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PRODUCTIVITY BULLETIN

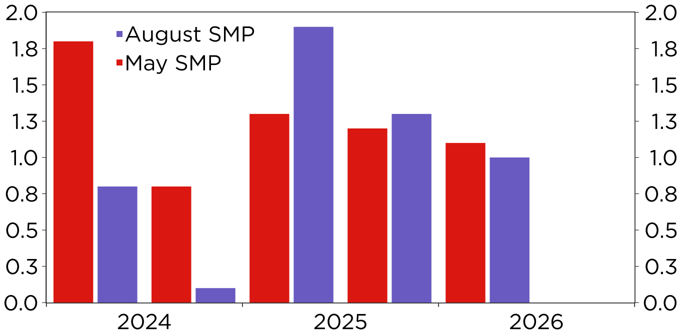
Westpac Economics' view on the outlook

RBA's productivity pessimism is only half the story

- One of the most puzzling elements of the RBA's revised forecasts is the assertion that aggregate supply is lower than previously thought.
- One of the RBA's key judgements is that the identified weakness in supply capacity is going to persist.
- Further investigations suggest that this could be largely based on noisy hours worked data.

Labour productivity (non-farm)

Comparison of year-ended growth forecasts



Source: , Macrobond, Westpac Economics

> "This lack of unwind from the spike in hours, and the apparent full attribution of that into the productivity growth outlook, is a key judgement embedded in the RBA forecasts without much explicit interrogation."

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RBA's productivity pessmism is only half the story

Noisy hours worked data could be muddying the view on productivity

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One of the most puzzling elements of the RBA's revised forecasts, released in last week's Statement on Monetary Policy (SMP), is the assertion that aggregate supply is lower than previously thought.

A speech this week by the Deputy Governor, Andrew Hauser, attempted to shed some light on this view, using among other things the scenario-building modelling technology previously used by the RBA during the pandemic.

In this speech, the Deputy Governor exhorted the audience to be more mindful of the uncertainties around any forecast. We agree: forecasting is difficult. This is why our interest rate expectations are always characterised as being conditional on things turning out broadly in line with our own forecasts. There are always risks around any forecast. There are also always assumptions to be made. In its latest forecast round, the RBA has tried to tease some of these out. There are, however, some key judgements the RBA is making that are either unstated, or being glossed over to some extent without being fully interrogated.

One of these key judgements is that the identified weakness in supply capacity is going to persist. Deputy Governor Hauser's speech highlighted a range of indicators still pointing to supply constraints. They are, however, all current and backward-looking indicators, not forward-looking ones. As such, they say nothing about whether the weakness in supply is going to persist or why. They also do not indicate whether things are tighter than you thought, only that things are still tight.

The rear-view mirror

Deputy Governor Hauser's speech was largely framed around trying to explain the upside surprises in Australian inflation outcomes recently. Yet there has been no net surprise in trimmed mean inflation since the November forecast round. September quarter 2023 surprised on the upside, and the RBA responded to this by raising rates at the November 2023 meeting. Since then, it has had a downside surprise (December quarter 2023, leading to a reversion in forecasts in February), an upside surprise (March quarter 2023) and then June quarter being 'broadly' as expected.

Understanding the past is helpful for the lessons one can take. But when one is making a policy decision that affects the economy with a lag, it is important to question any assumption about past conditions persisting. The RBA's analysis in the SMP and Deputy Governor's speech does not do that. Instead, it seems to be hanging current policy decisions on data surprises that reflect conditions – and wage policy decisions – from a year ago.

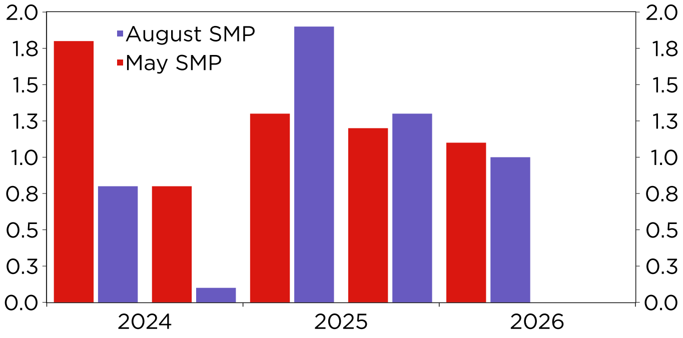
Signal versus noise

While the RBA has attempted to triangulate its view with other (backward-looking) indicators, the forward-looking view is captured in its forecasts.

The main revision to its view that pointed to lower supply capacity was an unexpectedly large downward revision to forecast labour productivity growth over the year to the June quarter 2024, since the May forecast. The RBA now expects growth in productivity to be 1 percentage point lower than it did three months ago. This shift occurred even though three of the quarters in the calculation are actual data; only the June quarter is a forecast. It is not explained by the March quarter figures being released in the interim; this outcome was broadly in line with what the RBA had been expecting.

Labour productivity (non-farm)

Comparison of year-ended growth forecasts



Source: , Macrobond, Westpac Economics

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Rather, the change in view reflects an apparent spike in hours worked in the June quarter, the denominator in the labour productivity calculation: GDP divided by hours worked. While the GDP figures for the June quarter will not be released for a few more weeks, an estimate of the hours worked is already available from the monthly labour force data.

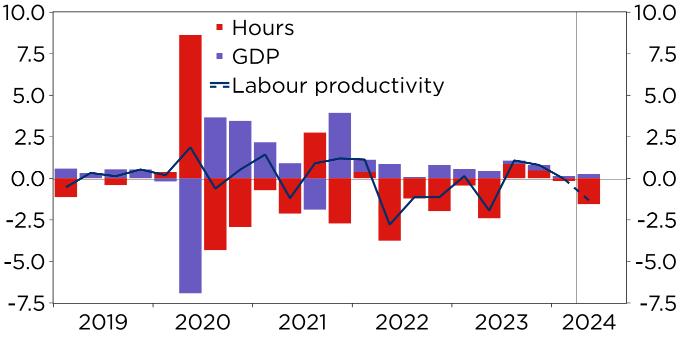
This showed an unusually large 1.6% jump in hours in the June quarter. To put this into perspective, the average absolute quarterly change in hours was around 0.6% in the decade preceding the pandemic. While we did see large swings in hours around lockdowns and when the international borders closed and reopened, there is no immediately obvious reason for the spike in the June quarter.

It is possible that a significant portion of the spike in hours has been driven by noise and/or a measurement issue relating to shifting in seasonal patterns. This view is particularly compelling given we have seen hours worked remain virtually flat over the three quarters to the end of March. Despite this, RBA forecasts suggest that the big June spike is expected to largely persist with hours worked continuing to track steadily higher (as shown in chart 9 of the Deputy Governor's speech). There is little to no allowance, that we can see, for any of the shift possibly being just noise.

If this estimate of hours worked carries through into the national accounts, then measured labour productivity will fall in the June quarter unless economic output increases by 1.6% or more, or past GDP is revised higher, which are extremely unlikely.

Labour productivity

Contribution to quarterly % change*

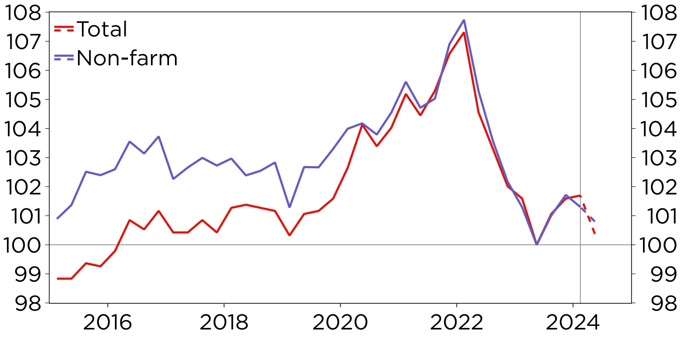


Source: ABS, Macrobond, Westpac Economics

Such a fall would give back most of the gains over the previous three quarters. The RBA seems to be taking this as a sign that supply capacity is weaker than they previously thought, and persistently so. (Never mind that more hours worked implies more hours being supplied.)

Labour productivity

Index June quarter 2023=100*



Source: ABS, Macrobond, Westpac Economics

This lack of unwind from the spike in hours, and the apparent full attribution of that into the productivity growth outlook, is a key judgement embedded in the RBA forecasts without much explicit interrogation.

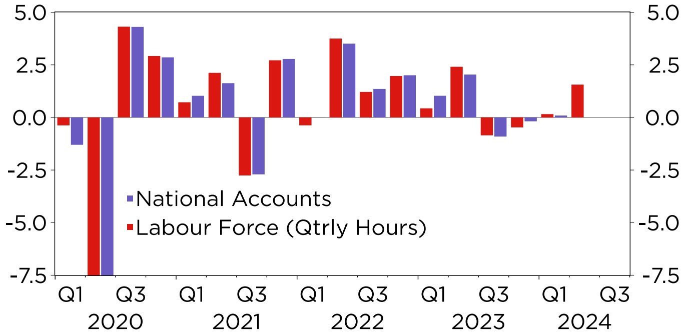
Normally, the quarterly measure of hours worked from the Labour Force data is a good guide to the measure of hours worked used to calculate productivity in the national accounts. But this has not always been the case, and the data are sometimes also revised.

Since the pandemic, many patterns of seasonality have shifted, including patterns of leave-taking by workers. This has affected data on hours worked, making these data more volatile and prone to revision.

Fortunately, the ABS has processes to re-benchmark data to be more coherent and incorporate additional data sources. One of these processes will occur with the July Labour Force data to be released this week, incorporating a full financial year of hours worked data. We think that some of the volatility will diminish following this re-benchmarking. Related to this, we suspect some of the RBA's pessimism around GDP per hour worked – labour productivity – could also be overdone.

Growth in hours worked

Quarterly % Change



Source: ABS, Macrobond, Westpac Economics

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(No) Rise of the machines

Because it has apparently taken full signal from this surprise on hours, the RBA now thinks aggregate supply is lower than previously thought and that it will take longer for the supply side of the economy to fully recover. There is another aspect to the RBA's supply side pessimism, however, related to its view on business investment and thus the ratio of the capital stock to the supply of labour (the 'capital/labour ratio'). This ratio is directly relevant to the outlook for productivity: workers are typically more productive when they have more or newer capital to work with. The process of increasing the capital/labour ratio is known as 'capital deepening'.

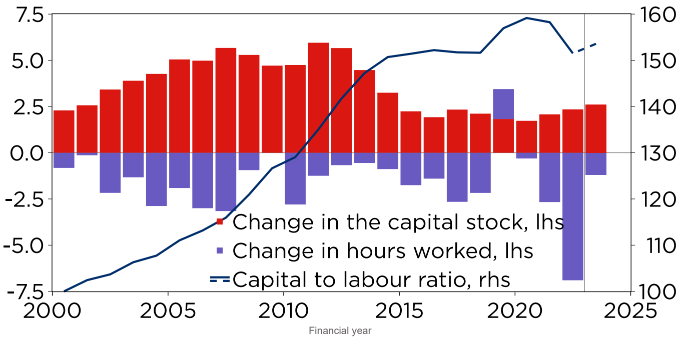
Population and hours worked forecasts were revised higher at the same time that the RBA's near term forecast for business investment was revised lower. This means there is now virtually no capital deepening over the whole of the RBA's forecast period: the capital to labour ratio remains low, after falling by around 4.0% over the 2023-23 financial year. The productivity the RBA is expecting is all coming from multifactor productivity, that is, improvements to processes and know how which boost the amount of output produced by a given amount of labour and capital (See Graph 3.6 in the Outlook chapter of the SMP.)

If the capital/labour ratio did indeed fail to rise in coming years, it would be extremely unusual. Capital deepening is typically an important contributor to growth in labour productivity. Growth in multifactor productivity also contributes, but over the most recent completed productivity cycle (2017-18 to 2021-22), the ABS estimates that capital deepening and multifactor productivity made an equal contribution to growth in labour productivity. And in the previous three cycles, the contribution of capital deepening has been more than twice that of multifactor productivity.

It is also a strong assumption to revise up one's view of future population growth and assume that businesses do not respond to either the higher demand or the larger workforce by investing more. We have already started to see businesses and governments respond to the larger population and invest more. As a result, the capital to labour ratio has increased across the economy, and more quickly, in the non-mining sector of the economy.

Capital deepening

Drivers of the change in the capital to labour ratio*

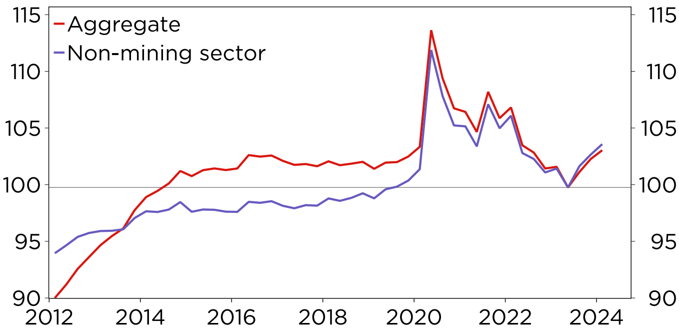


Source: ABS, Macrobond, Westpac Economics

Digging a hole in labour productivity

Capital to labour ratio

Index: June quarter 2023=100



Source: , Macrobond, Westpac Economics

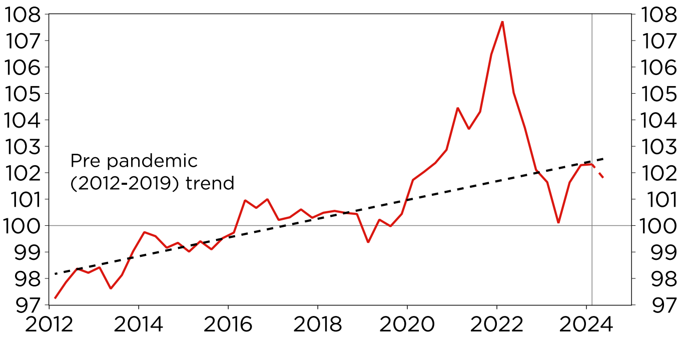
Even if the RBA's pessimism on productivity is borne out, there is a further question of how relevant this is for future domestic pricing pressures. This depends on whether the weakness in productivity is occurring in parts of the economy that enter into domestic inflation.

Prior to the June quarter, we had seen a turnaround in labour productivity, particularly in the non-mining sector of the economy where it had increased by 2.2% over the three quarters from the June quarter 2023, to be 2.3% above pre-pandemic levels (average 2019 levels). Labour productivity in the non-mining sector appeared to be back at the trend prevailing between the end of the mining investment boom and the start of the pandemic (2012 to 2019 period).

In contrast, labour productivity in the mining sector has continued to remain around recent lows. But

Non-mining labour productivity

Index 2019=100*



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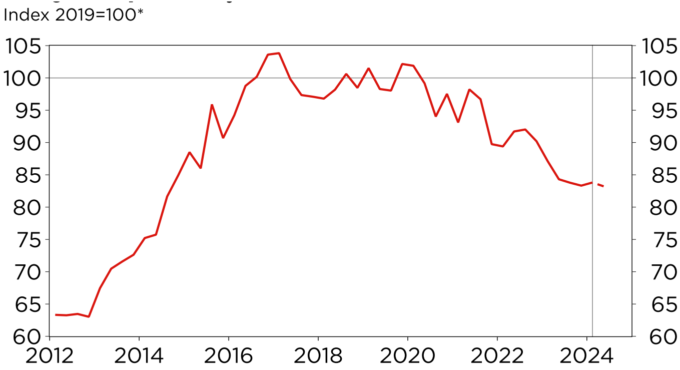
as a price-taking export industry, this would have little bearing on domestic pricing pressures.

Conclusion

Deputy Governor Hauser is right: forecasting is hard, and the uncertainties are particularly large in this post-pandemic period. While the RBA is trying – within the confines of some prescriptive recommendations from the RBA Review – to elucidate how it tackles those uncertainties, there is more to be done on this front. All forecasters need to acknowledge the risks around their forecasts. In addition to the variability around consumption and unemployment that Deputy Governor Hauser focuses on, forecasters need to be alert to uncertainties around how some data series are measured and allow for the possibility that recent outcomes are just measurement noise. The nuances around these measurement issues are often country-specific. In other cases, it comes down to recognising that a change in view about one part of the economy can imply that the outlook for other parts of the economy could have changed as well.

Mining labour productivity



Source: , Macrobond, Westpac Economics

Whether the RBA's pessimistic view of supply capacity turns out to be correct will only become clear over time. We will, however, get some helpful updates from the re-benchmarking of hours worked data coming this week, and the June quarter national accounts next month.

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