20 April 2017

HSBC Global Research

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- The RBA's next move largely depends on the outlook for wages
- Measurement issues and the changing relationship between the labour market and wages are complicating the outlook
- We expect the rise in commodity prices and national incomes to support a modest rise in wages growth

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It's all about wages

For an inflation-targeting central bank, wages growth matters. Indeed, the two key empirical models that the RBA uses for forecasting inflation both have wages and the labour market as key inputs. The first is a 'Phillips' curve' model, which suggests that as the unemployment rate falls, and spare capacity in the labour market is reduced, wages and inflation rise, as workers are able to demand greater pay. Second is the 'mark-up' model which suggests that prices are set as a mark-up over costs. In this model, unit labour costs (productivity-adjusted wages growth) are a key input.

However, structural change in the labour market and measurement issues are making these relationships more complicated. In particular, the measures of wages growth, which are at their lowest levels in multiple decades, are much lower than the historical relationship with the unemployment rate would imply.

There are many possible explanations. It could reflect underemployment, with the broader measures of spare capacity less positive than the headline unemployment rate. This could reflect a shift to more part-time jobs, reducing the bargaining power of workers. It could be the result of technology, globalisation and structural factors, which are making it harder for workers to demand wage rises. Another factor may be that the very large cycle in commodity prices and national income in recent years has affected wage settings. Importantly, measurement issues in the official labour market statistics have been further complicating any assessment. Job vacancy, job advertisements and business surveys all show stronger labour market conditions than the official statistics.

We see the RBA as unlikely to cut interest rates any further, given concerns about the housing price and credit boom in Sydney and Melbourne. With no cuts likely, the key question is: When might the RBA start to lift the cash rate? For this to happen we believe the central bank would need to be convinced that wages growth is picking up. There is considerable uncertainty about when this will happen. However, our view is that the recent lift in commodity prices, and the boost it has delivered to national income, should deliver some support for wages growth. History shows a strong positive correlation between Australia's wages growth and commodity prices.

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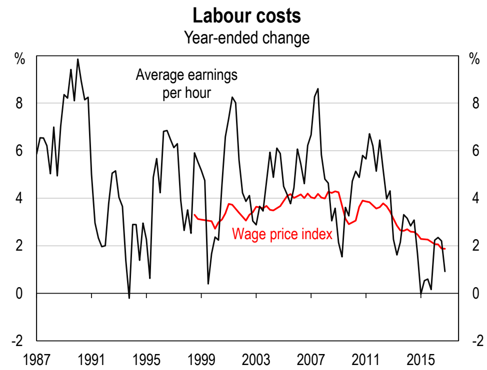
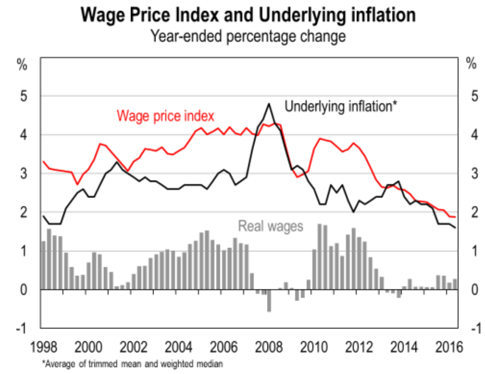
1. Wages growth is weak on all measures



Source: ABS

2. Core inflation is below the 2-3% target



Source: ABS, HSBC estimates

Wages growth and underlying inflation are low

All measures show that wages growth is sluggish

All of the available measures of wages growth have slowed in recent years, with the key ones suggesting that pay is growing at its slowest pace in multiple decades. The wage price index and average earnings in the national accounts measures are both showing sluggish growth (Chart 1). The wage price index is growing only a little faster than underlying inflation, leaving real wages growth weak (Chart 2).

Without a pick-up in real wages growth to support consumer demand, it is hard to see domestic inflation picking up. As underlying inflation is below the RBA's 2-3% target band, running at around 1.5% y-o-y, judging whether and when the central bank might decide to lift its cash rate is very much about determining when wages growth will pick up, or if it could slow further.

The relationship with unemployment is changing

The Phillip's curve relationship is changing

What makes the outlook complicated is that the relationship between wages growth and the labour market appears to have changed. In the past, a closing of the gap between the unemployment rate and the estimate of full employment (currently around 5-5.25%) of the magnitude seen recently, has typically seen a pick-up in wages growth (Chart 3). On this occasion, wages growth has continued to fall, despite the tightening of the labour market.

This historical relationship suggests that a fall in the unemployment rate typically drives higher wages growth (and, in turn, inflation). As Chart 4 shows, wages growth has been unusually low in the past three years, given the level of the unemployment rate.

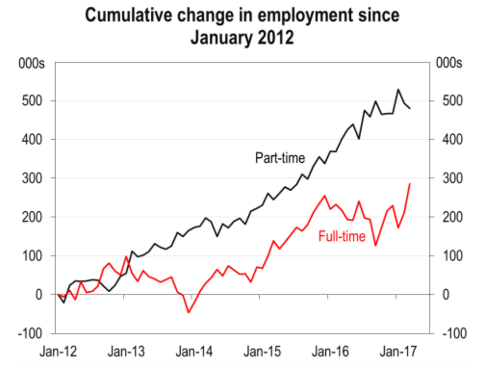
3. Labour market relationship is changing

Source: ABS, RBA

4. Wage growth surprisingly low

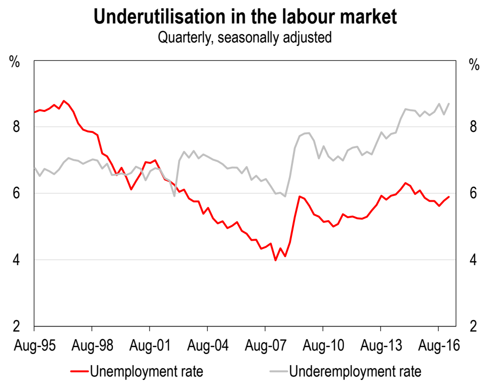
Source: ABS, HSBC estimates

5. Jobs growth has been mostly part-time



Source: ABS

6. Underemployment is still high



Source: ABS

Structural, cyclical or measurement problems?

More part-time and less full-time jobs could be reducing bargaining power

The apparent disconnect between labour market developments and wages growth could reflect a range of possible factors and there is considerable uncertainty about which is playing the largest role.

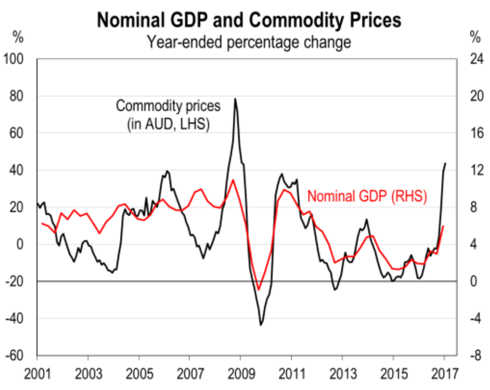
First, it could be structural. One of the clear trends to emerge over the past couple of years has been strong growth in part-time employment and weak growth in full-time jobs (Chart 5). This has meant that, while more people are finding jobs and the unemployment rate remains below the peak seen in late 2014, some of those people want to work longer hours and the underemployment rate remains elevated (Chart 6). In short, the unemployment rate is overstating the degree of tightness in the labour market, which may explain why wage growth has slowed, rather than picked up.

Commodity price-driven national income cycle is important

Second, it could be cyclical. In Australia's case, recent nominal growth in the economy has been mostly driven by the very large cycle in commodity prices in recent years. Although Australia's exports do not make up a significantly larger proportion of GDP than in other developed economies, Australia's exports do experience more significant price swings, which drives significant movements in nominal growth (Chart 7). Historically, these swings in commodity prices and the terms of trade have had an impact on wage growth, and may explain part of the recent weakness in wages.

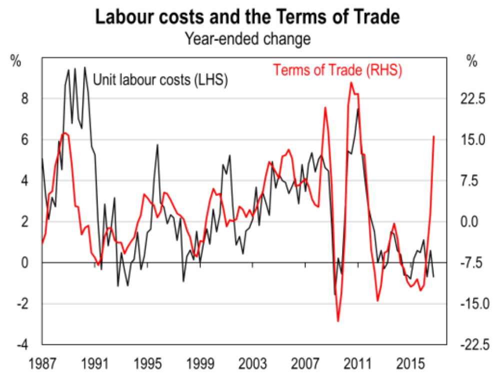
Third, there are considerable measurement issues in the official labour force numbers at present, which makes it more difficult to assess trends, particularly on a timely basis. In

7. Higher commodity prices lift incomes



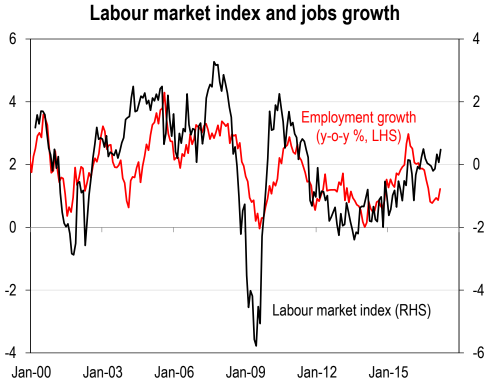
Source: ABS, RBA

8. Commodity prices correlate with wages



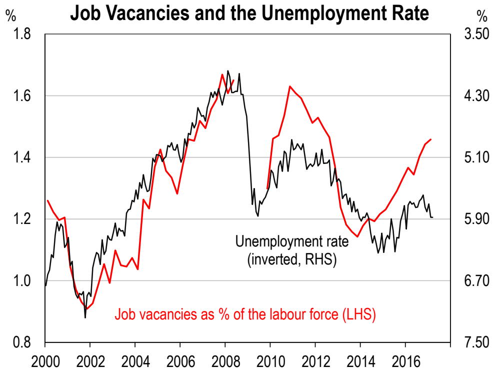
Source: ABS, HSBC estimates

9. Official measures out of line with others



Source: ABS, HSBC estimates

10. Official survey is the odd one out



Source: ABS

particular, the seasonal pattern in employment has changed substantially over the past couple of years (possibly due to survey changes implemented by the Bureau of Statistics in 2014). This has rendered the monthly seasonally-adjusted change in employment largely meaningless.

Measurement issues complicate the analysis

The annual rate of employment growth should be more reliable, as one does not have to use any seasonal adjustment. However, even here there have been some puzzling trends, with jobs growth looking unusually strong over 2015 – touching 3% y-o-y – before falling back to below 1% more recently (Chart 9). This seems at odds with other labour market indicators (such as job advertisements and the business and consumer sentiment surveys), which we collect into an index and have shown a steadier, gradual improvement. The recent rise in the unemployment rate has also been out of line with the continued lift in surveyed job vacancies (Chart 10).

State and industry developments shed a little light, but not a lot

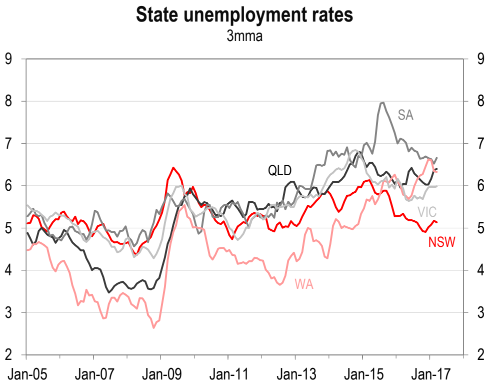
Clearly, the national trends in the labour market are challenging to interpret. In an effort to better understand them, we can also look at trends across states and industries.

Net migration has helped counter differences in state-level labour demand

The first thing that stands out is that, regardless of how state labour markets have performed, they have all experienced a noticeable slowdown in wages growth. In particular, the large non-mining states, New South Wales and Victoria, have had quite healthy labour markets with fairly low unemployment and record levels of job vacancies but have still seen wages growth slow significantly (Charts 11, 12 and 13).

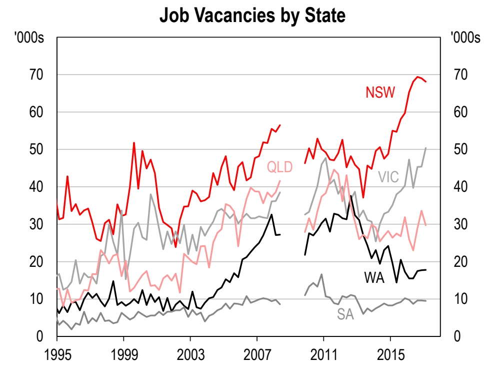
Of course, labour is highly mobile in Australia and so wages in one state can be influenced by what is happening elsewhere. The end of the mining boom has seen a fall in inter-state

11. Tighter labour markets in NSW/Victoria



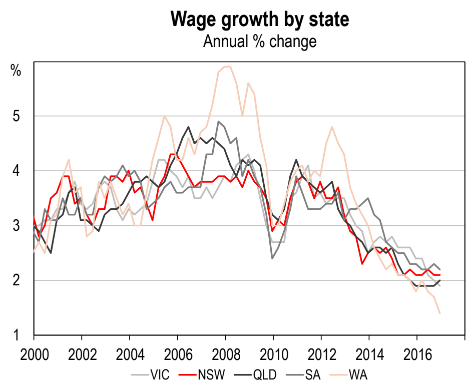
Source: ABS

12. NSW/Victoria have higher vacancies too



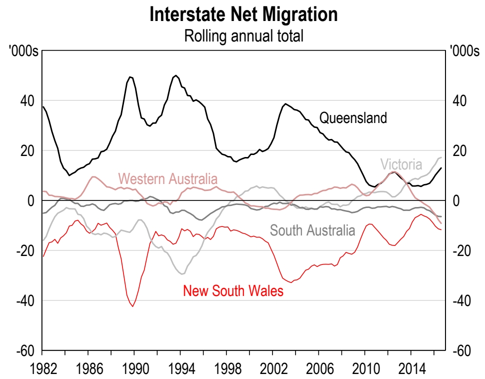
Source: ABS

13. Wages growth has slowed everywhere



Source: ABS

14. Net migration to Victoria in particular



Source: ABS

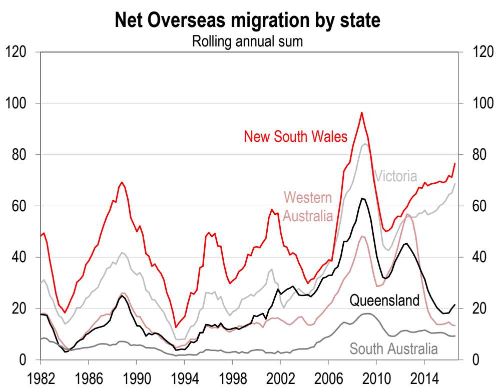
migration to Western Australia, with an offsetting rise in inward migration to Victoria (Chart 14). New South Wales and Victoria have also been the main recipients of international migrants in the past couple of years (Chart 15). In short, solid growth in labour demand appears to have been adequately met by labour supply, due to inward migration, in the two large non-mining states, which has helped to keep wages growth suppressed.

State-level data can also shed some light on another interesting recent labour market trend: the strong pick-up in full-time employment in 2015 and the subsequent slowdown seen since then. It appears that this phenomenon has almost entirely been driven by New South Wales – and, moreover, within just a handful of industries within New South Wales. However, when labour force numbers are broken down so far, the sample sizes involved become very small and so the results need to be treated with scepticism. That suggests the national trends that these numbers are driving also need to be questioned.

Industry divergence helps explain some of the slowdown in wages growth

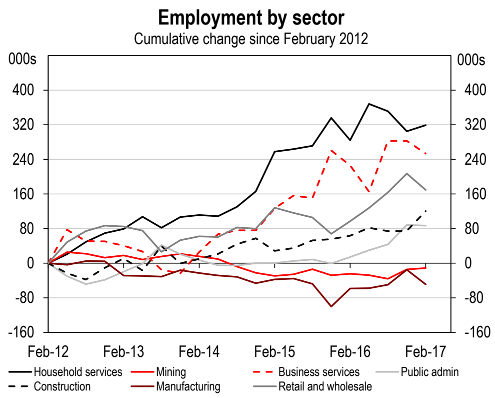
Industry-level numbers also show that much of the job creation in recent years has been in the services sectors, led by healthcare and household services, while many of the job losses have been the in the mining industry. This shift from higher paid mining jobs to lower paid services jobs has contributed to an overall slowdown in wages growth. However, the compositional shift cannot fully explain the slowdown as wages growth appears to have slowed in all of the industries.

15. NSW/Victoria have high offshore migration



Source: ABS

16. High-pay jobs lost; low-pay jobs gained



Source: ABS

How the RBA is reading all of this

The labour market has become an increasing focus for the RBA recently. We see this as largely a result of the fact that the official unemployment rate has risen in recent months.

The RBA is highly uncertain about the wages outlook too

Like us, the RBA has been noting that the other measures of labour market conditions have been stronger than the official labour force statistics. In the recent board minutes, the RBA noted that 'although forward-looking indicators of labour demand continued to suggest an increase in employment growth over the period ahead, this had been true for some time without leading to an improvement in labour market conditions' (18 April 2017). A key question is whether the other indicators will weaken or the official labour market numbers will strengthen, to close the gap. Our view is that the multiple surveys involved in the other measures are providing a clearer reading than the official labour force survey, which has been suffering from small sample issues, amongst other problems.

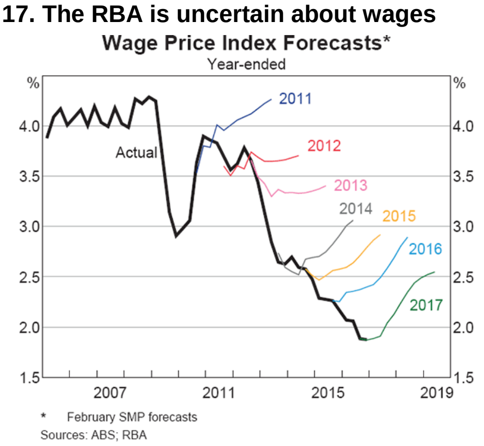
However, even if the labour market is a bit tighter than the official labour market numbers suggest, the weak wages growth is hard to explain. A recent RBA Bulletin article suggested that the relationship between wages growth and the labour market had changed but made it clear that the central bank is uncertain as to why (see Bishop, J., and Cassidy, T. (2017) 'Insights into low wage growth in Australia', RBA Bulletin, 16 March). The RBA Bulletin article also included a chart of the RBA's own forecasts for wages growth (Chart 17 below), which suggests that the central bank has had considerable difficulty forecasting wages growth recently.

As we have discussed above, our preferred explanation for the low wages growth has been the long and drawn out cycle in commodity prices (a point we have been making for some time now, see *Australia's low inflation: It's part of the rebalancing act*, 13 July 2016). A look at the RBA's own forecasts for the terms of trade, which is driven by commodity prices, may help to explain why the wages forecasts have differed so significantly from the outcomes (Chart 18 shows the RBA's own forecasts of the terms of trade, as at November 2015). We expect the recent lift in commodity prices and national income to support a modest pick-up in wages growth.

Wages growth needs to rise before the RBA would consider lifting the cash rate

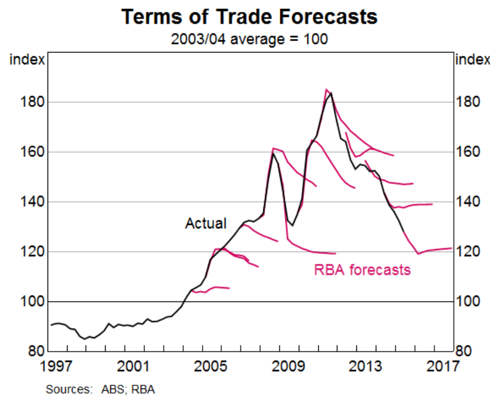
We remain of the view that the RBA has no appetite to cut its cash rate further, largely because further cuts would boost the already booming Sydney and Melbourne housing markets (see *The RBA Observer: On hold, with no appetite for further easing*, 3 March 2017). However, wages growth needs to rise before the central bank would consider lifting the cash rate, as faster wages growth is needed to lift underlying inflation. Although there is considerable uncertainty about the outlook for wages growth, we see the balance of risks as tilted to the upside and expect a modest lift in wages growth in H2 2017, with the RBA lifting its cash rate in 2018.

17. The RBA is uncertain about wages



Source: RBA (16 March 2017)

18. Commodity prices have also surprised



Source: RBA (20 November 2015)

Table 19. HSBC's forecasts for Australia and New Zealand

	Year-average			Year-ended						
	2016e	2017e	2018e	Q416	Q117e	Q217e	Q317e	Q417e	Q118e	Q218e
%*										
AUSTRALIA										
GDP	2.5	2.8	3.2	2.4	2.2	2.2	3.6	3.3	3.2	3.2
Consumption	2.7	2.6	2.8	2.6	2.5	2.6	2.8	2.5	2.5	2.6
Public consumption	3.9	1.9	2.0	3.2	2.7	1.2	1.5	2.0	2.0	2.0
Investment	-2.4	3.0	3.0	0.1	1.3	1.6	5.5	3.9	4.1	3.5
- Dwelling	7.9	5.1	-3.0	5.6	3.8	3.9	6.7	5.8	2.6	-1.8
- Business	-8.8	-1.6	3.4	-5.5	-4.1	-3.2	0.7	0.1	1.8	3.5
- Public	7.7	15.5	9.9	12.5	16.6	14.0	18.9	12.7	13.0	10.6
Final domestic demand	1.6	2.6	2.7	2.1	2.1	2.0	3.2	2.8	2.8	2.7
Domestic demand	1.7	2.5	2.7	2.2	2.4	2.0	3.1	2.8	2.8	2.7
Exports	7.6	8.7	9.0	8.9	8.2	8.0	9.3	9.3	8.9	9.1
Imports	0.4	6.8	6.9	3.3	7.3	6.1	6.8	7.2	7.2	7.0
GDP (% quarter)	--	--	--	1.1	0.9	0.7	0.8	0.8	0.8	0.7
CPI	1.3	2.3	2.6	1.5	2.2	2.4	2.3	2.3	2.5	2.5
Trimmed mean	1.7	1.8	2.2	1.6	1.7	1.7	1.9	1.9	2.1	2.1
Unemployment rate	5.7	5.6	5.3	5.7	5.7	5.6	5.5	5.4	5.3	5.3
Labour price index	2.0	2.1	2.8	1.9	1.9	2.0	2.2	2.4	2.6	2.7
Current A/C (%GDP)	-2.6	-0.6	-0.5	-0.9	0.0	-0.8	-1.1	-0.6	-0.5	-0.6
Terms of trade	-0.4	6.3	-2.8	15.6	19.1	11.6	2.6	-5.9	-7.4	-3.3
Budget balance (%GDP)	-2.4	-2.2	-1.4							
Capital city house prices	4.9	4.3	1.7	5.4	6.2	4.8	3.8	2.4	2.3	2.0
Private sector credit	6.1	5.3	4.1	5.7	5.7	5.6	5.3	4.6	4.1	4.1
USD/AUD (end period)	0.72	0.75	0.75	0.72	0.75	0.72	0.75	0.75	0.75	0.75
Cash rate (end period)	1.50	1.50	2.00	1.50	1.50	1.50	1.50	1.50	1.75	1.75
%*										
NEW ZEALAND										
GDP	3.1	3.2	3.3	2.7	2.8	3.1	3.2	3.6	3.5	3.3
Consumption	4.2	3.5	3.2	4.3	4.7	3.4	2.8	3.2	3.2	3.2
Govt consumption	2.3	3.8	3.4	3.6	3.4	4.2	3.9	3.8	3.5	3.4
Investment	5.7	4.7	4.4	6.9	5.3	4.5	4.3	4.7	4.8	4.3
Final domestic demand	4.2	3.9	3.6	4.8	4.6	3.8	3.4	3.7	3.7	3.5
Domestic demand	4.4	4.2	3.5	5.8	4.5	5.0	4.4	2.8	3.6	3.5
Exports	1.6	2.2	3.3	-2.1	1.9	-0.6	1.3	6.2	3.4	3.2
Imports	4.0	5.0	4.0	7.4	7.2	5.2	4.3	3.3	3.9	3.9
GDP (% quarter sa)	na	na	na	0.4	0.9	1.0	0.9	0.8	0.8	0.8
CPI	0.6	1.9	1.9	1.3	2.1	1.9	1.9	1.6	1.5	1.8
Unemployment rate	5.1	5.2	4.9	5.2	5.2	5.3	5.2	5.1	5.1	5.0
Labour price index	1.7	1.9	2.2	1.6	1.7	1.8	2.0	2.0	2.1	2.1
Current A/C (%GDP)	-2.7	-1.1	-1.4	-2.4	-1.2	-0.9	-1.1	-1.1	-1.2	-1.4
Budget balance (%GDP)	0.7	0.7	1.2							
NZD/USD (end period)	0.69	0.70	0.70	0.70	0.67	0.70	0.70	0.70	0.70	0.70
Cash rate (end period)	1.75	1.75	2.25	1.75	1.75	1.75	1.75	1.75	2.00	2.00

Source: ABS, RBA, HSBC forecasts. *unless otherwise specified.

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