Economic Overview

The strong economic growth experienced in Australia in 1997-98 continued into the September quarter 1998. GDP grew by 1.0 per cent in the September quarter and by 5 per cent over the year to the September quarter.

The strong growth in the September quarter was underpinned by strong domestic demand growth; consumption and business investment grew strongly, although dwelling investment fell moderately. Net exports also contributed to growth in the September quarter, although a decline in the terms of trade meant the current account deficit widened.

The continuing strength of the Australian economy despite the weakness of a number of our major Asian trading partners and uncertainty in global financial markets reflects the sound fundamentals underpinning domestic spending. Inflation remains low, interest rates are at historically low levels, solid employment growth is continuing, corporate profits are healthy and wages are growing moderately. These fundamentals are, in turn, underpinned by sound macroeconomic policies which have concentrated on fiscal consolidation and the maintenance of low inflation in a credible monetary policy framework. The relatively modest slowdown in export volume growth to date also reflects the more responsive and flexible nature of the Australian economy. As the IMF noted at the conclusion of its examination of the Australian economy in October 1998:

> Growth has been underpinned by an improved policy framework and regulatory reforms that have promoted investment and boosted productivity.

One feature of the recent strength of the Australian economy is the rise in measured labour productivity. This improvement in productivity (discussed briefly in Box 4) — another benefit of extensive product and factor market reforms — is also contributing to the sound fundamentals of the Australian economy.

As outlined in the *Mid-Year Economic and Fiscal Outlook 1998-99,* GDP growth for the remainder of 1998-99 is forecast to moderate from the very strong rate of growth recorded over the year to the September quarter. In year-average terms, GDP is forecast to rise by 3¼ per cent in 1998-99 and by 2¾ per cent in 1999-2000.

Available indicators remain consistent with still solid domestic demand growth in the December quarter. Partial data suggest that dwelling and business investment, while slowing from their 1997-98 rates of growth, will remain at high levels in 1998-99. (The outlook for the dwelling sector is reviewed in Box 3).

DEVELOPMENTS IN THE WORLD ECONOMY

Economic conditions proved difficult in 1998 for a number of countries – particularly in East Asia – and growth in world output consequently is expected to have slowed from 4.1 per cent in 1997 to around 2¼ per cent in 1998. World growth is expected to remain at around the same level in 1999 (see Box 1 for further comment), as a relative improvement in East Asia is offset by some slowing in activity in Europe and North America. However, the uncertainties that have surrounded the international outlook over the past year persist, with sentiment in global financial markets in particular remaining volatile.

The Russian debt default in August last year provoked a fundamental reassessment of emerging market risk, resulting in increased risk premia and capital instability for many economies. A series of three reductions in official interest rates in the US – in conjunction with easings in monetary conditions in Europe and other developed countries – helped to calm financial markets, but renewed concerns about Latin America early this year show that the risk remains.

The ***United States'*** economy proved an important support for global activity last year, combining very strong domestic demand, continued employment growth and a low inflation environment. GDP in the third quarter 1998 was 3.5 per cent higher than the year-earlier level, and partial indicators of activity in the final quarter suggest a similarly brisk pace has been maintained. Retail trade in December was 6.7 per cent higher than a year earlier, suggesting another strong contribution to growth from private consumption in the December quarter. The housing sector remains strong, and stronger than expected gains in employment in the December quarter – resulting in an unemployment rate of just 4.3 per cent – will provide continued support for household incomes. Despite the current strength of activity, a slowing towards longer-term potential rates of growth continues to be expected during 1999. A number of important factors are pointing in that direction: widening external sector imbalances; weaker profits growth along with lower levels of capacity utilisation that will dampen private investment; and a smaller overall increase in the level of the US stock market in the second half of 1998, which is expected to contribute to slower private consumption growth as wealth effects wane.

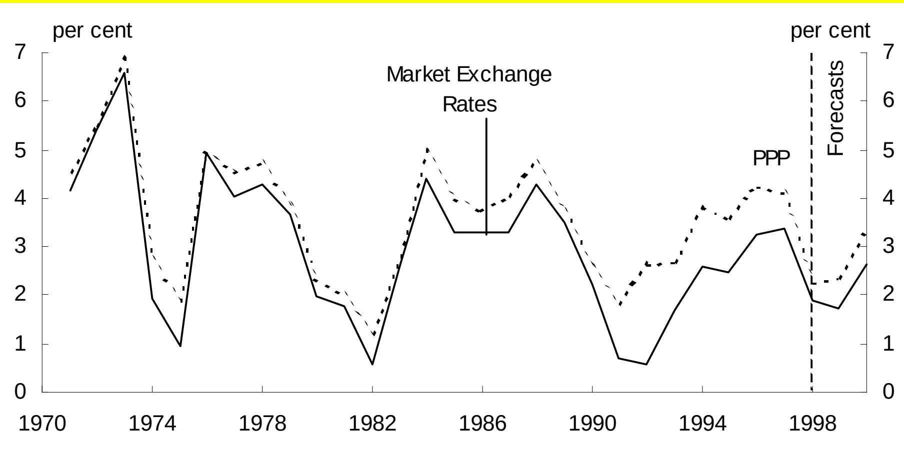
Inflation is expected to be slightly higher in 1999 than was the case in 1998, but not to the point of raising concern. Some of the factors that had a depressing effect on inflation last year – a strong currency, falling commodity prices, and subdued unit labour costs – are expected to moderate and thus provide a source for increased inflationary pressures. However, a slowdown in domestic activity will help to offset these effects leaving inflation little changed. A continuation of the impressive inflation performance in the US would provide scope for further interest rate easings should the economy slow quicker than expected.

Box 1: Alternative measures of world growth

In the December 1998 *World Economic Outlook and International Capital Markets Interim Assessment* (WEO), the IMF published two estimates of world GDP growth, reflecting alternative weights for individual countries. The IMF's existing measure weighted each country's growth relative to its value of GDP expressed in purchasing power parity (PPP) terms. The alternative method uses weights reflecting the value of GDP expressed in US dollar terms using market exchange rates. The World Bank and many private sector organisations provide estimates using this alternative method, while the OECD uses PPP weights in deriving regional aggregates.

The effect of this alternative method is to give advanced economies a substantially larger weight in the world economy and, consequently, substantially less weight to developing countries. (In 1997, industrial economies accounted for 78 per cent of world GDP using market exchange rates, while they accounted for only 55 per cent of world GDP using PPPs.) Large changes also occur in the relative importance of individual countries under the alternative methods. Two of the most significant changes are those to China and Japan. China goes from being the second largest economy in the world with a GDP share of 11.5 per cent to the seventh largest with a share of around 3 per cent. Japan moves from number three in the world using PPP to number two using exchange rates, with its share of world GDP increasing from 7.7 per cent to around 14 per cent.

Chart 1: World GDP growth[(a)]



(a) Treasury estimates and forecasts.

continued

Box 1: Alternative measures of world growth (continued)

The alternative methods also produce significantly different outcomes for world growth. Using the PPP method, world growth has averaged 3¾ per cent since 1970, while using the exchange rate method the average has been 3 per cent. Significant differences in the magnitude of peaks and troughs also occur in the two series depending on which group of economies are responsible for the pick-up or slowdown in growth. Using the PPP method, the current slowdown is almost as severe as that of the early 1990s. However, using the exchange rate method, it is relatively mild compared with the previous episode. This is because the current slowdown is largely due to weakness in developing economies, which have significantly more importance using the PPP rather than the exchange rate method.

The major risks to the US outlook this year remain principally those attached to financial market instability: the potential for the financial volatility in Latin America to impact on domestic activity through trade and financial channels; the effects of an increased risk aversion in general upon the cost and availability of capital domestically; and the risk posed by any substantial correction of equity prices. The continued rise in the US trade deficit with Japan also poses the risk that trade protectionism may find a stronger voice this year. But it is also important to recognise the scope for stronger than anticipated outcomes, reflecting the possibility of structural improvement in productivity and continued supportive policy settings. There has been a general tendency in recent months to revise up forecasts of GDP growth in 1999, but such adjustments could prove to be too modest; if so, the pattern in recent years of unfulfilled expectations of a return to trend growth might again be repeated.

European growth is also set to moderate this year, with a continued weak global environment depressing export earnings, and the effects of exchange rate appreciation in 1998 contributing to weaker industrial production; business sentiment in particular has suffered from weak export orders. Nonetheless, economic growth in Germany is estimated to have been 2.8 per cent in 1998, driven by strengthening domestic demand, especially private consumption, and supported by accommodative monetary conditions. Consumer sentiment and spending remain strong throughout Europe — particularly so in France — while higher levels of capacity utilisation across the euro area might help to offset the effects of weaker business sentiment on capital expenditure plans.

The European growth outlook in 1999 is weakest for the core euro economies Germany, France and Italy but solid growth is still expected in Spain, Finland and Ireland. The euro periphery economies should continue to benefit from the reduction in interest rates associated with the convergence to a single euro base interest rate. While the Stability and Growth Pact will limit the euro members' capacity to loosen fiscal policy in response to slower growth in 1999, there is still some capacity to allow for a cyclical easing in fiscal policy if growth in the euro area weakens by more than that forecast in 1999. With inflation remaining low — around 1 percentage point below the target of 2 per cent or less set by the new European Central Bank (ECB) — there is scope for lower interest rates in Europe. The ECB's willingness to lower rates further might be constrained by concerns about its credibility and structural weaknesses in European product and labour markets which could limit the capacity of monetary policy to further stimulate growth.

Following the European Commission's fixing of euro conversion rates against the national currencies of the 11 euro economies on 31 December 1998, the euro began smooth trading in financial markets on 4 January 1999. Despite the success of the euro's launch, European authorities face numerous challenges in cementing the success of EMU, including accurately estimating how the dynamics between interest rates and exchange rates affect — both individually and collectively — the 11 economies in question. On the other hand, the advent of the euro may also bring greater price and product competition which in turn will support growth and price stability.

In 1998 the ***United Kingdom*'s** economy recorded growth of around 2½ per cent, however, activity slowed through the course of the year. Growth of 0.2 per cent was recorded in the last quarter of 1998, to be 1.6 per cent higher than a year earlier. Official forecasts are for growth in 1999 to slow in the range of 1 to 1½ per cent, well below trend. The emerging consensus points to the possibility of a weaker outlook, but data on employment and output, to date, are mixed. There are signs that private consumption growth has slowed, while net exports have continued to constrain growth, largely reflecting the decline in Asian demand. Policy settings in 1999 should prove supportive, with Government plans to boost public investment spending, combined with four easings in monetary policy by the Monetary Policy Committee since October 1998. Interest rates have been lowered from a peak of 7.5 per cent in June 1998 to 6 per cent in January, with further reductions likely in the face of a lower inflation outlook.

Japan, however, is in its worst recession in 50 years with September quarter National Accounts data revealing the fourth consecutive quarter of economic contraction. Private consumption is yet to show any sustained sign of recovery as employment prospects continue to deteriorate and household incomes fall. Business investment is forecast to further contract through 1999 as a result of excess capacity, declining profitability and an appreciating yen. The December quarter Bank of Japan business survey (Tankan) revealed that corporate sentiment had deteriorated over the quarter, with firms expecting weak sales and profit levels and ongoing difficulties accessing credit. Industrial production remains flat with the inventory adjustment process still to reach its conclusion.

Efforts by the Japanese government to stimulate the economy through increased public works expenditure have had some positive effect on economic activity in recent months, however, the sustainability of further fiscal initiatives remains a concern. Gross government debt levels are already amongst the highest in the OECD and the fiscal constraints imposed by a rapidly ageing population make ongoing boosts to public expenditure levels problematic. The recent sharp spike in long-term bond yields, partly resulting from the announcement of substantial new bond issuances set down in the FY1999 Budget, is already being reflected in higher long-term commercial rates and, as such, would be an unwelcome development for business confidence. Japan's latest fiscal statement, the national budget for FY1999 (beginning 1 April), saw total planned expenditure for FY1999 increase by around 2¼ per cent compared with last year's overall expenditure. There remains some uncertainty, however, about how much of this stimulus will actually be delivered, as it relies upon local governments' willingness to increase their own expenditure levels.

Ultimately for Japan to return to a sustainable growth path, it must implement policies that are aimed at removing the structural barriers to growth that exist within the economy. Implementation of a broad range of reforms right across the Japanese economy is required, and though this process has commenced, most importantly within the financial sector, the Japanese Government will need to be vigilant to ensure its continuation. The recent nationalisation of the Long Term Credit Bank and Nippon Credit Bank signals a welcome renewed determination on the part of authorities to deal with the debt overhang within the Japanese banking sector. Utilisation of public funding to restore the banking industry's capital base must also lead to fundamental restructuring within the banking sector.

China continues to be the major source of economic growth in the ***Asian region***, recording growth in 1998 of 7.8 per cent, supported in the second half of the year by increased infrastructure spending. This policy stimulus is also expected to provide a solid foundation for growth through 1999, which is expected to be in the order of that achieved last year. The recent bankruptcy of a provincial financial institution may represent an important step in financial sector reform and structural reform more generally. Without such reform, current rates of economic growth may not be maintained in the longer term. Despite weakness in the private sector, solid growth continues in Taiwan, supported by stimulatory measures which are expected to continue through 1999.

Recent positive signs in troubled Asia continue to be reaffirmed, with evidence that the rate of contraction in activity has slowed markedly in most economies, with some recording positive growth in the third quarter. Most notable has been the resumption of growth in Korea in the third quarter, with strong monthly sales and production figures into the fourth quarter. Partial indicators also point to a resumption in growth in Thailand, while the rate of contraction in activity in Malaysia, and to a lesser extent Indonesia, appears to be slowing.

Activity in the Philippines has rebounded strongly, with a significant contribution from the agricultural sector, which had been constrained by the severe drought in the first part of 1998. The depressed regional economy continues to restrain activity in Hong Kong and Singapore, although there are positive signs in partial indicators and the financial sectors.

In line with a general recovery in world financial markets, increased stability in Asian financial markets and currencies has facilitated a reduction in interest rates, which will be important to the recovery in domestic activity. The general recovery in stock markets across the region highlights the pick-up in investor confidence.

While these positive signs are encouraging, the recovery in troubled Asia, in particular for the four crisis economies, is still expected to be protracted, with further contractions in a number of economies in the region expected in the current year. Recovery to strong, sustainable rates of growth in the region will require continued structural reforms, in particular in the financial sector. In some cases these much-needed reforms are likely to place a constraint on growth in the short term.

Over the past six months there has been considerable capital flight from ***Brazil*** as markets have directed increasing attention to debt levels and the Government's projected fiscal position. This capital flight has recently intensified with concern growing about Brazil's ability to deliver policy measures in line with their IMF package. With pressure on the exchange rate increasing, authorities first devalued and have since floated the real. This has been accompanied by a tightening of monetary policy, which should help to contain the inflationary impact of devaluation.

A period of economic contraction in Brazil has been anticipated in most assessments of the world economy. While recent events have clearly added to uncertainty, as yet there are insufficient signs to conclude that the impact will be larger than already anticipated. In part the anticipated slowing of activity in Brazil is the necessary result of policy measures aimed at delivering stability in financial markets, addressing structural problems and addressing Brazil's significant debt burden. Dealing with these issues in a decisive manner, as with Asia, is necessary for a later resumption of strong growth. It thus remains imperative for Brazilian authorities to introduce policy measures aimed at improving the fiscal position in line with their IMF agreement if renewed significant pressures on the exchange rate are to be avoided.

DOMESTIC ECONOMIC ACTIVITY

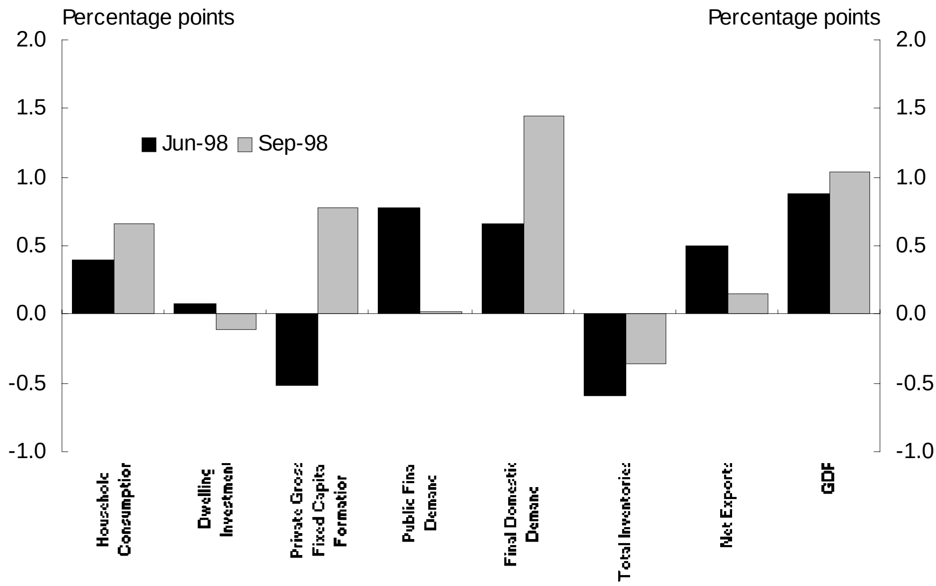
The September quarter 1998 National Accounts recorded GDP growth of 1.0 per cent in the quarter. The result reflected continued strong growth in domestic demand and a modest contribution from net exports (Chart 2).

Domestic demand increased by 1.4 per cent in the September quarter, driven by strong business investment and household final consumption growth, while dwelling investment fell moderately.

Net exports contributed 0.2 percentage points to growth in the September quarter, following a 0.7 percentage point contribution in the previous quarter. Export volumes of goods and services rose 0.7 per cent, while import volumes of goods and services fell by 0.1 per cent.

There were some significant revisions to historical data in the September quarter National Accounts. These reflected both changes to the methodology underlying the National Accounts (see Box 2) and the collection of more complete survey data from the various sources used to compile the Accounts. These revisions led to an increase in the estimate of GDP growth in 1997-98 to 4.6 per cent, with upward revisions to growth in business investment and public final demand more than offsetting downward revisions to growth in household consumption and dwelling investment.

Chart 2: Contributions to GDP growth(a)



(a) Adjusted for asset sales.
Source: ABS Cat. No. 5206.0.

Box 2: Changes to the Australian National Accounts

The September quarter 1998 National Accounts were the first to be published by the Australian Bureau of Statistics (ABS) in accordance with the System of National Accounts 1993 (SNA93). This introduced a number of methodological changes, the integration of the National Accounts with supply-use tables (a type of input-output table) and the introduction of chain volume measures to replace constant price estimates.

As a result of the changes there is now a single measure of GDP which replaces GDP(A) — the average of the expenditure (GDP(E)), income (GDP(I)) and production (GDP(P)) based estimates of GDP — as the 'headline' measure.

Volume estimates replace constant price estimates of National Accounts variables. Chain volume measures are annually re-weighted measures which provide better indicators of movement in real output and expenditure because they take account of changes in price relativities from year to year.

There are also a number of changes in terminology, for example: private final consumption expenditure becomes household final consumption expenditure; change in stocks becomes change in inventories; non-dwelling construction is now referred to as other buildings and structures; and wages, salaries and supplements is now compensation of employees.

Details of the changes to bring the National Accounts into line with SNA93 and associated methodological developments are outlined in ABS Cat. No. 5253.0 *Upgraded Australian National Accounts* which was released by the ABS on 4 November 1998.

Household consumption

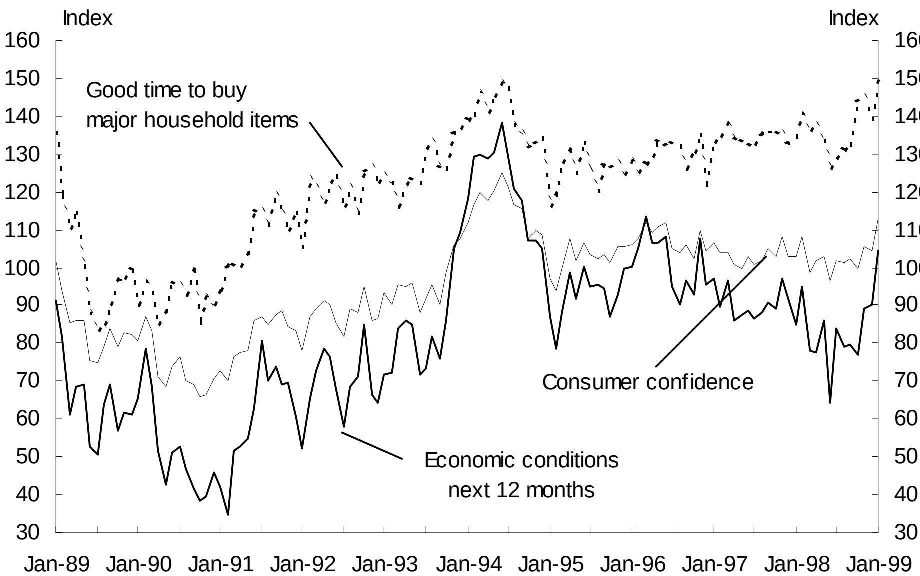
Household consumption expenditure rose 1.1 per cent in the September quarter, following growth of 0.7 per cent in the June quarter. Consumption of 'other services' contributed around 0.5 percentage points to growth in total consumption and retail contributed 0.3 percentage points.

Recent partial indicators suggest continuing growth in household consumption. The value of retail trade rose 0.3 per cent in November following a very strong 1.0 per cent increase in October. These results reflected growth over all sectors of retailing during this period, with the exception of household goods retailing. Over the year to November, current price retail trade grew by a strong 5.2 per cent. There are also anecdotal reports of strong pre-Christmas sales.

Motor vehicle registrations fell by 1.9 per cent in December following a strong rise of 7.3 per cent in November. Competition between the major car manufacturers for market leadership in 1998 contributed to car registrations reaching a record level. While car sales are unlikely to repeat the strong growth of 1998 in 1999, continued price competition, particularly in the small car market, and the release of new models should support motor vehicle registrations at high levels over coming months.

Consumer confidence improved markedly over the second half of 1998 after declining for much of the first half of the year (Chart 3). This improvement has continued into 1999 with consumer sentiment jumping sharply by 8.3 per cent in January to its highest level since September 1994. Consumers' assessment of the economic outlook over the next year is at a two year high. It is expected that recent interest rate cuts, rising real wages and solid employment growth will continue to underpin consumer confidence during at least the early part of 1999, which in turn will support household consumption. There has also been an improvement in consumers' assessment of whether it is a good time to buy a major household item — which may flow on to a recovery in the household goods retailing sector.

Chart 3: Consumer confidence



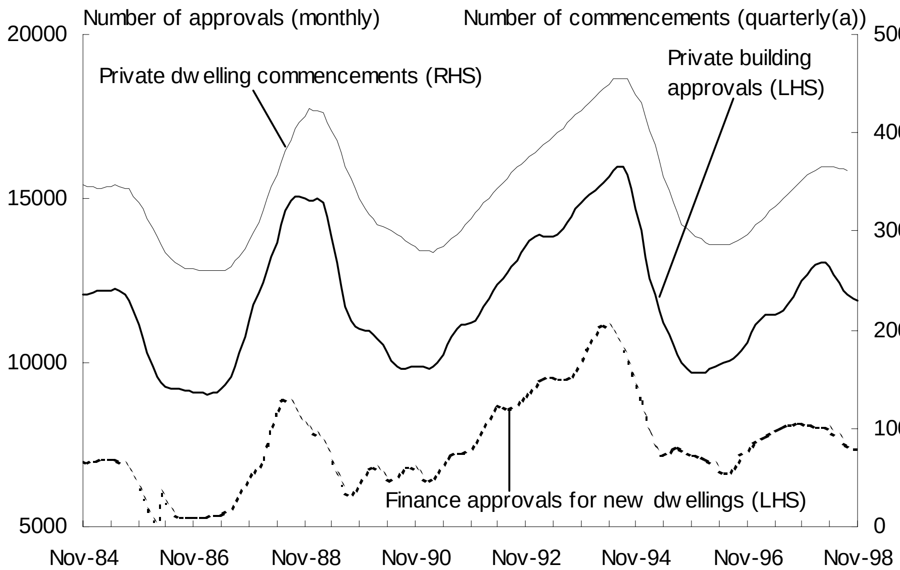
Source: Westpac-Melbourne Institute Consumer Sentiment index.

Dwelling investment

Dwelling investment fell by 2.2 per cent in the September quarter after rising for seven consecutive quarters. While the outlook is for a slightly weaker dwelling sector over coming quarters, there are some factors that should mitigate the extent of any decline in housing activity relative to recent experience (see Box 3).

Partial indicators of activity in the housing sector have moderated in recent months, but they remain at healthy levels (Chart 4). Finance approvals for new dwellings increased by 2.8 per cent in November following a rise of 2.1 per cent in October. The large fall in private building approvals in the September quarter is expected to lead to some weakness in total private commencements in the December quarter. Total private commencements fell by 0.5 per cent in the September quarter, after falling 0.2 per cent in the June quarter. Nevertheless, commencements remain close to the level that has pertained since the December quarter 1997. However, growth in building approvals has rebounded somewhat in recent months, growing by 0.3 per cent in November and 2.1 per cent in October, suggesting that commencements are likely to remain at high levels for some time yet. Furthermore, given the time taken between commencement and the completion of home construction, this relatively high level of commencements will sustain dwelling activity in coming quarters.

Chart 4: Trend indicators of dwelling activity



(a) Monthly data interpolated.
Source: ABS Cat Nos 8371.0, 8752.0 & 5609.0.

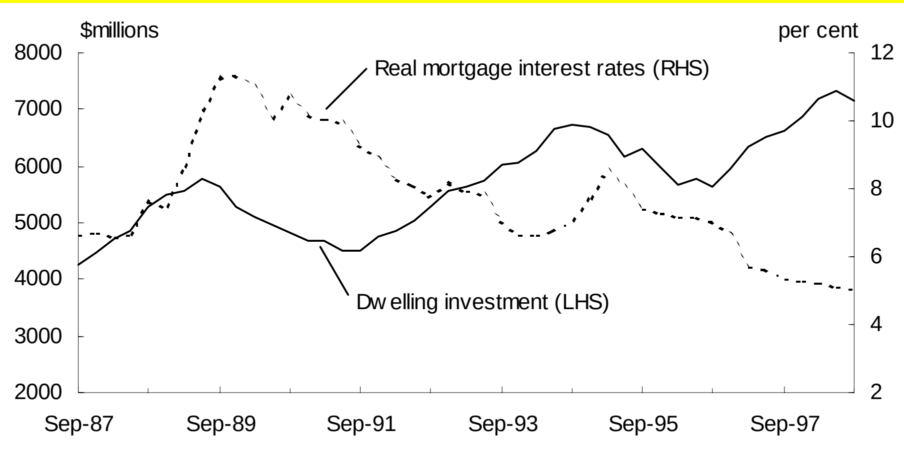
Underpinning these indicators of activity in the dwelling sector are positive fundamentals. The Commonwealth Bank/HIA index of housing affordability rose by 4.8 per cent in the September quarter to be 7.5 per cent higher than two years ago. The Citibank/REIA index of home affordability fell 2.3 per cent in the September quarter, however it remains close to its record level set in the March quarter. The factors underpinning affordability remain positive: household income is rising; house price inflation is moderate; and the indicator lending rate for banks' standard variable home loans is at its lowest nominal point since 1970 and its lowest point in real terms since the mid-1980s. Ongoing competition in the home mortgage market and the effect of the most recent reduction in official interest rates that occurred in December 1998 will continue to keep mortgage interest rates at these low levels.

Box 3: Dwelling investment cycle — Why it won't be as pronounced as the last

There are number of factors that should mitigate the extent of any slowing in housing activity relative to previous cycles.

A significant short-term influence on the housing sector is changes in interest rates. Chart 5 shows that, in the past two housing cycles, activity peaked as interest rates increased. However, in the current cycle, interest rates have remained very low while dwelling investment has reached a record level. As such, the prospect of ongoing competition in the home mortgage market and the effect of the most recent reduction in official interest rates in December 1998 should continue to support housing activity and result in a more moderate downturn compared with previous cycles. Solid growth in household disposable income and moderate house price inflation should also ensure that housing affordability remains high.

Chart 5: Dwelling investment and interest rates



Source: ABS Cat. No. 5206.0 and RBA Bulletin.

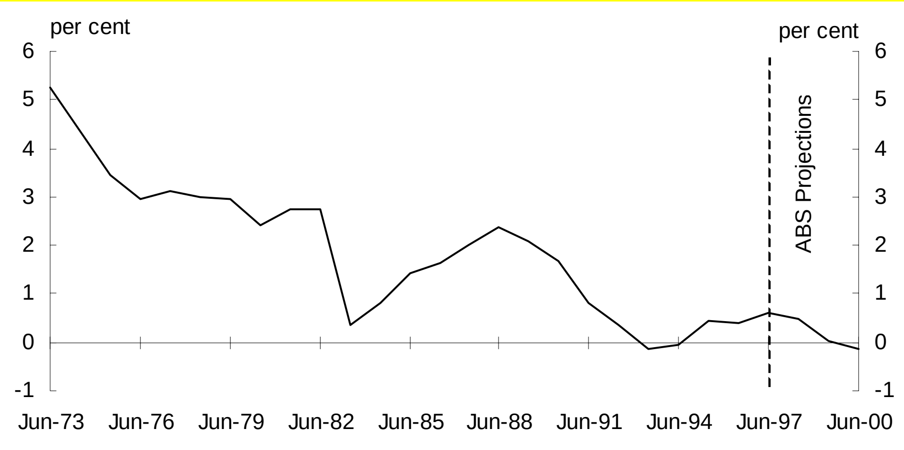
Against this, slower population growth across the age cohort traditionally considered to be the key household forming age group will constrain activity in the current cycle. Chart 6 shows that projected growth in the 26-35 year old cohort over the next few years is relatively weak. On the other hand, changing social trends (such as increased divorce rates since the 1970s) and strong demand from 'baby-boomers' suggest that the significance of this cohort may be waning.

Continued

Box 3: Dwelling investment cycle — Why it won't be as pronounced as the last (continued)

A further distinguishing characteristic of the current cycle relates to the value of home construction. The real average unit value of dwelling commencements is at a historically high level – reflecting a long-term structural trend toward larger and more expensive housing. This has contributed to dwelling investment reaching record levels despite the number of commencements being around 18 per cent below the peak of the previous cycle (Chart 4).

Chart 6: Growth in 26-35 age cohort



Source: ABS Cat. Nos 3201.0 and 3222.0.

While it is difficult to form an assessment of the level of underlying demand for housing, demand in the near future is unlikely to fall significantly because of high affordability and moderately supportive demographics. As a result, activity in the housing sector could remain around levels close to the average long-term underlying demand for housing after the peak of the cycle passes, largely avoiding the boom-bust pattern of recent cycles.

Business investment

Private business investment rose strongly, by 8.5 per cent, in the September quarter following a 13.3 per cent fall in the June quarter. New private business investment, which abstracts from the effects of purchases of second hand assets from the public sector,[1] increased by 7.8 per cent in the quarter, following a fall of 4.6 per cent in the June quarter. New equipment investment (abstracting from asset sales) also rebounded strongly, rising by 11.3 per cent in the quarter, after a fall of 5.7 per cent in the June quarter. New buildings and structures construction (abstracting from asset sales) rose by 5.5 per cent in the September quarter, after a fall of 4.2 per cent in the June quarter.

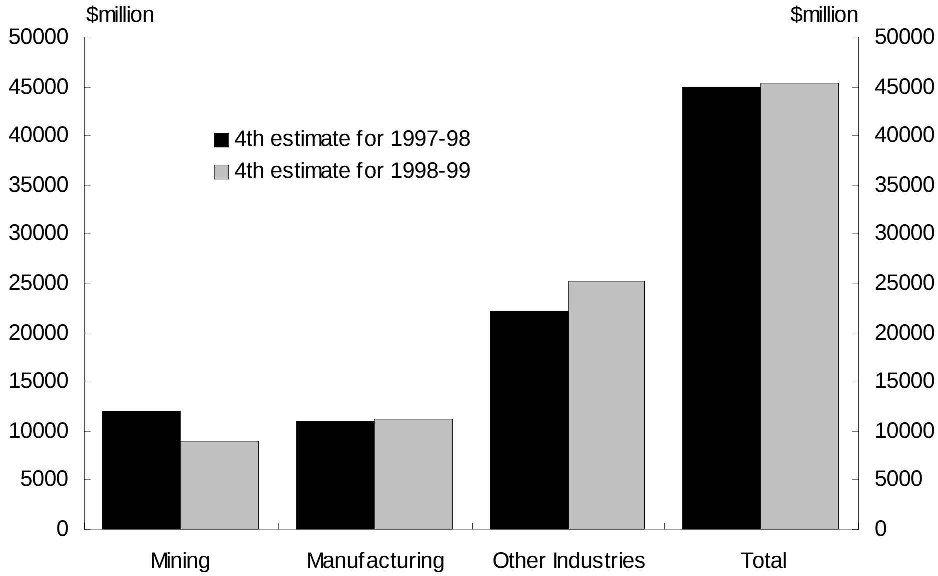
The most recent survey of investment intentions, the ABS *Private New Capital Expenditure* survey taken in October/November 1998, suggests that plant and equipment investment will remain at a high level in 1998-99. The fourth estimate of plant and equipment investment was in line with both the equivalent estimate last year and the previous estimate for 1998-99. When the 5-year average realisation ratio (the ratio of actual to expected investment) is applied to these investment intentions, it implies a broadly unchanged level of plant and equipment investment in 1998-99 relative to 1997-98 in current price terms.

Investment intentions for non-residential construction were 6 per cent above the equivalent estimate last year and are in line with the previous estimate for 1998-99. When the 5-year average realisation ratio is applied to these investment intentions, it implies growth of around 12 per cent in non-residential construction in 1998-99 in current price terms.

Chart 7 shows that, while the fourth estimate of overall investment intentions are in line with the equivalent estimate last year, there are considerable differences between industries. Mining investment intentions are much lower than the equivalent estimate last year, while investment intentions in the ‘other industries’ category (which includes the transport, telecommunications and construction industries) are well above the equivalent estimate last year. Investment intentions in the manufacturing sector are almost identical to the corresponding estimate last year.

1 The transfer of ownership of some assets between the public and private sectors can have a significant effect on published estimates of business investment and public final demand. Such asset sales will have no effect on aggregate activity, but can provide a misleading view of movements in individual components. For this reason, it is preferable to abstract from such influences when interpreting fundamental movements in economic activity.

Chart 7: Expected private new capital expenditure, by industry



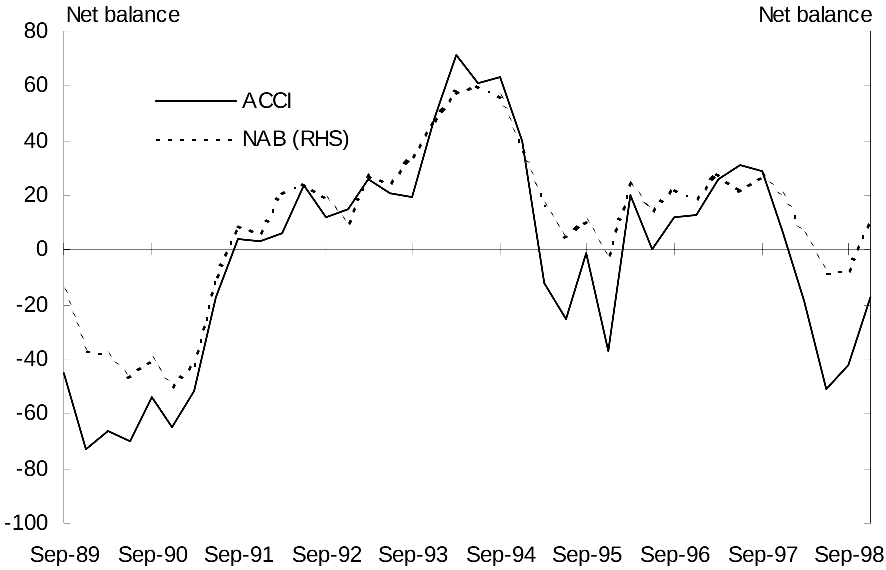
Source: ABS Cat. Nos 5625.0 & 5646.0.

Some care needs to exercised in interpreting the anticipated changes in the level of mining investment. Investment in that sector has grown strongly over the last four years and a slowing in investment in line with the maturing of the sector's investment cycle is to be expected. In addition, some moderation in mining investment seems to be consistent with the weakness in commodity prices and world demand. While long-term returns determine the viability of mining investments, short-term market conditions may influence judgements as to the optimal timing of investments. It is important to note that there are several major investment projects which have been deferred rather than cancelled, which implies that the investment will occur at a later time. Importantly, in the short term, the level of investment undertaken in the mining industry will be supported by projects currently under construction.

Partial indicators of non-residential construction activity are consistent with the investment intentions data in that they point to high levels of activity in 1998-99. Finance commitments, while volatile on a monthly basis, were at supportive levels for the September quarter. Building approvals were at strong levels over the June and September quarters. Recent strength in office, retail and other business premises commencements should support activity in the medium term. Activity will also be underpinned by continued work on large projects such as the Eastern Distributor, although the deferral of some large mining projects will reduce engineering construction activity.

The latest major business surveys generally suggest that businesses are becoming more confident about the outlook for business conditions. Firms are generally confident about future levels of activity for their own business, as evidenced by the solid outlook for sales, output and profits across the majority of business surveys. Such assessments are likely to be supportive of business investment decisions. Importantly, there has been a step-up in measures of business confidence after the sharp downward movement in the middle of 1998 (Chart 8). These sharp falls coincided with considerable negative press coverage of the possible fallout for Australia from the crisis in parts of Asia.

Chart 8: Business confidence



Source: ACCI/Westpac Survey of Industrial Trends & NAB Business Survey.

The *Australian Chamber of Commerce and Industry (ACCI)/Westpac Survey of Industrial Trends* and the National Australia Bank's *Quarterly Business Survey* for December recorded a strong rebound in measures of business confidence from the low levels of mid-1998. The most recent *Yellow Pages Small Business Survey* for November (which surveys firms employing no more than 19 people) also recorded an improvement in business confidence to around the strong levels of a year ago.

Public final demand

There were revisions to public final demand in the September quarter National Accounts, with public final demand growth in 1997-98 revised upwards from -0.1 per cent to 2.6 per cent.

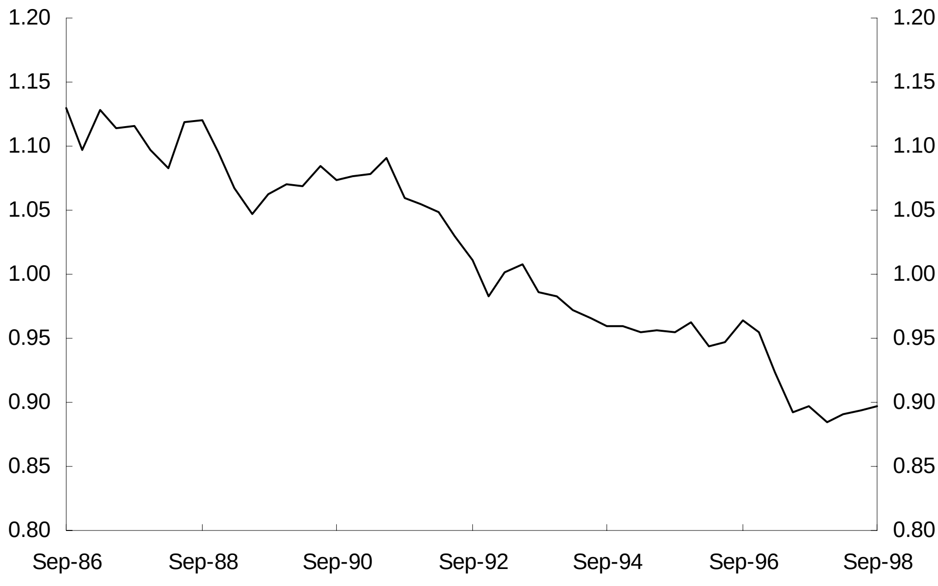
Coming on top of this revision, underlying public final demand (i.e., abstracting from the impact of second hand asset sales to the private sector) was broadly flat in the September quarter, rising by 0.1 per cent. However, underlying public final demand is expected to rise strongly over 1998-99 as a whole, driven primarily by strong growth in public gross fixed capital expenditure. The main contributions to public investment growth in 1998-99 are currently expected to be from both the Commonwealth public enterprise sector and State/local sectors, including Olympics-related construction.

Inventories

Private non-farm inventory volumes recorded solid growth in the September quarter following strong growth in the March and June quarters. However, inventories made a negligible contribution to GDP growth in the September quarter as the rate of growth was similar to that recorded in June. Growth in manufacturing and wholesale trade inventories accounts for most of the strength in private non-farm inventories growth over 1998, while retail trade and other non-farm inventories have remained broadly steady over the same period.

The current price inventories to sales ratio increased steadily over the first three quarters of 1998 as inventories growth exceeded sales growth (Chart 9). However, this followed a substantial fall in the inventories to sales ratio from early 1997, suggesting that some of this growth may have been intended to return inventories to desired levels. The inventories to sales ratio in the September quarter 1998 was the same as that recorded in the September quarter 1997.

Chart 9: Inventories to sales ratio



Source: ABS Cat. No. 5206.0.

Farm and public marketing authority inventories detracted slightly from growth in the September quarter, continuing the unwinding of the March quarter build-up as grain stocks were shipped later in the crop year than usual. Other public authorities stocks also detracted slightly from growth in the September quarter.

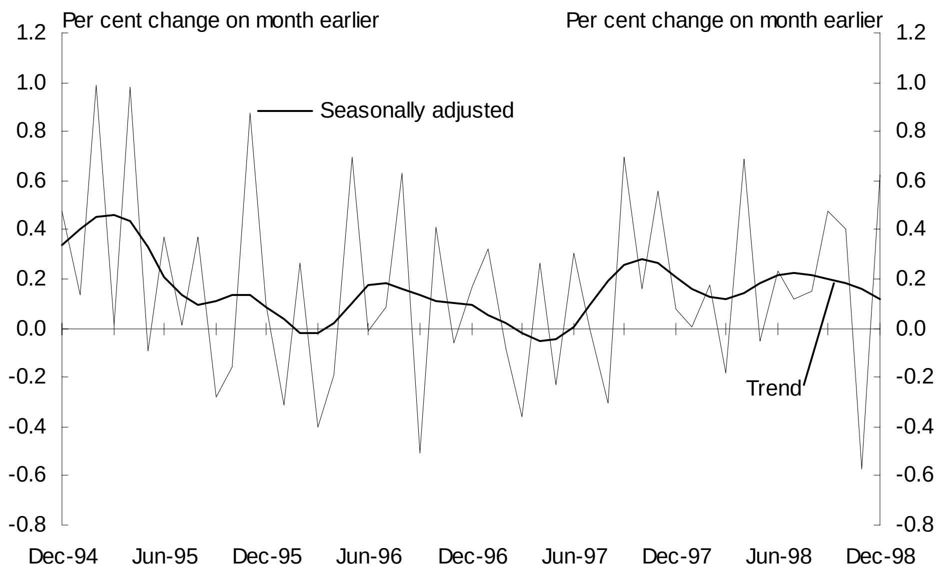
Labour market

Employment grew 0.6 per cent in the December quarter, following a 0.5 per cent rise in the previous quarter. The unemployment rate fell to 7.5 per cent in December, the lowest figure since September 1990. The number of unemployed is the lowest since December 1990. The participation rate was unchanged at 63.2 per cent, equal to its average value over the last decade.

Monthly labour force estimates can be considerably volatile on a month to month basis (Chart 10). This volatility was highlighted in the three months to December, where employment rose strongly in October (35 200) and then fell sharply in November (49 800), before rising very strongly in December (53 600).

In trend terms, which abstracts from this volatility, employment has been growing steadily as a result of the strong economic growth over the past year or so. While the pace of growth in employment slowed in the second half of 1998, trend unemployment has been falling for six months and fell to 7.7 per cent in December 1998, its lowest value since October 1990.

Chart 10: Monthly growth in employment

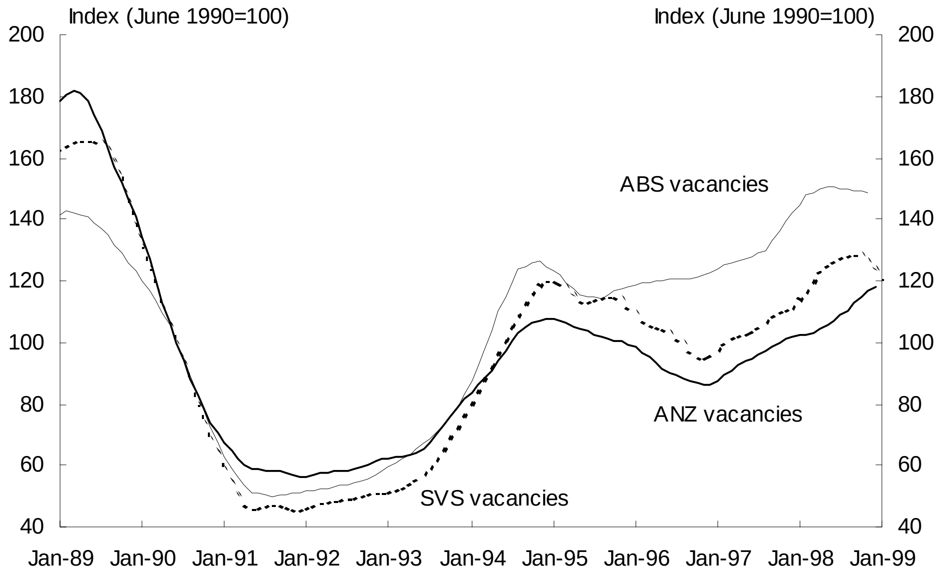


Source: ABS Cat. No. 6202.0.

The near-term outlook for the labour market remains positive (Chart 11). The high level of the various job vacancies series points to further growth in employment in the months ahead. The ANZ series is at its highest level since

February 1990, the Skilled Vacancy Survey (SVS) is at a high level and the ABS's measure of job vacancies is close to its highest level on record.

Chart 11: Job vacancies series (trend)



Source: ABS Cat 6354.0; DEWRSB Skilled Vacancy Series; ANZ Job Advertisements Series.

A recent feature of the labour market has been high rates of measured labour productivity growth (see Box 4). A cyclical slowing in productivity is expected after the recent period of very strong growth.

Wages

Wages are forecast to grow by 4 per cent in year-average terms in 1998-99 on a National Accounts basis, broadly similar to growth in 1997-98. Despite a very strong September quarter, growth in average weekly ordinary time earnings for full-time adults (AWOTE) in through-the-year terms was 4.2 per cent. Over the course of the 1998-99, wages growth is expected to moderate slightly, reflecting some slowdown in economic activity.

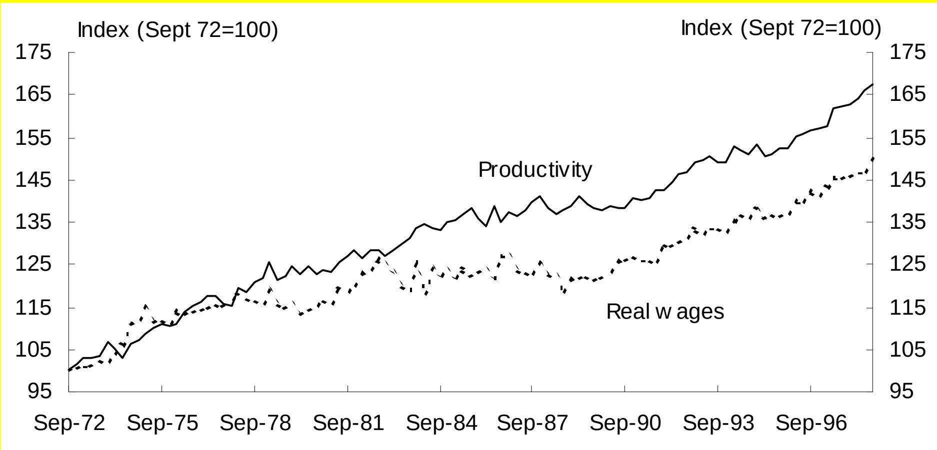
Box 4: Australia's labour productivity performance

Measured labour productivity in Australia has grown strongly in recent years, increasing on average by around 4 per cent per annum since late 1995, compared with an average productivity performance of around 2 per cent per annum over the last twenty years.

The benefits to the economy of the recent strong productivity performance are widespread. The strong growth in labour productivity over the last two years in particular, coupled with moderate growth in nominal wages, has contributed to the maintenance of low inflation, providing a direct benefit to consumers and business.

Real wages have increased relatively strongly during the 1990s, without putting significant upward pressure on real unit labour costs (Chart 12). This, in turn, has contributed to the strong growth in corporate profitability over this period. Increases in real wages have also supported growth in household income, which has contributed to ongoing growth in consumption spending.

Chart 12: Labour productivity and real wages



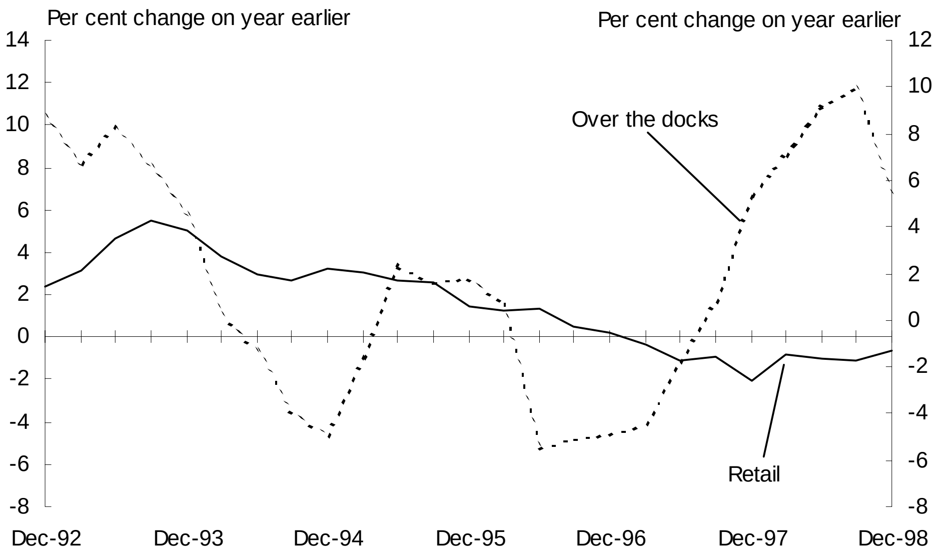
Source: ABS Cat. No. 5206.0

Ongoing reform in the labour market should reinforce the improvement in productivity. However, some cyclical slowing in productivity growth is expected in 1998-99 as employment continues to grow solidly in response to the stronger activity in 1997-98, and output growth slows as a result of the Asian crisis.

Prices

The All Groups Consumer Price Index increased by 1.6 per cent in the year to the December quarter 1998, with underlying inflation also remaining at 1.6 per cent. Prices of private sector goods increased by 0.2 per cent in the quarter and by 1.0 per cent over the year, while private sector services increased by 1.0 per cent in the quarter and 2.7 per cent over the year. Prices of wholly or predominantly imported goods fell by 0.7 per cent in the December quarter, the third consecutive fall. Continuing competitive pressures (reflecting both domestic and international factors) have been an important influence in subduing the pass-through of higher import prices (Chart 13).

Chart 13: Import prices and inflation



Source: ABS Cat. Nos 6444.0 & 6414.0.

Current account

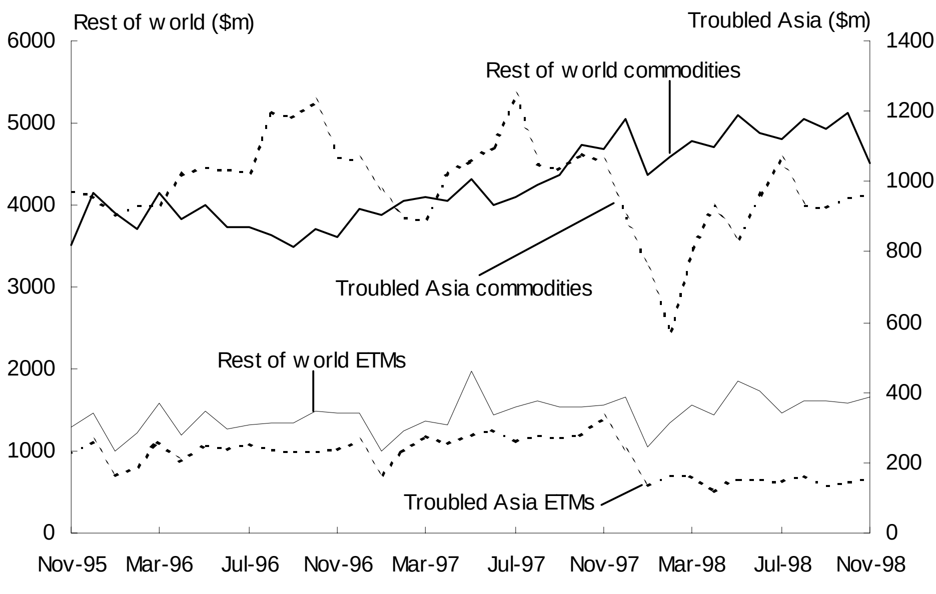
The current account deficit (CAD) was $7.3 billion in the September quarter 1998, or around 5 per cent of GDP on an annualised basis. This result reflected a significant increase in the goods and services deficit as well as a slight increase in the net income deficit. In volume terms, net exports contributed positively to growth in the quarter with slight growth in export volumes and a marginal fall in import volumes. However, while export prices were reasonably flat import prices increased, leading to a deterioration in the terms of trade. Hence, although in volume terms the balance on goods and services improved in the September quarter, in current price terms there was a significant deterioration.

The diversion of exports away from some Asian markets experienced since late 1997 has continued throughout 1998, although to different extents for commodity and non-commodity exports. In the three months to November 1998 the value of commodity exports was 2.6 per cent higher than the same period in 1997 (as shown in Chart 14). Exports of commodities to Korea, Indonesia, Malaysia, the Philippines and Thailand were down 10.3 per cent with commodity exports to the rest of Asia (excluding Japan) down 14.4 per cent. However, commodity exports to the rest of the world and Japan were up 21.5 per cent and 0.5 per cent respectively.

Abstracting from exports of non-monetary gold, the value of commodity exports in the three months to November 1998 was 1.1 per cent lower than the same period in 1997. Commodity exports less gold to Korea, Indonesia, Malaysia, the Philippines and Thailand were down 9.0 per cent over this period, with the value of these exports to Japan and the rest of Asia down 1.9 per cent and 9.8 per cent respectively. However, exports of commodities less gold to the rest of the world were up 7.9 per cent.

In contrast to commodity exports, exports of elaborately transformed manufactures (ETMs) have declined 3.6 per cent, with decreases in exports to most of our major ETM markets in Asia only partially offset by an increase to the rest of the world of 11.9 per cent.

Chart 14: Exports by destination and type



Source: Unpublished ABS data.

The downturn in Asia continues to affect the tourism industry with total arrivals in the three months to November 1998 down 3.0 per cent compared with the same period twelve months earlier. Arrival numbers from Korea, Indonesia, Malaysia, the Philippines and Thailand fell 34.4 per cent over this period, but were partially offset by an increase in arrivals from the rest of the world of 1.8 per cent (most notably from New Zealand, Europe and the United States). International tourism will start to benefit from Australia's rising profile as the 2000 Olympics approaches.

Recent monthly trade data suggest that the balance of trade component of the current account in the December quarter will be weaker than the previous quarter, leading to a deterioration in the current account deficit. This in part reflects the weaker international environment. Such a deterioration in the current account deficit was foreshadowed in the updated forecasts contained in the *Mid-Year Economic and Fiscal Outlook 1998-99*. However, compared with previous episodes of a deterioration in the current account deficit, particularly in the 1980s, Australia now has a vastly improved set of economic fundamentals to withstand any deterioration in the trade balance. Macroeconomic policy now operates in a sound and transparent framework, with the mix of policy (i.e., fiscal consolidation and credible monetary policy) accommodating the depreciation of the Australian dollar while also delivering low inflation and low interest rates.