Economic Overview

The March quarter 1998 National Accounts confirmed continued strong growth in the Australian economy. Partial and forward looking indicators of activity suggest that growth has continued in recent months, although at a somewhat slower pace than that recorded in the latter half of 1997. Available indicators point to continued firm activity in the consumption, dwelling and business investment sectors of the economy. Underlying inflation remains subdued. A number of transitory factors appear to have depressed export growth and boosted import growth in the March quarter. Trade data for the June quarter are more positive. An important development that became evident over the course of 1997-98 is the success Australian exporters are having in diverting sales away from weaker markets in East Asia to markets in North America, Europe and other parts of Asia. This is discussed further below.

One factor contributing to the successful diversion of exports is the strong economic growth being enjoyed by the Unites States and Europe. Domestic demand remains strong in these economies, offsetting the impact of weaker demand from Asia. Asian economies are still undergoing major adjustments and, while there are some more positive signs, there is still no clear evidence of a turnaround in their overall performance. Japan continues to face serious economic disruption and its short-term prospects will be governed by the purpose and resolve of the Japanese Government under new Prime Minister Obuchi to address the country's major policy challenges.

These and other issues affecting the world outlook are discussed in the first section of the Overview. The next part examines the available data on economic activity in Australia. This leads to a discussion of some of the ways the Australian economy is responding to the slowdown in Asia and the impact of the Asian crisis on business and consumer confidence in Australia. The final section of the Overview outlines the results of some recent surveys of business confidence, along with a brief discussion of what these results might mean for economic activity.

DEVELOPMENTS IN THE WORLD ECONOMY

The Asian financial crisis and weakness in Japan continue to have an adverse effect on world economic activity. On the other hand, the economic performance of the United States and Europe has continued to be strong. Growth in the United States in 1998 to date has been higher than expected and growth in Europe continues to strengthen, with increased domestic activity more than offsetting the decline in external demand. In part, the strength of these economies derives from the redirection of investment funds from the Asian region.

Japan

The Japanese economy is in recession, with output falling in both the December quarter 1997 and the March quarter 1998. Private demand is very weak, with poor levels of confidence reflected in flat consumption and falling business investment.

In part, recent developments in Japan are related to the downturn in the rest of Asia, reflecting sharply lower export demand and the exposure of Japanese banks and corporates to countries such as Indonesia, Thailand and Korea. Nevertheless, the dominant contributors to Japan's current problems are domestic in nature, and reflect not only weak macroeconomic demand conditions but also long-standing structural problems, particularly in the financial sector.

Japan's most immediate structural problem is the deterioration in bank balance sheets stemming from the substantial level of non-performing loans. Problems in the financial sector have had a significant impact on consumer confidence and spending, and businesses have faced difficulties accessing credit. Reform of the financial sector commenced on 1 April with the introduction of the 'Big Bang' liberalisation program and, more recently, the Government has announced details of a plan to help resolve the bad debt problem as a matter of highest priority. The Government has also outlined a number of broader structural reform measures, including a review of the taxation system intended to reduce corporate taxation rates to nearer international standards, and infrastructure reform aimed at increasing the efficiency of the domestic economy in the areas of transport, distribution and telecommunication.

The Government's macroeconomic policy response to the lack of demand in the economy has concentrated on fiscal measures, involving mainly increased spending on public works, but also including an extension of temporary income tax rebates.

While the full implementation of the fiscal stimulus measures announced to date is expected to help stimulate activity in the second half of 1998 and into 1999, a sustainable recovery of the Japanese economy will depend importantly on the effective implementation of needed structural reforms and on the restoration of business and consumer confidence. This will be a major task facing the Japanese Government under its new Prime Minister, Mr Keizo Obuchi.

Developments in the rest of Asia

The large outflow of capital from the region in the second half of 1997 caused dramatic falls in exchange rates and stock markets in many East Asian economies. Some stability has returned to financial markets in recent months, with the Korean won and the Thai baht, in particular, strengthening substantially against the US dollar; the Indonesian rupiah, however, remains very weak and volatile. Stock markets remain weak in most countries.

Despite this increased stability in financial markets, significant impacts on real sector activity are now more observable. With the exception of China and Taiwan, each of the major economies in the East Asian region experienced falls in output during the March quarter (Charts 1 and 2). Indonesia, Korea and Malaysia were the worst affected, with GDP contracting by over 5 per cent from the previous quarter;[1] preliminary estimates for Indonesia indicate a further sharp contraction occurred in the June quarter. Hong Kong moved into recession in the March quarter with a second consecutive quarter of falling output, and Singapore contracted for the first time since September 1996.

Chart 1: GDP Growth North East Asia (Q/Q)

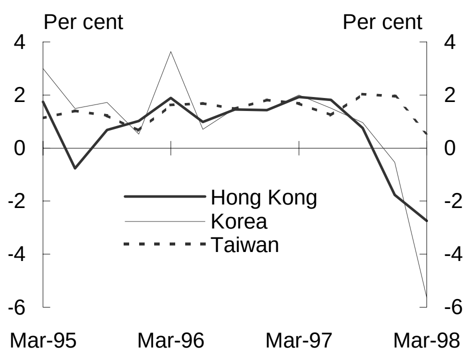
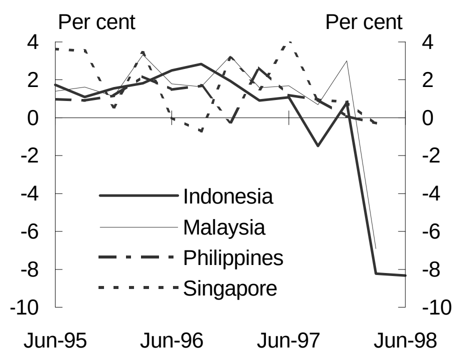


Chart 2: GDP Growth South East Asia (Q/Q)



Source: CEIC

One indication of weakness in domestic activity in the Asian region as a whole is the sharp fall in import demand that has occurred during 1998. This has been particularly evident in Indonesia, Thailand and Korea, where import levels have recently been below year-earlier levels by between 37 and 47 per cent. Higher domestic currency costs for imported products and a lack of credit to finance imports have been additional important factors constraining imports in these countries.

- One positive outcome of the large contraction in imports is a substantial reversal in the current account positions of many East Asian economies. The swing from large current account deficits to surpluses in Korea, Thailand and Indonesia is a necessary adjustment as these countries can not, at present, attract the foreign capital needed to finance current account deficits. The surpluses will also assist in reducing external liabilities and rebuilding foreign exchange reserves.

1. Seasonal adjustments have been done by Treasury.

There are still no clear signs that the fall in demand and activity in the affected Asian economies, as a whole, has been arrested and begun to be stabilised. Some more positive outcomes are apparent — for example, recent retail sales data in Korea, Hong Kong and Singapore and industrial production in Korea, Malaysia and the Philippines — but the evidence remains patchy at this stage.

Despite the substantial real currency depreciations experienced by many of these Asian economies (Table 1), there is as yet little sign of a substantial improvement in export performance. In part, this reflects the disruption that has occurred to trade finance and also the importance of intra-regional trade. Japan alone absorbs around 10 per cent of the exports of Korea, Taiwan, Malaysia and Indonesia, and 13 and 17 per cent respectively for Thailand and the Philippines. As indicated in Chart 3, intra-regional trade (to Japan and to other countries in the region) has contracted sharply since late 1997. In contrast, exports to the United States have remained strong and those to the rest of the world (ROW) have strengthened.

Table 1: Exchange Rate Movements

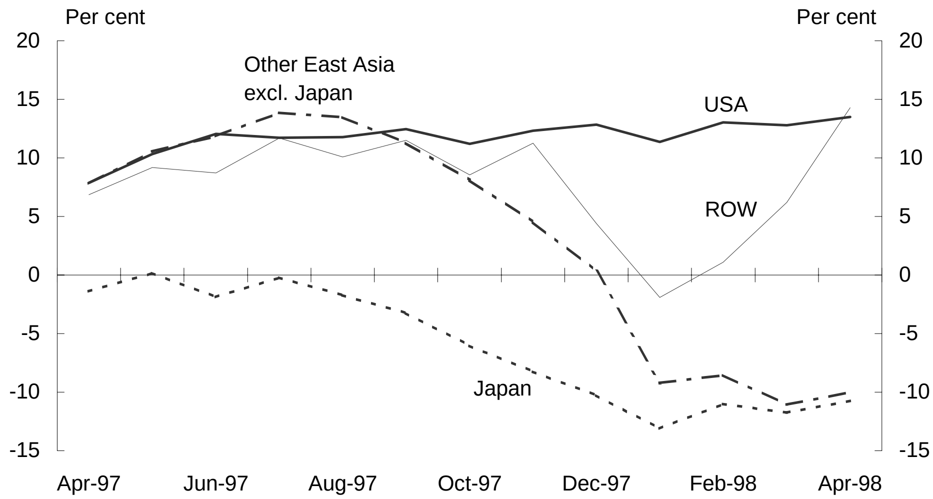
	Movements against Japanese Yen			Movements of Real Effective ER		
	Jun 97-Jan 98	**Jan 98-Jun 98**	**Total**	**Jun 97-Jan 98**	**Jan 98-Jun 98**	**Total**
Taiwan	-3.1	2.6	-0.5	-6.4	0.6	-5.8
Singapore	-3.2	9.7	6.2	-4.2	1.5	-2.8
Hong Kong	13.9	8.5	23.6	6.1	3.4	9.7
Malaysia	-26.3	6.1	-21.8	-35.9	12.6	-27.8
Korea	-28.7	11.0	-20.9	-35.7	27.5	-18.0
Indonesia	-53.2	-56.5	-79.6	-67.7	-1.7	-68.2
Thailand	-40.5	23.6	-26.5	-42.1	26.8	-26.6
China	15.7	7.3	24.2	na	na	na

Source: JP Morgan; Reuters

There have been suggestions that the recent weakness of the yen could undermine the gains in export competitiveness resulting from the earlier currency depreciations of many East Asian economies. This is more relevant for Korea and Taiwan, which compete head on with Japan in international markets; for example, between 40 and 50 per cent of Korea's exports compete directly with Japanese exports. Despite recent weakness in the yen, overall currency movements over the past year remain favourable for Korea and neutral for Taiwan (Table 1). Movements against the yen are less relevant for countries such as China, Thailand, Malaysia and Indonesia; these countries export very different goods than Japan and their competitiveness in third countries will not be directly affected by the recent fall in the yen. Even so, with the exception of China and Hong Kong, significant net depreciations have been maintained despite some reversals during 1998.

- Apart from the impact on trade, movements in the yen also have implications for debt servicing. In this regard, a weak yen will help reduce the cost of servicing foreign debt for countries that have significant yen-denominated debt, such as Thailand, Indonesia and Korea.

Chart 3: East Asian Export Growth by Region



Source: CEIC

Note: A three month moving average has been applied to the monthly export data, which is valued in US dollars, and growth rates have been calculated on a through-the-year basis.

Economic growth has slowed significantly in **New Zealand** over recent quarters, with GDP contracting in the first quarter of this year. The slowdown is a reflection of falling net exports in the wake of the regional currency crisis, weakening domestic demand and a loss of consumer and business confidence. Employment growth has decelerated sharply while the unemployment rate has risen from a low of 6 per cent to 7.1 per cent over the five quarters to the March quarter 1998.

Overall monetary conditions have eased considerably since mid 1997, with a significant fall in the exchange rate likely to assist a recovery in net exports. The current account deficit, which had deteriorated to nearly 8 per cent of GDP by late 1997, narrowed slightly in the first quarter of this year.

United States and Europe

Outcomes in the United States and Europe continue to surprise on the upside, helping provide a solid foundation for overall world economic growth.

In the **United States** economic activity remains buoyant, with GDP in the June quarter 1998 around 3½ per cent higher than the year-earlier level. Robust economic growth continues to be supported by strong domestic demand, outweighing the impacts of reduced demand from Asia and the strength of the

US dollar. Growth slowed in the June quarter, on the back of a deteriorating trade performance with Asia and an inventory adjustment, along with transitory effects such as the General Motors strike. Underlying growth, however, is expected to remain strong, supported by continuing robust private consumption.

The impressive economic growth performance continues to support solid employment growth, with the unemployment rate falling to around 4½ per cent. Despite a tight labour market, inflation remains low, with core inflation around 2¼ per cent, assisted by the strength of the US dollar.

Economic growth in the United States is still expected to moderate to more sustainable levels over the remainder of 1998 and 1999, which will assist in alleviating inflationary pressures.

The economic recovery in the major **Continental European** economies continues to strengthen, broadening into the domestic economies and helping to offset the weaker external sector resulting from Asia's downturn. The smaller European economies have already been growing strongly, and growth will be further assisted by the convergence of interest rates towards those of France and Germany, in the lead-up to the commencement of European Economic and Monetary Union (EMU). France and Germany have enjoyed stronger investment spending, and continued employment growth and rising consumer confidence have underpinned improved consumption spending.

Although employment growth in the core economies of Europe has shown some improvement, high unemployment rates across Continental Europe remain a significant concern.

The **United Kingdom's** economy is at a mature stage in its growth cycle with growth slowing to around 2½ per cent in the June quarter. Private consumption and investment are the driving force behind economic growth, while net exports have been detracting from growth in the face of falling demand from Asia and the strong pound sterling.

The tight labour market conditions and the strength in domestic demand continue to pose inflationary concerns. Underlying inflation at 2.8 per cent remains above the Bank of England's inflation target, but the strength of sterling, weak commodity prices and restrictive fiscal policy have been dampening influences on prices. Since mid-1996 the Bank of England has implemented seven successive interest rate increases, the most recent in June. In July 1998 the Bank voted to leave rates unchanged at 7½ per cent.

DOMESTIC ECONOMIC ACTIVITY

The March quarter National Accounts data confirmed continuing growth in the domestic economy. GDP(A) grew by 1.3 per cent in the March quarter, and 4.9 per cent over the year to the March quarter, up from 3.8 per cent over the year to the December quarter 1997.

The largest contribution to growth in the March quarter came from a substantial rise in **stocks**. The **private non-farm stocks to sales ratio** rose in the March quarter, reflecting the large rise in stocks and a slight fall in sales (Chart 4). While there has been a long-term decline in the stocks to sales ratio as firms have introduced more efficient inventory procedures, the decline was particularly sharp through 1997 as sales growth outstripped growth in stocks. Hence, notwithstanding the substantial rise in stocks in the March quarter, it is not apparent that stocks are at an uncomfortably high level relative to sales. It was noted in the 1998-99 Budget, in fact, that the stocks to sales ratio then prevailing might be below desired levels. Business liaison also points to some of the stock build-up being in response to anticipated disruption flowing from the waterfront dispute.

Chart 4: Stocks to Sales Ratio

Source: ABS Cat. No. 5206.0

The build-up in **public marketing authority stocks** in the March quarter appears largely to be due to a temporary decline in cereal exports. The Australian Wheat Board (AWB) has indicated that there were delays in wheat sales in the March quarter as buyers awaited an indication of likely price outcomes. These sales have been finalised, with wheat normally shipped in February and March being shipped during the June and September quarters.

Real private consumption expenditure was flat in the March quarter, but this followed strong growth of 1.4 per cent and 1.7 per cent in the September and December quarters 1997 respectively.

Private business investment rose by 12 per cent in the March quarter, although the rise largely reflected the purchase of the Dampier to Bunbury gas pipeline from the public sector. Abstracting from asset sales, **new equipment investment** fell by 4 per cent in the quarter, after rising by 4 per cent in the December quarter 1997. **New non-dwelling construction** rose by 9 per cent in the quarter, following a fall of 4 per cent in the previous quarter.

The delay in cereal exports noted above, together with the slowing in exports to East Asian markets, led to a decline of 2.2 per cent in the volume of **exports** in the March quarter. Strong domestic expenditure underpinned further growth in **imports** of 3.1 per cent. As a result, net exports detracted 1.3 percentage points from growth in the quarter.

As outlined below, partial indicators of activity suggest that the economy continued to grow in the June quarter, despite the continuing effect of the Asian crisis on some sectors.

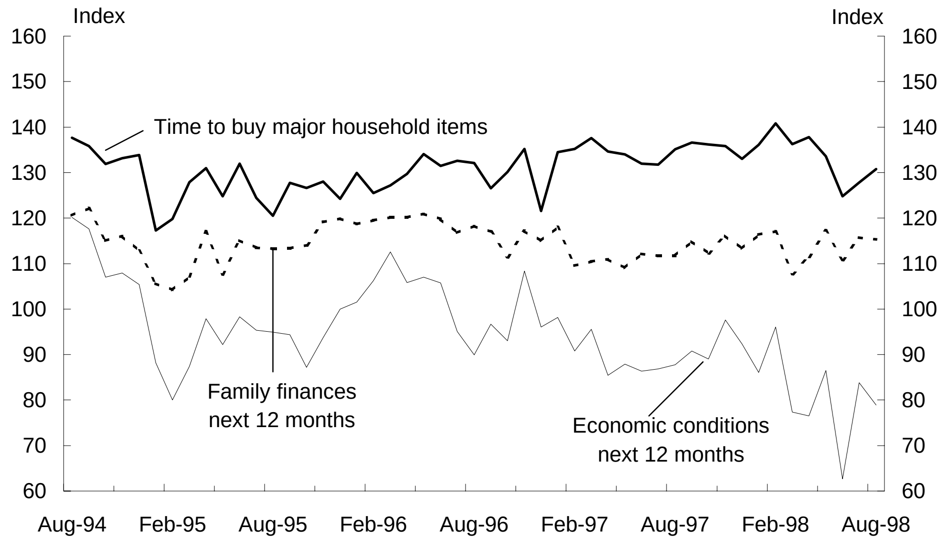
Private Consumption

Current price retail trade fell by 0.8 per cent in June in seasonally adjusted terms after rising moderately in May and April. Over the year to June retail trade rose by 3.8 per cent. In constant price terms, retail trade fell by 0.2 per cent in the June quarter (seasonally adjusted) and rose by 2.8 per cent over the year. At the same time, motor vehicle registrations continued to grow very strongly, up 18.5 per cent in the year to June in trend terms.

Key influences on the outlook for consumption will be growth in real household disposable income, which in turn depends on the future course of employment, wages and inflation. These fundamentals remain favourable. Wages continue to grow moderately, inflation is low and measures of household wealth remain strong with equity prices holding up and house prices rising. The AMP's strong listing on the Australian Stock Exchange in June 1998 is also favourable for consumption as members who have sold (or will sell) their shares are likely to use part of the proceeds to finance additional expenditure. Whether this consumer expenditure eventuates as expected, however, will be influenced by the state of consumer confidence.

The *Westpac-Melbourne Institute Consumer Sentiment Index* was broadly unchanged in August after rebounding in July from a sharp fall in June (Chart 5). Most of the rebound in July was attributable to a turnaround in the component of the index which measures expectations of economic conditions in the next twelve months. This was the component that had declined sharply in June, with the timing of the survey in that month coinciding with considerable press coverage about movements in the exchange rate and speculation about interest rates. Overall, consumer confidence would appear to be consistent with continued growth in consumption expenditure.

Chart 5: Westpac/Melbourne Institute Consumer Sentiment Index



Source: Westpac-Melbourne Institute Survey of Consumer Sentiment

Private Investment

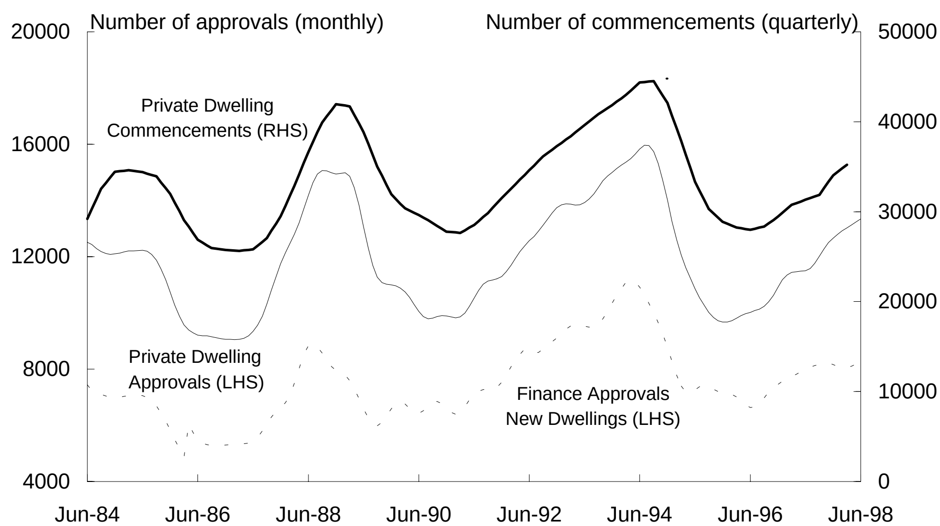
As noted previously, after abstracting from asset sales, business investment fell in the March quarter. However, expectations of total capital expenditure in 1997-98 as recorded in the ABS's March quarter *Private New Capital Expenditure (CAPEX) Survey* were firm, implying a resumption of investment growth in the June quarter. The March quarter expectation for equipment investment in 1997-98 (which includes actual survey data for the September, December and March quarters and expectations for the June quarter) was 15 per cent higher than the equivalent estimate for 1996-97. The March quarter estimate for building investment in 1997-98 was 13 per cent lower than the equivalent estimate for 1996-97. However, these estimates are at odds with other partial indicators of building activity. The June data for non-residential building approvals confirmed the very strong growth experienced throughout 1997-98 to date. Commercial finance commitments for June are also well above levels of a year ago. The level of work yet to be done for both building and engineering activity is also at relatively high levels.

The March quarter CAPEX also included the second set of expectations for business investment in 1998-99. The second estimate for 1998-99, taken in April / May, was 9 per cent higher than the first estimate for 1998-99, taken in January / February. This rise in expectations between the first and second set of expectations is lower than the experience of recent years and may reflect a more cautious attitude amongst investors in the light of the economic and financial instability in Asia. Indeed, as the 1998-99 Budget Papers noted, given recent developments in Asia, a less pronounced expansion of intended investment was likely than is normally the case in periods of solid growth. Overall, the expectations data remain consistent with modest growth in business investment in 1998-99.

Partial indicators of **dwelling** activity, while exhibiting some month-to-month volatility, also point to continued strength in dwelling investment (Chart 6). While there was a fall of 2.5 per cent in private housing commencements in the March quarter, this follows a very strong rise of 10.5 per cent in the December quarter, the strongest quarterly increase since the September quarter 1988. Given the time taken between commencement and the completion of home construction, the relatively high level of commencements will support dwelling investment in coming quarters.

Private building approvals rose by 7.3 per cent in June. The net increase in approvals in recent months provides further evidence that housing activity will continue at a firm pace. Finance approvals for new dwellings rose by 11 per cent in June.

Chart 6: Indicators of Dwelling Activity (Trend)



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

Underpinning these indicators of activity in the dwelling sector are positive fundamentals. The Commonwealth Bank / HIA index of housing affordability rose by 3.1 per cent in the March quarter to be 24 per cent higher than two years ago. The Citibank / REIA index of home affordability rose by 2.3 per cent in the March quarter and is 5 per cent higher than a year ago. The factors underpinning affordability remain positive: the indicator lending rate for standard variable home loans offered by banks remains at 6.7 per cent, its lowest level since 1970 (there has been a small increase in some fixed loan products offered by some lending institutions reflecting the cost of borrowing money in the bond market); household income is rising; and house price inflation is moderate.

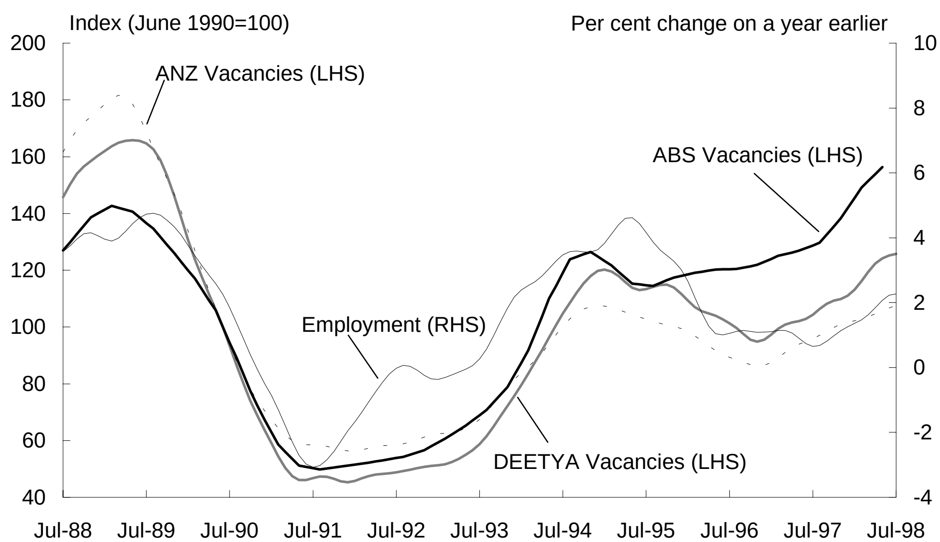
Labour Market

Employment growth in the year to July was 2.2 per cent, continuing a fairly steady acceleration of employment growth over the course of 1997-98. This is consistent with the strengthening in output growth over the past year. Employment growth in year average terms in 1997-98 was 1.3 per cent, in line with the estimate in the Budget Papers of 1¼ per cent growth.

The high level of the various job vacancy series, which are an indicator of actual hiring activity by employers in the short term, point to continuing employment growth in the months ahead (Chart 7). The ABS job vacancy series is at its highest level since the series began in 1979 while the ANZ job advertisements series is at its highest level since April 1990 and the DEETYA Skilled Vacancy series is at its highest level since January 1990.

The unemployment rate rose slightly to 8.3 per cent in July as the labour force grew more strongly than employment. The participation rate rose to 63.5 per cent in July.

Chart 7: Vacancy series and Employment



Source: ABS Cat. Nos. 6203.0, 6354.0; DEETYA Skilled Vacancy Series; ANZ Job Advertisements Series

Wages

Average weekly ordinary time earnings (AWOTE) rose by 0.6 per cent in the June quarter compared with growth of 1.4 per cent in the March quarter. In through-the-year terms, growth in AWOTE remains moderate at 4.3 per cent. Average weekly earnings (AWE) rose by 0.5 per cent in the June quarter, after being flat in the March quarter.

Prices

Underlying inflation remained subdued in the June quarter 1998 at 0.4 per cent (compared with 0.5 per cent in the March quarter). The price of imported items fell in the quarter, largely reflecting the continued decline in the price of passenger motor vehicles. Prices of imported motor vehicles have fallen by over 15 per cent in the past three years. Over the year to the June quarter underlying inflation was 1.6 per cent. Underlying inflation has now been below 2 per cent in year to terms for five consecutive quarters.

Headline inflation also remains low, at 0.6 per cent in the June quarter. Over the year to the June quarter, headline inflation was 0.7 per cent, compared with a fall of 0.2 per cent in the year to the March quarter. The rise in the June quarter reflects increases in hospital and medical services, food and housing (largely due to local government charges), partly offset by falls in passenger motor vehicle prices. Consumer inflation expectations, as measured by the *Westpac/Melbourne Institute Survey*, were 4.5 per cent in the month of August.

Current Account Balance

In the March quarter 1998, the current account deficit increased significantly to $7.5 billion, or around 5.4 per cent of GDP, reflecting a deterioration in the balance of trade. A rise in the current account deficit in the March quarter was anticipated, given the impact of the Asian crisis on Australia's exports and the ongoing strength of domestic demand. Recent monthly trade data indicate that the balance of trade component of the current account deficit is likely to have narrowed in the June quarter. Some of this improvement reflects increased cereal exports as some of the wheat exports that normally would have occurred in the March quarter have been shipped in the June quarter (with some further catch-up likely in the September quarter), as discussed above. In addition, some of the imports that would have normally occurred in the June quarter seem likely to have been brought forward to the March quarter, as part of a stock build-up ahead of the waterfront dispute.

Export Diversion

The 1998-99 Budget Papers discussed the likely impact of the economic and financial crisis in East Asia on the outlook for exports and domestic activity, including the mechanisms through which it was expected these developments would be transmitted through the Australian economy.

The economy was expected to be directly affected by lower export volumes and lower export prices, partially offset by a lower value for the Australian dollar. It was also noted in the Budget Papers that the stronger growth in the United States, Europe and the rest of the world was likely to result in the diversification of Australia's export markets, encouraged by movements in the exchange rate. Rural commodity exports were expected to be less affected than many other exports because the volume of rural commodity exports is primarily supply determined, and is not particularly responsive to changes in income growth in the importing countries. Given that non-rural commodity exports are also affected by supply factors and tend to be homogenous goods, freely traded on established world markets, it was expected that there would be considerable scope to divert sales to other markets outside Asia. On the other hand, since elaborately transformed manufactures (ETM) exports are more sensitive to changes in income in the importing country, Australia's ETM exports were expected to be more susceptible to the events in Asian markets.

The trade data over the course of 1998 has presented a picture broadly in line with the expected developments outlined in the Budget Papers, and prior to that, in the 1997-98 Mid-Year Economic and Fiscal Outlook released in December 1997.

After falling in January 1998, the value of Australia's exports of commodities and simply transformed manufactures has recovered solidly throughout the year. In the three months to June 1998, the value of these exports was 12.3 per cent higher than the corresponding period twelve months earlier. This result reflects solid growth in exports of gold, coal, metalliferous ores and metal scrap and non-ferrous metals, outweighing lower exports of cereals. As noted previously, there were some temporary influences delaying cereal exports in the March quarter. Exports of commodities to the 'troubled' Asian economies[2] have declined over this period by over 14 per cent. However, this has been more than offset by solid growth in exports to Japan (primarily driven by strong increases in the second half of 1997) and other Asian countries and a very strong increase of over 35 per cent in exports to the rest of the world, particularly the United States.

As expected, exports of ETMs to the troubled Asian economies have declined sharply, almost halving in the three months to June 1998 compared with the corresponding period twelve months earlier. However, abstracting from the effects of a sale of a frigate to New Zealand in May 1997, total ETM exports are still up by 5.5 per cent in this period, reflecting strong increases in exports to other Asian countries (up 13.5 per cent), and the rest of the world (up 16.7 per cent). This strength is primarily attributable to a large increase in

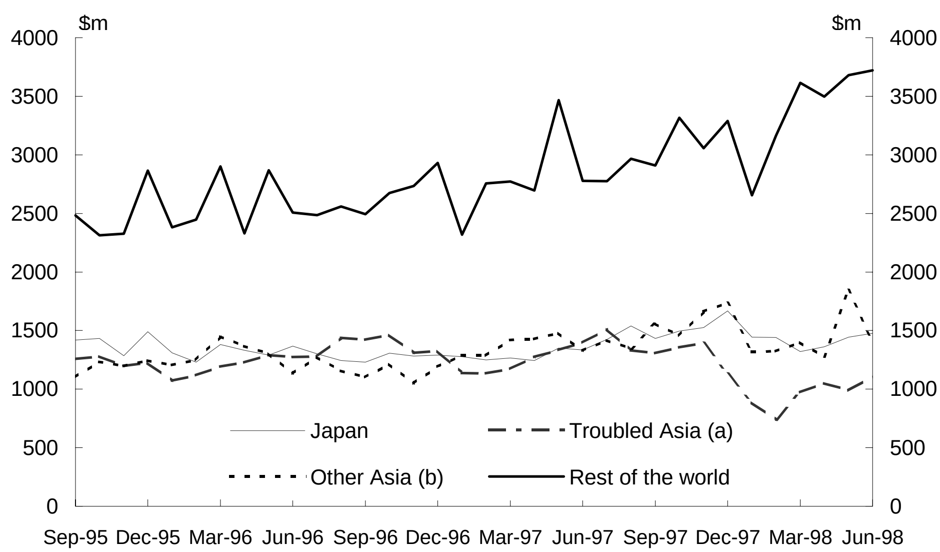
2. 'Troubled' Asian economies covers Indonesia, Korea, Malaysia, the Philippines and Thailand.

exports of transport equipment (other than the frigate), partially offset by lower exports of power generating machinery and equipment.

This pattern of diversification is also evident in Australia's services trade. The tourism industry has been significantly affected by the downturn in East Asia, with the number of visitors from Korea, Indonesia and Thailand falling dramatically. However, the industry has been able to take advantage of its increased competitiveness, attracting a large increase in the number of visitors from North America, Europe and Singapore.

In the three months to June 1998, merchandise exports to Australia's major trading partners in the Asian region were down by 1.8 per cent over the same period in 1997, but exports to all other countries rose by 21.9 per cent over the same period (Chart 8). Looking at particular markets, merchandise exports in the three months to June to Indonesia, Thailand and the Philippines declined by more than 30 per cent compared with the same period last year. Over the same period, there has been significant growth in exports to the United Kingdom and the United States (of over 50 per cent and 40 per cent respectively) and Germany (almost 30 per cent).

Chart 8: Exports by Destination



(a) Indonesia, Korea, Malaysia, the Philippines, and Thailand.
(b) China, Hong Kong, India, Singapore, and Taiwan.
Source: Unpublished ABS data derived from monthly trade statistics.

The extent of the diversification of Australia's exports evident in the recent trade data highlights the fact that it is misleading to attempt to assess the direct impact on Australia's exports of developments in Asia using a simple framework based on previous export shares to the region and expected growth in the region.

Business Confidence

The Budget Papers noted that a particularly uncertain, but still highly important, channel through which events such as those occurring in Asia can impact on domestic activity is via a decline in business confidence. The confidence of business in the outlook both for their own firm and for the economy more generally can be an important influence on their decisions to employ and invest. Uncertainty about the future can lead to a more cautious approach to investment and employment decisions.

As discussed in the Budget Papers, the uncertainty engendered by the economic and political events in Asia was expected to be reflected in some decline in business confidence. Recent business surveys point to a deterioration in business confidence (Charts 9 and 10, Box 1). Not unexpectedly, the decline has been most pronounced in the manufacturing sector, given that, as discussed above, manufacturing exports are likely to be harder hit by the decline in Asian markets than commodity exports. There is, nevertheless, some discrepancy between the results of some of the surveys and other indicators. For example, a number of surveys point to a decline in hiring intentions and yet job vacancies continue to rise.

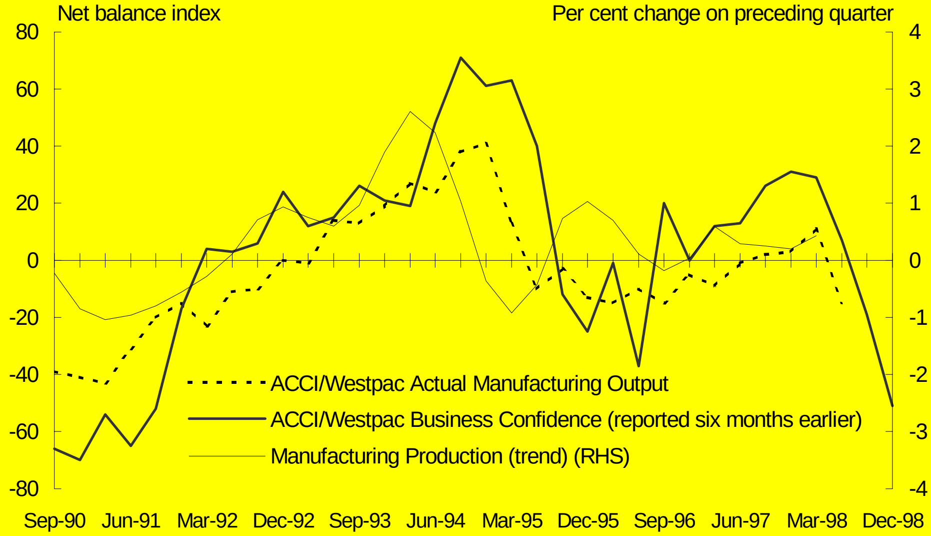
As noted in Box 1, while movements in some measures of business confidence at times track the direction of change in output or growth rates as measured by the ABS, the relationship is relatively loose. Hence, it is difficult to translate a net balance of responses to survey questions into more precise quantitative changes in economic variables. More generally, measures of business confidence need to be interpreted carefully and to be considered alongside a range of other indicators of likely developments in the economy.

Box 1: Business Confidence and Economic Activity

In recent months the various surveys of business confidence have received considerable attention. Following is a discussion of the relationship between the survey measures of business confidence and economic activity as measured by the Australian Bureau of Statistics (ABS) in the National Accounts.

Of the business surveys that specifically ask respondents about their levels of confidence, the largest recent fall in confidence has been reported in the Australian Chamber of Commerce and Industry (ACCI)/Westpac Survey of Industrial Trends. The ACCI/Westpac survey also recorded a fall in the measure of output in the June quarter, but to a lesser extent than the fall in the measure of business confidence. As is evident in Chart 9, there is a loose relationship between the ACCI/Westpac measures of business confidence and quarterly output on the one hand and quarterly trend changes in manufacturing production, as measured by the ABS, on the other. While the ACCI/Westpac survey measures sometimes move in the same direction as changes in manufacturing production, there have been periods of significant divergence between the series.

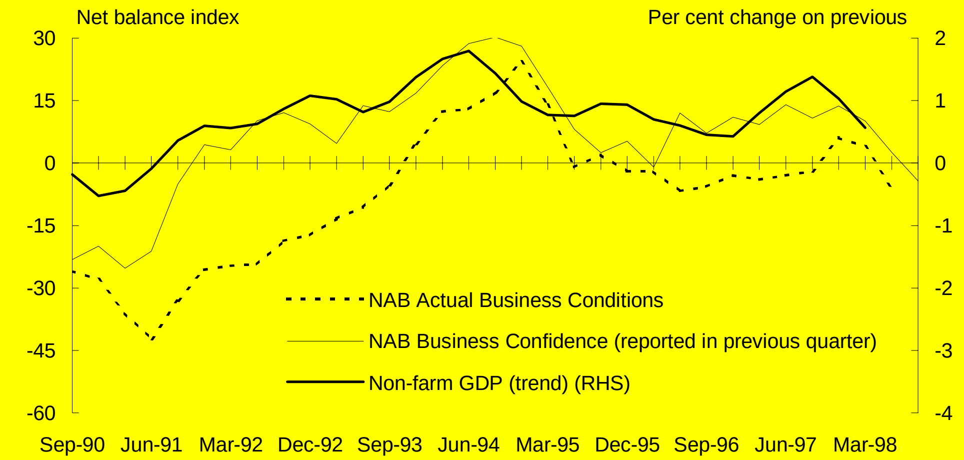
Chart 9: Manufacturing Confidence and Manufacturing Production



Source: ACCI/Westpac Survey of Industrial Trends and ABS Cat. No. 5206

Given that the ACCI/Westpac survey is focussed on the manufacturing sector and that around 80 per cent of respondents are exporters (and therefore may have been affected directly by the Asian crisis), it is not surprising that this survey has recorded larger falls in business confidence and business conditions than have business surveys covering a broader range of industries. Chart 10 shows recent trends in the National Australia Bank (NAB) business survey and illustrates the relationship between the survey's quarterly business confidence measure and trend quarterly growth in non-farm GDP. Again, as with the ACCI/Westpac survey, the relationship between the survey results and actual activity as measured by the ABS is quite loose. There have been periods when the two series have diverged; for instance, in 1995 business confidence fell while non-farm GDP continued to grow at a solid pace.

Chart 10: Confidence and non-farm Gross Domestic Product



Source: NAB Business Survey and ABS Cat. No. 5206

There are several factors that could explain the looseness of the observed relationship between the business survey results and activity. First, the business survey measures are reported as net balances, which are calculated by subtracting the percentage of respondents predicting a fall in a selected indicator from the percentage of respondents expecting a rise. Thus, the magnitude of expected increases and decreases are not taken fully into account. In addition, not all surveys' net balance results are weighted according to the size of the surveyed business. In such cases, a small business that expects business confidence to improve would have the same impact on the net balance result as a large business that expects confidence to improve. The ABS Business Expectations Survey provides weighted responses but does not have a question on general business confidence.

Changes in business confidence may be strongly influenced by changes in actual trading conditions in the current quarter or in the recent past. Such instances may limit the information content of confidence measures as an indicator of likely future outcomes. In Charts 9 and 10 the ACCI/Westpac and NAB business confidence measures appear at times to move in line with the business conditions reported by respondents and, in some instances, to lag changes in output as measured in the National Accounts.

An alternative way of viewing this relationship is that changes in business confidence may loosely reflect changes in underlying factors which dictate business decisions, such as sales or the cost of capital. As such, confidence measures may primarily serve as a broad consistency check against an assessment of likely future outcomes obtained from an analysis of those underlying factors.