# Australian Economic Comment

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Australia

## Dismal productivity likely to delay rate cuts

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- The market is all a-flurry with excitement about the prospect of central bank rate cuts. We suggest RBA observers should cool their engines. We see the RBA as likely to be one of the last of the developed economy central banks to deliver cuts, reflecting a range of factors. These include that the RBA was one of the last to start hiking, lifted rates by less than many others and that inflation is falling more slowly in Australia than in, say, the US. A deeper factor at work is that Australia's productivity performance in the post-pandemic period has been one of the poorest across the developed world (see chart). This has meant that growth in unit labour costs (wages adjusted for productivity) is well in excess of what is consistent with the RBA's 2-3% inflation target. A policy focus on the supply-side is needed. If productivity can be improved, rate cuts could be considered sooner.

First, the good news. Inflation has peaked and is heading in the right direction. It has also fallen a little faster than the RBA was forecasting back in November 2023 (although it is on a similar path to the RBA's forecast in August 2023). Given this, it is all but certain that the RBA will choose to hold its cash rate steady, at 4.35%, when it meets this week.

With the rate-hiking phase likely to be finished, the market has rapidly shifted to pricing cuts, following developments offshore, particularly in the US – perhaps a bit too rapidly, in our view (see *Five reasons why the RBA may not cut rates in 2024,* 8 January 2024).

It seems likely to us that rate cuts for Australia are quite some time away.

Start with the fact that, although Australia's inflation has eased, it is still well above the RBA's 2-3% target band.

Indeed, as a point of comparison, core inflation in Australia is still much further above the RBA's inflation target, than US core inflation is above the Fed's target. Over the year to Q4 2023, Australia's trimmed mean ran at 4.2% y-o-y, and even in the last six months of 2023 its annualised rate was 4.1%, well above the 2.5% midpoint of the RBA's target band (see *The RBA Observer: Good progress, but it's too early to talk about rate cuts,* 2 February 2024). By comparison, the US core PCE was 2.9% y-o-y in December and 1.9% six-month annualised, compared with the Fed's inflation target of 2%.

The key factors supporting elevated Australian core inflation are the domestic components, particularly rents, utilities, and insurance, all of which may prove to be sticky: rents, by a hard-to-fix housing shortage; energy, by the ongoing costs of the energy transition; and insurance, by the impact of climate change on making the weather more erratic.

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More broadly, services inflation is still running strongly, though it has eased from its peak.

The deeper problem here may be that productivity has been weak in Australia recently, and, as the chart below shows, much weaker than in much of developed world (see *Australia's productivity problems,* 10 August 2023).

Weak productivity growth has occurred at the same time as annual wages growth has picked up, from running at around 2% pre-pandemic to 4% recently. Wages growth of 4% would normally be consistent with the RBA's 2-3% inflation target if productivity were rising at 1-2% year. Instead, productivity has *fallen* by 2% over the past year. As a result, unit labour costs are running at 6.4% y-o-y, which is far too high for the RBA's inflation target.

Of course, as labour is a key input into services, high unit labour cost growth is more apparent in supporting services inflation, and likely to add to its 'stickiness'.

Why has productivity been so poor in Australia post-pandemic?

A possibility is that the exceptionally tight labour market at the end of the pandemic, exacerbated by the closed border, has meant a lack of skills in the economy and that has weighed on productivity. Or that the tight jobs market drive increased labour hoarding.

Another possibility is that changed workplace behaviour has played a role. Perhaps increased work from home has weighed on productivity.

However, labour markets have been tight across the developed world. Increased work from home has also been a key feature in lots of locations. And yet, Australia's productivity performance is distinctly worse than elsewhere.

A particularly stark contrast can be drawn between US productivity growth and Australia's. Australia's weaker performance is also more similar to Europe and New Zealand.

In short, the US economy appears to be getting the sort of cyclical upswing in productivity that often follows a recession, but this does not appear to be the case in Australia. A possible explanation is that the pandemic related policy measures taken to keep workers in their jobs and protect businesses from insolvency were much stronger in Australia, New Zealand and much of Europe, than they were in the US. As a result, many workers retained their jobs through the pandemic and corporate insolvencies were exceptionally low. But this also meant that the economy was not shaken up as much as during a typical recession in Australia.

Our colleague, Fabio Balboni, recently wrote about this question of cyclical versus structural weakness in productivity for Europe (see *Cyclical or structural? Weak eurozone productivity and what it means,* 2 February 2024). Fabio noted that there is limited evidence of labour hoarding being the cause and that the 'chances of a bounce-back in productivity in the near-term seem tiny', which is likely to support elevated underlying inflation pressures in Europe.

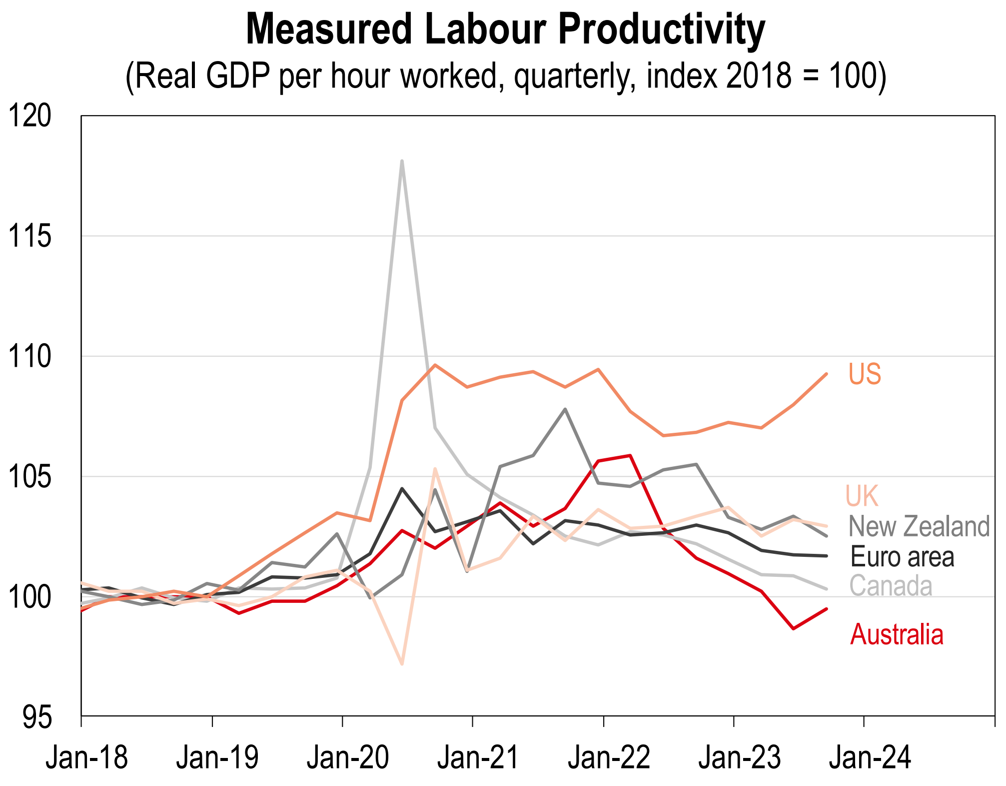
For Australia, recent work by local research institute, e61, led by Dan Andrews, points out that although Jobkeeper was highly successful in keeping workers in their jobs, over time, as the economy reopened, 'the wage subsidy started to tie individuals to less productive firms translating into weaker income growth and poorer skills use'.

We wrote about the possibility that the extraordinary forbearance offered through the pandemic, and lack that of a policy focus on using the 'crisis as an opportunity' to do reform, was potentially a missed opportunity (see *If the pandemic doesn't shock Australia to do reform, what will?,* 6 April 2022).

As we pointed out in our more recent outlook piece for 2024, the best thing for fiscal policymakers to focus on would be supply-side reform that lifts productivity (see *Australia in 2024: Managing an economy at full employment,* 22 January 2024). This would help to lift living conditions, but also reduce the cost of living (aka inflation) sooner.

Without a lift in productivity, rate cuts may be a distant prospect.

**Chart 1. Australia's productivity performance post-pandemic has been dismal**




Source: OECD

Reference

e61 Institute, 'What can jobkeeper teach us about job retention schemes?', by Dan Andrews, Matt Nolan, and Lachlan Vass. *E61 Micronote 15,* 20 November 2023.

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