

Economic Strategy

Why the RBA won't hike rates any time soon

- The decline in Australian unemployment is so slow, that it may be 2019 before wages growth makes the RBA hike rates.

Over the past four years, we have been able to successfully analyse the monetary policy of the Federal Reserve by looking at unemployment. We found that when the US unemployment rate fell below the natural rate of unemployment, then the Fed was likely to hike rates. The natural rate of unemployment is a level below which a tight labour market tends to result in upward pressure on wages. This in turn increases inflation.

In Figure 1, we use the same approach to analyse Australian monetary policy. In an article published in the Reserve Bank Bulletin in June, the RBA determined what the Fed calls the natural rate of unemployment at the level of 5%. Just as in our pieces of the Fed, we also determine the minimum rate of unemployment. This is determined as the lowest level that unemployment has fallen to in the last 30 years. In Australia, this minimum level of unemployment was reached at a level of 4.1% in March 2008. When unemployment falls to that level, then the excess labour force is exhausted. Employment can only be increased by giving jobs to new entries into the labour force through population increase.

As in our US analysis, we project the current rate of decline of Australian unemployment to determine when the level of future unemployment will fall below the natural rate. This tells us when rate hikes are likely to begin. The problem in Australia is that unemployment is falling at a glacial pace. Australian unemployment peaked in August 2014 at a high for this cycle of 6.2%. In November 2017, the level had fallen to 5.4%. Our projection of further declines is shown in Figure 1 as the red line. Our projected unemployment does not fall to the natural level of unemployment until June 2019. Only after that, will unemployment fall to such a level that it will start to put upward pressure on wages and inflation. Until that occurs, there is no need for the RBA to hike rates.

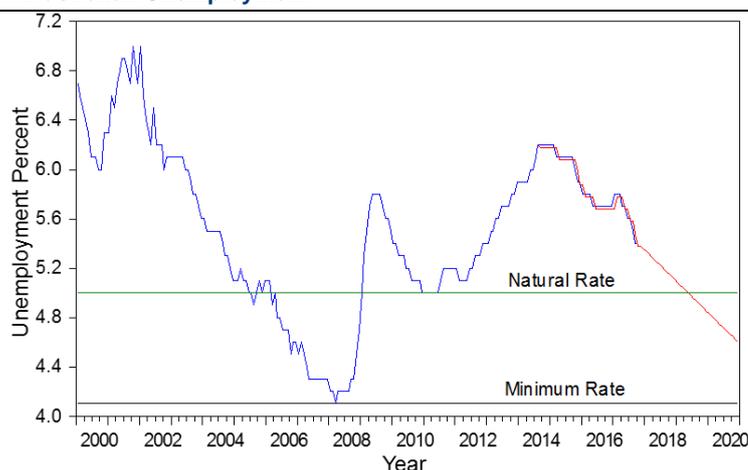
Why is it that the decline in Australian unemployment is so slow? One reason might be the high level of under-employment. The ABS tells us that when we include the number of people in part-time employment who want full-time jobs, then their estimate of underemployment in November 2017 rises to 8.3%. As employment grows, there is an additional source of supply of labour from this pool of under-employment. This acts to slow the decline in unemployment. It also acts to slow the increase in full time wages.

Conclusion

Analysing the Australian labour market in the same way as we have analysed the US labour market, we conclude that the Australian labour market is only tightening at an extremely slow pace. At the current decline of unemployment, the Australian level of unemployment will only fall below the natural rate in the last half of 2019.

This suggests that the kind of wages pressure and inflation pressure that might force the RBA to hike the cash rate will not emerge before that time. The RBA is not going to hike rates any time soon.

Figure 1: Australian Unemployment



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