

6.1 ECONOMIC CONDITIONS

Overview

Economic growth in the ACT is forecast to be solid in 2008-09 after moderating in 2007-08.

The economy is forecast to expand on the basis of growth in government consumption and government and private investment, although growth is expected to be below the recent high rates. The ACT unemployment rate is expected to remain low despite a forecast easing of employment growth in 2008-09. Recent labour supply constraints are likely to ease to some extent as supply and demand move closer to balance in 2008-09, although they may still impose some dampening effect on employment growth.

The Outlook for the ACT Economy

The prospects for the **ACT economy** remain positive in 2008-09. Demand conditions are expected to remain solid after some moderation in 2007-08, although growth is forecast to remain below the growth rate of the past few years.

The key economic aggregates for the ACT are summarised in Table 6.1.1.

Table 6.1.1
Economic Forecasts, Year-average percentage change

	Actual	Forecasts ^(a)		Projections ^(b)		
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
ACT						
State Final Demand	5.7	1¾	3¾	4¾	4¾	4¾
Employment	3.8	1	¾	1½	1½	1½
Population	1.2	1	1	1	1	1
Consumer Price Index	2.9	3¼	3	2½	2½	2½
Wage Price Index	4.1	4¼	4¼	4	4	4
Gross State Product	5.0	1½	2½	3	3	3
Australia						
Gross Domestic Product ^(c)	3.3	4¼	3½	3	3	3

Notes:

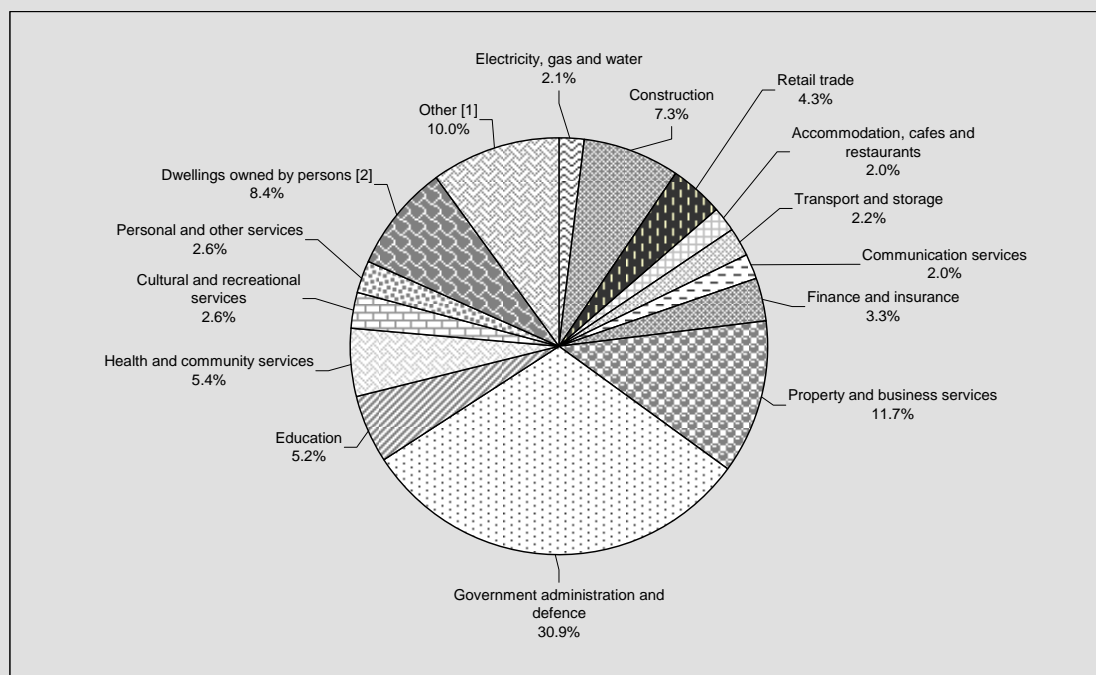
- (a) Forecasts and projections are rounded to a ¼ of a percentage point to reflect the relative level of accuracy used in forecasting economic parameters. This is standard forecasting practice used by governments throughout Australia.
- (b) Projections are based on long-run averages and are provided for planning purposes only. They do not reflect an expectation (forecast) of actual outcomes.
- (c) Commonwealth Government forecast are provided in the 2007-08 Mid Year Economic and Fiscal Outlook published in October 2007.

Nationally, growth in final demand has pushed inflation beyond the Reserve Bank's target range of 2-3 per cent and the Bank has responded by increasing interest rates on three occasions in recent months. In addition, the commercial banks have further increased borrowing rates as a consequence of increased credit risk in global financial markets. These interest rate increases are expected to dampen demand and investment in the forthcoming period.

For the ACT, savings measures foreshadowed by the Commonwealth Government are likely to have an impact on the local economy. However, with unemployment at historically low levels and a substantial commitment to increased infrastructure, including both dwelling and non-dwelling construction, the ACT economy is well placed to absorb the impact of any cuts at the Commonwealth level.

Gross State Product (GSP), the Australian Bureau of Statistics' headline measure of the ACT economy, is forecast to grow at 2½ per cent in 2008-09. The improvement in growth on the 2007-08 forecast is expected to be underpinned mainly by a rebound in construction activity.

Structure of the ACT Economy
Figure 6.1.1: Share of Gross State Product 2006-07
(Current Price Industry Value Added)



Source: ABS Cat. No. 5220.0

1: 'Other' includes Agriculture, forestry and fishing industry, Mining industry, Manufacturing, Wholesale trade and Taxes less subsidies on products.

2: This industry values the services provided by dwellings to renters and owner-occupiers. Rent is imputed for owner-occupied dwellings to enable the services provided by those dwellings to be treated consistently with the marketed services provided to tenants by rented dwellings.

GSP measures the level of production in the economy. It is a different concept to State Final Demand, which measures the level of expenditure in the economy. Previously the ABS estimated GSP using the Income/Expenditure approach. This method was subject to inconsistencies as current price income data was deflated using a price deflator derived from the best possible nominal and real estimates of expenditure that encompass as much as possible of GSP. Last year the ABS released estimates of GSP incorporating a new method - the Production approach. In publishing the new estimates the ABS has removed the 'experimental' tag. In previous ACT Budgets, GSP was presented as a memorandum item, consistent with advice from the ABS at the time that users should exercise caution when using estimates of GSP for measuring economic activity. Reflecting ABS confidence in the reliability of GSP as an indicator of actual economic activity, it was included as a formal forecast for the first time in the ACT Government's 2007-08 Budget Mid Year Review.

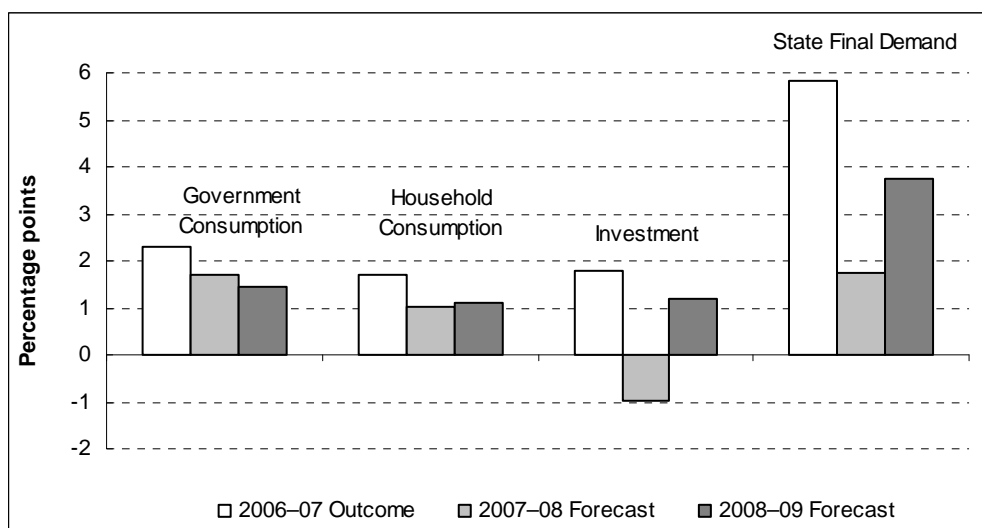
One of the significant advantages of the new method is that it provides estimates of value added at the industry level for the first time. This enables a detailed analysis of the structure of the ACT economy.

The largest industry in the ACT is government administration. This reflects the Territory's position as the hub of government service delivery for the nation. Furthermore, two other industries which are dominated by the government, the health and education industries, combined contribute over 10 per cent to the ACT's economy. Part of the reason for the high contribution of these industries is that the health sector in the ACT provides health services not only for the ACT but for the greater Capital Region and the tertiary education sector provides training for Australian and overseas students. The Property and Business Services industry is the second largest in the ACT. The industry reflects the value of the ACT's property market to the total economy (which is also reflected in the Dwellings owned by persons sector), and the extent of consulting type businesses which support the government sector. A rising component of GSP in recent years has been the construction industry. This predominantly reflects the exceptional levels of commercial construction over this period.

The future structure of the ACT economy is not likely to change significantly. In well functioning markets, resources flow to those places which can add the most value. With the ACT's comparative advantage in government service delivery it is expected that this industry will continue to provide significant value added in the ACT economy.

State Final Demand (SFD) is forecast to grow at 3¾ per cent in 2008-09, an increase from expected growth rates in 2007-08 but still below the growth rates of the past few years. The forecast growth in 2008-09 reflects contributions from growth in ACT and Commonwealth Government outlays, growth in household consumption and growth in dwelling and non-dwelling investment. Growth is forecast to remain below the recent years' trend due predominantly to the below trend growth in Commonwealth Government outlays in the ACT. Contributions to SFD from the various components are shown in Figure 6.1.2.

Figure 6.1.2
Contributions to Growth in ACT State Final Demand



Source: ABS, Cat. No. 5206.0 and ACT Treasury estimates

Government consumption expenditure, particularly that of the Commonwealth Government, is a key determinant of economic activity in the ACT. The increased efficiency dividend being imposed on all Commonwealth Government agencies in 2008-09 will lead to a moderation in the growth of Government outlays in the ACT. Despite this, Government consumption expenditure is still expected to be the largest contributor to SFD growth.

Growth in household consumption expenditure in the ACT is expected to remain broadly stable in 2008-09 after a moderation in growth in 2007-08. Retail sales have been easing in 2007-08 in response to interest rate increases and moderating employment growth. Sales of new motor vehicles, while growing strongly since early 2007, are expected to ease in 2008-09, as petrol price increases and contractionary monetary policy dampen demand.

Investment is forecast to grow solidly in 2008-09 with contributions from the private and public sectors, with the latter underpinned by ACT Government infrastructure investment. The outlook for ACT **dwelling investment** is for solid growth. Increased land supply should allow for investment growth, especially considering the strength of underlying demand. The level of demand is such that it is expected to remain solid despite contractionary monetary policy and more restrained population and employment growth. Residential property **turnover** is therefore expected to experience moderate growth, consistent with a moderating economy, while real property **prices** are expected to be flat in 2008-09.

Business investment is expected to continue around the high levels experienced in recent years. While the growth rate is expected to have slowed in 2007-08, it is likely to pick up again in 2008-09, given the outlook for commercial construction.

Non-dwelling construction growth is forecast to increase in 2008-09 after an easing in 2007-08. After the completion of a number of large commercial construction projects in 2007-08, non-dwelling construction growth will be underpinned in 2008-09 by some large commercial developments, such as the Australian National University Exchange, Section 63, and new offices to house the Australian Security Intelligence Organisation and the Office of National Assessments. More details are provided later in this chapter.

ACT **labour market** activity is expected to ease across the forecast period. Employment growth is forecast to moderate slightly to $\frac{3}{4}$ of a per cent in 2008-09, with the continuation of supply constraints and easing of demand, primarily from the Commonwealth Government.

Population growth over the forecast period is expected to be 1 per cent, in line with the long-run average. Natural increase and overseas migration rates are forecast to continue being strong contributors to population growth. These factors will be offset somewhat by net interstate migration which is likely to be lower than the very high levels experienced in the recent years, as a result of slower employment growth by the Commonwealth Government.

Changes in Commonwealth Government outlays are the most significant **risk** to the ACT's economic forecasts. The potential for significant savings measures impacting the ACT, arising from the upcoming Federal Budget, magnifies this risk in the short-term. These economic forecasts have been based on the assumption that the Commonwealth Government will deliver a budget surplus in 2008-09 of 1.5 per cent of Gross Domestic Product (GDP), including their announced savings and spending measures. The anticipated savings measures are expected to reduce forecast outlays for 2008-09 and the forward years, however, these outlays will still exceed the 2007-08 levels.

Although **interest rates** are expected to remain relatively stable over the forecast period, the impacts of contractionary monetary policy will take time to flow through the economy, meaning the effects may be felt for some time to come, even if monetary policy settings were eased during the forecast year. The risk is that the contractionary stance of monetary policy impacts on the national economy to a greater and faster extent than anticipated by the RBA. Such a situation would generate weaker levels of ACT economic activity than currently forecast.

Furthermore, if volatility in stock markets begins to impact on personal wealth, particularly through lower superannuation returns, there is a risk that economic activity in the ACT may be lower than forecast as individuals lower their consumption and investment.

Labour Market

Employment growth is expected to moderate slightly in 2008-09 as skills shortages continue to constrain supply. Steady demand for labour is expected to keep the trend unemployment rate low and the labour force participation rate around record highs.

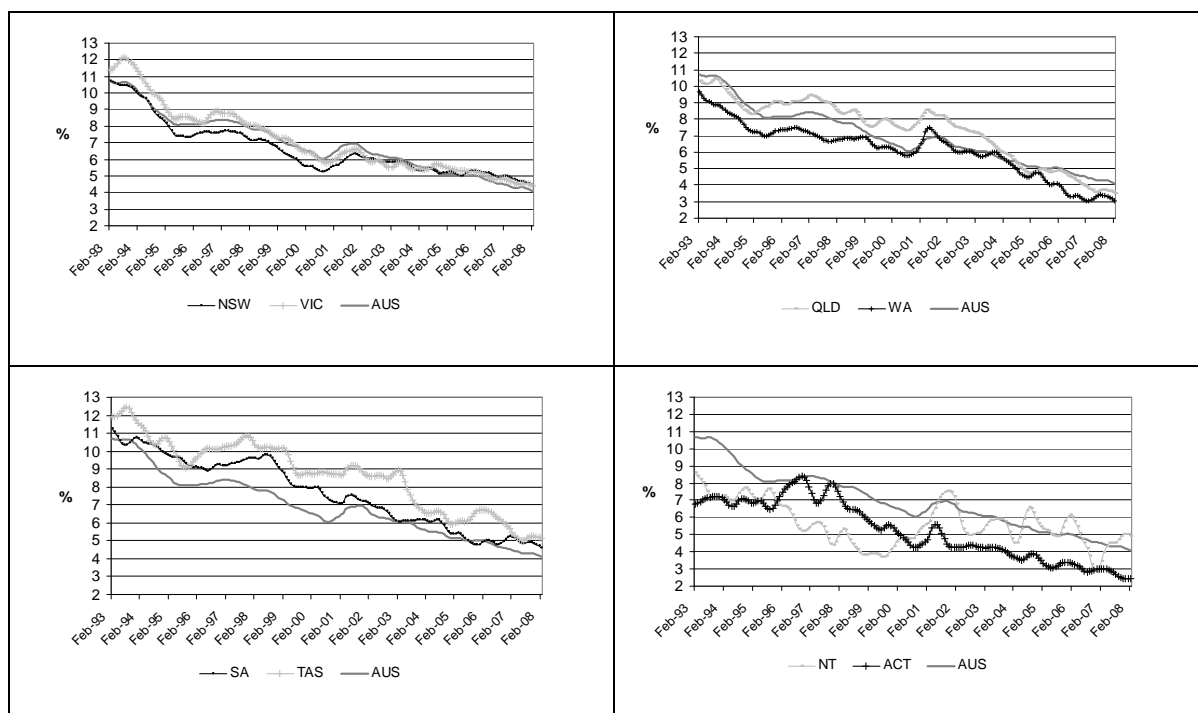
Employment

Following forecast employment growth of 1 per cent in 2007-08, employment growth for 2008-09 is forecast to moderate slightly to $\frac{3}{4}$ of a per cent, below the long-term average rate. The lower rate of employment growth in 2008-09 is a result of continuing supply constraints, although these are expected to ease somewhat in 2008-09, along with some moderation in labour demand. The unemployment rate is at historically low levels - currently averaging a trend rate of 2.5 per cent for 2007-08. Over the last 15 years the unemployment rate in the ACT has gradually trended down, a pattern consistent with the other jurisdictions. For the most part of this period the ACT has had the lowest unemployment rate (see Figure 6.1.3). The low unemployment rate is expected to continue throughout 2008-09.

Contractionary monetary policy is likely to soften demand for labour both nationally and in the ACT. In addition, the hiring intentions of the Commonwealth Government will lead to less demand in the ACT, while in relation to supply, skills shortages continue to pose significant challenges for employers. These skills shortages may be alleviated somewhat by the potential job reductions at the Commonwealth level, resulting from Commonwealth budget saving measures. A shift in employment from the Commonwealth public service to elsewhere in the ACT labour market would not, however, lead to an overall increase in employment growth. Given that the ACT is currently near full employment, the contribution to employment growth is expected to come from increases in participation (as new workforce entrants tend to move directly into employment) and net overseas migration.

At the national level, employment has grown faster than forecast by the Commonwealth Government in the 2007-08 Federal Budget. The Mid Year Economic and Financial Outlook (MYEFO) published in October 2007 indicates this will moderate to $1\frac{3}{4}$ per cent in 2008-09. Currently the trend rate of national unemployment stands at 4.1 per cent.

Figure 6.1.3
Trend Unemployment Rate, States/Territories and Australia (Monthly Data)



Source: ABS Cat No. 6202.0

Labour costs

Wages growth, as expressed by the Wage Price Index (WPI), is forecast to grow at 4¼ per cent in both 2007-08 and 2008-09. The current higher inflation climate has the potential to lead to increased claims for compensatory wage increases. This, combined with labour supply constraints and a continued steady demand for labour, poses upside risk to wage growth over the short-term. This is especially so in many service industries that are experiencing skills shortages. This is partially offset by the stated intention of the Commonwealth Government to restrain Commonwealth public service salaries.

For the year to the December quarter 2007, annual WPI growth was 4.4 per cent per annum, higher than the 4.2 per cent per annum recorded nationally. Taking inflation into account, growth in real wages over this period was 1.1 per cent in Canberra, slightly lower than the 1.2 per cent recorded nationally.

Skilled vacancies in the ACT

Skills shortages remain a nation-wide problem impacting on the ACT. Shortages for particular skills are a function of overall labour market tightness. Job vacancy indicators such as the Department of Education, Employment and Workplace Relations' (DEEWR's) Skilled Vacancy Index and Australian JobSearch website, indicate that there are a large number of vacancies across a spectrum of occupations/professions.

Skills shortages in the ACT can be attributed to two factors. Firstly, in a number of specialised areas, workers can require significant training over several years to develop appropriate skills. Supply shortages in such areas will be signalled by higher wages. However, the labour market supply response to those types of skill shortages can take a long period of time given the lag in training.

The second factor driving skills shortages is attributable to the general demand for labour exceeding supply and workers with transferable skills being drawn from relatively low wage occupations to higher wage occupations. In a well functioning labour market, workers in higher wage occupations can be expected to be adding greater economic value to the ACT economy relative to lower wage occupations.

This second factor is illustrated by the Australian Bureau of Statistics 2006 Census data which indicate that around 28 per cent of ACT's workers were found in the 'government administration and defence' sector. Treasury's analysis of the 2006 Census data further suggests that individuals employed in this sector have educational qualifications across a number of different fields, including approximately 25 per cent without tertiary qualifications.

This suggests that a significant proportion of semi-skilled individuals are moving into the public sector as administrative assistants or similar generalists, leaving vacancies in other less-skilled occupations such as labourers or sales assistants. It is supported by wage data indicating the average weekly ordinary earnings for the 'government administration and defence' sector in the ACT increased by around 27 per cent between the 2001 and 2006 Census.

Meanwhile, wages in semi-skilled occupations have risen by 10 per cent, and decreased in some industries such as 'transport and storage' (down 12 per cent), 'retail trade' (down 6 per cent) and 'accommodation, cafes and restaurants' (down 5 per cent).

Investment

Housing market

The ACT housing market is expected to experience moderate growth over the forward estimates, despite the Reserve Bank of Australia's (RBA) contractionary monetary policy stance. This is consistent with average population growth, a strong labour market and continued household income growth.

Property turnover is forecast to grow modestly in 2008-09 following strong growth in the previous three years. House prices are likely to record flat real growth in 2008-09 as increasing supply is able to meet the underlying demand.

First home owner activity is expected to remain subdued, consistent with these buyers being the most sensitive to interest rate movements. This will be somewhat offset by the ACT Government's Housing Affordability initiatives.

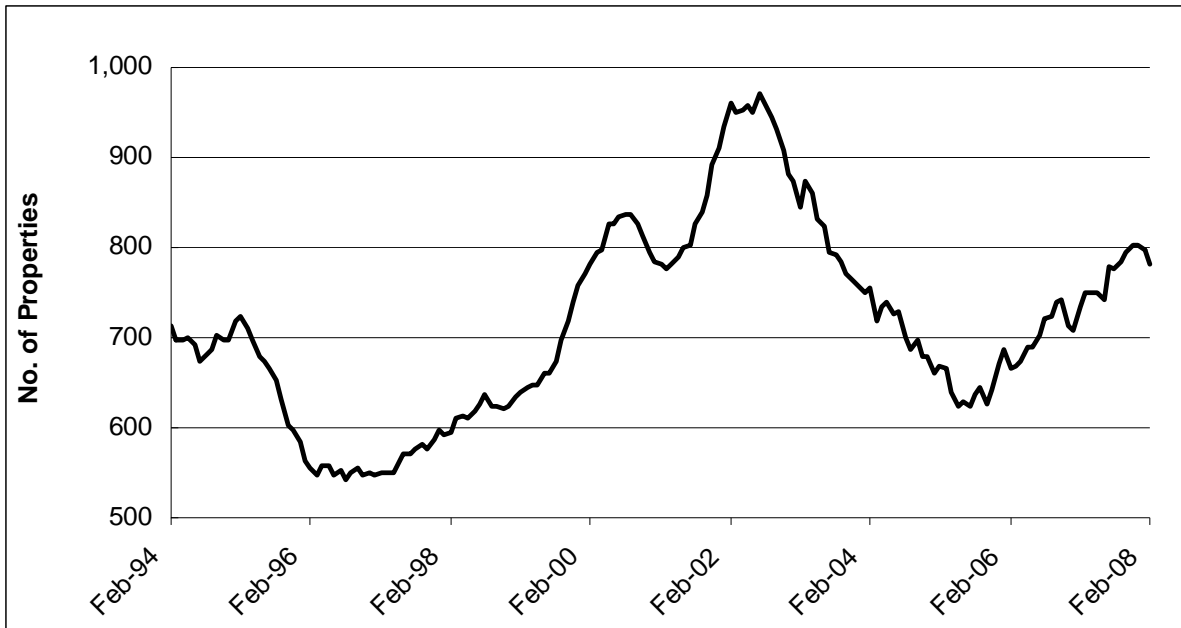
Investors are expected to increasingly enter the housing market in 2008-09 as rental returns improve relative to other investments.

Turnover of new and established dwellings

Underlying demand for residential property has remained strong in the ACT due to recent higher than usual population growth and the high levels of household disposable income in the ACT. Despite the underlying demand, residential property turnover in 2007-08 has been hindered somewhat by supply constraints and contractionary monetary policy. The RBA has indicated that it expects to maintain contractionary monetary policy for some time. Already in 2007-08 there have been four 25 basis points rises in interest rates. The ACT Government, however, has been actively addressing supply constraints. In 2007, the Government announced its *Affordable Housing Action Plan* which introduced a range of measures, including an accelerated land release program. This has the objective of delivering up to an additional 5,000 dwelling sites (including those by the private sector) by the end of 2008.

Moving forward, demand for residential property is likely to come from both owner-occupiers and investors. However, there is a risk that contractionary monetary policy and financial market volatility will ease the growth of personal wealth which could in turn moderate demand. Overall confidence in recent years, as a result of the perceived job security associated with low unemployment, is expected to be replaced with relative uncertainty due to Commonwealth Government's foreshadowed saving measures. As a result, growth in turnover is likely to moderate from the strength experienced in recent years.

Figure 6.1.5
ACT Residential Turnover, 12 Month moving average,
Monthly original data



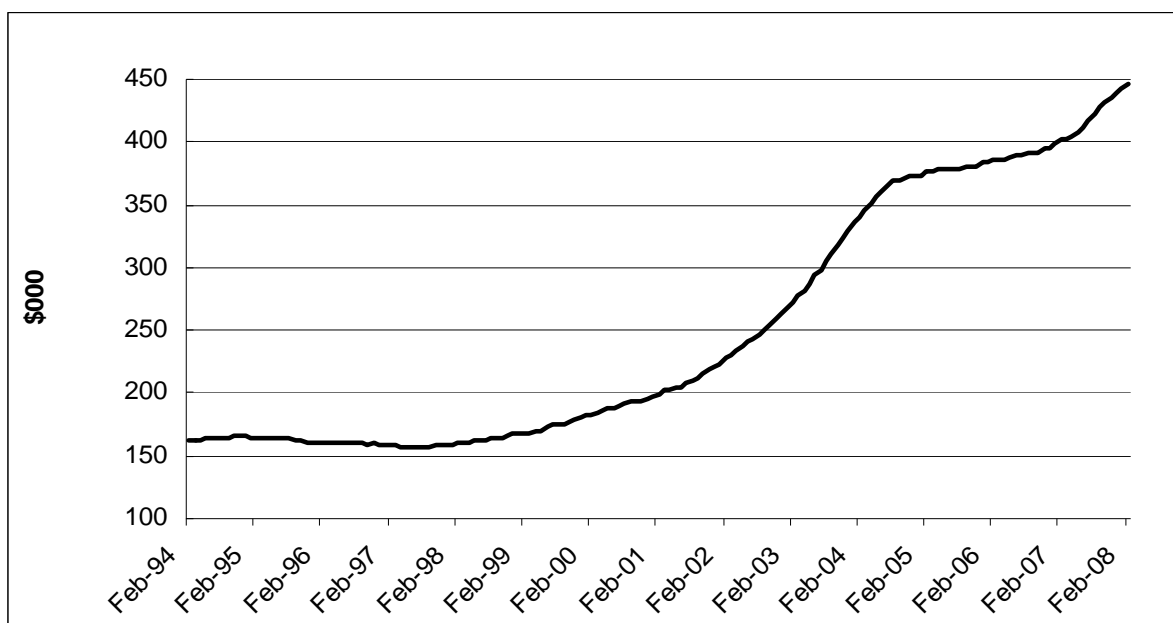
Source: ACT Planning and Land Authority

Price movements

Despite the recent tight conditions in the ACT housing market, growth in residential property prices is expected to moderate in 2008-09. The RBA's monetary policy stance, the Commonwealth Government's employment intentions and moderating growth in wealth (including superannuation) associated with financial markets, have created an environment conducive to moderating demand. This is likely to place downward pressure on house price growth.

Offsetting the downward pressure on price growth is the pent up demand for housing, associated with the recent strong population growth. This demand should ease somewhat as population growth slows and the ACT Government's accelerated land release program brings supply and demand closer into balance. As a result, real residential property prices in the ACT are expected to be flat in 2008-09.

Figure 6.1.6
ACT Residential Property Average Price, 12 month moving average,
Monthly original data



Source: ACT Planning and Land Authority

Rental Market

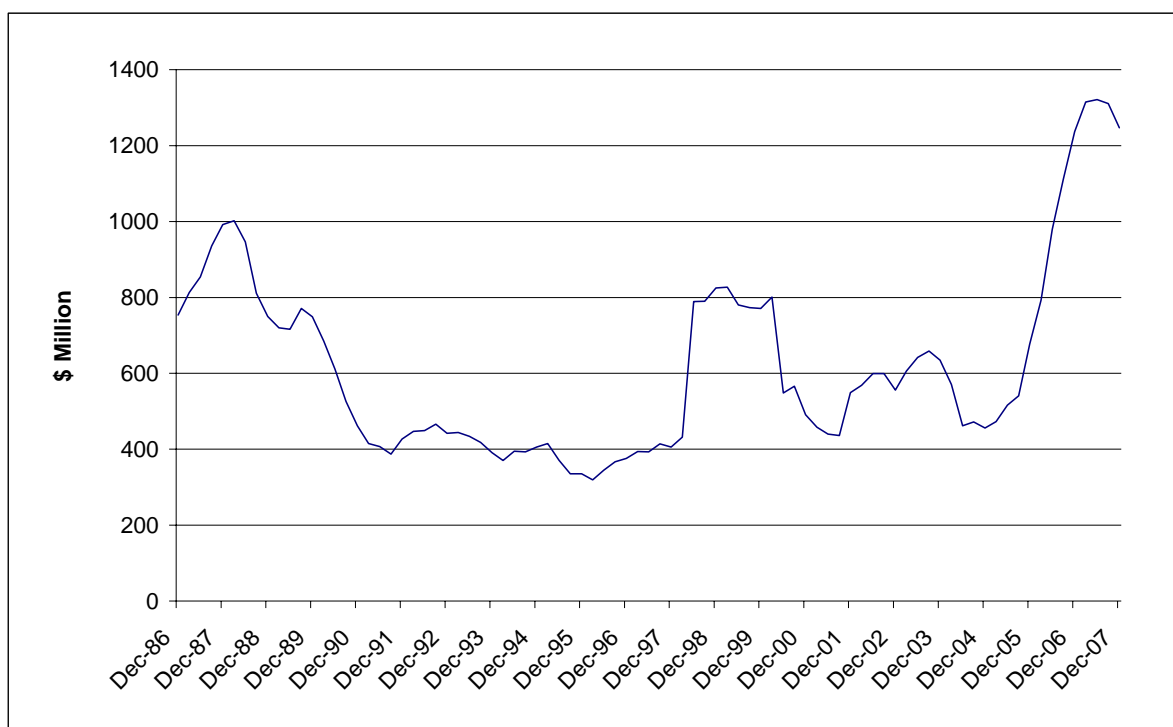
Small investors dominate the private rental market in the ACT, which provides approximately 26,000 dwellings for rent. Commonwealth Government changes to superannuation policy in 2006-07 resulted in a number of these small investors converting their holdings of private rental properties into superannuation investments. This pattern was repeated Australia-wide as the relative attractiveness of superannuation improved. Volatile financial market conditions in the latter half of 2007-08, however, have restored the attractiveness of residential property investment, especially given the tight rental markets being experienced in most states and territories. The relative attractiveness of residential property investment should place downward pressure on rental price growth if increased investor activity leads to an increase in rental supply. The annual residential property return for a three-bedroom house in Canberra to December 2007 was 18.6 per cent, the third highest of all capital cities. With financial market returns now in single digits there is likely to be less pressure for rents to increase in order to provide a competitive return for residential property investors, as has been the case in recent years.

The rental vacancy rate in the ACT, at 2.6 per cent in December 2007, is higher than all other capital cities. Although rental market conditions are expected to remain tight, an easing in vacancy rates in 2007-08 is likely to continue through 2008-09 as new supply of units and land become available. Easing vacancy rates are also expected to place downward pressure on the growth in rents.

Non-Dwelling Construction

The volume of ACT non-dwelling construction work done in 2007 was \$1.25 billion (in price adjusted terms). This surge in non-dwelling construction has been unprecedented in the Territory's history, even eclipsing the activity associated with the construction of the New Parliament House in the late 1980s. Much of the construction surge of 2007 was related to the development of new office blocks as the Commonwealth Government workforce expanded.

Figure 6.1.7
Volume of ACT non-dwelling construction
Annual original data



Source: ABS Cat. No. 5206.0

While non-dwelling construction growth is forecast to moderate in 2007-08, as a number of high value projects are completed, it is anticipated that the level of activity will remain high. Non-dwelling construction is then forecast to accelerate in 2008-09 as a number of major projects committed, or proposed with a high degree of certainty, commence.

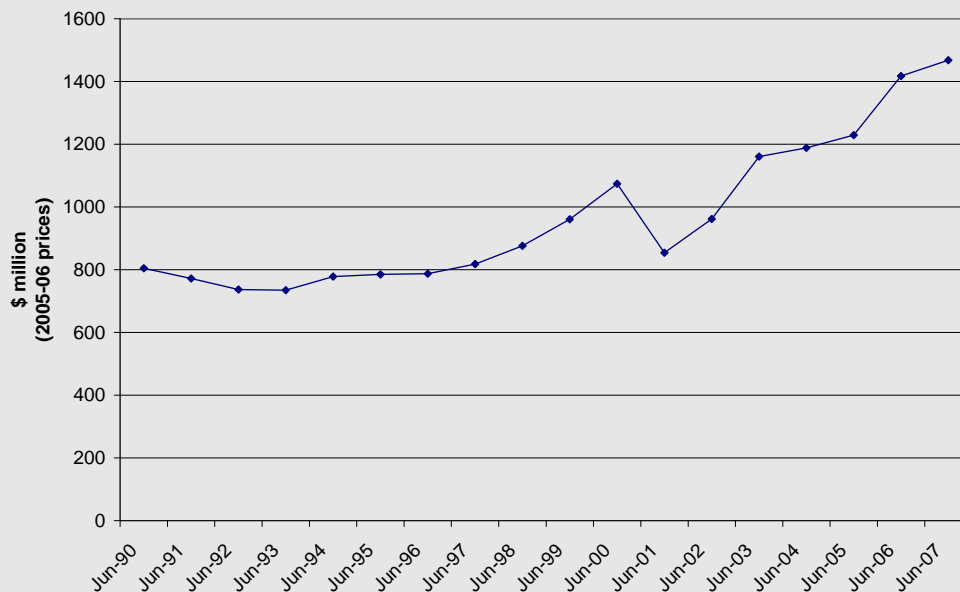
Construction Industry - Current and Future Trends

The construction industry in the ACT is comprised of dwelling and non-dwelling construction. Dwelling construction comprises residential house and unit construction as well as alterations and additions to residential housing. Non-dwelling construction comprises office, retail and industrial building construction, as well as the construction of roads, bridges and other infrastructure.

Current Status

The total value of the ACT's construction industry rose rapidly between 2001-02 and 2006-07 (see Figure 6.1.8). The industry was worth approximately \$1.6 billion in 2006-07, which represented 7.3 per cent of ACT's Gross State Product. Non-residential construction has underpinned the construction industry in recent years, with a record value in the Territory in 2006-07.

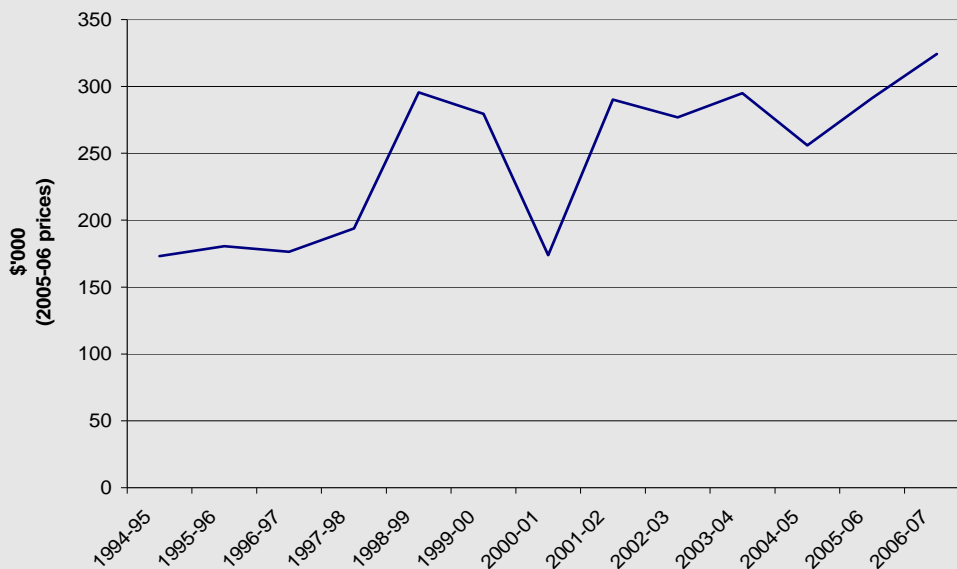
Figure 6.1.8
ACT construction industry
Annual industry value added



Source: ABS Cat. No. 5220.0

The value of construction per worker in the ACT has remained above \$250,000 for the past six years (see Figure 6.1.9). In 2006-07 this figure rose to \$324,000 as construction activity in the ACT peaked. The rise above \$300,000 could be reflective of the skills shortages in the wider ACT labour market. The value of construction per worker is expected to fall in 2007-08 as a number of significant construction projects are completed, before once again rising in 2008-09 as activity in the commercial construction sector rises once more.

Figure 6.1.9
Value of ACT construction per construction worker
Annual original expenditure data



Source: ABS Cat. Nos. 5206.0 and 6291.0.55.003

Future Trends

Demand for new office space in recent years has largely been as a result of the expansion in the number of Commonwealth public servants working in the ACT. As the work started in recent years is completed, and the number of new projects falls, non-dwelling construction in 2007-08 is expected to moderate.

The value of non-dwelling construction in the ACT is then forecast to rise in 2008-09 as a number of large projects commence. Over the next 3-4 years there is over \$4 billion worth of commercial construction projects committed, or proposed with a high degree of certainty in the ACT. The following table lists some of the more significant projects under way or likely to commence between 2008-09 and 2011-12.

Major construction projects ongoing or expected between 2008-09 and 2011-12	
• ACT Government Office Building (City)	• ANU Exchange (ANU)
• ANU John Curtin School of Medicine (ANU)	• ASIO and Office of National Assessments (City)
• Canberra Airport offices and terminal (Airport)	• Department of Environment and Water Resources (York Park)
• Constitution Avenue Offices (City)	• Attorney General's Department (Barton)
• Department of Health (Woden)	• Department of Education, Science and Training (City)
• National Archives (Deakin)	• Section 45 (Belconnen)
• Section 63 (City)	• Section 68 (City)
• Westfield Belconnen (Belconnen)	• Workers Club (City)
• Woden East (Woden)	

Furthermore, the ACT Government is expected to release more commercial land as demand for more office space in the ACT continues. This would lead to further development opportunities in the non-dwelling construction sector.

Strength in the construction industry in 2008-09 and beyond is also expected to continue from the residential construction sector. As a result of the underlying demand for housing, and the initiatives announced as part of the ACT Government's *Affordable Housing Action Plan*, residential construction growth is expected to be solid, despite the dampening effects of contractionary monetary policy and more restrained population and employment growth. As part of its *Affordable Housing Action Plan* the ACT Government has brought forward the release of a substantial number of dwelling sites. The accelerated release, combined with the new land supply as a result of other initiatives under the Plan, is expected to increase the number of dwelling sites available by up to 5,000 by the end of 2008.

The ACT Government is forecasting significantly increased infrastructure spending in 2008-09. An additional \$1 billion of capital expenditure over the next five years has been committed in this Budget. This brings the value of new capital spending in the Territory by the ACT Government to around \$1.4 billion over the next 5 years.

With over \$4 billion in commercial construction expected between now and 2011-12, the continued strength in the dwelling investment sector and significant Government spending in infrastructure, the construction sector projects a very healthy outlook over the short to medium term. It should be noted that this is despite previously announced major commercial projects being placed on hold following the current Commonwealth Government's taking office.

Consumer prices and interest rates

Consumer prices

Continued rapid expansion of the Australian economy has led to strong growth in employment, however, the supply side of the economy has been unable to expand at the same rate, leading to capacity constraints which are starting to flow on to higher wages and higher consumer prices. As the expectation of demand pressure peaks nationally during 2007-08, the growth in consumer prices, as measured by the Consumer Price Index (CPI), is also expected to peak at 3¼ per cent for 2007-08. This is above the RBA's target band for inflation of 2-3 per cent on average over the economic cycle. CPI growth is forecast to ease back to 3 per cent in 2008-09, at the top of the RBA's inflation target band, following the expected moderation in domestic demand brought about by contractionary monetary policy.

Consumer prices in Canberra in 2006-07, as measured by the CPI, grew by 3 per cent. This was largely influenced by an increase in vegetable prices, housing costs and health costs. With these prices continuing to increase, along with the prospect of further fuel price increases, the CPI growth for 2007-08 is expected to increase before slowing down in 2008-09. The CPI grew at 3.3 per cent in Canberra in the year to the December quarter 2007, above the 3 per cent CPI growth recorded nationally.

Interest Rates

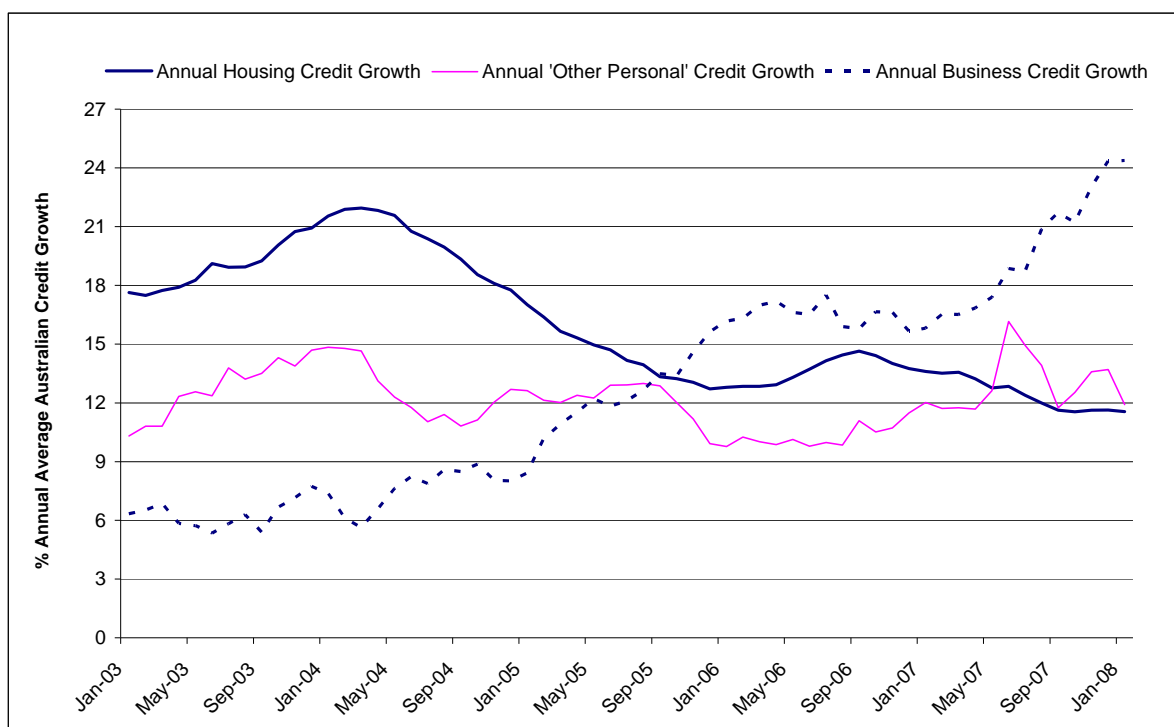
The RBA has raised the official cash rate target by 1 percentage point since August 2007, taking the target rate to a twelve year high of 7.25 per cent. Additionally, many financial institutions have increased their interest rates above the official rises by around 0.3 percentage points in response to increased costs of raising wholesale funds.

The RBA has stated that it is concerned about inflation, given the current strong demand and the recent outcomes of quarterly CPI, which are likely to mean that inflationary pressure will persist throughout 2008. The RBA has signalled its intention to keep raising interest rates until demand slows and there is an indication that inflation has peaked.

In this environment, it can be expected that downward pressure will be exerted on investment, household spending and overall economic growth in the ACT in the remainder of 2007-08 and into 2008-09.

Business credit growth has not yet reflected the impact of interest rate rises over the past year. However, the growth in housing and other personal credit has trended downwards following increases in interest rates.

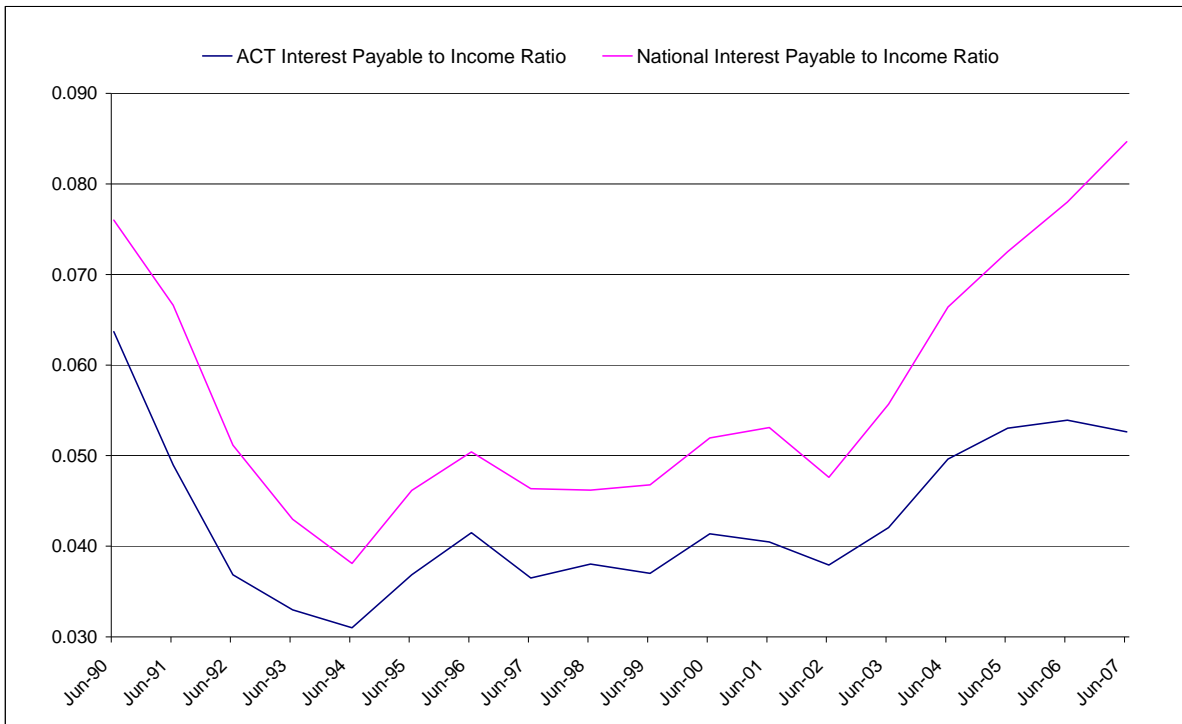
Figure 6.1.10
Australian Annual Growth in Credit



Source: RBA

Although ACT households possess higher than average income levels and debt servicing abilities, the willingness of ACT households to hold high levels of debt has slowed over the past year as a response to higher interest rates. This diverges from the national trend. It also reflects a relative improvement in the ability of ACT households to service their interest liabilities compared to Australian households overall in 2006-07. However, this data does not include the four interest rate rises in 2007-08 which would be expected to increase the interest payable to income ratio for both Australia and the ACT.

Figure 6.1.11
Interest to Income Ratios



Source: ABS Cat No. 5220.0