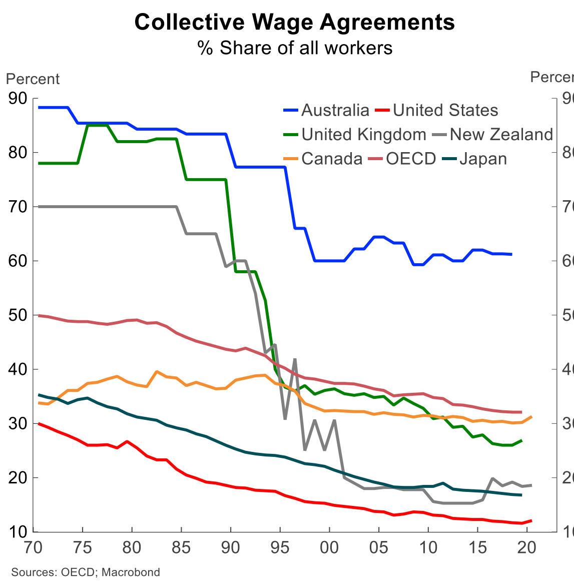
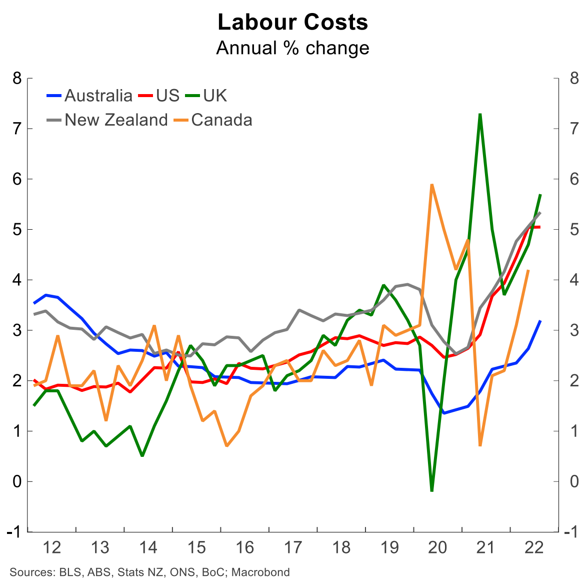
Tuesday, 6 December 2022

Wages - RBA's Key to a Soft Landing

- **Unemployment rates have fallen to lows not seen in several decades around the developed world. However, when it comes to wages growth, a disconnect has emerged.**
- **In Australia, the latest Wage Price Index (WPI) read of 3.1% per annum suggests that wages growth continues to be consistent with the Reserve Bank's (RBA) 2 – 3% inflation target. This does not hold true in other comparable nations, such as the US, New Zealand, Canada and the UK, where wages growth is North of 5%.**
- **The key question is whether we are lagging what's happening overseas or whether we are different. We argue that wage setting features in Australia reduce the risks of excessive wages growth. The built-in inertia created by having a high share of workers on collective agreements means wages growth is *less responsive* to current conditions in the labour market.**
- **Australia's wage setting system provides the RBA with the best chance to navigate the narrow path ahead and achieve a soft landing. Changes to Australia's industrial relations, introduced through the *Fair Work Legislation Amendment (Secure Jobs, Better Pay) Bill 2022*, are unlikely to materially impact the chances of achieving a soft landing.**
- **Undoubtedly, by providing the framework for more genuine bargaining there is upside for wages growth. This is consistent with our near-term wages growth outlook of around 4½% in 2023. However, as the labour market stabilises, we expect wages growth to drift towards its long run equilibrium – likely to be around 3.5% going forward.**
- **Moreover, it will take time for negotiations to occur, be approved by the Fair Work Commission, and flow into pay packets. This timing may mean pay rises occur after the RBA has finished its hiking cycle and when growth in the economy and private sector wages are moderating.**



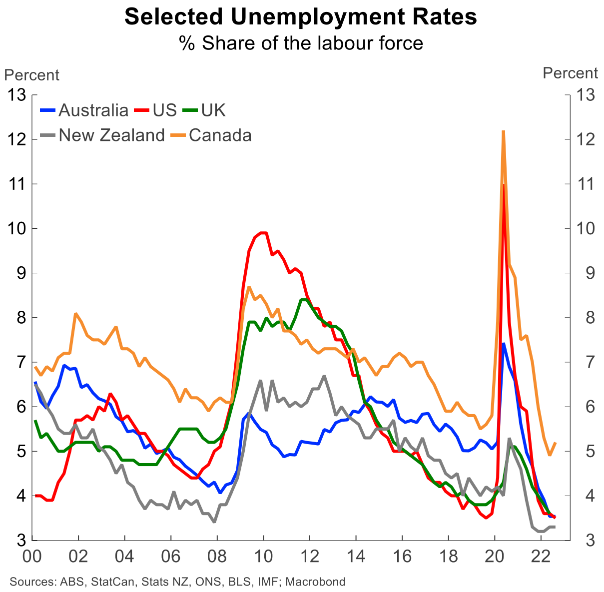


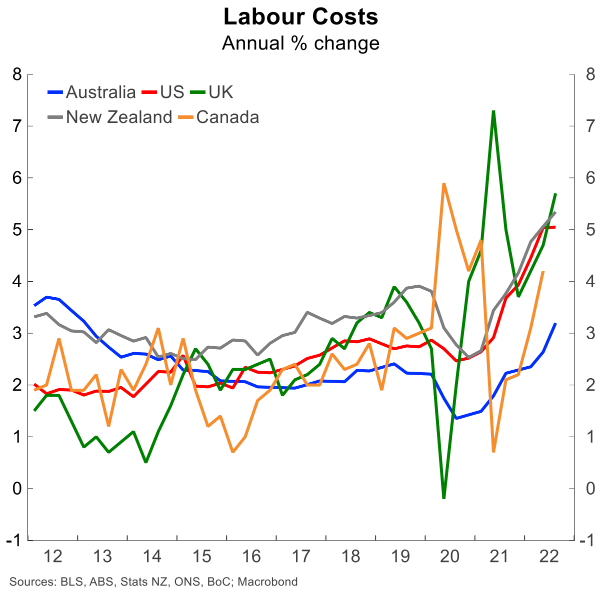
Governments and central banks around the world provided unprecedented levels of support during the COVID-19 pandemic. As a result, economic activity bounced back strongly once restrictions were eased. This has seen unemployment rates fall to decade lows around the world. However, when it comes to wages growth a disconnect has emerged. In economies like the US, UK, Canada and New Zealand, wages growth has picked up strongly and there is a real risk of a wage price spiral. In these countries wages growth is inconsistent with their respective inflation targets and central banks have had to respond aggressively.

In Australia, wages growth has picked up to above the levels recorded prior to the pandemic. However, the latest Wage Price Index (WPI) read of 3.1% per annum suggests that wages growth continues to be consistent with the Reserve Bank's (RBA) 2 - 3% inflation target.

The key question is whether we are lagging what's happening overseas and it's only a matter of time before wages growth accelerates to levels that are inconsistent with the RBA's inflation target? Or is Australia different, and can we get through this period of elevated inflation without recording excessive wages growth?

We argue that wage setting features in Australia's labour market reduce the risks of excessive wages growth. While wages growth may very well continue to accelerate, Australia's wage setting system provides the RBA with the best chance to navigate the narrow path ahead and achieve a soft landing.





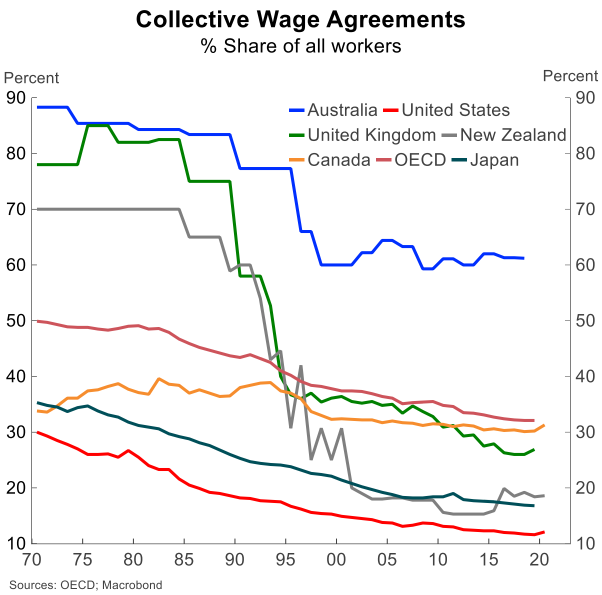
Wage setting systems

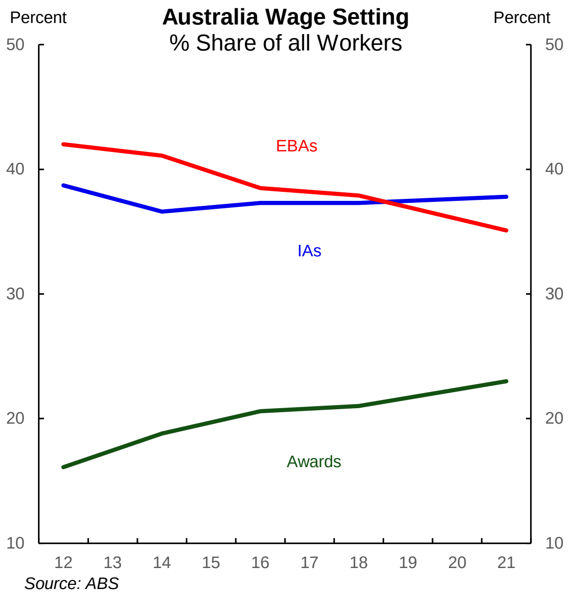
Wages can be determined by several different pay settings mechanisms. At one extreme, all wages can be determined by individual agreements between employers and employees. At the other extreme, wages growth can be completely centralised and determined by an official body.

In the 1970s, Australia, like many other comparable nations, had a highly centralised wage fixing system. Under this system, wages growth was indexed to inflation. In the early 1970s, the Organisation of the Petroleum Exporting Countries (OPEC) restricted the supply of international crude oil leading to a sharp increase in its price. With lower supply, economic activity eased both in Australia and globally. Higher inflation also eventuated as the higher price of crude oil was passed through to consumers. Under the centralised wage fixing system, wages chased higher prices and contributed to the period of stagflation – slowing economic activity, rising unemployment, and rising inflationary pressures. It took the deep recession of the early 1990s to get inflation down to more sustainable levels. The unemployment rate increased to above 10% between late 1991 and around mid-1994.

We have come a long way since the 1970s. Australia now has a hybrid wage setting system where wages are determined by a mixture of Individual Agreements (IAs) on the one hand, and broader collective agreements, including both Awards and Enterprise Bargaining Agreements (EBAs), on the other. This differs from other comparable OECD countries, such as the UK and New Zealand, which have seen a more comprehensive shift towards IAs as the primary form of wage setting.

In Australia, the share of workers who have their wages determined by collective agreements is well above the shares recorded in the US, the UK, Canada, New Zealand, and the broader OECD average.





The Australian wage setting system

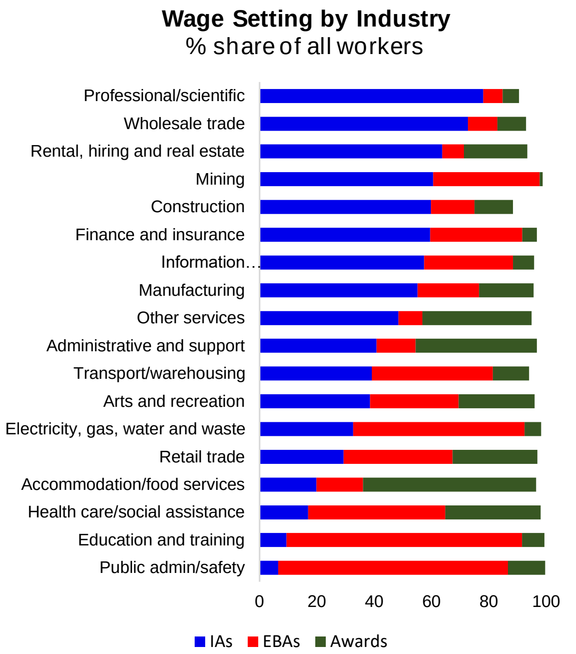
In Australia, wages are determined in three main ways: through Individual Agreements (IAs), Enterprise Bargaining Agreements (EBAs) and Awards. The latter two can be considered "collective agreements."

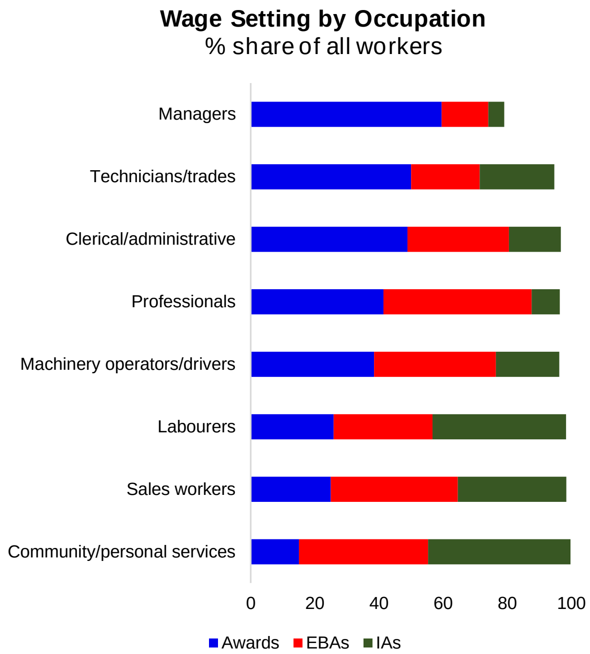
Around 38% of all workers have their wages set by entering formal or informal IAs with their employers. Most of these workers are employed on a permanent full-time basis in the private sector. A large share of these workers are in the professional, scientific, and technical services; construction; mining; and real estate services industries. These workers tend to be in highly skilled roles such as managerial, professional, and technicians/trade roles.

Around 35% of workers are covered by EBAs which are agreements negotiated at the enterprise level between an employer and a group of employees. On average, EBAs tend to have a duration of around three years, and the terms and conditions in EBAs continue to operate until they are replaced. Most of these workers are employed on a permanent full-time basis in the public sector and, therefore, EBAs tend to be the dominant form of wage fixing system in industries where the public sector is a large player. This includes public administration and safety; education and training; electricity, gas, water and waste services; and health care and social assistance.

Commonwealth government EBAs are approved and registered by the Fair Work Commission (FWC). State public service agreements are registered by the relevant Industrial Relations Commissions.

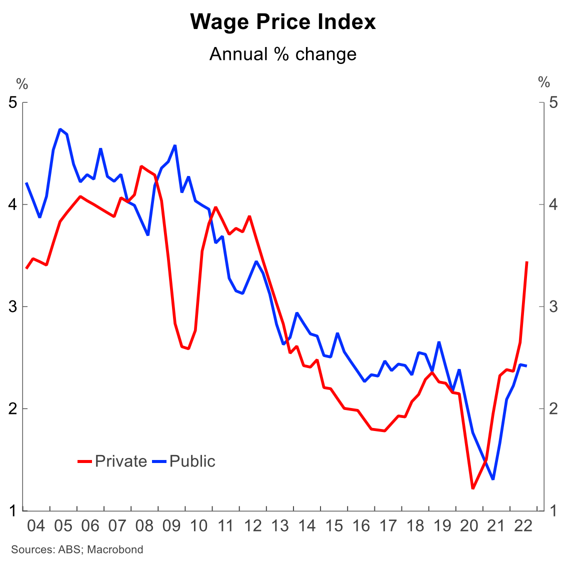
Finally, around 23% of workers are covered by Awards, which are legally enforceable determinations that set out minimum terms and conditions of employment. Most of these workers are employed on a part time and causal basis in the hospitality, retail trade and healthcare industries. The FWC sets out these minimum terms, which are reviewed on an annual basis. In reviewing these minimum standards (which includes the minimum wage), the FWC is required to consider macroeconomic factors, including productivity, competitiveness, inflation and employment growth, as well as microeconomic factors such as inequality and relative wage growth.

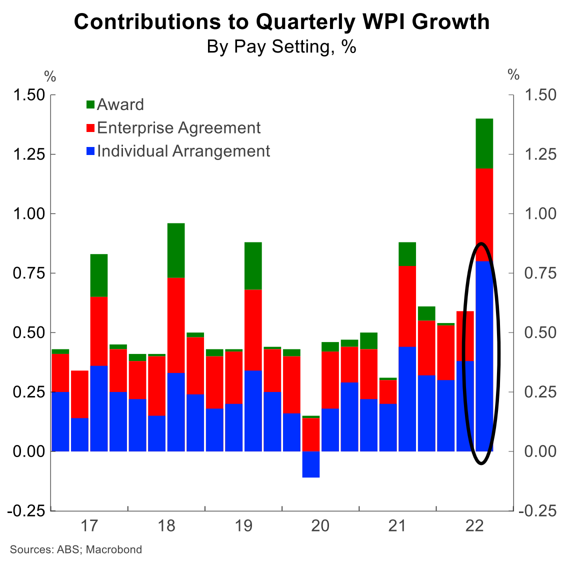




Recent Wages Growth Outcome

In the September quarter 2022, the WPI increased by 3.1% in annual terms. This was higher than the pre-pandemic decade average of around 2.5%. The private sector drove most of the pickup in wages growth, with private wages growing by 3.4% compared with the 2.4% recorded in the public sector.

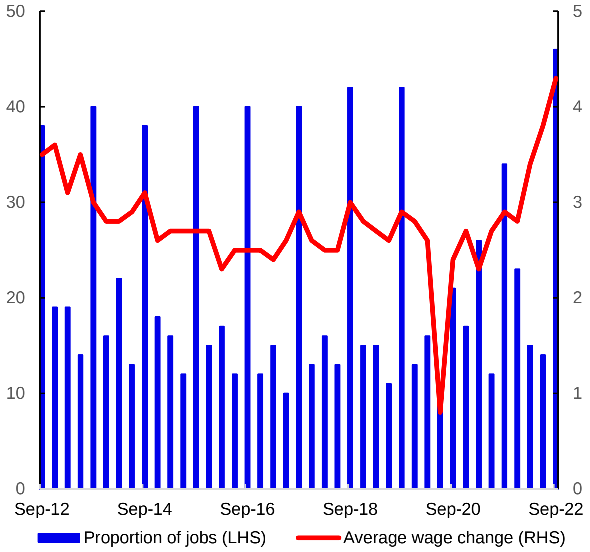




In quarterly terms, the WPI grew by 1.4% when looking at the original series. IAs contributed around 60% of the quarterly wage growth, notwithstanding that these agreements only cover around 38% of workers. Indeed, close to half of all workers in the private sector had their wages renegotiated in the quarter and recorded an average wage increase of 4.3% - the strongest in over a decade. The overwhelming majority of these workers reported that their wages had been previously reviewed within the last 12 months.

Private Wages Growth

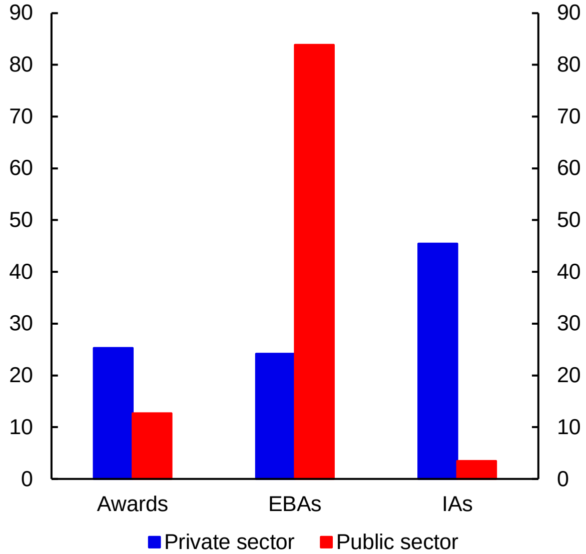
% Share of jobs with wage change and average annual change



Source: ABS

Wage Setting by Sector

% Share of total job



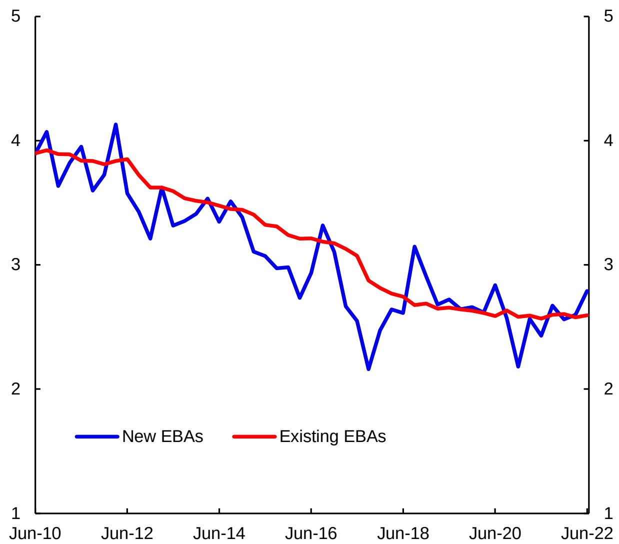
Source: ABS

EBAs contributed around 28% of the quarterly wage increase, which is lower than the 35% share of workers covered by EBAs. Wages growth caps by state governments, including the NSW and Victorian governments, are weighing on these outcomes.

Nonetheless, we are seeing a tick up in the average wage increase for renegotiated EBAs. The most recent FWC data shows that average wage increases for EBA's approved in October was 3.5%. This is higher than wages growth of 2.6% for existing EBAs in the June quarter 2022 (latest available data).

Wages Growth for EBAs

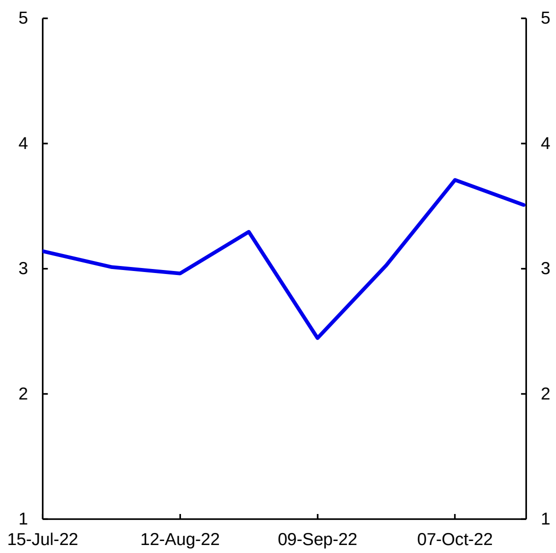
% Annual wage increases for EBAs registered by the FWC



Source: Department of Employment and Workplace Relations

Wages Growth for New EBAs

% Annual wage increases for new EBAs



Source: Fair Work Commission

Awards contributed around 15% of the quarterly wage growth. This reflects the FWC decision to increase award wages between 4.6% and 5.2%, with the first part of the award-based wage increase paid in the September quarter 2022. This was the largest award increase in more than a decade. However, notwithstanding such a large increase in the minimum wage, the contribution to overall growth was small.

Why does Australia's wage setting systems lead to inertia in aggregate wages growth?

If wages across the economy were consistently growing at 4.3% over time, which was the average wage increase in renegotiated private sector wages over the September quarter, this would be inconsistent with the RBA's inflation target. But they are not. On average wages have grown by 3.1% across Australia in the latest year to the September quarter.

The average annual wage increases for EBAs approved over the first half of October was around 3.5%. This is consistent with the RBA's target. The stock of existing EBA's recorded average wages growth of 2.6% in the June quarter 2022. These EBAs were negotiated under different labour market conditions and therefore are growing at a lower rate, when compared with new EBAs and renegotiated IAs. State governments continue to impose wages growth caps, which is also delaying the pass through of the tighter labour market to higher wages growth.

Award conditions increased significantly in the September quarter due to a minimum wage increase of 5.2% - the highest increase in a decade. But the increase will be passed through in different stages and is a one off; award conditions have been set at this level for a year and will not accelerate until the time of the next review for the 2022-23 financial year. At that time, the labour market could be slowing as higher interest rates start to bite more and the strong recovery in net overseas migration increases labour supply.

Aggregate wages growth is much slower to react to labour market conditions in Australia because there is a large share of workers subject to collective bargaining arrangements. IAs are more responsive to current conditions in the economy and labour market, due to:

- ***More frequent wage renegotiations***. When the labour market is tight, individuals can look for higher paying jobs and demand higher wages. Employers are willing to meet demands as there is limited scope to replace existing workers. Awards and EBAs on the other hand are set for a pre-determined period.
- ***Individual negotiations allow workers with strong bargaining positions to put their best foot forward***. Awards are determined by the FWC. The FWC is required to consider the macroeconomic impacts of their decisions. EBAs reflect the "average productivity" of employees in an enterprise. This may be one reason workers on IAs in some industries are paid more than workers on EBAs.
- ***IAs are prevalent in more highly skilled areas where there tend to be acute skills shortages***. This includes professional services, property, construction, and mining industries. ABS data shows that more than 60% of all managers and 50% of all technicians and trades persons are on IAs.

The RBA found that IAs "can be thought of as a bellwether for broader wage pressures arising from a tight labour market." They also found that the sensitivity of wages growth to labour market conditions is much higher for IAs, compared with EBAs and awards.

Implications for monetary policy

As the RBA raises the cash rate to bring down inflation, the path towards achieving a soft landing narrows. However, Australia's wage system keeps the path wider than would otherwise be the case.

It means that aggregate wages growth is not as responsive to the tight labour market and strong economic conditions as in other comparable countries. While we expect wages growth to accelerate across all sectors, it will take time for this to happen. Once this tick up occurs, the cash rate is likely to have peaked and private wages growth might already be slowing due to lower demand and an increase in net overseas migration.

This all means that the risk of a wage price spiral in Australia is low and significantly less than in other comparable nations. It also provides the RBA with the cover to sit back and assess the impacts of the current rate hikes on the economy. Given the wage system, the RBA does not have to be as aggressive as central banks in other nations.

The wage setting system may very well help produce a soft landing.

Interaction with the Fair Work Legislation Amendment (Secure Jobs, Better Pay) Bill 2022

The Government has recently passed the *Fair Work Legislation Amendment (Secure Jobs, Better Pay) Bill 2022* (the Bill) through the Australian Parliament.

The Bill will implement several changes including making the better off overall test more flexible, making it easier to renegotiate EBAs that have expired and limiting the use of fixed time contracts.

By far the most controversial parts of the Bill are changes to industrial action provisions and the expansions of both the multi-employer bargaining regime and the low-paid bargaining stream, which will be renamed the Cooperative Workplaces Bargaining Stream and the Supported Bargaining Stream, respectively.

Currently, *multi-employer agreements* can be made where two or more employers agree to bargain together or where employee bargaining representatives arrange for separate employers to bargain together. But there are stringent conditions, including receiving a ministerial direction.

Under the new law, it will be easier to opt into multi-employer agreements. The legislation widens the right of employees across different organisations to bargain as one with multiple employers.

To be included, the FWC must be satisfied that employers share a "common interest" and are "reasonably comparable." There will be carve outs: the construction sector is excluded but will continue to have access to pattern bargaining; small businesses with less than 20 employees are excluded; and for business with less than 50 employees, the onus is on employees or their representatives (including unions) to satisfy the FWC that the common interest test is fulfilled.

The votes of employees - to seek a multi-employer agreement, to strike, or to accept an agreement - would be taken at the individual business level, rather than on an overall basis. This would prevent employees in larger business being able to dictate the fate of employees in smaller businesses.

There will also be changes to the *low-paid bargaining stream*, which will make it easier for employees in low paid industries to use EBAs, including multi-employer bargaining. Bargaining under this stream is expected to be heavily used by sectors that are heavily subsidised by the public, such as healthcare and childcare.

The Bill will also make it easier to *renegotiate expired EBAs*. The Productivity Commission recently noted that 56% of employees covered by an EBA are on an expired agreement. There is a concern that some employees have not wanted to renegotiate and let existing agreements continue to run. Under the new law, bargaining representatives will need to write to employers to start negotiations on expired agreements.

On *industrial action*, there will be safeguards in place, including the application of a "public interest test" by the FWC. This would be a high hurdle to cross when it comes to strategically important industries like aviation, transportation, and essential retailing. In addition, the FWC will be given more scope to mediate and assist parties resolve "intractable bargaining disputes." This will be done to avoid industrial actions when there is an impasse between bargaining parties.

Finally, the FWC will play a central role in *administrating the updated bargaining framework*. The FWC may be called on to make judgements around "common interest" tests, whether applications meet the "reasonably comparable" threshold and promote the "public interest." While the law and explanatory material specifics the types of factors the FWC should consider in making these judgements, ultimately the FWC could have some administrative discretion, which could have implications for the macroeconomic impacts of the Bill.

What does all this mean – upside risk for wages?

The objective of the Government is to "get wages moving again." Undoubtedly, by providing the framework for more genuine bargaining there is upside for wages growth.

The real question is whether there's too much upside – leading to unsustainable wages growth and placing the soft landing in jeopardy.

In our view this is unlikely – we do not think it puts the chances of a soft landing in jeopardy.

Given the exceptionally tight labour market, we are expecting wages growth of around 4½% in 2023. Upside for wages growth because of the changes introduced through the Bill is consistent with this forecast. As the labour market stabilises, we expect wages growth to drift towards its long run equilibrium – likely to be around 3.5% going forward.

It will take time for negotiations to occur, be agreed, approved by the FWC and flow into pay packets. This may mean pay rises occur when the economy and growth in private sector wages are slowing. In our view the main impacts are:

- ***a larger part of the stock of expired EBA's may be renegotiated.*** In the June quarter 2022 (latest available data) the wage increase of existing EBAs was 2.6% in annual terms. This compares to the wage increase of new EBA's in October 2022 of 3.5%. This change will mean that there is upside for wages.
- ***more low paid workers currently on awards could move to EBAs.*** This means there's some upside for wages. However, it's important to note that the minimum wage increase this year was significant at 5.2% and what we are likely to see is an increase in the level of wages for these low paid workers, with part of this adjustment already occurring. It is also important to note that some of these low paid industries are highly subsidised by the Government. Even though workers may experience a wage increase, which would normally be passed on through higher consumer prices, in certain cases, the impacts on prices are likely to be muted due to Government subsidies. Childcare is one example where the out-of-pocket costs for parents are likely to decline, even though wages for employees in the sector may increase.
- ***changes to the multi-employer bargaining stream are likely to directly impact a small population of workers.*** Currently, there are around 4 million people on EBAs. Around 200k will be carved out. The majority (over 3.6 million workers) are in medium- to large-sized businesses that employ more than 100 employees. Indeed, around 2.6 million are employed in businesses with more than 1,000 employees. These larger businesses are likely to bargain with their staff and have likely already delivered pay rises due to the tight labour market. It leaves around 350k workers in businesses employing less than 100 but more than 20 employees that may experience the largest change. This is a relatively small

share of the labour force and unlikely to materially change the aggregate macroeconomic landscape.

Conclusion and Outlook

Wage setting features in Australia's labour market reduce the risks of excessive wages growth. The built-in inertia created by having a high share of workers on collective agreements means aggregate wages growth is less responsive to current conditions in the labour market.

The inertia in the wage system is helping to contain wages growth, providing the RBA with the best chance to navigate the narrow path ahead and achieve a soft landing.

Changes to Australia's industrial relations, introduced through the *Fair Work Legislation Amendment (Secure Jobs, Better Pay) Bill 2022*, are unlikely to materially impact the chances of achieving a soft landing. Undoubtedly, by providing the framework for more genuine bargaining there is upside for wages growth. This is consistent with our near-term wages growth outlook of around 4½% in 2023.

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