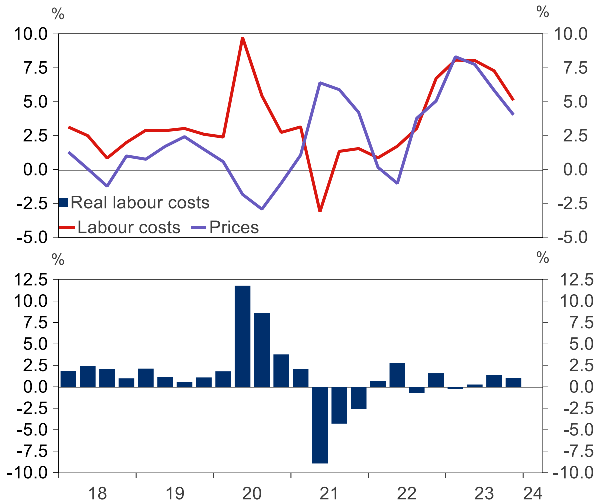
Friday, 15 March 2024

Labour and Cost Insights

Productivity Boost to Help With Inflation

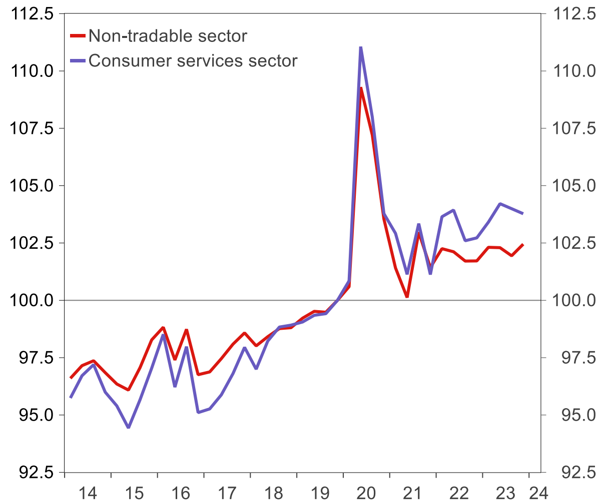
- **Businesses are responding to the dual pressures of weaker demand and diminished pricing power by boosting productivity.**
- **We have recently seen a turnaround in labour productivity, with the largest boost in consumer facing sectors where demand has eased the most.**
- **Higher productivity reduces labour costs, which is required to ensure inflation falls to be within the Reserve Bank's (RBA) 2 - 3% target band.**
- **Labour costs in the consumer services sector are now running at 1.7% on a six-month basis, just above the pre pandemic average of 1.3% and well below the peak of 4.6% recorded a year ago. This has occurred despite the catch up in wages growth for those employees on enterprise bargaining agreements and awards.**
- **These outcomes support our forecasts which have inflation moderating to 3.0% by the end of calendar 2024 and to be within the RBA's target band by the end of 2025.**
- **We are confident in the cyclical recovery in productivity, which is being supported by greater substitution across labour and capital inputs.**
- **The medium-term outlook remains more uncertain, although there are some positive signs here too. There is still the impetus for continued capital accumulation as we transition to net zero emissions and as we respond to the large population boost from last year.**

Prices and labour costs.
Consumer services sector. Annual % change.



Sources: ABS, Westpac Economics, Macrobond

Real unit labour costs
Index: December quarter 2019=100.



Sources: ABS, Westpac Economics, Macrobond

Labour productivity is a key determinant of long-term prosperity. Living standards can only continue to improve if we can produce goods and services more efficiently. In the 2022-23 year Australia experienced one of the sharpest falls in labour productivity ever recorded.

But 2022-23 was no usual year with measured productivity distorted by the ongoing ripple effects from the pandemic. The compositional shift in the labour market which resulted from lockdowns continued to unwind. During the pandemic we saw a boost in measured productivity as more workers in jobs that produce high levels of output per hour (such as professional and medical services) continued to work either at home or through new innovative arrangements (i.e. telehealth). Employees in jobs that account for less output per hour, such as retail or hospitality, were unable to work due to restrictions. As the restrictions were lifted, people returned to these jobs, reducing measured productivity. International students returning to Australia following the end of lockdowns also contributed to, and sped up, this unwind.

More broadly, we also saw hours worked rebound and grow more quickly than anyone expected as migrants and international students returned. The speed of the increase in hours worked meant investment in infrastructure, new buildings, equipment could not keep up. This reduced the amount of capital used by each worker, also contributing to the fall in measured productivity.

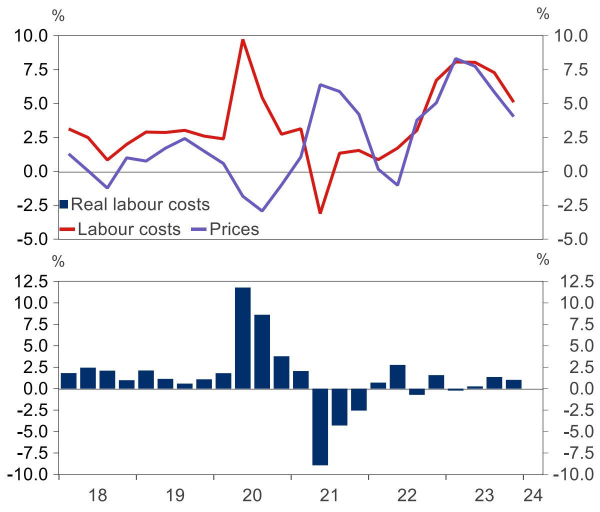
This sharp fall in productivity led to a large increase in labour costs – output per hour worked declined, which meant that the cost of producing the same amount of output increased. And this fuelled inflationary pressures as businesses were able to pass on the increase in costs.

Robust demand made this possible. Strong household balance sheets, and a pickup in income growth from the tight labour market, meant that consumers became less price sensitive and more willing to accept higher prices.

Are businesses still able to pass on higher costs?

This dynamic has now turned. We find that businesses are finding it harder to pass on higher labour costs to consumers. So called real unit labour costs have been increasing. This means that labour costs have been growing more quickly than output prices, squeezing margins. This is particularly true in the domestic services industries (includes domestic travel, accommodation, recreational, personal services, professional and IT services) and the broader non-tradable sector* where labour costs are an important part of total business costs.

Prices and labour costs.
Consumer services sector. Annual % change.



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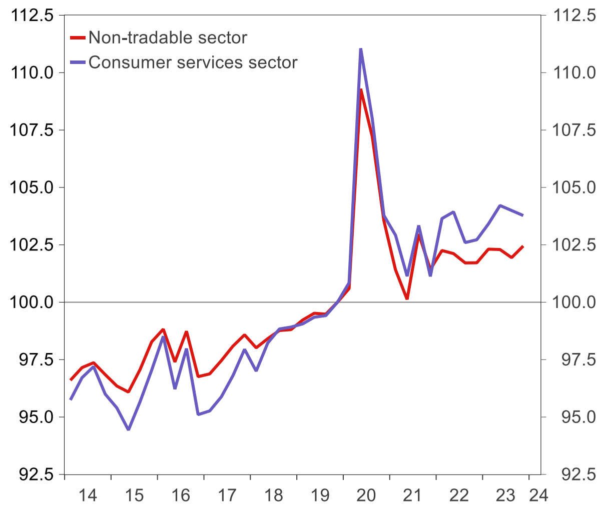
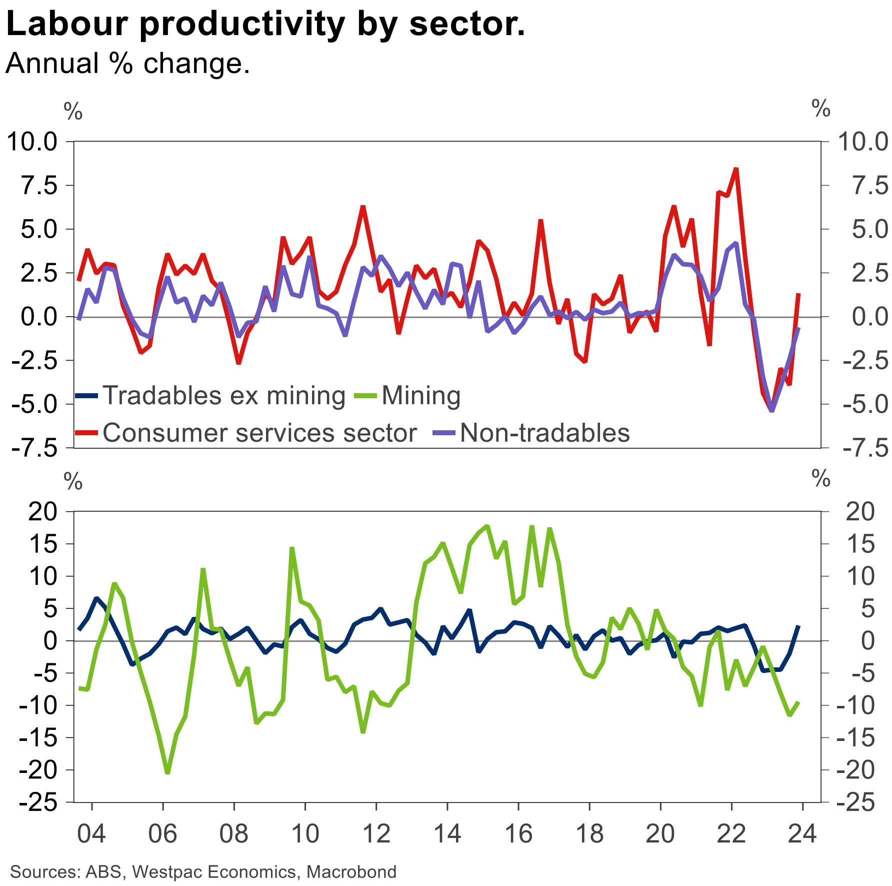


Sources: ABS, Westpac Economics, Macrobond

Over the past year real unit labour costs in the consumer services sector has increase by 1.1%, after falling through much of 2021 and 2022. This is consistent with Reserve Bank (RBA) liaison which also suggests that businesses have been having more difficulty passing on increases in costs.

In this environment businesses must take action to reduce costs and prevent a squeeze on margins. As we anticipated, that's exactly what we are seeing as businesses are enhancing productivity to drive down costs. In the sectors at the coalface of the consumer led slowdown in spending, productivity has increased the most as the impetus to reduce costs has been the strongest.

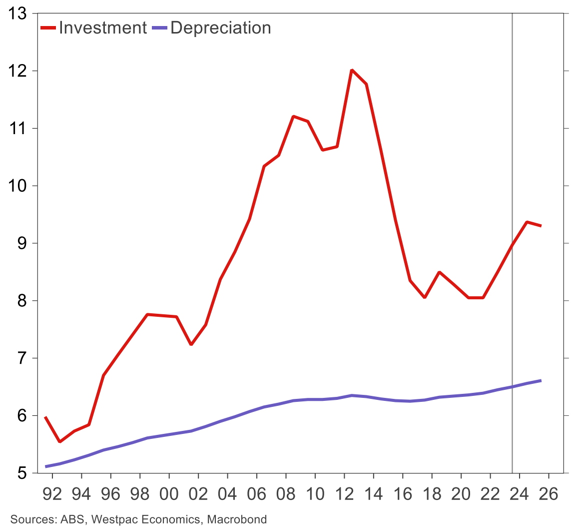


How are businesses boosting productivity?

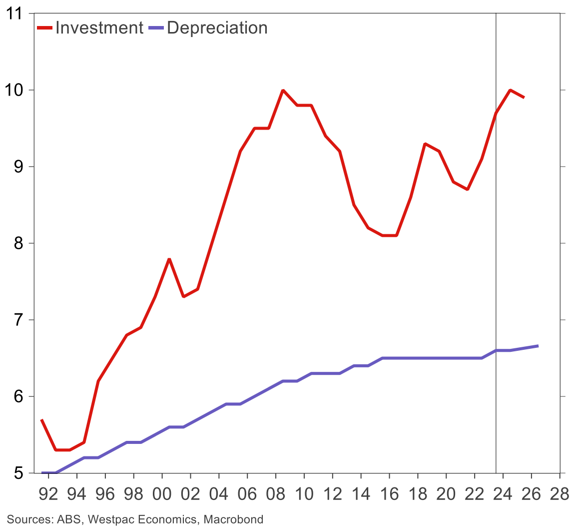
It's now easier for businesses to invest and buy capital goods (computers, machinery, cars etc) which were previously unavailable or had long lead times due to supply chain constraints. Additionally, the growth in the prices of these capital goods has been easing, and in some cases prices have even fallen. This is supporting investment and driving an increase in the capital stock (sum of all capital goods across the economy), which is catching up to the massive increase in hours worked recorded over 2022 and the first half of 2023.

Importantly, even though growth in investment has slowed, the level of investment remains high and is more than enough to offset depreciation (or the wear and tear on machines, equipment, and the broader capital stock) and grow the capital stock. In the non-mining sector of the economy total investment is running at close to 10% of the capital stock – in line with the high levels recorded during the terms of trade investment boom of the 2000s.

Investment and depreciation
% of the capital stock, Aggregate economy.



Investment and depreciation
% of the capital stock, Non-mining sector.

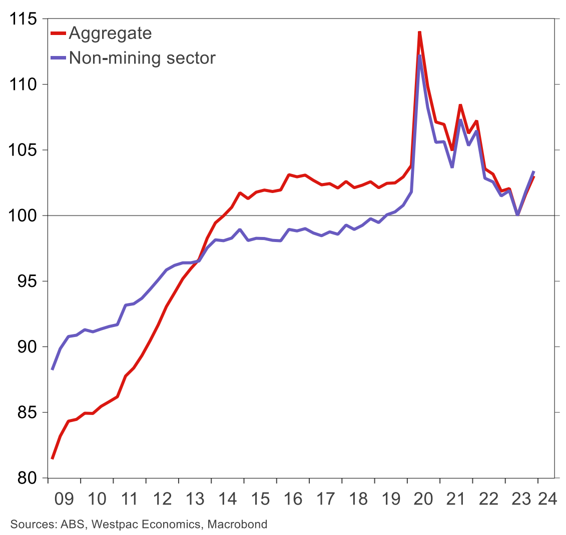


As the capital stock has increased and aggregate demand has slowed the need for labour has also diminished. As a result our estimates have the capital labour ratio – or the amount of machines, infrastructure, IT services, etc used by each unit of labour – reversing most of the fall experienced over the past year.

Across the economy, we estimate that the capital to labour ratio is just under its pre pandemic level, while in the non-mining sector this ratio is around its pre pandemic level. We expect the capital to labour ratio will continue to improve over the next two years as growth in the capital stock outpaces growth in hours worked.

The pace of the increase will be larger than usual – this should not be a surprise. The supply side of the economy is adjusting. The business sector has gone from a period where it could only expand by using labour to meet strong demand, to a period where capital goods are more freely available and demand has slowed, reducing pricing power and providing the impetus for increased productivity and cost efficiencies.

Capital to labour ratio
Index: June quarter 2023=100



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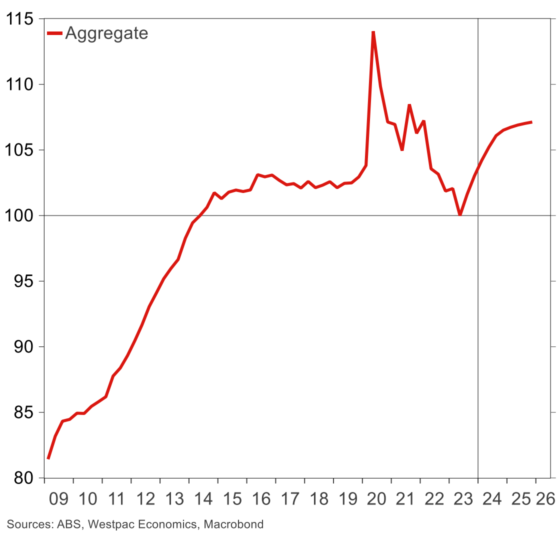
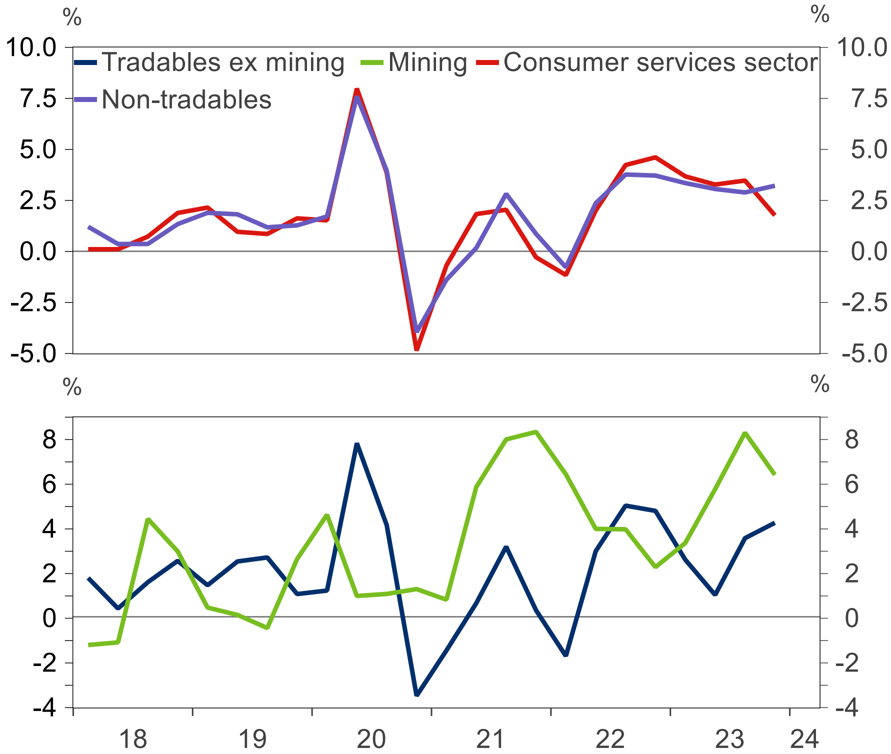


Why is this good for inflation?

The pickup in labour productivity is translating into a significant moderation in unit labour costs – or total labour cost per unit of output. Labour costs in the consumer services sector are now running at 1.7% on a six-month basis, just above the pre pandemic average of 1.3% and down from the peak of 4.6% recorded in the December quarter 2022 – just a year ago. The broader non-tradables sector has also made progress. However, this sector includes the care industries such as health care and education where government policy, at least in the short run, determines price outcomes.

Nominal unit labour costs, by sector.

% Change over six months.



Sources: ABS, Westpac Economics, Macrobond

What does this mean going forward?

Going forward we see the cyclical improvement in productivity continuing. We expect to see growth in the capital stock outpace hours worked and the capital to labour ratio increase further as businesses continue to invest in productivity to reduce costs.

This will contribute to easing inflationary pressures as labour costs continue to moderate supporting our forecast for inflation to fall to 3.0% by the end of 2024 and 2¾% by the end of 2025.

We are confident in the cyclical recovery in productivity, which is being supported by greater substitution across labour and capital inputs. But the medium-term outlook remains more uncertain, although there are some positive signs here too.

There is still the impetus for continued capital accumulation as we transition to net zero emissions and as we respond to the large population boost from last year.

**Note: the non-tradable sector includes all industries where exports and imports account for a significant share of output – this includes manufacturing, transport, wholesale, retail, and electricity. Domestic services or non-tradable includes all other industries, most notably household services, business services and construction services.*

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