Living Standards Have Peaked This Decade

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It will take an unlikely combination of strong productivity growth and falling real wages to achieve the forecasts in the Economic Outlook accompanying the latest federal government budget.

GDP growth is projected in the latest government Economic Outlook to average 3.25 per cent over the coming four years. In order to achieve this growth rate – blandly noted in the budget papers as a "return to trend" – modelling at Victoria University's Centre of Policy Studies (CoPS) finds that total factor productivity growth will need to return to its heyday of the 1990s, when it added an average of more than 1 percentage point to GDP growth every year.

The budget outlook anticipates that unemployment will drop from its present 6.2 per cent of the workforce to 5 per cent by 2020. This would give GDP an additional kick along from the eventual return to work of around 150,000 currently unemployed workers. However, for the economy to absorb these workers as the prices of important exports (such as iron ore) continue to fall, CoPS modelling shows that real wages would need to fall by an average of 0.2 per cent per annum.

Giving some perspective on the productivity growth required to achieve the optimistic Economic Outlook projections, a more sober projection for future growth in productivity adds just 0.3 percentage points to annual GDP growth (Figure 1). As explained by the Treasury, this is in line with recent averages in the developed world. Assuming, as the Treasury does, that the unemployment rate will fall to 5 per cent by 2020, this would yield GDP growth averaging 2.25 per cent over the coming four years (Figure 2).

The consequences of a sober assessment of productivity growth

After adjusting for falling prices and the significant foreign ownership of the burgeoning mining sector, living standards are set to stagnate as growth in GDP will translate into growth in real per capita incomes of just 0.1 per cent per annum. Although GDP per capita will continue to grow, the average real per capita income will not return to its 2012 peak in the forecast period. Prices received for exports relative to prices paid for imports – the "terms of trade" – will continue to unwind. Consequently the real exchange rate will fall and the purchasing power of the Australian dollar will be weakened (Figure 3).

Household disposable incomes, already impacted by the weak growth in real incomes, will be eroded further as the government gradually adds more than 1 percent of GDP to its revenue collection by 2020. This additional demand on household budgets will leave households with reduced real disposable income per capita. As a result, household consumption per capita will fall by an average of 0.6 per cent per annum.

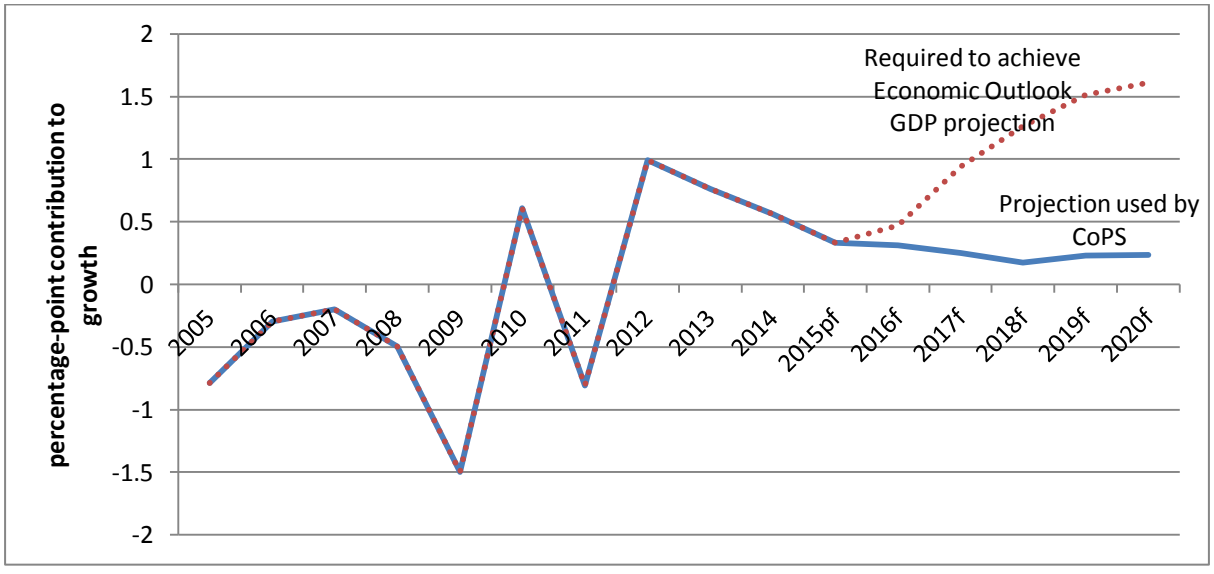
A reduction in unemployment will be possible only if there is a sustained fall in real wages, undoing the last 5 years of wage growth (Figure 4). From 2004, the unemployment rate fell while wages grew for five consecutive years. This was possible because strong growth in the terms of trade kept the consumer price index low, and because the mining construction boom caused significant supply pressures in the labour market. However, with unemployment now at 6.2 per cent and the terms of trade moving downwards, real wages may have peaked in 2015.

Weaker incomes lead to reduced expenditure by all sections of the domestic economy (Figure 5). The fall in investment expenditure is particularly significant as the mining sector returns to maintenance levels of investment following the construction boom.

Growth in exports of LNG and iron ore (DoI 2015) continues to account for the majority of strong growth in export volumes (Figure 6). Figure 6 illustrates the heavy concentration of GDP growth in the export sector. With its declining prices and increasing foreign ownership, strong volumetric growth in exports causes growth in national income to fall behind growth in GDP.

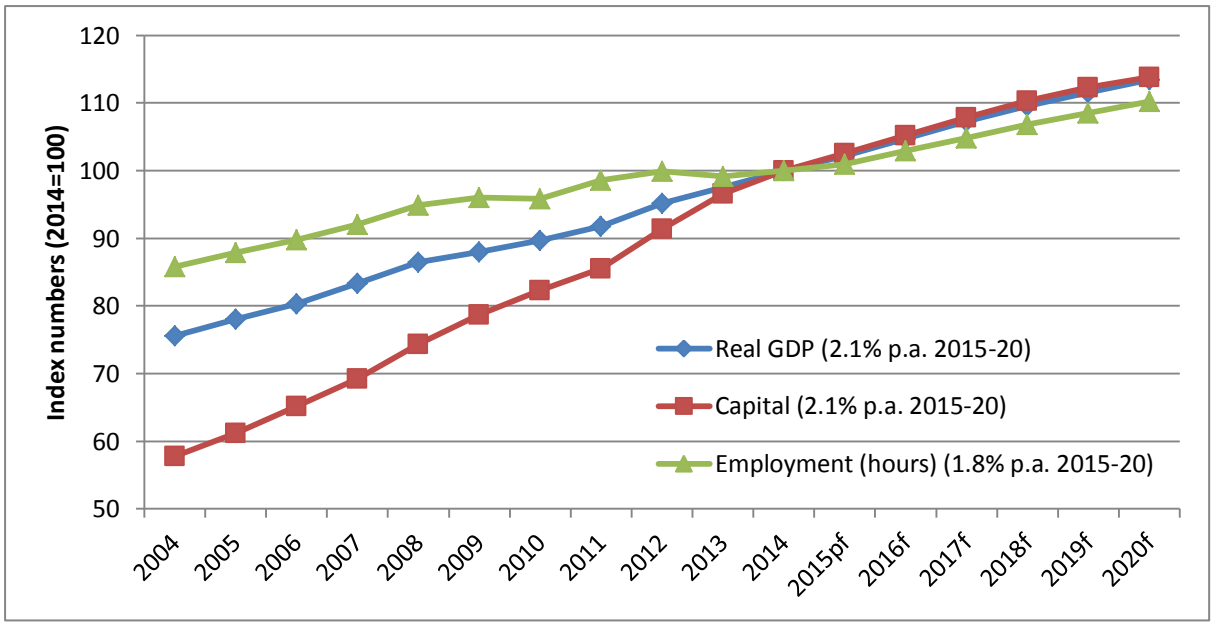
Weak domestic consumption and the falling terms of trade account for a small decline forecast for imports.

Figure 1: Contribution of total factor productivity to growth in GDP



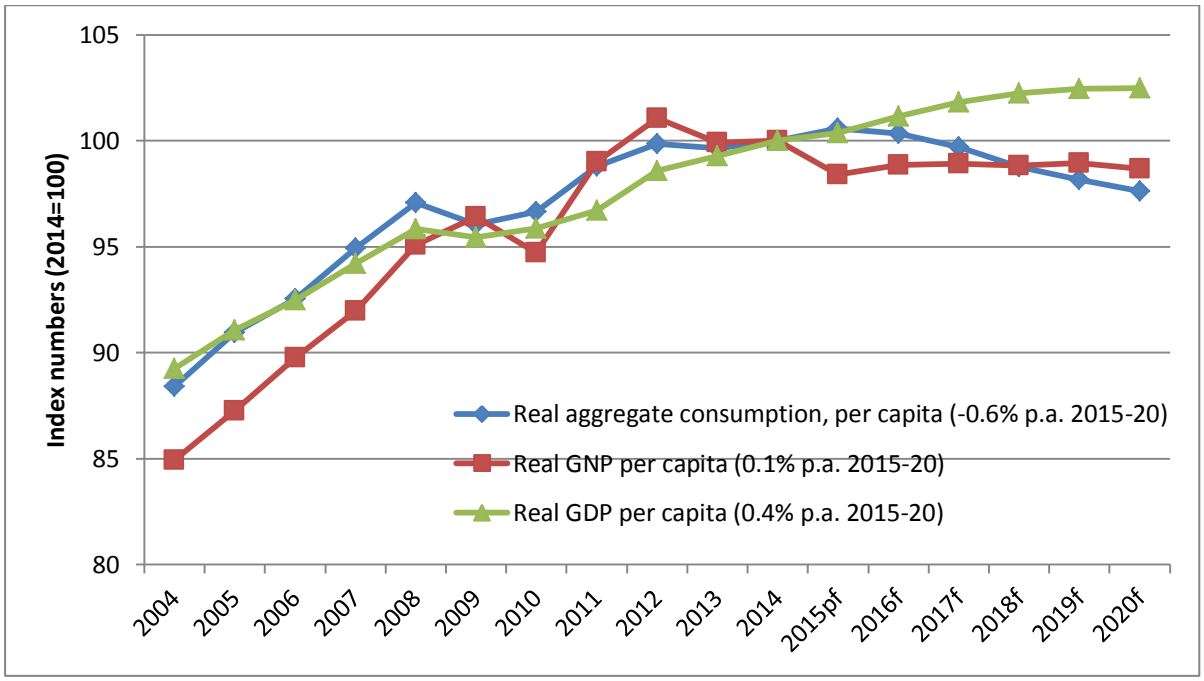
Source: ABS (2004-2014), Vic-Uni Model forecasts (f) based on Dixon et al (2014a, b). Partial forecasts (pf) for 2015

Figure 2: GDP supply side measures



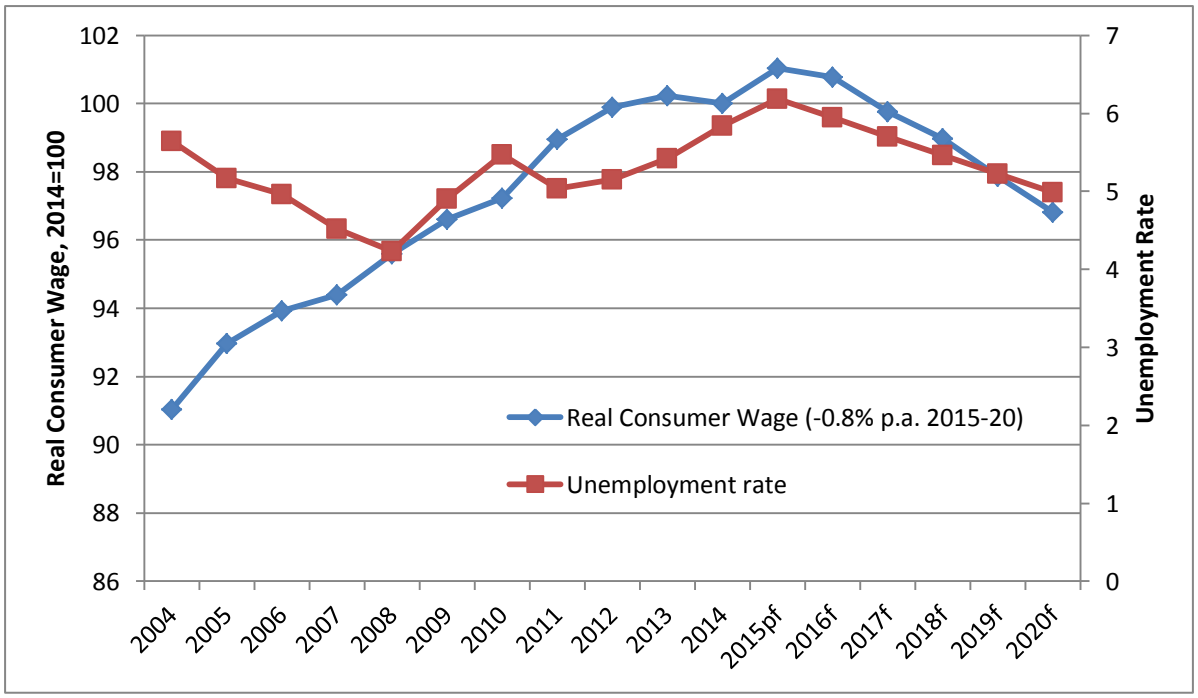
Source: ABS (2004-2014), Vic-Uni Model forecasts (f) based on Dixon et al (2014a, b). Partial forecasts (pf) for 2015

Figure 3: Measures of per-capita welfare



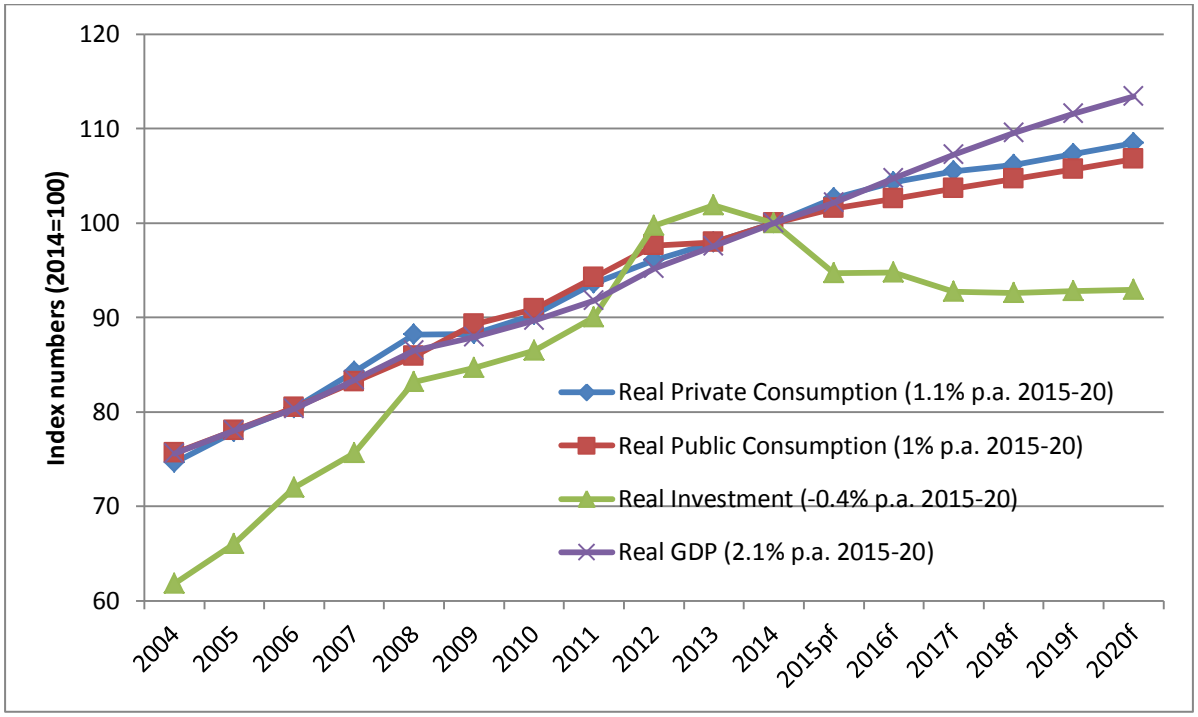
Source: ABS (2004-2014), Vic-Uni Model forecasts (f) based on Dixon et al (2014a, b). Partial forecasts (pf) for 2015

Figure 4: Real Consumer Wage and Unemployment Rate



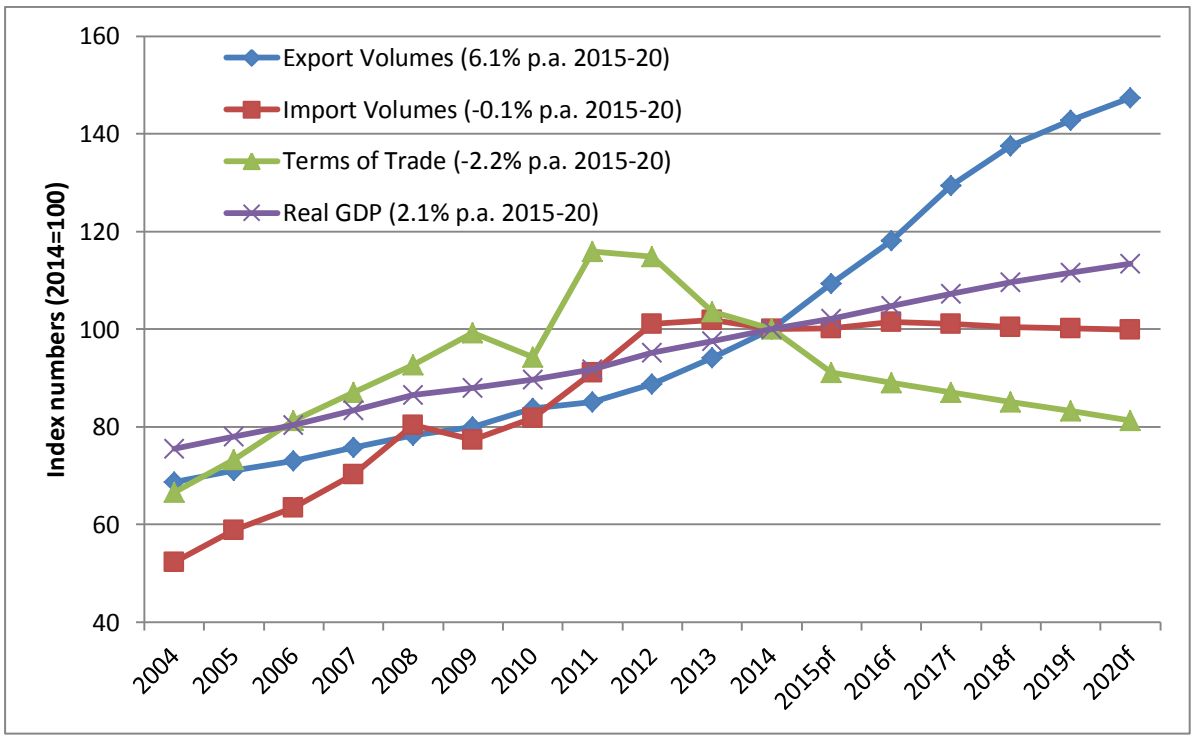
Source: ABS (2004-2014), Vic-Uni Model forecasts (f) based on Dixon et al (2014a, b). Partial forecasts (pf) for 2015

Figure 5: Domestic expenditure on GDP



Source: ABS (2004-2014), Vic-Uni Model forecasts (f) based on Dixon et al (2014a, b). Partial forecasts (pf) for 2015

Figure 6: GDP and trade



Source: ABS (2004-2014), Vic-Uni Model forecasts (f) based on Dixon et al (2014a, b). Partial forecasts (pf) for 2015

Table 1: Results for main macro aggregates

Average per annum growth (%)	2004-2015	2015-2020
Real Private Consumption	2.94	1.11
Real Public Consumption	2.72	1.00
Real Investment	3.95	-0.37
Export Volumes	4.32	6.14
Import Volumes	6.07	-0.05
Terms of Trade (ratio of export prices to import prices)	2.88	-2.23
Real GDP	2.78	2.12
Real aggregate consumption, per capita	1.18	-0.60
Real private consumption, per capita	1.24	-0.57
Real public consumption, per capita	1.01	-0.68
Price deflator, aggregate consumption	2.78	1.82
Real GNP	3.06	1.75
Real GNP per capita	1.35	0.05
Real GDP per capita	1.07	0.42
Population 15+	1.81	1.66
Population total	1.69	1.69
Employment (hours)	1.49	1.77
Employment rate	-0.05	0.25
Participation rate	0.15	-0.11
Real Consumer Wage	0.95	-0.85
Total factor productivity	-0.08	0.24

References

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