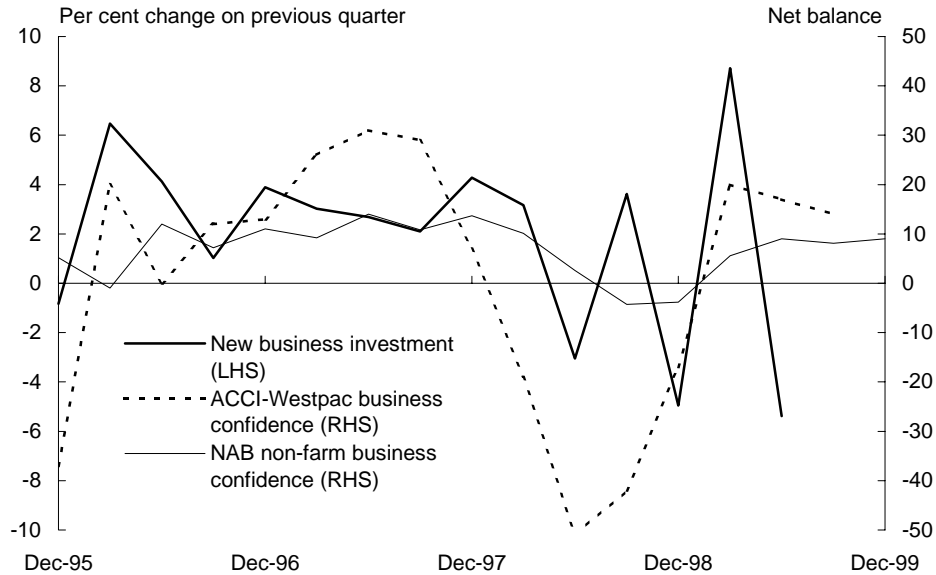
over 1998-99, with the Westpac-Melbourne Institute consumer sentiment survey rising by 18 per cent in through-the-year terms. This came after the weakening in sentiment over the middle and latter parts of 1997-98, which coincided with the downturn in troubled Asian economies.

**Dwelling investment** grew by 7.4 per cent in 1998-99 to reach its highest level on record. The May 1998 Budget forecast dwelling investment to grow by 10 per cent in 1998-99, which was revised down to 4 per cent in the MYEFO. This downward revision reflected weaker partial indicators of dwelling investment in the September quarter 1998 and pessimism surrounding the Asian financial crisis. A rapid recovery in consumer and business confidence coupled with low interest rates, contributed to dwelling investment being stronger than forecast in the MYEFO, despite declining housing affordability over 1998-99 (albeit from high levels) as a result of rising house prices.

Following six years of strong expansion, underlying **business investment** grew by 2.6 per cent in 1998-99. This moderation was broadly in line with the MYEFO forecast of 1 per cent growth but below the 8 per cent rise forecast at budget time. The slowdown in investment growth in 1998-99 was attributable to a 3.6 per cent fall in spending on new plant and equipment — the first fall in seven years. This partly resulted from a large decline in plant and equipment expenditure by the mining industry, reflecting the effects of low world commodity prices experienced since the onset of the Asian financial crisis and six years of high expenditure on plant and equipment. Offsetting this decrease was continued growth in new buildings and structures investment, which rose by 7.8 per cent. Some of the growth in new buildings and structures in 1998-99 was associated with the City Link road construction in Victoria and hotel, office and stadium construction for the Sydney Olympics.

There was a substantial recovery in business confidence over 1998-99 to near pre-Asian crisis levels as reflected in Chart 6. Moreover, in 1998-99 corporate profits (non-financial corporations) remained strong, rising by 6.0 per cent from 1997-98.

**Chart 6: Business investment and confidence**



After abstracting from the sale of second-hand assets to the private sector,<sup>10</sup> **public final demand** grew by 3½ per cent in 1998-99, compared with a Budget forecast of 1 per cent and 4¼ per cent forecast in the MYEFO.<sup>11</sup> This growth was driven by strong underlying investment at both the Commonwealth and State/local levels, together with solid growth in Commonwealth consumption expenditure.

**Stocks** contributed 0.7 percentage points to GDP growth in 1998-99, significantly higher than the Budget and the MYEFO forecasts. The steep decline in the non farm stocks-to-sales ratio experienced from late 1996 through 1997 was most likely attributable to very strong sales growth over this period, pushing non-farm stocks below desired levels. This decline in the stocks-to-sales ratio was partly reversed during 1998-99 as the ratio increased significantly. However, the sharp increase in the stocks-to-sales ratio in the June quarter 1999 probably reflected some unanticipated stock building due to weaker sales, especially in the manufacturing sector.

<sup>10</sup> Most notably the Commonwealth's sale of the National Transmission Network in 1998-99 and the WA Government's sale of the Dampier to Bunbury pipeline in 1997-98.

<sup>11</sup> In part, the stronger public final demand outcome in 1998-99 relative to the Budget forecast reflected classification changes undertaken by the ABS.



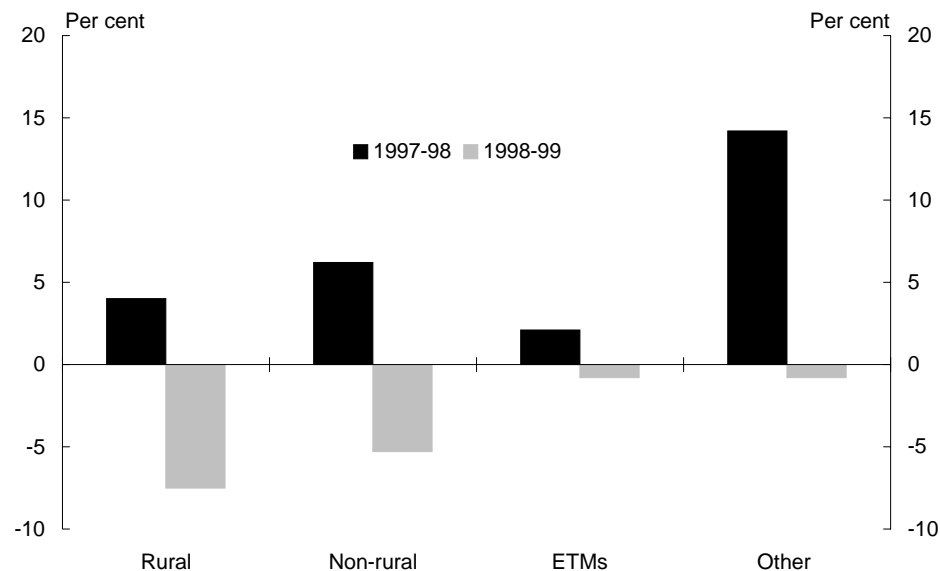
## External Demand

**Net exports** detracted 0.7 percentage points from economic growth in 1998-99, slightly more than the MYEFO forecast, but less than the Budget forecast. Import volumes grew by 5 per cent in 1998-99, which was less than the Budget forecast of 9 per cent but higher than the revised MYEFO forecast of 3 per cent. The slower growth in import volumes reflected the increased competitiveness of domestic import-competing industries following the decline in the exchange rate in 1998-99. Export volumes grew by 1.7 per cent, slightly below the Budget forecast of 2½ per cent and around the MYEFO forecast of 1½ per cent. Behind this moderate growth in export volumes was the economic recession in Australia's major trading partners in East Asia.

The **current account deficit** was \$32.4 billion or 5.5 per cent of GDP in 1998-99, slightly above the May 1998 Budget forecast but broadly consistent with the MYEFO forecast. As expected, the higher CAD in 1998-99 reflected a deterioration in the balance of trade. This reflected the lower deduction from economic growth in net exports being offset by a greater than expected deterioration in the terms of trade.

The terms of trade fell by 5.1 per cent in 1998-99, primarily reflecting an average 4.8 per cent fall in the Australian dollar prices of Australian commodity exports. In contrast, the price of elaborately transformed manufactures (ETMs) experienced only a slight decrease (0.8 per cent) and import prices grew slightly. Chart 7 compares the percentage changes of the Australian dollar prices of export categories in 1997-98 and 1998-99.

**Chart 7: Percentage changes of the Australian dollar prices of export categories**



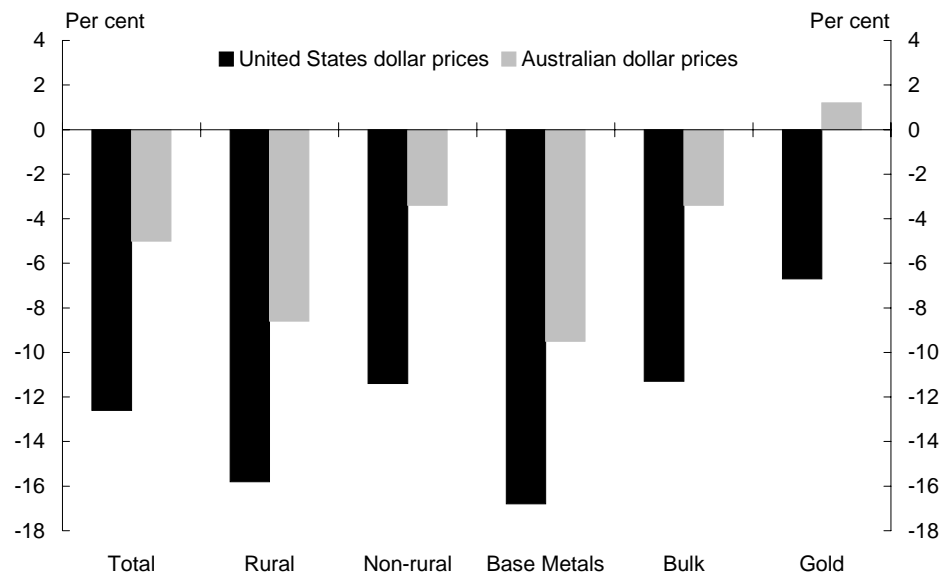
The decline in commodity prices in Australian dollar terms in 1998-99 represented a lagged response to the Asian financial and economic crisis. The major driving forces behind the declining prices of commodities included the outcome of annual trade negotiations of bulk commodities with major Asian trading partners, and the continued deterioration in the gold price through the year.

The economic recession in Japan and other Asian economies continued to depress the prices of commodities in the world market, particularly base metals and bulk commodities like iron ore, coking coal and steaming coal. The gold price remained depressed in 1998-99, falling further due to continued negative sentiment arising from uncertainty surrounding central bank sales and gold lending, and continued short selling by arbitrageurs.

The depreciation of the Australian dollar was not sufficient to prevent Australian dollar prices of Australian commodity producers from falling in 1998-99, given the extent of the decrease in the US dollar commodity prices. This was in contrast to the previous fiscal year when the prices of commodities declined in US dollar terms, but rose in Australian dollar terms.

Chart 8 compares the percentage changes of the prices of export categories in 1998-99 both in US dollar and Australian dollar terms.

**Chart 8: Percentage changes of the prices of export categories in US dollars and Australian dollars, 1998-99**



## Prices, Wages and Employment

**Inflation**, as measured by movements in the Consumer Price Index (CPI) remained subdued in 1998-99, rising by 1.2 per cent in year-average terms (and 1.1 per cent in the year to the June quarter 1999). This outcome was lower than both the MYEFO and the 1998-99 Budget forecasts, and largely reflected robust productivity growth, moderate wages growth and continuing competitive pressures (both domestically and abroad). Heightened competitive pressures limited the pass-through to retail prices of higher import prices following from the depreciation of the exchange rate. Declining motor vehicle prices also served to moderate overall inflation, with the prices of motor vehicles falling for the fifth consecutive quarter to the June quarter 1999. This resulted in the lowest motor vehicle prices since 1992.

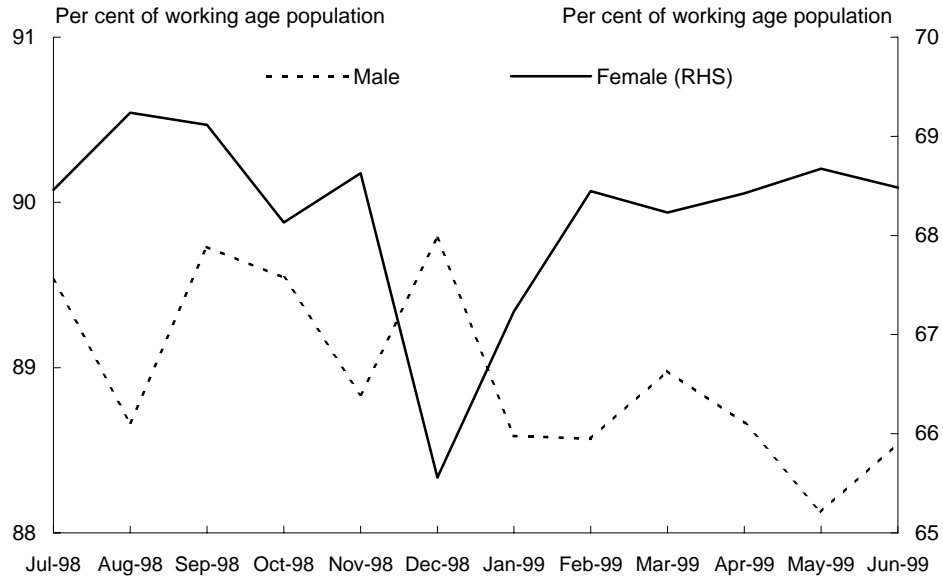
The introduction of the 30 per cent health insurance rebate on 1 January 1999 also contributed to the low inflation outcome as it reduced inflation by around  $\frac{1}{4}$  of a percentage point in 1998-99.

**Wages growth** remained moderate in 1998-99, underpinned by low inflation. Average earnings on a national accounts basis (AENA) grew by 3.9 per cent, consistent with the 1998-99 MYEFO forecast. Abstracting from the increase in the superannuation guarantee charge on 1 July 1998, AENA grew by 3.5 per cent, slightly lower than the 1997-98 outcome of 3.7 per cent. Other measures of wages growth also confirmed a moderation — AWOTE growth declined from 4.1 per cent in 1997-98 to 3.7 per cent in 1998-99, while the average annual wage increase for current enterprise agreements was 3.8 per cent in the June quarter 1999, compared to 4.1 per cent a year earlier. The spread of enterprise bargaining over recent years has ensured that sectoral wage pressures, such as in construction, IT and some skilled trades, were not transmitted more widely.

Moderate nominal wage increases, together with low inflation, resulted in relatively strong real wage growth in 1998-99. Nevertheless, robust productivity growth led to real unit labour costs being broadly unchanged over 1998-99.

Continued strong growth in domestic demand underpinned solid **employment** growth in 1998-99. Employment grew by 2.2 per cent in 1998-99, which was higher than both the May 1998 Budget forecast of  $1\frac{3}{4}$  per cent and the MYEFO forecast of 2 per cent. The **participation rate** averaged 63.2 per cent over 1998-99; this was in line with the Budget forecast, but slightly below the MYEFO forecast of  $63\frac{1}{2}$  per cent. It is possible that low mortgage interest rates and rising household wealth dampened labour force participation in 1998-99. As Chart 9 illustrates, the trend participation rate of prime working-age females was essentially flat over 1998-99, despite the strong employment growth experienced by this cohort. In addition, the participation rate of prime working-age males continued its long-term decline.

**Chart 9: Participation rate of 25-59 year cohort, 1998-99**



The **unemployment rate** continued to decline over the year, reaching a low of 7.2 per cent in June 1999. On average, over 1998-99, the unemployment rate was 7.6 per cent, which was lower than the Budget and the MYEFO forecasts of 8 per cent.

## CONCLUSION

Ongoing microeconomic reform has improved the ability of the Australian economy to adapt quickly to changes in the Australian and international economy. While an increasingly diversified and productive economy has been fundamental in helping to mitigate the effects stemming from the Asian financial crisis, microeconomic reform has been complemented by sound and stable macroeconomic policies. Integrated macro and microeconomic policies have allowed the appropriate exchange rate adjustments to take effect, which assisted to shield the Australian economy against the effects of heightened international instability and weakness.

The results of a more flexible economy and stable policy have (arguably) never been more apparent. In 1998-99, Australia achieved its most protracted period of economic growth since the early 1970s with sustained low inflation outcomes, rising employment, robust productivity growth and healthy corporate profitability. By international comparison, Australia's economic performance in 1998-99 was very impressive, even surpassing the US economy on some measures.