



# Weekly Economic Briefing Global Overview

## Parsing the Phillips curve

08 September 2015

For all the pessimism about the global economy right now, it is easy to forget that stress is largely confined to the emerging market complex and the commodity-producing developed economies. Growth is holding up well in the commodity-importing developed economies that make up the bulk of global GDP, with unemployment rates continuing to decline (see Chart 1). The dominant prism through which economists model the implications of changes in unemployment rate is the Phillips curve. In its original version, there was supposed to be a stable negative relationship between the unemployment rate and inflation. This appeared to give central banks the power to choose different combinations of inflation and unemployment according to their preferences. In practice, however, exploiting the Phillips curve has proven rather difficult. The negative relationship between unemployment and inflation only applies in the short run and, hence, attempts to push unemployment below its natural rate are doomed to fail and only result in higher inflation. Essentially, central banks can only lower unemployment without undermining their inflation targets when there is slack in the labour market.

Further complicating central bankers' jobs is that the slope of the short-run Phillips curve itself is liable to change over time. For example, today it is widely acknowledged that the Phillips curve is much flatter than it was in the past. This explains why underlying inflation fell relatively little during, and immediately after, the financial crisis, despite enormous increases in unemployment in most of the developed countries. It also helps explain why inflation is likely to rise only slowly now that unemployment is declining in most of the large developed economies, as well as why the ECB and Bank of Japan will need to keep policy extremely loose for a long period of time if they want to eventually hit their inflation targets. The flatness of the Phillips curve will also make it easier for the Fed and Bank of England to withdraw policy accommodation very gradually without seeing inflation spike. However, they also need to take care not to keep policy too loose for too long; if inflation were to surprise to the upside, it would require very tight policy and high unemployment to get it down again.



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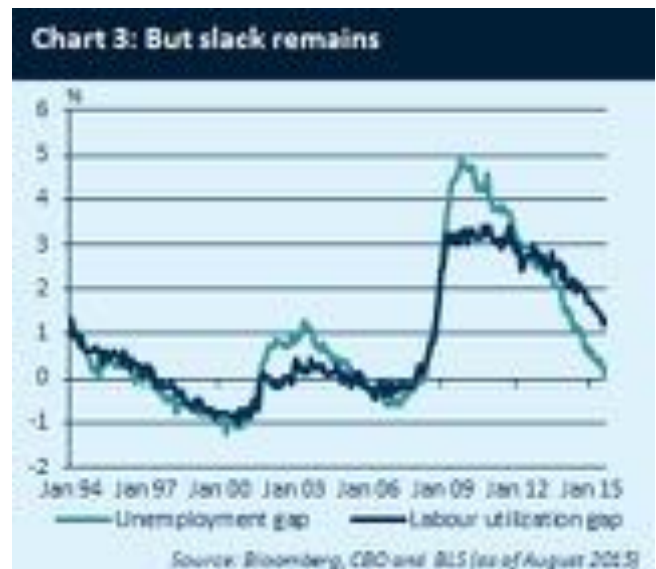
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## Reconsidering slack

With the volatility in financial markets showing only nascent signs of abating, last Friday's employment report for August was under even more scrutiny than usual. While the data were gathered by the Bureau of Labour Statistics (BLS) too early in the month to reflect any negative effects of the recent rise in global economic and financial uncertainty, the degree of improvement in labour market conditions did have the potential to influence Federal Open Market Committee (FOMC) members' thinking about the appropriate time to begin normalising policy rates. In the end, however, the report was unlikely to have changed any minds. **Those wanting to lift interest rates in September will look through the mildly disappointing 174k headline increase in non-farm payrolls** and point to the 0.2 percentage point (ppt) drop in the unemployment rate to 5.1% (a new cycle low), the decline in broader labour underutilisation, as well as the still firm trend rate of employment growth and argue that the labour market has improved sufficiently to absorb higher rates (see Chart 2). They will also express confidence that the tightening labour market will eventually push inflation back towards the 2% target, despite wage growth remaining stuck around 2%. Those wanting to wait longer will not have found the employment numbers strong enough to overcome their concerns about external growth, increased financial stress or the ongoing disinflationary forces buffeting the economy. We side with those arguing that the Federal Reserve (Fed) has waited long enough to act; starting now will send a message that policy moves are not hostage to modest bouts of financial volatility. However, we are unsure that Janet Yellen and the dovish core of the FOMC will agree with us, particularly when markets are pricing in less than a 50% chance of a rise at the next meeting. As such, **we would not be shocked to see the Fed raise rates next week, but we think that it is slightly more likely that the Committee will decide to wait until financial markets have calmed and there is clear evidence that domestic growth remains robust before acting.**

Of course, for those of us looking beyond the short term, **the path of interest rates is far more important than the timing of the first move itself.** One of the most important determinants of the speed of normalisation will be how quickly labour market slack diminishes. That is because most central bank inflation forecasting models still incorporate Phillips curve relationships, which assume a short-run trade-off between unemployment and inflation. Although inflation is less responsive to changes in slack than it was in the era of high inflation, few economists are willing to abandon the concept altogether. Exploiting the trade-off is also complicated by the fact that it has become more difficult to estimate labour market slack since the crisis because the unemployment rate has become a less useful proxy for the overall health of the labour market. We have, therefore, formulated our own measure of slack, which subtracts the gap between the U6 measure of labour underutilisation (incorporating people working part-time for economic reasons and discouraged workers) and the regular unemployment rate at a given point in time from the long-term average of that gap (see Chart 3). Unlike the regular unemployment rate, **our measure suggests that there is still substantial slack in the labour market, though it has declined significantly over the past five years.** On current trends, slack will probably not be eliminated until at least the end of 2016, underscoring why policy normalisation is likely to be very gradual.

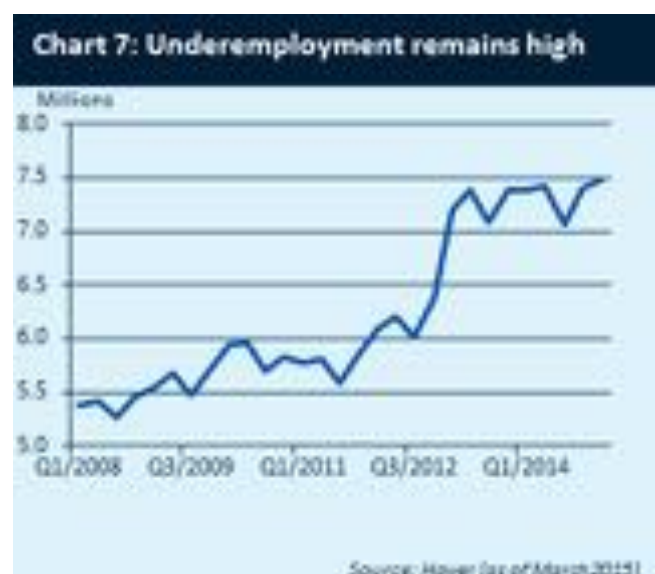


## A huge repair job

The Eurozone recovery is making inroads into the labour market slack that ballooned during painful double dip recessions. The harmonised unemployment rate for the region slipped to 10.9% in July, down from 11.6 in the same month last year and from a peak of 12.1%. While the ongoing cyclical recovery in the region is far from spectacular by international standards, it has clearly been sufficient to kick start job creation - **employment has risen by 1.45 million over the past 12 months, or 1%**. These effects are amplified in the Eurozone, with poor demographics meaning that the working age population is already shrinking slightly, although at present this is being offset by higher participation (an interesting contrast to developments in the US). Survey data suggest that this momentum will continue, or accelerate, with employment expectations in both the Purchasing Manager's Index and EC Economic Sentiment Survey having strengthened over recent months. There is a risk that the recent market turmoil will make firms more cautious with regards to recruitment. However, barring any interruption, the trends in employment provide encouragement that the recovery will prove sustainable. For illustration, the uptick in job creation has contributed to a 2.5% year-on-year (y/y) increase in employee compensation according to Q1 national accounts data. Combine this with unusually low inflation and it is easy to see why Eurozone consumers are feeling more confident. **The cycle is picking up its own momentum.**

Dipping beneath the headline Eurozone data shows, as always, its own story (see Chart 6). **First the good news; there are large portions of the currency union showing signs of rapid labour market improvement.** Unemployment rates have fallen markedly over the past year in Spain (22.2% from 24.3%), Portugal (12.1% from 14.1%) and Ireland (9.5% from 11.3%). The harmonised German unemployment rate meanwhile remains at record lows of 4.7%, with labour demand (measured by the Federal Labour Agency's job index) hitting a new peak in August. Italy has been getting in on the act, albeit in a typically more subdued manner, with unemployment falling to 12% (from 12.9%) and recent reforms to employment protection should encourage further job creation. **The corollary of this stellar performance is that some member states are not pulling their weight.** The unemployment rate in France has risen a shade to 10.4% over the past year alongside a recovery that has lagged the Eurozone aggregate.

The improvement in aggregate labour market conditions is encouraging, but what does this mean for wages and ultimately inflation? The first question to ask is how much slack is there in the Eurozone? **While headline unemployment remains high from an international perspective, this does not automatically mean that there are oceans of spare capacity.** Indeed, the OECD estimates that the equilibrium unemployment rate is 10% on account of high structural unemployment. Other data that measure labour underutilisation suggest that this understates spare capacity. For example, close to 7.5 million part-time employees currently report that they would like to work more (see Chart 7). Overall, it is likely to take years of above-trend growth to exhaust all of the spare capacity in Europe. A gradual tightening in conditions should support confidence that the region will not get stuck in a "lowflation" environment. However, reflation remains a long game.



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