Is Wage Inflation Looming?

The economic recovery is underway. As lockdowns have lifted across NSW, Victoria and the ACT, people have begun to return to their normal activities. Pent-up demand is being unleashed as consumers return to their favourite cafes, restaurants, and recreational venues.

Last week, we learned that employment was disrupted again in October by the extended lockdowns in NSW and Victoria. The good news was that NSW broke its 4-month streak of job losses. Jobs rebounded in the month, but Victoria's recovery is at least another month away.

We expect jobs growth will resume in the coming months. However, the participation rate will likely lift as people resume looking for work in NSW and Victoria, which in turn could put upwards pressure on the unemployment rate. However, job gains over next year should be firm enough to ensure the unemployment rate trends lower over next year, despite the recovery in the participation rate. Indeed, we expect it will trend lower over the coming year, and the unemployment rate could well be flirting with a '3' in front of it by the end of 2022.

Forward-looking indicators of labour demand point to a solid rebound in the labour market over coming months. Job advertisements for October showed a marked increase in hiring intentions to just shy of a decade high. Reserve Bank (RBA) liaison over recent months also suggested that firms affected by lockdowns were reluctant to lay off staff because of reported labour shortages and strong labour demand prior to the lockdowns.

The highlight this coming week will, therefore, be wages data. For close to a decade, wages growth was softening. In recent quarters, wages growth has turned a corner and has started to quicken. The wage cost index grew at a record low pace of just 1.4% in the year to the September quarter of last year. The latest reading showed a lift of 1.7% in the June quarter – the fastest annual pace in a year. However, the quarterly growth rate was just 0.4% in the June quarter, after two solid gains of 0.6%.

Wages pressures are a key influence on underlying price pressures in the economy. The RBA will start raising rates once actual inflation is "sustained" in its inflation target band. For this to occur, the RBA expects wages growth will need to be growing at an annual rate of at least 3%. Underlying inflation has recently just entered the target band, but the RBA will want to be convinced this is a sustained trend and not driven by transitory factors.

We expect wages grew 0.5% in the September quarter, taking the annual pace to 2.2%. We also anticipate wages growth will continue to move higher as the recovery continues. Wages growth should land just short of 3% per annum by the end of next year.

Labour shortages remain prevalent, especially in IT, trades and hospitality. The RBA's liaison program suggests that many firms experiencing difficulties finding labour are using other strategies to retain and attract employees rather than lifting wages, such as relying on bonuses. But we expect an increasingly tight market will likely see a shift towards raising wages. Indeed, our own survey of 1,000 small business customers last month showed 40% of business owners planned to give their workers a pay rise over the next 12 months.

It is a busy week for the RBA; Governor Lowe is speaking tomorrow on recent trends in inflation. Markets will be watching closely for fresh insights on the RBA's thinking on the debate over how persistent inflationary pressures will be. Later in the week, Assistant Governor Ellis will also deliver a speech.

The minutes of the November RBA Board meeting will be released tomorrow, although they are unlikely to reveal materially new information. It is because the meeting was followed by the quarterly Statement on Monetary Policy (SoMP), which laid out the RBA's expectations for the economy in detail.

The November meeting was significant because the RBA dropped its guidance that the cash rate would not be raised until 2024. The RBA also ditched the corresponding yield curve control program, which had a target of 0.10% on the April 2024 government bond. The target reinforced the RBA's forward guidance and helped contain bond and swap rates at 2-to-3-year maturities.

Financial markets are priced for the RBA to lift the cash rate in July 2022, but we think they have overshot and remain comfortable with our view that hikes will commence in early 2023.

With the discontinuation of the RBA's yield curve control program and the conclusion of the Term Funding Facility, the only remaining unconventional policy is the bond-buying program for bonds of 5-10 year maturities (i.e. quantitative easing). The first tranche began in November 2020 with a commitment to purchase a total of $100 billion in bonds at a pace of $5 billion per week.

The second $100 billion tranche concluded in September 2021.

In July, the Board announced that it would further extend the purchase program from September but at reduced pace of $4 billion per week.

This program is due for review in February of next year. We anticipate the RBA will further reduce the pace of its bond-buying program, most likely to $2 billion per week. Whilst a case could be made to scrap the program altogether, the RBA might fear such a decision would spur even more aggressive pricing from financial markets. Already, markets are fully priced for a rate hike in July of next year with three rate hikes to follow before the end of 2022.

The RBA has continued to push back on rate lift off in 2022, arguing that the pickup in underlying inflation will be gradual and price pressures are being driven by transitory factors. However, the longer that price pressures resulting from supply-chain disruptions and elevated energy prices persist, the greater the risk that inflation turns out higher than the RBA has forecast.

Inflation trends in other major economies will also be examined for clues. Last week, consumer price inflation in the US surged to 6.2% in the year to October – the fastest pace since the late 1990s. Whilst much of the rise was blamed on higher energy and gasoline prices, the price increases were broad based across sectors. Furthermore, US President Biden directed the National Economic Council to find solutions to reduce costs and declared 'reversing inflation' a top priority.

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Forecasts

		2021	2022				2023
End Period:	**Close (12 Nov)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.10	0.10	0.10	0.10	0.10	0.25
90 Day BBSW, %	0.04	0.07	0.10	0.15	0.20	0.40	0.65
3 Year Swap, %	1.34	1.30	1.30	1.25	1.20	1.20	1.30
10 Year Bond, %	1.79	1.95	2.05	2.15	2.25	2.30	2.30
US Interest Rates:							
Fed Funds Rate, %	0.125	0.125	0.125	0.125	0.125	0.375	0.625
US 10 Year Bond, %	1.56	1.75	1.90	2.00	2.10	2.20	2.25
USD Exchange Rates:							
AUD-USD	0.7286	0.75	0.76	0.77	0.78	0.78	0.79
USD-JPY	114.26	114	115	115	115	116	116
EUR-USD	1.1439	1.18	1.18	1.18	1.17	1.17	1.16
GBP-USD	1.3364	1.38	1.39	1.40	1.41	1.41	1.40
NZD-USD	0.7004	0.71	0.72	0.73	0.74	0.74	0.74
AUD Exchange Rates:							
AUD-USD	0.7286	0.75	0.76	0.77	0.78	0.78	0.79
AUD-EUR	0.6369	0.64	0.64	0.65	0.67	0.67	0.68
AUD-JPY	83.250	85.5	87.4	88.6	89.7	90.5	91.6
AUD-GBP	0.5452	0.54	0.55	0.55	0.55	0.55	0.56
AUD-NZD	1.0403	1.06	1.06	1.05	1.05	1.05	1.07

	2019	2020	2021 (f)	2022 (f)
GDP, %	2.1	-0.9	0.0	7.4
CPI (Headline), %	1.8	0.9	3.0	2.5
CPI (Trimmed mean), %	1.5	1.1	2.3	2.8
Unemployment Rate, %	5.2	6.8	5.3	3.8
Wages Growth, %	2.2	1.4	2.2	2.8

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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