HSBC Global Research

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Downunder Digest

Wages growth is set to lift, but how quickly?

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Economics - Australia

- The RBA has shifted its reaction function such that wages growth is playing a larger role in its cash rate decisions
- Although wages growth has edged higher, it is still well below the rates the RBA says it needs to see before hiking
- We review the wages metrics the RBA is likely to focus on, explain why, as well as describe the likely trends in these

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On-target inflation is not enough… wages need to rise too

The RBA has made it clear that its reaction function has changed. Whereas previously forecasting a pick-up, or even observing increased momentum, in underlying inflation was enough for the RBA to start lifting its cash rate, the central bank now needs to believe that, in its judgement, inflation is 'sustainably' on target.

The change in the reaction function stems from the RBA's long period of below target inflation and that low inflation expectations have become somewhat embedded. The focus is primarily on wages growth, which has been low for a number of years. The wage price index was 2.2% in 3Q21 and averaged 2.0% over the past six years, which is well below the 3.6% it averaged between 2000 and 2006 when inflation was sustained on target. The RBA Governor has stated that 3-4% wages growth is more likely to be consistent with inflation being sustainably in the 2-3% target range.

However, the RBA has also made it clear that its assessment will be informed by a range of wages metrics. The wage price index (WPI) is important, but the RBA will be guided by developments in the average earnings and unit labour cost measures and indicators of bonus pay and jobs market turnover.

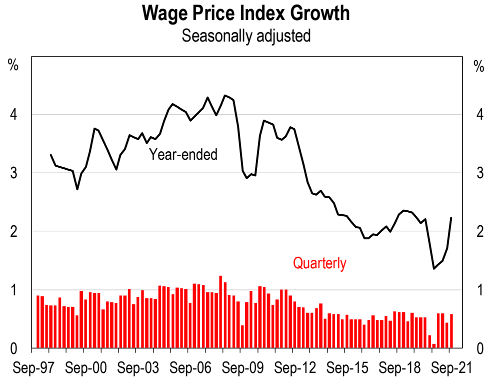
Models, such as the Phillips curve, also play a role, but as the RBA has pointed out, the relationship between the unemployment rate and wages growth has weakened in recent years. As such, even though the unemployment rate is nearing the central bank's own estimates of full employment, the Governor has also said that he will want to see actual wages growth lift, rather than rely on this relationship.

More broadly, we need to keep in mind the considerable inertia in Australian wages growth, given many wage contracts are long-lived (the average enterprise bargaining agreement is 3 years long) so lifting wages growth may take some time.

While there remains considerable uncertainty, given the RBA's changed reaction function, our central case is that there will be sufficient momentum in growth, inflation, and wages that gradual cash rate rises from 2H22 are likely.

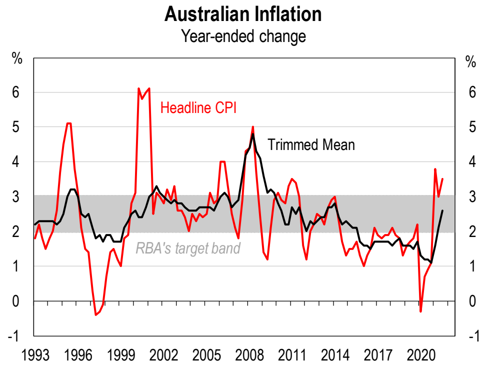
This is an abridged version of a report by the same title published on 16-Feb-22. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

1. Wages growth has remained subdued over the past decade…



Source: ABS, HSBC

2. …coinciding with a prolonged period of subdued CPI inflation outcomes



Source: ABS, HSBC

Australia has experienced a prolonged period of subdued wages…

Wages growth in Australia was low even before the pandemic…

Low wages growth in Australia is not a new phenomenon, or uniquely local. Prior to the COVID-19 pandemic, nominal wages growth – in Australia and other advanced economies – had been sluggish despite tightening labour markets. In the six years before the pandemic, Australia's wage price index showed average annual wages growth of only 2.0%, well below the 3.6% average of the early 2000s (Chart 1). CPI inflation, too, had experienced a prolonged period of remaining below the RBA's 2-3% target band (Chart 2). Part of the subdued CPI inflation likely reflects weak wages growth (and vice versa).

…due to both cyclical and structural factors

There are a number of cyclical and structural factors that have weighed on wages growth in Australia.

…with monetary policy and structural factors part of the explanation

On the structural side, factors such as competition, technological progress and a business mind-set focused on controlling costs are likely part of the story. A somewhat unique element for Australia was the end of the early 2000s mining boom, and the needed adjustment in much of the cost base when that inflationary force subsided. Changing demographics, increased labour supply and the globalisation of labour, as well as declining bargaining power of workers are also all possible factors.

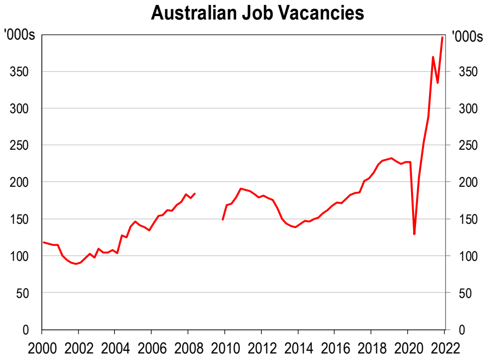
On the cyclical front, looking at the pre-pandemic period, it was also possible that monetary policy was too tight, as it focused more on financial stability and less on inflation. This could have resulted in spare capacity in the labour market, coinciding with a period of inwards migration, increased labour force participation, and elevated underemployment.

Wages growth has picked up…

Wages growth has lifted, but only gradually…

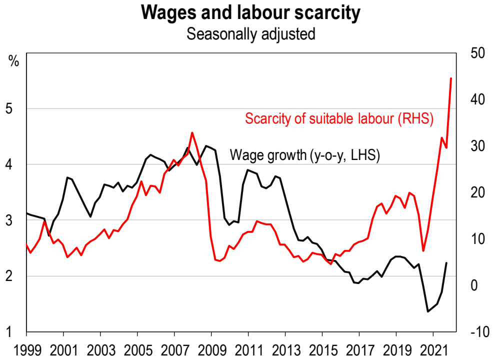
The most recent wage price index print for Australia showed a pick-up in wages growth to 2.2% y-o-y in 3Q21. This is up from the pandemic low of 1.4% a year earlier. In part, this reflects the impact of a closed international border, constraining labour supply, alongside robust labour demand. Indeed, forward-looking indicators of labour demand suggest continued support for wages growth (Chart 3 and Chart 4).

3. Labour demand has risen at the same time the border was closed…



Source: ABS, HSBC

4. …with businesses reporting labour shortages

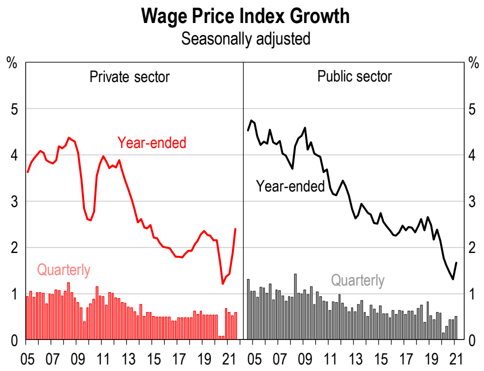


Source: Refinitiv Datastream, ABS, HSBC

…despite the closed international border and reported labour shortages

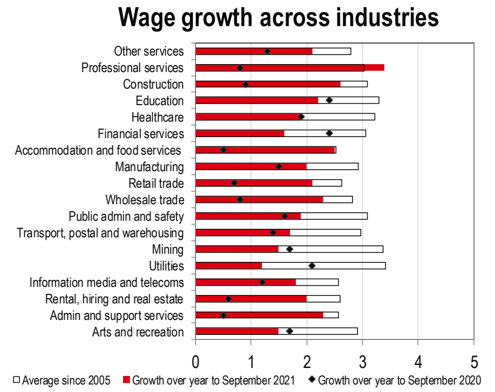
However, so far the pick-up in wages growth has only returned it the low rates observed in the years leading up to the COVID-19 pandemic. Unsurprisingly, wages growth has recovered more quickly for the private sector, bouncing back to a bit above pre-pandemic levels, while the public sector has recovered gradually, to still remain very low, in part reflecting only a slow unwind of the wage freezes imposed through 2020 (Chart 5).

5. Public sector wages have lagged the pick-up in the private sector…



Source: ABS, HSBC

6. …but wages outcomes across most industries are still below average



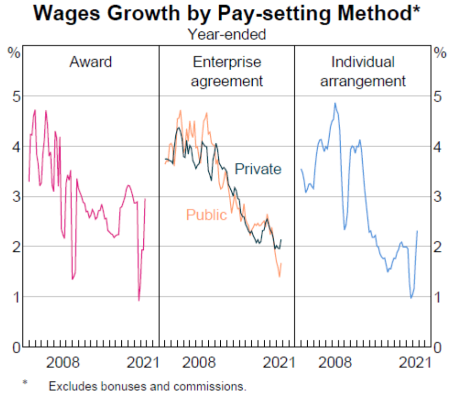
Source: ABS, HSBC

…but is still below where the RBA would like it…

The wage price index for 3Q21 also showed low outcomes across almost all industries. The only industry in the wage price index with growth above 3% as at 3Q21 was professional services, which is likely to reflect a more acute impact of the closed border on sourcing suitably-skilled labour (Chart 6). Wages growth appears to have lagged in industries with a higher prevalence of enterprise bargaining agreements (Chart 7). The wage price index is received at a considerable lag to the economy – the next print is due on 23 February and we expect it to show some further acceleration.

At this stage, it is clear that wages growth is well below the 3-4% rates that were the norm a decade ago and the sorts of rates the RBA needs to believe that inflation will sustainably run at 2-3% over the medium term.

7. Wages growth in enterprise agreements has been slower to lift



Source: RBA

8. Growth in average earnings per hour has exceed the WPI in recent years…

Source: ABS

…and Australia's wage setting system has considerable inertia

Although we expect wages growth to lift…

Although wages growth has picked up, and is likely to pick up further (see our forecasts below), there is considerable inertia in Australia's wages setting process. This suggests that wages should lift only gradually.

…it is likely to be gradual given the specifics of Australia's wages setting

Enterprise Bargaining Agreements (EBAs) are one factor imbedding some inertia in the system. EBA's are effectively a negotiation between the employer, employees, and their bargaining representatives, where the agreement lasts for no longer than 4 years (often around 3 years). By design, the multi-year nature, and infrequent re-negotiation of EBAs, means wages growth is slower to decline when wages are high, but equally slower to pick up when wages are low. Enterprise agreements (including federal and state) covered 38% of all Australian employees in May 2018 (latest available data).

Another factor adding some inertia in the system is Australia's Annual Wage Review decisions. The Fair Work Commission undertakes a review each year and sets the fixed nominal wage for the next 12 months, guided in particular by recent inflation prints. While this is likely to mean upward support for wages growth, the annual review means that wages are fixed for the next 12 months regardless of what happens to CPI inflation. Competitiveness is also a factor from a macroeconomic perspective, keeping in mind that Australia's minimum wage is already one of the highest in the world (at AUD20.33 an hour).

Alternative measures of wages growth

The RBA has started looking towards broader measures of wages growth

The wage price index is typically the RBA's preferred measure of wages growth, partly because it measures the change in wages and salaries where the quality and quantity of labour are held constant. However, the RBA has recently noted that it will be looking across the range of metrics when it is assessing the likely sustainability of the inflation impulse. We discuss some of these further below.

Average Weekly Earnings

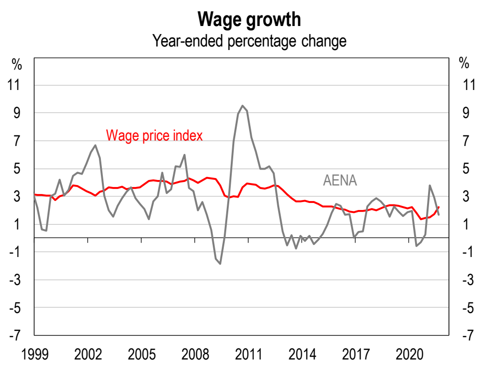
Average Weekly Earnings (AWE) measures the overall value of average wages and salaries provided by a survey of employers. Unlike the WPI, AWE is affected by compositional changes in the jobs market. For example, occupations, skill levels, and hours worked. We look at average earnings per hour. Average earnings per hour has mostly been growing ahead of the WPI since 2018, but is clearly subject to more volatility (Chart 8). The recent sharp spikes reflect the impact of Australia's COVID-19 restrictions, limited hours worked, and the impact of the closed border.

Average Earnings in the National Accounts

Average Earnings in the National Accounts (AENA) is a broader measure of wage growth. It measures the total compensation of employees (that is, total remuneration paid to an employee, including both wages and salaries and contributions by employers to pension and superannuation funds) divided by the number of wage and salary earners. This means that AENA is also affected by compositional change in the labour market.

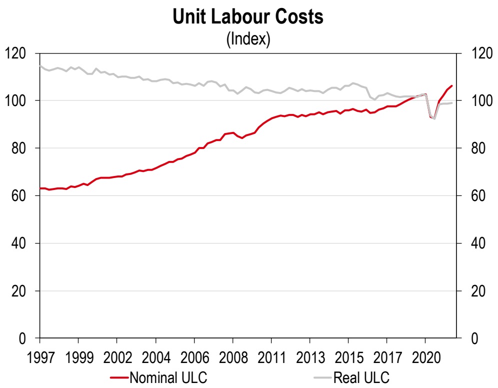
AENA has also tracked closely to the WPI over recent years (Chart 9). It shows the opposite spikes to AWE through the COVID-19 period, likely reflecting the sharp shocks to Australia's GDP rather than changes in hours worked.

9. …but AENA shows that compensation of employees is more subdued



Source: ABS, HSBC

10. Real unit labour costs have been relatively flat despite a nominal rise…



Source: ABS, HSBC

Unit labour costs

Unit labour costs are likely to be relied on alongside the usual Wages Price Index

Nominal unit labour costs are measured as AENA adjusted for productivity, and represent the labour cost of producing a unit of output. Over the long run, nominal unit labour costs are closely related to inflation. Real unit labour costs are adjusted by the price of firms' outputs (the GDP deflator), and are related to the labour share of income – that is, the proportion of total income in the economy that comprises compensation of employees.

While nominal unit labour costs have been increasing over time, real unit labour costs have remained relatively flat (Chart 10). Noticeably, nominal unit labour costs have risen sharply ahead of real costs since 2020.

Real wages growth

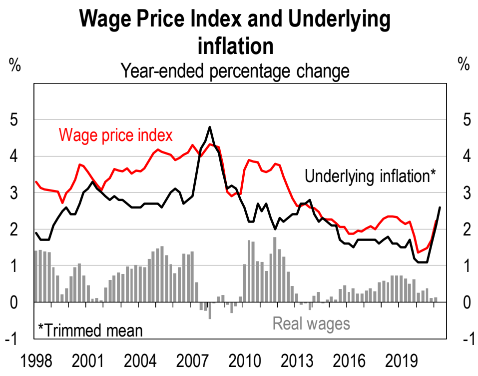
While nominal wages growth is important for inflation, real wages growth is important for household incomes and broader economic momentum. Real wages growth has been persistently subdued post-2013, and has trended towards zero since 2019 (Chart 11).

Alternative (non-wage) compensation

There have been reports of a pick-up in non-wages compensation…

Besides wage outcomes directly, to attract staff, firms continue to implement a range of non-base wage strategies. For additional income, captured in some statistics, this includes targeted bonuses. Alternatively, firms could offer flexible work policies, more training opportunities, or choose to hire staff with less experience. Although these are often reflected in an employee's total remuneration package, they are hard to determine in the data. An example of this is Australia's superannuation guarantee arrangements. The contribution is currently 10%, and is set to increase by 0.5ppts further each year until 12% in 2025. As we saw in 2021, the impact is likely to have dampened wages growth.

11. …and real wages growth has been notably subdued



Source: ABS, HSBC

12. The RBA's business liaison suggests 2-3% wages growth is still the 'norm'

Source: ABS, HSBC

…and firms are slowly transitioning to an expectation of higher wages

The RBA's own measures of expected wages growth

Finally, the RBA also has its own measures, constructed based on its business liaison programme. The RBA's own business liaison programme suggests that an increasing proportion of firms are now expecting to give employees' wages growth of 2% y-o-y or more, although still less than 30% of surveyed firms expect wages to rise by over 3% (Chart 12).

The Phillips curve and mark-up models

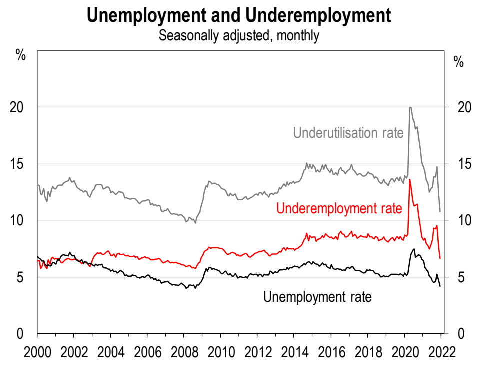
Another way to assess the wages and inflation outlook is through models of the economy. In particular, the RBA has tended to use two workhorse models – a Phillips curve model and a mark-up model.

The Phillips curve had flattened, particularly at the regional level…

The Phillip's curve

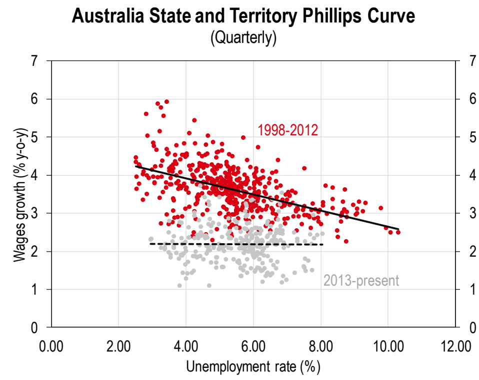
The Phillips curve model for wages suggests that as spare capacity in the jobs market falls (that is, the unemployment or underemployment rates fall), wages growth accelerates. In principal, the recent sharp fall in these labour market metrics should put upward pressure on wages growth (Chart 13). The unemployment rate, as of December 2021, dropped to 4.2%, its lowest level since 2008 and the underemployment rate also fell. Elevated underemployment was one factor influencing subdued wages growth before the pandemic, so a decline in both measures of labour market slack should help support wages growth further.

13. The labour market has tightened quickly…



Source: ABS, HSBC

14. …but may need to move further to generate higher wages growth



Source: ABS, HSBC

…suggesting an even tighter labour market may be needed to lift wages growth

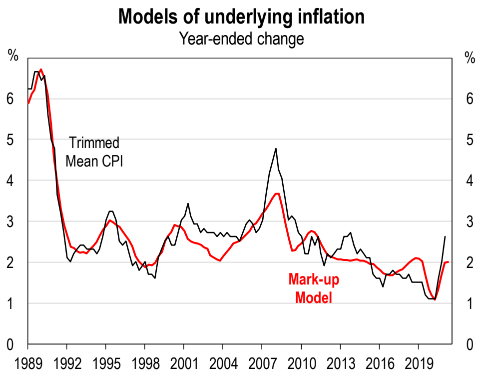
However, a key uncertainty for the RBA is just how quickly wages growth responds to a tightening labour market. The Phillips Curve – the relationship between unemployment and wages – has flattened over time (Chart 14). This suggests that even lower unemployment, or a longer period of labour market tightness, may be needed to lift wages.

The mark-up model

Wages growth is still an important metric for future CPI inflation outcomes

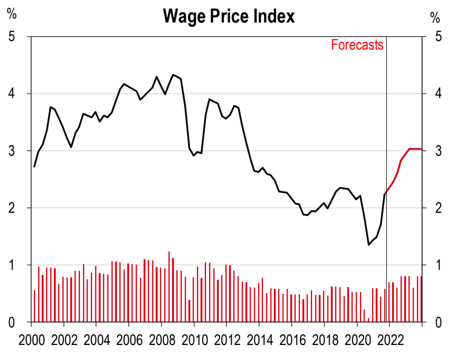
Another key model used by the RBA to link wages growth to a forecast for inflation is a mark-up model (Chart 15). This based on the idea that firms set their prices as a mark-up over costs, where unit labour costs reflect the labour costs businesses face, and that labour costs in excess of productivity growth should put upward pressure on prices. While the precise causal relationship is hard to determine, the high correlation suggests that wages are an important part of the inflation narrative.

15. Wages growth has been a poor explainer of inflation recently



Source: ABS, RBA, HSBC

16. We expect nominal wages growth to lift into 2023



Source: ABS, RBA, HSBC estimates

Our central forecast for wages

We expect wages growth to lift to 2.7% y-o-y over 2022…

Nominal wages growth has recently picked up to around its pre-pandemic rate. We expect wages growth to increase further from here, from 1.9% y-o-y in 2021, to 2.7% y-o-y in 2022, and 3.0% y-o-y in 2023 (Chart 16). The increase largely reflects pass-through from a tightening labour market. However, as outlined above, there are clear reasons to expect that the lift in wages growth may only be gradual.

…but this suggests that real wages growth will remain subdued over the short term

Although nominal wages growth is set to lift, it is likely to lag the current high rates of CPI inflation. From our CPI (trimmed mean) and wage growth forecasts, we back out an implied forecast for real wages growth, which shows that consumers bear the brunt of the lift in inflation through reduced purchasing power. Eventually, we expect real wages growth to return to positive territory, but until then, the subdued real wages growth could be a downside risk for growth and consumer confidence.

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