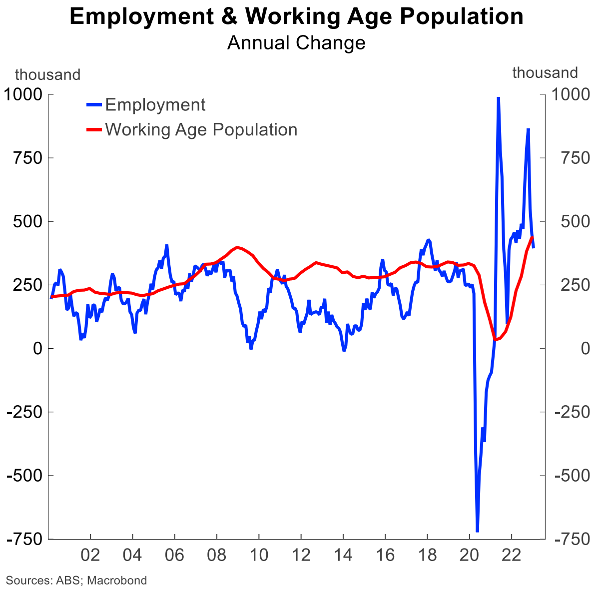
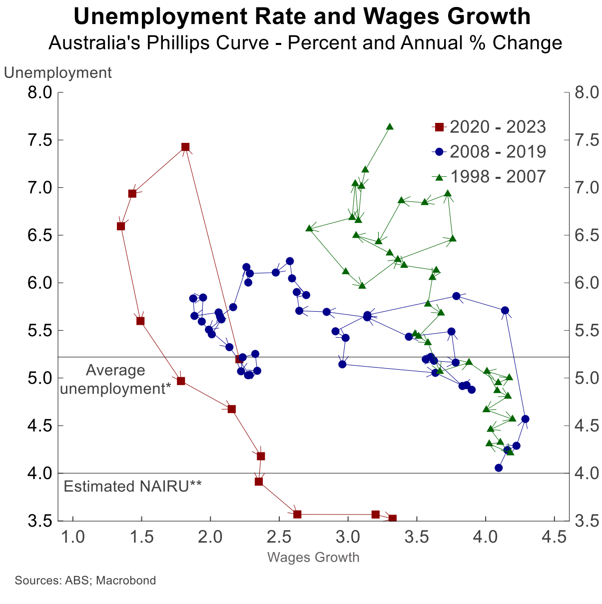
Thursday, 16 March 2023

Labour Market Insights

Jobs Could Give the Green Light For A Pause

- **The financial stress caused by the collapse of Silicon Valley Bank (SVB) could provide the Reserve Bank (RBA) with a trigger to pause in April. The labour force outcome is another factor that may provide the RBA the reassurance to feel comfortable with a pause. Depending on data outcomes, this could mean we have already seen the last hike this cycle.**
- **We expect a solid employment outcome in February of 50k. However, the underlying trend is likely to continue to show an easing in conditions. Record growth in labour supply combined with an easing in labour demand will likely see key indicators of labour market tightness, such as the share of the population in work, continue to soften.**
- **The growth in labour supply was initially driven by an increase in the number of females, and young and older Australian in jobs. Now that international boarders have reopened, the return of migrants is providing an influx of labour which is helping to fill worker shortages.**
- **We expect net overseas migration to be at least 335k in 2022-23, 100k higher than the official Budget estimate of 235k. This could see the share of the population in work ease by up to 0.5 percentage points and services inflation 0.2 percentage points lower than otherwise.**
- **These are unique features of the Australian economy. In other comparable economies such as the US and UK, strong labour demand has pushed up against inelastic labour supply - causing wages growth and services inflation to accelerate to unsustainable levels.**
- **In Australia, the labour supply response, coupled, with the inertia in our wage fixing system, has meant that wages growth continues to be sustainable. It also helps explain why historically low unemployment rates have been unable to generate a strong wage response - a stark change from the experience over the past few decades.**





In his speech following the Reserve Bank's (RBA) March Board meeting, the Governor indicated that a pause would likely be on the cards in April if the upcoming labour force, monthly inflation, retail spending, and business survey data did not surprise on the upside.

The Governor also made a subtle change to his guidance on how much longer the hiking cycle may have to run. In our view, the language around the need for further hikes was softened in a significant manner, with the Governor stating: "Our judgement, though, remains that further tightening of monetary policy **is likely** to be required to bring inflation back." This compares to the more definite guidance provided the day before in the RBA Board's policy statement: "The Board expects that further tightening of monetary policy **will be needed** to ensure that inflation returns to target."

This subtle change in guidance, the financial stress caused by the collapse of SVB and the way the Australian economy and labour market is evolving could possibly mean we have seen the last rate hike this cycle.

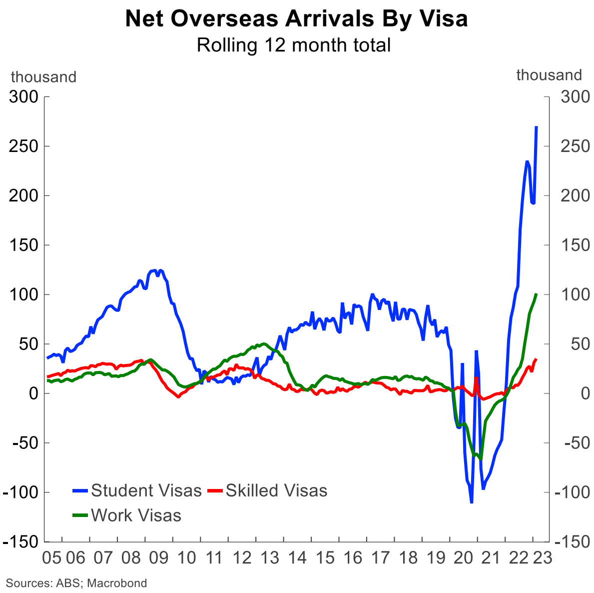
Will the labour market outcome surprise on the upside?

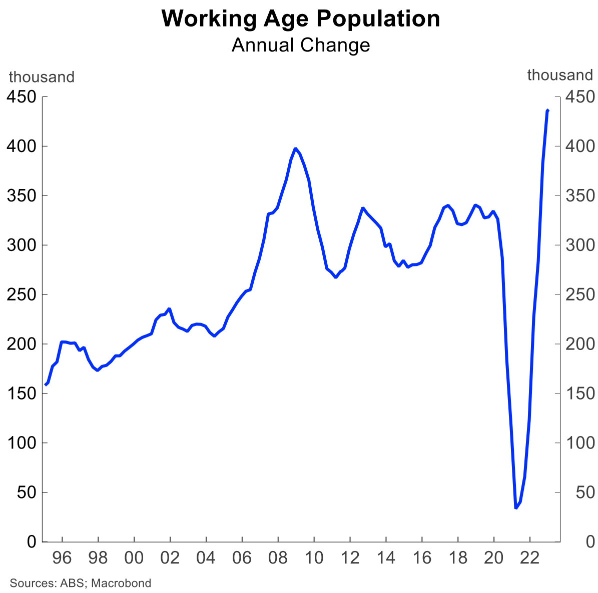
We are expecting the number of jobs created in February to be solid at around 50k jobs. The RBA is also expecting a solid outcome with the RBA Governor noting that there were around 100k more people than usual indicating that they would begin new jobs in February. This is likely to include graduates, migrants and people taking time off before starting new jobs.

While strong employment gains will point to the ongoing resolution of supply and demand mismatches, the underlying trend is likely to continue to show an easing in conditions. Record growth in labour supply combined with a slowdown in labour demand will likely see key indicators of labour market tightness, such as the share of the population in work, continue to soften.

On the back of record high overseas arrival numbers, we are expecting the increase in the working age population to at least match the increase in the number of people employed. Preliminary February 2023 data suggests that that there was a net monthly addition of 137k overseas arrivals in the visa categories that add to labour supply. This result comes on the back of the net monthly addition of 40k recorded in January 2023.

This would see the share of the working age population in work, a key measure of labour market tightness, go sideways after falling from a record high of 64.4% in November 2022 to 64.0% in January.





Employment to population: The key measure of labour market tightness.

The employment to population ratio, or the share of the working age population in work provides an indication of how much available labour is being used on a heads basis.

This has been a more powerful indicator than other measures. Around turning points, the unemployment rate could provide a misleading read on how labour market tightness is evolving. For example, if unemployed people are leaving the labour force because there are limited job opportunities, you could see unemployment decline even though conditions are deteriorating.

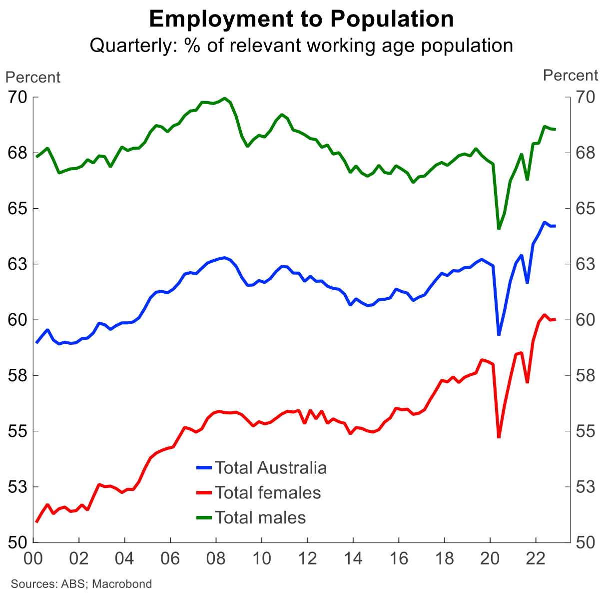
During the pandemic, businesses went into hibernation, people were becoming discouraged, as well as sick. This resulted in many people leaving the labour force temporarily. We saw the participation rate fall from 66.3% in March 2021 to 64.6% in September 2021. Across the same time, the unemployment rate declined from 5.6% to 4.6%. If you looked at the unemployment rate you may have thought the labour market was becoming tighter, which was in fact not the case. Over the same time, the employment to population ratio fell from 62.5% to 61.6% - this indicator correctly suggested there was more spare capacity in the labour market.

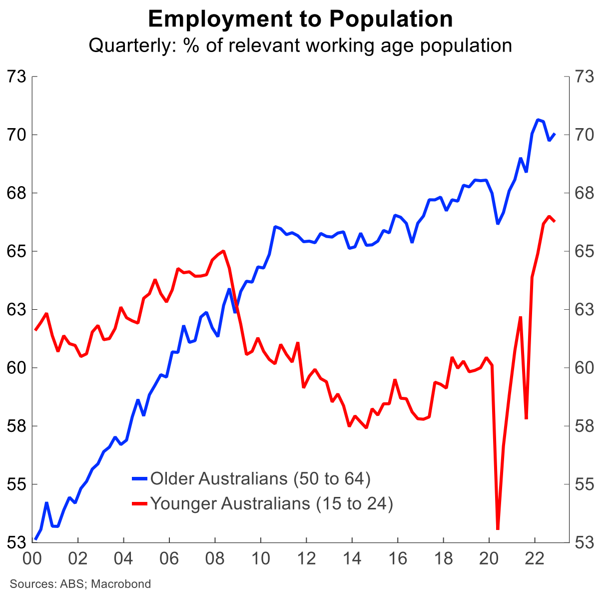
The employment to population ratio also provides an indication of how much potential labour supply is available to meet labour demand on a heads basis. This is particularly important in Australia where labour supply has responded to increases in labour demand. We saw labour demand accelerate in the lead up to the pandemic, averaging 2.5% growth in annual terms over the three years from 2017 to 2019. This was an entire percentage point higher than the average over the prior three years - from 2014 to 2016.

Stronger demand would normally see the number of unemployed and the unemployment rate decline. This was not the case with the unemployment rate largely going sideways over this period. What we did see was a noticeable increase in the employment to population ratio as people entered the labour market and added to labour supply. The employment to population ratio increased from 61.0% to 62.6%.

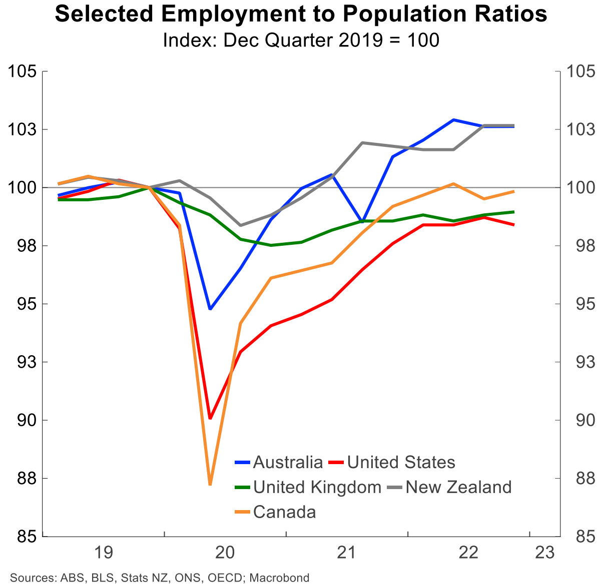
Unique features of the Australian economy: Domestic labour supply has responded.

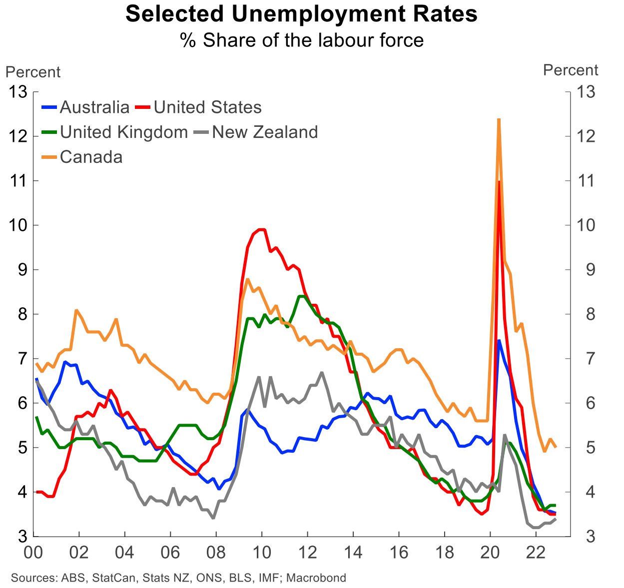
In Australia, labour supply has been highly elastic, responding to increased demand. This has seen the employment to population ratio reach a record high last year and remain elevated. The employment to population ratios for females, young Australians and older Australians have recently hit record high levels and remain elevated - this in part reflects the increase in the retirement age and improved job prospects.





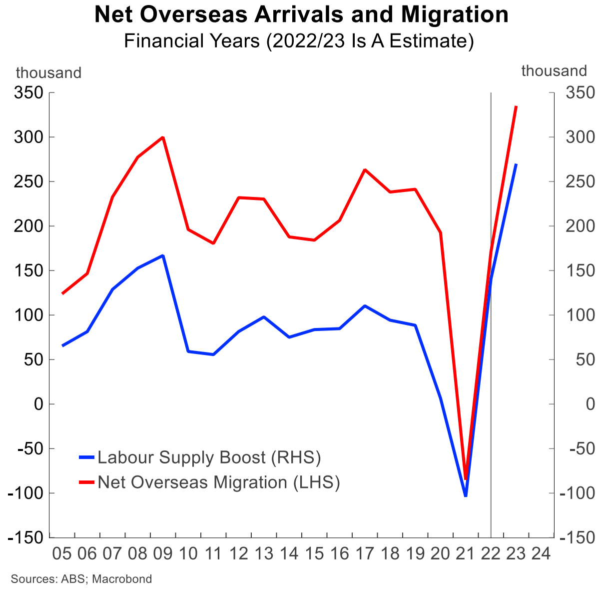
This differs from the experience in other advanced economies. In fact, Australia is one of one a few advanced economies which has seen the employment-to-population ratio increase to be above pre-pandemic levels. The US, UK and Canada are yet to return to their pre pandemic levels. Instead, strong labour demand has pushed up against inelastic labour supply. This has seen unemployment rates fall to record lows and wages growth and services inflation accelerate to levels that are inconsistent with inflation targets.

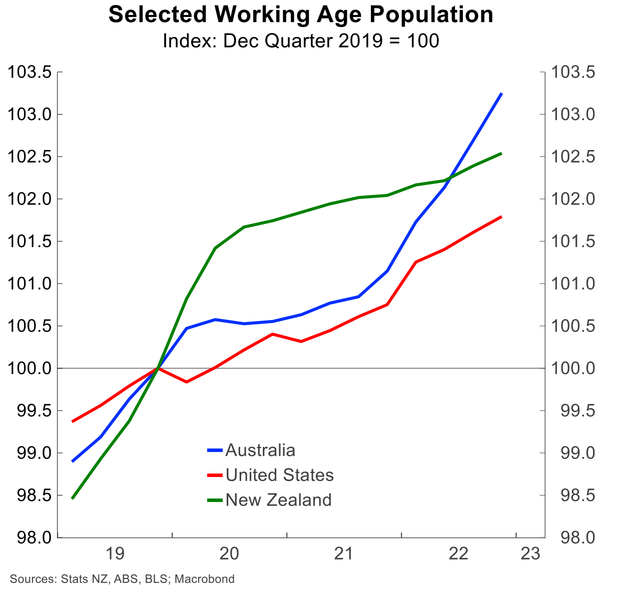




Strong migration means labour supply will continue to respond.

Net overseas arrivals in the visa categories that add to Australia's labour supply are increasing at a record pace. Over the seven months to January (of the 2022-23 financial year) there was a labour supply boost from these visa categories of more than 200k – the highest on record. This has translated into an increase in labour supply or the working age population, which is much stronger than in New Zealand, the other comparable economy which has seen its employment -to-population ratio increase to above pre-pandemic levels.





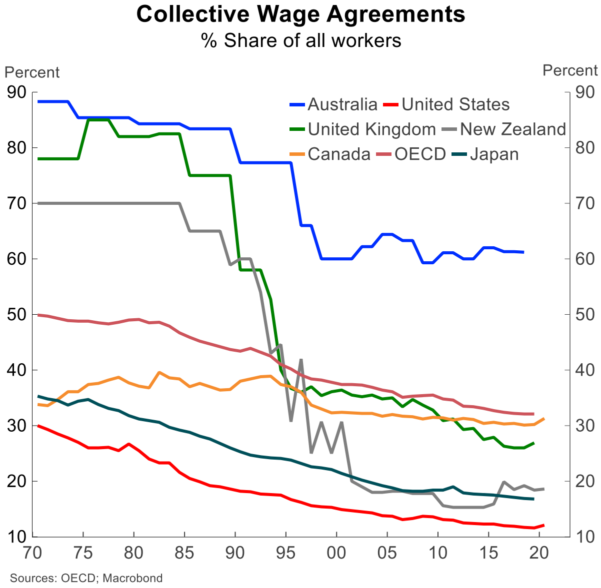
Inertia in wage setting will reduce the risk of excessive wages growth.

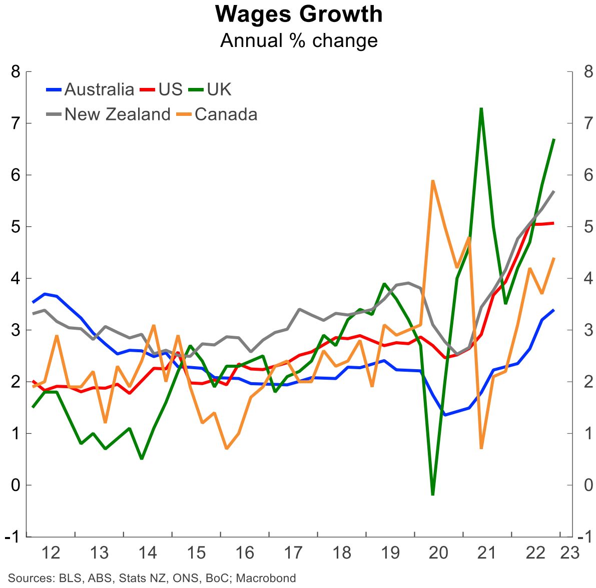
Aggregate wages growth has been much slower to react to labour market conditions in Australia because there is a large share of workers subject to collective bargaining arrangements, including Awards and Enterprise Bargaining Agreements (EBAs).

EBAs have an average life span of 3 years and, therefore, tend to be negotiated less frequently. When they are negotiated, they take time to be agreed, approved and flow into pay packets.

While we expect wages growth to accelerate for workers subject to collective bargaining arrangements, it will take time for this to happen. And once this happens, the cash rate is likely to have already peaked. Moreover, wages growth negotiated through individual agreements might already be slowing due to softer labour market conditions.

This differs from other comparable OECD countries, such as the US, UK and New Zealand, which have seen a more comprehensive shift towards individual agreements as the primary form of wage setting (see bottom-left chart) – and have also recorded higher wages growth.





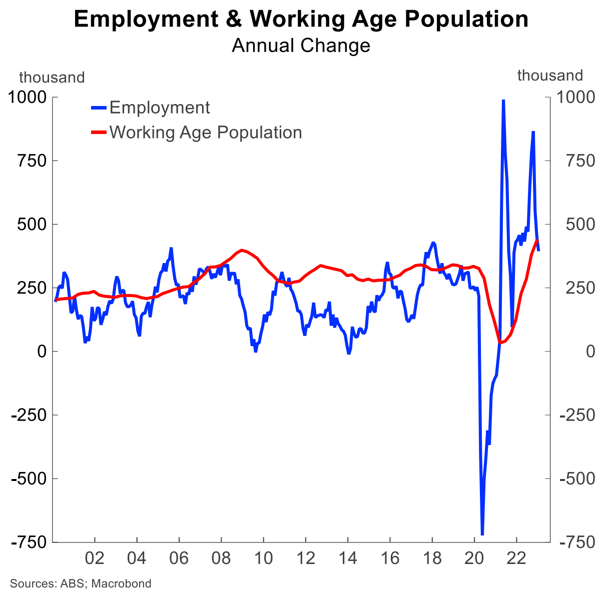
We're different, so what?

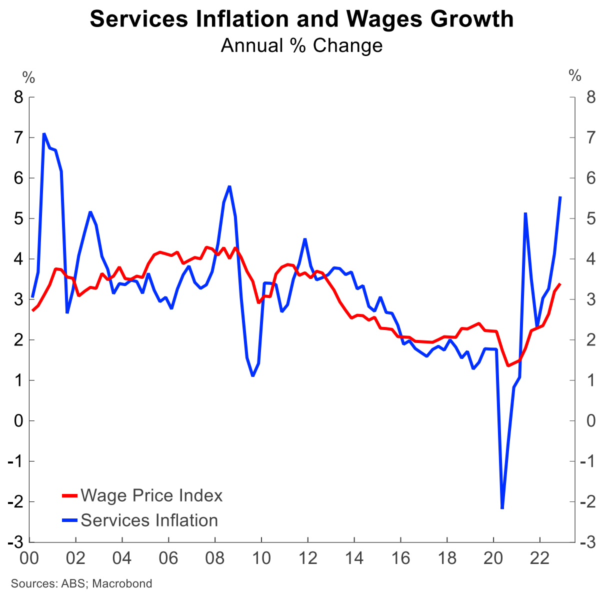
In his recent speech, the RBA Governor stated that we are now seeing clear signs that global goods disinflation is being transmitted to Australia. This process will continue, as global supply chains continue to improve and lower international shipping and freight costs are passed on to final consumer prices.

However, in other comparable economies such as the US, UK, and Canada, strong labour demand has pushed up against inelastic labour supply. This has seen wages growth and services inflation accelerate to levels that are inconsistent with inflation targets. Services inflation is directly related to wages growth and, therefore, tends to be stickier. The only way to get it down once entrenched is by hitting the economy hard and increasing unemployment significantly, in other words, by engineering a hard landing.

In Australia, the labour supply response, coupled with the inertia created by our wage fixing system, has meant that wages growth continues to be consistent with our inflation target.

These unique features of the economy are providing the RBA with the best chance to navigate the narrow path ahead and achieve a soft landing. It also means that the RBA does not need to push rates as high as other nations to bring inflation down.



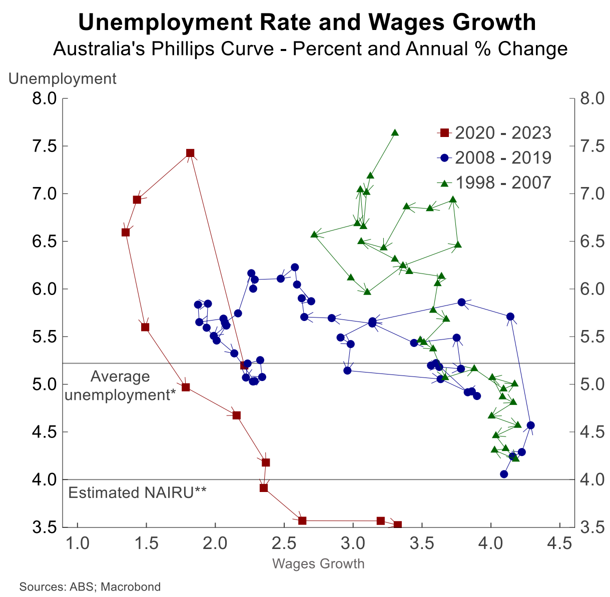


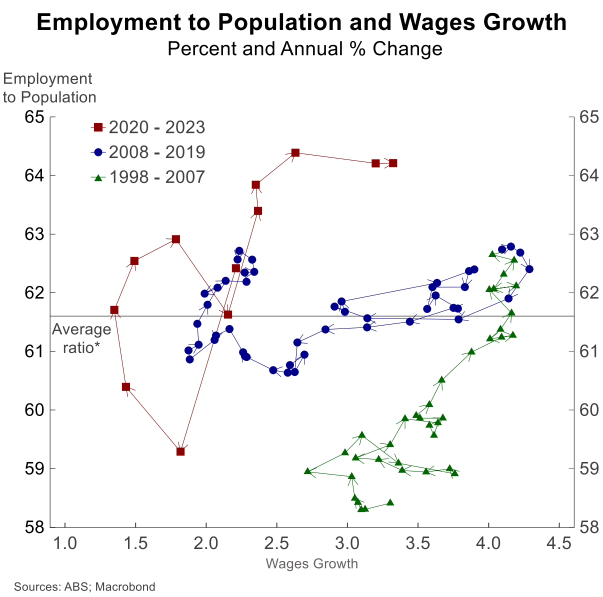
These features also help explain why historically low unemployment rates have been unable to generate a strongwages response as shown by the Phillips Curve – a stark change from the experience over the past few decades.

In the decade before the pandemic, an unemployment rate of 4.0% would have led to wages growth of around 4.3%. Today, the unemployment rate sits at less than 4.0% and wages growth is running at around 3.3% per annum.

The RBA and Treasury estimate that Australia's Non-Accelerating Inflationary Rate of Unemployment (or NAIRU) is around 4.0%. This is the rate of unemployment which is consistent with steady and stable inflation.

Further, the unemployment rate over the decade before the pandemic averaged around 5.3%. Since 2020 this rate of unemployment seems to be consistent with wages growth of less than 2.0%. It was consistent with wages growth of around 2.5% over the period from 2008-2019 and around 3.5% over the period from 1998-2007. A similar shift emerges when we examine the relationship between the employment to population ratio and wages growth.





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