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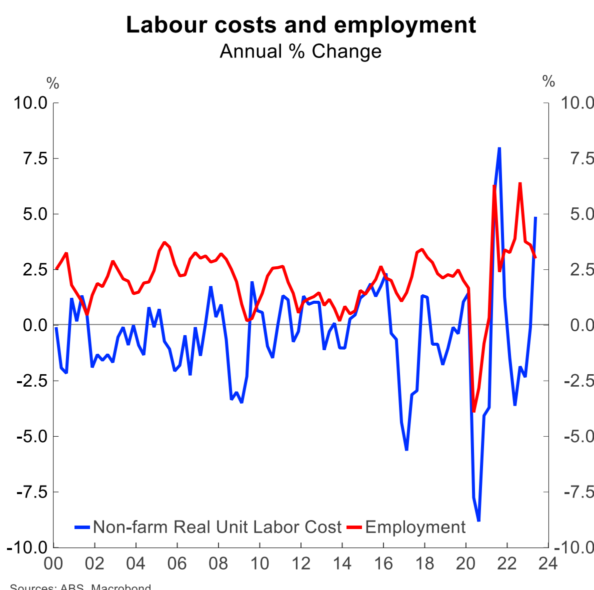
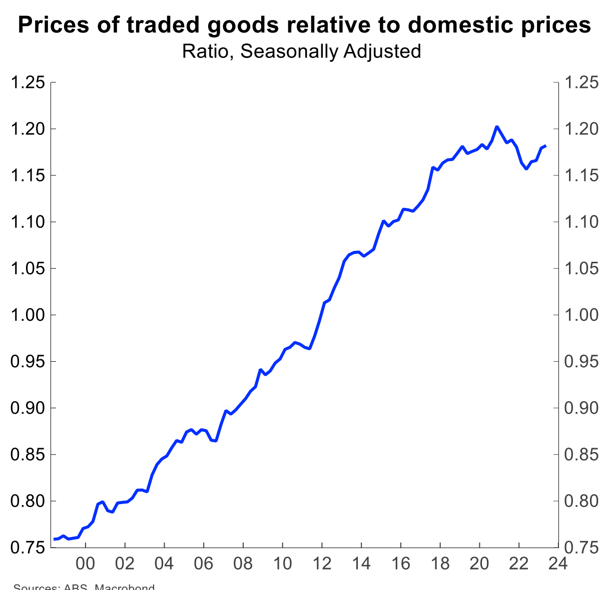
Labour Market Insights

Are We at a Tipping Point?

- **Historically, an increase in real unit labour costs (RULCs) has led to slower employment growth and, at times, employment losses. The recent increase in RULCs suggests that the backlog of labour demand could evaporate relatively quickly, accelerating the turn in labour market conditions currently afoot.**
- **We are expecting an employment gain of around 40k in August, unwinding the seasonal impact of school holidays in July. However, forward indicators, including the number of job ads and applications per job, are now firmly pointing to a slowdown in employment growth.**
- **A less popular, but arguably more important forward indicator of employment growth, is RULCs. This measures the labour related costs of production relative to sales prices – an increase in RULCs means labour costs are increasing faster than sales prices and it's becoming relatively less profitable to employ workers.**
- **Recent trends in RULCs help explain why businesses have continued to hire workers, despite productivity going backwards at a record rate and the pace of wages growth rising. The answer is that sales prices have been increasing more quickly than labour costs. This means hiring more workers adds to profits, even if they are relatively less productive and more expensive.**
- **However, this dynamic is shifting. Over the June quarter, RULCs increased by 3.2% to be 5.8% higher in annual terms – the strongest annual growth rate since the early 1990s (outside of COVID). So, sales prices are no longer increasing faster than labour costs when factoring in productivity. We see the unemployment rate increasing steadily to 3.8% by the end of 2023 and 4.7% by the end of 2024. However, a sustained increase in RULCs poses a downside risk to the labour market.**





Many have been surprised by the resilience in the labour market over the start of 2023. Labour supply measured by the working age population has surged by a record 2.8% over the year to July, but so far, the labour market has managed to soak up this rapid increase in supply. There's limited evidence of a softening in current conditions.

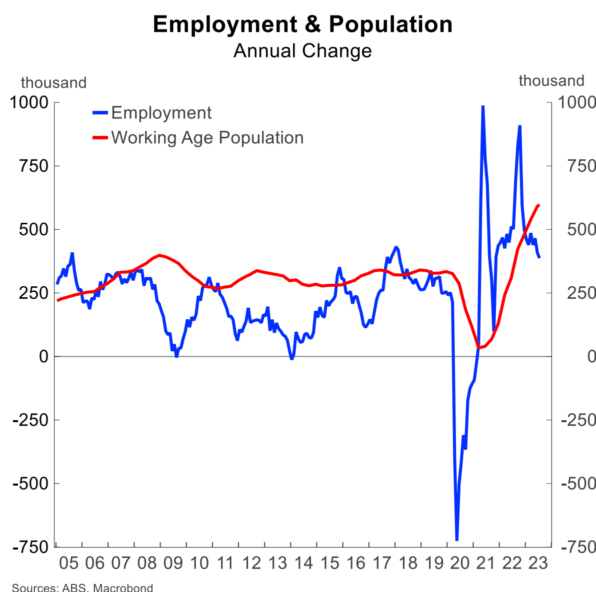
At the same time, wages have been increasing relative to before the pandemic and productivity has been going backwards at a record pace. This has made the labour cost of each unit of output more expensive, underpinning the increase in nominal unit labour costs (NULCs) which the Reserve Bank (RBA) has recently flagged.

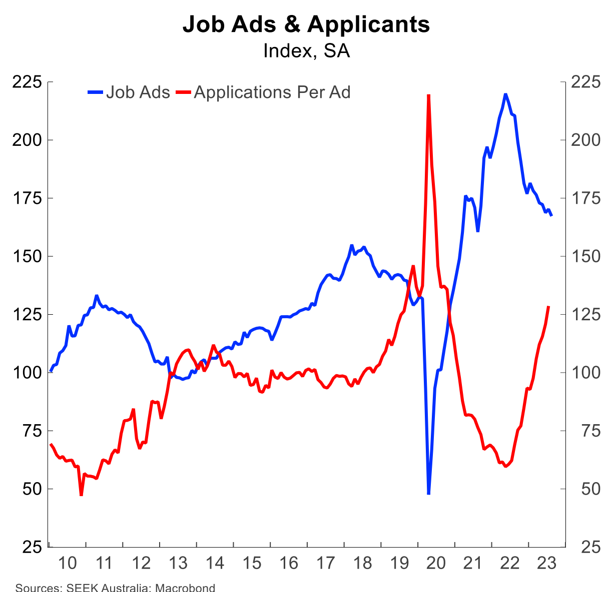
The huge appetite for businesses to continue employing workers partly reflects the huge backlog of excess demand which was accumulated while borders were closed. However, there has been an equally important story brewing in the background relating to businesses incentives to continue hiring.

Incentives were in place for employment growth to power ahead

What is often forgotten is that we have been hit by a demand shock, as well as a global supply shock. These shocks have seen the price of goods and services traded globally increase at an unprecedented pace, and for the first time ever, at a quicker pace than the price of domestic services. This has had two important implications – the acceleration in global inflation has fed through into an acceleration in domestic services inflation. Further, elevated inflation has allowed businesses to continue to make a nominal profit even though labour costs are increasing.

This has meant that growth in the sales prices received by businesses has exceeded the rising costs of labour. This is reflected in real unit labour costs (RULCs), which have been falling. The implication is that hiring more workers adds to profits, even if they are relatively less productive and more expensive. This incentive to continue hiring has played a large role in the labour market's ability to soak up the increase in labour supply.





The tide is now shifting

However, this dynamic is shifting. Over the June quarter, RULCs across the economy increased by 3.2% to be 5.8% higher in annual terms – the strongest annual growth rate since the early 1990s (outside of COVID). So, sales prices are no longer increasing faster than labour costs when factoring in productivity.

If the increase in RULCs continues, the incentive to continue hiring additional workers will become smaller, which could accelerate the decline in labour demand and prompt a more rapid turn in

labour market conditions. Historically, an increase in RULCs has led to a slowing in employment growth and, at times, employment losses.

For example, in the early 2000s RULCs were falling due to high commodity and sale prices – this led to strong employment growth. As output prices eased, wages growth picked up, RULCs increased, and employment growth slowed. This makes sense, higher RULCs points to costs increasing at a faster pace than prices.

Is there a risk employment growth continues to power ahead?

Employment growth could continue to remain strong, notwithstanding the moderation in the growth in output prices, if businesses are able to pass on higher costs to consumers or if productivity growth picks up. Given the slowdown in spending, the price setting power of businesses is likely to have peaked. Business surveys suggest firms are having more difficulty passing on higher costs to consumers - input prices are rising at a quick rate but retail prices are easing.

Furthermore, a sustained pickup in productivity growth takes time. Productivity is usually supported by structural reform, greater competition, and a larger capital stock to house the bigger population – things that take time to implement and flow through the economy.

Outlook

What are we expecting going forward? RULCs will continue to be volatile from quarter to quarter, but trends in underlying drivers suggests RULCs will continue to drift higher. Global inflationary pressures are receding due to weaker demand and improving supply chains. At the same time, wages growth is likely to remain elevated compared to pre pandemic rates.

Without an improvement in productivity, costs will continue to increase while prices growth will ease, putting upward pressure on RULCs and reducing the attractiveness associated with hiring more labour.

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