

AUSTRALIAN MARKETS WEEKLY

Underemployment dragging on wages growth



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- In this *week's* Weekly we look at wages growth in Australia, which has failed to lift despite traditional models of wages consistently forecasting a pick-up.
- Recent IMF work (Mohammad 2017¹) has found that traditional models of wages growth have largely underestimated the degree of spare capacity in the labour market by solely focusing on the unemployment rate. However, when including measures of underemployment (those wanting to work more hours) the models show a closer fit to historical wages growth.
- A decomposition of this analysis finds underemployment and lower inflation expectations can almost fully account for subdued nominal wages growth over the past few years. This has significant implications in interpreting the amount of spare capacity in the labour market and suggests we need to look at both unemployment and underemployment when assessing the outlook for wages growth. It also suggests we are unlikely to get much in the way of wage inflation unless serious inroads are made into underemployment.
- There are however some reasons for optimism. Measures of underemployment have a close relationship with the difficulty firms report in finding suitable labour (such a relationship could be due to firms gradually using up existing labour capacity amongst employees). The Quarterly NAB Business Survey suggests firms are finding it a bit more difficult on average in finding suitable labour, but that at the moment it is only a minor difficulty.
- This week, the main local focus will be on the RBA Meeting Tuesday and Wednesday's Q1 GDP. Offshore, the focus will be on the Non-manufacturing ISM tonight, followed by the ECB meeting (Thursday), UK election (Thursday) and the appearance of former FBI Director Comey before the US Senate Intelligence Committee.

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Wages low on underemployment and low inflation

The purpose of this note is to alert our readers to new emerging thinking on wages growth, which is a key input into domestic inflation. Over the past year, subdued wages growth has consistently failed to lift despite forecasts by the RBA and Treasury. Despite this divergence, there has been little analysis to date in explaining this divergence.

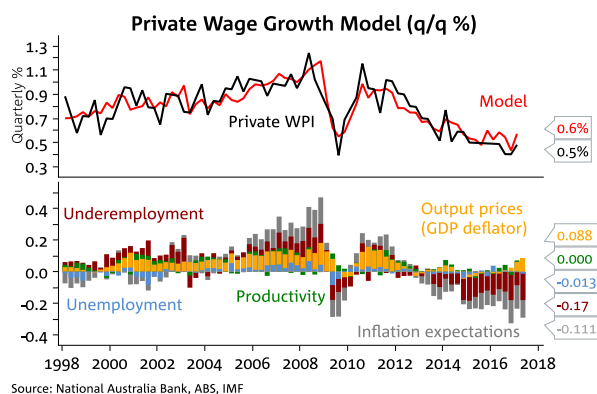
A recent IMF working paper by Mohommad (2017) has attempted to explain this divergence by incorporating alternative measures of labour market slack into a wage Phillips curve model. The model regresses private wages growth on underemployment and unemployment gap measures, expected inflation, and the GDP deflator to proxy for output prices.

Key markets over the past week

	Last	% chg week		Last	bp / % chg week
AUD	0.7451	0.4	RBA cash	1.50	0
AUD/CNY	5.08	-0.5	3y swap	1.86	-1
AUD/JPY	82.4	-0.3	ASX 200	5,866	0.8
AUD/EUR	0.661	-0.5	Iron ore	57.8	-0.2
AUD/NZD	1.047	-0.6	WTI oil	48.3	-3.5

Source: Bloomberg

Chart of the week: Underemployment drags on wages

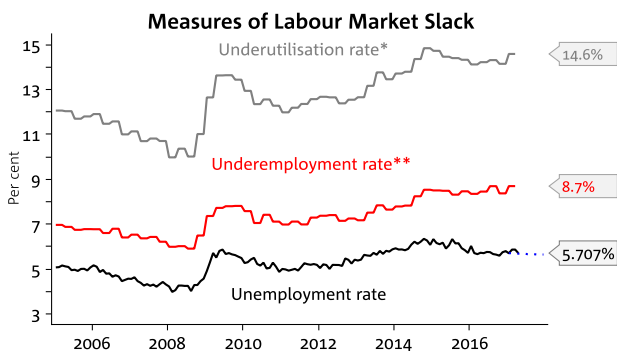


¹ Mohommad, A., (2017), "Labor Market Adjustment to Shocks in Australia", IMF Working Paper, WP/17/124

The results of the model and a decomposition of the contributions is found in Chart of the week. What is evident is the role underemployment has played dragging down wages growth, and together with lower than average inflation expectations has been the major factor weighing on wages growth to date.

The implication from this analysis is that when forecasting wages growth we need to look at wider measures of spare capacity in the labour market. It also suggests we are unlikely to get much in the way of wage inflation unless serious inroads are made into underemployment which is at high levels. That will likely see the RBA and Treasury paying close attention to underemployment measures as well as the headline unemployment rate.

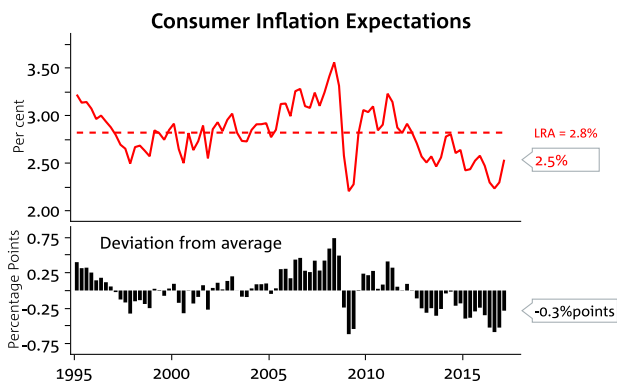
Chart 1: Underemployment remains elevated



* Unemployed and underemployed
 ** Would like to work more hours (and is able to work more hours)
 Source: National Australia Bank, ABS, RBA

The other component that is surprising in this analysis is the role inflation expectations have played in dragging on wages growth. Research done by the RBA suggests 2/5ths of firms on the Bank's liaison program indicated the CPI was the primary determinant of wage-setting. Rather perversely, that may mean higher headline inflation is required to drive higher wages growth.

Chart 2: Consumer inflation expectations below average



Source: National Australia Bank, Melbourne Institute

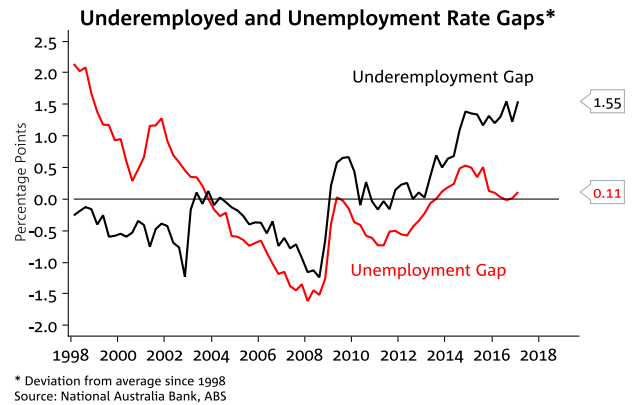
Modelling details

The model is a simple Philips Curve wage model that regresses the change in the wage price index against the unemployment gap, the underemployment gap, changes in unemployment and underemployment, inflation expectations, the GDP deflator and labour productivity.

The underemployment and unemployment gaps are measured as a deviation from sample average from 1998. The gaps are meant to represent the degree to which spare capacity is greater than its natural rate (or full employment level). There are of course alternative ways of measuring these gaps, including using HP filters that try to delineate between structural and cyclical components using variations around a trend.

The model can explain around 69% of the variation in wages growth and should be seen as supporting the assertion that the scale of underemployment is important for wages growth.

Chart 3: Underemployment gap rising

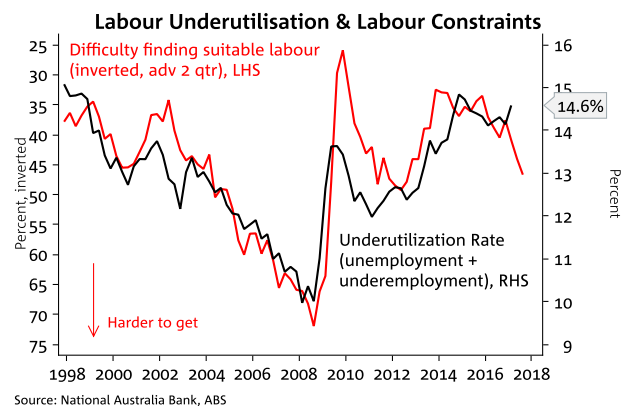


* Deviation from average since 1998
 Source: National Australia Bank, ABS

Outlook

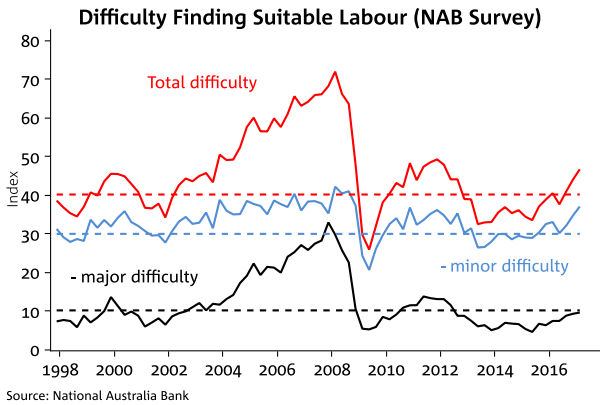
While inroads are likely needed to be made into underemployment to lift wages growth, there are some reasons to hope. Firms are finding it a bit more difficult on average in finding suitable labour which tends to follow wider measures of underutilisation (Chart 4). At the moment most of the difficulty is seen as only a minor constraint, but even the proportion of firms who cite it as a major difficulty is now back to its long-run average.

Chart 4: Difficulty finding labour leads underutilisation



Source: National Australia Bank, ABS

Chart 5: Difficulty finding suitable labour now above average



This week

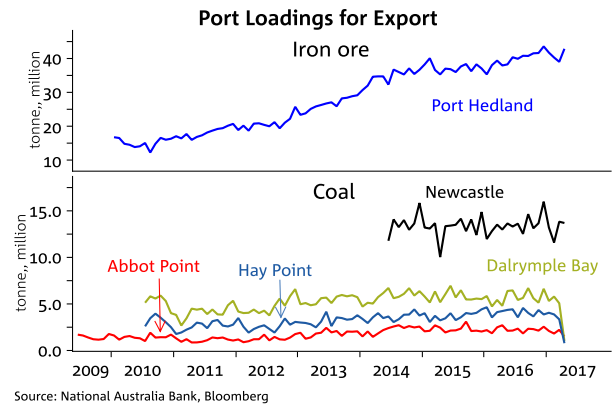
It's a busy week domestically with the RBA Meeting Tuesday (expect firm on hold) and GDP Wednesday. Also out will be the Balance of Payments (Tuesday) and the April Trade Balance (Thursday). Offshore, most focus will be on the ECB meeting (Thursday), UK election (Thursday) and the appearance of former FBI Director Comey before the US Senate Intelligence Committee.

For the RBA Meeting Tuesday the Board is universally expected to be on hold. Given another strong employment report since the last meeting, we wouldn't be surprised to see a neutral to positive tone to the post meeting statement, while some acknowledgment will need to be given to the temporary weakness that is likely to come from Wednesday's GDP print.

As for GDP, the market consensus looks for a 0.3% q/q outcome. The partial data to date is suggestive of a flat to a slightly positive outcome, though there is more partial data to come with net exports and government spending figures on Tuesday. NAB's official forecast is for a slight negative GDP outcome of -0.1% q/q.

From a currency perspective, Tuesday's Balance of Payments release could be interesting with some likelihood of Australia recording its first current account surplus since 1975. Thursday's Trade Report is expected to see a markedly lower trade surplus on the back of a hit to QLD coal loadings from Cyclone Debbie (Chart 6)

Chart 6: QLD coal exports likely down sharply in April



CALENDAR OF ECONOMIC RELEASES

Country	Economic Indicator	Period	Forecast	Consensus	Actual	Previous	GMT	AEST
Monday, 5 June 2017								
NZ	<i>Holiday - Queen's Birthday</i>							
AU	AiG Perf of Services Index	May				53.0	0.30	9.30
JN	Nikkei Japan PMI Services/Composite	May		/		52.2/52.6	1.30	10.30
AU	Melbourne Institute Inflation MoM/YoY	May		/		0.5/2.6	2.00	11.00
AU	Inventories/Company Operating profits QoQ	1Q	0.3/8.0	0.5/5		0.3/20.1	2.30	11.30
AU	ANZ Job Advertisements MoM	May				1.4	2.30	11.30
CH	Caixin China PMI Services/Composite	May		/		51.5/51.2	2.45	11.45
UK	New Car Registrations YoY	May				-19.8	9.00	18.00
UK	Markit/CIPS UK Services/Composite PMI	May		55/55.5		55.8/56.2	9.30	18.30
US	Markit US Services/Composite PMI	May F		/		54.0/53.9	14.45	23.45
CA	Bloomberg Nanos Confidence	Jun 2				58.5	15.00	0.00
US	ISM Non-Manf. Composite	May		57.1		57.5	15.00	0.00
US	Factory Orders/ex-Trans	Apr		-0.2/		0.2/-0.3	15.00	0.00
Tuesday, 6 June 2017								
NZ	Crown Financial Accounts	Apr					23.00	8.00
NZ	Value of All Buildings SA QoQ	1Q	0 (downside risk)	0.3		1.9	23.45	8.45
NZ	Wholesale Trade QoQ	1Q	1.7			0.7	23.45	8.45
UK	BRC Sales Like-For-Like YoY	May		-0.5		5.6	0.10	9.10
AU	ANZ Roy Morgan Weekly Consumer Confidence Index	Jun 4				112.2	0.30	9.30
JN	Labor Cash/Real Earnings YoY	Apr		0.3/		-0.4/-0.8	1.00	10.00
NZ	ANZ Commodity Price	May	2.9			-0.2	2.00	11.00
AU	BoP Current Account Balance/Net exports % of GDP	1Q		-1/-0.4		-4.0/0.2	2.30	11.30
AU	Government spending	1Q	1.2			1.4	2.30	11.30
AU	RBA Cash Rate Target	Jun 6		1.5		1.5	5.30	14.30
GE	Markit Germany Services/Composite PMI	May F		55.2/57.3		55.2/57.3	8.55	17.55
EC	Markit Eurozone Services/Composite PMI	May F		56.2/56.8		56.2/56.8	9.00	18.00
FR	OECD Economic Outlook						9.30	18.30
EC	Sentix Investor Confidence	Jun		27.4		27.4	9.30	18.30
EC	Retail Sales MoM/YoY	Apr		0.1/2.1		0.3/2.3	10.00	19.00
US	JOLTS Job Openings	Apr		5737.5		5743.0	15.00	0.00
CA	Ivey Purchasing Managers Index SA	May				62.4	15.00	0.00
US	Labor Market Conditions Index Change	May				3.5		
NZ	Dairy Auction, GDT-weighted price index		broadly steady			3.2	early am NZT	
Wednesday, 7 June 2017								
NZ	ANZ Job Advertisements MoM	May				2.8	23.00	8.00
NZ	Mfg Activity Volume/sa QoQ	1Q		/		-1.8/0.8	23.45	8.45
AU	AiG Perf of Construction Index	May				51.9	0.30	9.30
AU	GDP SA QoQ/YoY	1Q		0.3/1.6		1.1/2.4	2.30	11.30
CH	Foreign Reserves	May		3045		3029.5	3.30	12.30
JN	Leading Index CI	Apr P		104.3		105.5	6.00	15.00
GE	Factory Orders MoM/YoY	Apr		-0.3/4.7		1.0/2.4	7.00	16.00
GE	Markit Germany Construction PMI	May				54.6	8.30	17.30
UK	Halifax House Prices MoM	May		-0.2		-0.1	8.30	17.30
UK	Halifax House Price 3Mths/Year	May		3		3.8	8.30	17.30
EC	OECD Economic Outlook						10.00	19.00
EC	GDP SA QoQ/YoY	1Q F		0.5/1.7		0.5/1.7	10.00	19.00
CA	Building Permits MoM	Apr		2.5		-5.8	13.30	22.30
US	Consumer Credit	Apr		15		16.4	20.00	5.00
Thursday, 8 June 2017								
NZ	ANZ Truckometer Heavy MoM	May				-1.8	23.00	8.00
UK	RICS House Price Balance	May		20		22.0	0.10	9.10
JN	GDP SA QoQ/YoY	1Q F		0.6/2.4		0.5/2.2	0.50	9.50
JN	BoP Current Account Adjusted	Apr		1624.4		1731.2	0.50	9.50
AU	Trade Balance	Apr	1000	2000		3107	2.30	11.30
CH	Trade Balance CNY	May		336		262.3	4.20	13.20
CH	Trade Balance	May		47.8		38.1	4.40	13.40
CH	<i>Foreign Direct Investment YoY CNY</i>	May	<i>To be released 8-18 June</i>			-4.3	5.40	14.40
JN	Eco Watchers Survey Current/Outlook SA	May		48.6/48.5		48.1/48.8	6.00	15.00
GE	Industrial Production SA MoM/YoY	Apr		0.5/2.1		-0.4/1.9	7.00	16.00
EC	ECB Deposit Facility Rate/Asset Purchase Target	Jun 8		0.3/4.5		-0.3/3.9	12.45	21.45
CA	Housing Starts	May		201		214.1	13.15	22.15
CA	New Housing Price Index MoM/YoY	Apr		0.3/4.5		-0.3/3.9	13.30	22.30
EC	ECB President Mario Draghi Holds Press Conference						13.30	22.30
US	Initial Jobless Claims	Jun 3		240		248.0	13.30	22.30
US	Ex-FBI Director Comey testifies before Senate Intelligence Committee						15.00	0.00
CA	BoC Financial Stability Review (Poloz/Wilkins press conference 45 mins later)						15.30	0.30
Friday, 9 June 2017								
UK	General election (voting ends 22.00 London time; 7am AEDT)							
CH	CPI/PPI YoY	May		1.5/5.7		1.2/6.4	2.30	11.30
AU	Home Loans # MoM/Investment lending \$ MoM	Apr	-0.8	-1/		-0.5/0.8	2.30	11.30
JN	Tertiary Industry Index MoM	Apr		0.5		-0.2	5.30	14.30
GE	Current Account Balance	Apr		24.5		30.2	7.00	16.00
GE	Labor Costs SA QoQ/YoY	1Q		/		1.5/3.0	7.00	16.00
UK	Industrial Production MoM/YoY	Apr		0.7/-0.3		-0.5/1.4	9.30	18.30
UK	Construction Output SA MoM/YoY	Apr		0.4/-0.3		-0.7/2.4	9.30	18.30
UK	Trade Balance	Apr		-3450		-4900	9.30	18.30
UK	BoE/TNS Inflation Next 12 Mths	May				2.9	9.30	18.30
UK	NIESR GDP Estimate	May				0.2	13.00	22.00
CA	Net Change in Employment/Unemployment Rate	May		15/6.6		3.2/6.5	13.30	22.30
CA	Capacity Utilization Rate	1Q		83.5		82.2	13.30	22.30
US	Wholesale Trade Sales/Inventories MoM	Apr		-0.3		0.0/-0.3	15.00	0.00
Saturday, 10 June 2017								
CH	<i>New Yuan Loans/Aqgregate Financing CNY</i>	May	<i>For release 10-15 Jun</i>	1000/1200		1100.0/1390.0	9.00	18.00
Upcoming Central Bank Interest Rate Announcements								
Australia, RBA		6-Jun	1.50%	1.50%		1.50%		
Europe ECB		8-Jun	-0.4%	-0.4%		-0.4%		
UK BOE		15-Jun	0.25%	0.25%		0.25%		
US Federal Reserve		15-Jun	0.75-1.00%	0.75-1.00%		0.75-1.00%		
Japan, BoJ		16-Jun	-0.1%	-0.1%		-0.1%		
New Zealand, RBNZ		22-Jun	1.75%	1.75%		1.75%		
Canada, BoC		13-Jul	0.5%	0.5%		0.5%		

GMT: Greenwich Mean Time; AEST: Australian Eastern Standard Time

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