Australia's productivity renaissance underpins a boom in profitability but animal spirits remain dormant

It has been de rigueur among policy makers and economists for a while now to bemoan the slowdown in Australia's productivity growth. In its annual update released in April, the Productivity Commission showed that multi-factor productivity – the efficiency with which labour and capital contribute to production in the private sector – contracted in the 2012/13 financial year. Even the Reserve Bank has weighed in on the debate. In its annual essay competiton this year, it has asked undergraduate students to explain the marked slowdown in productivity growth in the past decade.

And yet the March quarter National Accounts confirm that Australia has been undergoing a renaissance in labour productivity for the past three years. The level of production or gross value added in the private sector per hour worked expanded by 1% in the March quarter and has grown at a compound annual nominal rate of 3.5% for three years. This is well above the annualised rate of 1% in the preceding decade and comparable to Australia's golden period of productivity growth in the late 1990s and early 2000s.

The productivity resurgence largely stems from the renewed capital and cost discipline that corporate Australia has embraced. The persistence of a sluggish revenue enviroment has forced companies to aggressively trim costs and lift efficiency to support earnings growth. Logistics company and bell weather for the economy, Toll Holdings, is one of a number of companies that recently announced plans to restructure and reduce costs to mitigate the effects of persistent margin pressure.

The new cost discipline has seen unit labour costs – growth in wages minus productivity growth – remain broadly unchanged for over two years. With the exception of the financial crisis, this represents the longest period of stagnant unit labour costs since the late 1990s. Subdued unit labour costs have supported profits and helped to contain service sector inflation.

The cost focus has helped to deliver a boom in profitability, with the National Accounts revealing another impressive set of results for Australia's corporate sector. Gross operating surplus, the economy wide after tax profit measure, increased strongly in the March quarter to be 9% higher than a year ago. Profits of financials and for private non-financial corporations are now both 15% higher than their pre financial crisis peaks.

The flipside of the productivity renaissance and new cost discipline has been a very sluggish labour market. The National Accounts show that aggregate hours worked in the private sector have been stagnant for the past three years, and is barely above the pre financial crisis peak in 2008. The stagnant profile is all the more striking considering that population growth has been booming, increasing by 10% or over 2 million residents in the past six years. The persistent weakness in the labour market clearly represents a key concern for the Reserve Bank.

At face value, the 1% lift in nominal GDP in the March quarter points to an improvement in revenue conditions. Nominal GDP is the dollar value of production and in contrast to real GDP, does not adjust for fluctuations in the price level. Nominal GDP has grown by an annualised rate of over 5% in the half year to March, the fastest rate of growth in three years. This is a welcome sign but growth is coming off a very low base because the economy has been mired in a nominal recession for the past two years. Nominal GDP expanded at an annual average rate of less than 4% in each of the past two calendar years, representing the slowest rate of growth since the recession of the early 1990s.

Despite the pick up in nominal GDP growth, the National Accounts and a recent survey by the Bureau of Statistics of investment intentions suggest that animal spirits are still dormant and that businesses remain reluctant to take on new projects, a fact acknowledged in recent communications from the Reserve Bank. Nominal private sector business investment was unchanged in the March quarter and remains 2% lower than a year ago, while businesses expect to pull-back their capital spending significantly in the 2014/15 financial year.

The corporate sector clearly shows little appetite for risk and the Reserve Bank shows little inclination to ease policy further to revive dormant animal spirits given its watchful eye on speculative mortgage lending to investors. Thus, the revenue environment and labour market conditions will likely remain subdued, and the new cost discipline will continue to keep inflation well contained.

Two key investment implications flow from this. First, the prospect that interest rates will remain lower for longer than many expect will continue to underpin the reach for stocks with sustainable yield. Second, the focus on trimming costs should continue to underwrite Australia's productivity renaissance and the boom in corporate profitability.

The signal to rotate out of high yielding defensive stocks will be an increase in risk taking by the corporate sector, associated with a lift in official interest rates among the world's major central banks, and a re-acceleration of growth of business credit in Australia.

But an increase in risk appetite in the near term remains remote. Animal spirits around the world are still dormant, nominal GDP growth is still stuck in low single digits in many countries, monetary policies in developed markets are likely to remain accommodative to close their still large output gaps, and there is little sign in Australia of a handover in growth from the mining sector to business investment in the non-mining sector.

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Charts underpinning the analysis are available on request.

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