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TREASURY MINISTERIAL SUBMISSION

FOI 2427 -
Document 1

9 November 2018

PDR No. MS18-003819

Treasurer

Pages 2-6 and 8-13 have
been deleted as they are
not relevant to this request.

ANALYSIS OF WAGE GROWTH

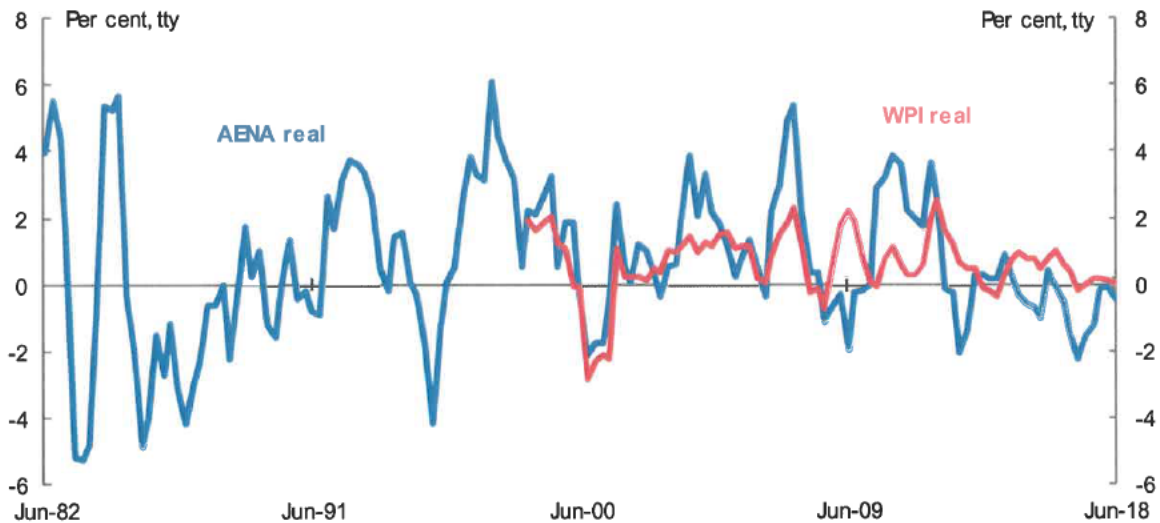
Timing: Prior to the release of the September quarter 2018 Wage Price Index on 14 November.

KEY POINTS

- This note provides context on wage growth for the upcoming September quarter 2018 release of the ABS Wage Price Index (WPI), the most commonly reported measure of wage growth. As of 9 November, the median market expectation for the September quarter is for growth of 0.6 per cent in the quarter and 2.3 per cent through the year.
- In recent years, wage growth has been slow in Australia across all measures, industries and regions. Wage growth remains subdued, but has strengthened from the historical low of 1.9 per cent reached during the 2016-17 financial year. Growth picked up slightly to 2.1 per cent in the June quarter 2018 and was broad-based across industries.
- Weak wage growth is not unique to Australia. The causes remain somewhat of a puzzle, with much debate amongst prominent policymakers and institutions around the world.
- Nominal wage growth, or simply wage growth, is commonly thought of as consisting of two components: that which compensates the worker for inflation and that which provides an extra increase in wages above inflation, termed real wage growth.
 - Recent slow wage growth has occurred alongside low inflation and a decline in expectations for inflation in the future, which may have reduced the component of wage increases that workers are demanding as compensation for inflation.
- In the long run, real wage growth is determined by productivity growth. If workers are more productive relative to their cost to firms, firms find it profitable to hire more workers. This increased demand for labour places upward pressure on wages.
 - Productivity growth has been around its long-run average in trend terms for most of the period during which wage growth has been slow, although it weakened in 2017-18.
 - Both productivity and real wage growth in Australia have been significantly affected by the mining boom over the past decade. To some extent, weak real wage growth may reflect a cyclical adjustment associated with the unwinding of the boom.
- In the short term, spare capacity in the labour market is an important cyclical factor that influences wage growth. As the unemployment rate falls, wage growth tends to increase.
 - Ordinarily, an unemployment rate around the level experienced in recent years would be associated with stronger wage growth than has occurred. Several factors may account for this, including elevated underemployment, increased flexibility in the labour market and prevalence of part-time work, and a higher share of employment in services.

Angelia Grant s22
Division Head
Macroeconomic Conditions Division
Phone: 6263 3153

Contact Officer: s22
Phone: s22

Chart 7: Real wage growth

Note: Series deflated by the Consumer Price Index.
Sources: ABS cat. no. 6345.0, 5206.0 and 6401.0.

2. Drivers of wage growth

- Nominal wage growth, or simply wage growth, is commonly thought of as consisting of two components: that which compensates the worker for inflation and that which provides an extra increase in wages above inflation, termed real wage growth.

Inflation and inflation expectations are important for nominal wages

- Over the long term, wage growth and inflation tend to be related (Charts 8 and 9).
- Recent low nominal wage growth has occurred alongside low inflation and a decline in inflation expectations. Actual inflation outcomes and expectations of future inflation are important drivers of wage growth.
 - To the extent that people form their future expectations based on actual outcomes today, a decline in actual inflation will also constrain future inflation expectations.
- The declines in inflation outcomes and expectations likely explain some part of the decline in nominal wage growth (Charts 8 to 10).
 - Inflation outcomes and expectations are important because they are incorporated into wage rises that people negotiate. That is, if people expect the rate of inflation to be lower in the future, then they may negotiate lower wage rises. Additionally, wage negotiations typically occur infrequently.
 - Indexing of wage rises to CPI outcomes may be another factor which can explain recent low wage outcomes.
 - Inflation is forecast to gradually return towards the middle RBA's medium-term target band. As inflation picks up, the cyclical drag on wage growth from low inflation expectations is likely to abate.

MECD input:

As discussed, can you please update/verify:

- Around 285,000 new jobs have been created in the past year, with around 63 per cent of those being full time.

And check that you are comfortable with pts below on wage growth, as context for Treasurer.

- Since September 2013, Australia has experienced an average real wage growth of 2.2 per cent, which is lower than that experienced in France, Germany, the UK and the US. However, there are a number of ways to measure real wages which may yield different results.
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 - In the short term, spare capacity in the labour market is an important cyclical factor that influences wage growth. As the unemployment rate falls, wage growth tends to increase.
 - Ordinarily, an unemployment rate around the level experienced in recent years would be associated with stronger wage growth than has occurred. Several factors may account for this, including elevated underemployment, increased flexibility in the labour market and prevalence of part-time work, and a higher share of employment in services.]

- The Government has tasked the Productivity Commission to conduct productivity reviews every five years. The first report was tabled in October 2017 and the Government is working through it carefully.
- In the projection years, wage growth is projected to accelerate further to be 3½ per cent in both 2020-21 and 2021-22 as spare capacity is absorbed. As outlined in the Budget, the economy grows at an above-potential pace to close the output gap in the projection years. This puts upwards pressure on prices and wages.

Pages 1 and 3 have been deleted as they are not relevant to this request.

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BACKGROUND:

- Wage growth was relatively strong and stable throughout the 2000s with pre-GFC through-the-year growth in the WPI averaging over 3½ per cent.
- The WPI grew by 2.1 per cent through the year to the June quarter 2018, up from 1.9 per cent in the June quarter 2017. It remains subdued by historical standards.
- Spare capacity in the labour market is an important factor influencing wage growth.
 - The unemployment rate was 5.3 per cent in July, down from its recent peak of 6.3 per cent in July 2015.
 - The underemployment rate was 8.5 per cent in May, below the peak of 8.9 per cent in February 2017.
- Part of the explanation for subdued wage growth lies with subdued consumer price inflation.
 - In the June quarter, the trimmed mean CPI, a measure of underlying inflation, increased by 0.5 per cent in the quarter to be 1.9 per cent higher through the year.
- Over the longer term, wage growth is strongly influenced by productivity growth.
 - During the mining investment boom, the real consumer wage – the wages that people receive for their labour, compared to the prices of goods and services they consume – grew much faster than the real producer wage – the price businesses pay for labour, compared to the price of their outputs. This was because the dramatic increase in the terms of trade meant firms could sell their output at much higher prices, while consumer prices did not increase nearly as rapidly, in part because of a high Australian dollar.
 - Following the peak of the mining boom, this process reversed. As we reach the end of adjustment process from the mining investment boom, we can expect labour productivity to once again drive the growth in real wages.
- Weaker productivity growth seems unlikely to be a cause of the current period of low wage growth in Australia.
 - Mining productivity growth has been particularly strong over the past few years as large investment projects moved into the production phase. Because the construction phase of the mining boom has been winding down, it is unclear to what extent this productivity will translate into wage growth in the mining industry.
- Treasury’s projections of economic parameters (including wage growth) from 2020-21 onwards are determined by a medium-term methodology.

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