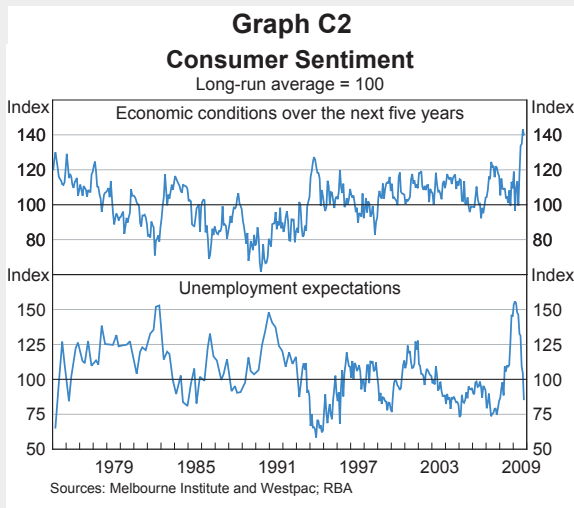
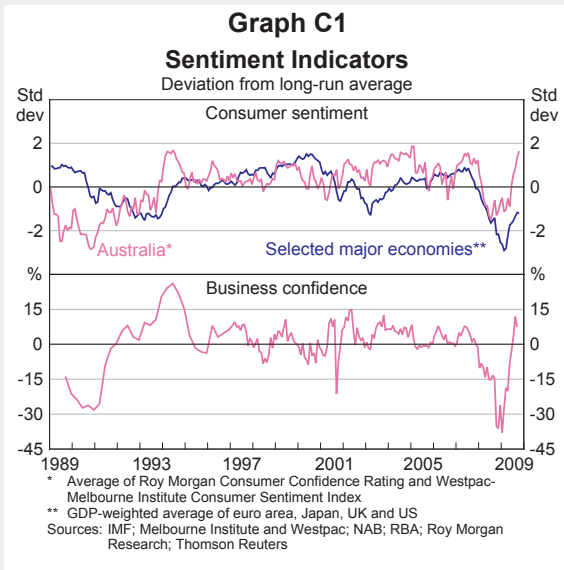


## Box C: The Recovery in Confidence

The contraction in the global economy late last year and earlier this year was characterised by a sharp increase in risk aversion and a collapse in business and consumer confidence. Risk premia in financial markets rose markedly and firms and households delayed their spending plans – particularly for capital and durable goods – as they became more cautious. Recently, the extreme risk aversion evident earlier in the year has abated and there has been some recovery in business and household confidence around the world.



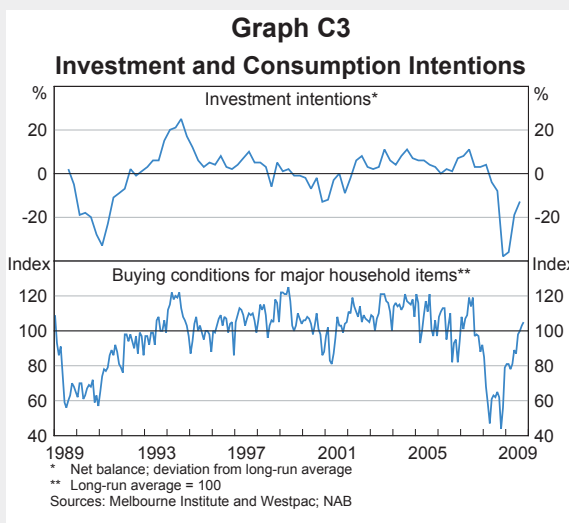
These trends have also been evident in Australia, although confidence did not fall to levels as low as in many other countries and the rebound has been much sharper (Graph C1). While indices of consumer sentiment fell considerably through 2008, they remained less negative in Australia than in the early 1990s recession and have since recovered to near-record levels. The improvement in sentiment is particularly evident in the forward-looking measures, with more individuals reporting that they are optimistic about medium-term prospects for the economy than has been the case since the consumer sentiment survey commenced in 1973 (Graph C2). There has also been a marked reduction in households' concerns about unemployment; earlier this year, reported concerns about unemployment were at their highest level for more than three decades.

Measures of business confidence also declined markedly last year, particularly around the global financial market turmoil in September. They have, however, risen

since the beginning of the year. For Australia, the NAB survey measure of business confidence is around its highest level since 2003, while measures in other business surveys have also risen over recent quarters, to be well above long-run averages. The rise in confidence has been seen across all industries and states.

In comparison with the significant pick-up in measures of business confidence, measures of current conditions for firms have shown a less marked rise, with most surveys reporting that current conditions are around or only slightly above average. Similarly, despite the high reported level of confidence, firms' stated investment intentions over the coming year remain below average (Graph C3). The difference in measures of confidence and current conditions is also evident in the consumer surveys; while their level of confidence is high, when consumers are asked about current buying conditions for major household items, their responses are only just above average.

Interpreting the recent rise in confidence is complicated by a lack of historical precedents for such large swings in business and consumer confidence over a short period of time. Earlier research by the Bank found that sentiment measures in Australia have some predictive content in regard to the future level of economic activity and that they can provide useful information about current conditions, especially since they are available on a timelier basis than some other measures of activity.<sup>1</sup> However, there have been earlier episodes – most obviously the sharp fall in business confidence



following the terrorist attacks in the United States in September 2001 – when large swings in confidence were not closely linked to subsequent developments in the economy. To some extent the recent recovery in confidence may partly reflect a sense of relief that the very bad outcomes thought possible earlier in the year have not materialised, with the Australian economy in particular performing better than was widely expected. If so, the recent sharp rise in confidence may not translate fully into future household and business spending. ↗

1 See Roberts I and J Simon (2001), 'What Do Sentiment Surveys Measure?', RBA Research Discussion Paper No 2001-09 and Aylmer C and T Gill (2003), 'Business Surveys and Economic Activity', RBA Research Discussion Paper No 2003-01.