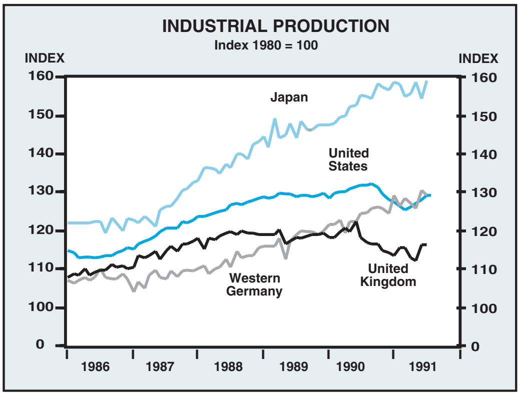
Financial Markets and the Economy in the September Quarter

The domestic economy remained weak in the September quarter. There were some early signs pointing towards recovery, but these have been confined mainly to the housing sector. Flat economic activity was accompanied by further declines in inflation and inflationary expectations. Consumer prices as measured by the CPI have not risen at all in the first half of the year. In the light of these trends, cash rates were eased further in early September. The long-term bond rate declined significantly over the quarter, and the exchange rate rose against a weakening US dollar.

The World Economy

There are signs that the US economy is beginning to pick up, but at a relatively slow pace (see Graph 1). Indicators such as housing starts and industrial production have risen over the past couple of months, but employment growth remains weak, as does growth in monetary and credit aggregates. Reflecting concerns about the uncertainty of the recovery, the Federal Reserve lowered its key short-term interest rate in two steps, by a total of 0.5 of a percentage point over the quarter.

The Japanese economy continued to slow in the September quarter. Monetary policy was eased in July and short-term interest rates



Graph 1

continued to drift down later in the quarter. The western part of Germany also showed some signs of slowing, although the labour market remains tight and west German inflation has been running at around 4 per cent in recent months. Still concerned about inflationary pressures, the Bundesbank tightened monetary policy in August, but by less than markets had expected. In eastern Germany, the large falls in economic activity seem to have come to an end.

Exchange rates exhibited some volatility over the quarter, particularly in August in response to a number of interest rate movements, and to the attempted coup in the Soviet Union. After optimism early in the quarter, the US dollar was affected by growing concerns that the US recovery may not be as strong as previously thought. The interest differential between Germany and the US widened further. Over the quarter, the

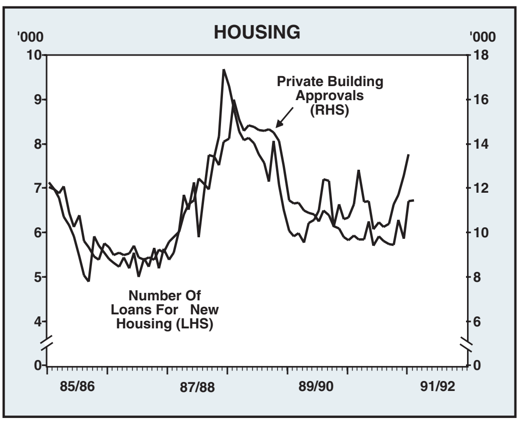
US dollar depreciated by almost 8 per cent against the Deutschemark and by 3 per cent against the yen.

Long-term bond rates around the world also showed a tendency to decline. US 10-year bond rates fell by 0.7 of a percentage point, to around 7.5 per cent. In Japan, bond rates also declined as it became more apparent that the economy was slowing. On the other hand, German bond rates remained fairly steady, reflecting continued concern about inflation.

The Domestic Economy

Real GDP declined further in the June quarter, bringing the cumulative fall in output over the year to 2.4 per cent. Activity continued to be subdued in the September quarter, although there were some tentative signs of recovery, mainly in the housing sector. There was also some pick-up in business confidence as measured by the CAI/Westpac survey of the manufacturing industry. At the same time, business investment remained at low levels, and little improvement in investment was expected over the coming year.

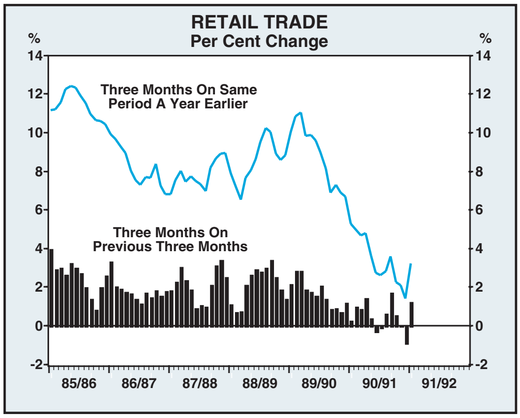
The pick-up in housing has been reflected in the main leading indicators (see Graph 2). Loan approvals for new housing rose by 16 per cent in the three months to July compared with the previous three months.



Graph 2

Local government building approvals rose sharply in July and were little changed in August; in the three months to August, total approvals were 11 per cent higher than in the previous three months.

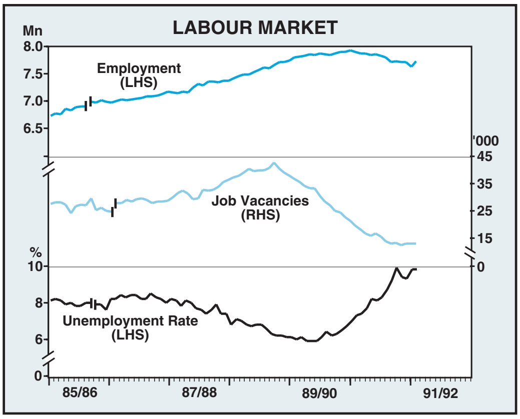
Other indicators of the real economy have remained fairly subdued. Retail spending rose by 2.2 per cent in July, possibly boosted by more mid-year sales than usual (see Graph 3). In the three months to July, sales were 1.2 per cent higher than in the previous three months. Business investment has fallen substantially during this downturn. Investment in plant and equipment declined by 11 per cent in 1990/91, while investment in buildings and structures fell by 14 per cent. Business surveys are not yet showing any pick-up in capital expenditure plans; expectations for construction investment are particularly weak.



Graph 3

Recent monthly data on employment have been volatile, with a record fall in July being followed by a record rise in August (see Graph 4). In underlying terms, employment seems to have levelled out; there has been little net change in employment since March this year. The ANZ job vacancies series, which has been a useful leading indicator of labour market conditions in past cycles, has flattened out over the past five months, after falling for the previous eighteen months.

The weakness in the real economy has been accompanied by continued progress in reducing inflation. Most measures of



Graph 4

The national accounts consumption deflator, which is not influenced by lower mortgage interest charges, rose by 3.8 per cent during 1990/91.

Growth of wages has also slowed significantly, in line with the slower growth of consumer prices. Statements by the ACTU suggest that the next general wage rise to be sought by the union movement will be an increase to cover the increase in the CPI over the last three quarters of 1991. In the meantime, the current National Wage Case is considering the potential role of enterprise bargaining and productivity agreements in the wages system.

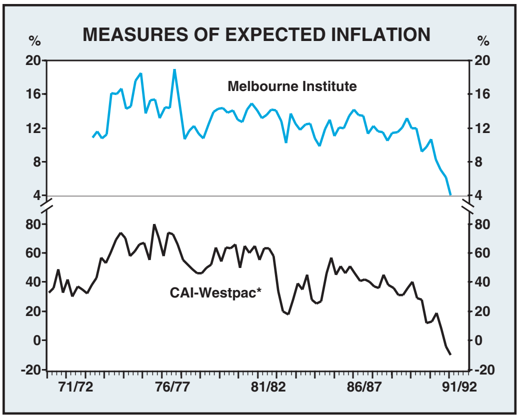
the inflation rate had dropped to the 2 to 4 per cent range by the June quarter (see Table 1), a substantial reduction from a range of 4 to 8 per cent a year ago. The Consumer Price Index rose by 3.4 per cent in the year to the June quarter, down from 4.9 per cent in the March quarter. The drop in the annual rate was helped by lower petrol prices, mortgage interest charges, and fruit and vegetable prices, but the slowing of price increases has nonetheless been broadly based.

Inflationary expectations have declined further, along with the decline in actual inflation (see Graph 5). Surveys taken in September indicate that consumers expect inflation to average about 4 per cent over the next year, a reduction of two percentage points from what they were expecting as recently as the June quarter, and significantly below the average rate of around 12 per cent which consumers had expected during the 1980s. Business surveys have also pointed to low

Table 1: Growth in Prices and Earnings
(year-ended basis)

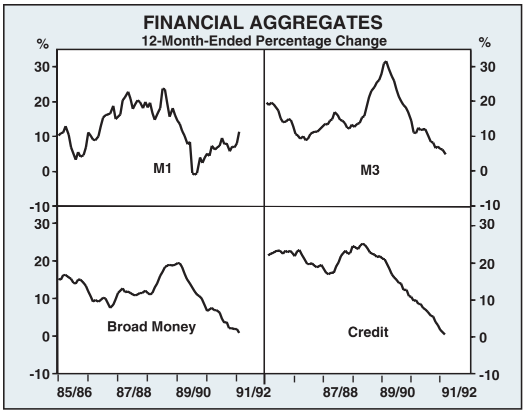
	June 1990	June 1991
Consumer Prices		
– CPI	7.7	3.4
– Consumption deflator	6.0	3.8
– Retail trade deflator	5.3	3.7
Construction Materials		
– House building	6.3	2.1*
– Other	7.2	2.8*
Manufacturing Prices		
– Articles produced	4.4	2.6*
National Accounts Deflators		
– GNE	5.4	2.4
– GDP	4.2	1.2
Earnings		
– Award wages	5.8	1.9*
– Ordinary-time earnings	6.6	5.0
– Average earnings (national accounts)	8.1	3.0

* Year to July 1991.



*Net balance expecting to raise prices.

Graph 5

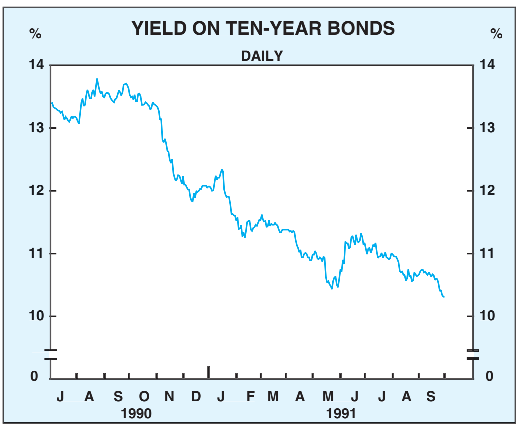


Graph 7

price expectations. The CAI/Westpac survey of manufacturers reported that a majority of respondents expect their selling prices either to remain stable or to fall in the period immediately ahead.

Lower inflationary expectations also have been reflected, though to a lesser extent, in long-term bond yields (see Graph 6). The rise in yields that took place in the second half of the previous quarter, following the resignation of the Treasurer, was more than reversed. Yields on 10-year bonds ended the quarter at 10.3 per cent, their lowest level since 1980.

Growth of credit and the broad monetary aggregates remained very slow in the September quarter, reflecting the continued weakness in private spending (see Graph 7). Credit outstanding showed little change in July and August, after falling by a little over 1 per cent during the preceding three months. In the year to August, credit grew by only 0.6 per cent. Both M3 and broad money have also grown relatively slowly in recent months.



Graph 6

The downturn in the economy has seen a substantial turnaround in the public sector budget position. The 1991/92 Commonwealth Budget is expected to be in deficit by $4.7 billion – the first deficit since 1986/87 and a change of $6.6 billion from last year's outcome. Most of this change reflects the impact of the downturn in activity on revenues and outlays. Combined with an increase in State financing requirements, this implies an increase in the PSBR to 4.3 per cent of GDP in 1991/92. This compares with a peak public sector surplus of 1.6 per cent of GDP in 1988/89, and a peak deficit of 7.0 per cent of GDP in 1983/84.

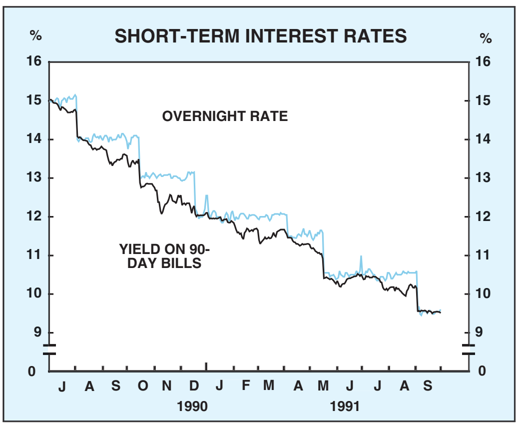
Australia's current account deficit has fallen markedly over the past year. This has reflected not only a decline in imports but also strong growth in exports, particularly of manufactured goods. The deficit for 1990/91 as a whole was $15.7 billion, or 4.1 per cent of GDP. The monthly current account deficit for August was $575 million, after deficits of around $1 billion in each of the previous three months; the cumulative deficit in the first eight months of 1991 was $8.6 billion.

After rising through the June quarter, commodity prices fell over the September quarter, bringing the index back to around its level of six months ago. Declines in wool prices were a major factor in the recent falls, although a number of other rural commodities and metals were also weak.

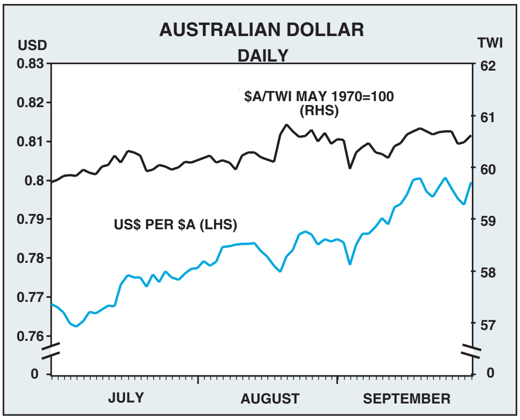
Financial Markets

Against this background of sluggish activity and declining inflation and inflationary expectations, the Bank announced on 3 September that overnight cash rates would be reduced by 1 percentage point, to about 9.5 per cent (see Graph 8). Other short-term interest rates fell in response, though the cut had been partly anticipated; 90-day bill rates settled at around 9.5 per cent. Interest rates charged by financial intermediaries also adjusted quickly, with the major banks lowering their prime rates on business loans by between 0.75 and 1 percentage point from the second half of September. For housing, the cuts were mostly 0.5 of a percentage point. The average reduction in banks' lending rates, about 0.7 of a percentage point, was more or less equal to the reduction in costs of deposits.

The Australian dollar rose against a weakening US dollar, ending the quarter at around US80 cents, compared with US77 cents at the start of the quarter (see Graph 9). Against the yen, the Australian dollar was largely unchanged over the quarter, at around 106 yen, and against the Deutschemark and most European currencies it fell. Overall, the trade-weighted index rose from a little under 60 at the start of the quarter to 60.6 at the end. This rise essentially reflected the rise against the US dollar and currencies linked to it.



Graph 8



Graph 9

Sentiment towards the Australian dollar remained positive throughout the quarter, notwithstanding the further decline in Australian interest rates and continuing weak commodity prices. Confidence in the currency appeared to be buoyed by the growing realisation that inflation in Australia has moved to low levels by international standards. Interest rates in a number of other countries had also fallen, albeit to a smaller extent.

Although the rise in the exchange rate during the quarter was largely against the weaker US dollar, there were times when the strong market sentiment towards the Australian dollar appeared capable of lifting it higher against a wider range of currencies. The Bank intervened in the market on several occasions to try to keep that sentiment in check. Over the quarter, the Bank's foreign exchange market operations resulted in net sales of Australian dollars (purchases of foreign currency) of $1.26 billion; a large part of the foreign currency purchased ($0.81 billion) was subsequently sold to the Government to meet its requirements.