8.1 ECONOMIC CONDITIONS

Overview

The ACT economy is expected to continue operating at a high level of activity, with the unemployment rate remaining around its current historically low level. In 2006-07 the economy is forecast to grow solidly but with activity constrained by labour shortages. Household consumption and investment are expected to increase moderately, and Australian Government expenditure is forecast to ease from the strong growth recorded in the previous year. Business investment is anticipated to grow strongly. Employment prospects are expected to remain positive, while wages growth and inflation remain sustainable.

The Outlook for the ACT Economy

The **ACT economy** continues to be supported by strong employment, strong business profitability and sustained wages growth. However, growth is currently being constrained by the limited availability of labour. Tight labour market conditions are expected to continue in 2006-07, holding down the rate of economic growth in the ACT.

The key economic aggregates for the ACT are set out in Table 8.1.1.

Table 8.1.1
Economic Forecasts, Year-average percentage change

	Actual	Forecasts[a]		Projections[b]		
	2004-05	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**
ACT						
State Final Demand	3.2	3½	3	4¾	4¾	4¾
Employment	1.7	¾	¾	1½	1½	1½
Unemployment	3.6	3¼	3¼	4	4	4
Population	0.3	½	¾	¾	¾	¾
Consumer Price Index	2.3	3	2¾	2½	2½	2½
Australia						
Gross Domestic Product	2.5	2½	3¼	3½	3¼	3¼
Memorandum item[c]						
ACT Gross State Product	3.0	2	2½	2½	2½	2½

Notes

(a) Forecasts and projections are rounded to a ¼ of a percentage point to reflect the relative level of accuracy used in forecasting economic parameters. This is standard forecasting practice used by governments throughout Australia.

(b) Projections are based on long-run averages and are provided for planning purposes only. They do not reflect an expectation (forecast) of actual outcomes.

(c) The measure of production in the ACT economy, Gross State Product (GSP), is presented as a memorandum item, consistent with advice from the Australian Bureau of Statistics (ABS) that users should exercise caution when using estimates of real growth in the GSP measure for economic analysis, and consistent with the ABS labelling the real estimates of GSP as ‘experimental’. The ABS estimates of real growth in GSP are derived indirectly. The method involves deriving a price deflator from the best possible nominal and real estimates of expenditure (SFD) that encompass as much as possible of GSP. This deflator is then applied to current price income estimates of GSP. Given these measurement issues, the ABS is currently developing estimates of GSP using the production approach. The ABS believes that better quality real estimates of GSP can be produced using this approach. Experimental estimates using the new approach are expected to be released during 2006.

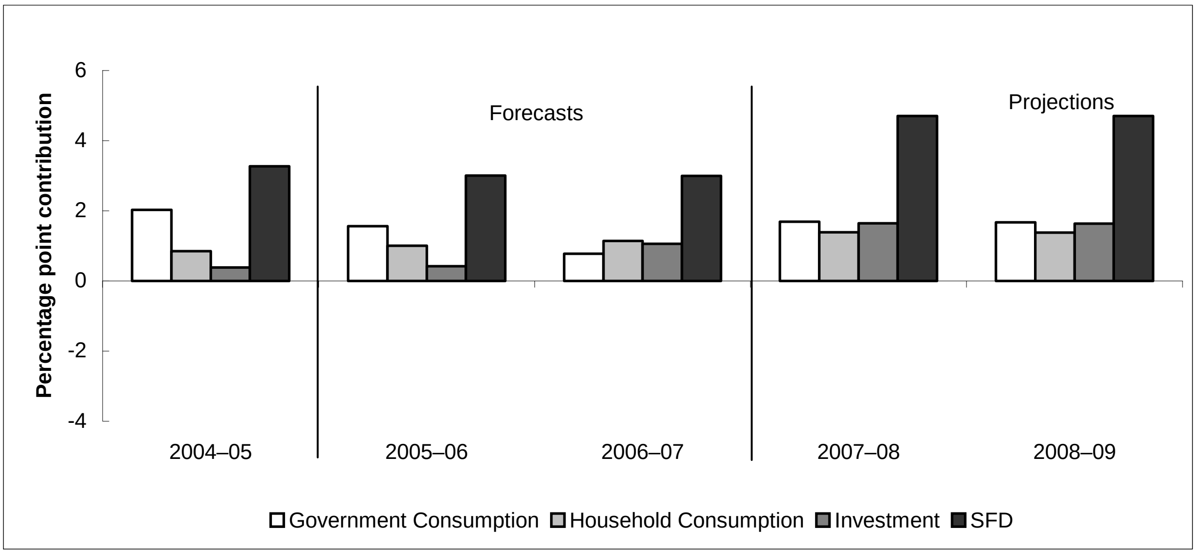
The Australian Government is forecasting the national economy to strengthen in 2006-07 following moderate growth in 2005-06. The Australian Government's outlook is for household consumption and dwelling investment to be relatively subdued, and for economic growth to be supported by strong business investment and an increase in the rate of growth of exports. This expected rebalancing of growth from domestic to external sectors is seen as desirable and as underpinning the sustainability of the current 15-year economic expansion. As the effect of higher oil prices flows through the economy, the Australian Government expects inflation to reach 3 per cent in 2005-06, the upper bound of the monetary policy target band, before easing in 2006-07.

Economic growth in the ACT is expected to remain strong, but below the national average, largely reflecting the labour constraints which are more prevalent in the ACT than elsewhere in Australia. The strength of the national economy has made it more difficult for the ACT to attract labour from other states. Unlike some other states, the ACT is also not benefiting from the recent very large increase in export prices, particularly for coal and iron ore, and subsequent increase in export volumes.

Gross State Product (GSP), the Australian Bureau of Statistics measure of ACT economic production, is forecast to grow at around its historic average. However, there can be a significant divergence between actual economic activity and that measured by GSP. The GSP measure may not deliver a true picture of the ACT economy and the ABS advises users to exercise caution when using GSP estimates for economic analysis.

State final demand (SFD) is expected to ease in 2006-07 reflecting modest growth in Australian Government outlays in the ACT and private consumption and housing investment. In contrast, business investment is forecast to grow strongly. Contributions to SFD from the various components are shown in Figure 8.1.1.

Figure 8.1.1
Contributions to Growth in ACT State Final Demand



Source: ABS, Cat. No. 5220.0 and ACT Treasury estimates

Government consumption expenditure, particularly that of the Australian Government, is a key determinant of economic activity in the ACT. Following strong Australian Government consumption expenditure in the ACT in 2005-06, the Australian Government is forecasting slower, but still solid, growth in outlays in 2006-07. At the same time, it is also forecasting substantial increases in employment, with many of these positions potentially based in and around the ACT. However, government consumption is likely to be constrained by the tight labour market conditions.

Private consumption expenditure in the ACT is expected to continue to grow at a modest rate. While consumption will be supported by solid real wages growth and income tax cuts from 1 July 2006, this support is likely to be offset to some extent by slower growth in household wealth as house price growth remains subdued. Higher interest rates and petrol prices are also expected to subdue household spending.

The outlook for **business investment** in 2006-07 remains strong with ACT businesses confident about their prospects. Non-dwelling construction and investment in machinery and equipment are both forecast to grow strongly. The volume of non-dwelling construction activity undertaken in the ACT in the first half of 2005-06 was 70 per cent higher than a year ago and the highest half-year investment since 1989-90. The large amount of construction work in the pipeline is expected to sustain this high level of activity. This work includes the Bunda Street Carpark, the Gungahlin Drive Extension, the Alexander Maconochie Centre, several office buildings, the expansion of the main runway at the Canberra Airport and a new retail outlet at Canberra Airport. The new Defence headquarters complex at Bungendore is also expected to significantly boost investment and employment in the region, including the ACT, over the next three years.

The outlook for the ACT **housing market** is for modest growth, as the market continues to move through a period of consolidation after the recent national housing boom. The recent increase in the number of residential building approvals suggests new building activity is likely to increase over the next 12 months. Residential property **turnover** is also expected to increase slightly while property **prices** are expected to be maintained in real terms.

The **employment** forecast for 2006-07 continues to be constrained to ¾ per cent growth by the tight labour market. At the national level, the Australian Government forecasts employment to grow by 1 per cent in 2006-07, slightly below the growth in the working age population. This moderate easing of national labour market pressures is not expected to be sufficient to address tight labour market conditions in the ACT.

This tightness of the labour market is the most significant **risk** to the ACT's economic forecasts. Should the current skill shortages in Australia worsen then growth may be further constrained in the ACT. Conversely, a weakening in the national demand for labour could alleviate the skill shortage problem in the ACT, and increase growth, by allowing the ACT's share of net interstate migration to increase.

Other risks arise from interest rates and Australian Government expenditure in the ACT. Further sustained rises in interest rates are likely to impact adversely on private consumption and investment in the ACT, particularly given the build-up in household debt in recent years. Should the Australian Government not meet its budgeted spending and employment intentions, or the ACT receive a smaller share of this spending, then this could also reduce economic activity in the ACT.

Housing market

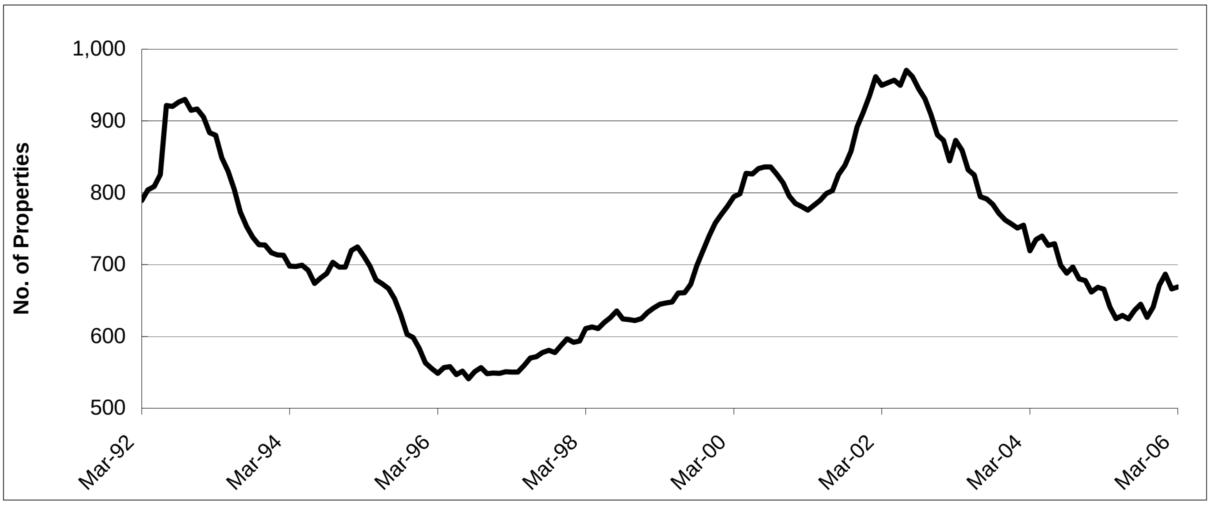
The outlook for the ACT housing market is for continued modest growth, consistent with the continuing tight labour market conditions and household income growth. Property turnover is expected to return to longer-run average levels over the forward estimates while property prices are expected to be maintained in real terms. The outlook is for first homebuyers to continue their recent trend of returning to the market as housing affordability continues to improve in line with strong growth in household incomes. The trend in dwelling approvals is also forecast to rise and return to long-run average levels.

The current pattern of modest growth in the housing market constitutes a more sustainable medium-term outlook than the boom period of 1999 to 2003. The relative low point in the housing cycle was reached in the Spring of 2004 when ACT housing finance commitments, residential building approvals and property turnover all fell to historic lows. However, even during this period, ACT residential property prices were maintained in real terms.

Turnover

Indicators now point to ACT residential property turnover returning to longer-run average levels, notwithstanding that the cyclical nature of residential property turnover makes the concept of a 'long-run average level' somewhat problematic. This outlook is supported by the current upward trend in turnover, interest rates remaining low by historic standards despite the rise in May 2006, and strong growth in household incomes as the labour market remains tight.

Figure 8.1.2
ACT Residential Property Turnover, 12 Month moving average, Monthly original data.

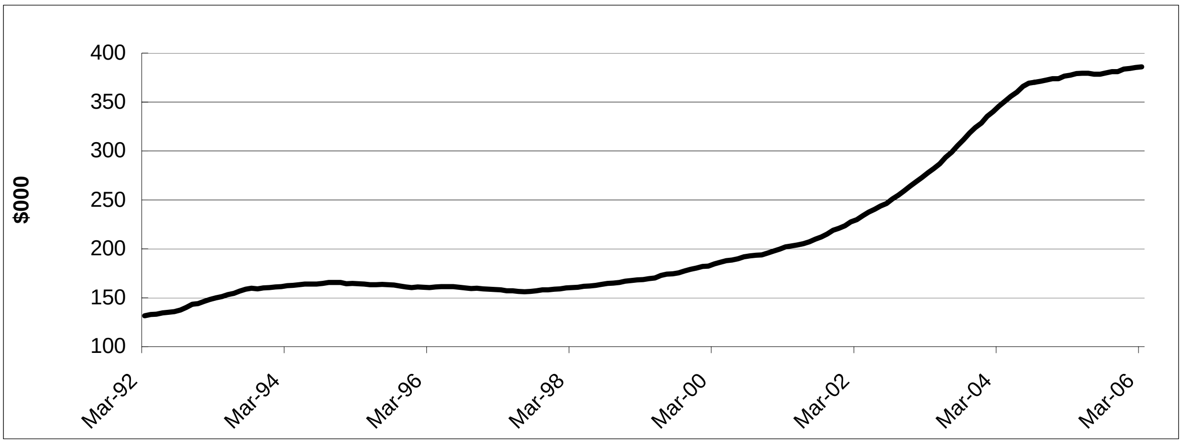


Source: ACT Planning and Land Authority.

Prices

Residential property prices are expected to be at least maintained in real terms in 2006-07. This is consistent with the relatively low point the ACT is experiencing in the current housing cycle and the expectations of lower private consumption growth. Despite the fall in turnover since the height of the property boom in late 2003, and while the rate of price growth has slowed markedly, prices have continued to grow in nominal terms and have tended to at least be maintained in real terms.

Figure 8.1.3
ACT Residential Property Average Price, 12 Month moving average, Monthly original data



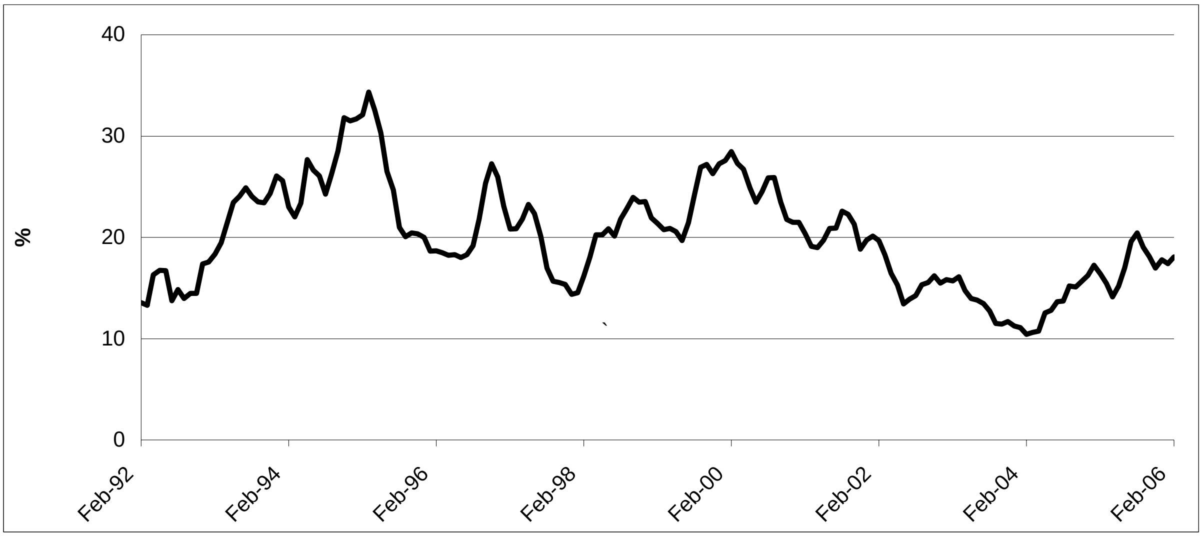
Source: ACT Planning and Land Authority

First homebuyers

The outlook for first homebuyers is for their share of the market to continue to increase, consistent with a continued improvement in housing affordability in the ACT as house price growth remains moderate, the tight labour market allows people to borrow with confidence and interest rates remain low. The increase in the first homebuyer proportion has also been supported by subdued investor interest in the residential property market as investors have focussed on strong share markets that have been providing higher returns than the property market.

Since early 2004, first homebuyers have increasingly returned to the market, as evidenced by the first homebuyer proportion of housing finance commitments generally rising, to stand at a little under 20 per cent in February 2006 and in line with the long-run average proportion.

Figure 8.1.4
Finance to First Home Owners as a Proportion of Total Housing Finance, Number of Commitments, 3-Month moving average, Original monthly data.

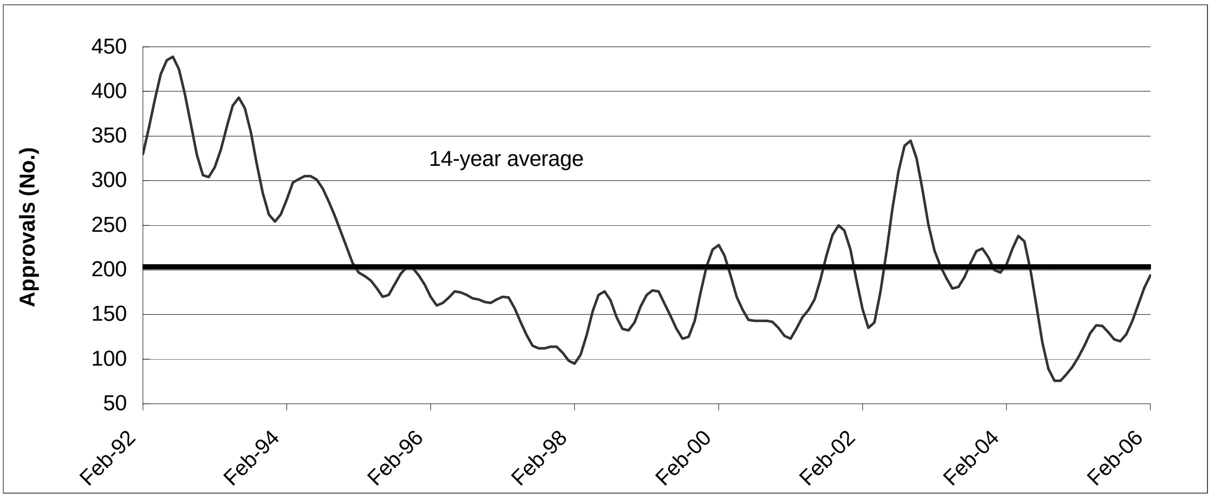


Source: ABS Cat. no. 5609.0.

New Dwellings

Construction of new dwellings is expected to record modest growth in 2006-07. This outlook is consistent with the current trend in the number of ACT residential building approvals being on the rise and at a level near the long-run average. The outlook of modest growth for residential approvals is also consistent with the ACT residential land market that is showing early signs of strengthening with an increasing demand for vacant blocks of land, particularly below the $170,000 price point.

Figure 8.1.5
Residential Building Approvals, Monthly Trend Data



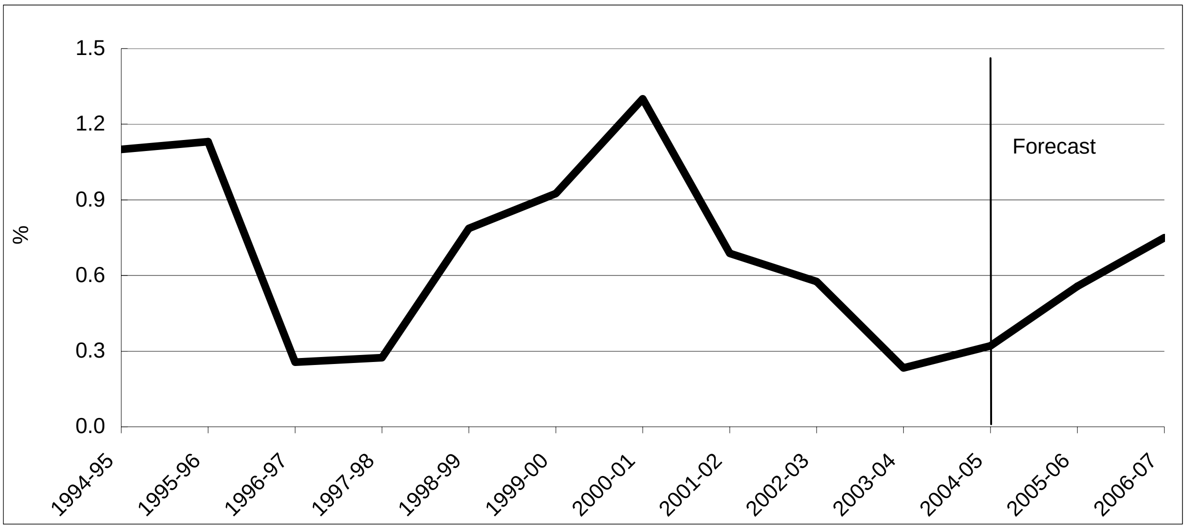
Sources: ABS Cat No 8731.0.

Population

The rate of growth in the ACT's population is forecast to strengthen to ¾ per cent in 2006-07, a growth rate considerably higher than the growth rates recorded in recent years. This will translate into a ½ per cent increase in the size of the ACT's labour market.

The ACT's population movement has in recent times been characterised by the natural increase (births less deaths) being partly offset by a net outflow reflecting excellent job opportunities throughout most of the country. While a net outflow is expected to continue, it is expected to reduce in magnitude, resulting in higher population growth overall. The improvement in the pattern of net interstate migration to the ACT is largely predicated on a weakening in employment growth in the ACT's traditional markets for interstate migrants, particularly in New South Wales.

Figure 8.1.6
Annual ACT Population Growth (Original, Quarterly Data)



Source: ABS Cat No. 3101.0 and ACT Treasury

Labour Market

The ACT labour market remains very tight, with the trend unemployment rate around a record low and the labour force participation rate near a record high. These conditions are likely to persist as both national labour demand and the demand for labour in the ACT remain strong.

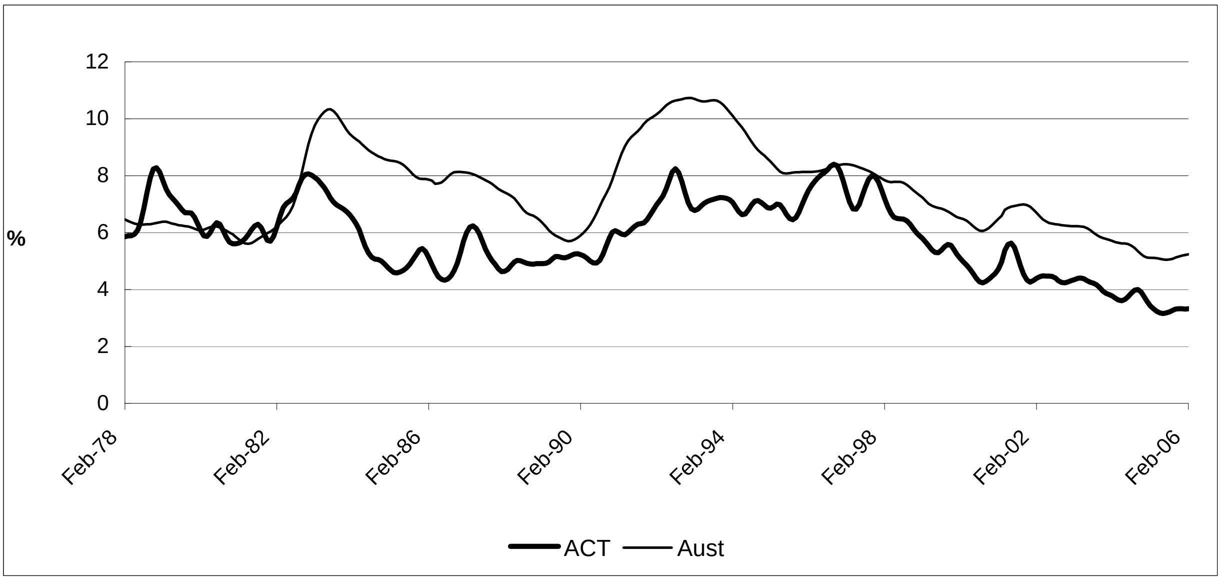
Given the outlook for demand, employment is expected to increase in 2006-07 primarily due to increases in the ACT population and to a lesser degree increases in participation, particularly participation by older age cohorts.

Employment

Following an expected ¾ per cent growth in employment in 2005-06, the growth in employment in 2006-07 is forecast to be constrained to ¾ per cent, that is, around half the long-run average annual growth rate, as a result of the continuation of the tight labour market nationally. These tight labour market conditions, nationally and locally, are placing upward pressure on wages. The contribution to employment growth of ¾ per cent in 2006-07 will be from an increase in the ACT population (½ per cent contribution) and an increase in participation (¼ per cent contribution), particularly from older age cohorts.

At the national level, employment is forecast to grow at 1 per cent in 2006-07, an easing from the 2 per cent rate in 2005-06 but a rate not much below the growth in the working age population and, therefore, it is not expected that the national labour market will ease sufficiently to provide significant relief to the local ACT labour market.

Figure 8.1.7
Trend Unemployment Rate, ACT and Australia (Monthly Data)



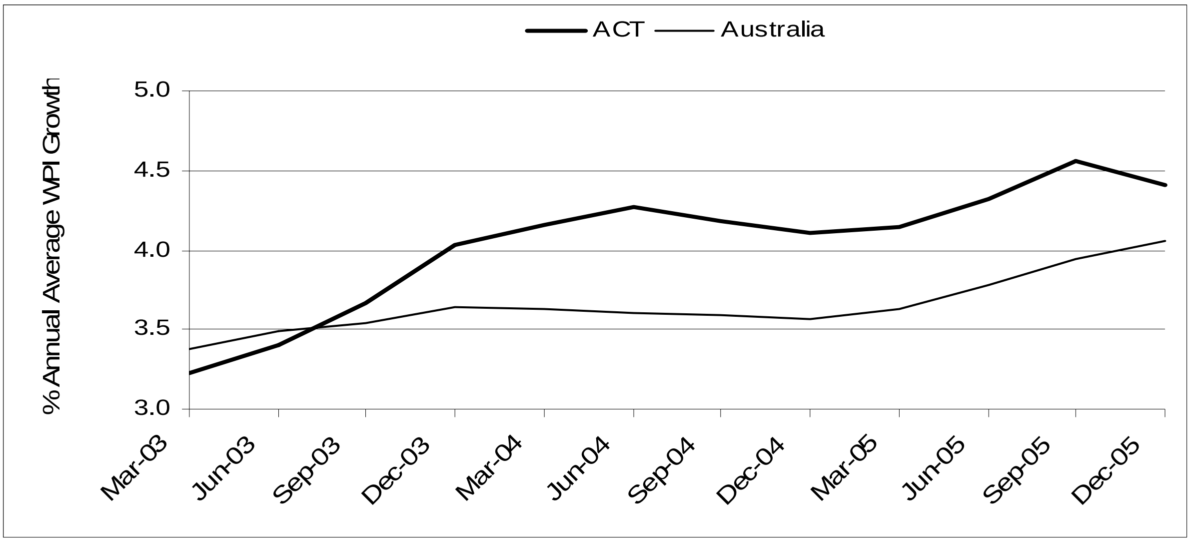
Source: ABS Cat No. 6202.0

Labour costs

The Australian Government has forecast strong wage growth in both 2005-06 and 2006-07, with the Wage Price Index (WPI), growing at 4 per cent in both years. Labour supply constraints, especially in many service industries, in an environment where economic demand is expected to stimulate business growth, will be expected to sustain future wage pressures. This may be somewhat offset by a tightening in monetary policy.

WPI growth has been higher in Canberra than nationally since June 2003. For the year to December 2005, annual average WPI growth was 4.4 per cent per annum, compared to 4.1 per cent per annum recorded nationally. Taking inflation into account, growth in real wages over this period was 1.8 per cent in Canberra, compared to 1.4 per cent nationally. Public sector wages in Canberra grew at an annual rate of 4.8 per cent for the year ending December 2005 — faster than wages growth in the private sector, which was 3.6 per cent.

Figure 8.1.8
Annual average growth in Wage Price Index (WPI)



Source: ABS Cat. No. 6345.0

Skills Shortages

Skill shortages have been reported across a number of sectors in the ACT including construction trades, motor vehicle trades, accounting, childcare, and government administration. The skills shortages currently being experienced in the ACT reflect both short-term and long-term influences.

Short-term influences

To a large extent, the current skill shortages reflect the current strength of the economy. The Australian economy is currently experiencing its longest expansion on record (15 years). The demand for labour associated with such a lengthy economic expansion has reduced the national trend unemployment rate to 5.1 per cent, its lowest level in 30 years. The ACT's trend unemployment rate is at its lowest level on record (3.2 per cent).

The national demand for labour has not only lowered unemployment rates across the country, it is also creating increased national competition for labour. Consequently, some workers who would have been employed in the ACT have been attracted by job opportunities interstate, contributing to a lack of appropriately skilled labour in the ACT.

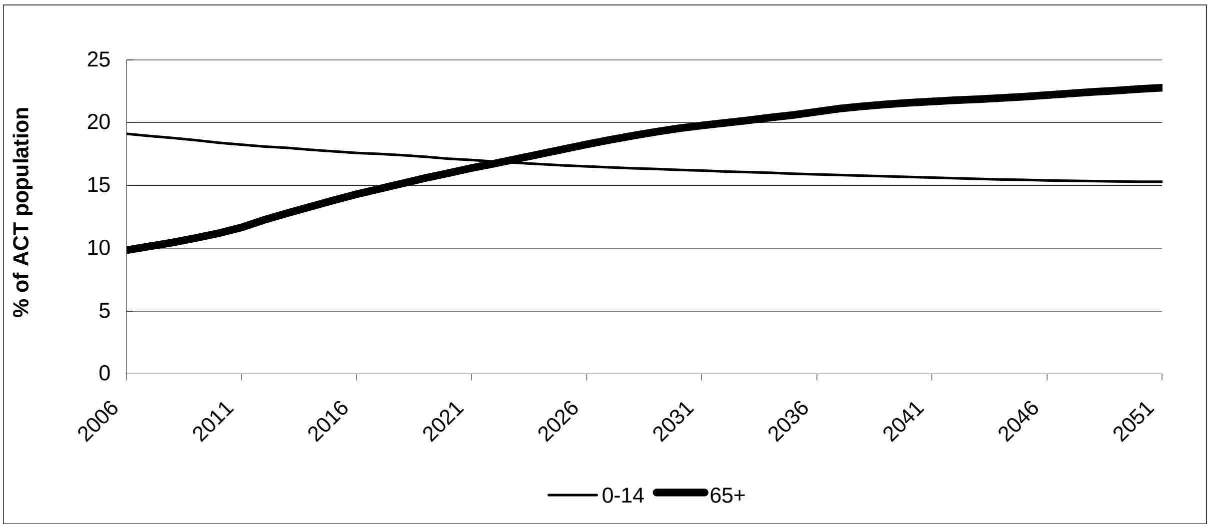
The ACT's labour force is highly mobile and therefore sensitive to cyclical influences. In the year to 30 June 2005, the ACT's gross interstate migration flows (that is, people moving from the ACT to interstate and vice versa) were equivalent to 11.4 per cent of the ACT's population, second behind the Northern Territory (15.9 per cent). By comparison, the national average for gross migration flow as a proportion of population was 1.8 per cent.

There is also increased demand for labour at an international level, with data from the International Labour Organisation showing countries such as the United Kingdom, New Zealand, and Canada experiencing historically low unemployment rates. This also has some impact on the availability of skilled labour in the ACT.

Long-term influences

The skills shortages in the ACT also reflect long-term structural demographic factors. In particular, as the population ages, workforce participation is expected to fall. In 1971, 4.4 per cent of the ACT's population was aged 65 years and over. By 2001, this proportion had risen to 13.3 per cent and, using medium growth ABS projections, 22.8 per cent of the ACT's population will be aged 65 years and over by 2051. The ACT's labour force is currently projected to peak in 2026, and gradually decline thereafter. Therefore, the ACT's labour supply is constrained by more of the population moving into retirement.

Figure 8.1.9
Projected Proportion of the ACT Population Aged Zero to 14 Years and Aged 65 Years and Over (Original, Annual Data)

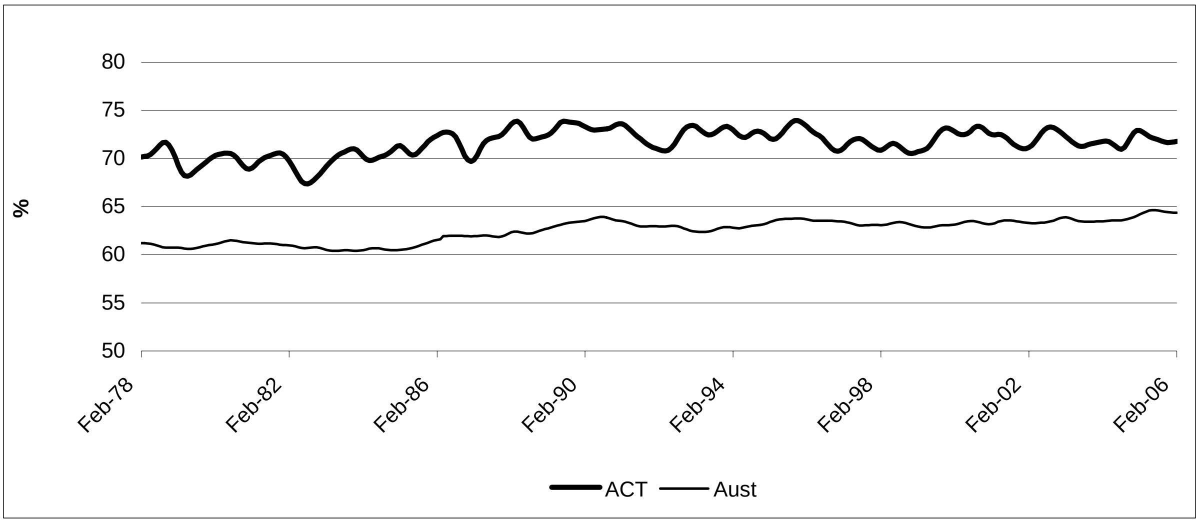


Source: ABS Cat No. 3222.0 Series B.

There are signs that ACT labour force participation amongst some older age cohorts is increasing. For example, the labour force participation rate for ACT males aged 60 to 64 years rose from 51.5 per cent in August 2004 to 59.3 per cent in January 2006, its highest level since September 1988. There has been a significant upward shift in labour force participation by ACT females aged 60 to 64, with the participation rate rising from 27.4 per cent in June 2002 to 44 per cent in January 2006, the highest rate on record.

The increase in the participation rate amongst older age groups reflects two factors. The cohorts of people moving through into older age groups have higher levels of education and stronger attachments to the labour force than previous generations. This means that the current generation of older aged persons are more inclined to participate in the labour market than previous generations. The second factor is that the prolonged period of high employment growth and low unemployment means that older workers are less inclined to leave the labour force than they have been in the past.

Figure 8.1.10
Trend Labour Force Participation Rates, ACT and Australia (Monthly Data)



Source: ABS Cat No. 6202.0.

Consumer prices

Consumer prices in Canberra, as measured by the Consumer Price Index (CPI), are expected to grow at around the same rate as the Australian Government national forecast of 3 per cent in 2005-06 and 2¾ per cent in 2006-07.

While continued wage pressures have the potential to flow through to consumer prices, global competition for production of manufactured goods will continue to have a deflationary effect on prices. Additionally, with monetary policy specifically targeting inflation, long run price movements should be contained.

The Canberra CPI generally follows national movements. In the year to the March quarter 2006, the CPI grew 2.9 per cent in Canberra, broadly in line with the 2.8 per cent CPI growth recorded nationally. In Canberra and nationally, growth in the CPI for services has outpaced that of goods for the year to the March quarter 2006.

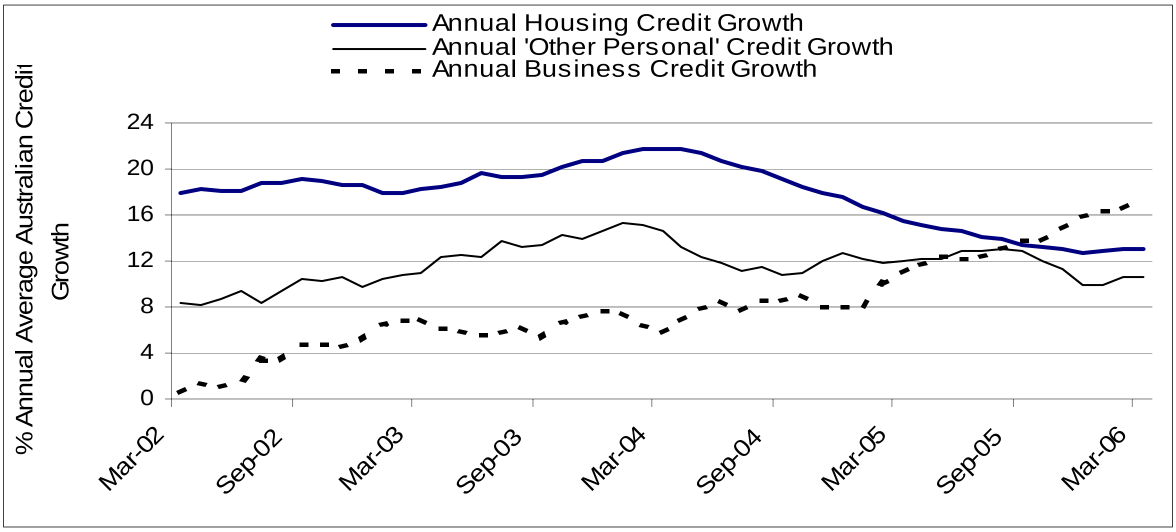
Financial Markets

On 3 May 2006, the Reserve Bank of Australia (RBA) raised the cash interest rate target by 0.25 percentage points to 5.75 per cent, the first change in the cash interest rate target since the 0.25 percentage point rise in March 2005. In explaining the latest rise, the RBA cites upward revisions to world economic growth forecasts, sustained growth in consumer spending and credit, strong equity markets, and sustained price and wage inflation.

Higher interest rates can be expected to have a downwards influence on business investment, household spending, and economic growth in the ACT in 2006-07.

Although credit growth eased somewhat in 2005-06, contributing to an easing in the rate of consumption growth, the rate of credit growth remains high by historical standards. Although driven by an expansion in business debt, recent overall credit growth has been further buoyed by the recovery of housing and personal credit growth observed since January 2006.

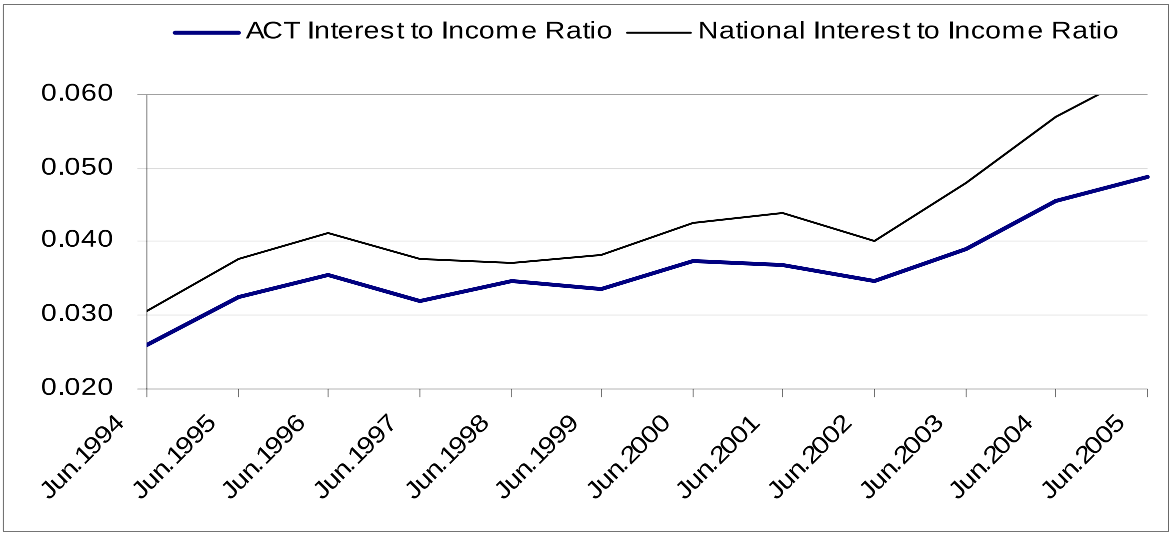
Figure 8.1.11
Australian Annual Growth in Australian Credit



Source: RBA

ACT households continue to hold high levels of debt and interest liabilities compared to incomes. This situation leaves households more sensitive to any tightening of monetary policy than was the case during the 1990s. However, higher average incomes in the ACT compared to those earned nationally, may, in part, reduce the impact of interest rates rises on ACT households.

Figure 8.1.12
Interest to Income Ratio



Source: ABS Cat No. 5220.0