Tag 2: A Discussion of ACCI's Business Barometer™

Excerpted from ACCI's Economic Submission to the Safety Net

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What the barometer does is provide a contemporary measure of economic activity that provides an indication of the state of the economy and its current trends that is almost entirely contemporary with the present.

It is because of this gap in the state of our knowledge that business surveys were designed. Their aim is to provide an early indication of the state of the economy and of its various components. While such surveys are less comprehensive than the national accounts, their advantage is that they focus on conditions within the private sector and their results are almost immediately available.

The private sector aspect is of major importance. While the design of the National Accounts is based on expenditure, the structure of business surveys focuses instead on production. While GDP is supposed to measure value added, there are many extraneous elements in its composition, from public sector outlays on valueless forms of government spending to the estimated productivity of non-market transactions such as the value added of owner occupied homes. The intention is to estimate the level of production but the actual result is not as easily interpreted as it is often assumed.

Business surveys are more straightforward. They generally avoid providing dollar values and instead concentrate on whether there has been an increase in some area of activity, a decrease or no movement at all.

In understanding the barometer, it is important to appreciate that business surveys provide up-to-the-minute estimates of the actual state of the economy. The time differential between sending out survey questionnaires and putting the results into the public arena is generally less than a month. Most survey results

have been gathered within a fortnight of their actual date of publication. If properly conducted they provide information about things as they are which are essential for the proper management of our economic affairs.

What is needed is a measure of the current state of the economy which indicates the present level of activity as well as its present trends. To provide such a measure, ACCI has developed its Business Barometer™ which is built from a composite of the three national economic surveys it conducts. These surveys are:

. the ACCI/Westpac Survey of Industrial Trends

. the National Survey of Business Expectations

. the Survey of Investor Confidence.

In constructing the barometer, each of these surveys provides measures of current economic conditions in a number of significant areas of the economy. Most importantly, the three surveys provide data on current business conditions, which is a coincident indicator, investment, which is generally a leading indicator, and employment, which tends to lag.

Each of the measures in each of the surveys was converted into an index. These separate indexes were then converted into a composite indexThat can range from 0 to 100. Therefore, when interpreting the data an index level of 50.0 indicates that there is a balance between those who responded that conditions were improved and those that replied that conditions had declined. Thus any level below 50 indicates that conditions are deteriorating, and conversely, a reading above 50 indicates conditions on average are improving.

For the period from March 1966 through until October 1997, the barometer is comprised exclusively of the data from the *ACCI/Westpac Survey*. Since October 1997, however, each quarter is comprised of the results of the three

surveys conducted by ACCI so that as each additional observation of the economy is made, these can be incorporated into the barometer.

But as with any set of time series data, the barometer is made up of random, seasonal, trend and cyclical components. What we are looking for are the current trends in actual conditions because it is these which genuinely matter. The seasonal and random factors can obscure present conditions and it is therefore imperative to remove their influence before examining the data. Therefore, the final data as presented are the trend data.

There are two aspects to the data as presented by the barometer. Firstly, by looking at the level of the barometric reading one can make judgements about the state of the economy. The higher the barometer is above 50, the better economic conditions are. Similarly, the lower the barometer is below 50, the worse one would say conditions have become.

Thus, one can distinguish between the periods of strong economic performance and those in which it has been weak. The higher the barometer has become, the relatively more robust the economy was measured to have been at the time.

Secondly, the movements between quarters provide a measure of current economic trends. If each quarterly reading is higher than the quarter before, then the appropriate interpretation would be that the economy is improving. And if each subsequent reading is lower than in the previous period, then one would conclude that the economy was slowing relative to its previous level.

Measuring the Past

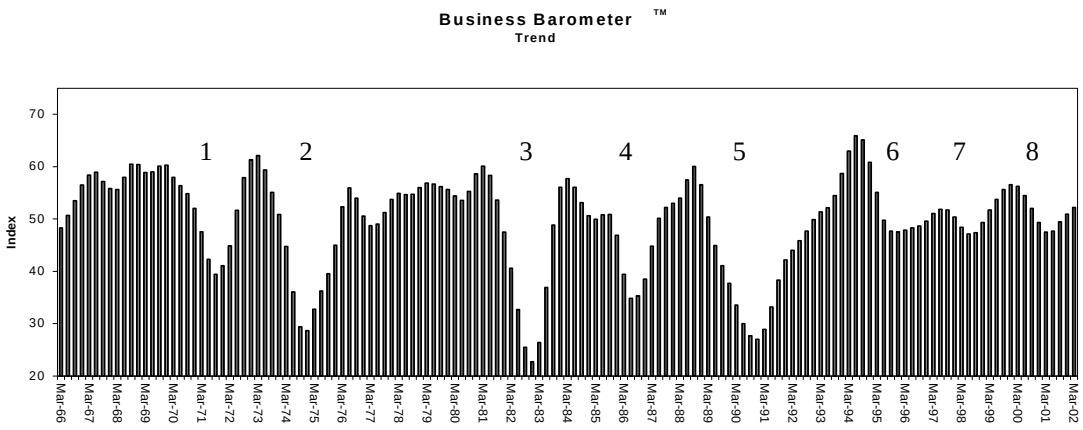
Although the barometer was only introduced in 2001, because of the form of its composition it already has a 35-year history stretching back to 1966. It is therefore possible to test the accuracy of its construction by looking at its historical record. If it provides an accurate reading of past movements in the

economy, there is strong reason to be confident that it will continue to estimate the economy's relative strength between periods and its trends into the future.

The graph showing the barometer provides the contours of the economy over the past third of a century. It shows the periods of relative strengths and weakness. But what is evident are the deep pockets where the barometer has fallen sharply indicating a downturn in economic activity. It is in an examination of these periods that the value of the barometer becomes clearly visible.

The eight periods of economic downturn date the trough of each cycle and provide a measure of the relative weakness of the economy in each period. These eight downturns and the low point of the cycle are shown below. A brief explanation of the causes of the downturn is also given.

- *Number 1*: June 1971 – RBA credit tightening
- *Number 2*: December 1974 – wage explosion, first oil shock
- *Number 3*: December 1982 – 38-hour week and second oil shock
- *Number 4*: June 1986 – return to wage indexation and fall in the terms of trade
- *Number 5*: December 1990 – RBA credit tightening
- *Number 6*: December 1995 – RBA credit tightening
- *Number 7*: June 1998 – Asian crisis
- *Number 8*: March quarter 2001 – RBA credit tightening



This presents an account of every downturn and locates the trough to when most observers would agree the trough actually occurred. The depth shown in the barometer also provides an accurate indication of the relative magnitude of the downturn that occurred.

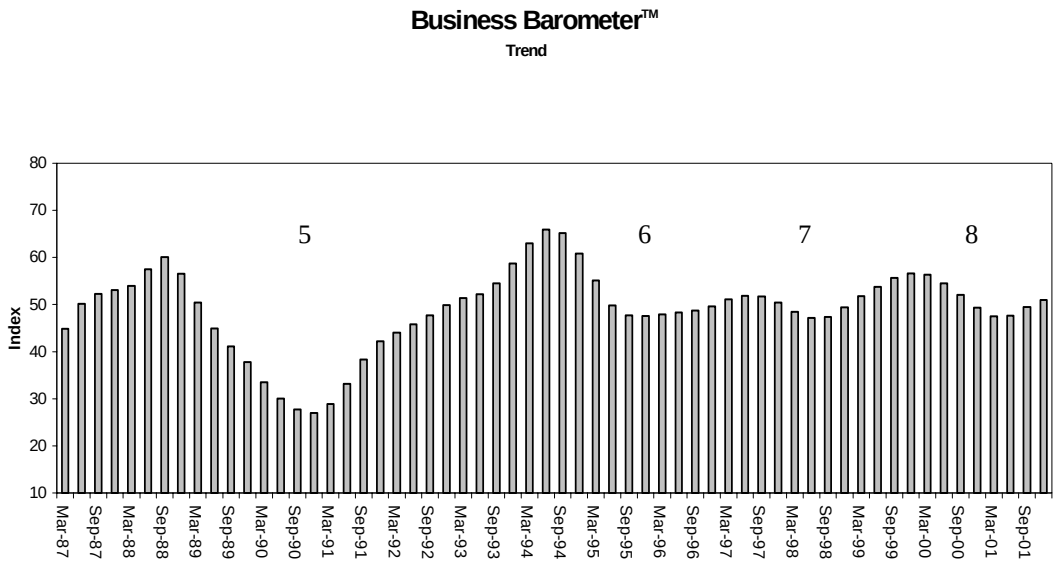
Comparison with Employment Data

It is an important confirmation of the validity of the barometer that fluctuations in the economy itself are reflected in changes in the index. The close connection between movements in the barometer and movements in what the ABS tells us about the economy is necessary if we are to use the barometer to measure the state of the national economy. A look at the overlap between the survey data embodied in the barometer and the economy overall brings out how close this relationship is.

The two charts below show the movement in the barometer and the movement in full-time employment. The employment measure is the annualised quarterly growth rate based on the trend data.

What is clear is that even though the employment data is more volatile, the movement in employment growth and the contours of the barometer closely match, although the slowing in employment tends to come with a delay.

For each of the slowdowns identified in the barometer there is a matching slowdown which occurs in employment growth. The massive downturn in the barometer during the early 1990s is seen in the massive contraction in employment which occurred over the same period. There is a similar slowdown in full-time employment following the raising of rates in 1994 and this too mirrors the downwards movement in the barometer. It is also clear that the Asian crisis was reflected in both the downwards movement in the barometer and in the growth rate of full-time employment. And then, finally, the present period has shown both a fall in the barometer and a fall in the growth in the number of full-time jobs, although with a slight delay between the economy beginning to slow and the growth rate of employment beginning to fall.



Interpreting Current Economic Conditions

The barometer is designed to portray current conditions with next to no delay. In the March quarter, the *Survey of Investor Confidence* was released in January and the *National Survey of Business Expectations* was released in February. Not until the *ACCI/Westpac Survey* is released in March will the full data for the current quarter be complete. Nevertheless, we now have a measure of activity in the private sector for the March quarter which shows present trends and is a leading indicator of the ABS data on full-time employment.

As the first chart shows, activity levels have now begun to rise but this rise only means that conditions have begun to improve from the low levels reached at the beginning of last year and does not imply that activity is strong. Now is not the time to be significantly raising wages, since an increase in wages will only slow economic recovery and prolong the weak labour market conditions.

It is good to see that full-time employment has been increasing for two quarters but it must still be born in mind that these increases have come after a prolonged

decline. Full-time employment remains well below the peak reached in the September quarter of 2000.

Also of note is that private investment has not responded adequately to the reductions in the rate of interest of the last year and of particular concern is that there is a general recognition that rates have reached bottom and will begin to rise later in the year. Spurring the move to higher rates in the money market is the recent CPI numbers which may not allow the Reserve Bank of Australia any leniency to keep rates low if they perceive that inflation will become a problem.

The perception that rates will rise may in turn cause business to revaluate investment decisions with the additional costs that will come from higher interest rates, even though rates remain at a relatively low level today. The importance of investment is that it is only through innovation and investment that higher living standards in the future can be created and productivity increased.

The slowdown in the international economy has caused international demand to slow over the year which can be seen from the slow down in Australian exports. The international slowdown though it may have come to an end means only that conditions are not getting worse rather than suggesting that conditions are again improving as they did through the 90's.

It should be remembered that safety net wage adjustments have played a part in slowing the labour market growth relative to the levels of improvement that might have other wise been achieved. Raising award wages on an across-the-board basis must inevitably cost some employees their jobs or prevent others, who might have found work, from gaining employment.

There are some who argue that the effects on employment of raising the minimum wage are small but no one would argue that they are non-existent. As the Australian system of wage adjustment affects more than those at the bottom

of the pay scale, but is paid across the entire awards classification system, and may indeed also have significant flow on effects, the effect of higher wages costs are consequently larger. The slow down in the economy and the past increases in award rates ensures that more people lost their jobs or failed to find them than would otherwise have been the case had award rates not been raised to the extent they were.