24 February 2023

ECONOMIC UPDATE

The Wage Debate

Key Points

- **Wages growth is picking up;**
- **But not as quickly as the financial markets or the RBA had forecast;**
- **This should increase confidence that inflation will not get out of hand;**
- **But there will be at least another two quarter percentage point rate hikes on the way.**

Everyone is interested in what is happening to wages

For financial markets and economists understanding the size of wage rises matters. Wages is the major source of income for most households. So the higher wages growth the more money consumers have to spend. Wages growth is also the largest cost for many firms. Any rise in labour costs must either be absorbed by business or passed onto customers.

On both counts, movements in wages growth can have a significant influence on inflation. The difficulty is that movements of inflation can also influence wages growth. Workers would like compensation for price movements. Further, periods of rising inflation typically signal that demand in the economy is rising more strongly than supply. Typically, this demand-supply imbalance will not only impact the market for goods and services but also the jobs market. So the factors that lead to higher inflation also can drive higher wages growth.

So movements in wages growth can have significant macroeconomic implications. And for this reason they are one of the most watched pieces of economic data, particularly during periods of rising inflation. This was particularly the case with the Q4 Wages Price Index (or WPI, the best measurement of wage movements) given the RBA has become more concerned about the inflation outlook.

The outcome was that wages growth is rising but not at the rate that the RBA and financial markets had been anticipating. The quarterly growth rate of 0.8% is only modestly stronger than it was at the end of 2021. The annual wages growth rate of 3.4% is consistent with a return of inflation of 2-3%. One reason that wages growth has not been stronger has been the lid being kept on public-sector salaries. But wages growth in the private sector still only rose by 3.6% over the year to December 2022 (and 0.9% in the quarter). And wages growth was above 4% in only two sectors in 2022 (wholesale trade and manufacturing).

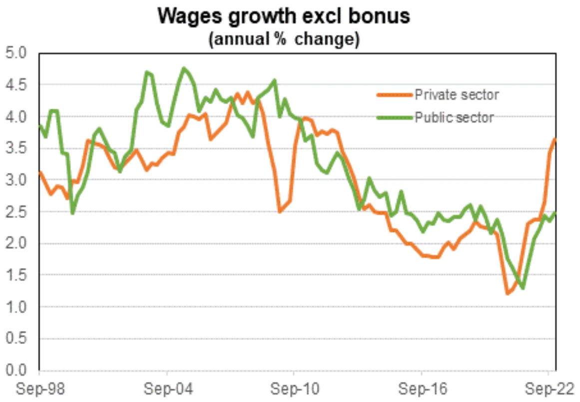
The best guess is that wages growth will head higher. Partly because stronger wage rises are likely in the public sector. It is in recognition that the jobs market will remain tight for this year and inflation will still be relatively high. It is also because movements in wages growth lag developments in the jobs market that in turn lag changes in the wider economy.

Nonetheless, the lack of workers has been the biggest problem facing firms' since the end of 2021. But wages growth in 2022 was only 3.6%. Why the WPI data was less than what had been suggested from non-ABS indicators (such as the Seek Wage data) is unclear. Perhaps it was because the other data included bonuses. But the WPI growth including bonuses was still only 3.8%. Maybe it is because the other data is biased towards larger firms that have the potential to pay higher salaries. It is notable that the wage growth expectations of full-time workers has remained moderate despite the strength of the jobs market.

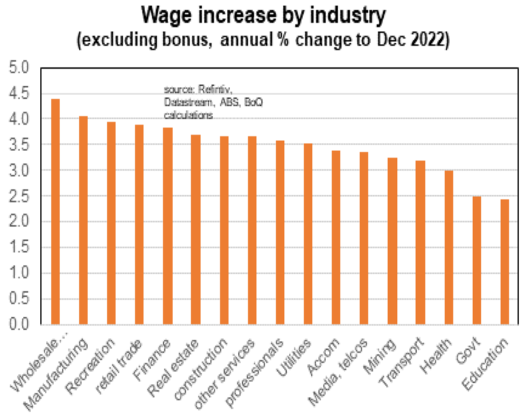
To me it does not look like we have the conditions for a wage breakout. Profit margins are up but that largely reflects the high commodity prices earned by mining (and related) firms. Strong demand has enabled firms to pass on higher prices. But there are growing signs that demand will be slowing over the course of this year (particularly consumer spending).

All of the RBA talk over the first couple of weeks of February indicates that there are at least two more quarter percentage point rate hikes on the way in coming months. My view is that should be more than enough to keep inflation in check. The coming months will determine whether that is also the view of the RBA.

Wages growth is picking up albeit not as fast as expected.

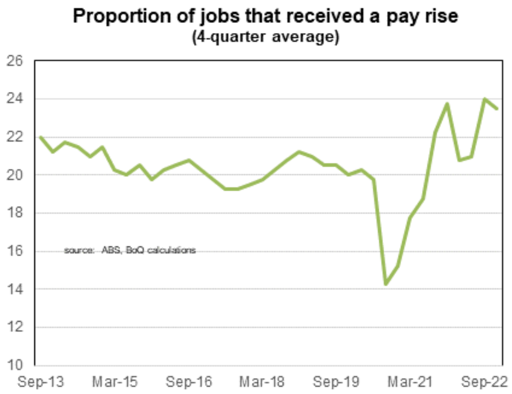


Wages growth is between 3-4% in most sectors.

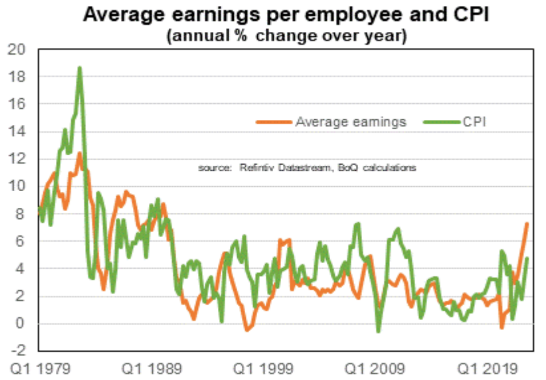


Worker expectations for wage rises have not picked up substantially.

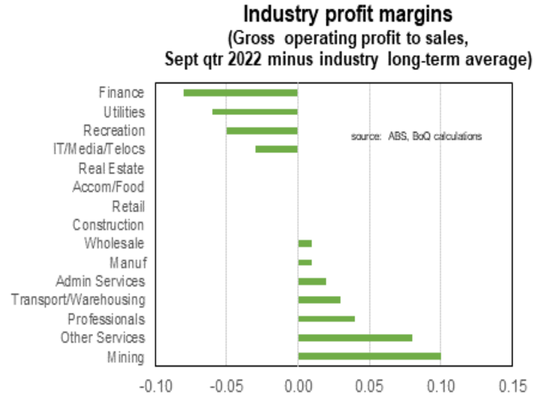
More jobs than usual received pay rises although it is about the same proportion as last year.



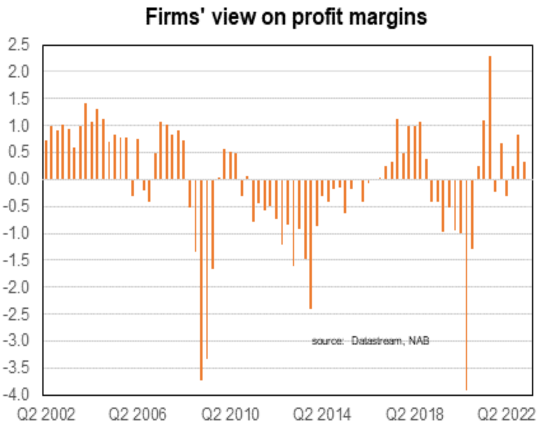
Sometimes wages growth leads and other times it lags movements in the inflation rate.



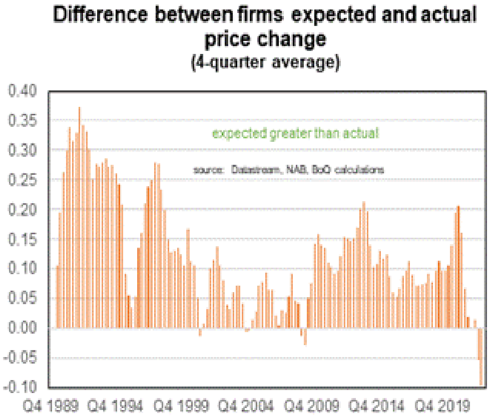
Outside of mining (and other services) profit margins in most sectors are not unusually wide.



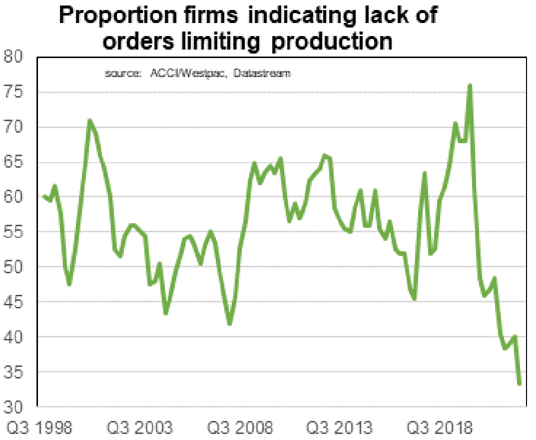
This is consistent with feedback from firms' that profit margins are only a little above average.



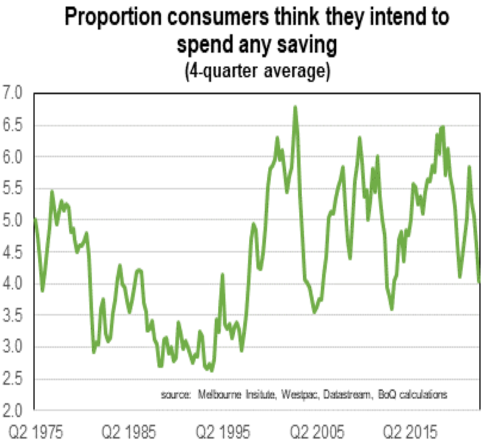
Firms have been surprised about how much they have been able to raise prices.



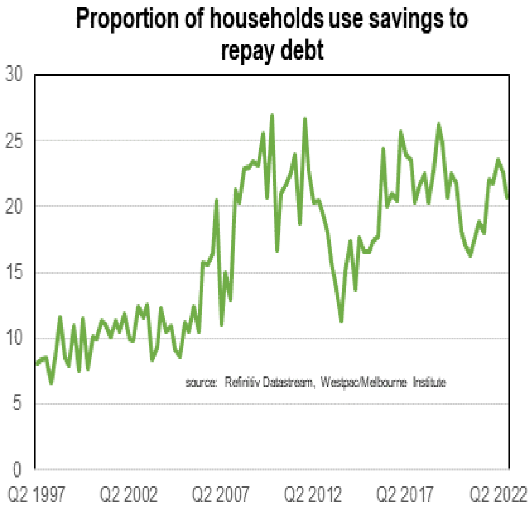
The high level of demand has allowed firms to pass on increased prices.



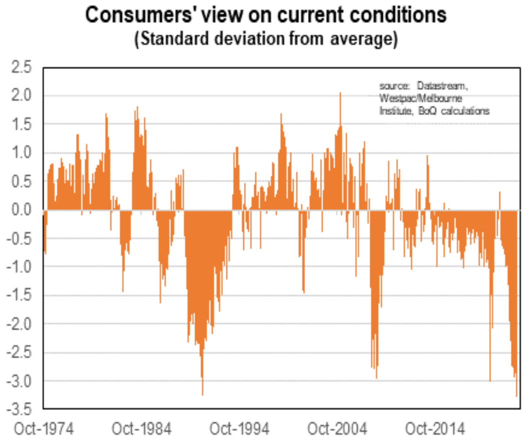
In time this will end as consumers are becoming less keen to spend.



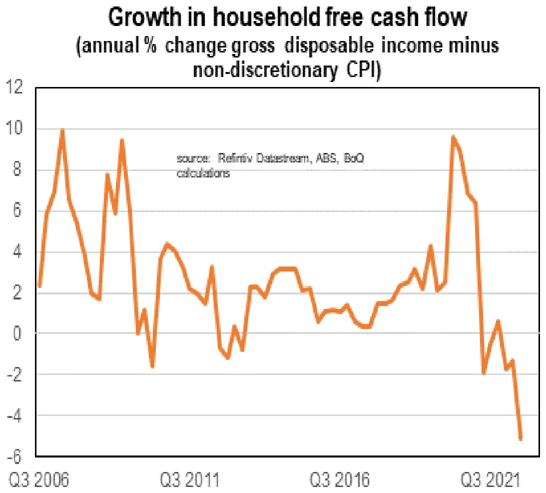
And remain keen to pay down debt.



High wages growth in the 1970s occurred when consumers thought conditions were good. That is currently not the case.

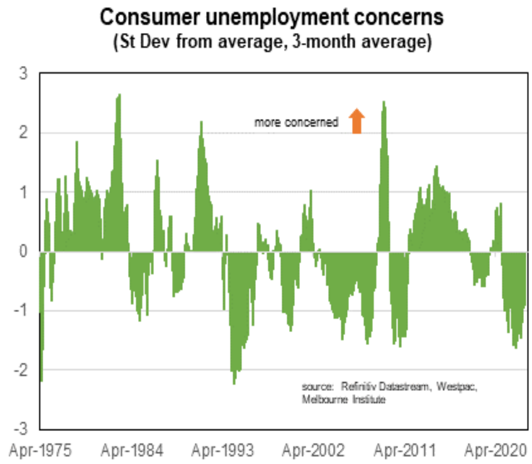


A key reason for consumer pessimism is the sharp decline in their available cash flow.



Households views about inflation have declined (although remain high).

They remain confident about the jobs market (albeit less so than in mid-2022).



The US labour market is a different beast to Australia.

We live in interesting times.
Regards

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