BULLETIN

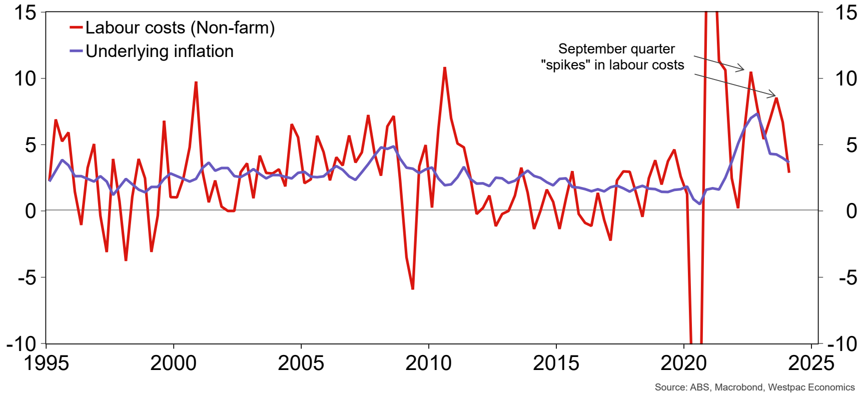
17 June 2024

Stagflation threat receding rapidly, bringing rate cuts into frame

A critical outcome largely missed in the March quarter National Accounts was the significant stepdown in unit labour cost growth – a measure of the domestic cost base and a key driver of underlying inflation. This measure of labour costs is now growing at 2.9% in 6-month annualised terms, lower than the annual rate of 3.2% recorded over 2019 when underlying inflation was running at 1.5% (or 1 percentage point under the midpoint of the RBA's inflation target).

Labour costs and inflation

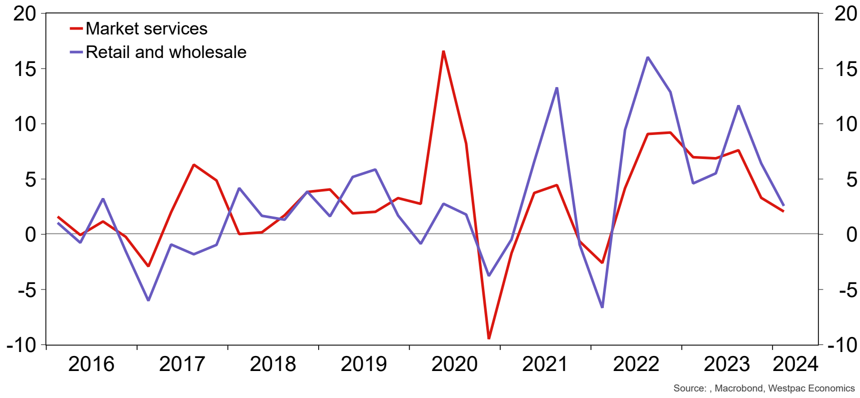
6-month annualised (%)



The moderation in labour costs has been more pronounced in the non-mining sector of the economy, particularly in the industries at the coalface of the consumer led slowdown in spending. Here, the impetus to reduce costs and become more "productive" has been the greatest. Indeed, six-month annualised growth in labour costs in the market services and the retail and wholesale sectors were 2.1% and 2.6%, respectively – below the growth rates recorded in 2019.

Labour costs by sector

6-month annualised (%)

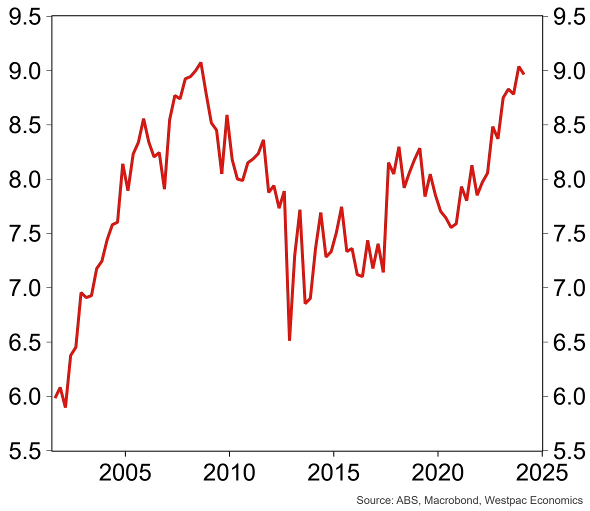


Importantly, we do not expect growth in unit labour costs to accelerate from here. Instead, the significant stepdown is expected to be sustained going forward. The benign Fair Work Commission (FWC) 2024-25 minimum and award wage increase means we are unlikely to see the "spike" in labour costs in the September quarter, which has characterised the data over the past two years. In fact, we expect to see labour costs moderate further given the softening in labour market conditions and the turnaround in labour productivity experienced since the middle of 2023.

It is no surprise that this was missed. The focus has been on the demand side of the economy and whether policy settings are restrictive enough to bring demand and supply into better balance. However, as we have been saying for some time, the supply side of the economy is not static or fixed. The supply side continues to respond to the ripple effects of the pandemic, and the ramp up in investment in intangibles (such as computer systems, digitalisation of processes, updating digital storage) and capital goods more broadly.

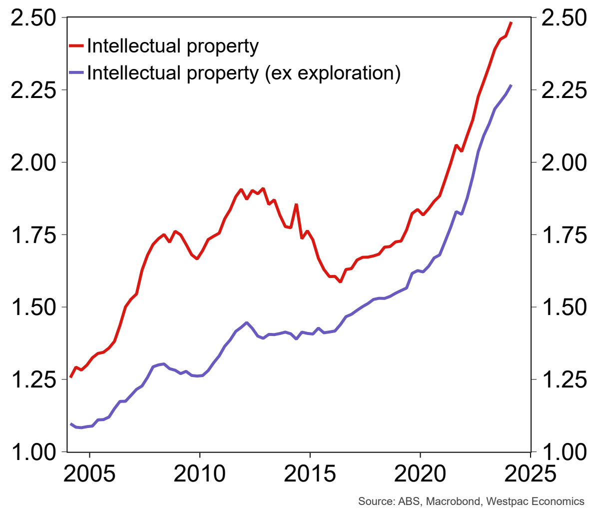
Non-mining business investment

% of GDP



Business investment

% of GDP



Take population growth as an example. Australia's population expanded by a record 650k persons in 2023, with around 550k driven by net overseas migration. Given the speed and extent of this increase, businesses were unable to use all this labour supply as efficiently as possible – the capital such as machines, IT systems, infrastructure, digital networks required all lagged the increase in labour supply. As the capital stock catches up, businesses will be able to use this record boost in labour supply more efficiently. This will continue to increase labour productivity which reduces the effective cost of labour (or unit labour costs) as it means more can be produced with the same resources.

Why are labour costs moderating and is it sustainable?

For a services-based economy like Australia growth in labour costs is the key driver of inflation over the long-term. Labour costs (or unit labour costs) is measured as total labour costs (wages, salaries, benefits) per unit of output. This in turn is determined by labour productivity and average growth in earnings – higher growth in labour productivity and lower wages growth reduce growth in labour costs and vice, versa.

Prices, on average across the economy, tend to be set as a fixed markup over these labour costs, underpinning the strong empirical relationship between growth in labour costs and inflation - underlying inflation averaged around 2.6% per annum in the 20-years preceding the pandemic, while labour costs grew by on average by 2.5% per annum. It's easy to see why there is such a tight or "co-integrating" relationship - if inflation continues to outpace growth in labour costs, margins will increase providing businesses with an incentive to undercut their competitors, sell higher volumes and make more profits. This increase in supply will in turn lead to a moderation in inflation if markets are to clear.

Labour productivity

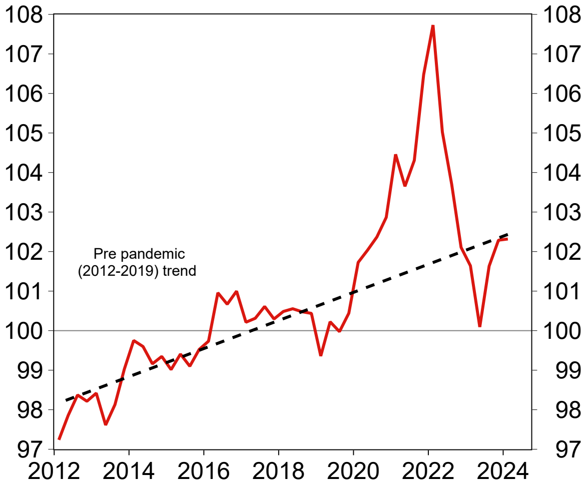
Coming out of the pandemic labour productivity declined, which effectively meant the amount of output produced per hour worked fell. This has rarely happened in the past and we have explained that this was driven by several temporary factors, including compositional shifts in the labour market, the longer time lags required to build the capital stock and use the larger labour supply efficiently, and measurement errors (given how large shocks have been). Given the temporary nature of these shocks, we also expected a turnaround in labour productivity, which continues to play out largely as expected.

Since the June quarter 2023 we have seen a turnaround in labour productivity, particularly in the non-mining sector of the economy where labour productivity has increased by 2.2% over the three quarters from the June quarter 2023, to be 2.3% above pre pandemic levels (average 2019 levels). Labour productivity in the non-mining sector appears to be back at the pre pandemic but post mining investment boom trend (2012 to 2019 period).

On the other hand, mining continues to drag. Labour productivity in the mining sector has fallen by almost 1 percentage point since the June quarter 2023 and is around 16% below 2019 levels. The lack of investment in the mining sector is telling, which is why it's important to separate the non-mining and mining segments of the economy.

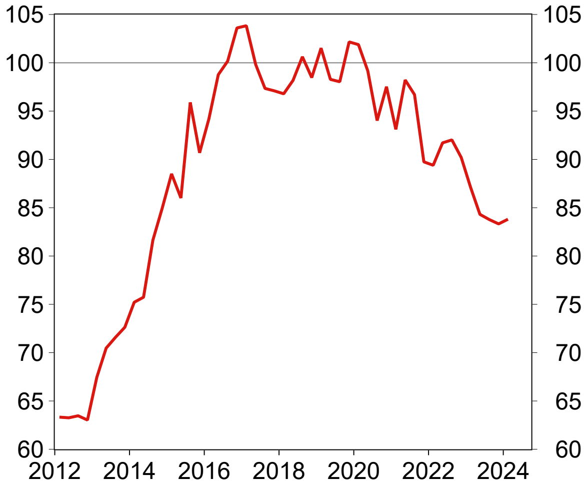
The experience has varied across the non-mining sector of the economy. In the discretionary parts of the economy where the pullback in consumer spending has been more pronounced, we have seen the largest productivity response – businesses have been unable to pass on higher costs so have looked to boost productivity instead. Market services (professional services, accommodation and food services, arts and recreational etc), and retail and wholesale have seen the largest responses – a 2.3% and 3.0% increase in labour productivity since June quarter 2023, respectively.

Non-mining labour productvity
Index 2019=100



Source: ABS, Macrobond, Westpac Economics

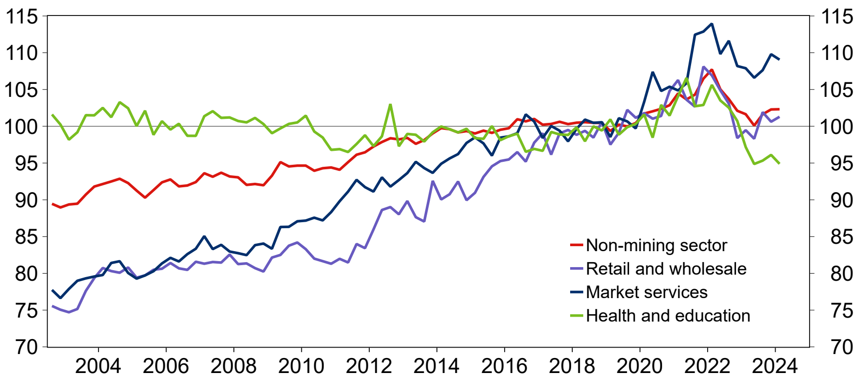
Mining labour productvity
Index 2019=100



Source: ABS, Macrobond, Westpac Economics

However, parts of the non-market sector (health and education) have seen labour productivity continue to go sideways since the June quarter 2023 and remain around 5% below 2019 levels – we are wary of the difficulties in measuring productivity in care-based services sectors, but this is a potential sign that demand remains more resilient and supply constraints more binding in these sectors.

Labour productvity in the non-mining sector
Index 2019=100



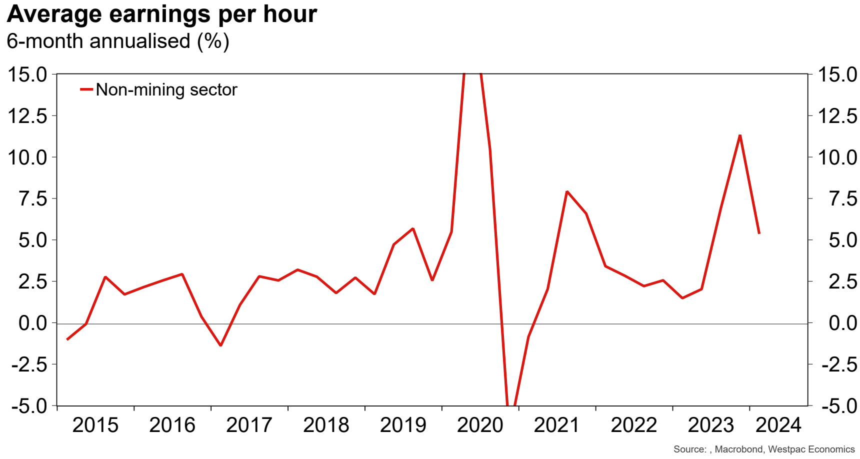
Source: , Macrobond, Westpac Economics

Wages growth

In the September quarters of 2022 and 2023 we saw large spikes in wages growth and therefore labour costs. This was driven in part by larger than average minimum and award wage increases, along with other FWC decisions which boosted wages in certain sectors (such as aged care). The FWC decision for 2024-25 was a 3.75% increase for minimum and award wages – 2ppts lower than the 5.75% increase in award wages given last financial year. Going forward as inflation returns to target, it appears the FWC will award increases consistent with the inflation target (at around 3.5% - 4%) and deliver tailored decisions which impact certain industries and cohorts.

We have also recently seen larger than average wage increases in Enterprise Bargaining Agreements (EBAs), particularly in the public and non-market sectors. It takes time for EBAs to be negotiated, agreed and updated which is why these wages lag the general cycle. In our view this catch-up has largely played out, with wage increases in recent EBAs characterised by a large upfront increase in the first year followed by smaller increases in the second and third years.

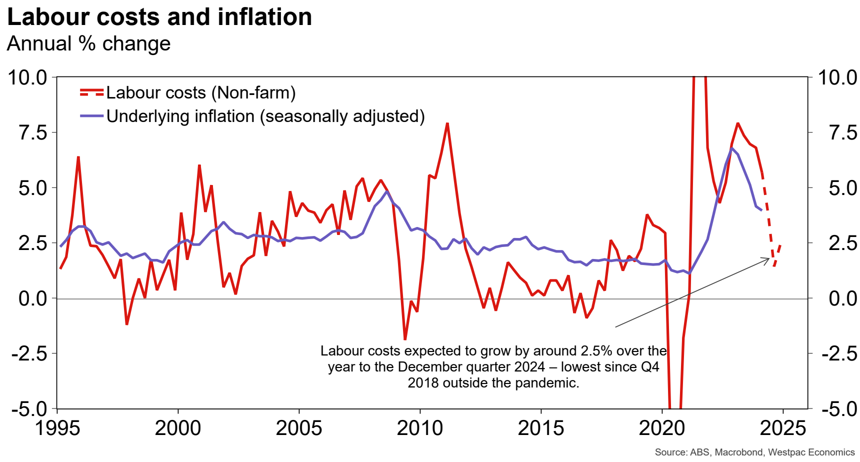
This suggests that wages growth for around 60% (around 25% covered by award and minimum wages and 35% by EBAs) of employees in the Australian economy has peaked and will start to decelerate. At the same time, for the one third of workers who have wages set by individual agreements, we have already seen a significant deceleration in wages growth which is likely to continue given the softening labour market. As a result, we have already started to see average earnings per hour moderate, particularly in the non-mining sector, a trend we expect to see continue as we progress through 2024.



The narrow path

Putting this together – the turnaround labour productivity and cooling wages growth – it is likely that unit labour cost growth will see a further moderation going forward. Indeed, our forecasts point to growth in labour costs moderating to around 2.5% in annual terms by year-end. This is consistent with our view that underlying inflation will be running at around 3.5% by the end of the year, dropping to 3.0% by mid-2025

A too narrow focus on the demand side of the economy may see us wandering off the narrow path. If policy remains too restrictive for too long, we may slow demand too much given the recovery in supply. If this occurs, we could be in a situation where we undershoot the inflation target.



What of Stagflation?

As inflation continues to be above the RBA's target band, while the economy continues to slow and the labour market soften, there is growing talk of a sustained stagflation in Australia – a situation where inflation remains elevated as the economy grinds to a halt or goes backward, leading to an increase in unemployment. The textbook example of this, that gave rise to the term itself, was the long period of persistent stagflation that occurred during the 1970s and 1980s.

However, the risk of this occurring is extremely low in our view. Stagflation is usually triggered by negative supply side shocks. These shocks reduce output, leading to higher prices, which also feed into higher business costs, particularly labour costs. The stagflation of the 1970s began when a series of supply shocks – relating to the oil crisis – became embedded in wage and price setting with large wage increases a key part of this dynamic.

By comparison, we have had a 'transitory supply shock' coming out of the pandemic, with sharply lower population growth and falling productivity now giving way to resurgence in population growth and a turnaround in productivity. This is increasing supply through higher growth in productivity. At the same time, this positive shock is also reducing labour costs.

Moderating labour costs is inconsistent with elevated or accelerating inflation. While new supply shocks (shipping difficulties and supply chain breakdown) present a fresh risk, at this point the data is consistent with positive supply side shocks dominating, leaving the risk of stagflation in Australia very low.

Pat Bustamante, Senior Economist

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