Economic Overview

Australia's strong economic performance continued into 1999 with the economy achieving its sixth consecutive quarter of growth of one per cent or greater in the March quarter.

The strength of growth in the March quarter, together with a significant upward revision to growth in the December quarter, means that growth in 1998-99 will be somewhat higher than the 4¼ per cent forecast in the Budget.

Recent partial indicators, including surveyed intentions for business investment, are consistent with the Budget's forecast of a moderation in the rate of growth in 1999-2000 to 3 per cent. This reflects, in part, the direct and indirect effect of below-trend growth in the world economy since 1998, which has resulted in slower growth in Australia's export volumes and a moderate decline in the terms of trade. With indications that economic growth is resuming in Asia, world economic growth is expected to stabilise in 1999 and to strengthen in 2000. As a result, the outlook for Australian growth overall is for a pick-up over the course of 1999-2000, with improved prospects for the export sectors in particular.

Some discussion of the likely impact of the Asian financial and economic crisis on the different sectors of the Australian economy was contained in the Summer 1998 edition of the *Economic Roundup*. It was concluded that sectors with exposure to Asia through exports would be most affected, but that the impact of the slowdown in Asian demand on export volume growth would be ameliorated by several factors including the strength of other important world markets. Importantly, it was also noted that strong growth in domestic demand would provide considerable support for overall economic growth over the ensuing eighteen months.

This Overview revisits that analysis to focus on how various sectors of the economy have fared during the two years since the Asian crisis began to unfold. The strength in domestic demand has continued and, as a result, most sectors of the economy have experienced strong growth over the past two years. However, export oriented industries have been hurt by the slower world growth.

DEVELOPMENTS IN THE WORLD ECONOMY

The release of first quarter national accounts data for many economies, and more recent indicators, have confirmed a gradual strengthening in world economic growth since the beginning of the year.

The remarkable strength of the United States' economy has continued in the first half of 1999, while first quarter growth in Europe has shown a modest rebound from a weak last quarter of 1998. In Japan, positive growth returned after five successive quarters of contraction, with an unexpectedly strong result reported for the first quarter of 1999. While this number is unlikely to reflect underlying activity, there are indications of stabilising activity and improving business sentiment. In other East Asian economies, the recovery seen in recent quarters continues to strengthen with strong first quarter growth reported in several regional economies, most notably Korea. Regional financial markets are also reflecting increasing investor confidence. Improved confidence has returned in other emerging markets, most notably in Latin America, where a positive first quarter growth result and better-than-expected inflation outcomes have been reported in Brazil.

The momentum of the **United States'** economy has continued into the first half of 1999, with few signs as yet of the long-anticipated slowdown in activity. While recent data have raised some prospect of a moderation in growth in housing investment, there is increasing evidence that a recovery may be underway in the manufacturing sector. Moreover, record high levels of consumer confidence, on the back of further strong employment growth and stock market gains, continue to buoy consumption growth.

Despite this underlying strength, growth is still expected to moderate over coming quarters. This expectation rests broadly on an increasing tightness in supply side conditions, with pressure in the labour market, increases in energy prices and firming prices in other commodities, and a moderate tightening expected in financial conditions.

Very strong productivity growth — 2.6 per cent through the year to the first quarter 1999 — continues to sustain current GDP growth rates despite increasing supply constraints, without raising inflationary pressures. Recent consumer price index data continue to show inflation as subdued, a picture that is reinforced by broader indicators of inflationary pressure, including labour costs.

The US Federal Reserve tightened US monetary policy at its 30 June Federal Open Market Committee meeting, raising the official interest rate target by a quarter of a percentage point to 5 per cent. The Committee said that the return to stability in US financial markets had enabled it to reverse part of the interest rate cuts made in response to the instability experienced from September to November 1998. However, the move also reflects the clear potential for the inflation outlook to deteriorate over coming quarters if activity does not slow of its own accord and current productivity growth rates are not sustained. To this end, the increase in interest rates should, to some extent, contribute to a necessary slowing in activity. However, the US economy could continue to outperform expectations, particularly if it is experiencing a significant structural improvement in productivity growth.

First quarter national accounts data for **Japan** reported growth of 1.9 per cent in the quarter — a result beyond even the most optimistic of expectations. The surprisingly large increase follows five successive quarters of contraction and raised Japan's growth rate to 0.1 per cent through the year to the March quarter, from a fall of 3.0 per cent through the year to the December quarter. Nevertheless, while there have been recent signs to suggest some improvement in economic conditions, the first quarter result would appear to overstate the degree of underlying improvement.

Growth in the first quarter was evenly divided between growth in public and private demand, with a small detraction coming from net exports. While the increase in public demand had been broadly anticipated following the fiscal stimulus package announced in November last year, there was little in the partial indicators to suggest that private demand would also provide a significant positive contribution to growth. Private final consumption was reported to have grown by 1.2 per cent in the quarter, while non-residential private investment was up by 2.5 per cent and residential investment by 1.2 per cent.

That said, there have been some recent signs in the partial indicators that the deterioration in the economy may be bottoming. The Bank of Japan's June Tankan survey of business expectations reported an improved outlook across both manufacturing and non-manufacturing enterprises, whilst the rate of decline evident in industrial production since mid-1997 has stabilised since the start of the year. Recent reporting also suggests that there has been some improvement in household expenditure levels, even though household incomes continue to fall. Further, the ongoing recovery in other East Asian economies will provide support for Japanese exports to the region over coming months.

Questions surround the sustainability of the recent reported improvement in business confidence and consumer expenditure, particularly given that the bulk of last year's fiscal stimulus packages now appear to have been largely expended.

Japan's current economic difficulties are predominantly a result of domestic structural problems which will need to be addressed if Japan is to achieve strong and sustainable growth rates over the medium to longer term.

First quarter growth in **Europe** was solid (at 0.5 per cent in the quarter), representing a modest but promising strengthening in activity after the weakness recorded in the last quarter of 1998. While industrial production remains subdued overall, a broad strengthening in business investment and a pick-up in forward orders in Germany suggest the outlook is for steady improvement. Other indicators from Germany, France and the United Kingdom appear consistent with accelerating European growth in the second half of 1999, assisted by supportive monetary conditions and improving external demand. While weakness has persisted in Italy, a gradual improvement in growth is anticipated over coming quarters.

GDP growth in **Germany** rebounded (to 0.4 per cent) in the first quarter of 1999, although some of the growth reflected temporary factors such as strong Easter consumption and government spending on the Kosovo conflict. Strong new orders data and increasing external demand suggest that industrial production may be set to strengthen, while there are tentative indications that business sentiment may be improving.

Economic growth in the **United Kingdom** was flat in the first quarter of 1999, with a slowing in the services sector and persistent weakness in manufacturing. However, recent data point to the prospect of growing domestic demand, with the weakness in manufacturing showing signs of stabilising, household consumption improving, consumer credit demand increasing and the housing market picking up. Demand should also be supported over coming quarters by the significant easing in monetary policy since October 1998.

The momentum of **New Zealand's** recovery continues to strengthen gradually with robust growth (of 0.7 per cent) recorded in the first quarter this year. The strengthening recovery reflects recent improvements in consumer and business confidence, stronger export growth and supportive monetary conditions.

While significant uncertainty remains, the outlook for the emerging market region of Latin America has improved on the back of an improvement in investor confidence and in financial conditions, as well as a firming in commodity prices. In **Brazil** — the largest economy in that region — recent data have shown strong growth in the first quarter with decelerating inflation. While the Brazilian economy is still expected to contract this year following the severe financial market instability of late 1998 and early 1999, the implementation of IMF-backed fiscal and monetary reforms and the recent easing in monetary policy, have brought forward the prospect of a sustained recovery.

The release of strong first quarter data in many of the Asian economies has been encouraging. However, despite these results, it is premature to expect a rebound to sustained rates of growth similar to those experienced pre-crisis, particularly given the still significant structural barriers that many of the economies face.

In **Korea** there has been further evidence of a strengthening in economic activity, with GDP growing strongly (by 4 per cent) in the first quarter of 1999. This result builds on the steadily improving growth recorded in the previous two quarters.

Strong growth in private consumption and a solid recovery in machinery and equipment investment have been important contributors, but the slowing in the rate of stock depletion continues to be a significant factor behind the turnaround. That said, with some tentative signs that construction activity may provide support to growth over coming quarters, combined with a continuation of strong export growth, the prospects for more broadly-based growth in Korea remain encouraging. The positive outlook is reinforced by a continuation of expansionary monetary and fiscal policy settings.

Indonesia is also showing signs of improved economic activity, with preliminary second quarter GDP data showing continued strong growth of around 5 per cent in the quarter. This follows on from the strong growth recorded in the first quarter, which signaled Indonesia's emergence from the severe recession experienced in 1998. While this recent growth is strong, it is coming off a low base, and the economy has some way to go before it reaches the level of activity experienced pre-crisis.

While political and economic disruption will continue to pose the greatest risks to recovery in Indonesia, it is expected that the economy will enjoy a more broadly-based recovery later in the year. This outlook is supported by increasing levels of investor confidence and the accommodative monetary and fiscal policies that the Government is pursuing. Expansionary fiscal policy in particular is expected to be more effective in stimulating activity given the improved frameworks for the disbursement of funds that have now been put in place.

In **Thailand**, GDP increased again in the first quarter (by 1.6 per cent), albeit at a slightly slower rate than in December. It has been investment rather than a consumption or external stimulus that has provided for a return to economic growth. This has been supported by recent partial data on manufacturing and private investment, but the outlook for consumption activity continues to be mixed. However the recent reduction in the consumption tax rate from 10 per cent to 7 per cent, combined with the accommodative monetary policy and higher expenditure targets, should see consumption growth provide further support to economic activity later in the year.

Both **Malaysia** and the **Philippines** recorded growth (of 2.4 per cent and 1 per cent respectively) in the first quarter. This was Malaysia's second quarter of growth following the recession in 1998. Investment growth, and increased external demand have been the most important factors behind the improvement in economic activity. However, consumption remains subdued in both economies. Stronger consumption growth seems likely later in the year, as ongoing improvements in business and consumer confidence and stock markets combine with expansionary fiscal and monetary policies to provide a more broadly-based recovery.

Singapore has rebounded strongly since the mild recession experienced in mid-1998. The March quarter national accounts revealed a strong recovery (of 1.7 per cent in the quarter), which followed the return to growth recorded in the December quarter. Singapore has enjoyed a more broadly-based recovery, with both consumption and investment growing strongly. The stronger domestic economy was accompanied by stronger trade activity, however the strong recovery in imports outweighed the improvements in export growth, leading to a detraction in growth from net exports.

Taiwan's March quarter national accounts revealed solid GDP growth (of 1 per cent in the quarter), primarily led by a strong recovery in exports. Recent partial data show retail sales and industrial production returning to strong growth and, with ongoing improvements in export conditions, domestic demand should recover more strongly.

Hong Kong has been hard hit by the regional crisis, with the March quarter national accounts revealing the sixth consecutive quarterly contraction in GDP (by 0.8 per cent in the quarter). Domestic demand remains flat and there are few signs of a pick-up in exports. Property prices also continued to fall heavily in the March quarter. With the Hang Seng Index growing strongly since September 1998, and an improvement in regional trading conditions, a return to growth is expected in the second half of 1999.

China's growth is still relatively robust, but it is expected to slow during the course of 1999. The Government's objective of 7 per cent growth is still achievable but hinges largely on the Government's fiscal stimulus. The infrastructure spending program is now winding up and its stimulus to activity will decline as the year progresses. This slower investment growth is occurring at a time when private consumption growth is relatively soft. However recent moves by the central bank to reduce deposit rates should help to provide some support to consumption.

The trade surplus is running at around one-third the rate of last year, but foreign direct investment is only marginally lower than last year and foreign exchange reserves are high and are being maintained. The most recent import and export data show a strong surge in imports growth, with only a moderate pick-up in exports. However, the improved regional recovery should see increases in China's exports and improvements to its economy more generally. These will be important given that there is no early prospect of domestic drivers of growth taking over.

As with many other Asian economies, the medium and longer-term growth prospects will be improved through significant reforms to both the financial and corporate sectors of the economy. In China, whilst the leadership is committed to reform, one of their quandaries is that the short-term dislocation and disruption which can be part of the reform process can also lead to an increase in unemployment during the adjustment period.

This is a problem that most of the Asian economies will face as they embark upon crucial reforms to remove or reduce the structural impediments to higher growth.

Box 1: Structural reform progress in the Asian region

Whilst there is much reform that remains to be done, considerable progress has been made over the past eighteen months, particularly with regard to the implementation of the IMF's reforms in Korea, Indonesia and Thailand. This progress has been instrumental in the return of investor and consumer confidence, as evidenced by recent stability in exchange rates and falls in the premium charged by the markets for much needed capital. In terms of financial sectors there have been two key common elements to the reform programs: crisis management measures; and measures aimed at strengthening and improving their general operation.

Crisis management was required to deal with the large short-term external liabilities of financial institutions. In Korea, it was implemented through an agreement between domestic banks and their foreign creditors to exchange the original debt obligations for government-guaranteed debt of longer maturity. In Indonesia and Thailand, financial sector foreign debt obligations were initially met through the use of foreign exchange reserves and funds made available under the IMF program, and by encouraging the roll-over of short-term debt as it matured. In Indonesia authorities also forged an agreement with creditors to restructure their debt obligations.

In all three program economies, many institutions were either closed or merged, while measures have been put in place to recapitalise the financial institutions that have been deemed viable. Recapitalisation, to date, has occurred mainly through the use of public funds, which has resulted in a large increase in government ownership of financial institutions. In addition, asset management corporations have been established to purchase and auction off the non-performing loans of weak financial institutions. This will help to strengthen the balance sheets of the surviving institutions and, importantly, make them more attractive to private sector investors, which will be crucial to the next stage of financial sector restructuring. Although not subject to an IMF adjustment program, Malaysia has also undertaken similar steps in its financial sector.

An equally important part of financial sector restructuring has been measures taken to strengthen and improve the operation of financial sectors in the crisis economies. Inadequate prudential regulation and supervision, and the legacy of a long history of government intervention in the allocation of credit, had left financial institutions ill equipped to assess, price, and manage risk in an increasingly open environment. Actions to address these problems have focused on improving loan classification and provisioning standards, capital adequacy requirements and foreign exchange exposure limits. Steps have also been taken to improve accounting standards and tighten disclosure requirements for financial institutions.

Box 1: Structural reform progress in the Asian region (contd)

The other key focus of structural reform has been the corporate sector. In the three IMF program countries, a number of legal and regulatory reforms have been initiated to facilitate corporate restructuring and enhance corporate governance. Examples include the elimination of cross-debt guarantees in the Korean chaebols and the amendment of bankruptcy and foreclosure regulations in Thailand to better define the rights of creditors and debtors.

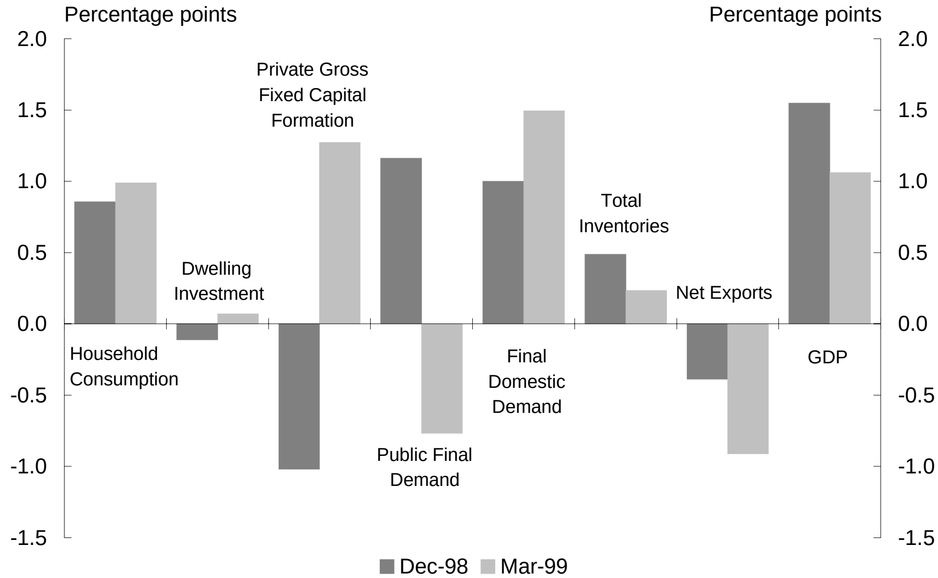
Corporate reform will be crucial for the successful resolution of the problems in the financial sector as the inability of the corporates to service large debts in the face of the recession and initially high interest rates was a major factor in undermining the health of the financial sector. In the IMF program countries, voluntary debt work-outs have taken place between corporates and their creditors, which has involved creditors keeping lines of credit open to firms that are deemed viable while requiring them to submit rehabilitation plans. Firms deemed unviable have had their lines of credit cut, which has inevitably forced them into bankruptcy. In Indonesia, where the corporate sector accounted for a large proportion of foreign debt, an agreement on debt restructuring was negotiated with foreign creditors, which led to the establishment of a government exchange guarantee scheme, complemented by a set of non-binding guidelines for debt work-outs with domestic and foreign creditors.

There will be substantial benefits for these countries if they remain committed to their structural reform programs. More appropriate foreign and domestic debt structures will mean that the financial and corporate sectors will be less vulnerable to slowdowns in activity and changes in market sentiment. As commercial considerations become more important in the allocation of resources by financial institutions and corporates, there will tend to be a more efficient use of the nation's resources. These factors are likely to mean that in the future growth will be based more on improvements in productivity, rather than capital accumulation, and as such will be more sustainable.

DOMESTIC ECONOMY

The strong performance of the Australian economy has continued into 1999. The March quarter National Accounts recorded that the economy grew by 1.1 per cent in the March quarter of 1999 and by 4.8 per cent through the year to the March quarter. Activity in the quarter was underpinned by strong growth in private demand, in particular in household consumption and business investment. Dwelling investment also increased solidly after declining over the previous six months. Net exports detracted from growth in the quarter, with the recent strength in domestic demand inducing a significant rise in import volumes and slow world growth contributing to a small fall in export volumes.

Chart 1: Contribution to growth in the March quarter



Source: ABS Cat. No. 5206.0.

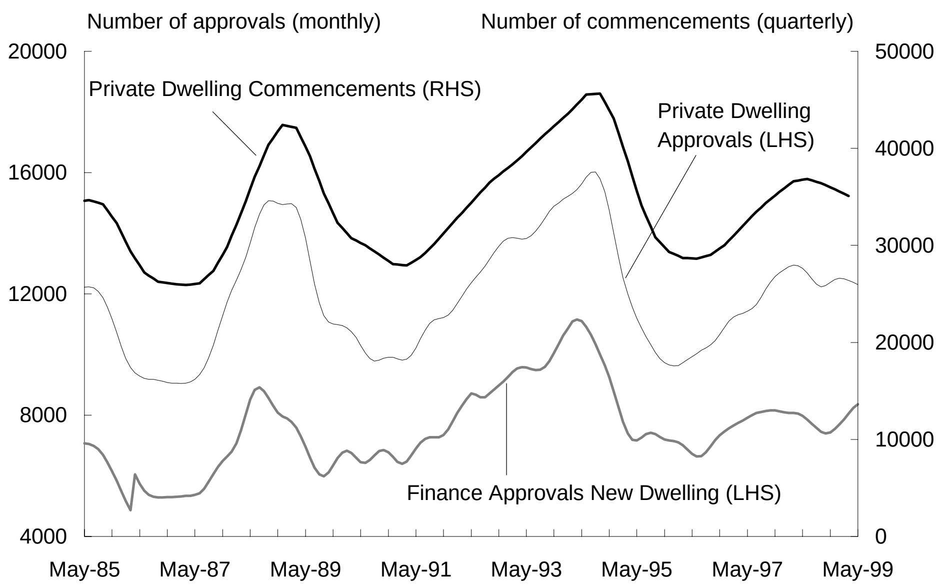
The strong rebound in **business investment**, which grew by 9.6 per cent in the quarter reversing most of its large fall in the previous quarter, was the outcome of particularly strong machinery and equipment spending — up 21.6 per cent. Machinery and equipment spending alone contributed 1.5 percentage points to growth. In contrast, spending on building and construction fell by 9.2 per cent in the March quarter.

The most recent ABS *Private New Capital Expenditure Survey* (CAPEX survey) reported that investment intentions for 1999-2000 were about one-fifth below intentions for the equivalent estimate in 1998-99. There was significant variation between sectors, with responses from the mining sector, for example, pointing to sharp falls in investment (this is discussed in more detail below). Non-residential construction expectations were down by one-third. The ABS noted that comments from businesses suggested the reduction in the level of expected expenditure in 1999-2000 was due to several factors including: the deferral of new mining projects because of low commodity prices; Y2K compliance diverting funds away from potential capital investment; and, in some industries, expenditure moderating from high cyclical peaks.

Other more recent surveys suggest that the moderation in business investment will be less marked than suggested by the CAPEX survey. For example, the ABS *Australian Business Expectations Survey* suggests that the level of capital expenditure in 1999-2000 will be broadly unchanged from its 1998-99 level. The *National Australia Bank's Quarterly Business Survey* (the NAB survey) and the *Australian Chamber of Commerce and Industry/Westpac Survey of Industrial Trends* (the ACCI/Westpac survey) have reported an improvement in anticipated capital expenditure in recent surveys.

Recent leading indicators of **housing activity** point to activity being maintained at a relatively high level, following the apparent peaking in the dwelling investment cycle in 1998. Private sector house approvals rose 13.2 per cent in May to their highest level since January 1995, while total building approvals rose 3.5 per cent. In the three months to May, finance approvals for the construction of dwellings rose 12.5 per cent. In trend terms, finance approvals for construction of dwellings has now grown for seven consecutive months and is at its highest level in over four years.

Chart 2: Indicators of dwelling investment (trend)



Source: ABS Cat. Nos. 5609.0, 8731.0 and 8750.0.

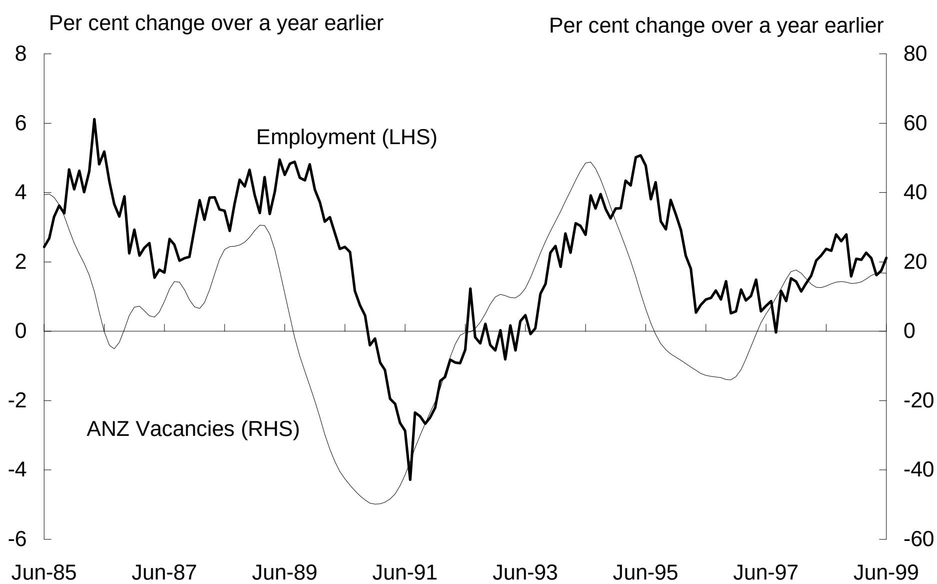
Recent retail trade data and motor vehicle registrations suggest that **consumption growth** may be slowing from the fast pace recorded in 1998. Monthly retail trade data are volatile and need to be interpreted carefully. For example, the timing of Easter significantly affected the March and April estimates. However, the rate of growth in the trend measure of retail sales has been slowing since February, while growth in motor vehicle registrations has slowed very slightly from record levels in 1998.

In 1998-99 **employment** grew by 2.2 per cent, up from 1.4 per cent in 1997-98. The unemployment rate averaged 7.6 per cent over 1998-99, the lowest figure since 1989-90. The participation rate averaged 63.2 per cent over 1998-99, up marginally from its level in 1997-98, but slightly below its average over the last five years.

Employment growth picked up modestly over the latter half of 1998-99. Abstracting from the volatility of monthly movements in the seasonally adjusted labour force series, the average monthly increase in employment in the second half of 1998 was 14,200, rising to around 16,200 persons in the first six months of 1999. The trend measure of employment was still growing at a healthy 1.8 per cent through the year to June 1999. The trend unemployment rate fell to 7.3 per cent by June 1999, its lowest level since August 1990.

The outlook for the labour market remains positive. Jobs advertisements series remain at high levels — the ANZ series increased by 2.1 per cent in June and the ABS series increased sharply by 17.8 per cent in the June quarter. Moreover, surveyed employment intentions have also improved in recent months and importantly, economic growth remains strong.

Chart 3: Employment and job advertisements



Source: ABS Cat. No. 6202.0 and ANZ Bank.

The March quarter National Accounts confirmed the absence of significant **inflationary pressures** in the economy. The household consumption deflator rose by 0.4 per cent in the March quarter and by 1.7 per cent over the year. In through the year terms, the increase in the consumption deflator has remained below 2 per cent for the last two and a half years. This is consistent with the low Consumer Price Index (CPI) outcomes observed over the same period — the CPI fell by 0.2 per cent in the year to the March quarter 1998 and rose by 1.2 per cent in the year to the March quarter 1999.

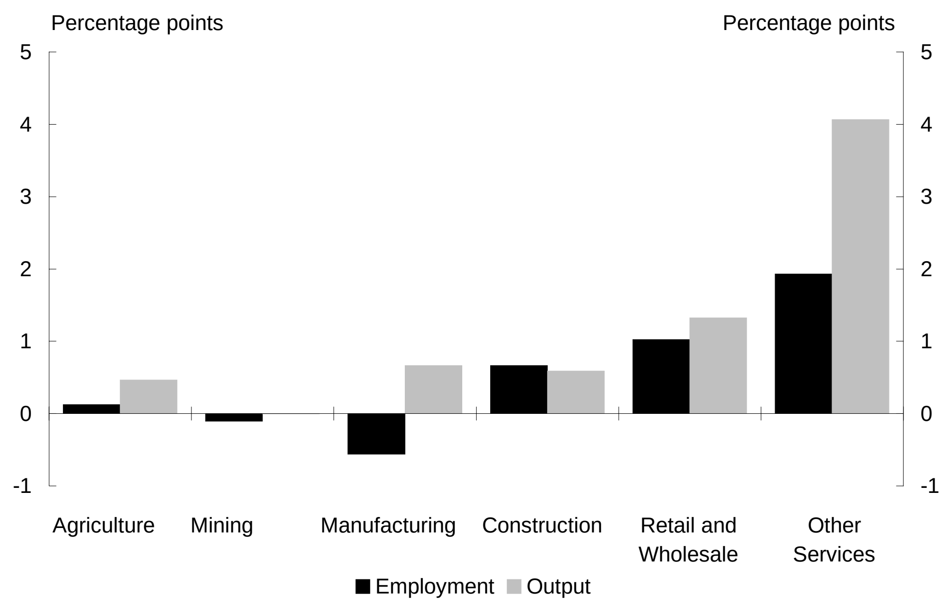
Inflation is expected to increase modestly from recent low outcomes, with the CPI expected to reach the bottom of the Reserve Bank’s target range over the next year.

The March quarter **current account deficit** of 5.9 per cent of GDP is consistent with the Budget forecast of a deficit of 5½ per cent in 1998-99 as a whole. The widening of the current account deficit over the past eighteen months should be viewed as a part of the necessary adjustment process to the East Asian crisis. It is important to note that not all countries can run an external surplus at the same time — surpluses must be matched by deficits. Indeed the crisis countries of East Asia have a need for the immediate future to run current account surpluses to consolidate their external finances and re-establish their credentials to borrow again. The fact that the current account deficit has been readily financed against the background of sustained low domestic interest rates and a rising exchange rate over the course of 1999, is evidence of the confidence international capital markets have maintained in Australia as an investment location. The current account deficit is forecast to decline slightly to 5¼ per cent of GDP in 1999-2000.

INDUSTRY PERFORMANCE

Since the onset of the Asian economic and financial crisis, sectors of the Australian economy that are predominantly domestically oriented have performed well. Export-oriented sectors have been adversely affected by the effect of the crisis on world growth. This is reflected in their relative contribution to economic and employment growth over this period (Chart 4).

Chart 4: Industry contribution to growth, June 1997 to March 1999

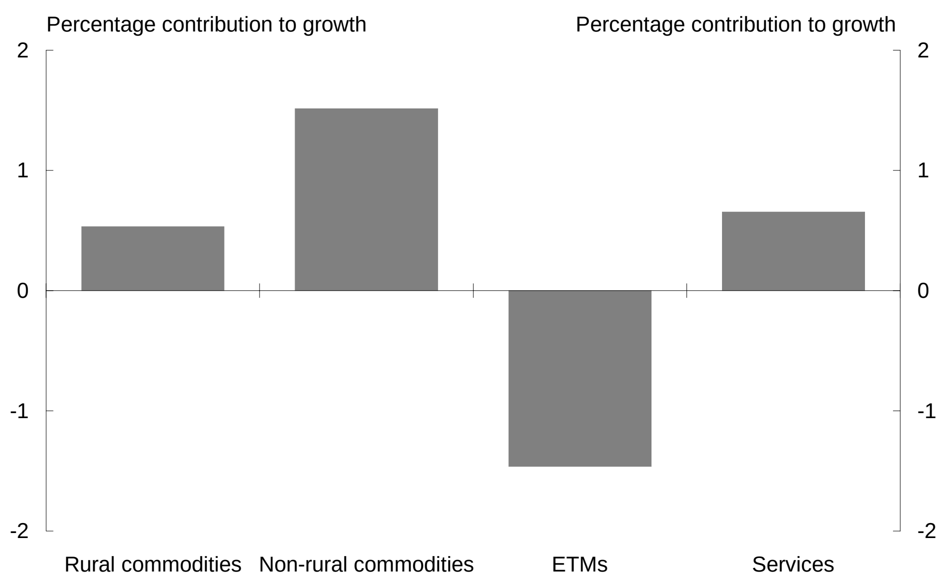


Source: ABS Cat. Nos. 5206.0 and 6203.0.

A key feature of the performance of the Australian economy in the 1990s has been the strong growth in productivity. Increased productivity has contributed to the maintenance of low inflation. Real wages have increased relatively strongly, without putting significant upward pressure on real unit labour costs. This, in turn, has contributed to the strong growth in corporate profitability over this period, as well as sustaining remarkably strong employment growth in comparison with the growth in the working age population. Increases in real wages have also supported growth in household income, which has contributed to ongoing growth in consumption spending and economic growth. As Chart 4 implies, productivity has increased in most sectors of the economy since June 1997, particularly in the manufacturing and 'other' service sectors.

The economy grew by 8.3 per cent between the June quarter 1997 and the March quarter 1999. The bulk of the growth since June 1997 occurred in the service sectors of the economy, with the impact of the Asian crisis evident on the mining sector, which made no net contribution to growth during this period. The manufacturing sector contributed moderately to growth, driven by the strong domestic demand for goods, despite the decline in exports of elaborately transformed manufactures (ETMs) due to the lower demand in major Asian markets (Chart 5).

Chart 5: Contribution to growth in total exports, June 1997 to March 1999[(a)]



(a) Excludes non-monetary gold.
Source: ABS Cat. No. 5302.0.

The following sections discuss in more detail these developments in key sectors of the economy.

Agriculture

After a fall in gross farm product in 1997-98 to $22.6 billion, farm product is on track to recover modestly in 1998-99 to $23.9 billion. This improvement reflects a return to more favourable weather conditions, resulting in large increase in cropping areas and a return to high yields across a range of commodities, including wheat. Overall increases in the production of meat, cotton, dairy and fisheries commodities over the year are also expected, and appear likely to offset substantial falls in wool production, reflecting the long-term decline in the size of the Australian sheep flock.

A large proportion of Australia's agricultural produce is exported, either as unprocessed commodities or processed goods, and there remains a strong correlation between agricultural production and overall rural commodity export volumes. In addition to the supply side influences such as a return to favourable weather conditions, a gradual recovery in the international economy over the coming year is expected to strengthen demand for Australian rural exports. Better economic prospects in important Asian markets are expected to generate modest improvements in key farm exports, including wheat and meats to South Korea, wool and barley to China, and dairy products to the Philippines, Malaysia and Indonesia.

Expanding markets in the Middle East (including Saudi Arabia for live sheep exports and Iran for wheat) and Latin America (for wheat, wool, beef and sugar) are also becoming important destinations for agricultural exports in addition to the traditional European and US markets.

The abundant stocks of some commodities combined with weakened global import demand continued to depress prices for a range of commodities in 1998-99. While world prices for Australia's rural commodity exports have stabilised over the past four months, they are more than 20 per cent below 1997 levels in United States dollar terms. The price falls in the past two years have been driven, in particular, by sharp falls in prices for wool (down over 30 per cent in United States dollar terms) and sugar (down over 44 per cent). Nevertheless, world commodity prices are expected to recover gradually in line with a strengthening international economy.

The decline in the Australian dollar tended to cushion Australian producers from the large price falls in 1997-98. However, the more recent appreciation in the dollar over the course of 1999 has resulted in prices in Australian dollar terms falling 11 per cent on last year's levels.

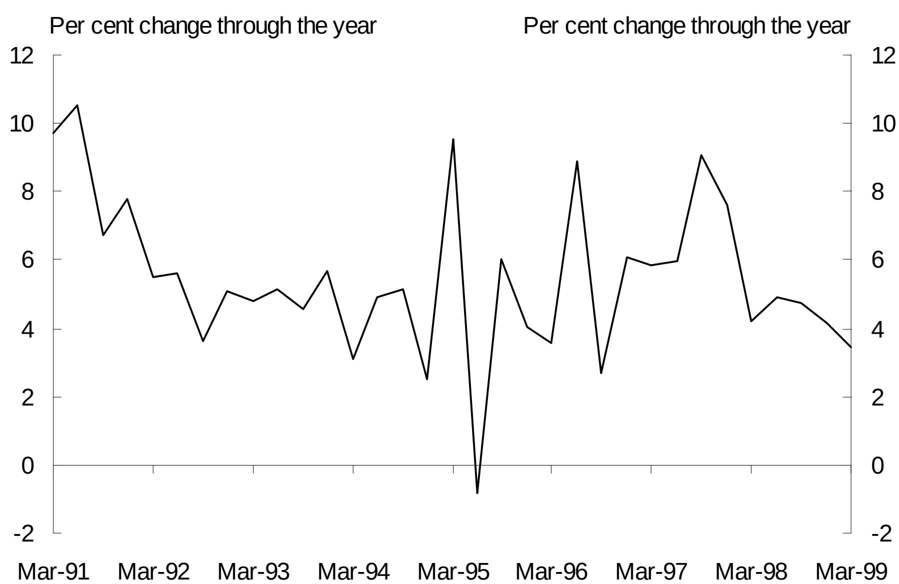
The overall picture for 1998-99 emerging from the March quarter National Accounts data is for an improved outlook for production and exports of meat, cereals, dairy and fisheries products that will offset declines in wool and sugar exports. While the expected gradual recovery in demand in international markets will assist Australian exporters, particularly those who were most affected by the Asian crisis, record global production and large carry-over stocks continue to subdue world prices for rural commodities, especially for wool, sugar and barley. In this environment, the composition of farm production in Australia will continue to change, with a trend away from sheep-related livestock enterprises and into those crops, such as wheat, that offer higher returns.

Mining

Following four years of growth above 5 per cent, mining production slowed during the first three quarters of 1998-99, falling by 2.7 per cent through the year to the March quarter 1999, partly reflecting disruptions to crude oil and condensate production. Strong growth in mining production over the mid-to-late 1990s was underpinned by the high rates of mineral exploration and investment which had occurred for most of this decade. The resultant increase in mining production occurred across a broad range of commodities.

As exports of resource commodities are largely supply-driven, and with around 60 per cent of mining production going directly into export sales, the rise in production helped to underpin average resource commodity export growth (excluding gold) of around 5½ per cent per annum over the last four years (Chart 6). Thus, despite the financial difficulties in East Asian countries from the latter half of 1997, and reflecting earlier increases in supply capacity, the volume of resource commodity exports has continued to grow, albeit at a slower rate than in the mid-1990s, rising by 3.4 per cent through the year to the March quarter 1999.

Chart 6: Growth in resource commodity export volumes



Source: ABS Cat. No. 5302.0.

The level of exploration expenditure is critical to the ability of the mining sector to expand its productive capacity in the medium to long term. While as noted above, exploration expenditure has been strong for most of the decade, it has declined sharply since the onset of the East Asian crisis, falling by around one-third of the level eighteen months ago. Similarly, mining investment has slumped in recent months, falling by 27.5 per cent through the year to the March quarter 1999.

Some decline in mining exploration and investment is to be expected following the strong growth in mining investment over the past six years. In addition the outlook is being influenced by the recent declines in, and the subdued prospects for, resource commodity prices. While mining investment projects tend to have long lead times and focus on longer-term demand and supply conditions, current low prices — including for gold which accounts for around 60 per cent of total mineral exploration expenditure[1] — and the oversupply existing for many commodities are likely to be influencing incentives to explore and invest. Resource commodity prices fell by around 10 per cent in United States dollar terms and around 5 per cent in Australian dollar terms in the year to the March quarter 1999. Lower prices have also reduced producer margins and exploration expenditure has been affected in the drive to reduce costs.

Investment intentions in the CAPEX survey (taken in April / May 1999) and the June quarter ABS *Australian Business Expectations Survey* suggest that mining investment will fall signficantly in 1999-2000. Indeed the number of projects at an advanced stage of development (that is projects which are either committed or under construction) as reported in the *Delta Electricity/Access Investment Monitor* fell by around 10 per cent in the March quarter 1999, in part reflecting the deferral of a number of projects.

Production and export capacity in the short-term will be underpinned by the completion of some large projects in the coming year. In particular, the commissioning of several large base metals projects (such as the Cawse, Bulong and Murrin Murrin nickel mines and the Century zinc mine) will help to support export volumes, as will the recovery in traditional East Asian markets. While growth in production coming on-stream is expected to slow early in the next decade as a result of the current subdued exploration and investment outlook, it is nevertheless expected to remain at high levels. As mining projects accounted for around 50 per cent of projects ‘under consideration’ or ‘possible’ in the March quarter *Delta Electricity/Access Investment Monitor*, it appears that there are a large number of projects that could quickly become committed if the outlook were to improve.

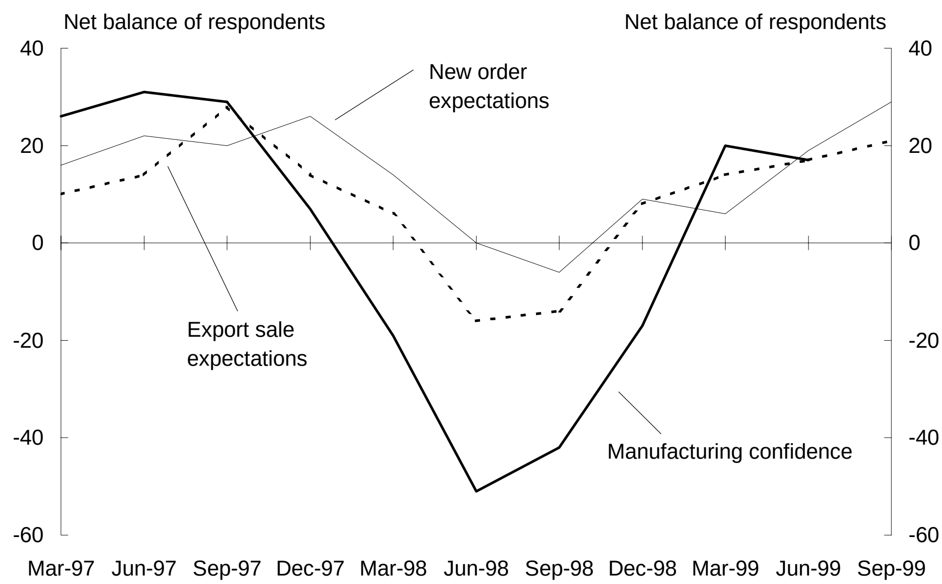
1. Excluding petroleum.

Manufacturing

Manufacturing output has grown at an annualised rate of 4 per cent over the last two years, almost double that of the previous two years. This reflects strong growth in domestic demand supported by the increased competitiveness of import-competing industries, and has occurred despite a fall in manufactured exports. Importantly, growth in manufacturing production has increased over recent quarters, reflecting both solid sales growth and a run-up in stocks.

The strong performance of the manufacturing sector over the past two years is at odds with that sector's view of the outlook for manufacturing over that period. As Chart 7 illustrates, over the period of the Asian crisis the ACCI / Westpac measure of business confidence in the manufacturing sector fell sharply (though it has recently returned to around pre-Asian crisis levels). Notably, the measure of business confidence fell by more than expectations for exports and new orders. (Around 70 per cent of ACCI / Westpac survey respondents are involved in some form of export activity.)

Chart 7: ACCI/Westpac survey



Source: Australian Chamber of Commerce and Industry/Westpac Survey of Industrial Trends.

Around 30 per cent of manufacturing output is exported and, as expected, the impact of the Asian crisis was more pronounced on Australia's exports of elaborately transformed manufactures (ETMs) than for other categories of exports.[2] In the three months to September 1998 compared with the same period in 1997 the value of ETM exports to South Korea, Indonesia, Thailand and Malaysia was down by 48 per cent, while total ETM exports were 6 per cent lower.

In recent months, there has been some encouraging improvement in export performance due to an improvement in growth in some East Asian economies and the commencement of some diversion of ETM exports to other markets. In the three months to May 1999 compared with the same period a year earlier the value of ETM exports to South Korea, Indonesia, Thailand and Malaysia was 18 per cent higher, although the value of Australian ETM exports worldwide was lower. A return to growth in ETM export volumes is expected in 1999-2000 as the world economy improves. This outlook is supported by the most recent ACCI/Westpac survey which indicates that manufacturers now expect exports to return to around pre-crisis levels.

Chart 4 implies that, over the last two years, labour productivity growth has been strong in the manufacturing sector, as output has increased while employment has fallen. Given the uncertainty facing manufacturers over this period, as reflected in falling confidence about the economic outlook, there may have been a reluctance to increase employment. However, manufacturing employment stabilised over the first half of 1999. The outlook for manufacturing employment is positive with solid domestic demand and an improving outlook for manufactured exports. There was also a sharp improvement in the ABS survey of job vacancies in the manufacturing sector over the past year. Employment intentions, as measured by the ACCI/Westpac survey, increased to their highest level since 1994-95 and overtime expectations rose to their highest level since 1989. Importantly, an increase in the number of hours worked can be a precursor to employment growth.

Manufacturing investment has been subdued over the last two years, with the most pronounced fall occurring in non-residential construction. However, investment picked up sharply in the March quarter 1999 and the indicators of future investment outcomes are positive: the most recent CAPEX survey indicates that a modest improvement is expected in manufacturing investment in 1999-2000; manufacturing profits are strong; measures of business confidence have bounced back; and capacity utilisation is relatively high. In addition, the ACCI/Westpac survey reported increased plant and equipment investment

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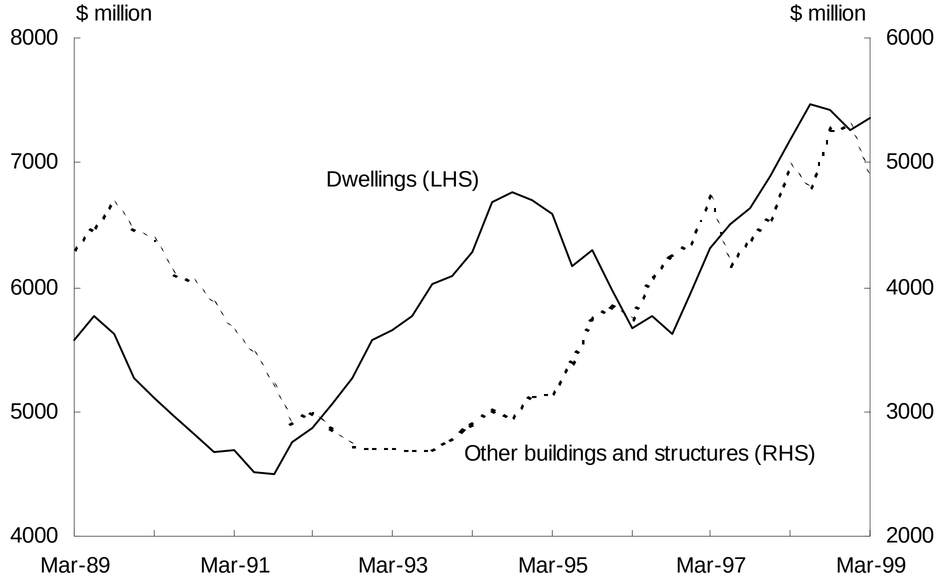
2. While most manufactured exports go to non-Asian countries, there is limited scope to divert those that do due to the nature of manufactured goods. In addition to lower demand in the troubled Asian economies, exporters of manufactured goods also faced a loss of competitiveness against indigenous competitors in these markets owing to the relative appreciation of the Australian dollar against those currencies. See the Summer 1998 edition of the Economic Roundup.

intentions over the next 12 months. Spending plans on buildings and structures were also firmer, with the strongest reported net balance in four years.

Construction

Construction activity picked up over 1997 before tapering off in mid-1998, with both dwelling investment and non-residential building and engineering investment peaking during 1998 (Chart 8).

Chart 8: Components of construction activity



Source: ABS Cat No. 5206.0.

Several years of strong growth in non-residential investment underpinned activity in the construction sector, mainly driven by large scale projects in mining, infrastructure, offices and Olympics-related projects. The dwelling investment cycle has also been in an upswing for much of this period supported by housing affordability that rose to record levels as interest rates fell, real household incomes increased and house price inflation remained relatively subdued.

A distinguishing feature of the current dwelling cycle is the absence of an oversupply of housing. In the current cycle, which began in the last half of 1996, the level of dwelling investment grew steadily for two years, with housing approvals peaking at around 20 per cent below the peak of the previous dwelling cycle. However, approvals and commencements appear now to have plateaued following the peaking of the cycle that occurred in 1998.

Construction activity has also been supported by the trend towards larger, more expensive housing. Employment in the construction sector has grown in line with activity over the past few years and reached record levels in 1999 (Chart 9).

Over the period ahead the prospects for dwelling and non-residential investment that underlie construction activity differ. New non-residential investment fell by 8.0 per cent in March quarter 1999 and is expected to decline further as many of the projects that drove strong investment growth have been completed or are approaching completion. Approvals and finance data point to a decline in the level of activity. While some of the most recent business surveys show improvements in business investment intentions for new buildings, in line with favourable credit conditions and overall strength in corporate profitability, the poor outlook for world commodity markets is expected to depress mining construction activity significantly.

On the other hand, with supply and demand conditions in the housing sector currently broadly balanced, activity in the housing sector should continue to grow moderately at rates consistent with meeting the long-term underlying demand for housing.

Consistent with underlying high output levels, construction employment showed renewed strength in the June quarter 1999, rising by 3.9 per cent. Over the past two years the construction sector, which comprises only about 7 per cent of total employment, has accounted for over one-fifth of employment growth in Australia.

Chart 9: Employment in the construction sector

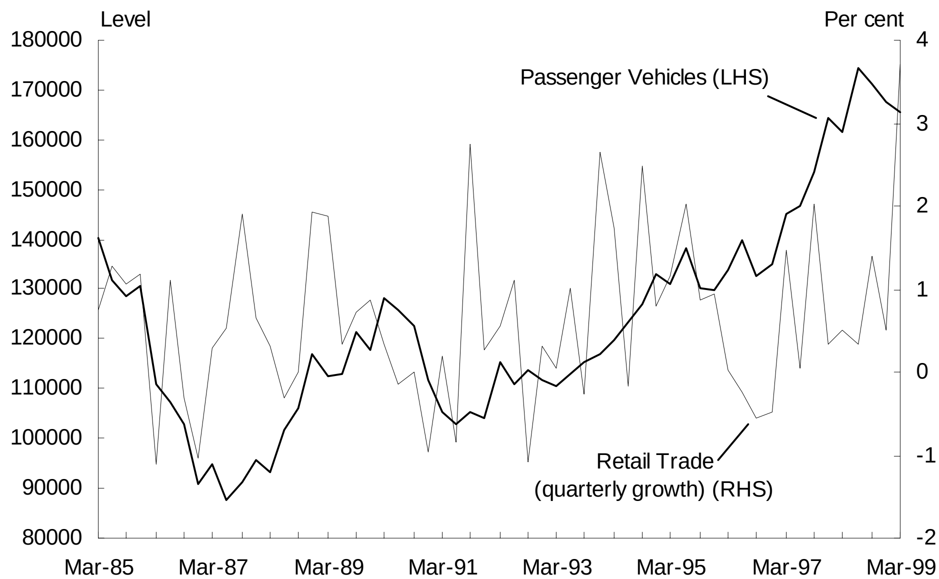
Source: ABS Cat. No. 6203.0.

Retail and wholesale

Wholesale and retail activity has increased strongly over the past two years, with the wholesale sector, in particular, growing very strongly at around 8 per cent per annum in year-average terms. Growth in retail activity has been more subdued, but still firm at about half this rate.

Activity in these sectors largely reflects domestic economic conditions. The strong growth in private consumption of the past two years has driven the increase in activity in these sectors. Retail sales grew strongly over that period, underpinned by rising household incomes and wealth, low interest rates and rising employment. Motor vehicle registrations rose to record levels in 1998. Trend growth in retail sales has slowed in 1999 and 1999 year-to-date registrations are comparable to 1998 figures.

Chart 10: Retail trade and motor vehicle registrations



Source: ABS Cat. Nos. 8501.0 and 9301.0.

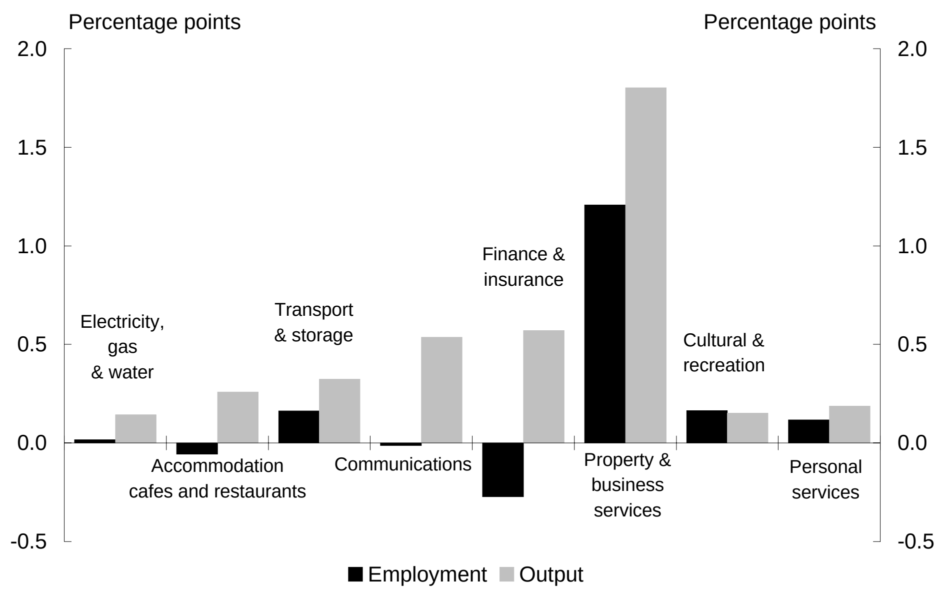
Employment has also continued to grow in these sectors in line with activity, although the relative performance of the wholesale and retail sectors has been reversed. Over the past two years retail sector employment has grown by 8.1 per cent, while wholesale sector employment has grown by 2.5 per cent. This may reflect the greater scope for productivity increases that is likely to exist in the wholesale sector compared with the more labour intensive retail sector.

Private consumption growth was very strong in 1997-98 at around 4½ per cent, with similar growth expected to have been recorded again in 1998-99. Although private consumption growth is likely to moderate in 1999-2000 to around 3¾ per cent, this is still above the long-term trend of around 3¼ per cent. Hence, activity in these sectors is likely to continue to grow, albeit at a more moderate pace than in recent years. This outlook is supported by various business surveys. The ABS *Australian Business Expectations Survey* reported that the sectors were optimistic about sales and employment in both the short and medium term and the NAB quarterly survey suggests that the relative output and employment performance of the two sectors over the past year is likely to continue in the next year. Importantly for these sectors, consumer confidence recovered to pre-Asian crisis levels in the first half of 1999.

Other service industries

The remaining service industries have also benefited from the strong domestic demand growth of the past two years. These sectors, which account for almost one-half of domestic economic activity and just over one-half of total employment, comprise a diverse range of industries such as accommodation, transport, utilities, communications, finance, property and business services. They are predominantly domestically oriented with their outputs often forming inputs to other domestic sectors. However, service exports have been growing rapidly over the past decade and some of these sectors have an increasing direct exposure to international developments.

Chart 11: Other market sectors contribution to growth June 1997 to March 1999 (a)



(a) Excludes non-market sector industries, ie government administration and defence, education, and health and community services.

Source: ABS Cat. Nos. 5206.0 and 6203.0.

Growth in these 'other' services has broadly matched that of the economy overall, reflecting their aggregate size. However, this masks considerable divergence between individual components. Communications has been the fastest growing sector of the economy over the past two years, expanding by almost one quarter, more than double overall economic growth. Property and business services has also grown strongly at twice the national average. There has also been strong growth in accommodation, cafes and restaurants in the past year, while most of the other sectors have grown broadly in line with GDP.

Services exports, which had experienced solid growth to East Asia up until mid-1997, declined after the onset of the financial crisis in East Asia. Short-term arrivals from Asian countries fell sharply in the wake of the Asian crisis — between the March quarter 1997 and the March quarter 1999 arrivals from South Korea fell by 63 per cent, from Thailand by 37 per cent and from Japan by 13 per cent. However, this was mitigated by increased arrivals from Europe and North America, reflecting the strength of their economies and the increased attractiveness of Australia as a holiday destination following the depreciation of the Australian currency against the United States dollar and major European currencies. Growth in education-related travel services has fallen, but business service exports have continued to grow solidly.

The continued diversion of service exports to markets outside East Asia, coupled with an improved outlook for East Asia (excluding Japan) should lead to service export growth returning to trend over the next couple of years. Short-term arrivals in 1999 to date exceed arrivals in the same period last year and arrivals from East Asia have increased, although they remain well below pre-crisis levels.

Employment growth has been particularly strong in some of these sectors over the past two years. For example, employment grew by 13.6 per cent in property and business services. This sector's share of national employment has risen from 7.4 per cent a decade ago to around 11 per cent today. While employment has fallen in the finance, utilities and communication sectors, this is most likely to have been driven by structural reform and changed practices in these sectors, rather than the Asian crisis *per se*.

The outlook is for these 'other' sectors to continue to grow much in line with recent performance, albeit at a slightly slower pace as the economy slows. This is supported by the ABS *Business Expectations Survey* which reported that all these sectors expect to grow at or faster than the national average, with good growth in profits also expected. This outlook is also broadly supported by the NAB quarterly survey.