ECONOMIC UPDATE

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WEEK ENDING 19TH NOVEMBER 2021

BOQ GROUP

Key points

- **Wage growth has picked up from its 2020 lows;**
- **But it remains too low for the RBA to feel comfortable about raising rates;**
- **There are a growing number of reasons to expect wages growth to be north of 3% in 2023;**
- **And that is when we enter interest rate hike territory.**

Summary

The September quarter wages data was for financial markets the most eagerly anticipated piece of economic data for the remainder of 2021. The outcome (measured as excluding bonuses) came in at a 0.6% rise (2.2% over the past year), close to expectations. That was a pretty good outcome given that about half the country was in lockdown for much of the third quarter. But the quarterly increase was in line with the pace recorded in the first half of 2021. Part of the pickup of wages will be 'catch up', a payback for the wage freezes last year when uncertainty about the pandemic impact was at its peak.

Assuming that wages growth does pick up from here at best it will be 9-12 months before it would breach the 3% mark nominated by the RBA. And there are reasons to think that the pickup of wages growth will be slower. For a start enterprise bargaining agreements and public service pay caps limit how quickly national wages growth can rise over the next 6-12 months.

There is still an excess supply of labour. The unemployment rate can fall further. The underemployment rate is also well above long-term average. There is also likely to be a rise in the participation rate. But past the next 6-12 months it will be the return to higher levels of immigration that will be the most significant issue for the supply of workers.

In recent years workers have not been expecting big pay rises, partly reflecting a period of low inflation. That could change if prices go up at a 3%-plus for an extended period. Firms' expectations about profit margins have also been pretty subdued in recent years, leaving them little room to pay higher wages. But sustained strong demand may again lead to firms becoming very comfortable about the profit outlook. One reason why profit margins have narrowed in recent years has been an extended period of weak productivity growth. But it looks like we are in for a run of strong business investment. And that should lead to a bounce in productivity growth in coming years.

With some luck with COVID the economy looks like it will be in for a good run over the next couple of years. This should lead to declines in the unemployment rate and (eventually) wages growth north of 3%. Once that happens we enter interest rate rise territory.

Wages outcome

The September quarter wages data was for financial markets the most eagerly anticipated piece of economic data for the remainder of 2021. That is because the RBA made it clear that for interest rates to rise they would need to be satisfied that inflation will sustainably be 2-3%. And in the RBA's view for that to occur will require wages growth to be above 3%.

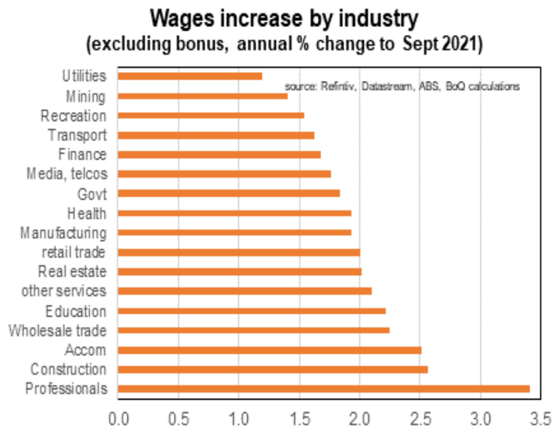
The outcome (measured as excluding bonuses) came in at 0.6% rise (2.2% over the past year), close to expectations. That was a pretty good outcome given that about half the country was in lockdown for much of the third quarter. Analysis conducted by the ABS indicated that the pattern of wage increases has returned back to pre-COVID norms.

Professional services led the way. Partly that would have been the pay hikes we read about for lawyers and accountants. It also might reflect strong demand for areas of IT. Higher pay though was a feature in a number of sectors. Accommodation and Food Services was one, reflecting the massive demand for workers as the sector re-opens for business in NSW and Victoria. Wage rises apparently have been lower in mining, curious given that by some measures it is the sector facing the most severe worker shortages.

Part of the pickup of wages will be ‘catch up’, a payback for the wage freezes last year when uncertainty about the pandemic impact was at its peak. It also reflects the high demand for labour.

Wages growth is picking up.

The biggest pay increases have been for professionals.



Over recent years higher pay rises have tended to come in the way of bonuses. That has been because employers have been reluctant to lock in higher fixed costs in an uncertain economic environment. But over the year to September annual pay rises were the same regardless of bonuses. Another sign of strengthening demand for workers.

The Q3 number was high given the prevailing economic conditions. But still some distance from justifying imminent rate hikes. The quarterly increase was in line with the pace recorded in the first half of 2021. In that regard the September quarter figure was a point’s decision to RBA Governor Phil Lowe in his argument with financial markets. Prior to the release of the wages data financial markets had been signalling that the first rate hike will take place around June next year. Phil Lowe said that pricing implies a far more rapid pace of wages growth than what the RBA is forecasting. The Q3 numbers turned out to be closer to the RBA view.

Even assuming that wages growth does pick up from here at best it will be 9-12 months before it would breach the 3% mark nominated by the RBA. That would make September (and more probably December) the absolute earliest that the RBA would begin to hike rates. And there are reasons to think that the pickup of wages growth will be slower. For a start enterprise bargaining agreements and public service pay caps limit how quickly national wages growth can rise over the next 6-12 months.

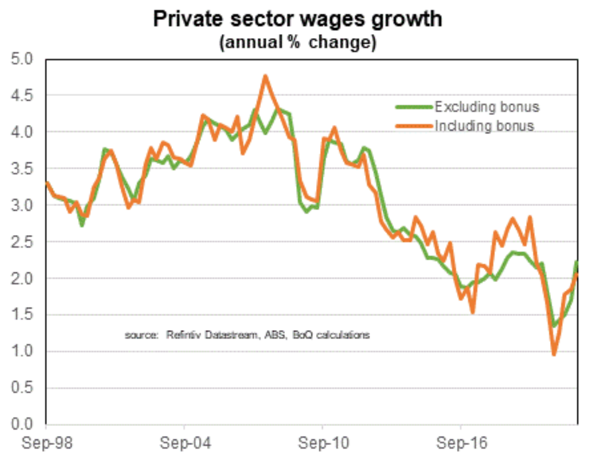
The demand for labour is currently very strong. But there is still an excess supply of labour. The unemployment rate can fall further. About a third of the unemployed say the reason they haven’t been able to get a job is that there are not enough vacancies or there have been too many applicants. In the current environment you would expect these factors to be less of a problem. The underemployment rate (the proportion of people who are employed but would like to work more hours) is also well above long-term average.

There is also likely to be a rise in the participation rate. The RBA believes that a proportion of the people have only temporary left the labour force and are likely to return once the economy re-opens. Given that the participation rate was at a record high as recently as March this appears to be a reasonable argument. We will find out in the next few months.

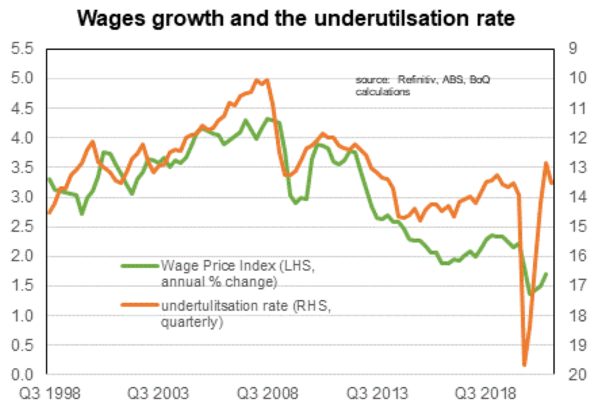
But past the next 6-12 months it will be the return to higher levels of immigration that will be the most significant issue for the supply of workers. There has been steps to open up the borders to international students. Decisions about a more expansive opening of the international borders appears likely to wait until sometime in 2022. Substantially higher immigration will require not only our international borders to be open but also that of other countries, notably China.

There has been discussion that higher immigration leads to lower wages growth. The evidence is mixed. In the noughties immigration was strong and wages growth was decent. By contrast in the 2010's there was periods of strong immigration growth that coincided with weaker wages growth. The difference in the two decades was the economy was very strong in the 2000's creating a very strong demand for labour that high immigration could only partially fill. But the economy was not as strong in the following decade.

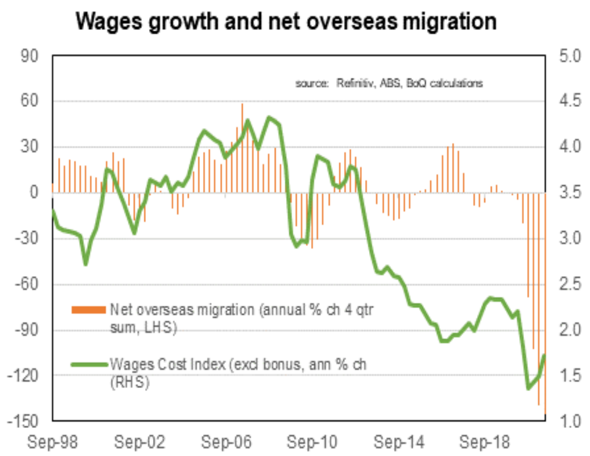
Bonuses have played a bigger role in pay in recent year but less so in 2021.



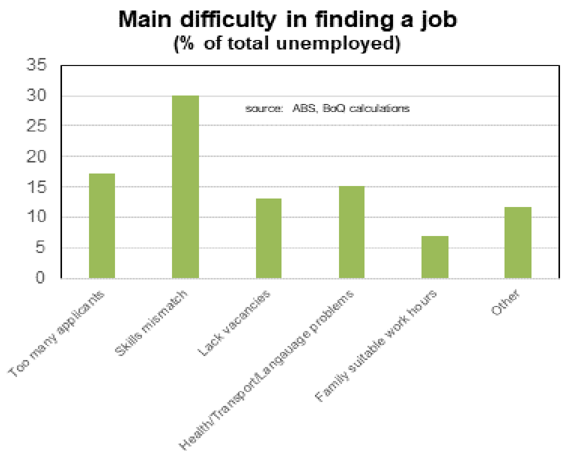
There are still plenty of people who would like to work more hours.



The impact of immigration on wages growth has been mixed.



There is scope for unemployment to fall further.



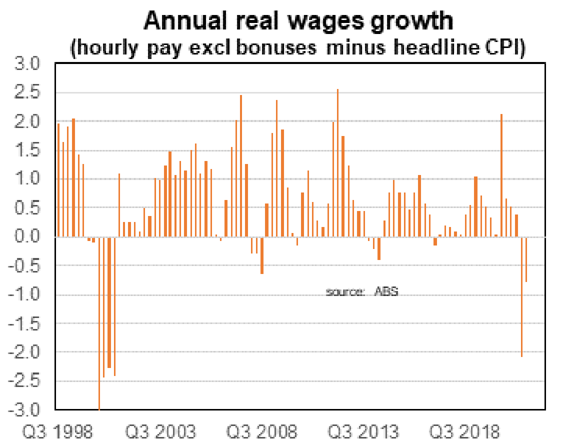
In recent years workers have not been expecting big pay rises, partly reflecting a period of low inflation. That could change if prices go up at a 3%-plus for an extended period. Firms' expectations about profit margins have also been pretty subdued in recent years, leaving them less secure in paying higher wages. But the strong demand in H1 saw expectations about margin expansion rise to near record levels. These expectations got challenged during the Sydney/Melbourne lockdown. Sustained strong demand may again lead to firms becoming very comfortable about the profit outlook.

One reason why profit margins have narrowed in recent years has been an extended period of weak productivity growth. It looks like we are in for a run of strong business investment. And that should lead to a bounce in productivity growth in coming years.

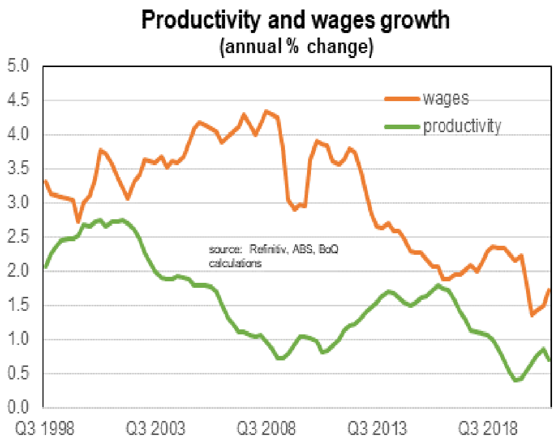
Bonuses have played a bigger role in pay in recent year but less so in 2021.

Firms expectations that profit margins might narrow has made them more reluctant to pay higher wages.

The pickup of inflation has led to a decline in 'real' wages.



Weak national productivity growth has reduced the ability to pay higher wages.



The RBA has good reasons to expect modest wages growth over the next 12-18 months. With some luck with COVID the economy looks like it will be in for a good run over the next couple of years. This should lead to declines in the unemployment rate and (eventually) wages growth north of 3%. Once that happens we enter interest rate rise territory.

We live in interesting times.

Regards

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