ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 25TH FEBRUARY 2022

BOQ GROUP

Key points

- **Wages growth is picking up;**
- **But it remains too low for an imminent rate hike;**
- **The increase in wages growth this year is likely to be steady rather than sharp;**
- **The earliest rate hike is likely to be August/September of this year;**
- **I am still looking for the first move to be in the December quarter.**

Summary

Most likely it will be movements in wages that will be the big issue for the domestic interest rate outlook this year. According to the ABS, wages growth (excluding bonuses) increased by 2.3% last year (0.7% in the December quarter). Some in financial markets expected a higher print. But as the RBA has pointed out there are institutional reasons why the pickup of wages growth is more likely to be steady than sharp.

The big picture is that despite the strong demand for workers across most industries there are few sectors where wages growth is above 3%. And there are no states where wages growth was above 3% in 2021. This included Western Australia where the unemployment rate is already in the 3's. Indeed, only five industries had wages growth of above 2.5% in 2021 and none of the five largest states. The economic fundamentals do point to stronger wages growth is on the way. But at the end of last year wages growth was still too low.

The wages price index is the best pure measure of changes in wages growth. Pre-1998 Average Weekly Ordinary Time Earnings (AWOTE) was the key wages data that everyone focused upon. The most recent AWOTE number indicated that wages rose by only 2.1% over the year to November 2021, a little under the growth rate for the Wages Price Index. The AWOTE data also confirmed that wages growth will still moderate at the end of 2021.

An interest rate change in June/July is still possible although the wages data released in February makes it less likely. This is consistent with financial market pricing that has (rightly) reduced the chances of a rate increase in June/July. More probable dates for the first rate change are either August (after the Q2 CPI figures) or September (after the Q2 wages numbers).

At this stage I am sticking to my view that the first rate hike will be in Q4. My view is not the consensus view. At the time of writing financial markets had priced in almost a one percentage point rate increase by the time I think the first rate move may take place. Maybe the financial markets view will turn out to be correct. But it will also require wages growth to be substantially stronger than what has been indicated from the recent evidence. Time will tell who is right.

The RBA passes its first wages test

Most likely it will be movements in wages that will be the big issue for the domestic interest rate outlook this year. With the unemployment rate at multi-decade lows the RBA's main focus is on inflation. And it is wages growth (adjusted for productivity growth) that sets the sustainable rate of inflation. Wages growth will also be important in determining whether the current level of household debt is sustainable.

According to the ABS, wages growth (excluding bonuses) increased by 2.3% last year (0.7% in the December quarter). Over the second half of last year that measure increased at an annualised pace of 2.5%. This is an indication that wages growth is shifting up, but only a notch. Some of the pickup in the last quarter of last year reflected award pay rises that are usually delivered earlier in the year. But the stronger jobs market played a role.

Some in financial markets expected a higher print. But as the RBA has pointed out there are institutional reasons why the pickup of wages growth is more likely to be steady than sharp. Pay increases for those on awards typically happen annually. And enterprise bargaining agreements are often multi-year. Wage changes happen the quickest for those on individual agreements.

The RBA noted that pay increases can come in the form of bonuses if firms wish to reward workers without wanting to lock in a permanently higher level of labour costs. This is what happened in the 2010's when firms were confronted with an uncertain economic outlook, low inflation and tough competition. Bonuses were not as important in the decade prior to the GFC when the strong economic outlook and robust labour market meant firms were more confident about passing on cost increases.

Currently those receiving bonuses are achieving faster pay rises. In the private sector wages growth including bonuses rose by almost 3% in 2021 (compared to 2.4% excluding bonuses). Maybe the bonuses were a one-off reward for staff that endured pay freezes over 2020-21. Certainly after the best part of a decade of cost constraint it is likely that some firms would still be reluctant to structurally boost their labour costs. The desire to retain staff in a tight labour market though must have played some role.

Wages growth is picking up although so far it has only returned to its pre-pandemic level.

Wage rises have been faster for workers receiving bonuses.

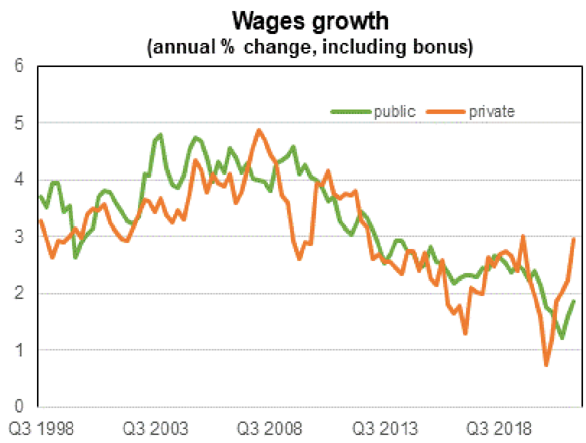
The biggest pay rises over the past year have been for workers in the Accommodation and Food Services and Retail sectors. Maybe that reflects the high demand for workers in those two sectors at a time when staff availability has been heavily impacted by the lack of immigration (particularly in Accommodation and Food Services). Mostly though workers in those two sectors benefitted from an increase in award wages.

The big picture is that despite the strong demand for workers across most industries there are few sectors where wages growth is above 3%. This includes mining where profits have been strong and demand for labour high (the high proportion of miners on enterprise bargaining agreements is the probable reason). And there are no states where wages growth was above 3% in 2021. This included Western Australia where the unemployment rate is already in the 3's. Indeed, only five industries had wages growth of above 2.5% in 2021 and none of the five largest states. The economic fundamentals do point to stronger wages growth is on the way. But at the end of last year wages growth was still too low (particularly in a world of 3%-plus inflation).

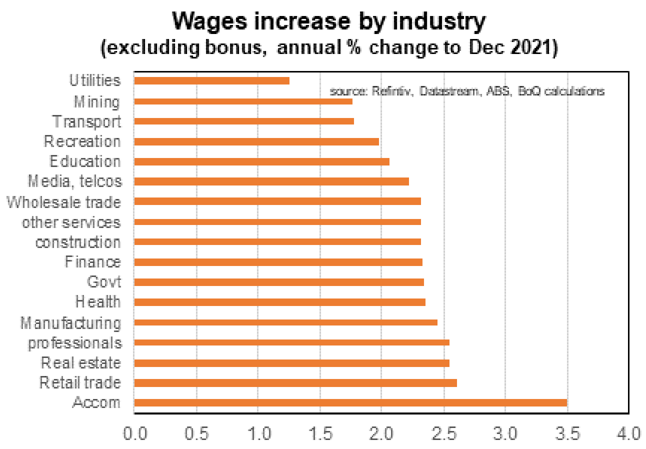
Over the past year the private sector has achieved stronger pay rises than the public sector. Historically this is unusual with public-sector wages often rising faster. The recent slower pace of public sector wages mainly reflects the caps that state governments have placed on salaries. As you would expect over time the trend of private- and public-sector wages growth is broadly the same. After all both sets of workers come from the same labour market. The strong labour market and rising inflation means we should expect to see higher wage rises for both the public sector over the coming couple of years.

Many workers are suffering from a cut in their real wage.

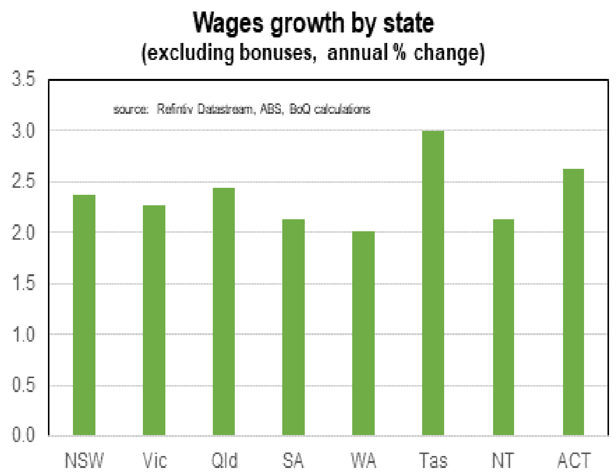
Wages growth has been stronger for private-sector employees.



There was only one industry where annual wages growth was above 3% in 2021.



And no states had wages growth above 3%.



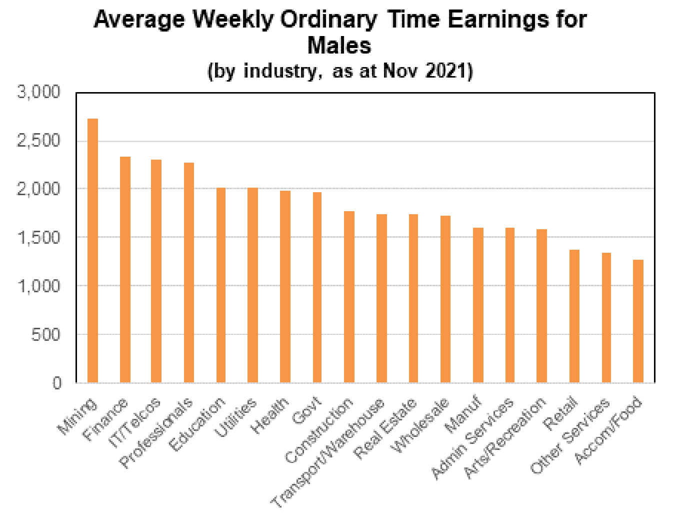
Other measures of wages growth

The wages price index is the best pure measure of changes in wages growth. But it doesn't give an indication of movements in labour costs. For example, during good times firms may decide to 'promote' more workers as a way to give them a pay rise to keep valued employees. One qualitative measure of labour costs is provided from the NAB business survey where firms in Q4 2021 indicated that labour costs had returned back to the level seen in the pre-GFC days.

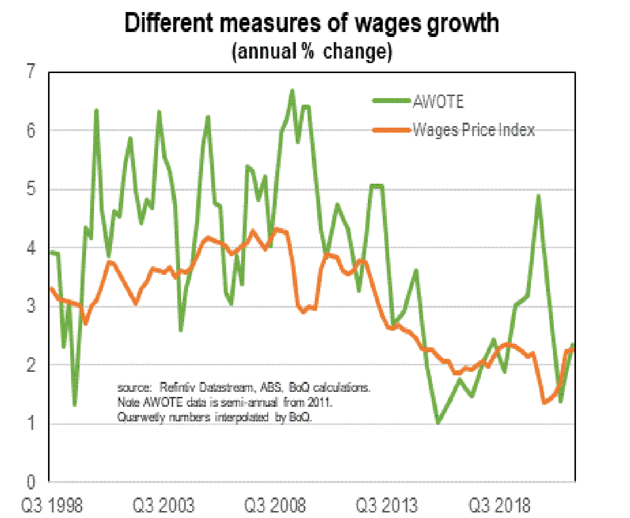
Pre-1998 Average Weekly Ordinary Time Earnings (AWOTE) was the key wages data that was everyone focused upon. That measure calculates changes in the average wage. Movements can be influenced not only by wage rises (what the Wage Price Index tries to calculate) but also changes in job composition in the economy. For example, AWOTE would rise if there were more people employed in mining (the highest paid industry) than retail sector (one of the lower-paid sectors).

On average AWOTE has risen by around 0.75% more each year than the Wage Price Index, an indication of people either moving to better paying jobs within their industry or moving to higher-paid industries. The most recent AWOTE number indicated that wages rose by only 2.1% over the year to November 2021, a little under the growth rate for the Wages Price Index. The reason for that was that the biggest pay rises in 2021 were in the lower-paid sectors (such as Accommodation and Food Services). The AWOTE data also confirmed that wages growth will still moderate at the end of 2021.

The unemployment rate is declining across all regions.

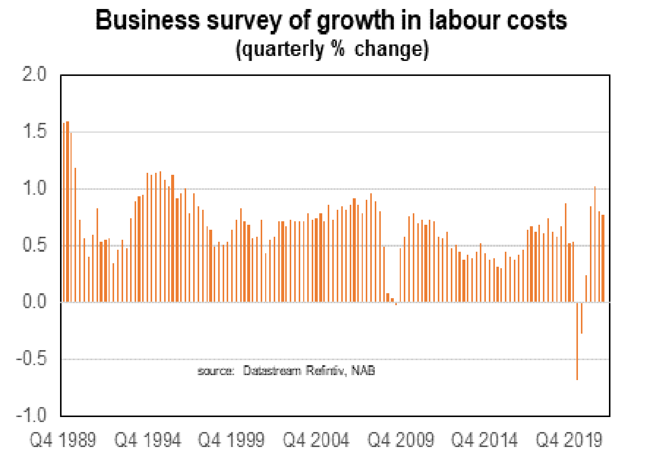


Other measures of wages growth while picking up are still low.

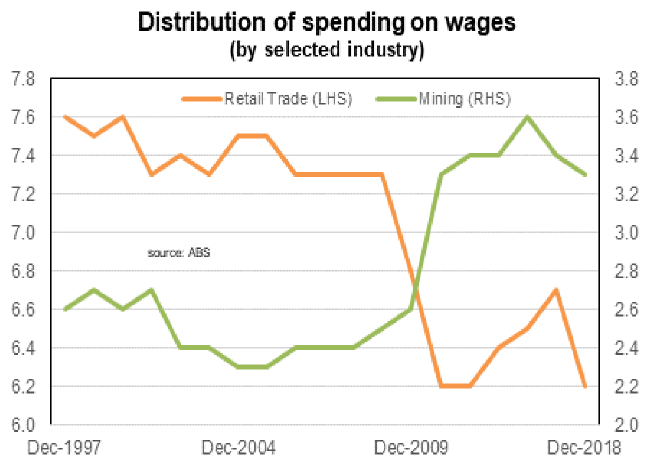


The GDP figures include a measure of average employee earnings. That can be influenced not only by wage rates and changes in job composition but also movements in the proportion of full-time and part-time workers. Over the year to the September quarter that measure rose by just 1.1%, well below the 3.25% typically of the 2000's when inflation was typically within the RBA's target band.

Firms report that labour costs have moved up to pre-GFC levels.



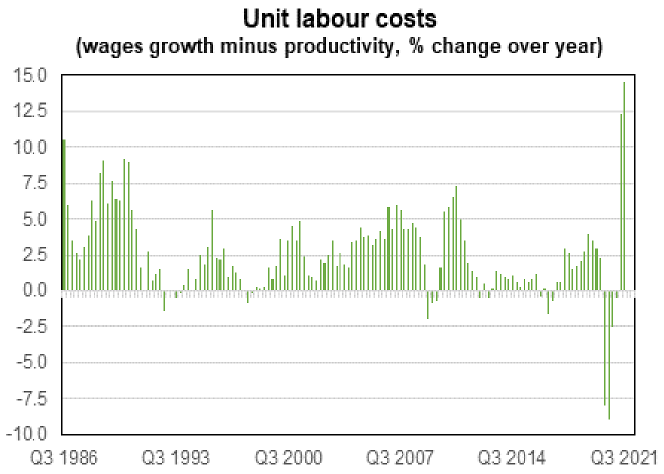
Over time a higher proportion of workers move to higher paid industries, such as mining



The best measure of how labour costs impacts inflation is movements in unit labour costs. That measure includes all the costs that firms need to pay to employ workers (such as wages, superannuation and payroll tax) but also takes into productivity growth. Higher productivity growth means firms are more able to pay higher wages growth.

Productivity growth though can be a difficult beast to measure particularly in the short term when it is heavily influenced by the bumps-and-grinds of the quarterly economic data. Currently unit labour costs have increased very strongly. But that is less due to strong growth in labour costs and more due to very slow productivity growth due to the combination of weak economic growth (due to lockdowns associated with COVID) and strong employment growth.

The unemployment rate is very low. And so is the underutilisation rate.



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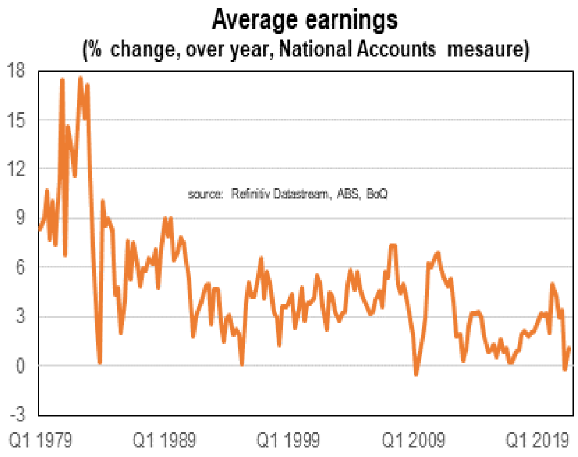

The message from the recent wages data is that wages growth is rising but is not yet strong. The extremely low underutilisation rate, strong economy and rising inflation all suggest that wages growth will almost certainly head higher this year. But the evidence to date is that the pickup in wages growth is more likely to be steady than rapid.

This means that while an interest rate change in June/July is still possible, the wages data released in February makes it less likely. This is consistent with financial market pricing that has (rightly) reduced the chances of a rate increase in June/July in the days following the wages numbers. More probable dates for the first rate change are either August (after the Q2 CPI figures) or September (after the Q2 wages numbers).

At this stage I am sticking to my view of the first rate hike will be in Q4. Waiting until Q4 will ensure that the unemployment rate is in the 3's, an important element to sure economic growth benefits the bulk of society. Waiting until Q4 will also ensure that wages growth is sustainably above 3%.

My view is not the consensus view. At the time of writing financial markets had priced in almost a one percentage point rate increase by the time I think the first rate move may take place. Maybe the financial markets view will turn out to be correct. But it will also require wages growth to be substantially stronger than what has been indicated from the recent evidence. Time will tell who is right.

We live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland

BOQ | Level 22 Chifley Towers Sydney NSW 2000

Twitter: @petermunckton

Email: peter.munckton@boq.com.au