The 2017/18 year in review

With key economic data for the last financial year now released, this issue of Plain English Economics provides a summary of the state of the Australian economy in 2017/18.

Economic Growth

Key Statistic: GDP up 3.4% between June 2017 and June 2018.

Australia’s economic growth accelerated over the 2017/18 financial year, with the annual rate of increase in real Gross Domestic Product (GDP) at the end of June being 3.4%. This is in line with the longer-term average for Australia and comfortably above the latest annual population growth estimate of 1.6%. At the same time in the previous year, economic growth was 1.9%.

![Annual % Growth in GDP](chart)

Source: Australian Bureau of Statistics 5206

Following 5 years of subdued activity, business investment spending picked up in 2017/18. The 4.1% increase in business investment reflected an increase in non-mining sector capital expenditure, with mining investment continuing its decline following the high levels reached in the mining boom. Mining sector investment spending peaked in June 2012. Growth in non-mining sector investment since then has begun to offset the mining decline.

However, notwithstanding the fall in mining sector investment, past capital expenditure has enabled the mining industry to continue to expand its productive capacity. This has been reflected in higher export volumes over recent years. This trend continued in 2017/18, albeit at a slower rate. Export volumes increased by 3.7% between the June quarters of 2017 and 2018, with resource exports some 10.3% higher. In contrast, rural exports recorded a decline of 8.5% last financial year, with drought conditions across large parts of the country impacting on volumes.

As was the case in the previous financial year, import volumes jumped over 2017/18, with a rise of 6.2%. This can be partially attributed to improved business investment, with the import of capital items rising by 11.8%. Changes in capital expenditure levels will typically have a direct impact on imports, as the majority of capital goods are produced overseas. With import volumes rising by more than exports, the overseas sector made a net negative contribution to Australia’s economic growth.

In contrast, Government spending made a positive contribution to economic growth in 2017/18. Although Commonwealth and State governments have generally been seeking to reduce the size of fiscal deficits and /or build surpluses, expenditure growth has still been positive. In the year to June 2018, real spending by the public sector was 4.5% higher, with increased Government spending on infrastructure making a significant contribution to this rise.

As shown on the chart below, the contribution to growth from household consumption spending was significant and above the levels recorded over recent years. Consumption is the largest component of demand and will often make a very significant contribution to economic growth. In the year to June 2018, household consumption spending rose by 3.0% in real terms, which was
above the 2.7% increase recorded in the previous year. Over the past two decades, household consumption has increased at an average annual real growth rate of 3.1%.

![Contribution to GDP (% pts Year to June 2018)](source: Australian Bureau of Statistics 5206)

**How to read the above chart**

The chart shows the relative contribution that each of the main categories of expenditure had on the 3.4% increase in GDP in the year to June. It can be seen that consumption alone had a positive 1.7% contribution, suggesting that all other categories combined had a positive impact of 1.7%.

Some of the increase in consumption that has occurred over recent years has been funded by households lowering their allocation to savings in order to fund this consumption. This reflects the fact that growth in real wages has been very low in recent years and a lower allocation to savings is required to fund the consumption spending that has taken place. As at June 2018, the percentage of household disposable income that was saved and not spent on consumption was 1.0%. This represents a decline from the 2.5% recorded last year and 5.5% in June 2016.

![Household Savings Ratio (%)](source: Australian Bureau of Statistics 5206)

Positive household sector savings are clearly more sustainable than ongoing net deficits. With the Government not producing any net savings, and some sources of overseas funding drying up following the GFC, Australia has become increasingly reliant on household savings as a source to fund investment spending by businesses. Therefore, should the decline in the household savings ratio continue, there may be an increased reliance on overseas borrowings to fund any future expansion in business investment.

Q1: Discuss two significant influences on the pattern of Australian economic growth over 2017/18.

**Employment**

**Key Statistic:** Unemployment rate of 5.3% as at August 2018.

Australia’s unemployment rate has declined marginally over the past year, falling from 5.6% in August 2017 to 5.3% in August this year.

Employment growth has been relatively strong. However, rising workforce participation has reduced the extent to which employment growth has created lower unemployment. In the year to August, employment expanded by 2.5%. This was well above the 1.6% increase in the size of adult population. However, a rise in the workforce participation rate (i.e. the percentage of the adult population either employed or seeking employment) from 65.3% to 65.7%, meant that there was only a small 0.3% reduction in the unemployment rate to 5.3%. The participation rate is close to a historical high, with the rise countering the longer-term impact of the ageing of the Australian population.
With employment growth being below the overall rate of expansion in economic output (i.e. GDP), there appears to have been an increase in labour productivity over the past year. The National Accounts suggests that GDP per hour worked increased 1.0% in the year to June 2018. This extends a period of improving GDP per hour worked over recent years – which has been at least partially due to the impact of the increased productive capacity in the mining sector.

Q2: Explain why the rate of growth in the labour force may be different to the rate of growth in the size of the adult population.

Inflation

Key Statistic: CPI increased 2.1% in the year to June 2018.

Inflation has lifted from a low point 2 years ago, with Australia’s Consumer Price Index (CPI) rising by 2.1% in the year to June 2018. This is higher than the 1.9% increase recorded one year earlier, with inflation now back within the Reserve Bank’s 2% to 3% target range. However, “Underlying Inflation” (calculated by removing the more volatile or large one-off category movements) is below this target range at 1.9%.

Australia’s low rate of inflation is consistent with that being recorded in developed economies around the globe. Item categories such as clothing (down 2.0%) and communications (down 4.2%), with a heavy import component, have tended to have particularly low rates of price growth over the past year.

In contrast, items produced in Australia have tended to have higher rates of price growth. This was particularly the case for service categories that are considered “essential” and less impacted by cyclical weakness in demand. Health costs, for example, rose by 5.2% in the year to June and education costs rose by 2.7%.

Contributing to the low rate of inflation is the current lack of “cost push” pressure from wages. Despite strong employment growth, there has been very little upward pressure on wages growth. The chart below traces the annual rate of increase in underlying inflation and the Wage Price Index. In the 12 months to June 2018, the Wage Price Index was 2.1% above the level of one year earlier.

Q3: Describe how Australia’s inflation rate has been impacted by labour markets and wages growth over recent years.

External Accounts

Key Statistic: Current Account deficit was $54.1 billion in the 2017/18 financial year, which was 2.9% of GDP.

Australia’s Current Account deficit has increased sharply over the past year. The $54 billion deficit in 2017/18 was well above the $39 billion recorded in the previous financial year.

In addition to a higher volume of exports, the dollar value of exports was also positively impacted by higher export prices in 2017/18. Receipts from the exports of goods rose by 8.1% in the year to June 2018. However, with the dollar value of imports rising by 9.0%, the surplus on the Merchandise Trade account contracted from $13.5 billion in 2016/17 to $12.1 billion in 2017/18.

With the price of Australian exports rising by slightly more than the price of imports, there was a small improvement in the Terms of Trade last financial year. The Terms of Trade Index increased from 115.2 points in June 2017 to 117.6 points in June 2018. The Terms of Trade is still below its peak in September 2011 of 151.8 points.

In addition to the small deterioration in the Balance on Merchandise Trade was a widening of the deficit on the Net Services Account. Despite continued growth in service export earnings, from items such as education and tourism, a rise
in service imports meant that the Services deficit expanded from $2.6 billion in 2016/17 to $5.9 billion in 2017/18.

The largest component of Australia’s Current Account deficit is the deficit on the Incomes Account. This consists primarily of interest payments on Australia’s foreign debt and income payments (e.g. rents and dividends) on overseas owned Australian assets. With low interest rates prevailing globally, there was a reduction in the Income account deficit between 2010 and 2016. However, the deficit on the incomes account has expanded again over the past 2 financial years. During 2017/18, the net Income deficit was $60.3 billion, up from $49.8 billion in the previous financial year.

With Australia continuing to record deficits on the Current Account, there has been an ongoing requirement to fund this deficit. This funding comes predominantly in the form of overseas borrowings. Equity purchases of Australian assets (e.g. property and shares) can also be an important source of funding. However, over recent years, net financing from equity sources has declined and currently all of Australia’s net foreign liabilities are in the form of debt rather than equity. Australia currently has more equity investments overseas (e.g. overseas shareholdings owned by Australians) than it has equity liabilities (e.g. shares of Australian companies owned by foreigners). As a result, Australia’s foreign debt has had to increase faster than otherwise to offset the decline in funding from equity purchases. In 2017/18 Australia’s net foreign debt increased 7.4% to be $1,036 billion. As a proportion of nominal annual GDP, the foreign debt now represents 56.3%. This compares with 54.9% one year earlier.

Q4: Describe the impact an increase in the Terms of Trade would have on the Current Account position, all other things being equal.

Monetary Policy

**Key Statistic: Cash interest rate at 1.5%**

Monetary policy has been steady over the past year, with no change in the overnight cash interest rate since August 2016, when the Reserve Bank cut the cash rate to 1.5%.

With demand and inflationary pressures only moderate, the Reserve Bank has been able to maintain interest rates at record low levels. In addition, with most overseas interest rates also exceptionally low, there has been pressure on the Reserve Bank to maintain low interest rates here, so as to avoid upward pressure being placed on the $A. If Australian interest rates rose above those of overseas, buying support would tend to be generated for the higher yielding $A.

Fiscal Policy

**Key Statistic: The Commonwealth Government moved from a deficit of $18.2 billion in 2016/17 (1.0% of GDP) to a deficit of $10.1 billion in 2017/18 (0.6% of GDP). This deficit is expected to be $14.5 billion (0.8% of GDP) in 2018/19.**

There have been only relative small reductions in the size of the Commonwealth Government’s deficit position over recent years. As such, movements in fiscal policy have not had a significant impact on the overall level of activity in the economy. There has been some acceleration in the reduction in the deficit over the past year as a result of increased economic growth and higher commodity prices, which have increased the earnings base from which taxation can be raised.

Despite pressures on Government expenditure, due to factors such as rising health costs and the general ageing of the population, further reductions in the size of the deficit are forecast in the years ahead. A surplus position is expected to be recorded by 2019/20. At the end of June 2018, Australian Government net debt was $342 billion or 18.6% of GDP.