

Briefing Note:

Australia's Economy Heads Into Election on a Weak Note

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This week the Australian Bureau of Statistics released the last set of quarterly GDP data to come out before the likely Commonwealth election, widely expected to be called for May. Coalition leaders were hoping a strong report would boost their standard talking points about being the best “economic managers.” They were badly disappointed.

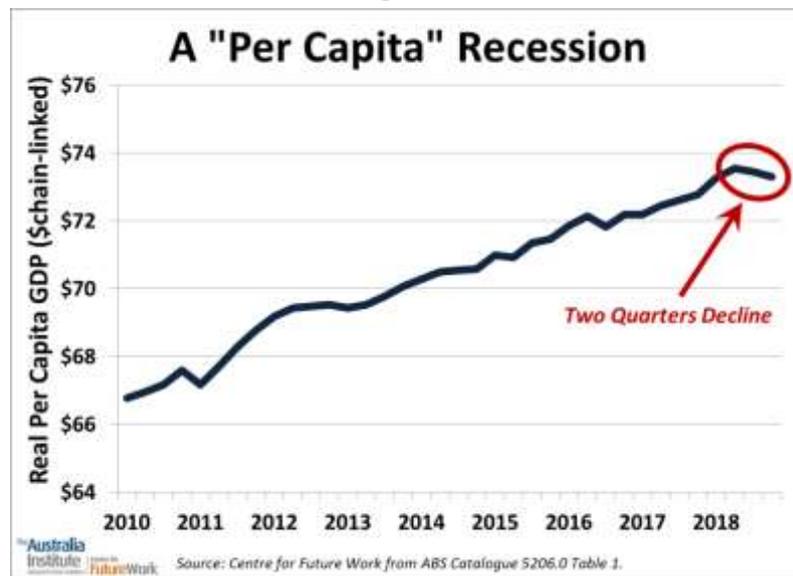
The headline numbers were very weak: GDP expanded in the December quarter by just 0.18%. That marked the third consecutive quarter of slowing growth, and left the bottom line dangerously close to turning negative – potentially heralding a recession (Australia's first in almost three decades).

Prime Minister Scott Morrison was already predicting that electing a Labor government would throw Australia's economy into recession. But his government has certainly set the stage for that possibility: the economy grew just 0.4% over the last six months, the weakest six month increment since the GFC hit at end-2008. Perhaps Mr. Morrison is trying to shift blame for a slowdown that is clearly well underway, to the next government rather than his. This might be politically convenient, but it is economically unconvincing. No change in government can immediately alter broad macroeconomic trajectories, which respond only with significant time lags to shifts in policy that also require time to implement. If a downturn does indeed occur in the near future, it will clearly reflect the legacy of past actions – not future ones.

Growth was so slow in the last six months, in fact, that relative to population Australia's GDP has now contracted for two consecutive quarters: creating a so-called “per capita recession” (see Figure 1). It is often overlooked that Australia's relatively strong economic record over the last generation was largely driven by rapid population growth (now mostly via immigration). When adjusted for population growth, Australia's GDP performance was not actually superior compared to many countries (like Japan or Germany) with slow or zero

population growth. Now Australia's GDP growth is being outpaced by continued population growth – and hence real output is falling in per capita terms.

Figure 1



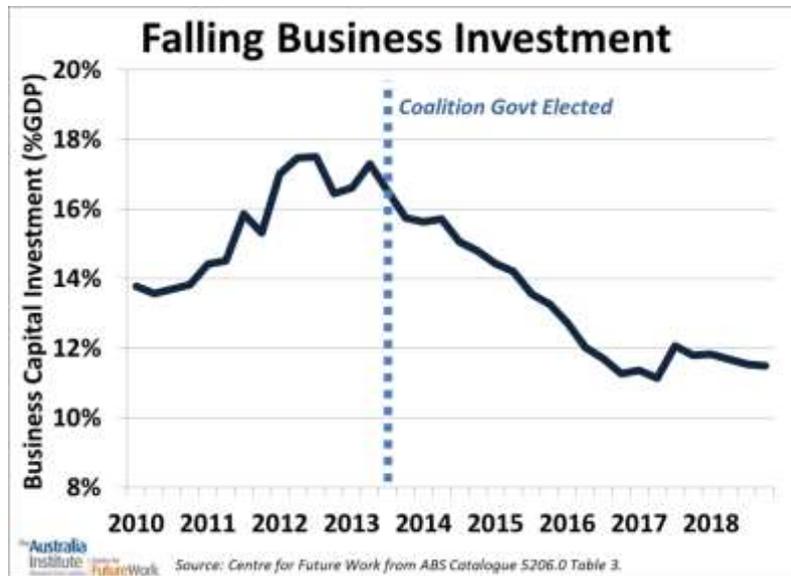
Apart from the slow headline rate of growth, there are more troubling signs buried in the details of the ABS report that suggest deeper structural weakness in the economic outlook. On the expenditure side of the ABS report, spending was weak across most sectors of the economy. Consumer spending grew less than 2% in the year ending in the December quarter, the slowest in five years. Stagnant wages, falling housing prices, and record indebtedness (consumer debt now equals 200% of disposable income in Australia, one of the heaviest debt loads in the world) are all undermining consumer spending. Since household spending accounts for about half of all GDP, when consumers are in a bad mood the whole economy feels their misery.

The outlook was even worse in other key categories of spending. Australia's trade balance on goods and services deteriorated in the December quarter, pulled down by the third straight quarter of shrinking real exports. Investment in dwellings declined at a 13% annualized rate; housing construction is now contracting in the face of falling property prices. Business capital investment fared little better: up less than 1% in the year to December.

Indeed, the weakness of private capital spending is one of the most worrisome signs for the future trajectory of Australia's economy. Private sector investment tends to lead the rise and fall of the broader economy. But as a share of total GDP, business capital investment has fallen dramatically over the past five years – corresponding almost perfectly with the reign of a supposedly "business-friendly" government in Canberra (see Figure 2). Profits have been strong, but companies are sitting on that cash. The long-hoped-for rebound in

business spending, after the big decline in resource-related spending after 2012, is nowhere to be seen. Continued stagnation in business investment augurs badly indeed for Australia's future performance: both in weaker short-run demand and job-creation conditions, and through a long-run erosion in productivity growth and innovation.

Figure 2



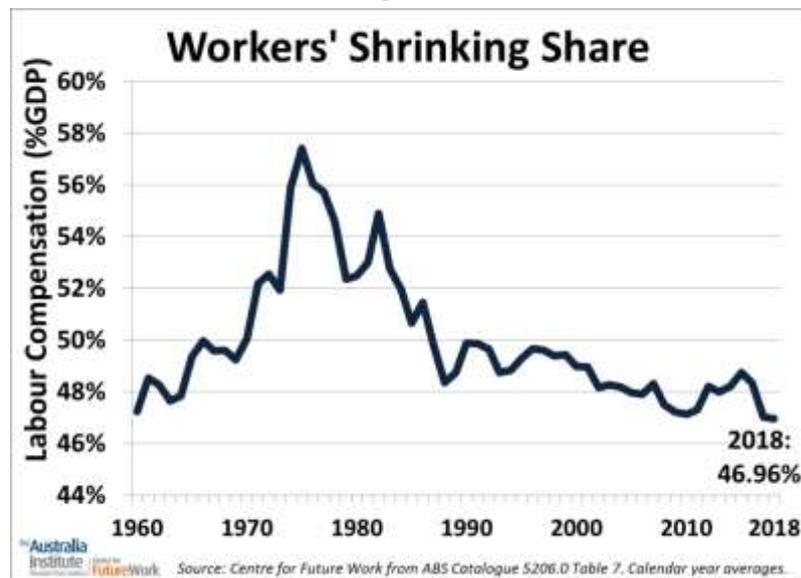
About the only bright light in overall aggregate demand in Australia over the past year has been the public sector. Total government current consumption (consisting of spending on healthcare, education, and other current services) grew 5% in the year ending in December, led by a 10% increase in federal programs. Government capital spending grew even faster, by 12% over the year – reflecting big infrastructure projects (mostly at the state level).

Without that leading role played by the public sector, Australia's GDP would have been lower in December than six months earlier. In other words, we would already be in recession. But it is awkward for the current government to claim credit even for this narrow miss: Australia avoided recession last year only because of *increased* government spending, which runs completely against the grain of the government's actual fiscal priorities (expenditure restraint and tax cuts).

Another insight into the weakness of Australia's economic trajectory is provided on the income side of the ABS national accounts. The December quarter saw a continuation of the redistribution of income away from workers and toward businesses: total wages grew by less than 1% in the quarter (driven by modest employment gains and slight increases in nominal wages). But business profits (measured by gross corporate operating surpluses) grew three times as fast. This implies another reduction in the share of total GDP going to workers. Payouts of wages, salaries and superannuation contributions declined in the quarter to 46.9% of GDP. For the calendar year as a whole, the labour share also averaged

under 47% – the lowest for any complete year since the ABS began collecting quarterly GDP statistics in 1959 (see Figure 3).

Figure 3



The continued redistribution of national income toward business and away from workers reflects the perverse combination of continued productivity growth (with each worker producing more real output) and flat or falling real wages. Indeed, wage increases have at best kept up with consumer price inflation in recent years (implying zero real wage gains). By some measures, nominal wages have lagged behind prices – leading to falling real wages. So workers are producing more real output, but their real incomes are stagnant or declining.

This worrisome trend is confirmed by an alternative measure of wage growth that can be derived from the ABS national accounts data. We can compare total labour compensation from the GDP report, to separate data (from the labour force survey) on employment; the ratio of the two constitutes a broad measure of average compensation. It grew less than 0.3% in the December quarter – slowing notably from the September quarter. And over the year to December, compensation per employee grew just 1.9%. By this measure, compensation per worker is once again lagging behind consumer prices. This weakness has been a key factor behind the parallel weakness in consumer spending noted above.

It is interesting to note that this national accounts measure of wages is growing more slowly than ABS's more commonly reported Wage Price Index (WPI). The WPI indicated a 0.5% increase in the December quarter, and a 2.3% increase over the previous year. Even that is a historically weak pace of wage growth. But the WPI often overestimates true wage growth, because it controls for changes in job quality from one period to the next. By holding a representative "basket" of jobs fixed, the WPI excludes the effects on average wages of changes in hours worked, a shift toward lower-paying jobs, and other structural changes. In

contrast, measuring labour compensation per employed Australian captures all these effects; according to this more comprehensive measure, wage growth in Australia has therefore been even weaker than commonly reported.

The multi-dimensional slowdown in Australia's economy as the election approaches will make it much harder for the current government to promote itself as the best choice for managing the economy. That has been a traditional centerpiece of the Coalition's campaign narratives. Its effectiveness this time will be damaged by accumulating signs of broader economic weakness. Given the weakness in household incomes and financial well-being which has caused consternation and anger in communities across Australia, many voters will simply not believe that the national economy is indeed in "good hands."

Of course, not all the problems illuminated by these latest GDP numbers are the direct fault of current policy. Global uncertainty has certainly played a role (as evidenced by Australia's deteriorating real trade balance). But the failure of the Coalition government's vision of business-led "trickle down" growth looms large across much of the ABS report.

After all, the government's economic strategy rests on the assumption that in an appropriate context (of government fiscal restraint, lower taxes, deregulation, and restrained labour costs), private sector investment and innovation will lead the whole economy to prosperity and stability. But there is no visible payoff from this trickle down vision: in particular, weak private capital spending, despite strong profits, seems to refute the core logic of the whole strategy. Meanwhile, the costs of fiscal restraint and income inequality are increasingly obvious: especially in the form of weak consumer spending that is clearly attributable to the stagnation of Australian wages. Any bright spots in the outlook – in particular, the benefits of expanded government spending and investment – are largely in spite of the Coalition's priorities, not a credit to them.

Australia's GDP growth in recent years was driven by a huge expansion in the property sector, growing consumer debt, and an expansion in resource exports (especially LNG) that has now levelled off. Those drivers seem to have run out of steam. More sustainable engines for future growth (based on investment, both public and private, innovation, and domestic demand) will be needed to avoid a more painful downturn.

In this regard, the latest data also pose challenges for the opposition – not just the government. The slowdown certainly undermines the Coalition's traditional arguments about being the most suitable party to manage the economy. But if Australia's economy is indeed heading into a weak patch (or even a recession), then a new government will need to be ready to respond quickly: with powerful measures to stimulate aggregate demand, boost wages, and foster investment (invoking more varied and effective levers than business tax cuts). In short, it will be a time for strong medicine, not tinkering.