ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

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BOQ GROUP

Summary

- Wages growth of 3% is the RBA's line in the sand for a return to a normal economy;
- Wages growth has been subdued for much of the past decade;
- A key factor behind low wages growth has been the sub-par performance of the domestic economy;
- But the economy is getting stronger;
- And this is leading to stronger wages growth that could challenge 3% in the next year.

Right now one of the important economic indicators in the economy is wages growth. The RBA has indicated that 3% wages growth is the line that needs to be crossed before wages can be considered 'normal'. Conceptually the best measure of wages growth is the Wages Cost Index. A structural change in wages growth took place following the GFC.

Low wages growth has been a feature across industries over the past year. No sector had wages growth above 2.25%. And a number had growth of under 1%. The trend decline of wages growth has also been evident across all sectors over the past decade. The most significant slowing in growth rates were in the sectors that experienced the highest growth in wages in the 2000's.

Partly lower wages growth over the past decade reflects global factors. Strong competition limited the ability of firms to raise prices. The advent of new technologies likely played a role. An important reason was that the end of the mining boom meant that national income has been was substantially weaker than it had been pre-GFC. That said wages growth has significantly lagged the pickup of national income growth since 2016. Low wages growth reflected an economy that was not strong enough for long enough.

In the 1960's and 1970's the strong labour market created a wage 'overhang'. This meant that that a period of low wages growth was necessary to encourage firms to create more jobs. Certainly growth in real unit labour costs (the growth in how much it costs a firm to employ a worker after taking into account productivity growth and the prices a firm charges) was quite high around the peak of the mining boom.

Firms are indicating that they have not seen times as good as this for at least the past twenty years. This means they are currently going on a hiring splurge. And a growing number of them are saying that they are finding it hard to get good staff. Wages growth has been an annualised 2.5% over the past quarters. And the stronger economy and rapidly improving jobs market suggests further wage rises are on the way.

Slowing wages growth has been a feature of the past decade

There are literally thousands of economic indicators (and the number continues to grow). Some numbers are more important than others. And which ones are important can changes depending upon the state of the economy. Right now one of the important ones is wages growth. Labour is the largest cost in most industries. So it plays a crucial role in what prices firms' charge, how many workers they employ and what is the size of their capex budget. Wages are the largest source of

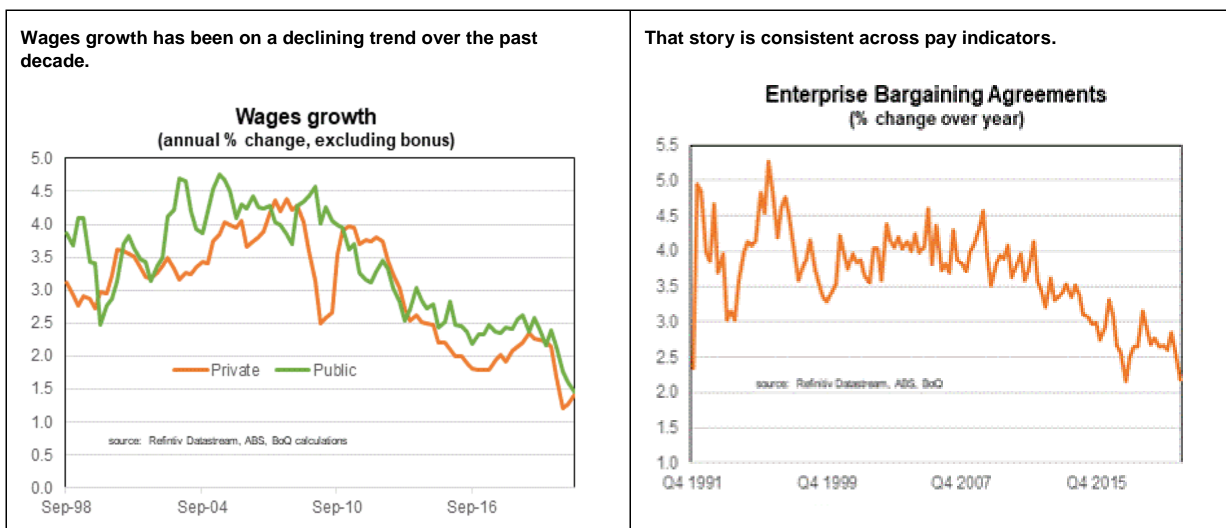
income for most households and therefore plays a crucial role in determining the strength of consumer spending.

For these reasons economists (including those at the RBA and Treasury) keep a careful eye on wage developments. The RBA has indicated that 3% wages growth is the line that needs to be crossed before wages can be considered 'normal'. In other words, wages growth above 3% is a necessary condition before interest rates rise.

As an aside, it shows you how things can change. Right now the RBA is very focussed upon encouraging wages growth to go higher than 3%. Back in the 1990s the worry was whether wages growth could be sustainably reduced down to 4.5%!

Conceptually the best measure of wages growth is the Wages Cost Index. That indicator measures the hourly growth of earnings for the same group of jobs. The aim is to purely measure the change in the actual wage of a job, abstracting from changes in hours worked, the type of work done or the composition of the labour force. The data indicates that that a structural change in wages growth took place following the GFC. Typically public-sector wages growth have risen by more than the private sector. That might not be the case this year. Large budget deficits means that Governments' need to keep an eye on cost growth.

Other indicators of wages growth (such as pay rises granted through enterprise bargains) tell a broadly similar story. Wage rises offered through enterprise bargaining, rose modestly from the early 1990s until the GFC and then fell.

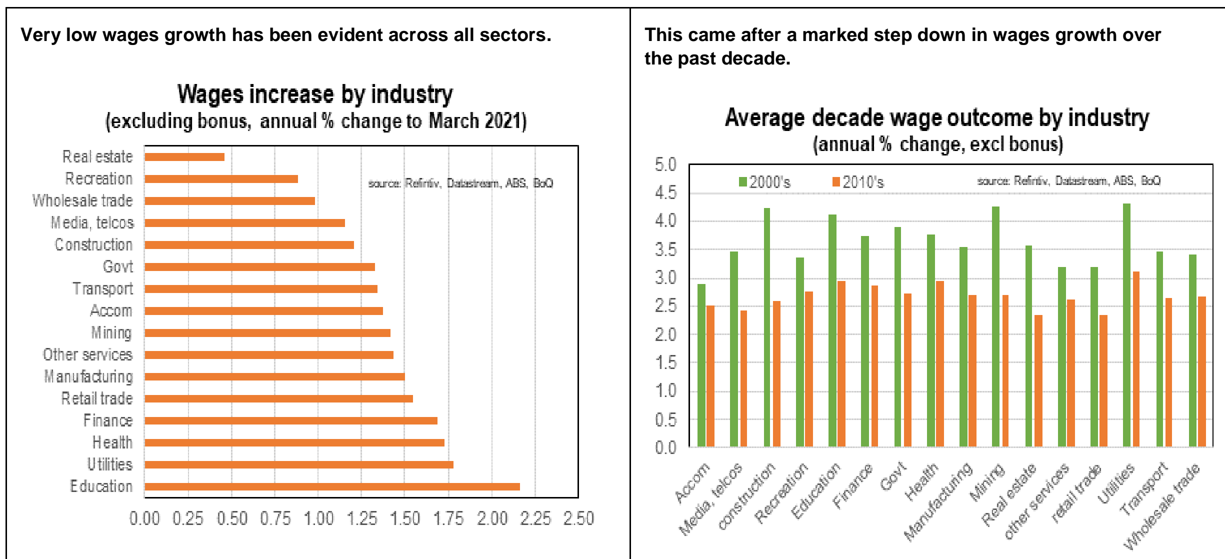


And has been evident across industries

Low wages growth has been a feature across industries over the past year. No sector had wages growth above 2.25%. The sectors that experienced the strongest growth (education, utilities and health) all are strongly influenced by government policy. A number of industry had wages growth of under 1% (notably the recreation sector).

The trend decline of wages growth has also been evident across all sectors over the past decade. The most significant slowing in growth rates were in the sectors that experienced the highest growth

in wages in the 2000's. In some sectors the slowing reflected the impact of the end of the mining boom (mining, construction). In others it reflected structural change (utilities, finance).

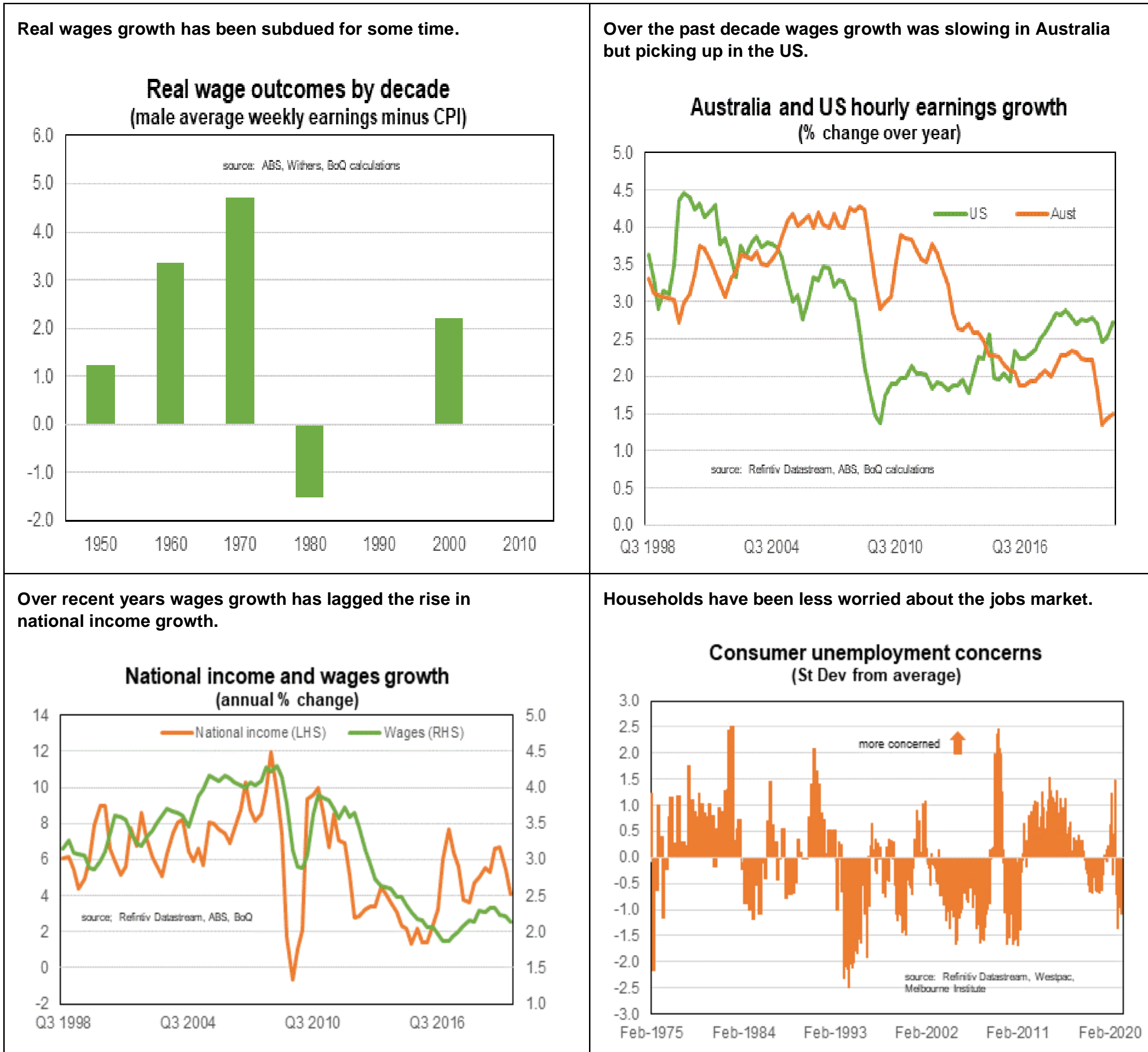


The domestic economy was not strong enough for long enough

Which leads to the question as to why did wages growth slow substantially in the 2010's?

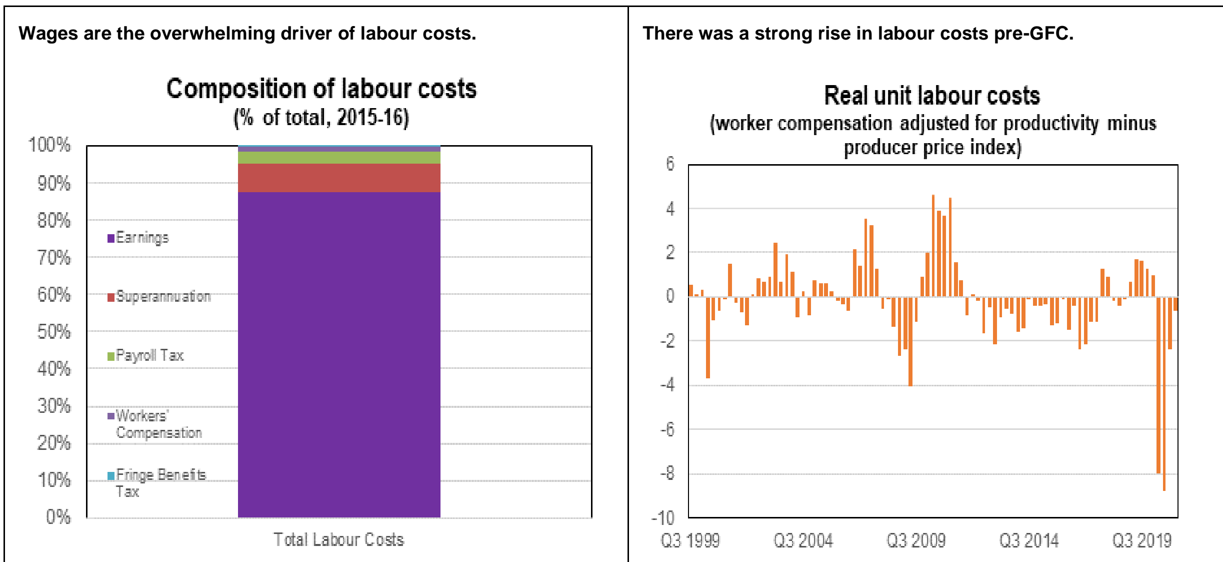
Partly lower wages growth reflects factors evident globally. Strong competition limited the ability of firms to raise prices (so they could afford to pay higher wages). The advent of new technologies likely played a role. Some economists point to the decline of trade unions. A few commentators think that workers worried about losing their job means they have not been demanding a pay rise. But that is inconsistent with survey evidence that household fears about unemployment pre-COVID were below average.

An important reason was that the end of the mining boom meant that national income growth for much of the past decade has been was substantially weaker than it had been pre-GFC. That said wages growth has significantly lagged the pickup of national income growth from 2016.

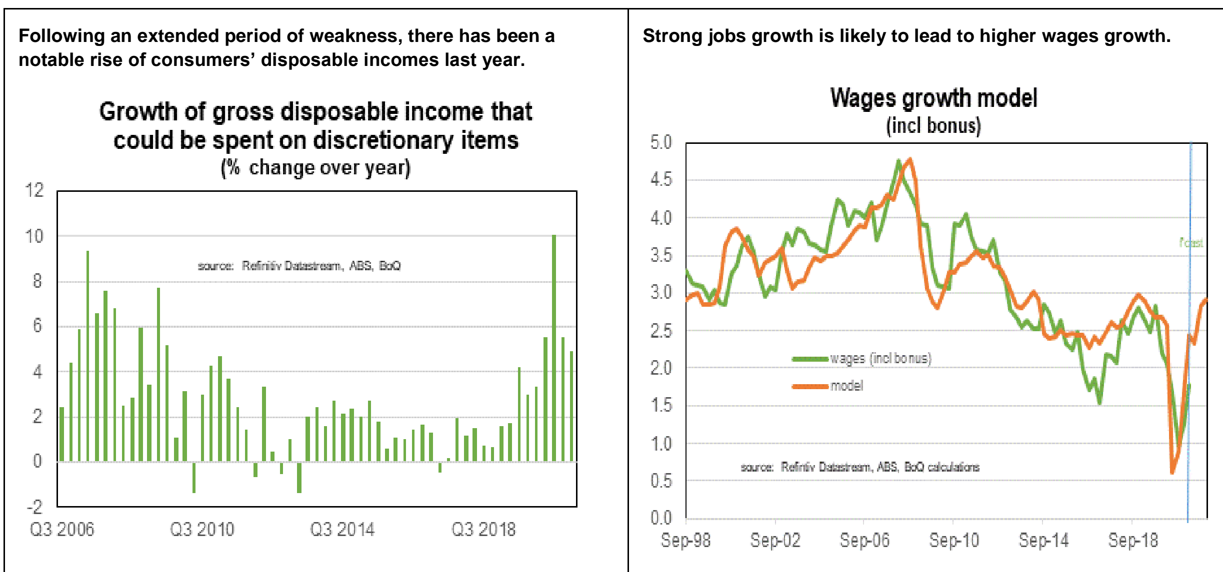


A related factor could have been that the boom times of the 2000's led to a notable rise in labour costs. This is what happened in the 1960's and 1970's, creating a wage 'overhang'. This meant that that a period of low wages growth was necessary to encourage firms to create more jobs.

Certainly growth in real unit labour costs (the growth in how much it costs a firm to employ a worker after taking into account productivity growth and the prices a firm charges) had grown strongly in the years prior to the peak of the mining boom. The weak productivity growth in the years up to COVID would have been another factor keeping unit labour costs high. But the biggest factor behind weak wages growth was that the economy was not strong enough for long enough.



Very low wages growth has been the main reason there has been an extended period of weak consumer spending. Growth of household disposable incomes after taking into account price rises for essential items (food, petrol, utility bills) averaged only around 1% over the decade since the GFC. The good news is that there has been a strong rise of disposable incomes rose strongly during COVID. This has nothing to do with wages but mainly reflected the impact of very strong government income support (JobKeeper and an enhanced JobSeeker).



Implications

Wages growth is very important. It is the biggest driver of firms' costs. And it is the biggest source of consumer incomes. For this reason it is an important driver of economic growth. And the inflation outlook.

Wages growth has been disappointingly low over the past decade. Some of that might be reflecting global forces (globalization, technology). But a big part was the fallout of the mining boom. And this meant that the Australian economy had not been running strong enough for long enough.

But that was then. Firms are indicating that they have not seen times as good as this for at least the past twenty years. This means they are currently going on a hiring splurge. And a growing number of them are saying that they are finding it hard to get good staff. At the same time more firms are indicating that they are feeling more comfortable about putting up prices. These are the indicators that you would look for stronger wages growth.

Wages growth has been an annualised 2.5% over the past quarters. And the stronger economy and rapidly improving jobs market suggests further wage rises are on the way. Including given the projected strength of the labour market wages growth could be close to the magic 3% mark by the end of this year!

We live in interesting times.

Regards,

Peter Munckton
Chief Economist
Bank of Queensland