Economic Outlook

The following is a reprint of Part 1 of Statement 2, Economic and Fiscal Outlook, from Budget Paper No. 1 — Budget Strategy and Outlook 1998-99.

OVERVIEW[1]

The Australian economy should continue to record solid economic growth, low inflation and a further reduction in the unemployment rate in 1998-99.

Economic growth will slow over the course of 1998-99 as a consequence of the economic and financial difficulties being experienced by some of Australia's Asian trading partners, including Japan. Growth in activity will be supported by continuing strong growth in domestic demand, underpinned by favourable fundamental influences. GDP is forecast to grow by 3 per cent in 1998-99, following estimated growth of 3¾ per cent in 1997-98. In the absence of the downturn in Asia, Australia's GDP growth in 1998-99 would likely have exceeded that estimated for 1997-98.

The economic crisis in Asia will have an adverse effect on both export volumes and prices, and the resultant reductions in exporters' incomes will affect outputs and incomes in associated industries. It is important, however, to keep in perspective the likely impact on Australia's export prospects of developments in specific markets. Allowance needs to be made for the diversification of Australian exports in recent years and the capacity for exporters to divert sales to alternative markets, especially in the light of a more competitive exchange rate. The Asian crisis will also affect confidence, resulting in slower growth in business and consumer spending than would otherwise be the case. But not all of the influences from events in Asia will be negative. In particular, Australia has benefited from the reallocation of world capital flows which has contributed to higher equity prices and lower bond yields in the long-established markets. In addition, the depreciation of the Australian dollar against most currencies outside Asia has offset the decline in world commodity prices and improved the competitiveness of Australian firms. These developments will support domestic activity.

Some of the factors which encouraged strong growth in domestic demand in 1997-98 will continue to have an influence in 1998-99. Low interest rates, stemming from reductions in the official cash rate and greater competition

1 In this Statement, unless otherwise specified, monthly and quarterly data are expressed in seasonally adjusted terms. The current price GDP (Income) measure is used as the nominal measure of GDP, while GDP (Average) is the constant price GDP series used.

Table 1: Domestic Economy Forecasts(a)

	Outcomes(b) 1996-97 Year Average	Estimates 1997-98 Year Average	Forecasts 1998-99 Year Average	Forecasts Four quarters to June 1999
Panel A - Demand and Output(c)				
Private consumption	2.4	5	4	3 1/2
Private investment				
Dwellings	1.1	12	10	8
Total business investment(d)	17.4	8	6	5
Non-dwelling construction	18.5	-4	9	8
Equipment	16.9	13	5	3
Private final demand(d)	4.5	6 1/4	5	4
Public final demand(d)	0.0	3 3/4	2 1/4	1
Total final demand	3.6	5 3/4	4 1/4	3 1/2
Increase in stocks(e)				
Private non-farm	-0.4	0	1/4	0
Farm and public authority	-0.5	1/2	0	0
Gross national expenditure	2.7	6	4 3/4	3 1/2
Exports of goods and services	10.1	3 1/2	2 1/2	6
Imports of goods and services	12.3	12	9	8
Net exports(e)	-0.4	-2 1/4	-1 3/4	- 3/4
Gross domestic product (Average measure)	2.7	3 3/4	3	3
Non-farm product	2.3	4	3 1/4	3
Farm product	15.1	-5	-1	3
Panel B - Expenditure Excluding Tranfers and One-off Transactions(c)(f)				
Total business investment	13.2	13	8	5
Non-dwelling construction	13.2	1	10	9
Equipment	13.2	19	6	4
Public final demand	2.3	1 3/4	1	3/4
Increase in stocks(e)	-0.3	0	1/2	0
Gross national expenditure	3.2	5 3/4	4 3/4	3 1/2
Exports of goods and services	7.4	5 1/4	2 1/2	6
Panel C - Other Selected Economic Measures				
Prices and wages				
Consumer Price Index (12th series basis)	1.3	0	2 1/2	2 3/4
- Treasury 'Underlying' measure (12th series basis)	2.0	1 1/2	2 1/2	2 3/4
Gross non-farm product deflator	2.3	1 1/2	3	3 1/2
Average earnings (national accounts basis)	4.9	4 3/4	4 1/4	4 1/4
Labour market				
Employment (Labour Force Survey basis)	1.1	1 1/4	1 3/4	1 3/4
Unemployment rate (per cent)(g)	8.7	8 1/4	8	7 3/4
Participation rate (per cent)(g)	63.5	63 1/4	63 1/4	63 1/4
Household income and saving				
Real household disposable income	3.8	3 1/2	3 1/2	3 1/4
Household saving ratio (per cent)	4.7	3 1/4	2 3/4	
External accounts				
Terms of trade(h)	1.6	-1 1/2	-1 1/4	1 1/4
Current account balance				
$billion	-17.7	-25	-31	
Percentage of GDP	-3.4	-4 1/2	-5 1/4	

(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using annual original data.
(c) Average 1989-90 prices.
(d) The ABS has recently advised that it is likely to treat the $2.4 billion sale of the Dampier to Bunbury gas pipeline by the WA Government in 1997-98 as the sale of a second-hand fixed asset. If so, this would act to lower forecast public investment with an offsetting boost to private investment, although the forecasts in Panel B would be unaffected.
(e) Percentage point contribution to growth in GDP (Average).
(f) Transfers are net second-hand asset sales from the public sector to the private sector. One-off transactions are gold sales by the Reserve Bank of Australia, 'lumpy' imports of aircraft, ships and satellites and exports of ANZAC frigates.
(g) The estimate in the final column represents the forecast level in the June quarter 1999.
(h) Adjusted to exclude computer import prices.

among lenders, will support private sector activity, particularly dwelling and business investment. Strong growth in consumption is expected, supported by continuing solid employment growth as well as a transitory boost from gains to consumers as a result of the AMP Society demutualisation.

Employment growth should remain firm, supported by recent and prospective growth in non-farm activity and the unemployment rate is forecast to fall to around 7¾ per cent in the June quarter 1999.

While a modest rise in underlying inflation is expected as recent increases in import prices flow through into retail prices, it is expected to remain within the 2 to 3 per cent band. Some moderation in wage growth is forecast.

The current account deficit is forecast to rise to $31 billion, or 5¼ per cent of GDP, reflecting the weaker international environment and continuing solid domestic demand growth.

The uncertain nature of the international economy, particularly the state of the Japanese economy, poses a considerable risk to the outlook for the Australian economy in 1998-99 and beyond. As usual, weather conditions will be crucial for the farm sector with further widespread rainfall required to achieve the assumed average seasonal conditions.

THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

Financial crises in several countries in East Asia and renewed weakness in the Japanese economy have brought a deterioration in the outlook for global economic growth in 1998. Continuing solid, but more sustainable, growth in North America and a consolidation of growth in Europe is, however, expected to support world growth of 3 per cent in 1998. The world economy is expected to improve in 1999 to growth above the average level since 1970. Inflationary pressures are expected to remain subdued in major industrial countries.

Table 2: Economic Indicators for Selected Countries and Groupings

	GDP Growth(a)				CPI Inflation(b)			
	1996	1997	1998(e)	1999(e)	1996	1997	1998(e)	1999(e)
United States	2.8	3.8	2¾	2	2.9	2.3	2	2½
Japan	3.9	0.9	¼	1¼	0.1	1.7	½	¼
Germany	1.4	2.3	2¾	2¾	1.5	1.8	1½	2¼
OECD(c)	2.8	3.1	2½	2½	4.3	3.7	3½	3
World(d)	4.1	4.1	3	3¾	-	-	-	-
East Asian MTP(f)	7.1	6.2	2	4	5.2	3.6	7¾	6¼
Total MTP(g)	4.9	3.9	1¾	3	3	2.5	3¾	3¼

(a) Major Trading Partners (MTP) GDP growth is calculated using Australian merchandise export trade weights.
(b) The GDP deflator for the OECD. MTP CPI inflation is calculated using Australian total merchandise trade weights.
(c) OECD *Economic Outlook 63* historical and forecast figures.
(d) IMF *World Economic Outlook May 1998* historical and forecast figures.
(e) Unless otherwise stated, forecasts are Treasury forecasts.
(f) Australia's East Asian MTP are China, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand.
(g) East Asian MTP, Canada, France, Germany, Italy, Japan, New Zealand, the United Kingdom and the United States comprise Australia's total MTP.

Source: Various national statistical publications, OECD, IMF and Treasury.

The East Asian Crisis and Regional Outlook

A feature of world economic developments in 1997 of particular relevance to Australia was the financial turmoil which affected the East Asian region, especially Indonesia, Korea and Thailand. The onset of the crisis in the second half of 1997 was marked by sharp declines in currency and equity markets, as a sudden loss of confidence by investors in the face of accumulating evidence of underlying economic difficulties precipitated a large outflow of capital from the region. Following concerted international action, the situation in the countries concerned has generally stabilised. There has been a significant recovery in currency and equity markets, although to levels still well below those prevailing before the crisis.

The origins of the regional crisis can be traced back to underlying structural weaknesses in the financial sectors of a number of countries, together with large-scale capital flows and policy weaknesses, which led to over-heating of economies in the region, the emergence of major imbalances and an asset price spiral in the commercial and industrial property sectors. Private investment in the affected economies was financed increasingly by short-term, unhedged, foreign borrowings. The subsequent collapse in currencies left many borrowers unable to repay and service remaining foreign currency denominated loans.

The downturn exposed underlying weaknesses in corporate governance, lending practices, prudential and supervisory standards and a lack of transparency. Corporations and financial institutions carried excessive foreign borrowing exposures. Lending practices gave insufficient weight to profits and debt servicing capacity and placed too great a reliance on commercial property and other asset backing as collateral, or reflected government use of 'directed' lending to favoured industry and infrastructure projects.

Measures to deal with the weaknesses revealed in financial sectors are core requirements of the International Monetary Fund (IMF) supported programs for Indonesia, Korea and Thailand. In addition, these programs recognise that a return to sustained growth will be promoted by other structural reforms, including reductions in barriers to trade and direct foreign investment, acceptance of the need for transparent and arm's-length dealings between government and business, the dismantling of monopolies, and the commercialisation and sale of state-owned enterprises.

The financial and currency market fall-out has impacted on activity in the region, with an abrupt slowing in growth, a corresponding rise in unemployment and higher inflation. There has been considerable disruption of trade flows and trade credit, and widespread banking and business failures. The sharp contraction in domestic demand associated with the loss of confidence and corrective action has already contributed to a noticeable improvement in current account balances, aided by some pick-up in exports from improved competitiveness. The full impact of developments in the region is expected to be felt in 1998-99, with a modest rebound in activity forecast for the second half of 1999.

The shape and timing of economic recovery will depend upon both the scale of the task confronting the troubled economies and the responses of the governments concerned. The outlook depends on how vigorously necessary reforms are implemented by governments and the time it takes to re-establish financial stability and lock in the competitive gains from lower exchange rates. A noticeable pick-up in activity in Korea and Thailand should be apparent in 1999, after flat or negative growth in 1998. In Indonesia, where the deterioration has been more severe, the turnaround may take longer. In all three countries inflation is expected to rise sharply in 1998 before starting to moderate in 1999.

The outlook for Japan is a matter of concern. Not only is Japan heavily exposed to regional developments, its domestic economy is experiencing substantial weakness and showing no signs of an early turnaround. Weak consumer and investor confidence point to the prospect of little or no growth in Japan in the year ahead — although a range of government fiscal initiatives announced should provide some impetus to domestic demand. Export growth is expected to weaken in the face of weaker regional economic conditions in particular, but import growth is expected to slow significantly as a result of subdued domestic demand. In net terms, the external sector's contribution to growth in Japan will remain positive, but weaker, in 1998.

Substantial policy challenges face Japan. Its problems are essentially structural in nature and long standing, overlaid by major macroeconomic imbalances associated with a shortage of domestic demand. The economy is struggling with a substantial public debt burden, a still substantial asset price overhang, a weakened financial sector, low productivity growth and a rapidly ageing population. While some progress has been made on structural reform, including the financial sector reforms that commenced on 1 April 1998, and deregulation of the telecommunications and transport sectors, there continues to be a need to advance regulatory reform on a broad front.

The economic conjunction in Japan has demanded a re-assessment of macroeconomic policies, strongly urged by other major industrial countries. With only marginal scope to further reduce interest rates, fiscal settings have been made more expansionary in a number of steps since October 1997. The most recent package foreshadows tax cuts and additional spending of yen 16.7 trillion, equal to about 3¼ per cent of GDP. An issue facing the Japanese Government is the task of striking a balance between providing short-term stimulus to economic activity and pursuing medium-term fiscal consolidation plans.

China's growth is expected to slow from the 8.8 per cent recorded in 1997, reflecting some easing in domestic demand, a build-up in inventories, a commercial property overhang in some regions and a slowing in export growth and foreign direct investment. The Government has given repeated assurances that it will not devalue the currency which it sees as an important contribution to helping restore regional stability. This will, however, place more of the burden for meeting the official growth target on domestic activity.

In New Zealand, growth in activity slowed to 2.2 per cent in 1997 as the pace of domestic demand growth declined from its previous high rates and net exports continued to detract from growth. Domestic demand is expected to remain subdued in 1998 largely as a result of the effects of high real interest rates domestically and of weaker external demand on income growth.

Developments and Outlook in Other Regions

Prospects for North America and continental Europe remain positive and underpin a continuing sound international environment in spite of the weakness in Asia.

The resilience of the expansion in the United States is impressive — with growth in GDP of 3.8 per cent in 1997, the strongest in 9 years. As a consequence, the unemployment rate has fallen to its lowest level in 24 years. The health of the United States economy, in part, reflects sound fundamentals. The budget has been returned to surplus, inflation expectations have fallen, and both headline and core inflation remain at historically low levels.

Growth in activity has been driven by strong private consumption and investment spending which in turn has supported robust employment growth. In 1998, growth in industrial production is expected to slow from recent rapid rates in response to weaker domestic demand, lower net exports to Asia, and inventory adjustments. The combined effects of a significantly stronger currency and weaker export demand from Asia should result in an increased net export detraction from growth this year. With an expected slowdown in economic activity and weaker corporate profitability, investment expenditure should increase more slowly through 1998 and into 1999.

There are some risks to the United States outlook. The economy is operating at close to full capacity, and there are some signs of a pick-up in wage costs. The strength of the US dollar and the expected increase in cheaper imports from Asia should help to contain these pressures in 1998. Inflationary pressures, however, are likely to mount without a slowdown in the United States economy to more sustainable levels. In addition, some widening of the current account deficit is expected, which could give rise to trade tensions. The stock market has grown strongly, increasing the possibility of a sizeable correction; any such development could have important consequences for global financial markets.

The outlook in continental Europe seems positive, supported by favourable macroeconomic settings. There appears to have been substantial fiscal consolidation and convergence to a low inflation and low interest rate environment as countries prepare for the commencement of the European Monetary Union. With the expansion being only relatively recent, there is the prospect of a further pick-up in growth as private consumption consolidates and business investment expenditure strengthens. This is expected to outweigh any slowdown in net exports resulting from weaker Asian demand. Despite the improved outlook, structural reform will remain a priority in continental Europe in tackling high levels of unemployment within the unified currency framework.

The United Kingdom economic cycle, like that in the United States, is at an advanced stage. In response to a stronger currency and the tightening of monetary policy over the past 18 months, growth is expected to slow from the 3¼ per cent recorded in 1997 to a more sustainable rate in 1998.

Substantial shifts in current account balances of countries in different regions are likely to occur in 1998. For the United States and Europe, strong domestic demand and strong currencies will act to reduce surpluses or increase deficits, while weak domestic demand but increased export competitiveness will strengthen current account positions in East Asia. It will be important that such a development be seen as part of the adjustment to events in Asia within the framework of a continued favourable global outlook and not as evidence of major bilateral structural distortions. Any resort to trade action, for example, would harm the adjustment process and also affect the interests of countries not directly involved, such as Australia.

THE EFFECT OF INTERNATIONAL DEVELOPMENTS ON THE DOMESTIC ECONOMY

The financial and economic crisis in Asia will have a significant influence on the Australian economy in 1998-99. The most obvious effects will be on export volumes and prices, resulting in lower levels of exporters’ incomes than would otherwise be the case, with consequent impacts on output and employment elsewhere in the economy. However, as is already evident, the exchange rate will also be affected by these developments, in part influencing the manner in which the overall impact is shared throughout the community. A lower exchange rate than otherwise would have occurred will tend to lessen the impact of lower world demand and prices on exporters’ incomes while increasing the impact on consumers through higher import prices. There will also be other financial sector implications to consider, in particular the already observable tendency for lower bond yields. In addition, there will be indirect effects, not only as the impacts in the trade sector flow through into related sectors but also more generally as a result of impacts on household and business confidence. While the timing and magnitude of these effects are subject to uncertainty, it is important to keep in perspective the impact on Australia’s overall export prospects of developments in specific markets.

Direct Effects on Export Volumes

Factors Influencing Export Growth

Australia has a diverse range of exports covering rural and non-rural commodities, manufactures and services. Not surprisingly, reflecting this diverse base, there are a great many factors affecting Australia's export performance. As a result, attempts to analyse the direct impact on Australia's exports of developments in Asia using a simple framework based on export shares to the region and expected movements in GDP are likely to produce misleading results. In the past, such a framework has not provided a good basis for forecasting growth in Australia's export volumes, either to specific markets or in total.

There are several important factors that this simple framework does not incorporate. For instance, it does not allow for diversification of trade and the diversion of exports to alternative markets. These features have been characteristics of Australia's export performance throughout the 1990s. As indicated in Chart 1, the importance of various markets in contributing to growth in Australia's merchandise exports has varied over the 1980s and 1990s. During the 1980s, the importance of the non-Asian OECD countries to Australian export growth diminished; a trend that continued in the 1990s. In the 1980s, exporters found new markets in the rapidly growing East Asian economies. But the contribution to total export growth from those markets has declined in the 1990s, particularly in recent years. During the 1990s, markets outside the OECD and East Asia have contributed more significantly to growth in Australia's exports.[2]

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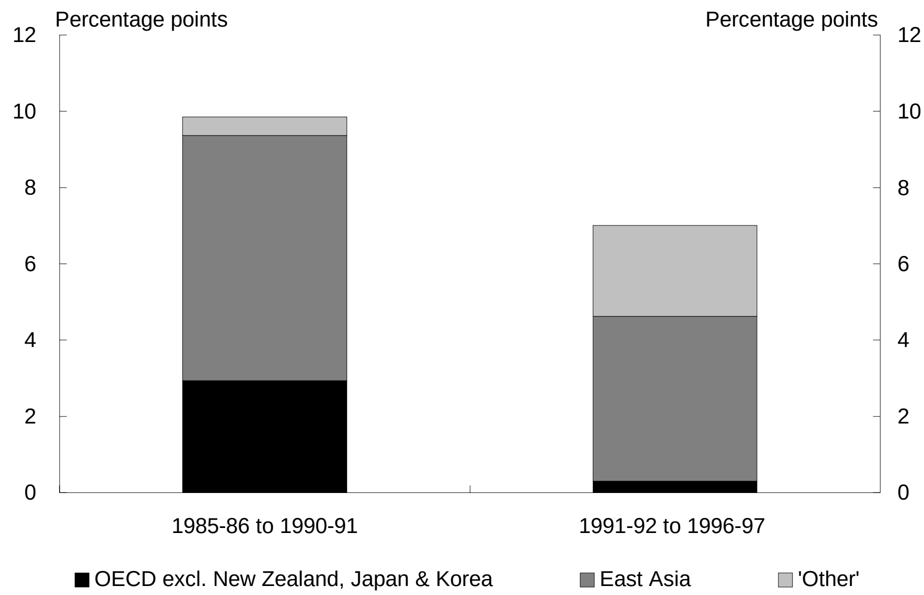
2 Included in this group of other countries are New Zealand, Fiji, Papua New Guinea, the Indian sub-continent, South Africa, the Middle East, Eastern Europe, the former Soviet Union, and South America.

Chart 1: Contributions to Merchandise Exports Growth, by Destination



Source: ABS data on the Department of Foreign Affairs and Trade's STARS database.

The recent strong growth in markets outside the OECD and East Asia has been broadly based. Very strong rates of growth have been sustained during the 1990s for exports to the Oceania countries (particularly New Zealand but also, more recently, Fiji and Papua New Guinea) and to South Africa. Complementing this over the past few years has been a strong acceleration in exports to the Indian sub-continent and a sharp reversal of the previous downward trend in exports to the Middle East and non-OECD Europe. In recent years, of all the countries in this 'other' grouping, only exports to South America have not kept pace with or exceeded previous average rates of export growth.

The relative strength of export growth to these emerging markets in the 1990s is also apparent across the major export classifications. Exports of non-rural commodities to this group increased on average over the 1990s at a double digit rate, with some slight acceleration in the past two years. This is faster than the overall growth in non-rural commodities over this period. Exports of manufactures to 'other' countries have increased by more than 16 per cent per annum since the mid 1980s, with slightly faster growth in the past two years. In comparison, exports of manufactures to all countries increased at a similar rate to this up to 1994-95, but there was a significant deceleration in the subsequent two years. Exports of rural products to these 'other' countries have increased significantly in the past two years, reversing an earlier downward trend. This outcome largely reflects increased cereal exports to the Middle East.

The diversification of export markets which has contributed to Australia's export growth in recent years demonstrates that it is inappropriate to view trade shares as being fixed. This is particularly important in the current international environment of weaker demand in East Asia but stronger growth in the United States, Europe and the rest of the world. Such a situation may well result in even greater diversification of Australia's export markets, although the speed with which individual exporters can establish alternative markets will vary. Nevertheless, as outlined below, greater diversification is likely to be encouraged by recent exchange rate movements.

A further factor that needs to be considered in assessing the impact of developments in East Asia on Australia's exports is that GDP growth in specific export markets has not proved to be a good indicator of growth in Australia's exports to those markets. Demand for many rural commodities tends to be influenced more by movements in population and changes in tastes and the stage of economic development than by any indicator of output or income. Demand for non-rural commodities tends to be related to trends in industrial production which, depending on the maturity of the economy and the relative importance of the services sector, might display a cyclical pattern somewhat different from that of GDP growth or growth in domestic demand in particular markets. In the case of some Asian economies in particular, many Australian exports are intermediate inputs into local production which is exported elsewhere; GDP growth in these economies will be an inappropriate indicator of the resultant demand for Australian exports.

Related to the above, a key factor influencing Australia's exports to any market will be the relative competitiveness of Australian producers. This will be important both in determining the aggregate level of exports and its distribution across countries. The relevant measure of competitiveness will include not only Australian production costs but also transport costs and exchange rate relativities, and will be affected by the presence of subsidies offered by competitors. More subjective factors will also be important, including desires to maintain stable trading relationships.

A particularly important aspect to be taken into account when considering the impact of developments in specific markets is the importance of supply considerations in influencing the performance of commodity exports. Rural exports are a good example of this, where farm production has been the main influence on the volume of Australia's exports in the short term rather than developments in any market. As a relatively low cost producer, Australia has the ability to vary sales to other markets as supply circumstances dictate for the majority of rural exports. Supply considerations are also an important influence on changes in exports of non-rural commodities.

The total amount of Australian production exported, and its distribution across countries, will thus be determined by a range of factors, and not simply GDP growth in specific markets. Importantly, export shares will be the final outcome of the process, not the principal determinant.

Impact of the Slowdown in Asia

Having regard to the above factors, in aggregate, **rural commodity** exports are likely to be less affected than many other exports as a result of developments in Asia. This is because the volume of rural exports is primarily supply-determined, with relatively low levels of responsiveness to variations in income growth in countries of destination. However, within this overall picture, there are individual rural commodities where demand from Asian economies will be seriously affected and where there is little opportunity of finding alternative markets; examples include exports of live cattle and horticultural products.

With demand for rural exports in aggregate relatively unaffected by developments in the troubled Asian economies, the main influence on the growth of rural exports in 1998-99 will be weather conditions and production. Although farm production is estimated to have fallen in 1997-98, it is likely to have remained at a high level; concerns in early 1997 about the impact of adverse weather conditions were largely unrealised due to timely rainfall which resulted, for example, in above-average levels of cereals production. The assumption of average seasonal conditions for 1998-99 implies a slight decline in rural production, although again the level of production is expected to remain high by historical experience. Coupled with a relatively low level of carry-over stocks at the end of 1997-98, this production profile suggests that rural export volumes should decline by around 1 per cent in 1998-99, following a small increase in 1997-98.

As noted previously, supply factors are also a very important determinant of the volume of **non-rural commodity** exports. This is particularly relevant at present, with strong growth in mining investment resulting in significant increases in supply capacity. Moreover, the recent decline in world prices for non-rural commodities has been largely offset by the depreciation of the exchange rate, with the result that the domestic currency returns to commodity producers have been maintained, if not increased, and this has encouraged continued high rates of capacity utilisation.

While East Asia has been the major market for Australia’s exports of non-rural commodities, the homogeneity of many of the products and the fact that they are freely traded on established world markets means that there is considerable scope to divert sales to other markets. To some extent this diversion has been occurring within Asia; for example, some producers have increased sales of bulk commodities to Taiwan and China to compensate for reductions in sales to Japan and Korea. Alternatively, the diversion might occur in relation to markets less directly affected by developments in Asia; the continuing solid growth forecast for OECD industrial production — influenced by the favourable outlook for overall activity in the United States and Europe — is of particular importance in this regard. In addition, the substantial nominal depreciation of a number of Asian currencies will help to sustain export growth from these countries, which will cushion the impact on those Australian non-rural commodity exports —

especially the bulk ores — that are intermediate inputs in Asian export production. However, the eventual effect will depend on the ability of the Asian countries to convert nominal exchange rate depreciation into sustained competitiveness improvements.

While there is scope to divert Australia's commodity exports away from the troubled Asian economies, the overall demand for Australia's commodity exports will be influenced by the fact that world activity and world industrial production will be adversely affected by developments in Asia. As a consequence, the volume of non-rural commodity exports in 1998-99 is forecast to grow modestly, by around 2 per cent (after abstracting from the boost to exports in 1997-98 from Reserve Bank gold sales in the September quarter 1997).

Exports of **elaborately transformed manufactures** (ETMs) are more sensitive to changes in income in countries of destination than either rural or non-rural commodities, and are thus more susceptible to adverse impacts from the slowdown in Asia. However, Asian economies have been of relatively less importance as destinations for such products than is the case for commodities. A factor contributing to ongoing strength in exports of manufactures during the 1990s has been the ability of Australian manufacturers to compete vigorously in terms of prices. Highlighting a willingness to accept lower margins to increase export sales, the relevant export price index in Australian currency terms has fallen throughout the 1990s in an environment of subdued increases for domestic output prices. This practice is expected to continue over the year ahead. Moreover, the net effect of recent bilateral exchange rate movements has been broadly to maintain the overall competitiveness of Australian producers, although their competitiveness relative to some Asian producers will have declined significantly. Overall, developments in Asia have significantly weakened the outlook for ETM exports. The volume of ETM exports is forecast to grow by around 7 per cent in 1998-99, compared with an average growth rate of 16 per cent over the past decade.

Services exports are also sensitive to changes in income in importing countries, and therefore will be significantly affected by the downturn in Asia. Indeed, outcomes have already been adversely affected, particularly in relation to tourism receipts, as a result of a sharp fall in Asian visitors. However, it is likely that reduced visitor numbers from Asia will eventually be partially offset by increased arrivals from other markets (particularly North America and Europe) as a result of exchange rate movements which have improved Australia's competitiveness in those markets. The continuing relative strength of North America and Europe will also help sustain growth in business service exports. As with ETM exports, growth in overall services export volumes is forecast to be significantly weaker than the average experienced since the mid-1980s; a rise of 3 per cent is forecast for 1998-99, compared with an average growth rate of 8 per cent over the past decade.

In summary, while it is important to keep the developments in Asia in perspective, and not rely on simple frameworks based on fixed trade shares, the volume of Australia's exports will be adversely affected by the financial and economic crisis in Asia. The extent of the impact will vary across export categories. Abstracting from the effect of irregular transactions (such as gold sales and the export of ANZAC frigates), exports of goods and services are estimated to increase by 5¼ per cent in 1997-98 and are forecast to increase by 2½ per cent in 1998-99. By contrast, the average rate of growth over the previous decade was around 7 per cent.

This outlook, however, remains uncertain. A weaker world environment than currently forecast could result in a more pronounced easing in export growth than expected. Conversely, the ability of Australian exporters to continue diverting sales to less affected markets could mean that exports remain more resilient than forecast.

Direct Effect on Export Prices

A weaker external environment will not only adversely affect export volumes, but will also impact on export prices. This downward pressure is already evident, particularly in relation to commodities. Since the onset of the financial crisis in Asia, world prices for commodities of importance in Australian trade, expressed in either SDRs or US dollars, have fallen by around 8 per cent. Although the price falls to date have been sharp, they are not large by historical standards, and a reasonable degree of stability has been evident since mid-January 1998. Some further weakness in world commodity prices cannot be ruled out, but underlying support should be forthcoming if the continuing solid growth expected in OECD industrial production (excluding Japan) throughout 1998 and 1999 eventuates. For Australia, the decline in world commodity prices to date has been entirely offset by exchange rate movements. In Australian dollar terms, commodity prices in April 1998 were around 4 per cent higher than at the onset of the crisis, and at a level which compares favourably with the average experience of the 1990s. As noted above, these developments provide encouragement for commodity producers to maintain production rates, and also have been a major factor supporting the terms of trade.

In analysing movements in the terms of trade (as currently published) it is necessary to allow for the effect of changes in computer prices.[3] The rapid fall in computer prices, combined with the increasing importance of computers within Australia's imports, has a major depressing influence on the growth in overall import prices. An indication of this effect, both in recent years and as forecast, can be gained by comparing the estimated changes in the terms of trade, both including and excluding computer imports, shown in Chart 2. Abstracting from computers, the terms of trade fell sharply late in 1997, principally the result of

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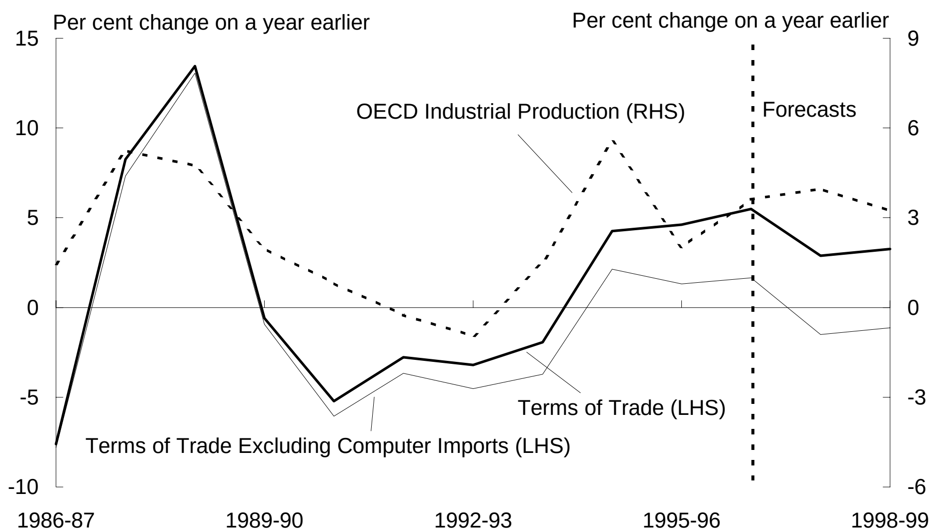
3 The ABS is in the process of introducing chain-linked volume indexes for national accounts estimates. For items where computers are relatively important, chain-linking will provide different estimates of rates of growth from those currently published. Those items particularly affected are equipment investment, imports of goods and services and the terms of trade.

the exchange rate depreciation feeding into higher import prices. It is likely that the terms of trade (abstracting from computers) weakened further during the first half of 1998; exchange rate induced increases in import prices early in the year are likely to have been combined with falls in Australian dollar denominated commodity prices (in part reflecting falls in negotiated coal prices for export to Japan). The terms of trade index (abstracting from computer imports) is forecast to rise gradually during 1998-99, reflecting the expected ongoing strength in OECD industrial production. Allowing for the effect of continuing significant declines in computer prices, solid increases in the published terms of trade are expected for both 1997-98 and 1998-99.

Chart 2: The Terms of Trade and OECD Industrial Production

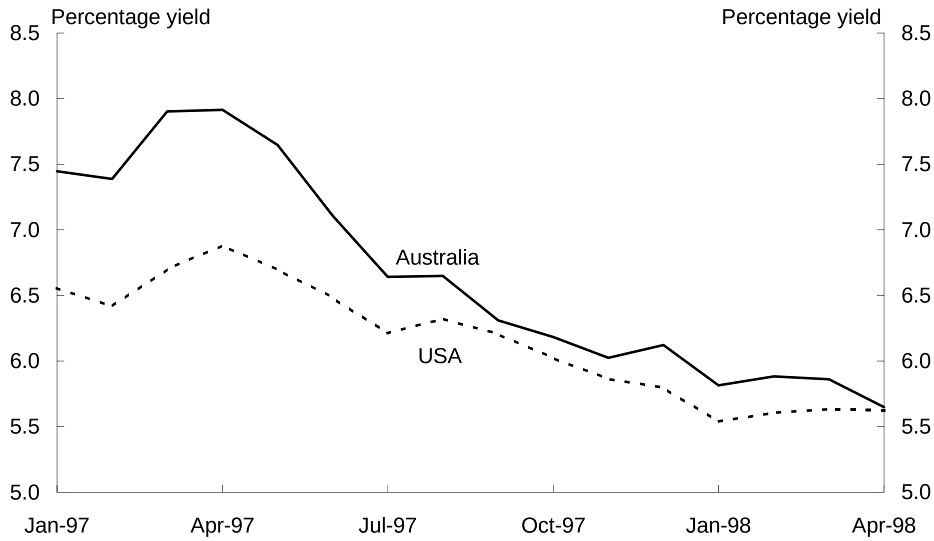


Source: ABS Cat. No. 5302.0, OECD and Treasury.

Financial Linkages

Australia appears to have benefited from the shift of world capital flows from a number of the Asian economies to more stable markets. Partly reflecting this ‘flight to quality’ and an ongoing favourable inflation outlook, long-term bond yields in Australia have continued to fall over recent months. The yield on 10 year government bonds has fallen by around two percentage points over the past year. At the same time, the differential between Australian and US 10 year bond yields has narrowed further, falling from around 100 basis points a year ago to be near parity recently (Chart 3), and the Australian stock market has risen accordingly. If sustained, higher stock prices and lower bond yields should have a stimulatory effect on domestic spending, helping to offset the negative impact on activity resulting from weaker export growth.

Chart 3: 10 Year Interest Rates for Australia and the United States



Source: Reserve Bank of Australia.

As noted earlier, the depreciation of the exchange rate against the US dollar has been important in offsetting declines in world commodity prices and maintaining domestic currency returns to commodity producers. The Australian dollar has also depreciated against the currencies of the other major industrial countries and appreciated against the currencies of the East Asian countries. The former group of countries are more important to Australia as a source of imports while the latter set of countries has been an important destination for Australia's exports. Accordingly, these exchange rate movements have led to an unusually large gap between the export-share and import-share weighted exchange rates, with the export-share weighted exchange rate rising by around 7 per cent in the March quarter compared with a 2 per cent increase in the import-share weighted exchange rate.

By itself, the higher export-share weighted exchange rate suggests that there has been a deterioration in competitiveness. However, other exchange rate measures indicate a modest improvement in competitiveness over the past year that will help stimulate Australian exports. An exchange rate index constructed using multilateral trade weights allows for changes in competitiveness arising from exchange rate movements against those countries which compete against Australia in world markets. Although volatile in recent months, this 'third-country' export-share weighted exchange rate has depreciated slightly over the past year, indicating a small improvement in Australia's competitiveness. The depreciation against the US dollar has also provided a boost to competitiveness, given that a large proportion of trade contracts are written in US dollars.

Indirect Effects

Any direct impacts on export volumes or the terms of trade will be reflected in sectoral incomes, with consequential indirect effects on expenditures, output and employment. A more uncertain, but equally important, channel through which weaker external conditions can impact on domestic activity is through a decline in business and consumer confidence.

Business surveys show a significant decline in business confidence over the past six months. At the same time, however, most such surveys indicate that actual trading performance has continued to improve. At this stage, it would appear that business decisions are related more to actual outcomes than to sentiment. Short-term employment expectations remain firm and reported job vacancies continue to rise. Year-ahead capital expenditure plans also remain firm, showing no downgrade in response to the decline in confidence.

There has been some recent volatility in surveys of consumer confidence, with increased pessimism evident in relation to consumers' perceptions about the state of the economy. However, perceptions about consumers' own financial positions remain sound and at a level which is comparable with the average experience of recent years. Recent indicators of consumer spending have been mixed, but the continuing strong growth evident in consumer credit suggests that any increased uncertainty is yet to have a significant impact.

Nevertheless, it is likely that consumer and business confidence will continue to be influenced by substantial media reporting of the 'Asia crisis'. This uncertainty may result in lower levels of private sector expenditures than would otherwise be the case, magnifying the overall effects of developments in Asia on domestic activity. Such effects are inherently difficult to estimate, both in terms of magnitude and timing. Nevertheless, some allowance has been incorporated in the forecasts, but with impacts on decision-making assumed to be more pronounced for business than for households.

In summary, the Asian crisis will have a significant impact on domestic economic activity. Lower export incomes and indirect effects on investment, consumption and employment growth will produce a substantial detraction from economic growth. In the absence of developments in Asia it is likely that the momentum in domestic activity evident in much of 1997 would have continued to build. That would have resulted in very strong growth in 1998-99, most likely stronger than the estimated outcome for 1997-98 of 3¾ per cent.

THE OUTLOOK FOR THE DOMESTIC ECONOMY

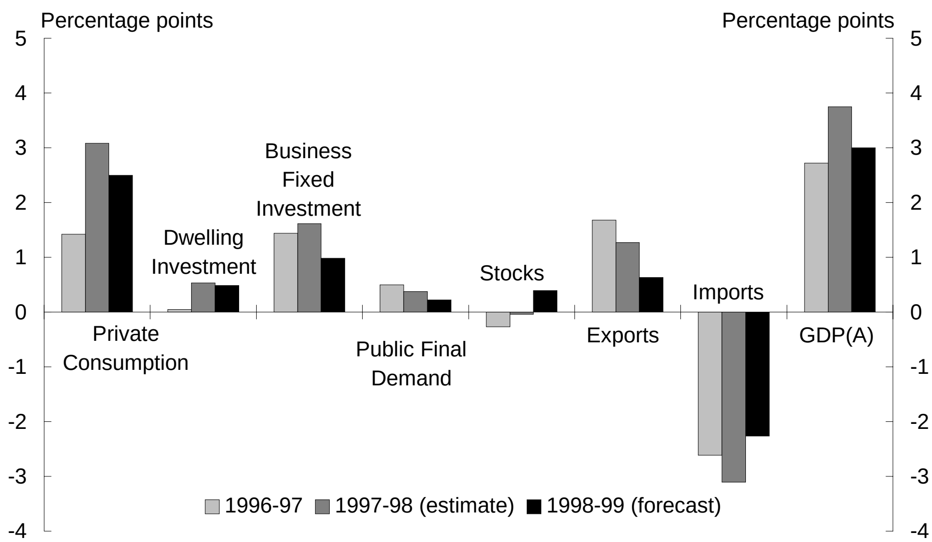
Forecasting Assumptions

The forecasts for the domestic economy have been developed in the context of the international environment outlined previously. In line with usual practice, it is assumed that nominal exchange rates remain broadly unchanged from average levels reached in recent months. The farm sector forecasts have been prepared on the assumption that seasonal conditions result in average yields across the range of major commodities.

Demand and Output

Solid economic growth is expected in 1998-99, although lower than in 1997-98, as continued strength in domestic demand cushions the negative effects from developments in Asia. Private demand growth is expected to remain robust, supported by favourable economic fundamentals: inflation is low; interest rates are low with part of the stimulus from declines in interest rates still to be felt; capacity utilisation is at a relatively high level; the balance sheets of the household and corporate sectors remain in good shape; the construction cycle is yet to reach its peak; and stock levels should be more responsive to movements in sales.

Chart 4: Contributions to GDP Growth(a)



(a) Adjusted for transfers and one-off transactions as noted in Table 1.
Source: ABS Cat. No. 5206.0 and Treasury.

Private Consumption

Private consumption growth is expected to remain strong in 1998-99, although easing somewhat from the rapid pace of 1997-98. Helping to limit the extent of this slowdown will be a likely boost to expenditure by households from the demutualisation of the AMP Society (see Box 1).

Box 1: The Effect of the AMP Demutualisation on Private Consumption

The demutualisation of the AMP Society involves the Society's listing on the stock exchange with members receiving shares in AMP in exchange for forgoing membership rights in the mutual society. After the listing, which is scheduled for mid-1998, AMP shareholders will be able to sell their shares, if they choose.

Since most AMP members are unlikely to have placed a monetary value on their membership in the mutual society, the shares they receive are likely to be viewed by them as a windfall gain. If members sell their shares, this gain will take the form of cash, while if they retain their shares, their perceived value of wealth will rise. While the sale of AMP shares will be matched by corresponding purchase transactions, the latter will be a reallocation of the financial assets of the purchasing parties. Part of the gains to AMP members is likely to be used to finance additional expenditure by households, with most of the impact expected to occur in 1998-99. Depending on the exact nature of the expenditure, it is possible that some household spending on home improvements would be classed in the national accounts as investment in alterations and additions rather than consumption.

This boost to consumption is likely to be similar to the recent United Kingdom experience, where consumers increased their expenditure using part of the gains from a number of large demutualisations. These consumers spent most money on home improvements, holidays and travel and household durables.[4] Around one-third of shares were sold in the months after listing, with around one-third of the proceeds used to finance additional consumption. Almost no members spent their gains in advance of the demutualisation.

Using the United Kingdom experience as a starting point, current market estimates of the total value of the shares to be issued suggest that the gains from the demutualisation could finance a considerable amount of additional consumption expenditure in 1998-99, with some analysts indicating the impact could be of the order of ½ percentage point of consumption growth. Such estimates are very uncertain, depending not only on the value of capitalisation of AMP upon listing but also on the behaviour of shareholders; given this, and the economic climate in which the demutualisation will be occurring, the additional assumed consumption effect is more conservative.

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4 Robert Fleming Securities Limited, *Economic Comment: Consumer Windfalls*, 13 August 1997. See also the November 1997 Bank of England *Inflation Report*.

Growth in real after-tax labour income is expected to be slightly lower in 1998-99 than in 1997-98, as a result of slightly higher inflation and a slowing in wage growth. However, growth in real household disposable income is expected to remain broadly unchanged. Slower labour income is expected to be offset by interest income growth as the effect of the earlier falls in deposit interest rates fades.

Despite the forecast for firm growth in household income, the household saving ratio is expected to decline in 1998-99 to around 2¾ per cent, a little lower than the average ratio over the 1990s to date. The dip in saving is largely explained by increased consumption funded out of the gains from the AMP demutualisation. These types of gains are excluded from the national accounts measure of household disposable income and are therefore not included in the national accounts estimates of saving.

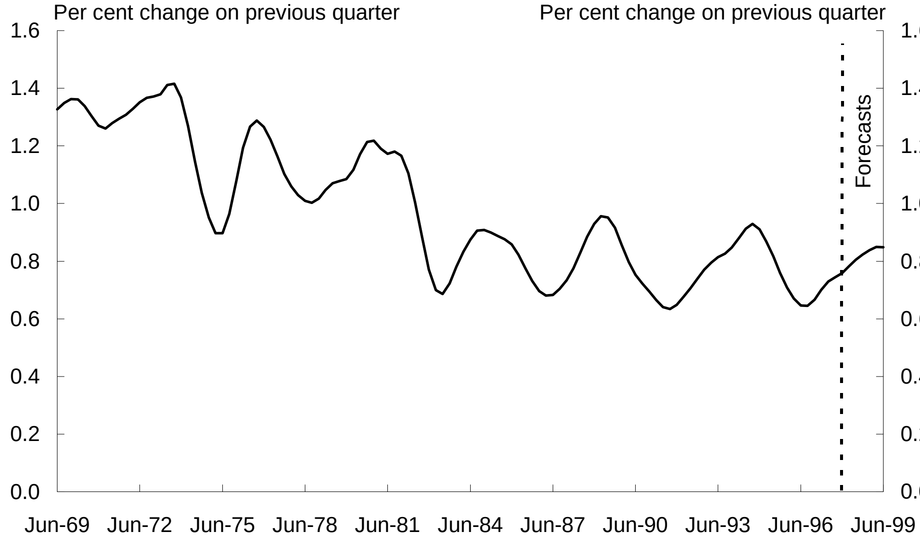
Dwelling Investment

Dwelling investment is expected to grow at a rapid pace in 1998-99, the second year of rapid expansion during this upturn. However, the pace of growth is expected to ease in the second half of 1998-99, as the demand for housing is satisfied by the increase in the dwelling stock. Developments in Asia are also expected to exert some dampening influence on activity in the medium-density sector during the course of the year.

The strength of the housing sector reflects high levels of housing affordability, mainly reflecting the very low level of housing interest rates. The standard bank variable mortgage interest rate is currently 6.7 per cent, the lowest level since 1970, and some introductory rates offered by lenders are considerably lower.

Cumulative increases in dwelling investment of the magnitude forecast are not uncommon during expansion phases of the housing cycle. Indeed, the implied growth in the dwelling capital stock is consistent with past experience (see Chart 5). Compositionally, however, forecast growth in dwelling investment is expected to be somewhat different to past cycles, with a significantly higher real average unit value of dwelling commencements in this upturn. Slower population growth across key household forming age cohorts than in previous dwelling cycles is expected to constrain the number of dwelling commencements in the current cycle. Against this, the historically high real average unit value of dwelling commencements reflects a long-term structural trend toward larger dwellings and also the weaker demand by first-home buyers in this upturn relative to previous experience.

Chart 5: Dwelling Net Capital Stock(a)



(a) Trend data.
Source: Treasury estimates.

Business Investment

Transfer of ownership of assets can have a significant impact on published estimates of business investment and public final demand. This has been the case in recent years, as is evident from a comparison of the information in Panels A and B of Table 1.[5] Such asset sales will have no impact on aggregate activity, but can provide a misleading view of movements in individual components. For this reason, it is preferable to abstract from such influences when interpreting fundamental movements in economic activity.

Growth in business investment (exclusive of asset sales) is expected to ease from the double-digit rates of growth experienced in recent years, with this deceleration being particularly marked through the year to the June quarter 1999. A number of fundamental influences will continue to act as a stimulus to investment: surveyed and estimated levels of capacity utilisation are at above-average levels; nominal interest rates are at low levels, with competition between lenders leading to recent falls in lending rates to small business; real interest rates have fallen over the past year; and profitability remains supportive. However, growth in business investment will be constrained by the effects of the Asian crisis on corporate profitability and capacity utilisation.

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5 The recent sale by the WA Government of the Dampier to Bunbury pipeline has not been incorporated in the 1997-98 estimates in Table 1 since at the time of preparation of the forecasts it was uncertain whether the ABS would treat the transaction as the sale of a second-hand asset or a going concern.

The recent weakening in business confidence as a result of the Asian crisis is also likely to result in some deferral of investment plans.

The balance between these opposing forces is difficult to forecast with any precision. However, the initial investment intentions for 1998-99 from the ABS *Private New Capital Expenditure (CAPEX) Survey* remained quite firm, despite being collected in January/February at the height of uncertainty about developments in Asia. Normally, in subsequent surveys, these initial investment intentions would be significantly increased as businesses firmed up plans for the actual budget year. The outlook of continuing solid, though easing, growth in investment in 1998-99 is somewhat conservative, in that it assumes a less pronounced expansion of intended investment in subsequent surveys than is normally the case in periods of solid economic growth. The assumed lower realisation of initial intentions seems appropriate in an environment where uncertainty is likely to remain significant.

Investment intentions data from the CAPEX survey provide some information on how positive investment fundamentals and the effect of Asia may translate into investment on an industry basis. The survey data indicate solid growth in business investment in 1998-99 is likely to be concentrated in the services sector, with mining investment expected to plateau after doubling over the past four years. Investment in manufacturing is expected to fall. The importance of the services sector for business investment reflects its importance to the whole economy: it accounts for around 70 per cent of GDP.

In terms of the components of business investment, equipment investment growth is expected to slow in 1998-99 after a number of years of strong growth. While growth should remain solid in line with favourable investment fundamentals, slower growth reflects in part the direct and indirect effects of the Asian slowdown and the natural maturing of the equipment investment cycle. Equipment investment is forecast to slow sharply over the course of 1998-99; abstracting from asset sales, equipment investment is forecast to increase by 4 per cent in the year to the June quarter 1999, compared with the double-digit rates of increase in recent years.

Non-residential construction investment is also expected to slow through 1998-99, but not as markedly as equipment investment. The amount of work in progress and yet to be completed is at a very high level, with a large amount of mining and infrastructure projects under way. This will support a continued high level of activity for some time, despite some Olympics-related projects nearing completion during 1998-99. Approvals are on a rising trend, and leading indicators such as finance approvals point to continued increases in the short term, further adding to the pool of work to be done. The longer planning schedules involved in construction projects suggest that delays and deferrals associated with the effects of developments in Asia are likely to be less evident during 1998-99 than will be the case for equipment expenditures.

Public Final Demand

Abstracting from asset sales, growth in public final demand is expected to continue to slow in 1998 99, largely reflecting slower growth in public consumption.

Public investment in 1997 98 was significantly affected by asset sales. Abstracting from these, public investment in 1998-99 is expected to fall by about the same rate as in 1997-98, with falls evident at both levels of government. Commonwealth government investment will be influenced by continued falls in public trading enterprise investment. State and local investment is expected to fall as Olympics-related spending abates and as some State government infrastructure programs run their course.

Public consumption is expected to grow more slowly in 1998-99 reflecting slower growth at both the Commonwealth and State government levels, consistent with fiscal consolidation objectives.

Non-farm Stocks

Private non-farm stocks are expected to contribute around ¼ percentage point to GDP growth in 1998-99 after a zero contribution in 1997-98 and a modest detraction in the previous year. The stocks-sales ratio has fallen sharply over recent quarters as sales growth has outstripped growth in stocks. This resumption of a sharp downward trend suggests that any earlier excessive holdings of stocks have now been eliminated, leaving businesses in a position whereby continuing solid growth in sales will be quickly reflected in production outcomes. There is also a possibility that current stocks-sales ratios are below desired levels, in which case a level of stock accumulation in excess of that forecast could be in prospect.

Farm Sector

In 1998-99, on the usual forecasting assumption of average seasonal conditions, the level of gross farm product is expected to remain broadly unchanged, only slightly lower than the most recent peak in farm production in 1996-97. However, there is some variation in the outlook for the main components of farm production, with lower grain production and livestock slaughterings expected to be partly offset by a larger wool clip as some rebuilding of the sheep flock takes place.

Net Exports

Net exports should make a large detraction from GDP growth in 1998-99, though by a slightly smaller magnitude than that in the previous year. Export growth is expected to weaken further in response to international developments (as discussed above), while import growth should remain strong.

The volume of goods and services imported increased at a rapid rate in 1996-97, and a similar rate of increase is estimated to have occurred in 1997-98. A number of factors contributed to this strength: continued strong growth in domestic demand in both years, but particularly in 1997-98; the composition of demand being relatively import-intensive, due to strong growth in consumption expenditure and equipment investment; and a lagged response to relative price movements which, through the course of 1996-97, favoured imports rather than domestically produced goods. Continued strength in domestic demand in 1998-99 is expected to underpin ongoing strong growth in import volumes. However, some easing of growth is in prospect. Domestic demand growth itself is forecast to increase at a slightly less rapid rate. Moreover, the composition of demand growth — with a relatively stronger contribution from construction investment than was the case in the previous year — should also have some dampening influence on growth in the imports-sales ratio. Further, higher import prices stemming from the recent depreciation of the Australian dollar against the currencies of the major industrial countries, including the United States, should act to dampen the effect of strong domestic demand.

Wages

Wage growth in the year to the June quarter 1999 is expected to be slightly lower than growth in the year to the June quarter 1998. The slowing in aggregate wage growth reflects some moderation of enterprise bargaining outcomes more than offsetting a slightly faster pace of award wage growth flowing from the April 1998 Australian Industrial Relations Commission (AIRC) safety net decision.

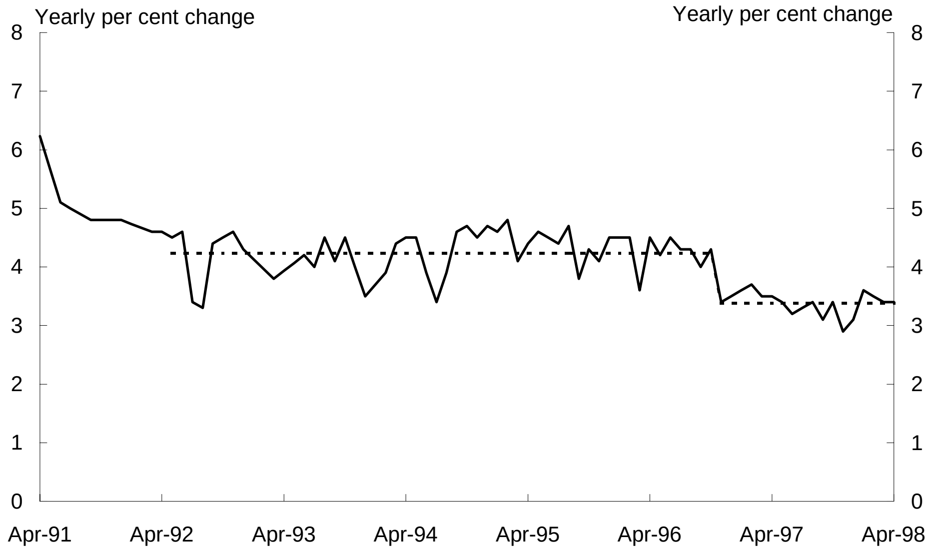
The legislated increase in Superannuation Guarantee contributions made by employers from 6 to 7 per cent on 1 July 1998 will contribute to growth in average earnings (on a national accounts basis) in 1998-99.

Prices

The underlying inflation rate is expected to rise over coming quarters, gradually returning to the Reserve Bank's monetary policy target range of 2 to 3 per cent and remaining in that band throughout 1998-99. By the June quarter 1999, the underlying inflation rate is forecast to reach 2¾ per cent, but with no signs of acceleration. Headline inflation is expected to increase in line with underlying inflation, also reaching 2¾ per cent by the June quarter 1999.

The prospect of continuing low inflation is reflected in low consumer and investor inflation expectations, with median consumer inflation expectations currently near a record low (see Chart 6).

Chart 6: Median Consumer Inflation Expectations



Source: Melbourne Institute of Applied Economic and Social Research, Survey of Consumer Inflationary Expectations.

The forecast gradual rise in inflation during 1998-99 primarily reflects the lagged pass-through into retail prices of the higher import prices which resulted in the latter part of 1997 and in early 1998 from depreciation in the Australian dollar against the currencies of major industrial countries. Another factor contributing to the rise is higher nominal unit labour costs, primarily resulting from a cyclical slowing in productivity growth. Acting in the opposite direction will be the moderating effect of some easing in demand pressure.

Higher import prices are also expected to lead to a gradual increase in broader measures of inflation, such as the gross non-farm product deflator.

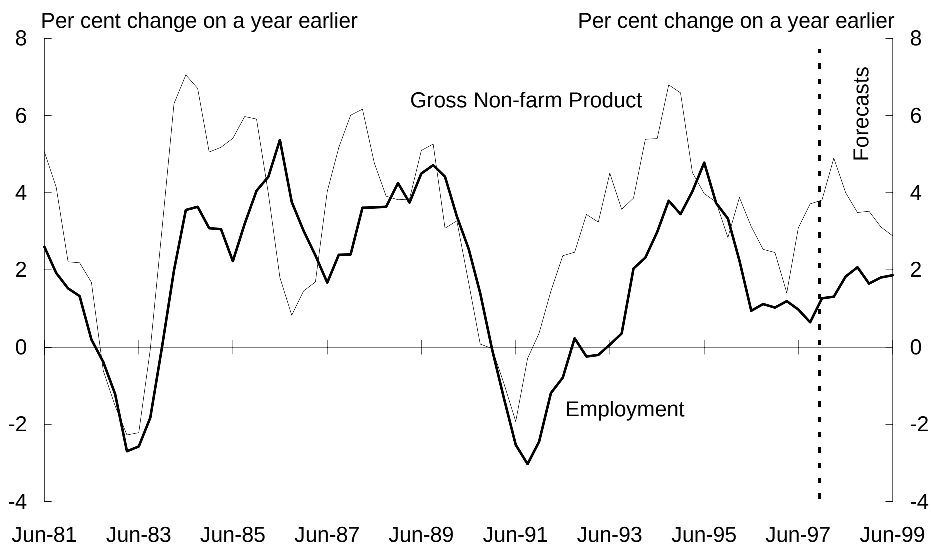
The Labour Market

The labour market is forecast to continue to improve in 1998-99, with further solid employment growth and a small fall in the unemployment rate expected.

Employment growth strengthened during 1997-98 and this momentum is expected to be carried through into 1998-99, underpinned by recent and prospective growth in non-farm activity (see Chart 7).

The outlook for continued solid employment growth is supported by the current high levels of job vacancies, with the ANZ series at around its highest level in three years and the ABS series at its highest level since the series commenced. Continued strong growth in job vacancies suggests that the recent drop in surveyed business confidence has not had an appreciable effect on firms' intentions to hire more staff.

Chart 7: Growth in Employment and Non-farm Activity



Source: ABS Cat. Nos. 5206.0 and 6202.0.

After growing strongly throughout 1997-98, labour productivity is expected to slow over 1998-99, as employment growth responds with a lag to the easing in output growth.

The unemployment rate is forecast to fall to 7¾ per cent by the June quarter 1999, its lowest level since the December quarter 1990.

The strong increase in employment in 1997-98 translated almost fully into a decline in the number of unemployed, as the participation rate remained broadly stable. The participation rate is forecast to rise slightly during 1998-99 in response to modestly improving employment opportunities. Housing affordability also appears to be an important factor in the decision whether or not to participate in the workforce. In this regard, the ongoing high level of housing affordability and its impact on existing mortgage repayment obligations might mean that the stimulus to labour force participation continues to be less than would otherwise be the case.

The Current Account Balance

The current account deficit is expected to increase to around $31 billion, or 5¼ per cent of GDP, in 1998-99. This anticipated rise is due to lower net export volumes and an increase in the net income deficit, partly offset by an increase in the terms of trade. The widening of the deficit is expected to be concentrated in 1998 with some narrowing occurring in 1999. As a per cent of GDP, the outcome for a particular quarter will be higher than that forecast for the year as a whole.

Statement 3 of this document[6] compares the forecast increase in the current account deficit with past current account deficit episodes.

Uncertainties Surrounding the Outlook

The events in Asia over the past year or so highlight some of the uncertainties associated with economic forecasting. While there was some awareness of the policy shortcomings of the Asian economies, along with the threat they posed to economic stability, the timing and extent of the financial and economic crisis was not predicted. The unpredictability of these developments underlines the difficulty of appropriately incorporating risks to the economic outlook, but at this stage three broad issues warrant consideration: the direct and indirect effects of international developments; the extent to which weather conditions might depart from 'normality'; and the extent to which current monetary conditions might underpin greater strength in domestic spending than forecast.

As outlined above, the downturn in Asia is an important factor impacting on the domestic outlook. However, the extent and timing of this impact is particularly uncertain, partly because it relates to the outlook for world activity itself. While there now appears to be greater stability in financial markets in most of the troubled Asian economies, the full effects of developments on real activity are still to be felt in these economies. Of particular concern is the outlook for Japan. A sharper and more protracted weakening in Japan than currently forecast could have significant impacts on world industrial production, with consequent implications for the volume and prices of Australian exports. This would be especially so if weakness in Japan was combined with a more pronounced slowing toward sustainable growth in the United States and weaker than expected growth in Europe. Furthermore, a tightening in monetary policy in the United States and/or a sharp correction in stock prices could have significant implications for financial markets in other countries. Conversely, activity in the United States has continually surprised on the upside for some years without introducing sustained inflationary pressures, and may continue to do so over the next year. In addition, the strengthening of growth in Continental Europe may gather further pace than expected in response to current relatively accommodating monetary settings. The outlook for international activity thus seems to be finely balanced.

There are necessarily uncertainties about the magnitude and timing of the impacts of these international developments upon the Australian economy. While the forecasts allow for a significant adverse direct impact, various factors could result in the impacts being overestimated. In particular, increases in supply capacity, continuing high Australian dollar returns to commodity producers, continued competitiveness of Australian exporters and their proven

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6 Statement 3 of *Budget Paper No. 1 — Budget Strategy and Outlook 1998-99*. Statement 3 is reproduced in this edition of the Roundup.

ability to expand sales into emerging markets may lead to export outcomes being higher than expected. Uncertainties surrounding indirect influences are also very large, and difficult to assess. Further weakening in business and consumer confidence could obviously result in lower levels of private sector expenditure than currently assumed. However, while events in Asia have already resulted in a decline in business confidence, the impact to date on expenditure plans appears to be modest. In particular, short-term employment expectations remain firm and year-ahead capital expenditure plans show no signs of deferral. If actual trading performance continues to grow solidly, as forecast, it could be that continuing high levels of private sector uncertainty fail to impart a constraining influence on overall activity to the extent incorporated in the forecasts.

The prospect of drought continues to pose a risk to farm production, though useful rains occurred during April throughout much of south-east Australia and the Bureau of Meteorology is cautiously optimistic about relatively normal rainfall patterns in the longer term. Nevertheless, follow-up rains are still required to ensure average seasonal conditions are achieved. If this does not occur, farm production could be lower than forecast, with flow-on effects to rural exports and GDP growth.

For private sector activity as a whole, the extent of the stimulus to private demand from current monetary conditions is an important uncertainty. The reductions in the official interest rate in 1997, competition-induced reductions in market interest rates and the decline in bond yields will all have a positive effect on activity in 1998-99. Some uncertainty relates to the extent of stimulus that should be incorporated in the forecasts, with the possibility existing that impacts on activity will be stronger, and more persistent, than assumed.