

NAB ECONOMIC INSIGHTS

SPARE CAPACITY AND THE LONG ROAD TO 2-3% INFLATION

NAB Group Economics



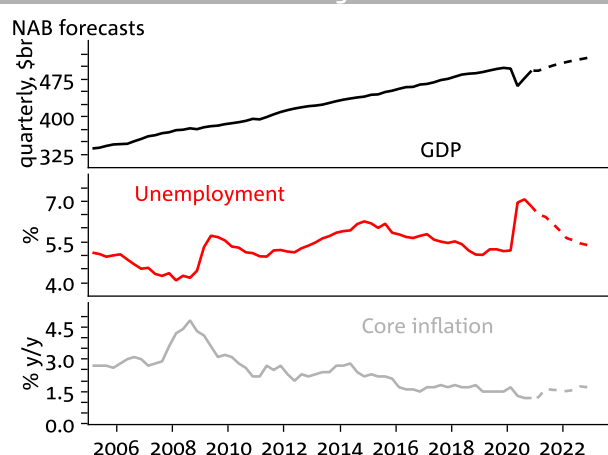
Spare capacity and why the RBA is years from achieving its inflation target

- Spare capacity is often measured by looking at current activity and unemployment and the distance from their ideal levels – potential GDP and full employment. At these levels the economy is running neither too hot or cold – which can prompt recessions – and inflation should be sitting within the RBA's 2-3% target.
- We update our estimates of potential GDP and full employment, where we think potential GDP growth has temporarily slowed to 1% while full employment is at 4.9%. In combination with our forecasts, this suggests the output gap will be broadly closed in 2022 and that it is plausible unemployment and inflation meet the RBA's goals in 2024, although we think there are downside risks to our outlook. Further, we note these estimates are imprecise and so economists and policy makers will monitor a range of timely indicators to gauge the spare capacity remaining in the economy.

Despite a very strong start to the recovery, the economy is likely to have spare capacity for some time.

The economic recovery is off to a strong start, where activity and labour market data has surprised to the upside in recent months. In the near term, NAB expects the economy to make further strong gains such that by Q1 2021 activity will have returned to pre-virus levels and by Q4 2022 the unemployment rate will be just above pre-virus levels at 5.3%.¹

Chart 1: NAB forecasts a strong rebound over 2021



Source: National Australia Bank, Australian Bureau of Statistics

This is a remarkable turnaround from the biggest global economic crisis since WWII. However, even if the economy returns to pre-virus levels there will remain a great deal of spare capacity in the economy. Economic activity will be below potential level and unemployment

above full employment level. Ongoing spare capacity means the economy is growing too slowly, remaining vulnerable to a downturn, and this will be reflected in continued weakness in inflation.

Potential GDP, full employment and inflation at target are the goals of monetary policy.

The concepts of potential output and full employment are crucial for central banks, where these “Goldilocks” levels occur when the economy is not running too hot or cold. If the economy drifts too far away from these levels this can prompt a recession and therefore central banks seek to keep the economy at these ideal levels.

- Potential output can be thought of as the level of economic activity when the economy is producing “at capacity”. This capacity tends to grow over time as the population grows, major investments are made and technology improves.
- Full employment refers to the level where, if unemployment falls below it, the labour market is tight and wage pressure rises – resulting in higher inflation. We use the term interchangeably with the Non-Accelerating Inflation Rate of Unemployment (NAIRU).

Macroeconomic theory suggests that if GDP rises above potential, then available resources (workers and capital) are under pressure. This sees business increase hiring and investment activity, so unemployment falls and wages and input costs rise. This, in turn, lifts inflation. If instead the economy is sustainably at potential, unemployment will be at NAIRU and inflation should be at the RBA's target of 2 to 3%.

Therefore, inflation sustainably at its target is a clear signal that these ideal levels have been achieved – the economy is running at a “just right” pace – and this is a key rationale for inflation targeting. This is important as potential GDP and NAIRU are not fixed levels and can't be measured directly – we can only estimate them through models, which are inherently imprecise.

Nevertheless, estimates for potential GDP and full employment are helpful guides for forecasting how far away from ideal levels we are. As such, in this note we update our estimates of potential GDP and full employment, to discuss spare capacity in the economy.

Prior to the pandemic GDP was below potential and unemployment above NAIRU

Immediately prior to the pandemic, the IMF estimates Australian economic activity was tracking 0.6% below potential GDP level, with this negative output gap having widened in 2018-19. This aligns with our view at the time that potential GDP was growing at a rate of 2.25%, while activity was tracking at a pace of 1.7% as weak income growth weighed on demand.

¹ NAB will published detailed updated forecasts in the next Forward View, on Wednesday 10 March 2021.

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Likewise, unemployment was too high at around 5.2% though mid to late 2019, where in contrast we thought NAIURU was between 4.5 to 5%. Further confirming the increase in spare capacity was core inflation, which slid to a low of 1.5%. As such, we had the view that further monetary stimulus was required and through 2019 the RBA halved the cash rate to 0.75%.

We estimate potential GDP growth slowed to 1% in 2020-21, as population growth collapsed, while the NAIURU is at 4.9%.

Following the large shock from the pandemic, economic activity collapsed. This saw a sharp rise in spare capacity, which resulted in widespread job losses and weak inflation.

The pandemic also impacted the path of potential GDP. Potential GDP tends to grow over time, where prior to the pandemic we estimated it was growing at an annual rate of 2.25%. Broadly, this reflected strong population growth of 1.5% p.a. and productivity gains of 0.75% p.a. Given border closures have seen population growth collapse, potential output growth has also slowed sharply, at the very least by the same amount as population growth.

We use the latest population forecasts from Treasury's Centre for Population to make a simple adjustment to our estimate for potential GDP growth. Comparing the forecasts pre- and post-virus, we use this difference between outlooks to adjust our 2.25% potential growth rate estimate. As such, we expect potential growth slows to 1% in FY21, before picking up to 1.9% in FY23.

Chart 2: Population growth will slow sharply

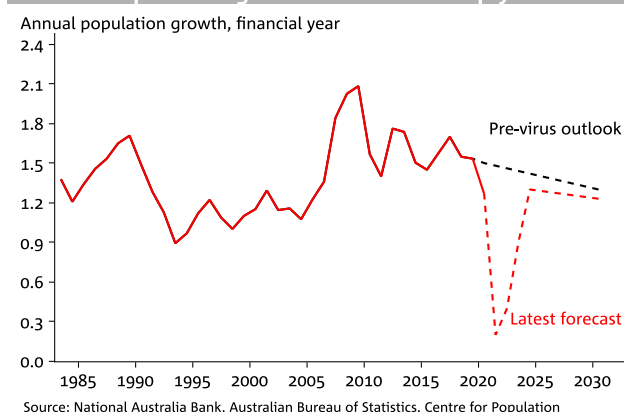
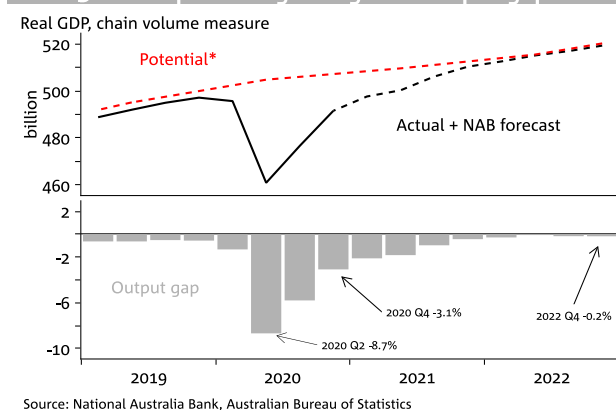


Chart 3: We expect a slight negative output gap in 2022



Given this outlook for potential GDP and our latest forecasts, the output gap is significantly reduced over 2021, to reach just -0.2% at the end of our forecast horizon. While the gap is broadly closed at this point, growth has slowed to broadly match potential suggesting little additional gains.

For the NAIURU, we update the RBA's NAIURU model from 2017 and estimate that the NAIURU is now at 4.9%. This model ties together actual and expected inflation, unemployment and various input prices.² This suggests that at the end of our forecast horizon, in Q4 2022, unemployment will still be 0.4pp too high.

These estimates suggest that by the end of 2022 the output gap is broadly closed, while the unemployment gap is on the way to closing – consistent with the usual lags between activity and unemployment. On these estimates, it is plausible inflation returns to 2-3% in 2024, although this will need low unemployment to quickly feed into a considerable turnaround in wages growth.

Chart 4: NAIURU remains a considerable distance away

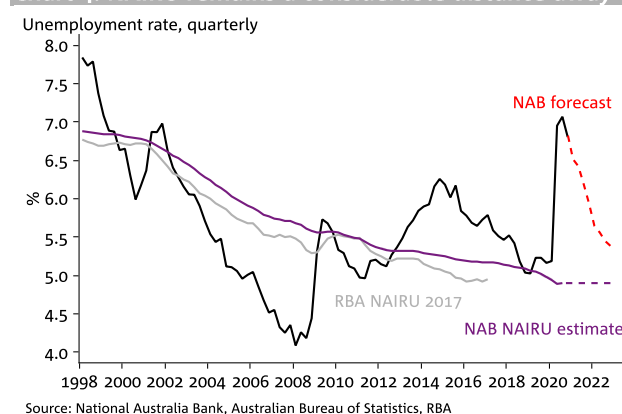
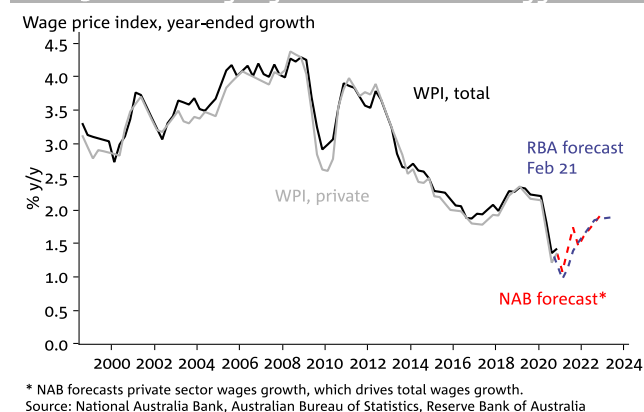


Chart 5: Where wages growth will remain sluggish



The estimates are imprecise, so the RBA will monitor inflation and other indicators to confirm spare capacity is shrinking

The pandemic has placed greater than usual uncertainty around these estimates for potential GDP and full employment. As such, while our estimates suggest the output gap may be closed as early as 2022, given the downside risk to our forecasts, we highlight the risk that GDP will remain short of what is needed to support full employment and the RBA's inflation target.

² See RBA: [Estimating the NAIURU and the Unemployment Gap](#)

Given the heightened uncertainty, the RBA has said it will wait to see inflation within the target, before raising the cash rate, as this is the clearest indicator that spare capacity has been reduced. This is in contrast to its usual approach to change the cash rate in *anticipation* of changes in inflation, where monetary policy takes 12-18 months for its full effect to be felt.

Fortunately, while it may be hard to gauge how much spare capacity is left based on GDP and unemployment alone, there are a range of indicators the RBA and economists can monitor. In addition to the official quarterly wages and inflation data, which will start to gather pace as spare capacity is reduced, more timely indicators exist in labour data and the NAB survey.

- **Job vacancies.** Every quarter, businesses report to the ABS how many workers they are looking to hire. At present, for every vacancy there is a high number of unemployed people, suggesting lots of spare capacity, although this is still very low compared to a usual recession.
- **Capacity utilisation.** Businesses report what capacity they are currently operating at. At present, this shows most industries are operating at below-average capacity, except for retail and manufacturing.
- **Difficulty finding suitable labour.** A measure of labour market tightness, this is the share of firms reporting difficulty finding the right workers. At present, this shows most industries are seeing above-average difficulty.
- **Labour costs by industry.** Another measure of labour market tightness, where tight markets should see labour costs rise. At present, this shows all industries are seeing below-average wage growth.

Chart 6: Unemployment-to-vacancy ratio is falling

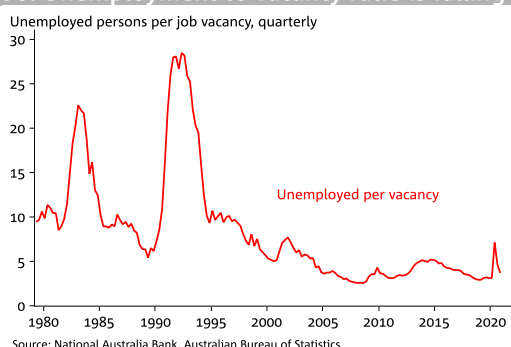


Chart 7: NAB survey indicators

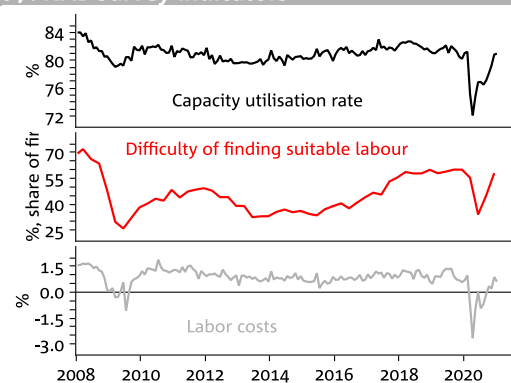


Chart 8: Capacity utilisation is mixed by industry

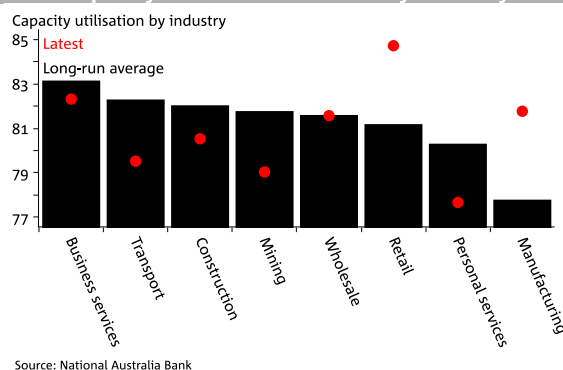


Chart 9: Firms report difficulty finding the right workers

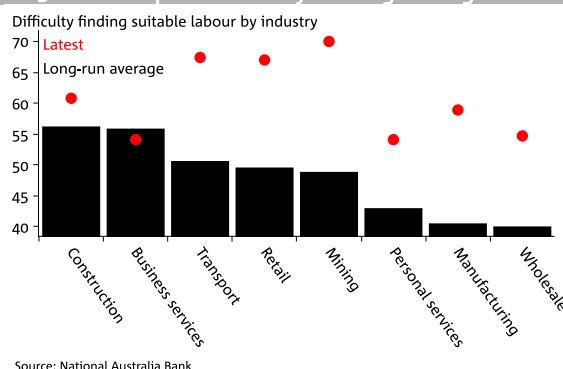
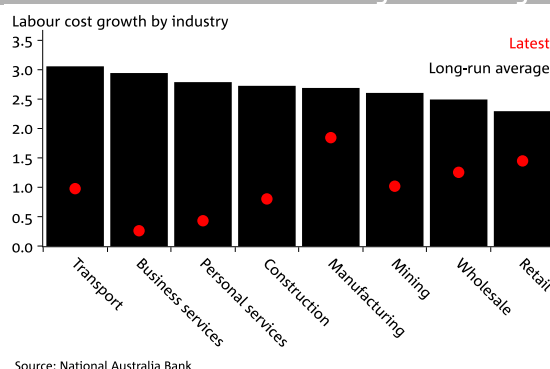


Chart 10: But all industries are seeing a weak wages bill



As spare capacity is reduced we expect the unemployment-to-vacancy ratio to fall and the survey indicators to be above-average, across most industries.

In our view, spare capacity is likely to be broadly worked through by the end of 2022. This makes it plausible that the unemployment gap is closed in 2023 and inflation returns to the target in 2024, given the usual lags between activity, unemployment and inflation. This accords with the RBA's expectations rates will be on hold at least until 2024, where it thinks it is highly unlikely full employment and inflation at target will be achieved before them.

However, we stress the risks to our economic forecasts are to the downside, while the path of potential GDP and full employment are highly uncertain – and recent history suggests these goals are often further away than estimates suggest. As the economy approaches potential GDP and full employment, it will be crucial to monitor timely indicators of spare capacity and inflation pressure.

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