ECONOMIC UPDATE

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WEEK ENDING 18TH FEBRUARY 2022

Key points

- **The Australian jobs market remains in a strong state;**
- **The January Omicron-driven weakness was concentrated in hours worked;**
- **All regions are benefitting from the strong labour market;**
- **Low immigration growth is a factor behind the very low unemployment rate. But so is the extremely strong demand for workers.**

Summary

The January labour market numbers were pretty much in line with expectations. Much of the weakness in the labour market reflected a big drop in the number of hours worked. The main reason for the large drop in hours worked was a big rise in the number of people taking leave. The big fall in hours worked means there is a high chance that the economy grew only modestly in Q1. But barring the arrival of another COVID wave over the next 8-10 weeks economic growth is on track to be very strong in the June quarter.

The RBA has been emphasising the importance of a very low unemployment rate for wider economic and social reasons. As at the end of last year the strong jobs market had resulted in some decline in long-term unemployment (although it remained high by historical standards). But with forecasts that the unemployment rate is likely to be in the '3's' by end-year 2022 and vacancies at a very high level further declines in long-term unemployment are virtually certain.

A very low unemployment rate is benefitting all regions across Australia. Over the past two years there has been an increase in the number of regions with very low unemployment rate and a reduction in the number of regions with a high unemployment rate.

There is an expectation that the strong jobs market will lead to rising wages growth. The RBA thinks that wages growth will be 3% by the end of 2023. Most financial market economists expect wages growth to hit that mark later this year. One argument about why the pickup of wages growth will be slower is how wages are set in Australia. The thinking is that multi-year enterprise bargaining agreements and current state government wage policies will make it difficult for aggregate wages growth to rise quickly. This needs to be offset by the rising anecdotal evidence from firms about rising labour costs.

The RBA noted that the unemployment rate reached 4% in NSW (and Victoria) pre-COVID without there being any significant rise in wages growth. But unlike last time the underutilisation rate has declined sharply in NSW (as it has elsewhere) and is now at its lowest level since the GFC.

It has been suggested that the sharp decline in the unemployment rate has reflected the lack of immigration. The history of movements in the unemployment rate and immigration if anything indicates the reverse relationship. Of course this time the driver of immigration flows was not economic (the unemployment rate) but government health policy. In that respect the current situation is closer to what happened during World War II, a time when both the unemployment rate and immigration growth was low.

The demand for workers currently is back near mining boom strength at a time of a slow increase in the supply of workers. The fall in the unemployment rate this time might have been slower if immigration was at pre-pandemic levels. But such is the current demand for workers a fall in the unemployment rate to a very low level would most likely still have taken place even if immigration was higher.

A strong labour market is unambiguously a good thing. It means that the economy is fulfilling its potential. Ensuring that most people who want a job can get one reduces income inequality in society. The key question though is how many jobs can be created without leading to other economic problems (particularly inflation). That is currently what we are finding out. The answer to that question is also the answer to when interest rates will begin to rise (and partly, how high interest rates will rise in this cycle).

The jobs market started this year as it ended the last - strong

The January labour market numbers were pretty much in line with financial market expectations. Jobs growth was a bit stronger than expected (+12,000) but was all part-time (full-time employment fell 17,000). Despite the arrival of the Omicron wave the unemployment rate was unchanged (at 4.2%). The unemployment rate of all the states is now under 4.5% (using a 3-month average). The underutilisation rate only ticked up a notch (10.9%). The underlying strength of the jobs market was highlighted by an uptick in the participation rate (monthly movements in the participation rate should be read with caution).

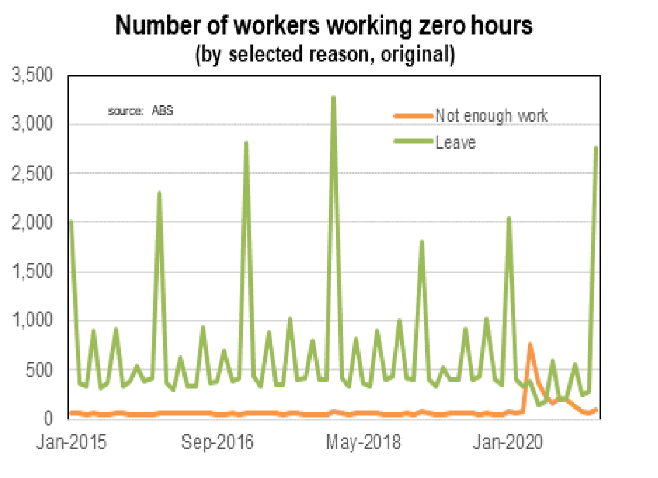
Also as expected much of the weakness in the labour market was reflected in a big drop in the number of hours worked in the month (down almost 9%, largely in NSW and Victoria). The concern was that the Omicron wave would result in workers being stood down as has happened during previous virus waves. According to the ABS this did not happen this time. Mainly that was because there was no substantial tightening of government regulations that reduced economic activity (apart from some areas of hospitality).

According to the ABS the main reason for the large drop in hours worked was a big rise in the number of people taking leave. Of course lots of people take holidays in January. But the number taking holidays this time was the second highest over the past eight years. The opening up of borders meant that people were able to travel inter-state to see families. The lockdowns of 2020-21 meant that there were plenty of people wanting to take advantage of getting out of the house.

The big fall in the number of hours worked in January means there is a high chance that the economy grew only modestly in Q1. But barring the arrival of another COVID wave over the next 8-10 weeks economic growth is on track to be very strong in the June quarter.

Job vacancies are at a high level.

Plenty of workers took leave in January.



A rising tide from a strong jobs market lifts all boats

A lot of the recent discussion about the state of the jobs market has been about it is an indicator of the strength of the economy, the impact of worker shortages for many firms or what a low unemployment rate might mean for wages growth (and therefore inflation and interest rates).

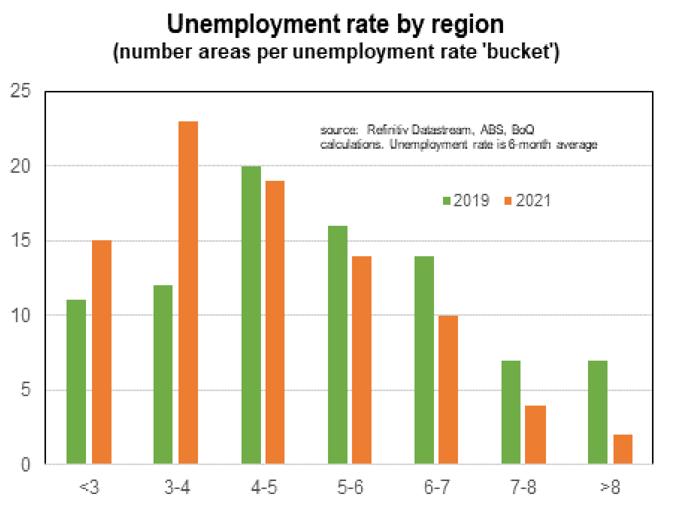
But the RBA has been emphasising the importance of a very low unemployment rate for wider economic and social reasons. Getting a job provides a substantial boost to incomes (and therefore the ability to spend). Reducing unemployment reduces income inequality. Employment provides a greater ability to borrow, potentially boosting wealth. Having a job is also one of the most effective ways of getting a job.

A strong labour market is also the best way to reduce long-term unemployment. Long-term unemployment (those unemployed for at least one year) is a problem because the longer you don't have a job the less likely you are to get one. The long-term unemployed are less likely to have contacts within the jobs market. And the longer someone is unemployed the greater the deterioration in their skills.

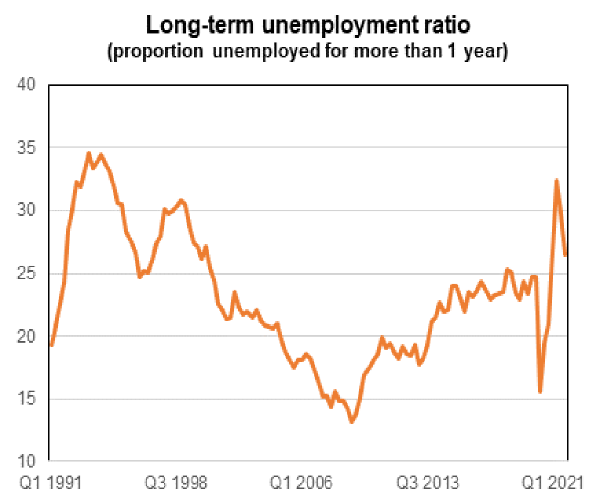
As at the end of last year the strong jobs market had resulted in some decline in long-term unemployment (although it remained high by historical standards). But the forecasts are that the unemployment rate is likely to be in the '3's' by end-year 2022 and vacancies are at a very high level. Further declines in long-term unemployment are virtually certain.

A very low unemployment rate is benefitting all regions across Australia. Over the past two years there has been an increase in the number of regions with very low unemployment rate (less than 4% measured on a 6-month average basis). And a reduction in the number of regions with a high unemployment rate (more than 6%). As at the end of 2021, there were only two regions with an unemployment rate of above 8% (both in Queensland).

The unemployment rate is declining across all regions.



A strong jobs market also means less long-term unemployed.



The unemployment rate and wages growth

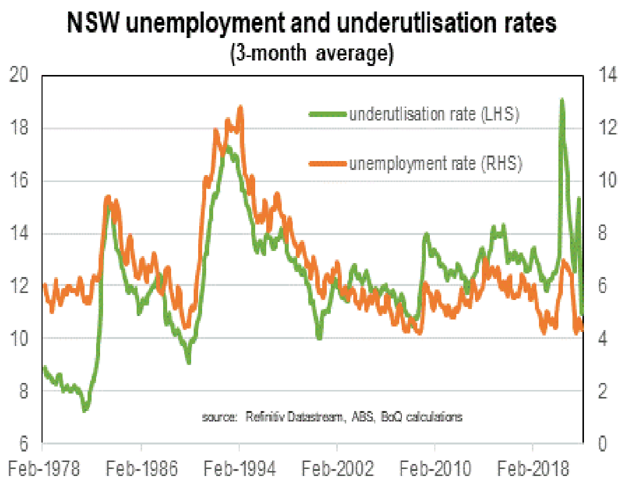
There is an expectation that the strong jobs market will lead to rising wages growth. The RBA thinks that wages growth will be 3% by the end of 2023. Most financial market economists expect wages growth to hit that mark later this year. Surveys suggest that household and businesses think that wages growth will be lower than financial market views. The answer to this question will determine how quickly interest rates rise (or even if they do!).

One argument about why the pickup of wages growth will be slower is how wages are set in Australia. The thinking is that multi-year enterprise bargaining agreements and current state government wage policies will make it difficult for aggregate wages growth to rise quickly. This needs to be offset by the rising anecdotal evidence from firms about rising labour costs.

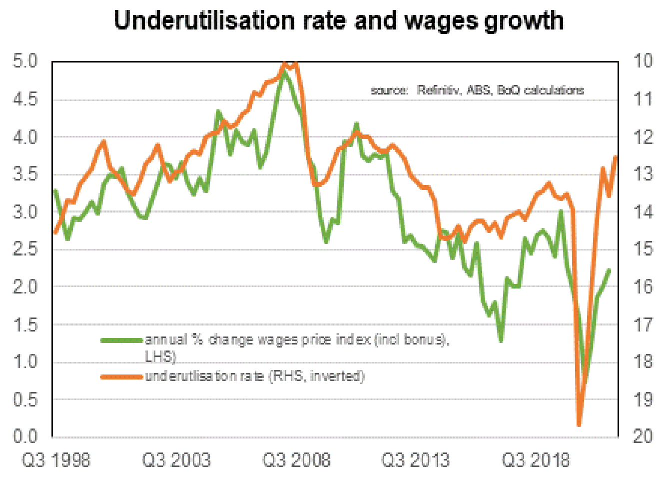
There is also the uncertainty as to how low the unemployment rate needs to fall before wages growth notably picks up. The RBA noted that the unemployment rate reached 4% in NSW (and Victoria) pre-COVID without there being any significant rise in wages growth.

But the underutilisation rate is a better measure of the state of the labour market (it includes both unemployment and underemployment) and therefore what influences wages growth. Pre-COVID the underutilisation rate was still elevated in NSW, a key reason why wages growth remained modest. But this time the underutilisation rate has declined sharply in NSW (as it has elsewhere) and is now at its lowest level since the GFC. The participation rate in NSW is also at a high level (although it was higher in the first half of last year). All of this increases the chances of rising wages growth.

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



The underutilisation rate has a strong influence on wages growth.



Immigration and unemployment

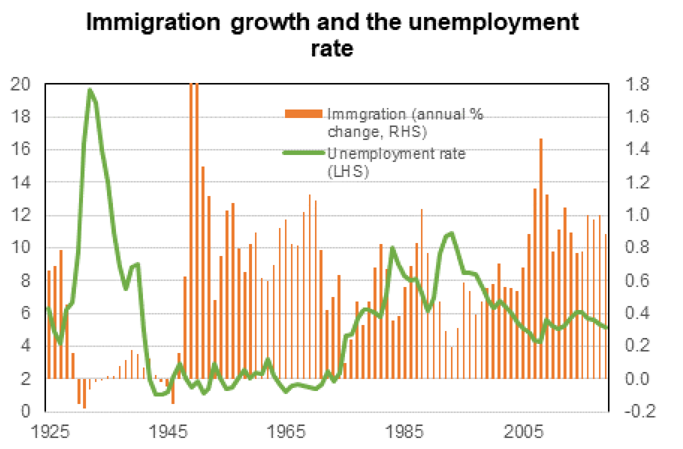
It has been suggested that the sharp decline in the unemployment rate has reflected the lack of immigration (reducing the supply of workers). The history of movements in the unemployment rate and immigration if anything indicates the reverse relationship. The periods when immigration growth was very strong (1950-60's, 2000's) were also periods when the unemployment rate was relatively low. Periods when the unemployment rate was high (the 1930's, 1980-90's) were periods when immigration was relatively low. So typically a low unemployment rate attracts a high rate of immigration (and vice versa).

Of course this time the driver of immigration flows was not economic (the unemployment rate) but government health policy. In that respect the current situation is closer to what happened during World War II, a time when both the unemployment rate and immigration growth was low.

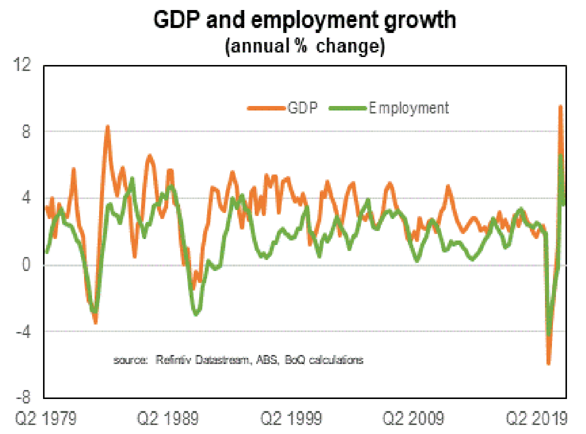
The decade prior to COVID was unusual as the unemployment rate was too high (5-6%) at a time of strong immigration growth. But it also was a time of a rising participation rate (despite low wages growth not providing an incentive to enter the labour force) and decent demand for labour (employment growth was pretty strong). But that was also a period when the Australian economy was turning in a sub-par performance, suffering from the end of the mining boom and a period of weak productivity growth. So maybe the unemployment rate could have been lower if immigration growth was slower. But it also could have been lower if economic growth was stronger.

Which brings us to the current period. The demand for workers is back near mining boom strength (the last time the unemployment rate was in the low '4's') at a time of a slow increase in the supply of workers (due to extremely low immigration). The fall in the unemployment rate this time might have been slower if immigration was at pre-pandemic levels (although higher immigration would have also created stronger economic activity and therefore more demand for workers). But such is the current demand for workers a fall in the unemployment rate to a very low level would most likely still have taken place even if immigration was higher (particularly given the already high rate of labour force participation).

Typically high immigration takes place during periods of a low unemployment rate.



Jobs growth was pretty strong pre-COVID but economic growth was only modest.



A strong labour market is unambiguously a good thing. It means that the economy is fulfilling its potential. Ensuring that most people who want a job can get one reduces income inequality in society. The key question though is how many jobs can be created without leading to other economic problems (particularly inflation). That is currently what we are finding out. The answer to that question is also the answer to when interest rates will begin to rise (and partly, how high interest rates will rise in this cycle).

We live in interesting times.

Regards

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