ECONOMIC VIEWPOINT

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017
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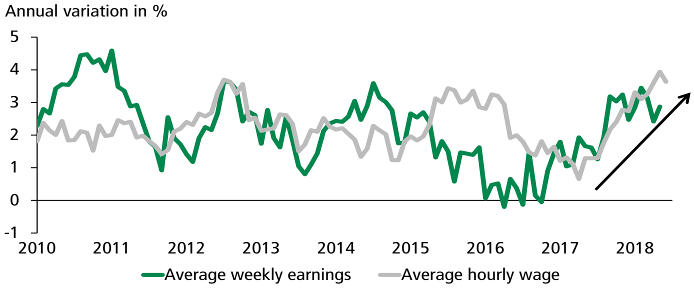
#1 BEST OVERALL FORECASTER - CANADA

The Sharp Increase in Wages May Contribute to Greater Inflation in Canada

Wages in Canada have risen faster in recent months. This adjustment is largely the result of labour shortages in some sectors and regions against a backdrop of a fairly high demand for workers. However, a rapid increase in wages does not reflect significant gains in worker productivity. This has fuelled fears that the quickened pace of wage hikes will eventually lead to higher upside pressure on inflation. The Bank of Canada (BoC) will have to monitor this situation closely and adjust the pace of its monetary tightening as a result.

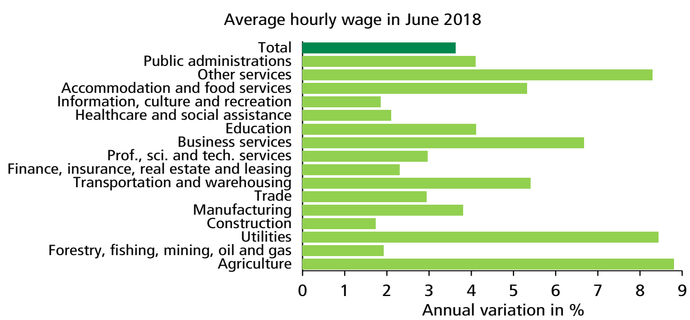
Wage growth in Canada has accelerated significantly in recent months. After relatively little change in 2016 and early 2017, annual changes in average weekly earnings and average hourly wages are now growing at roughly 3% (graph 1). Furthermore, this hike is fairly widespread, as the annual growth in the average hourly wage is high in several economic sectors (graph 2). From a geographic perspective, all the provinces are recording a significant annual increase in the average hourly wage (graph 3). Nonetheless, British Columbia, Saskatchewan and Ontario stand out due to growth that clearly exceeds the national average. However, it should be noted that the geographic distribution of average weekly earnings differs from these results because of the combined effect of higher hourly wages and the total number of hours worked. According to this measurement, Quebec clearly

GRAPH 1
Wage growth is accelerating in Canada



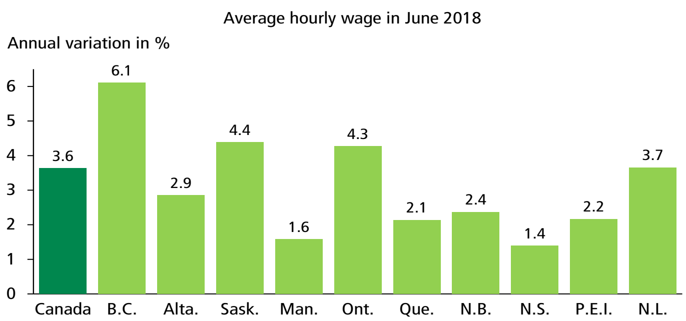
Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 2
Wage growth is fairly strong in several economic sectors



Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 3
Wage growth is highest in Ontario, Saskatchewan and British Columbia



Sources: Statistics Canada and Desjardins, Economic Studies

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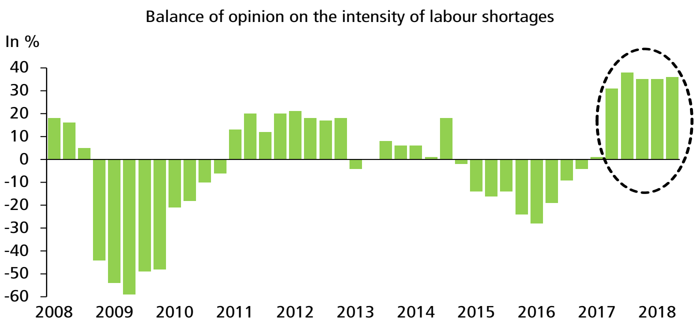
stands out from the other provinces with an increase that is significantly higher than the national average.

Labour Shortages Are Being Felt

The faster growth in wages can be explained, in part, by the labour shortages increasingly evident in certain sectors and regions. According to a BoC survey of businesses, labour shortages have continued to worsen since the spring of 2017 (graph 4). Some 34% of the businesses indicated that they were facing a labour shortage that restricted their ability to meet demand in the second quarter of 2018. Needless to say, this is a fairly large number historically.

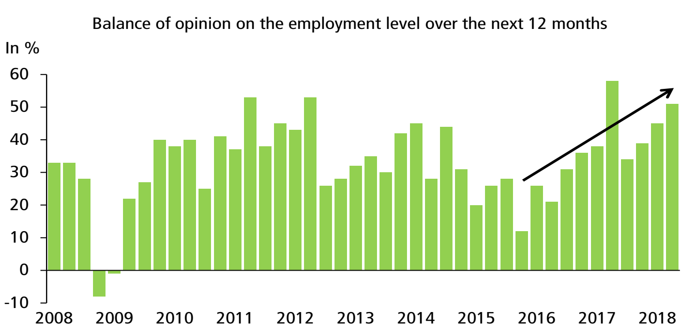
GRAPH 4
The labour shortage problem has continued to worsen since the spring of 2017



Sources: Bank of Canada and Desjardins, Economic Studies

However, there is no immediate solution in sight. The hiring intentions of businesses for the next 12 months are very high (graph 5). Furthermore, job creation has been very strong over the last few months, and the unemployment rate has dropped significantly, reaching its historic low (since 1976) on several occasions.

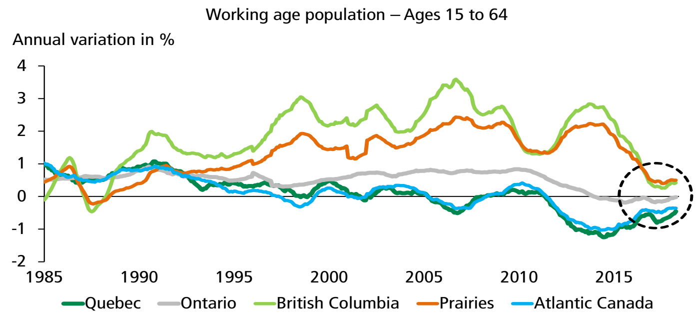
GRAPH 5
Hiring intentions are very high in Canada



Sources: Bank of Canada and Desjardins, Economic Studies

As regards available labour, the aging of the population, an issue often referred in recent years, continues unabated. The annual change in the working age population has slowed significantly virtually across the country (graph 6). Quebec and Atlantic Canada have been hit particularly hard, as their working age populations are declining. In Ontario, the change is practically zero, while growth is in steep decline in British Columbia and the Prairies. According to a BoC survey, British Columbia may be the province currently suffering the greatest labour shortages, which has translated into the fastest rise in hourly wages in the country. With a high demand for labour and a limited supply due to the aging of the population, there is every reason to believe that the upside pressures on wages may continue for some time.

GRAPH 6
Eastern and Central Canada are especially affected by the aging of the population



Sources: Statistics Canada and Desjardins, Economic Studies

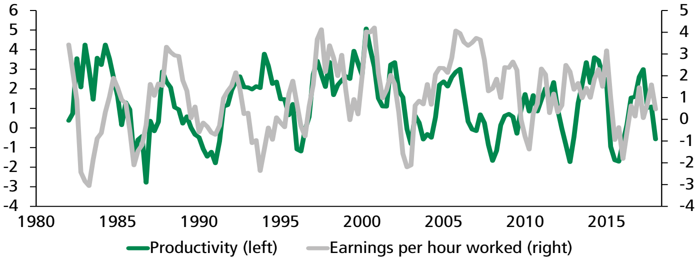
Productivity or Inflation?

Assuming that the relative significance of worker earnings as a portion of all types of income (household, business, and government) remains practically unchanged in the short and medium terms,[1] we can see a fairly close relationship between the change in real wages (i.e. minus inflation) and the rise in worker productivity (graph 7 on page 3). Thus, when workers achieve gains in productivity, they are usually able to benefit, in part, through higher wages. The opposite is also true when real wage growth remains at generally lower levels while there is little change in worker productivity.

Under these circumstances, one might expect to see the recent hike in worker wages go hand-in-hand with improved productivity. This is not the case, however. Instead, labour productivity lost ground during the last few quarters, and the annual change was slightly negative at the start of 2018 (graph 8 on page 3). Preliminary data also show that the situation may not improve in the second quarter of 2018.

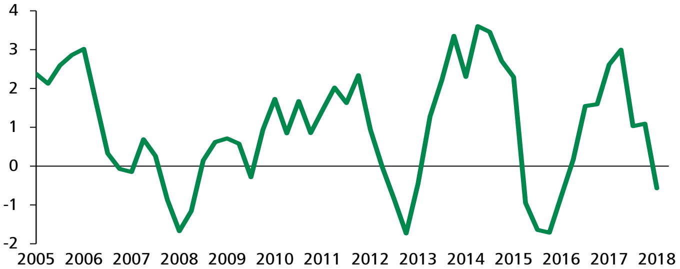
[1] The relative size of employee earnings as a portion of all types of income is not always consistent from a historical viewpoint. Moreover, a significant decrease occurred between 1990 and 1995. However, over the last few years, it has remained much more stable, with fluctuations contained within a fairly narrow range.

GRAPH 7
Real wage growth is usually associated with increased productivity



Sources: Statistics Canada and Desjardins, Economic Studies

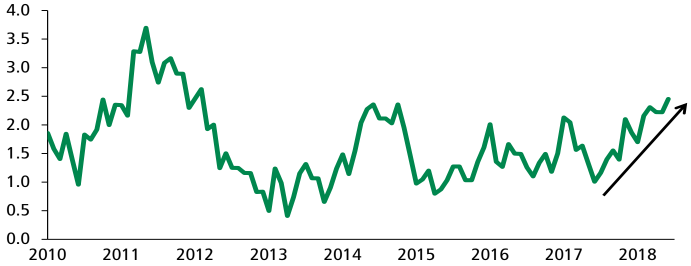
GRAPH 8
The growth in worker productivity was practically zero at the start of 2018



Sources: Statistics Canada and Desjardins, Economic Studies

This disconnect between productivity and rising wages raises important questions. The low productivity gains suggest that there will also be modest increases in real wages. Given that nominal wage growth is high, inflation could grow significantly and, at the same time, reduce real wage growth. The link is fairly straightforward: the rise in nominal wages will cause household spending to rise more quickly, which, in turn, will lead to upside pressures on certain prices, especially when production is operating at full capacity, as is currently the case. Under these circumstances, there is reason to fear that the total annual inflation rate will continue to climb in the months to come (graph 9). This finding is in addition to other observations that also signal further price growth. With excess production capacity fully utilized, upside pressures are appearing in business input and output prices according to the PMI indexes. The recent introduction of customs tariffs between Canada and the United States may also have an eventual impact on some consumer prices.

GRAPH 9
The total annual inflation rate is trending upward



Sources: Statistics Canada and Desjardins, Economic Studies

Rate Hikes Are Expected to Continue

Faced with these inflationary threats, the BoC will clearly have to remain vigilant. With an overnight target rate of 1.50%, the monetary policy remains expansionary. Other rate hikes will be necessary in order to achieve a neutral point when it comes to monetary policy. The speed and size of these increases will largely depend on changes in how inflation and economic growth are perceived.

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