Economic Overview

The focus of this Economic Overview is on recent and prospective employment trends.

Following moderate employment growth in the second half of 1996, underlying growth in monthly employment stalled in early 1997. These recent employment outcomes are likely to be a lagged response to two factors: the primary influence appears to be the easing in output growth in the second half of 1996; a complementary factor appears to be the strong real wage growth during 1996 from a combination of fairly stable nominal wage growth and falling inflation.

GDP growth, however, picked up in the March quarter 1997 from the relatively weaker performance over the second half of 1996; and, while the available data relating to the June quarter provide mixed signals, on balance they suggest that the step-up in the pace of output growth has been maintained.

Importantly, a number of factors should support strong GDP growth in the coming year. Continued strength in the international economy, easier monetary conditions and stronger growth in public spending at the State level, combined with a strong outlook for the construction sector — both residential and non-residential — support the Budget forecast of an acceleration in GDP growth in 1997-98.

While real wage growth is expected to remain relatively strong in 1997-98, some moderation from recent outcomes is in prospect. Nominal wage growth is expected to remain broadly unchanged, with falling inflation expectations and continuing high unemployment rates providing some moderating influence. Inflation is expected to edge up slightly from current levels, primarily reflecting recent exchange rate movements.

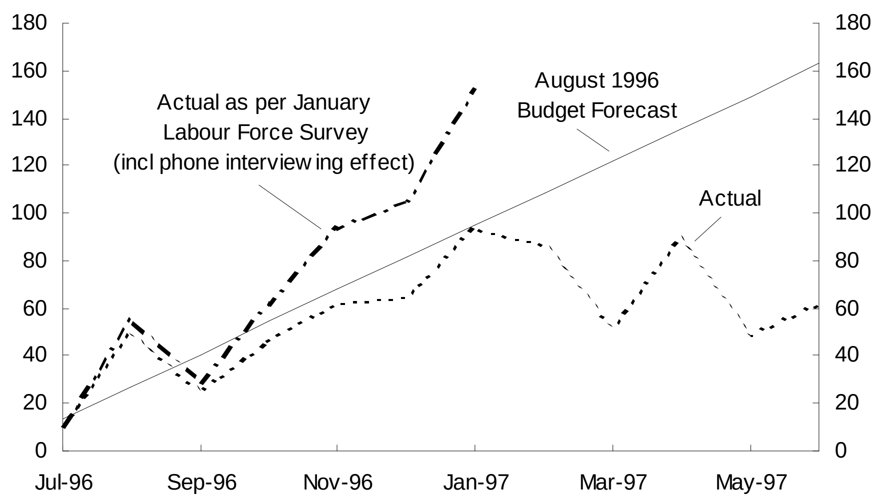
Recent and prospective movements in output and real wages are thus expected to underpin a pick-up in employment growth through the course of the coming year at a rate consistent with that forecast at Budget time. Early signs of this improvement are evident in recent increases in hours worked and continued trend growth in the level of job advertisements.

RECENT LABOUR MARKET CONDITIONS

A notable feature of the labour market during 1996-97 was the contrasting strength of employment in the first seven months of the year relative to subsequent months. This is particularly so if the possible impacts resulting from a change in surveying methodology were taken at face value. Initially the ABS reported that the introduction of telephone interviewing — rather than the predominantly face-to-face methodology previously used — was understating monthly employment changes in the published data over the initial part of the phasing-in period, which included the first half of 1996-97; if allowance were made for such an occurrence, in January 1997 it would have been possible to conclude that the annual increase in employment had met or exceeded the 1996 Budget forecast of a 2 per cent increase in the year to the June quarter 1997 (Chart 1). However, the ABS subsequently concluded that the introduction of telephone interviewing had a transitory — rather than permanent — impact on survey responses, suggesting that the effect had dissipated by the February 1997 survey and that the estimated level of employment in that month was consistent with what would have been expected had the earlier surveying procedures been maintained.

Putting aside such impacts, as evident in Chart 1, the cumulative increase in employment in the seven months to January 1997 was in line with the monthly profile implied by the Budget forecast. Rather than continued growth, however, there was a net downturn in the subsequent five months. As a result, employment in the June quarter 1997 was 1 per cent above the level a year earlier, rather than the 2 per cent forecast in the 1996 Budget. After increasing by 0.5 and 0.4 per cent in the September and December quarters 1996 respectively, employment grew by 0.2 per cent in the March quarter 1997 and fell by 0.1 per cent in the June quarter.

Chart 1: Monthly Employment Growth required to meet August 1996 Budget Forecast



With part-time employment continuing to trend upward, the weakness in employment since January 1997 was reflected in a loss of full-time positions. On an industry basis, the weakness is primarily related to developments in the tertiary industries. Employment in manufacturing was flat, consolidating gains in the second half of 1996 and contrasting with trends in output. Primary sector employment increased slightly, with an increase in agriculture offsetting a drop in mining. Within the tertiary sector there was a continued solid contribution from those areas related to private sector activity, offset by an equally solid detraction from those more closely related to public sector activity; for the latter, the fall in employment in the first half of 1997 contrasts with a stable employment outcome in the previous half year.

Determinants of Short-Term Employment Demand[1]

In the short term, changes in employment can be expressed as being determined by changes in output and real wages. However, businesses are typically cautious in adjusting employment levels to changes in these factors. In response to variations in activity and / or real wages, businesses may initially rely more on altering the extent to which their employees are utilised (for example, by altering overtime levels) rather than the level of employment, preferring to delay adjustments in the latter until it is apparent the changed circumstances are not transitory. A convenient way of analysing these lagged effects in econometric analysis is by the use of an error correction framework, which enables the estimation of sensible long-run properties while at the same time examining factors responsible for short-run deviations from the long-run relationship.

Estimation of such an historical relationship, based on data since the early 1980s, suggests that:

- A 1 percentage point increase in non-farm GDP in the current quarter will increase employment by 0.8 per cent after 5 quarters.[2] Most of the impact arises from changes in activity in the three quarters following the change in activity.
- A 1 percentage point increase in real wages is estimated to reduce employment by about 0.3 per cent after 5 quarters, with the bulk of the impact occurring in the first and second quarters after the change in real wages.[3] There is no impact on employment in the quarter in which real wages change.

This analysis suggests that changes in activity are the dominant factor affecting short-term employment movements, with changes in real wages playing a smaller, though still important, role. The predicted values derived from such an estimated relationship are compared with actual quarterly changes in employment in Chart 2. While employment is likely to be affected by factors other than output and real wages — for example, difficult to measure considerations such as the confidence of employers in the outlook — the

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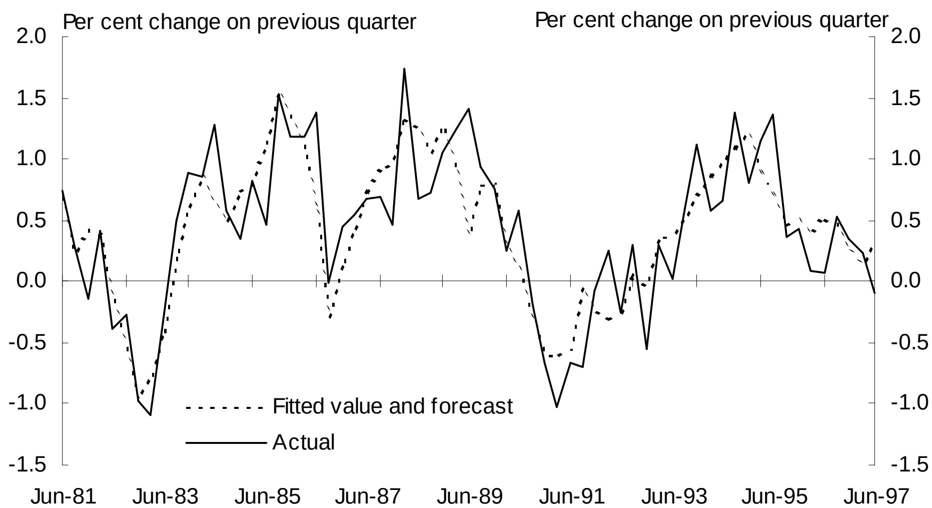
1 This analysis does not examine longer-run structural developments affecting the demand for labour or its supply — all of which are important in explaining unemployment.

2 Additional, though more minor, impacts of the change in output would be expected to occur after five quarters.

3 Again, the full effects would not be expected to have occurred after five quarters.

relationship, nevertheless, provides a good broad indication of quarterly changes in employment over the period since the early 1980s. Moreover, it also provides a good explanation of movements over the past year, although the predicted value for the June quarter 1997 is stronger than the actual outcome; nevertheless, that divergence is not inconsistent with previous experience.

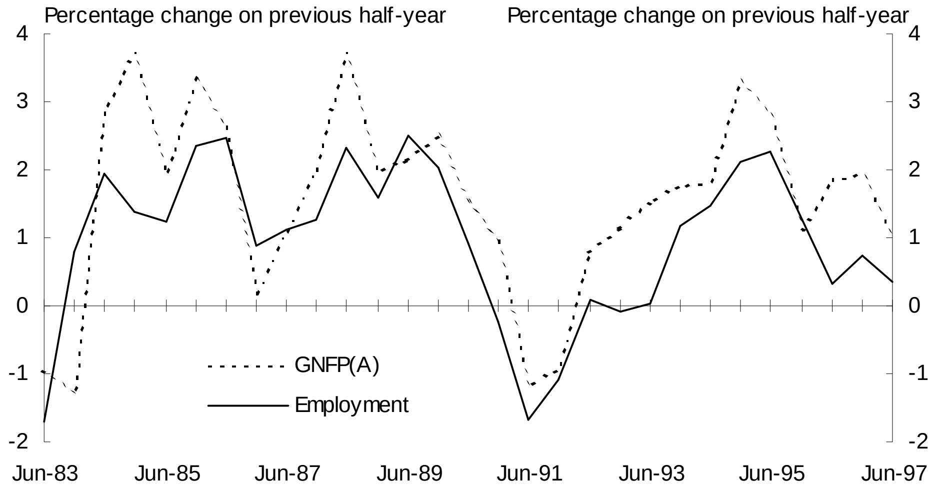
Chart 2: Employment Growth



The broad correspondence between fitted and actual values over the past year suggests that the net decline in employment in the first half of 1997 — while not anticipated at the time of the August 1996 Budget — can largely be explained by changes in output and real wages in the second half of 1996. While employment outcomes will represent the conjunction of movements in these two factors — with individual movements sometimes reinforcing each other, but at other times having opposing impacts — there is benefit in separately examining movements in each factor.

The relationship between half-yearly movements in output (non-farm GDP) and employment is presented in Chart 3; the above-mentioned lagged response of employment to changes in output is illustrated by bringing forward, by six months, the changes in non-farm GDP. Bearing in mind the high level of responsiveness of employment to changes in activity, the recent flat employment growth would appear to primarily be a lagged response to the slowdown in GDP growth in late 1996. Year-to growth in non-farm GDP in the first three quarters of 1996-97 eased to a greater extent than anticipated in the August 1996 Budget. The shortfall, which was concentrated in the first half of the financial year, was most apparent in public demand (due to much weaker consumption and investment at the Commonwealth level), but there also appears to have been some transitory weakness in private sector demand in the December quarter 1996.

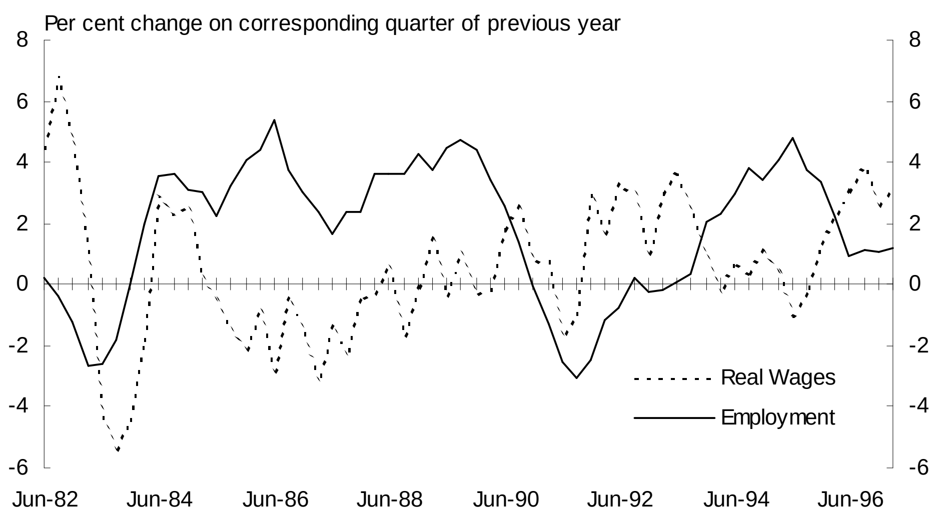
Chart 3: Growth in Non-farm GDP* and Employment



*GNFP(A) growth is brought forward 6 months, ie December 1996 half year growth appears as June 1997 half year growth, to illustrate the lag between growth in GNFP and employment.

An additional factor contributing to the recent weakness in employment appears to have been a significant rise in real wage growth, particularly from the beginning of 1996. The relationship between real wage growth and employment growth is illustrated in Chart 4.

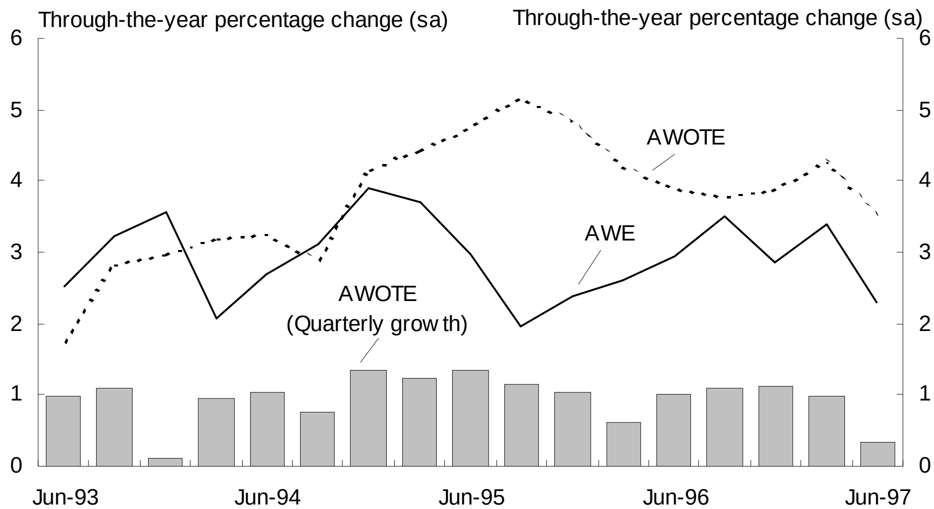
Chart 4: Real Wages and Employment Growth



There is a broad correspondence between periods of low real wage growth and strong employment growth (for example, throughout most of the 1980s and over the period from mid-1993 to late 1995) and, similarly, between periods of high real wage growth and weak employment growth (as in the early 1980s and the late 1980s / early 1990s). Real wage increases in excess of productivity gains will reduce company profits unless the higher costs can be passed on through higher prices. If profits are affected, this is likely to lead to lower employment and perhaps also investment.

The recent strengthening of real wage growth reflects a sharper than anticipated fall in inflation rather than rising nominal wages. As evident in Chart 5, quarterly rates of growth in nominal wages have been fairly stable (at a relatively high level) over the past couple of years, other than for the March quarter 1996 and the June quarter 1997.

Chart 5: Earnings Growth



Other Indicators of Labour Market Demand

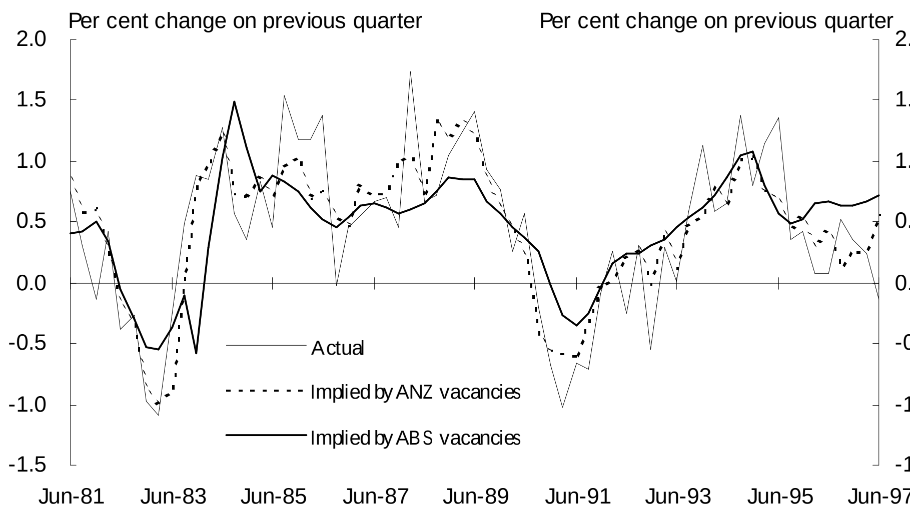
Recent employment outcomes can also be contrasted with more proximate indicators of labour demand, such as the level of job vacancies. Of the two data series which analyse aggregate vacancies movements,[4] conceptually the ABS measure would be expected to provide the more comprehensive indication because it is based on a direct survey of firms. In contrast the ANZ series is based on the number of advertisements appearing in major metropolitan newspapers; this series thus suffers from the likelihood of multiple recordings of a particular vacancy and from an inability to account for vacancies which are filled by means other than media advertising. Nevertheless, both data sources are widely used by commentators as indicators of current and prospective movements in aggregate employment.[5]

4 A third series, compiled by DEETYA, relates only to skilled vacancies.

5 The relationship between vacancies and employment growth is discussed in the Winter 1996 *Economic Roundup*.

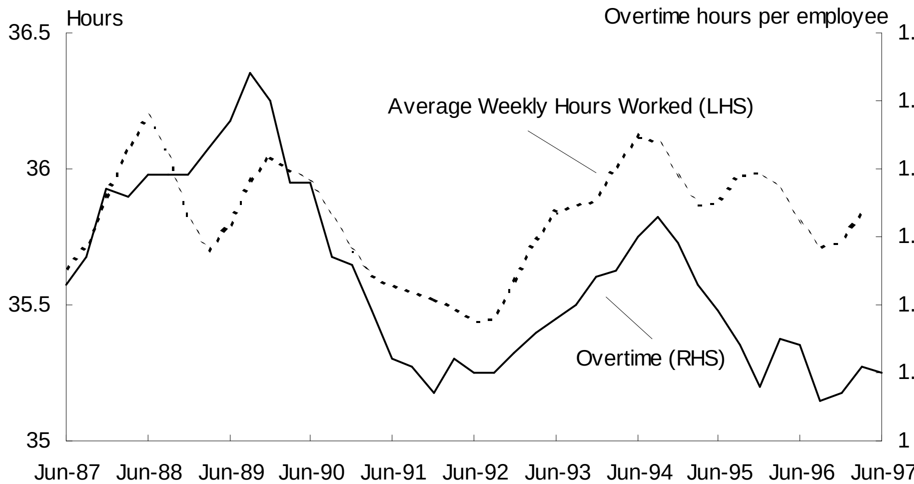
Based on estimated historical relationships, the predicted values for employment growth consistent with the level of the two job vacancies series are compared with actual outcomes in Chart 6. Despite the conceptual appeal of the ABS measure, the ANZ measure appears to have provided a better guide to actual employment movements over the entire period examined. This is particularly evident for recent outcomes, with the level of ABS vacancies being unusually high relative to employment growth. Based on historical relationships, the level of ANZ job ads would have implied slightly weaker increases in employment than actually occurred in the second half of last year, a similar outcome for the March quarter 1997, but a significantly stronger outcome for the June quarter 1997 than eventuated. As with the employment relationship discussed above, however, divergences of this magnitude over short periods are not out of line with earlier experiences.

Chart 6: Employment Growth Implied by Vacancy Series



As indicated above, changing circumstances in relation to aggregate labour demand are often more immediately apparent for indicators of the intensity with which the existing work force is being used, rather than the level of the work force itself. In this respect, there are some early and very tentative signs of an improvement in data relating to hours of work. While overtime data are volatile (see Chart 7), total overtime hours worked rose over the first six months of 1997. This follows substantial falls in the series since mid-1994, at least partly related to an increased tendency to cash out overtime in enterprise bargains. The small rise in overtime in recent quarters should therefore be interpreted in the context of a likely long-term trend decline in the series. Average hours worked by wage and salary earners rose in the March quarter, although these data are subject to considerable volatility.

Chart 7: Overtime and Hours Worked



The major business surveys provide mixed indications, in respect of both recent and prospective employment outcomes.

- In net balance terms, respondents to the NAB survey report actual employment outcomes for the March and June quarters 1997 which are somewhat more negative than for the previous half-year, consistent with the published aggregate employment data. The outcome for the March quarter was consistent with expectations, but the June quarter outcome failed to match earlier expectations of an improvement, rather like the above-mentioned relationships based on either output and real wages or job advertisements. Firms expect employment to improve in the September quarter, and in a more pronounced fashion than was expected for the June quarter.
- Respondents to the ACCI-Westpac survey reported a negative net balance for employment outcomes in the June quarter. The actual outcome, however, was significantly better than expected; in contrast, in the preceding four surveys, actual outcomes were slightly worse than expected. Employment expectations for the September quarter weakened again.
- Employment expectations for the Dun and Bradstreet survey are unchanged from earlier recordings, but above recent actual outcomes.

The preceding analysis suggests that recent employment outcomes are broadly consistent with developments in underlying fundamentals, namely the slowing of output growth and the rise in real wage growth in the second half of 1996. There have recently been some tentative signs of increased intensity of use of those who are employed, a common forerunner of increases in employment levels. Although mixed, the major business surveys also point to some improvement in employment expectations, and the level of job advertisements has trended up since the beginning of 1997. The extent to which such positive indications translate into stronger employment outcomes will be critically dependent upon recent and prospective developments in relation to output and real wages, with the former being of particular importance.

RECENT INDICATORS OF ECONOMIC ACTIVITY

As indicated above, non-farm GDP growth slowed in the second half of 1996, with the aggregate increase of 0.9 per cent over the two quarters being about half that observed in the previous two half-year periods. Some strengthening of output growth was apparent in the March quarter 1997, with non-farm GDP rising by 0.8 per cent. The strengthening was particularly apparent in a sharp rise in final demand, partially met by a strong decline in private non-farm stocks.

It is always difficult to confidently draw conclusions from the available partial economic indicators about implications for likely rates of change in quarterly GDP estimates. Nevertheless, the available indicators of activity — while providing some mixed signals — on balance point to underlying strength in demand in the June quarter, and support the view that there has been some step-up in the pace of output growth in the first half of 1997.

Credit growth has picked up in recent months, particularly in relation to business lending. Finance for the leasing of **equipment** has surged in the June quarter. The level of **non-residential building** approvals in the first half of 1996 is well down on record levels in the second half of 1997. However, this earlier level was boosted by the approval of some Olympics-related infrastructure, and there have also been reports of some projects being deferred into 1997-98, with businesses encountering delays associated with the restructuring of financing arrangements. Encouragingly, the June data indicate a return to higher approvals values, broadly consistent with underlying levels experienced throughout the second half of 1996. Moreover, the value of work yet to be completed is high — for both engineering construction and non-residential building — providing a foundation for activity in this sector for some time to come. Business expectations for equipment and non-residential construction investment for the June quarter were strong.

Recent credit statistics relating to **housing** finance remain consistent with an ongoing moderate recovery in dwelling construction. While finance approvals for new dwellings have moderated in recent months, they were up by 6 per cent for the June quarter as a whole, and are around 18½ per cent above year-earlier levels. Approvals of private sector building approvals in the June quarter were almost 3 per cent higher than in the March quarter and more than 19 per cent above year-earlier levels. Recent approvals levels have admittedly been boosted by some Olympics developments. Nevertheless, the likelihood of a further improvement in the already record level of housing affordability, as a result of the recent reduction in official interest rates, point to a continued strengthening in dwelling construction.

A feature of GDP growth in the March quarter 1997 was the extent to which a surge in final demand was met by a pronounced run down in **private non-farm stocks**, detracting 1.7 percentage points from GDP growth in the quarter. In the absence of any revisions to the March quarter data, changes in the level of non-farm stocks have the potential to be the most significant contributor to GDP growth in the June quarter; for example, a continuation of stock levels at the low levels attained in the March quarter would imply a contribution to June quarter growth of around 1 percentage point.

Allowing for likely movements in prices and applying appropriate quarterly seasonal adjustment factors, recent trade data indicate that fairly strong growth in **import volumes** appears to have resumed in the June quarter, after being flat in the March quarter. Such an outcome would be consistent with continued strength in sales in the quarter, and with a reduced proportion of aggregate sales being met by reducing stock levels than was the case for the March quarter. Abstracting from special influences (particularly the RBA gold sales), modest growth in **export volumes** appears to have continued in the June quarter, especially commodity exports.

A component which has not been a major contributor to the recent strengthening of credit growth is finance to individuals for purposes other than housing. **Consumer spending** is unlikely to have grown very strongly in the June quarter, with the final outcome being very dependent upon the extent to which consumption of services rebounded from a very weak March quarter. Allowing for the different seasonal adjustment processes involved, the decline in constant price retail turnover for the June quarter is likely to translate into an essentially flat outcome for the corresponding retail components in the national accounts; this differential would reverse that apparent for the March quarter data.

The **business surveys** represent another indicator with a more negative tone. On balance, respondents to recent surveys remained negative about actual trading conditions in the June quarter, with outcomes comparable with responses over the previous two years. However, it is difficult to draw precise implications for quarterly rates of growth in aggregate activity from such surveys; for example, the past two years have been characterised by significant variation in quarterly rates of GDP growth, encompassing instances of both very rapid and very marginal growth.

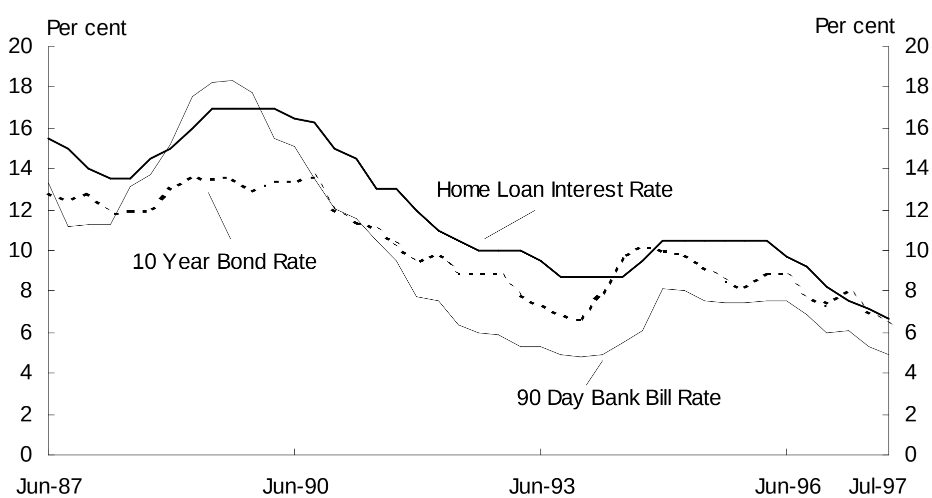
FACTORS INFLUENCING GROWTH OVER 1997-98

Given the lags which typically influence business decisions about employment, a pick-up in output growth in the first half of 1997 is a necessary requirement for the resumption of employment growth during the remainder of 1997. For such a strengthening in employment growth to be sustained, output growth will need to remain strong over coming quarters and beyond. In relation to that, there are a number of factors which suggest solid GDP growth in 1997-98, consistent with the outlook presented in the May 1997 Budget.

The **international economy** remains supportive. Economic growth in our major trading partners is expected to be around 4½ per cent in 1997-98, with inflation remaining low at around 3 per cent. There has recently been some financial instability in the East Asian region, reflecting weaknesses built up over a number of years. These will have to be addressed but there is a general appreciation of what is required and some policy action is being put in train. More discussion of the international outlook is included in an accompanying paper in this issue of the *Roundup*.

Monetary policy has been eased in 1996 and 1997. Cuts in official interest rates, coupled with competitive forces within the financial sector, have resulted in falls in nominal lending rates over the past year (Chart 8). These declines are most noticeable in respect of housing rates, where variable rates have fallen by more than 3 ½ percentage points since May 1996. Business lending rates have fallen by a little under 2 percentage points over this period. Long-term bond rates have fallen by around 240 basis points over the past year, in the process narrowing the differential with US rates to around 30 basis points. This development would suggest greater acceptance of a low inflation environment domestically and the enhanced credibility of both fiscal and monetary policies. Relative to underlying inflation, both short and long-term rates have fallen significantly from levels pertaining until mid to late 1996. The influence of the series of interest rate reductions is still to fully impact on aggregate activity but is evident in the depreciation of the exchange rate, which forms part of the transmission mechanism.

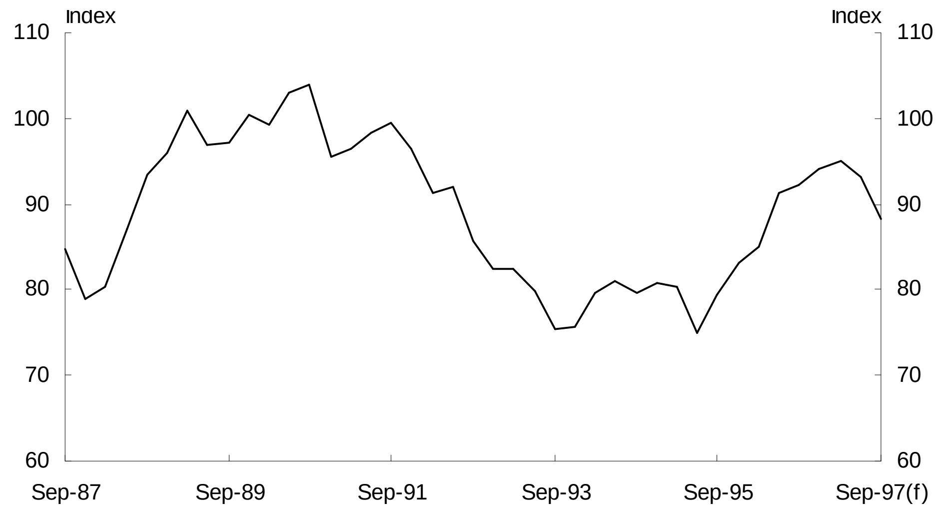
Chart 8: Interest Rates



Note: Data in this chart represents the last working day of the quarter except for the final observation with represents the last working day of July 1997.

After rising by about 24 per cent between the June quarter 1995 and March / April 1997, the trade-weighted index has fallen by almost 5 per cent, to a level comparable to that of a year ago. Primarily reflecting this depreciation, international cost competitiveness — calculated as exchange rate adjusted movements in relative unit labour costs — has improved since the March quarter 1997, reversing a deterioration evident from mid 1995 (Chart 9). Though the level of competitiveness remains below that experienced from early 1993 to mid 1995, this recent improvement should provide a stimulus for the tradables sectors over the year ahead.

Chart 9: International Cost Competitiveness



Note: An increase in the ULC index represents a deterioration in competitiveness. June and September quarters 1997 represent Treasury estimates.

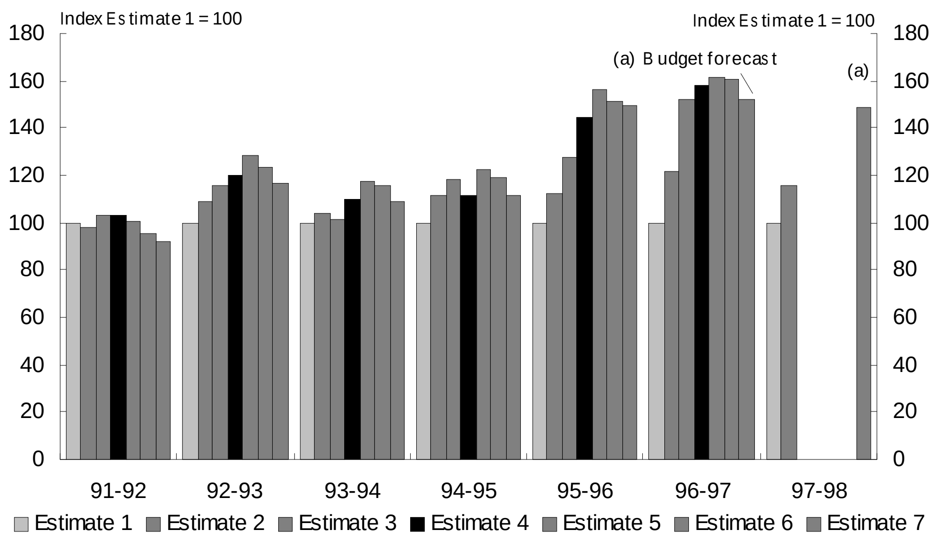
Despite continued fiscal consolidation at the Commonwealth level, **public final demand** growth is expected to be stronger in 1997-98 than in 1996-97, partly reflecting some deferral of expenditure from 1996-97. Current estimates also suggest that growth may be stronger than forecast in the May Budget, primarily reflecting information outlined in subsequent State Budgets.

The **housing** upturn appears to be well under way. The record level of affordability, the erosion of excess supply, and aggregate vacancies levels are all pointing to a strong recovery. If anything, these indicators may be interpreted as suggesting that the upturn may prove to be stronger than currently expected. However, there remain a number of constraining influences — lower levels of immigration, continuing relatively high levels of unemployment and continued pockets of excess supply — which are still expected to result in the strength of the current housing recovery being somewhat more muted than past recoveries.

Conditions for business investment remain favourable. The outlook for **non-residential construction** remains very positive, with work yet to be done remaining high and business expectations pointing to strong growth. The buoyant expectations contained in the second ABS capital expenditure survey estimate for 1997-98 (see Chart 10) suggest that buildings investment is expected to increase across all industries, and activity should be underpinned by several private infrastructure and Olympics related projects.

Equipment investment is expected to increase at a much more modest rate than in recent years, consistent with business intentions reported in the ABS capital expenditure survey. However, more recent surveys conducted by NAB and ACCI-Westpac point to some strengthening of expectations, and underlying fundamentals remain sound; for example, survey capacity utilisation measures have recently improved, and the corporate profit share and the net rate of return on the capital stock are high by historical standards.

Chart 10: Building Investment Expectations



While the preceding factors are all supportive of the outlook presented in the 1997-98 Budget, there are some areas of uncertainty. **Adverse weather conditions** have the potential to reduce farm product to a greater extent than currently forecast; the situation has become critical, with good rainfall required immediately in wheat-growing areas to avoid very low yields and production levels. There is also some uncertainty over the outlook for **consumer spending**. The forecast strengthening of consumption growth in 1997-98 will require the resumption of stronger employment growth, both in terms of directly boosting incomes and lifting consumer sentiment through reductions in unemployment. There is a risk that consumer spending in the early part of 1997-98 might be more subdued than forecast, given recent weak labour market outcomes. However, if employment growth does respond as anticipated to the stronger GDP growth experienced in the first half of 1997, stronger consumption expenditure would be expected to follow later in the year.