

Low Wages Growth in Australia – An Overview

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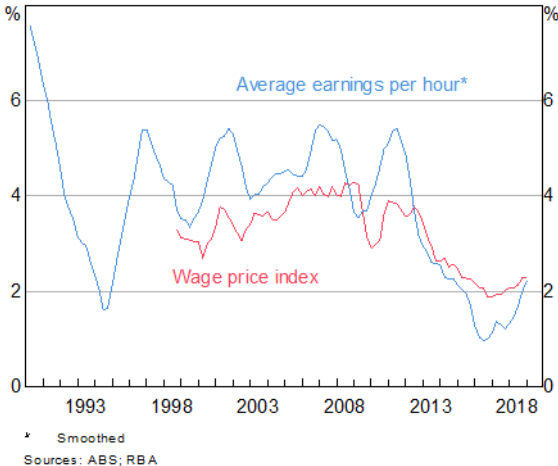
The low level of wages growth over the past five years has had important macroeconomic implications. Low wages growth has weighed on both household spending and government revenue as wages are the largest source of household income. Labour costs are also the largest component of business costs, so subdued wages growth has been associated with low inflation outcomes. There are also broader implications, with the lack of growth in real wages over the past seven years ‘one of the reasons why some in our community question whether they are benefiting from our economic success’ (Lowe 2018).

In this overview I provide a few key facts about aggregate trends in wage growth in Australia to set the scene for the discussions that will follow at this conference. In addition, I also discuss some analysis we have done at the RBA that disaggregates the data to look for potential drivers of the low level of wages growth. I conclude with a presentation of the results from one of our internal models highlighting the fact that wages growth has been abnormally weak over recent years. I do not present explanations for these facts in this introductory paper – rather my introduction is meant to ask some question that I hope others of you here will help to answer.

Aggregate trends

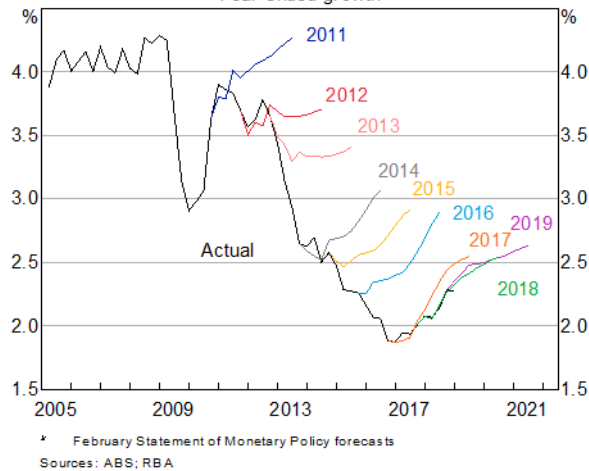
Growth has been low in a range of different measures of labour costs, such as the wage price index (WPI) and average earnings from the national accounts (Graph 1). WPI growth is lower than average across all industries and states, and dispersion in wages growth across jobs is at its lowest level in the 22 year history of the WPI series. As might be expected, wages growth is currently lowest in mining exposed industries and states, following a period of very strong wages growth during the large run up in commodity prices and subsequent mining investment boom. Over recent years, wages growth has been highest in household services jobs such as health care. While this is consistent with stronger employment growth in this sector, it is also the case that household services wages growth tends to be less responsive to changing labour market conditions than in other sectors.

Graph 1
Wages Growth
Year-ended



The sharp decline in wages growth between 2013 and 2016 took the Reserve Bank and other forecasters somewhat by surprise (Graph 2). Wages growth was also weaker than expected in many other advanced economies over this period. The negative forecast errors in wages growth were also correlated with negative forecast errors in inflation. In recent years, the Reserve Bank has devoted considerable resources to understanding the cyclical and structural factors that may have contributed to the decline in wages growth, both in Australia and globally.

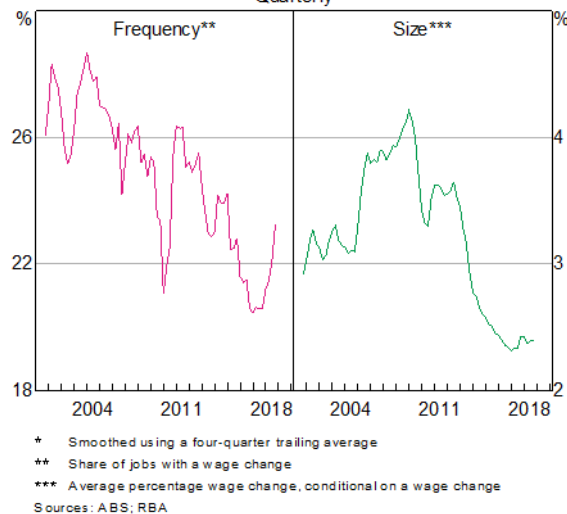
Graph 2
Wage Price Index Forecasts*
Year-ended growth



Insights from disaggregated data

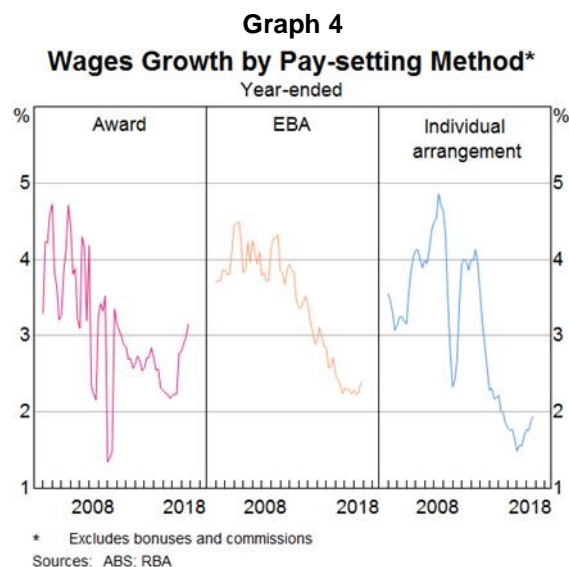
Firstly, we have a better understanding of the dynamics driving low wages growth in Australia as a result of access to job-level wages data. The analysis is the result of a collaboration between the Reserve Bank and the Australian Bureau of Statistics (ABS) using WPI data for around 18,000 jobs. Since 2012, both the average frequency and the average size of wage changes have declined (Bishop and Cassidy 2017). Most of the fall in wages growth between 2012 and 2016 reflected the declining size of wage increases (Graph 3). This is largely due to a reduction in the ‘large’ wage rises (of more than 4 per cent) that had been needed to draw workers into the mining-exposed parts and regions of the economy. The average size of wage increases has increased only slightly since 2016.

Graph 3
Frequency and Size of Wage Changes*
Quarterly



The average frequency at which wages have changed has also declined, and this is largely due to the rising share of wage freezes in the economy. Wage freezes are defined as ‘no change in wages for 1 year or longer’. In 2017, 30 per cent of all workers experienced no change in their nominal wages over the year, and nearly one half of those people had a wage freeze for 2 years or more. These wage freezes often stem from an explicit decision by firms and workers to freeze wages in response to weak demand, and may often be used in place of a pay cut. They can also occur when there is a larger-than-usual delay in renegotiating an employment contract. The industries where wage freezes have been most prevalent are in the retail, construction and professional, scientific & technology industries. More recently, there has been a decline in the prevalence of these wage freezes.

The dynamics of wages growth differ by pay-setting method in Australia, as a result of differences in the arrangements governing each pay-setting method and differences in the types of workers covered by them (Bishop and Cassidy 2019). In recent years, wages growth has been strongest for award-reliant workers as a result of Fair Work Commission decisions to increase award and minimum wages at a faster-than-average pace (Graph 4). Wages growth has been more stable for those workers on enterprise bargaining agreements (EBAs). In part, this reflects government policies in many jurisdictions over recent years that are designed to keep wages growth steady at around 2½ per cent for public sector workers. Within the private sector, lengthy negotiation delays in new EBAs have also contributed to wage freezes.



Workers on individual agreements have received wages growth that has averaged less than 2 per cent over recent years. This follows wages growth for these workers in excess of 4 per cent a decade ago. These workers are fairly heterogeneous in their level of pay and the industries they work in, however we have found that pay outcomes for individual workers are most responsive to labour market conditions. Indeed, wages growth in this pay-setting stream has picked up since its 2016 low as the labour market has tightened and wage freezes have declined.

A model based decomposition

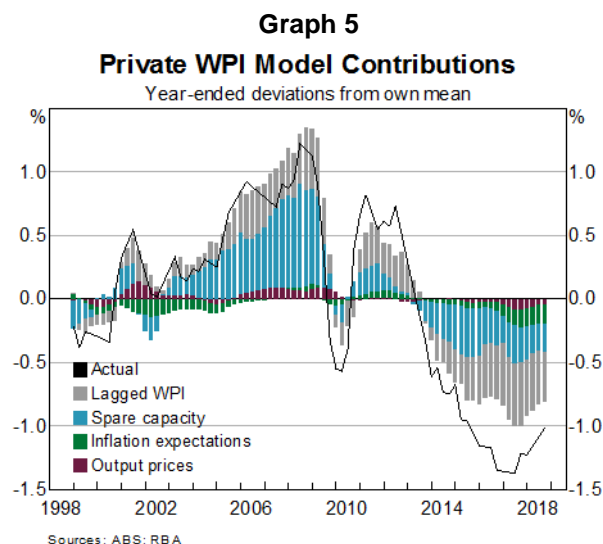
The Reserve Bank has also utilised the well-known Phillips curve framework to assess the role of cyclical factors in wage outcomes. The RBA’s Phillips curve model relates wages growth to spare capacity in the labour market, inflation expectations and output prices. Our assessment is that these cyclical factors have played a large role in low wages growth outcomes, though they are not a full explanation.

Graph 5 presents a decomposition of the RBA’s main wages model.¹ Spare capacity is measured as the difference between the unemployment rate and the RBA’s central estimate of the NAIRU. A similar model that includes broader

1 The model shown here is for private sector WPI growth only. This is because we have found that less of a Phillips curve relationship exists between public sector wages and spare capacity in the labour market.

measures of underutilisation that capture underemployment also produces similar outcomes. We use a ‘trend’ measure of inflation expectations that captures the common signal from a range of different inflation expectations series. Output prices, proxied by the domestic final demand deflator from the national accounts, is included to pick up the influence of firms’ selling prices on their ability to pay higher wages. One of the challenges with using such a model for both forecasting and for explaining recent outcomes, is that the model relies heavily upon two unobserved variables; an estimate of the NAIRU and the level of inflation expectations that will be most relevant in wage bargaining. The uncertainty around the model specification and the tendency for revisions of these variables should be taken into consideration when interpreting the results.

Spare capacity in the labour market is estimated to have been a drag on wages growth since 2013, although less so recently than it was a few years ago. This is consistent with the gradual decline in the unemployment rate over that time. Of course, this model decomposition is ex-post; in the regular reviews of the forecasts presented to the Reserve Bank Board we have found that, on average, we have underestimated in real time how much spare capacity there has been in the labour market since 2012. This is not necessarily because of persistent errors in our unemployment rate forecast, but because the slow-moving NAIRU is estimated to have declined a little over that time and we did not forecast this. Estimates of the NAIRU have also moved lower in other advanced economies over this time as unemployment rates declined without a corresponding pick up in wages growth.



A decline in inflation expectations has also weighed on wages growth according to the Phillips curve model. Inflation expectations have an important role in wage bargaining, either explicitly with some wages indexed to CPI outcomes or because real wages are the important consideration for employers and employees. Inflation expectations are estimated to have declined over recent years, associated with the decline in inflation outcomes. Finally, firms’ output prices have not risen as quickly as they did during the mining boom. It is difficult to disentangle the cyclical and structural explanations here. The strong growth in wages during the large run-up in the terms of trade outpaced that in many comparable economies, resulting in a decline in the international competitiveness of Australian labour. However, since then, low growth of wages has played the reverse role of improving international competitiveness, in conjunction with the depreciation of the exchange rate.

The graph above shows that wages growth has been lower than can be explained together by measures of labour market spare capacity, inflation expectations and output price inflation, and the usual lags between these variables and wages growth. The persistence of these unexplained errors could be the result of many factors. It may be the case that there are longer lags between a pick up in labour market conditions and wages growth than has previously the case; the recent pick up in wages growth in other advanced economies could support this argument. It may also be the case that there is more spare capacity in the labour market than what is getting picked up in the measured unemployment gap. However, the Phillips curve framework is less useful for identifying the role that broader structural factors may have played in low wages growth outcomes in Australia or elsewhere.

Conclusion

While we can describe the symptoms of low wages growth fairly well, we have a less clear picture of the underlying cause. A number of potential structural explanations have been posited; these include low productivity growth, changes in competitive dynamics owing to globalisation and technological change, or other changes in the relative bargaining power of labour. The agenda of this conference promises to provide some evaluation of these explanations and a better understanding of their relative role. Over to you.

References

Bishop J and N Cassidy (2017), 'Insights into Low Wage Growth in Australia', *RBA Bulletin*, March, pp 13–20.

Bishop J and N Cassidy (2019), 'Wages Growth by Pay-Setting Method', *RBA Bulletin*, June, viewed 20 June 2019. Available at <<https://www.rba.gov.au/publications/bulletin/2019/jun/wages-growth-by-pay-setting-method.html>>.

Lowe P (2018), 'Trust and Prosperity', Address given at the CEDA Annual Dinner, Melbourne, 20 November.