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Wage growth forecasts in the utilities sector

Report by Access Economics Pty Limited for
Australian Energy Regulator

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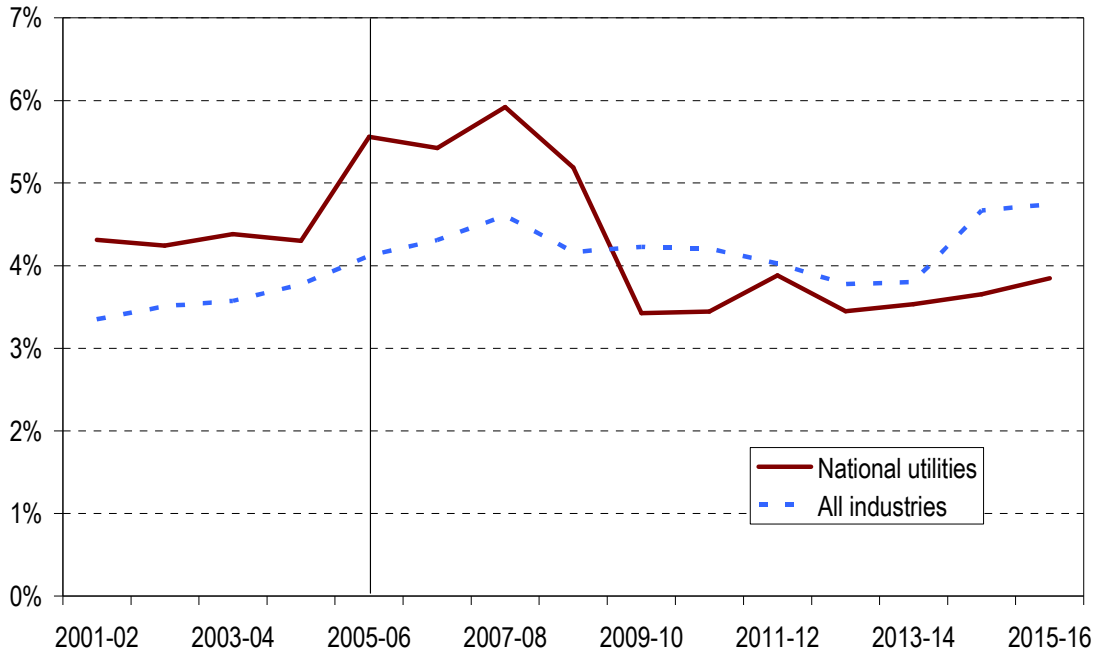
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SUMMARY OF RESULTS

Utilities sector wages growth

ANNUAL WAGE GROWTH IN THE UTILITIES SECTOR AND ELSEWHERE



After remaining close to the expected 'long-term' rate of 4¼% until 2003-04, wage growth in the utilities sector has leapt sharply in the past few years, even as productivity levels have reversed.

As the chart above suggests, wages growth in the first few years is likely to remain relatively strong due to the current skills shortages prevalent in the utilities sector. These shortages are not caused solely by growth in the sector itself, but have flowed from strength in other sectors – notably construction – in recent years and a similar shortage in the mining sector. Shortages in the construction sector from mid-2002 saw sharp short-term increases in wage growth which began to stabilise in mid-2005, partly as workers were drawn from other industrial sectors.

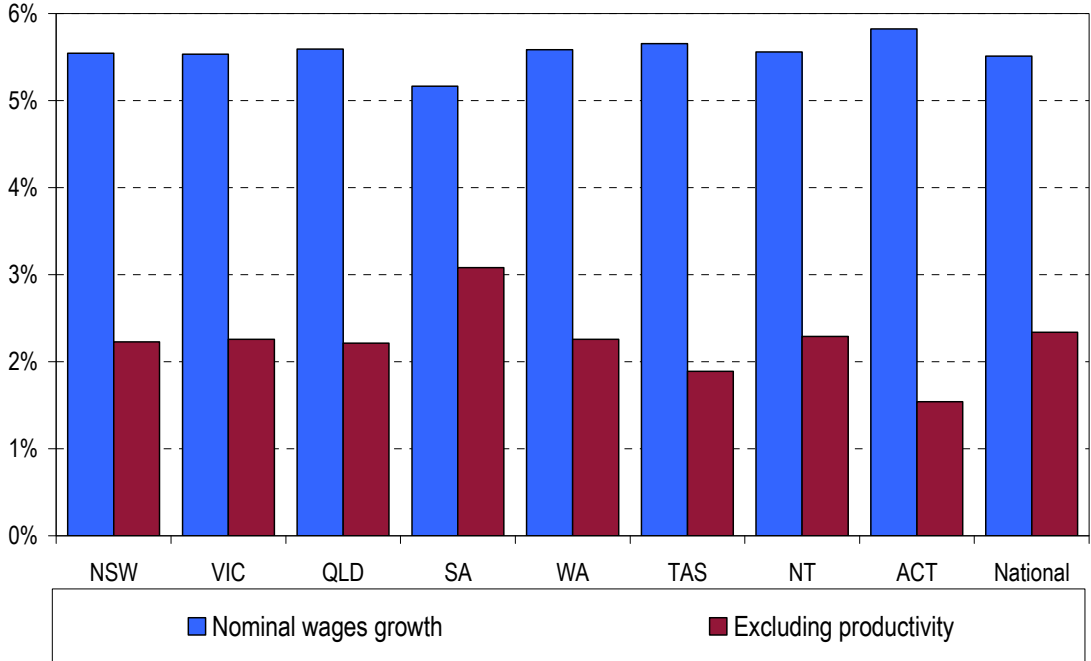
We would expect the current surge in (relative) utilities sector wage growth would last for a similar period of time, keeping growth in utilities sector wages relatively high compared to the broader economy. The gap may close slightly as overall wages growth picks up in response to changes in underlying inflation rates and a generally tight labour market.

Three year growth by State

Short term trends in wages growth are likely to be influenced by recent relative movements in State utilities sector productivity (and State wage outlooks in general). The results at the State and Territory level are shown below. While the results for nominal (and real) wage

growth are broadly similar, reflecting the longer term realities, there are difficulties in determining the growth in productivity levels by State.

UTILITIES SECTOR WAGES GROWTH TO 2008-09 (% PER YEAR)



Ten year growth by State

UTILITIES SECTOR WAGES GROWTH TO 2015-16 (% PER YEAR)



In general, stronger growing States will see faster growth in wages other things being equal. So, it is not surprising that Queensland and Western Australia are projected to have the fastest growing wage rates across the 10 years to 2015-16. The short-term is harder to pick as it can be affected by recent movements – some States will begin at an ‘above equilibrium wage’ while others will be in the process of catching up. These estimates will be affected by recent trends in State estimates of productivity growth in the industry. Similarly, recent movements in industry employment can also be significant – those States where employment has risen recently may expect lower productivity growth in the short run relative to the national average.

Annual results for wages growth

The tables below show the year-by-year forecasts for wages growth in the utilities sector and overall economy. Results are shown both in absolute terms, and with the effects of productivity increases removed. Initial results by State are more divergent – reflecting differing initial conditions in each State – with later results converging more to the national average, with differences primarily reflecting long term economic strength in each State.

ANNUAL NOMINAL WAGES GROWTH

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Nominal wages (utilities sector)										
NSW	5.7%	5.6%	5.3%	3.5%	3.5%	3.9%	3.4%	3.5%	3.5%	3.7%
VIC	5.3%	6.4%	4.9%	3.2%	3.3%	3.8%	3.4%	3.5%	3.8%	4.0%
QLD	5.6%	5.8%	5.3%	3.5%	3.5%	4.0%	3.5%	3.6%	3.7%	3.9%
SA	4.8%	5.4%	5.3%	3.5%	3.5%	4.0%	3.5%	3.6%	3.7%	3.9%
WA	5.5%	5.8%	5.4%	3.6%	3.6%	4.0%	3.6%	3.7%	3.7%	3.9%
TAS	5.1%	6.8%	5.0%	3.3%	3.3%	3.7%	3.3%	3.4%	3.6%	3.7%
NT	5.5%	5.9%	5.3%	3.6%	3.5%	4.0%	3.5%	3.6%	3.7%	3.9%
ACT	5.0%	7.5%	5.0%	3.2%	3.2%	3.6%	3.3%	3.4%	3.6%	3.7%
National	5.4%	5.9%	5.2%	3.4%	3.4%	3.9%	3.4%	3.5%	3.7%	3.8%
Nominal wages (all industries)										
NSW	4.2%	4.5%	4.1%	4.2%	4.2%	4.0%	3.7%	3.8%	4.6%	4.7%
VIC	4.2%	4.6%	4.1%	4.2%	4.2%	4.0%	3.8%	3.8%	4.7%	4.7%
QLD	4.5%	4.7%	4.3%	4.3%	4.3%	4.1%	3.8%	3.9%	4.7%	4.8%
SA	4.0%	4.5%	4.0%	4.0%	4.0%	3.8%	3.6%	3.7%	4.5%	4.6%
WA	4.7%	4.7%	4.2%	4.3%	4.3%	4.1%	3.8%	3.9%	4.7%	4.8%
TAS	4.1%	4.5%	3.9%	4.1%	4.0%	3.8%	3.6%	3.6%	4.5%	4.6%
NT	4.6%	4.7%	4.3%	4.3%	4.2%	4.2%	3.7%	3.7%	4.5%	4.6%
ACT	4.0%	4.6%	4.1%	4.1%	4.1%	3.9%	3.8%	3.8%	4.7%	4.7%
National	4.3%	4.6%	4.2%	4.2%	4.2%	4.0%	3.8%	3.8%	4.7%	4.7%

ANNUAL NOMINAL WAGES GROWTH (EXCLUDING PRODUCTIVITY)

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Nominal wages (utilities sector - excluding productivity)										
NSW	2.6%	1.3%	2.8%	3.0%	1.8%	2.1%	1.7%	1.9%	2.2%	2.3%
VIC	3.7%	-0.5%	3.7%	3.8%	2.3%	2.3%	1.8%	1.8%	1.6%	1.8%
QLD	2.9%	0.9%	2.9%	3.0%	1.8%	2.0%	1.6%	1.7%	1.8%	2.0%
SA	4.7%	1.7%	2.9%	3.1%	1.7%	1.9%	1.4%	1.6%	1.8%	1.9%
WA	3.2%	0.9%	2.7%	2.8%	1.6%	1.8%	1.4%	1.5%	1.7%	1.9%
TAS	4.0%	-1.6%	3.4%	3.6%	2.4%	2.5%	2.0%	2.0%	2.0%	2.2%
NT	3.3%	0.7%	2.9%	3.0%	1.8%	2.0%	1.5%	1.6%	1.7%	1.9%
ACT	4.2%	-3.1%	3.6%	3.7%	2.6%	2.8%	2.1%	2.2%	2.1%	2.3%
National	3.3%	0.6%	3.1%	3.3%	2.0%	2.1%	1.7%	1.8%	1.9%	2.1%
Nominal wages (all industries - excluding productivity)										
NSW	2.0%	1.6%	1.1%	2.3%	2.7%	2.2%	1.9%	2.1%	2.5%	2.5%
VIC	2.9%	1.6%	1.4%	2.3%	2.7%	2.0%	1.7%	2.1%	2.4%	2.3%
QLD	2.9%	1.4%	1.4%	2.6%	2.9%	2.4%	2.1%	2.4%	2.6%	2.8%
SA	2.4%	2.6%	1.7%	2.7%	3.0%	2.2%	1.7%	1.9%	2.6%	1.5%
WA	0.5%	1.3%	1.2%	2.3%	2.5%	1.9%	1.7%	1.9%	2.1%	2.0%
TAS	3.0%	3.4%	3.2%	2.6%	3.5%	2.9%	2.5%	3.4%	3.0%	2.3%
NT	1.8%	2.2%	1.9%	3.5%	3.4%	2.2%	3.0%	0.2%	2.4%	4.0%
ACT	3.4%	0.0%	2.3%	3.3%	3.4%	2.4%	1.7%	2.9%	2.8%	2.3%
National	2.5%	1.6%	1.4%	2.4%	2.8%	2.2%	1.9%	2.1%	2.5%	2.4%

FORECASTING WAGE GROWTH

Forecasts of wages growth, whether by sector, State or across the broader economy, can be split into three significant components:

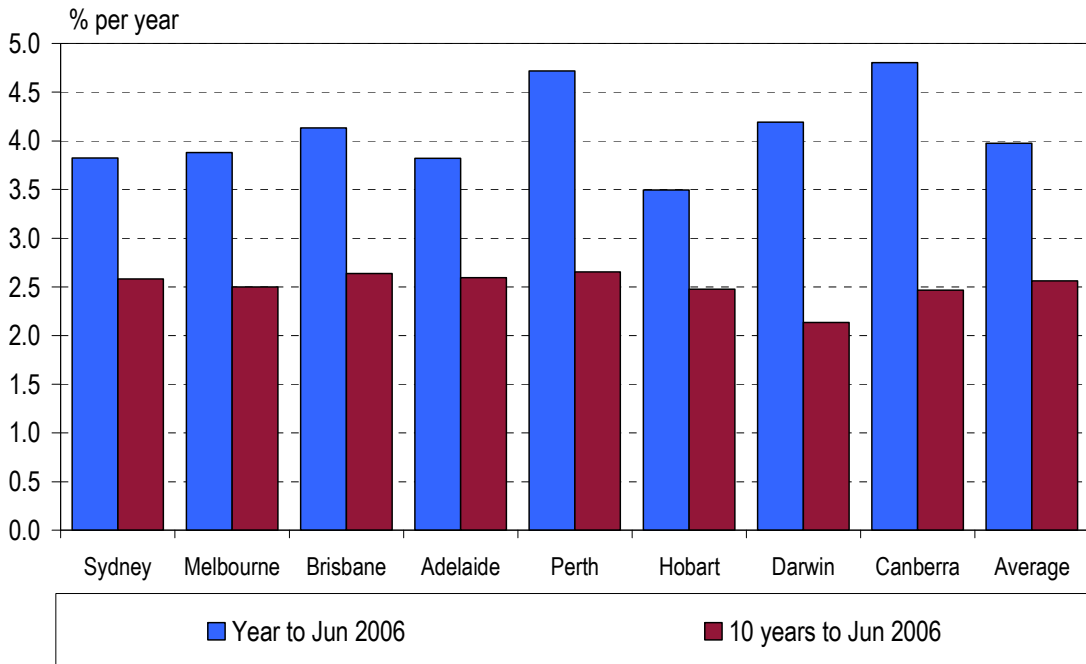
- ❑ Underlying inflationary trends;
- ❑ Growth in relevant productivity levels; and
- ❑ Cyclical factors.

Inflationary trends

Underlying inflation is an important driver of wage growth – workers desire their wage increases to at least keep pace with the increasing cost of living, with ‘real wage growth’ (increase in wages after the impact of inflation have been accounted for) often used as a measure of the true level of wage increase. The decline in CPI growth from the 6-9% per year range seen in the 1980s to the 2-4% range seen in recent years has been accompanied by similar declines in the measures of wages growth.

Inflation will tend to have a fairly constant impact on wage measures in different regions and industries in Australia, although at times different State (or sometimes even regional) variations can be important. At the State level, relative rates of economic growth can drive State¹ inflation rates at different speeds. As Chart 1 shows, over the past year prices in Perth and Canberra have risen particularly strongly, with inflation rates in Hobart far weaker.

CHART 1: INFLATION TRENDS IN AUSTRALIA



¹ CPI measures (as broadly used in the Australian context) refer to capital city prices only.

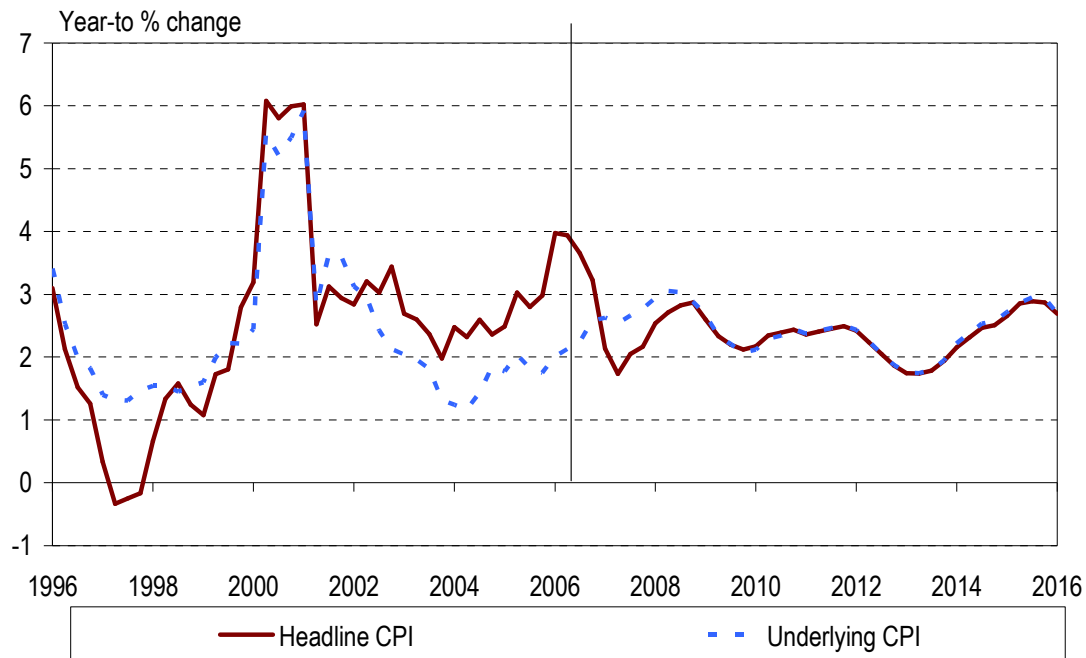
The chart also illustrates that, while short-term deviations can be significant, over the longer-term they tend to even out. As might be expected given economic patterns, there is slightly stronger average inflation in Brisbane and Perth and slightly weaker in Hobart. The Darwin result reflects the gradual lessening of the 'premium' on prices in that city that has occurred as the market for goods and services has expanded over the past decade. However, the fact that many goods are priced nationally means that over any extended time frame inflation rates will tend to equal out between the population centres in Australia – with short-term differences often reflecting different State and local taxation measures or service charges.

The outlook for inflation in Australia is explained in some detail in the later section of this report. However, in broad terms, underlying inflation² in Australia is picking up as demand begins to catch up to the potential level of supply in the economy. This has impacts on the cost of materials (and eventually on wages). Specific factors, such as petrol prices and bananas, can lift the headline rate of inflation, while leaving the underlying inflation rate relatively unaffected. It is the acceleration in underlying inflation that has led the Reserve Bank to increase interest rates, and this is the factor that will tend to drive wages growth up as well.

Chart 2 shows our forecasts of headline and underlying inflation growth across the coming decade. Underlying inflation tends to be far less volatile than the headline figure, and has remained well below the headline rate over the past three years. As one-off factors such as bananas move out of the CPI series, the headline rate should dip below the underlying rate. Note that, in the longer term, our forecasts for headline and underlying inflation are the same – as we are not attempting to forecast future natural disasters or petrol price spikes.

² The term 'underlying inflation' used to refer to the Treasury's specific measure of underlying inflation. This measure is no longer compiled and so now lacks a consistent meaning between commentators. We generally use the term to mean the broad idea of prices excluding volatile components. Where specific numbers are used, we use the 'private sector goods and services index' from the ABS' CPI publication.

CHART 2: HEADLINE AND UNDERLYING INFLATION FORECASTS



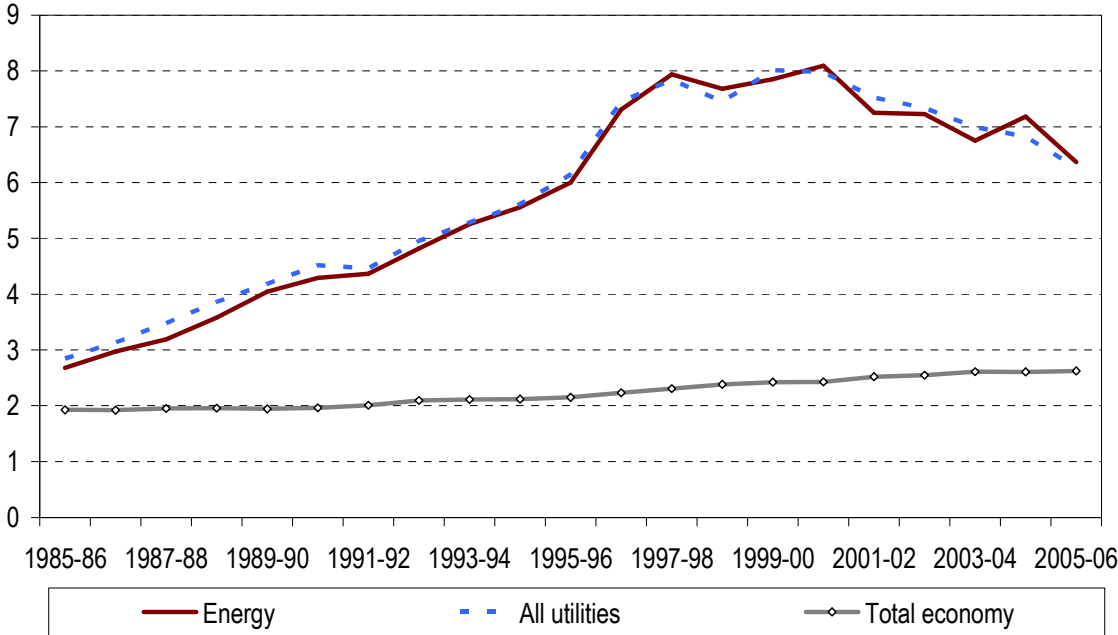
The inflation rate tends to move with the economic cycle (lagging by around 18 months). Broadly speaking, inflation rates should remain within the Reserve Bank’s stated 2-3% price band. While the headline rate should average slightly less than rates we have seen recently, the underlying rate may be slightly higher than over the past few years. The higher underlying rate is expected as the benefits of increasing low cost imports from China will have a lesser effect in coming years as the Australian dollar eases, and also as (relatively fast growing) health and medical costs take up an increasing share of the economy as the population ages.

Productivity trends

The second key driver for wage growth is **productivity**. The more work each individual worker can do, the greater the return is expected to be. The utilities sector has seen a very different pattern in its productivity growth rate to the general economy (where productivity growth has been quite steady).

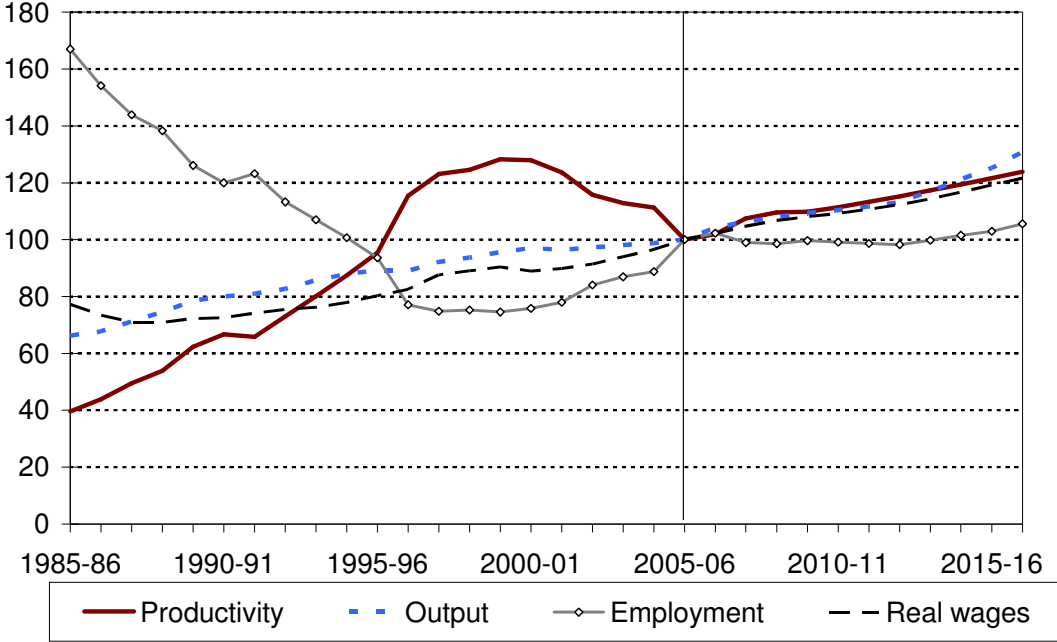
As Chart 3 shows, output per hour worked in the utilities sector generally (and in the ‘energy sector’ – electricity and gas – in particular) nearly trebled between 1985-86 and the end of the 1990s. While it has eased since this time, growth has still been far greater than in the general economy. So, while in 1985-86 the average output per hour worked in the utilities sector was 50% higher than the general rate, that figure is now closer to a 150% gap.

CHART 3: OUTPUT PER HOUR WORKED (\$) - INFLATION ADJUSTED



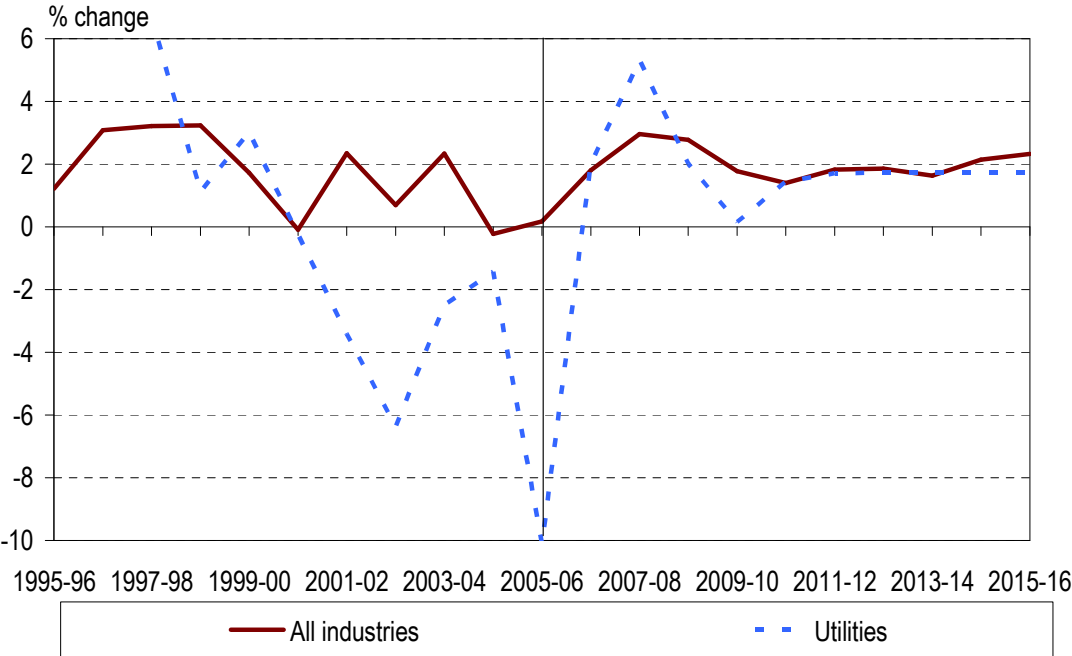
As the chart below shows, the growth in productivity occurred primarily because employment levels were falling sharply in the wake of deregulation, and declined again as employment growth returned. Throughout the period (and regardless of the concurrent movements in employment levels) output level rose in a fairly steady manner. This strong inverse relationship is not particularly surprising, as the output of the sector is far more capital-intensive than others. Indeed, much of the underlying demand for electricity and water will tend to rise with population (steadily growing) with an additional component reflecting the increasing use of electricity by each household (whether through more air-conditioners or more 'stand-by' setting on consumer electronics). Even as employment levels were cut during the periods of corporatisation and privatisation in the 1990s, output edged up steadily as supply and demand for electricity were largely unaffected.

CHART 4: KEY INDICATORS FOR THE UTILITIES SECTOR (INDEX – 2005-06=100)



Our longer term expectations for productivity growth in the utilities sector are that it will return to growth in line with national trends. As we anticipate utilities sector output will lag the broader economy (see the section on Utilities later), this implies relatively weak employment growth in the sector to maintain productivity growth.

CHART 5: PRODUCTIVITY GROWTH TRENDS



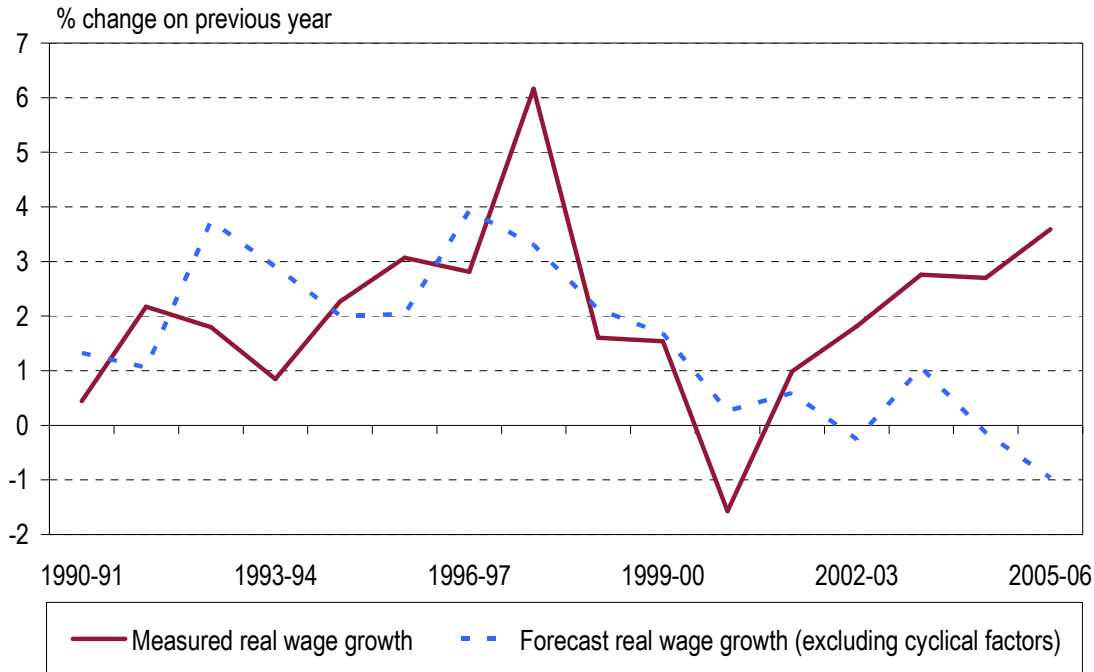
Because of the lag between employment and output growth there are greater cycles in productivity growth in an individual sector than in the broader economy (where different cycles from different industries will tend to cancel each other out). The recent strength in sector employment is anticipated to ease in the next few years allowing productivity levels to rebound somewhat.

Other cyclical factors

The remaining component of wages growth tends to reflect mismatches between demand and supply in employment, which allow employees greater strength in determining wage growth outcomes (as demand exceeds supply at present).

Chart 6 shows an estimate of expected utilities sector real wages growth based on growth in output and productivity (the use of real wages means that changes in inflation do not affect the results). The gap between this measure and the actual growth in wages is an estimate of the ‘cyclical component’.

CHART 6: ESTIMATE OF CYCLICAL FACTORS IN UTILITIES WAGE GROWTH



The period until 2001-02 saw the two measures average broadly the same (an average gap of just 0.2% per year). However, the last four years have seen the two measures move in different directions, with falling productivity rates not being reflected in falling wage growth – but precisely the opposite.

This result due in part to the increase in demand for workers in the utilities sector over recent years. Because output levels in the sector are not as reactive to employment changes, an increase in employment does not translate to increase in output – particularly in the short term. Much as the construction of new infrastructure is related to expected future demand for electricity and water rather than demand right at the moment, increasing employment can be required to run new facilities even before their output is fully utilised (or, more accurately, the output of the entire utilities grid).

This means, as can be the case in the mining sector, expected future demands can see employment levels rise, lifting wage rates as the sector tempts workers from other areas, even though output levels are broadly constant.

CHART 7: FORECAST OF CYCLICAL FACTORS IN UTILITIES WAGE GROWTH



So, while productivity bounces back, we would expect that to be reflected in a fall in the gap between underlying and actual wage growth. There will obviously be further cycles in the results around our central forecast, but the current unusual gap should unwind over time.

Our broad expectation is that the impact of skills shortages in the industry (and the economy in general) will decline across the next three years. With real output growth still weak and forward indicators for job markets signalling caution, it looked as if 2006 would usher in slower job gains despite an economy flush with money. But recent months confounded that, with a surge in jobs. That latest surge is consistent with the business surveys, which continue to loudly lament skill shortages. Yet the story in the forward indicators for the job market remains mixed at best:

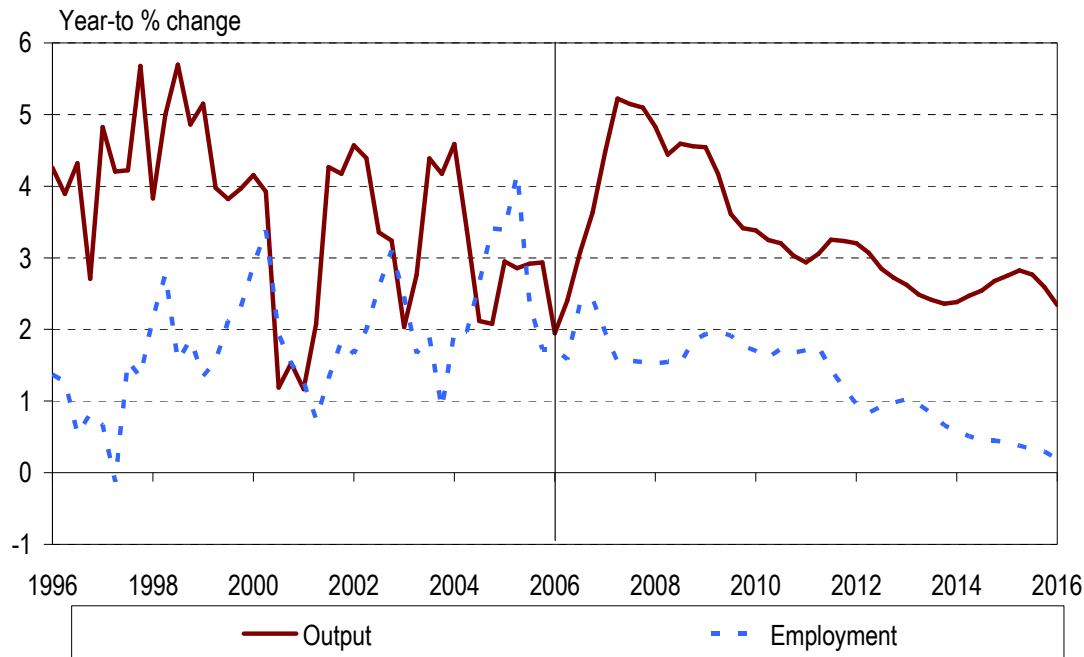
- ❑ ANZ jobs ads have fallen recently, but seem to have stabilised over the past couple of months. ANZ notes that "this indicates that employment growth will also soon stabilise at a lower level".
- ❑ The Department of Employment's *leading indicator* has been easing – but we are less inclined to believe it than usual. The main driver of continuing job gains is profits, and the latter is not represented (directly or indirectly) in the components of the indicator.
- ❑ The Department's *Skilled Vacancy Survey* is still at much the same levels since 2001, but is more down than up recently. As has been true for a while, trade vacancies are weakening outside of construction, but vacancies are more steady for professionals, and rising in IT.

We attribute the renewed surge in job gains of late to the same factor we saw underlying earlier strength in the job numbers back in 2004-05 – it is not so much that the economy is

growing fast, but that profits are very strong. That means that, if businesses can sell more, they can make rather more profit – hence their desire to take on extra people.

That is why the job growth seen in Chart 8 looks so unusually strong relative to the modest output growth Australia has managed since the east coast housing price boom sputtered out. It is not the strength of the economy seen in this chart that is vital – rather, it is the stunning strength in profits implied in Chart 15 and Chart 16 (see the section of **Broader Trends in Wages**).

CHART 8: GROWTH IN OUTPUT AND EMPLOYMENT



Note the good growth in output shown in Chart 8 doesn't point to improving demand strength for workers. Much of the lift in output around the corner will come from resource export volumes and related sectors – in effect, areas which are capital-intensive rather than labour-intensive, and hence providing little wind underneath the wings of job gains and allowing some of the pressure on wages to ease.

Decomposing State level indicators

Unfortunately, the way output data for industries at the State level is released can make estimation of State productivity growth somewhat fraught. While industry output at a national level is a 'value added' measure – at a State level the output level is effectively a measure of compensation of employees plus estimated industry profits. The first component is a broader measure than just wages, and can be affected by factors such as superannuation payouts, workers compensation cases and (crucially for this sector) severance packages.

Given that most State have seen a large drop in employment over this time – and not all during consistent time frames – the 'compensation' figures in some years will be boosted by payments to redundant workers, precisely at the time that the true measure of cost of employment is actually falling. The compensation payouts are effectively 'bringing forward' a

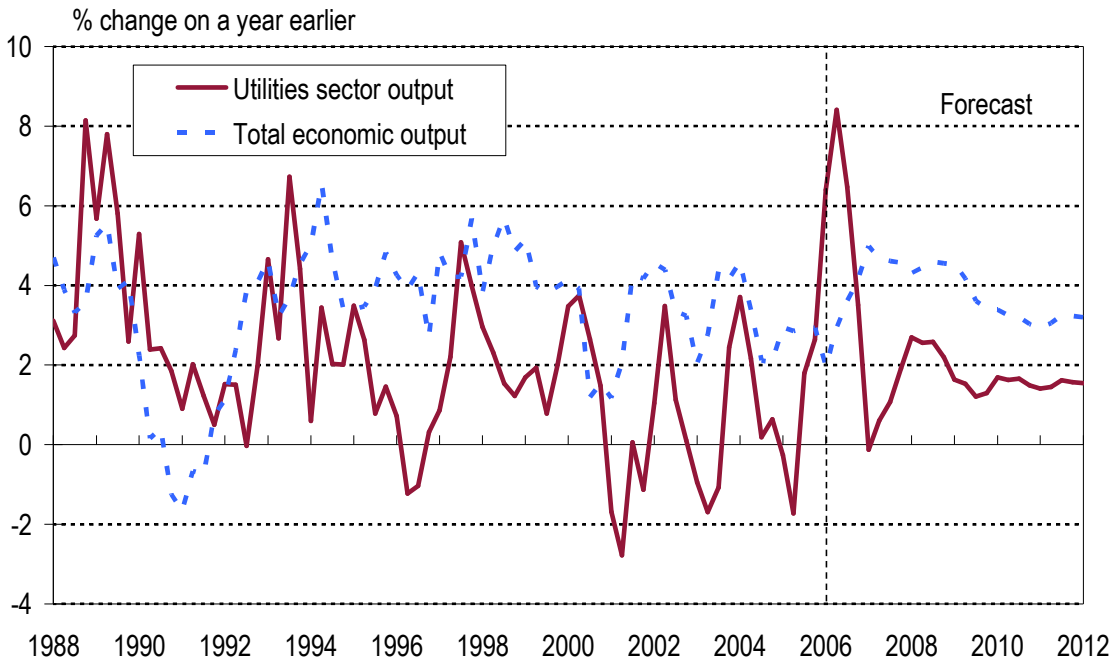
proportion of the future wages that would otherwise need to be paid if the employees were retained – the benefits being seen in lower wage costs in later years.

The effect of these impacts are to complicate the estimation of output per worker – in effect future wages are included in the output side (lifting the numerator in the productivity equation) and the lost employees are not included in the employment side (lowering the denominator in the same estimate). These problems also limit the ability to estimate average wages via this method (as, wages per worker is a common alternative measure of workers payments to average weekly earnings at the national level).

THE UTILITIES SECTOR

Both employment and output in the **utilities** (electricity, water and gas) are headed strongly upward at the moment – partly because they too are caught up in the China boom, as private and State-owned operations are all involved in a broad improvement of national infrastructure in this area. And it is also partly because some drivers (such as the electricity-hungry take up of air conditioning and home computing) help underlying demand growth.

CHART 9: UTILITIES SECTOR GROWTH



But we can't say that we expect good growth to be the story of the longer term. Water output may (we hope) become steadily more traded (or, if not, steadily more expensive), but chances are that output is unlikely to travel at speed. So too the other utilities – although climate change may help the demand for electricity (via air conditioning again), it will also tend to raise costs and hence prices. And various rules and regulations will be limiting the use of (and hence the demand for) electricity, water and gas over the longer term – some for bad reasons, and some for good.

That is why we tend to doubt this sector's ability to maintain a sprint for any great length of time (as our forecasts in Chart 9 above show). Laggard States continue to play catch-up on the reform front, with a wholesale electricity market recently becoming operational in WA.

BROADER TRENDS IN PRICES

Underlying inflation is rising as demand catches up to the economy's supply side potential – which, in turn, is raising wages and the cost of materials. Headline inflation has risen even more, topped up by bananas and petrol prices. The momentum behind demand may keep underlying inflation flirting with 3% for a while, but its next big move is down. New supply is coming – more workers, factories, mines and roads. That will send underlying inflation back down through 2007-08. And headline inflation may ease from now on as banana and petrol prices pull back.

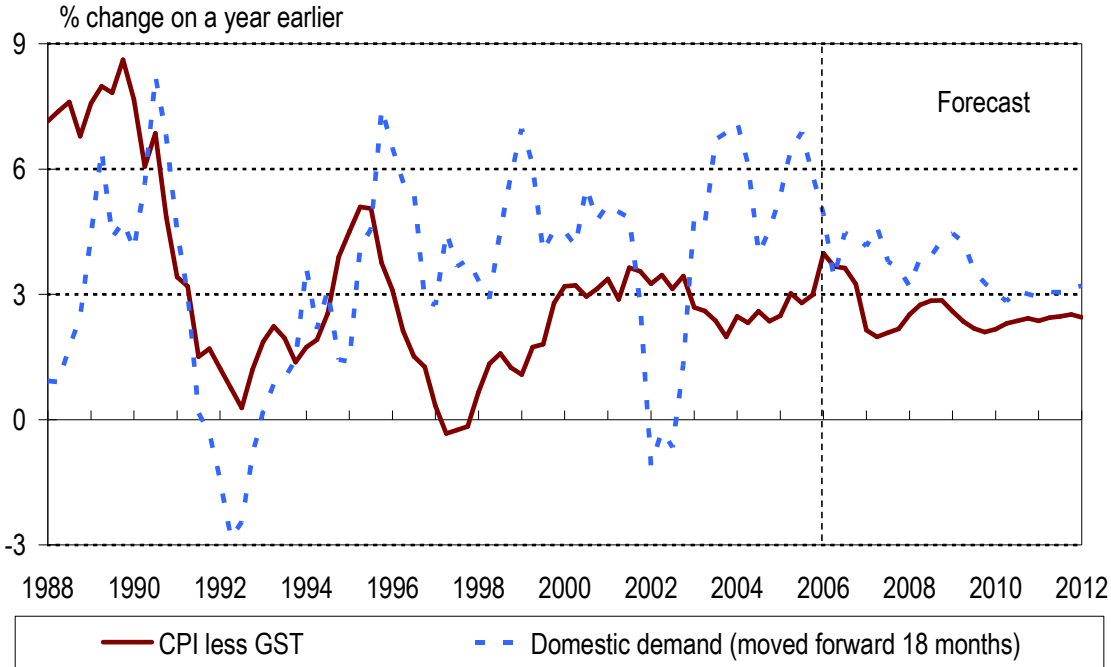
A banana and oil-fuelled burst sent headline CPI inflation to 4.0% (see Chart 10). On the measure we use – prices for non-volatile market goods and services – underlying inflation is still just 2.0%. But on the measures the Reserve Bank favours, underlying inflation has now crept close to 3%. (The Reserve's 'trimmed mean' ranks all the price changes in the CPI for everything from petrol to cereal from the largest rise to the largest fall, then trims off the top and bottom, leaving only the middle 70% of price changes. Similarly, its 'weighted median' ranks all price changes, then takes as the inflation rate the increase in the 'middle' item.)

Headline inflation will fall from here as petrol and banana prices are already dropping. But the key is, of course, where underlying inflation (not headline inflation) next heads. And the problem there is that measures of underlying inflation are better at indicating current price pressures than they are at forecasting future pressures. The latter depend on three key drivers – demand pressures, labour cost pressures, and import price pressures.

The classic description of inflation is 'too much money chasing too few goods' – or, in other words, demand greater than supply. Chart 10 is a reminder that demand growth has been high for ages – initially fuelled by a housing price boom (which encouraged the punters to indulge in retail therapy), and then a commodity price boom (which encouraged businesses to invest in new capacity). Most recently, big tax cuts have kept demand growth very strong. When demand starts to run ahead of supply capacity, two buffers take the shock – imports and inflation. Imports have grown faster than exports in recent years. In fact, if you measure the trade deficit using commodity prices at their 2003-04 levels (as a proxy for their longer term value), then 'demand' is about 5½% ahead of 'supply' in the Australian economy.

So will inflation continue to rise too? Not necessarily, as the supply side of the economy is strengthening fast. Participation in the workforce is up as firms use more workers to try to satisfy the strength in demand. And businesses are investing at rates never seen before. Indeed, so strong is investment that the overall stock of business capital – the machines, buildings, factories and mines of the Australian economy – is growing at the fastest rate since the early 1980s. That supply boost will increasingly free up capacity constraints and thereby take some pressure off prices. Similarly, the end of the housing price boom directly reduces price pressures. But even if supply is growing and housing prices are no longer rising fast, demand growth is still being pushed along by tax cuts. That makes demand a lingering threat to the inflation outlook – but hopefully not an overly dramatic one.

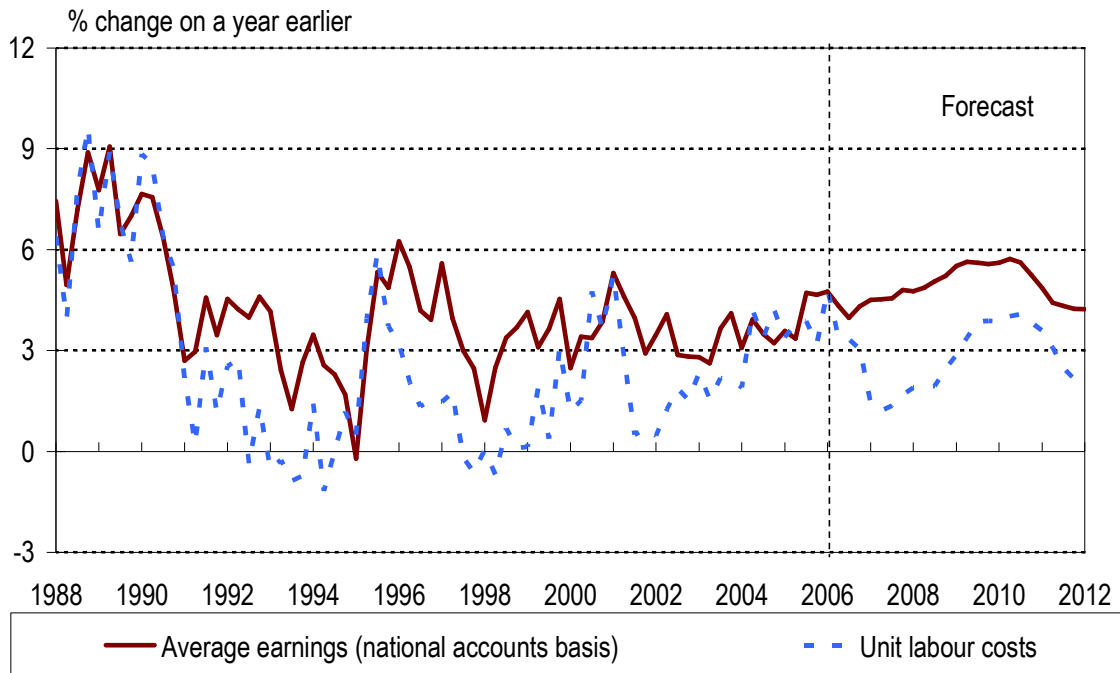
CHART 10: THE LAGGED IMPACT OF OUTPUT ON PRICES



Most concerns focus on the potential for **labour costs** to leap amid low unemployment and high profits, sending up inflation as a result. But, as Chart 11 shows, wage gains continue to be modest. In part that reflects today’s deregulated job market (in which big wage gains in one sector don’t leap the fence to other sectors). And in part it reflects the importance of labour costs rather than wage growth to inflation. Chart 11 shows both. The gap between them is due to gains in productivity – there is no need for selling prices to go up if the cost of a wage rise is covered by improved productivity. This latter gap is about to become rather important, as the investment in new plant and equipment and commercial and engineering construction already underway will soon show up as rather rapid productivity growth.

Or, in other words, investment boosts the speed limits of the economy (and so lowers the risks for inflation), and the channel through which this will show up is via subdued growth in labour costs. Hence labour cost growth may already have peaked for this cycle. The latter dichotomy explains Access Economics’ view that wage gains will lift further, but also that we don’t think gains in nominal unit labour costs will. If true, that would be good news.

CHART 11: WAGES AND LABOUR COSTS



So both demand pressures and labour costs may fade as inflation risks because the supply side is galloping to the rescue of price pressures. More and more productive workers will help restrain labour costs and help to boost supply relative to demand. Yet there may be inflation risks around the corner connected to the third key driver of inflation – **import prices**. As Chart 12 shows, the latter are volatile, typically moving in response to swings in the \$A. And they are typically low, thanks to the continuing transfer of manufacturing capacity from high cost developed nations to low cost developing ones. Globally, this raises productivity and lowers prices for many manufactured goods. Of late, however, import prices have shown signs of friskiness, as oil prices and the prices of other industrial commodities have leapt.

The good news is that we think oil prices may have peaked – and so does the consensus view of those in Access Economics' *Minerals Monitor* publication. Oil prices are seen back at \$US 55 by early 2009 by our survey panel, partly due to expected slowdown in the US taking some pressure off demand growth, and partly due to the Israel/Lebanon ceasefire and reduced tensions around Iran's nuclear ambitions. Moreover, the initial shock of higher oil prices was magnified at the pump by a sudden lack of refinery capacity. However, the latter has since lifted, and hence refiners' margins have dropped – especially in Asia.

The bad news is that we think most industrial commodity prices are close to peaking – and that, as and when they fall, the \$A will slide alongside them in sympathy. If that proves true, it could generate a considerable lift in import prices, perhaps through 2007-08 and 2008-09.

CHART 12: IMPORT PRICES AND INFLATION

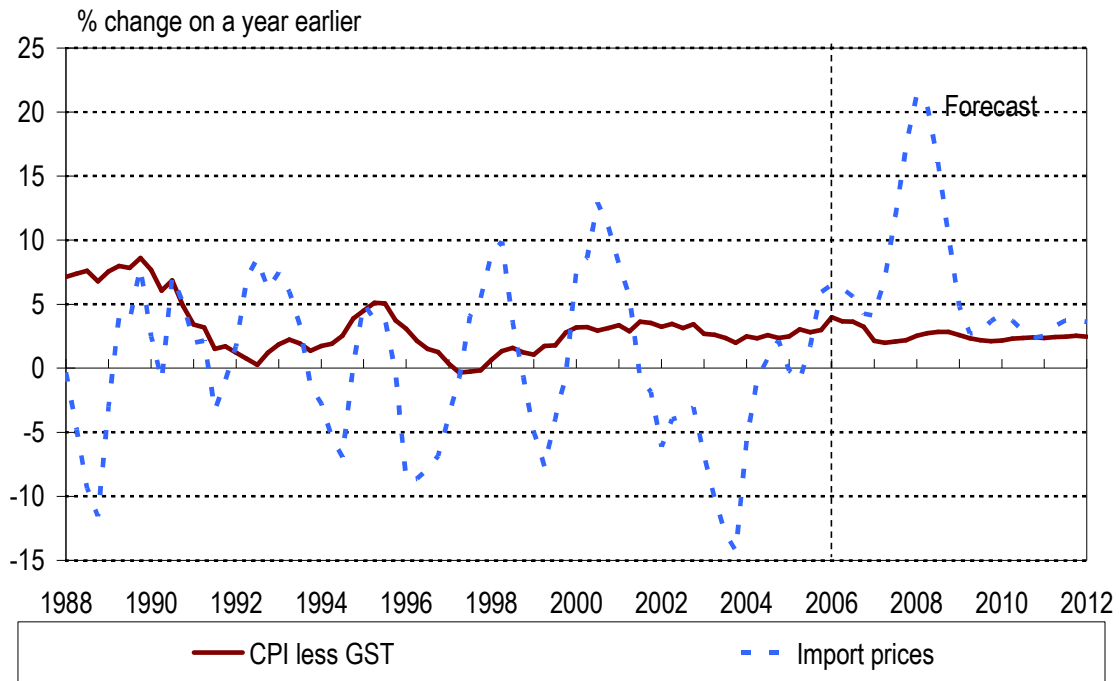


TABLE 1: PRICE INDICES

	Forecasts					
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Headline CPI index	151.6	156.5	159.9	164.3	167.9	171.9
% change	3.2	3.2	2.1	2.8	2.2	2.4
% change (12 mths to year end)	4.0	2.1	2.5	2.6	2.2	2.4
Underlying CPI index	151.2	154.8	159.1	163.6	167.3	171.2
% change	1.9	2.4	2.8	2.9	2.2	2.3
% change (12 mths to year end)	2.0	2.6	3.0	2.6	2.2	2.3

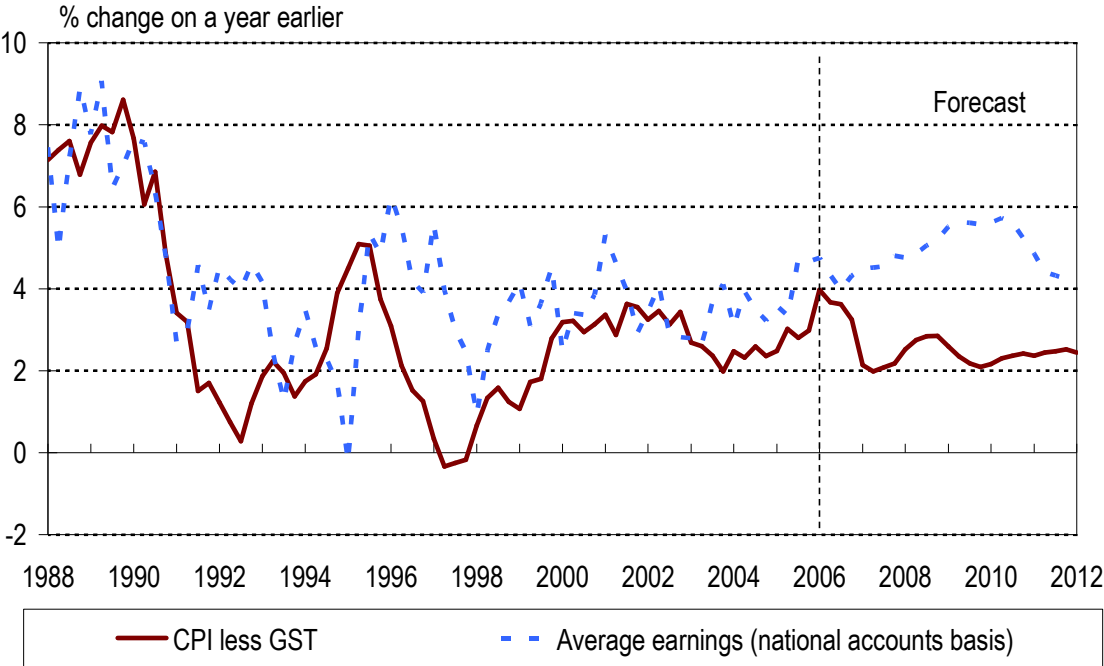
ABS no longer publishes the 'Treasury underlying CPI index'. To replace that, we use the private sector goods and services price index as an 'underlying' CPI. CPI indices are based at 1989-90=100.

BROADER TRENDS IN WAGES

Wage gains may continue to edge up towards 5%, but only slowly so. The coming increase in output capacity will steadily be matched by an increase in skilled workers thanks to increasing levels of targeted immigration, and the gradual transferral of skills to areas where wage growth has been strongest.

The news for **wage growth** remains pretty much the same as it has for a while now – yes, wage gains are probably still creeping up but, no, they continue to fall well shy of the feared lift in wage gains. Our preferred measure of wage inflation, the Labour Price Index (LPI) rose 4.1% in the past year (4.4% in the public sector, and 4.0% for the private sector), and has no particular momentum behind it at the moment. Other measures are mixed, with the national accounts-based measure up 4.8% in the past year (see Chart 13), while average weekly ordinary time earnings (AWOTE) is up 3.5% and average weekly earnings (AWE) is up 4.7%. On average therefore, a bit over 4%.

CHART 13: WAGES AND INFLATION



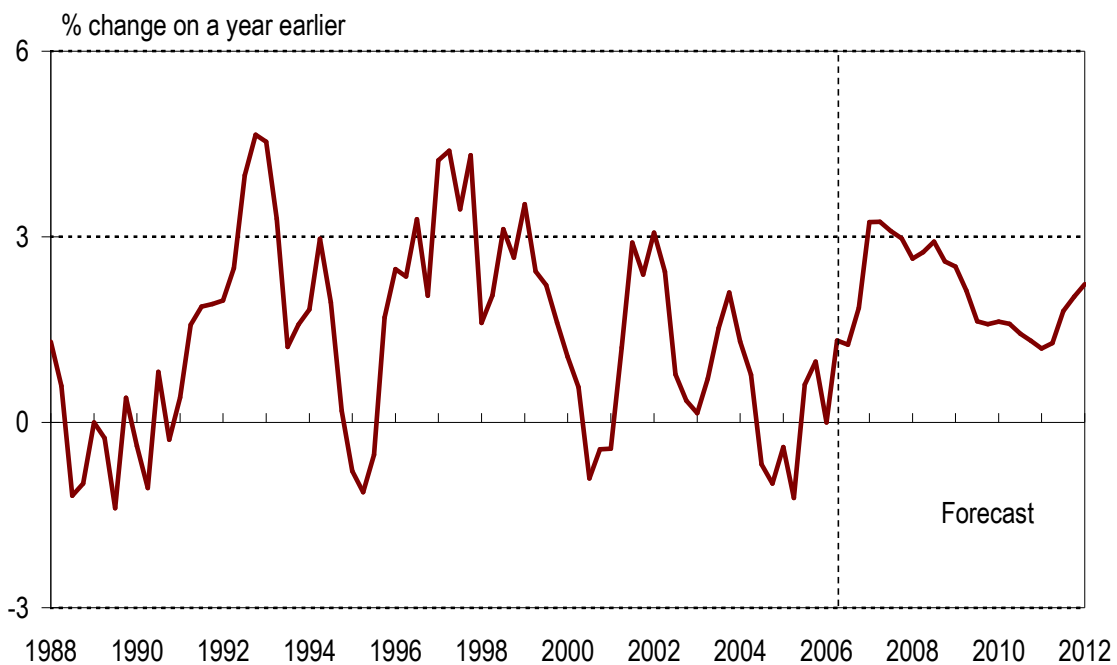
The same characterisation of “a bit over 4%” is broadly true in the enterprise bargaining data kept by the Department of Employment. The latest quarter saw a rise of 4.4% in new agreements signed, but the average among all agreements in force has been sitting at 4.1% for some time now. It’s as if industrial relations – once the bloodsport of the political arena – has swapped the cloth caps and balaclavas of times past for a nice cardigan. And that is great news – boring IR means that the economy can grow stronger for longer than ever before.

TABLE 2: WAGES GROWTH IN ENTERPRISE BARGAINING AGREEMENTS

Quarter	Private sector			Public sector			Total		Total All current agreements
	# of agmts	Employees ('000)	Wage rise (% annual)	# of agmts	Employees ('000)	Wage rise (% annual)	# of agmts	Employees ('000)	
Dec-04	929	166.5	3.7	88	81.8	4.6	1017	248.3	4.0
Mar-05	952	95.7	4.0	202	62.9	4.6	1154	158.6	4.3
Jun-05	1220	150.8	3.8	93	69.4	4.4	1313	220.2	4.0
Sep-05	1765	102.2	4.3	117	65.6	3.8	1882	167.8	4.0
Dec-05	2534	117.4	4.2	145	143.4	4.7	2679	260.8	4.5
Mar-06	2039	151.7	4.0	133	96.7	3.7	2172	248.4	3.8
Jun-06	2024	91.5	4.0	54	79.0	4.6	2078	170.5	4.4

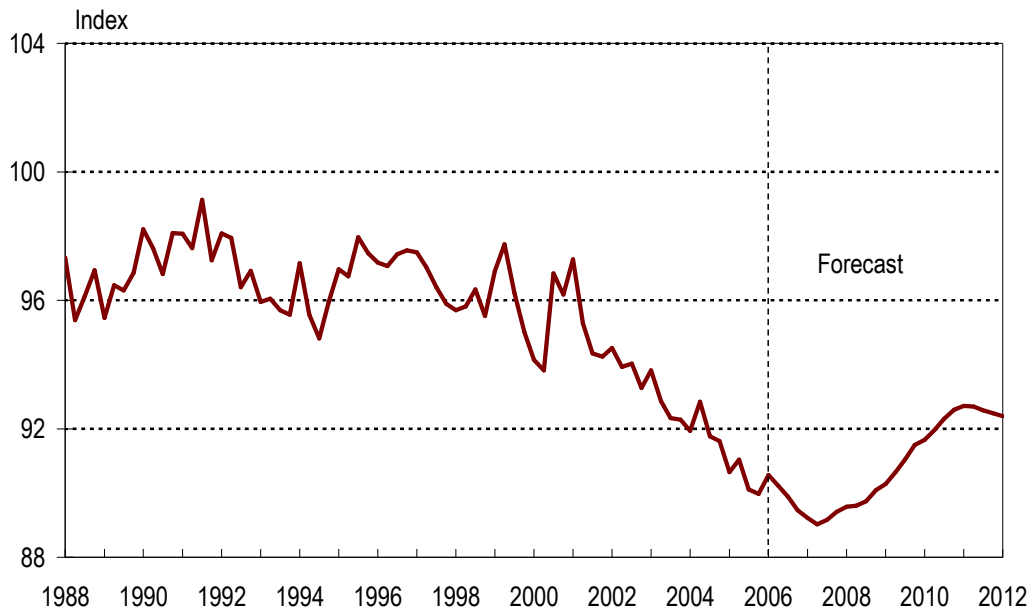
Source: Department of Workplace Relations Agreements database

CHART 14: PRODUCTIVITY GROWTH



Wage increases have been concentrated where they should be – in WA and Queensland, and in the utilities (6.9% in the past year), mining (5.9%) and construction (5.5%). Among broad occupation groups, the highest increases have been for intermediate production and transport workers (4.8%), tradespersons and related workers (4.7%) and professionals (4.5%). The industries recording the smallest increases are accommodation, cafes and restaurants (3.3%), cultural and recreational services (3.3%), retail (3.4%) and communications (3.4%).

CHART 15: REAL UNIT LABOUR COSTS



So:

- ❑ wages are growing fast where they should be and slower elsewhere and;
- ❑ overall wage gains remain well constrained.

That's great. Arguably it is attributable to a more flexible job market, as well as to the lift in numbers of people willing to work (an extra quarter of a million people put up their hand for a job in the past year and a half, giving employers more choice than they've ever had). Yet with the latest round of tax cuts and still rampant commodity prices, chances are that pressures on wages will continue to build. Our forecasts have wage growth edging up all the way through to 2008 – but steadily so rather than rapidly. Moreover, with productivity about to be boosted by the degree of 'capital deepening' now underway, that lift should not pose too many dangers for price inflation. That said, we also think that easing profits will combine with rising wage gains to send the wage share of the national economic pie back to where it was earlier this decade (see Chart 16). Or, in other words, today's wage pressures won't disappear anytime soon.

CHART 16: WAGES AS A SHARE OF NATIONAL OUTPUT

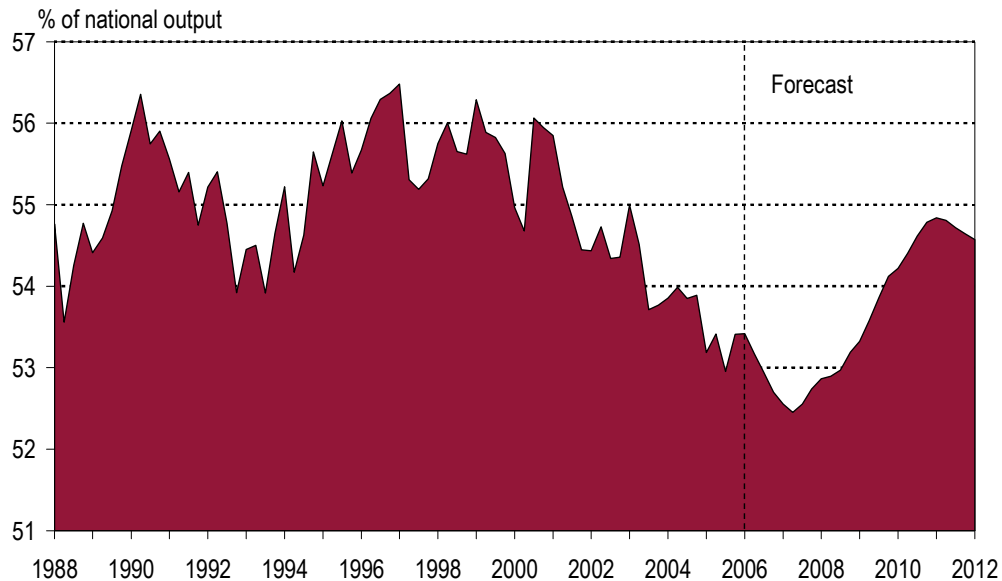


TABLE 3: MEASURES OF WAGES IN AUSTRALIA

	Forecasts					
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Average Weekly Ordinary-Time Earnings	\$1,031.97	\$1,072.35	\$1,125.98	\$1,170.27	\$1,217.32	\$1,262.83
Average Weekly Earnings	\$815.72	\$857.48	\$897.87	\$936.57	\$979.23	\$1,021.41
Non-farm wages & on-costs per worker	\$988.43	\$1,030.76	\$1,078.79	\$1,134.52	\$1,198.13	\$1,262.31

\$ per week in all cases

TABLE 4: NATIONAL MEASURES OF WAGE GROWTH

	Forecasts					
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Average Weekly Ordinary-Time Earnings	4.8	3.9	5.0	3.9	4.0	3.7
Average Weekly Earnings (AWE)						
% change	5.1	5.1	4.7	4.3	4.6	4.3
% change (12 mths to year end)	4.7	5.0	4.5	4.5	4.6	4.7
Labour price index	4.1	4.3	4.6	4.2	4.2	4.2
Non-farm wages & on-costs per worker	4.4	4.3	4.7	5.2	5.6	5.4

% change on previous year unless stated

TABLE 5: UNIT COSTS AND PRODUCTIVITY

	Forecasts					
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Nominal unit labour costs (% change)	3.9	2.8	1.5	2.3	3.7	3.9
Real unit labour costs (index)	90.4	89.7	89.3	89.9	91.2	92.4
% change	-1.4	-0.8	-0.5	0.7	1.4	1.3
Non-farm labour productivity (index)	127.5	129.9	133.8	137.4	139.8	141.7
% change	0.1	1.9	3.0	2.7	1.7	1.4