national australia bank

RBA not yet convinced on lower NAIRU

Key points

- At the February SoMP the RBA did "*not assess there is yet a compelling case to change our estimates of full employment.*" That is important because it is difficult for the RBA to coherently move rates to neutral settings while forecasting a labour market that stays tighter than full employment.
- This note highlights RBA analysis released under FOI (Documents regarding NAIRU) and details why, despite the RBA's caution, we remain comfortable with our base case that an unemployment rate in the low 4s is consistent with inflation sustaining near target. We expect the RBA will move towards that assessment over time.
- The RBA staff conclude the NAIRU is unlikely to have declined into the post-pandemic unemployment trough. We think a more likely scenario is the NAIRU was lower prior to the pandemic as well, and conduct an out-of-sample counterfactual exercise that allows for a NAIRU stable at 4% for several years.
- Wages outcomes have been consistent with a lower NAIRU, but until Q4, inflation outcomes had remained elevated, even compared to a 4.5% NAIRU. We think inflation has been reflecting catch up to earlier capacity pressure, and wages pressures have been the better guide.
- The trajectory of the labour market matters regardless of where full employment is. The deterioration in the global backdrop has shifted the balance of risks and will rightly shift focus from a quarter point here or there on the NAIRU, at least in the short term. Our assessment is that the starting point facing into intensified downside risk emanating from the global backdrop is a healthy, rather than overly tight, labour market.

The RBA has been constrained by their narrative framework

Unobservable variables like the NAIRU and the neutral rate are imperfect, but they are important anchors in central banks' frameworks. The RBA has had a clear narrative that restrictive policy has been appropriate, and policy is restrictive.

Looking forward, the RBA cannot coherently move policy to a neutral stance while they assess the labour market will remain overly tight through the forecast horizon.

The NAIRU has been in acute focus because the unemployment rate has been forecast to be broadly stable and plateau not far from NAIRU estimates. While that framework helps assess whether the labour market is too tight or too loose, it shouldn't distract from cyclical trends in the labour market.

NAB's view has been that the RBA would build confidence over time that the domestic backdrop is consistent with at-target inflation, but the only modestly restrictive starting point, the outlook for a pickup in growth, and the resilient labour market have created no urgency to move quickly. Gradual easing down to 3.1% in early 2026 would be needed to support growth and sustain the healthy labour market. Intensified global headwinds mean more or sooner support may well be required, and the risk now skews to the downside of that outlook.

RBA not yet convinced labour market near balance

The RBA in February highlighted as a key risk that "*we have misjudged how much excess demand there is in the labour market.*" Their current assessment is that an unemployment rate of 4.5% is consistent with full employment. At the February SoMP their conclusion was "*we do not assess there is yet a compelling case to change our estimates of full employment.*"

The RBA recently released under FOI internal analysis supportive of that public assessment (Documents regarding NAIRU). While we already knew the conclusions, it does provide some additional detail into the RBA's thinking. The work highlights possible arguments for a lower NAIRU:

- Lower wages growth;
- Supply side inflation being misattributed as excess demand in their models;
- Lower December quarter trimmed mean;
- Real wage catchup; and
- Lack of corroborating evidence from other labour market indicators.

The analysis also includes some modelling exercises that use a counterfactual NAIRU that continues a trend decline from mid 2016 to 4.0% at the end of 2022. The conclusion is that recent data has on balance been more consistent with a 4.5% than a 4.0% NAIRU. Federal Treasury, for their part, assess the NAIRU is 4¼%.

Taylor Nugent, Senior Economist, Markets

What if the NAIRU were 4%?

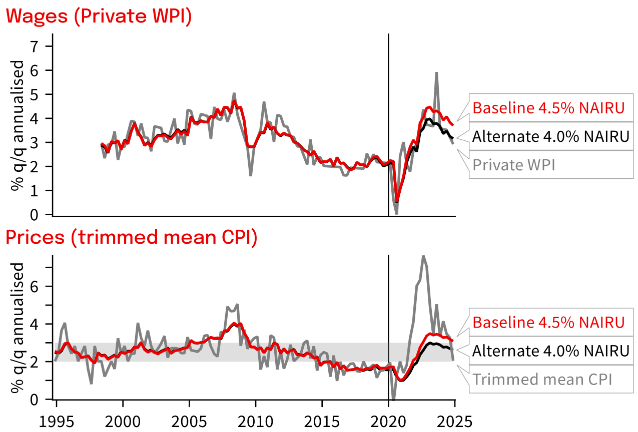
In general, we read the RBA analysis as testing a hypothesis that the NAIRU was declining through the first 3 years of the pandemic period. But it a discussion about whether the NAIRU was around 4% rather than 4½% was ongoing prior to the pandemic as well. Then, it was whether the RBA was persistently underestimating the amount of spare capacity in the labour market given low wages and prices growth.

There are 2 key challenges complicating the assessment of full employment in Australia:

- There is little recent experience with unemployment near NAIRU because policymakers fell consistently short of full employment prior to the pandemic.
- It is difficult to distinguish too-tight labour markets from other drivers due to pandemic shocks in the past few years.

We conduct an exercise that acknowledges that pre-pandemic uncertainty about where the NAIRU is and does not take signal from the evolution of data over the pandemic period. Instead, we calculate a counterfactual path of wages and prices if the NAIRU was steady and historical relationships persisted. We do this for a baseline scenario that takes the RBA's NAIRU estimate, and an alternate scenario where the NAIRU had declined to 4¼% by mid 2017 and was steady at 4.0% from 2020. The detail is in the appendix.

Scenarios Using RBA Phillips Curve models



Source: National Australia Bank, ABS, RBA

The high-level conclusion is that wages outcomes over the past 5 years are much more consistent with a NAIRU of 4 than 4.5%, but until Q4, inflation outcomes remained a little elevated for a 4.5% NAIRU world, and noticeably elevated relative to a 4.0% NAIRU world.

Wages or prices, which to believe?

The RBA internal research finds considerable support for their baseline view of the NAIRU outside of base wages growth, and this aligns with our own exercise. Inflation outcomes, as well as weak productivity and elevated unit labour costs, remain more consistent with a higher rather than lower NAIRU despite cooler base wage growth.

Inflation is higher than explained by labour market conditions during the pandemic inflation surge regardless of where NAIRU is, but the outcomes implied by the lower NAIRU scenario also leave significant 'excess inflation' to be explained over the past 18 months, when the obvious pandemic inflation surge had mostly faded.

One way the RBA reckons with the pandemic shock in their models is by including an AR(1) error term. This allows for shocks to have a lasting impact via correlated errors, but it is only used until Q2 2023. The work notes this may "*strip too much signal out of inflation*" but that "*it is also possible that supply-side inflation effects have taken longer to flow through than what we have accounted for with the adjustment ending after 2023Q2.*"

The tension between elevated inflation over the past 18 months and what is implied by a 4% NAIRU can be resolved if supply-side drivers continued to drive excess inflation over the past 18 months. While it is difficult to be precise about magnitudes, there are reasons this is plausible. These include indexation lags and infrequent adjustments in administered prices, CPI rents taking time to catch up to earlier growth in advertised prices, and insurance costs echoing earlier cost pressures with a delay.

NAB's view is that the labour market is not currently a source of excessive inflation pressure and much of the persistence in domestic inflation through 2024 was reflective of some catch up to earlier capacity pressures and upstream price adjustments.

Could recent data be a misleading signal about structural variables?

The RBA internal research highlights an alternate risk that even if inflation comes in near target in the near term, it won't sustain there unless the labour market cools further because the improvement is partly driven by factors that are likely to unwind such as slow new dwelling inflation and the prior weakening in the labour market.

Unemployment, and the unemployment gap, may not fully capture the evolution of the labour market over the past few years. Very elevated vacancies, for instance, revealed a labour market even tighter than the 3.5% unemployment rate implied during the peak of hiring in the post-pandemic expansion. More recently in earlier research, we found that a range of indicators suggested ongoing cooling in the labour market despite the broadly stable unemployment rate through 2024 (Unemployment remains low but job-finding is harder).

We view the greater moderation in many of these indicators as further evidence that the current labour market is not particularly wage inflationary, but it could also be an alternative explanation to a lower NAIRU for recent wages growth outcomes. Even if the unemployment rate broadly tracks sideways, these other indicators could give that a meaningfully different complexion.

Signals from these indicators are mixed. Some alternate measures generally strengthened in February (AUS: Detailed employment indicators generally strengthen in February). On the other hand, vacancies fell back to where they were in Q3 2024, and labour as a significant constraint on output from the (forthcoming) NAB Quarterly Business Survey fell in Q1 after stabilising through much of last year.

The appendix of this note includes some additional iterations of the wages Phillips curve model that build in alternate indicators.

Conclusion: The RBA's view can evolve

The RBA's central NAIRU assumption incorporates judgment and has been stable recently at 4½%, but it is not immovable. The internal work notes that "*a series of low prints or clear evidence that recent disinflation was driven by persistent factors that will continue to weigh on inflation would help to justify a lower NAIRU.*"

RBA Governor Bullock said last week "*we are alert to the fact that it might not be quite as tight, and we can sustain an unemployment rate down around these levels without adding to inflation pressure. That would be great. But we are still alert to the possibility that it might still be a little bit tight, and that what might put wages under upward pressure, and hence inflation.*"

Model estimates can deviate from the RBA's central assumption and are sensitive to incoming data. Q4 2024 data (including downside surprises to the RBA's CPI and WPI forecasts), lowered the model estimate by 10-15bp, but having moved higher in prior quarters it remained above the central assumption of 4½%. It was also "*only one data point, which is not sufficient basis for assessing slow-moving structural change.*"

For the RBA, a positive case to shift the NAIRU assumption is both very difficult to make, and highly consequential. It makes sense that the RBA will not rush such a decision and will be guided by their modelling frameworks. A shift will require a string of more supportive data.

NAB's long-held NAIRU assumption is 4¼%. Our forecast is for the unemployment rate to stabilise around that level, similar to the RBA's February unemployment track. But our forecasts anticipate that the RBA remains a little too cautious on inflation. Modestly cooler inflation outcomes than the RBA fears should help build comfort at the central bank that an unemployment rate around 4-4¼ is consistent with at-target inflation. The decision to cut in February showed they are open to the prospect, if still unconvinced.

While Australia is comparatively well placed facing into the current tariff shock, our trading partners in Asia have seen relatively high 'reciprocal' tariffs, while financial market turmoil will hit Australia via wealth effects and through confidence channels. Further the nature of the tariff rollout has amplified policy uncertainty. The distribution of risks has shifted.

As was made plain during the pandemic period, the inflation process is influenced by many factors, not just the gap between the central bank's estimate of NAIRU and the current unemployment rate. While estimates of NAIRU and the neutral rate are always important for any central bank to understand, the path of wages, inflation and policy rates is likely to be more influenced by the trajectory of the labour market than a quarter point here or there on estimates of the NAIRU. Accordingly, a focus on labour market dynamics may be a more useful signal for near-term policy outcomes than modest differences in assessment of the NAIRU.

Appendix

RBA's Wages Phillips curve model

$$\%\Delta WPI_t = \alpha + \beta\%\Delta WPI_{t-1} + \gamma(\frac{u_{t-1} - u^*_{t-1}}{u_{t-1}}) + \tau\Delta u_{t-1} + \varphi\frac{\%\Delta^{ye}DFDdef_t}{4} + \theta\frac{Trend_{t-1}}{4} + \epsilon_t$$

Where:

$\%\Delta WPI_t$	Quarterly growth in Private WPI
u_t	unemployment rate
ut*	NAIRU
Δu_t	Quarterly change in unemployment rate
$\%\Delta yeDFDdef_t$	Year-ended growth in domestic final demand implicit price deflator
$Trend_t$	Trend inflation expectations

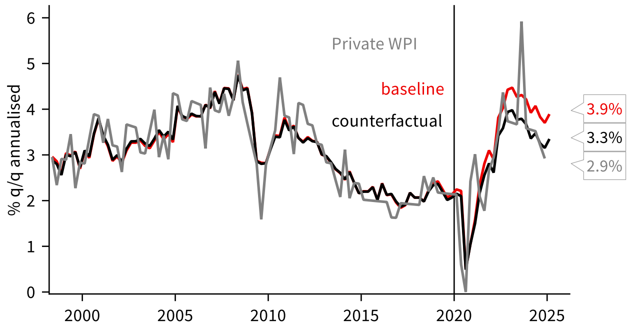
Source: RBA

Using the RBA's Wages Phillips Curve model estimated on data to the end of 2019, there is little in sample difference between the baseline and lower NAIRU scenarios, but the implied path of wages given the realised outcomes for unemployment and the other explanatory variables is quite different.

The trough in the unemployment rate in late 2022, combined with elevated inflation, implied a peak in private sector wages growth of 4.0% annualised in Q1 2023. A NAIRU of 4.5% implied a peak 0.5ppt higher at 4.5% annualised. The outcomes implied by the 4% NAIRU scenario fit the realised outcomes (in grey) much more closely.

Note the spike in Q3 2023 was the result of the elevated award wage outcome, which only partially reflected labour market wages pressures. Another benefit of our approach is it does not need to make a decision on how much signal to take from that outcome.

Wages Phillips Curve



Source: National Australia Bank, ABS, RBA

RBA's Prices Phillips curve model

$$\%\Delta TM_t = \alpha + \beta\%\Delta TM_{t-1} + \gamma(\frac{u_{t-1} - u^*_{t-1}}{u_{t-1}}) + \tau\frac{\%\Delta^{ye}CIPI_t}{4} + \theta\frac{Trend_{t-1}}{4} + \epsilon_t$$

Where:

$\%\Delta TM_t$	Quarterly growth in Trimmed Mean CPI
u_t	unemployment rate
ut*	NAIRU
$\%\Delta yeCIPI_t$	Year-ended growth in consumer goods import price index
$Trend_t$	Trend inflation expectations

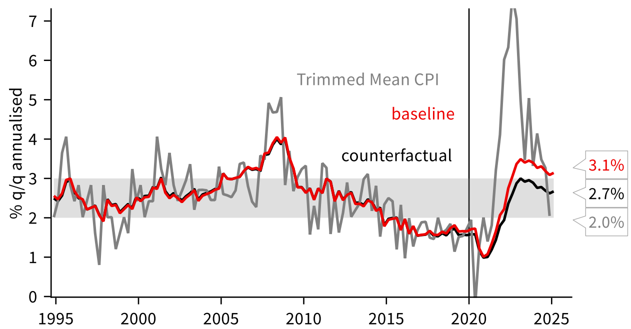
Source: RBA

We conduct the same exercise with the RBA's CPI/inflation Phillips Curve. The 2021-22 inflation surge is poorly explained regardless of NAIRU assumption. That is no surprise, given the milieu of non-labour market inflation drivers emanating from the COVID shock. More recently, apart from the soft Q4 outcome, trimmed mean inflation outcomes have been stronger than a Phillips curve relationship implies, but only a little stronger under the baseline scenario.

One way to interpret this exercise is that abstracting from the impact of other inflation drivers over the past 5 years, that path of goods import prices and unemployment outcomes suggest underlying inflation would have peaked at 3.5% before cooling back to 3.1% in a world where NAIRU has been 4.5%. There was a sharp and short-lived 'excess inflation' over 2021 and 2022, but there is only a little residual excess inflation to explain over the past 12-18 months.

Alternatively, in a 4% NAIRU world, inflation would have peaked at just 3%, and current labour market conditions are consistent with annualised inflation having returned to around a 2.6-2.7%.

Prices Phillips Curve

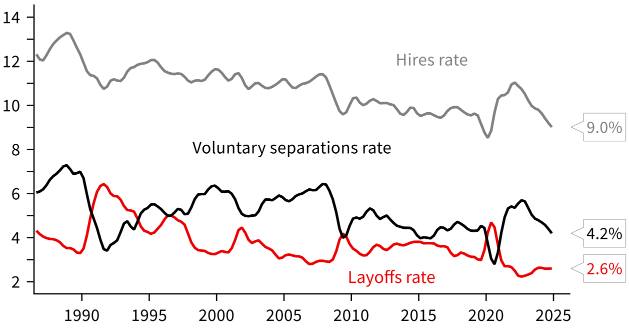


Source: National Australia Bank, ABS, RBA

Alternate labour market indicators

It's a low hiring and low firing labour market. Research from the US find that that the quits rate is an important wages growth indicator. Using non-public granular data from the labour force survey, the RBA calculates a 'voluntary separation rate' which is conceptually similar to a quits rate. This had moderated back to pre-pandemic levels by the end of 2024. The job finding rate and voluntary separations rate are currently low relative to their historical relationship with the unemployment rate, implying weaker wage outcomes than the unemployment gap alone.

Hires and quits have slowed

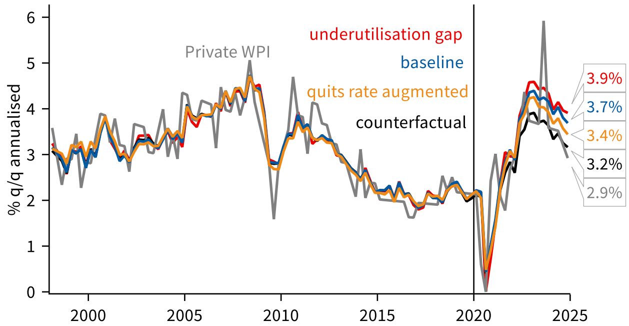


Source: National Australia Bank, Reserve Bank of Australia, ABS

Augmenting the RBA's Phillips curve with the voluntary separations rate points to a sharper deceleration in wages growth over the past couple of years. Alternatively using the RBA's volumes-based underutilisation gap rather than the unemployment gap projects wages growth much stronger than what has occurred.

In broad strokes, an alternate volumes-based underutilisation measure of labour market spare capacity implies dramatically stronger wages growth than has been realised and is not a useful addition. But augmenting the unemployment gap models with additional indicators like the voluntary separations rate or the job finding rate correctly predicts a sharper slowdown in wages pressures than implied by the rise in unemployment alone.

Wages Phillips Curve additional specifications



Source: National Australia Bank, ABS, RBA

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