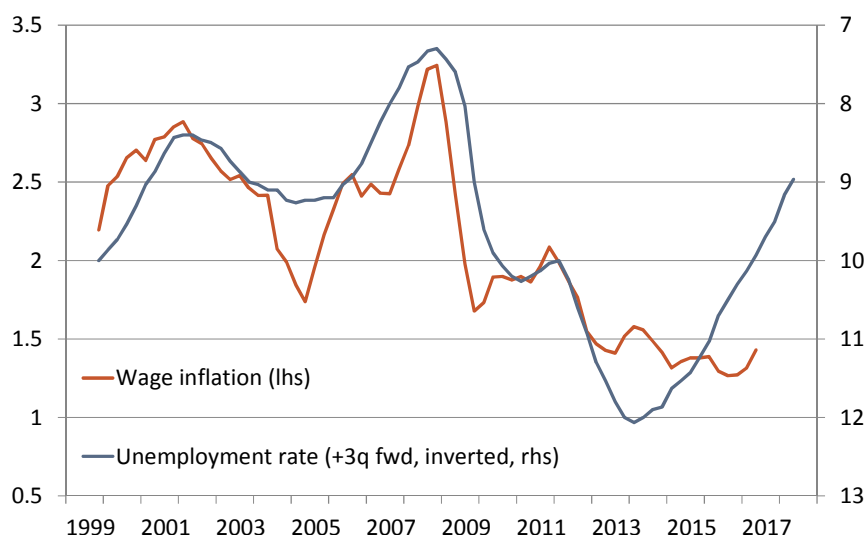


3 November 2017

Should the ECB still rely on the Phillips curve?

Eurozone wage inflation versus unemployment rate (%)



Unemployment rate and wage inflation in %. Wage inflation relates to the rolling four-quarter average of annual growth in compensation per employee. Unemployment rate is advanced by three quarters, inverted scale. Source: Eurostat, ECB

- **Does unemployment still matter for inflation?** One often hears economists refer to the Phillips curve, which illustrates the historical observation that low levels of unemployment drive inflation higher. However, the post-Lehman experience of low unemployment and low inflation in the US, the UK and Germany has raised serious questions about whether this relationship is still valid. Nevertheless, central banks continue to apply Phillips curve logic when conducting monetary policy. Does this still make sense, or are they simply following dogma?
- **When the Phillips curve worked:** Falling unemployment at the turn of the millennium coincided with strong wage growth. Then in the 2000s nominal wage growth slowed during a period of lower economic activity as unemployment increased. This sequence repeated itself throughout the business cycle, leading to the double whammy of the financial and euro crises. Wage growth peaked at 3.2% yoy in 2008 as unemployment reached a multi-year low of 7.5%. Wage growth declined shortly thereafter as unemployment surged after the collapse of Lehman. Following the euro crisis the unemployment rate hit 12.1% in Q2 2013 – wage growth slowed to a low of 1.3% yoy.
- **Is the Philips curve broken?** While the strong rebound in labour demand from 2014 onwards stopped wage growth from sliding further, it has not accelerated much along with the continued growth in employment since then. While the Philips curve is probably not broken, it may have fundamentally changed.
- **The new Phillips curve:** The following new structural factors mean that the response of wages to labour market slack is weaker than before (see [Notes on the inflation puzzle](#)): 1) workers accept lower wage growth in exchange for job security; 2) the demise of traditional employment trends has changed wage setting behaviour; 3) globalisation means national labour markets are becoming less relevant for domestic wage inflation over time; 4) higher rates of female and older workers' participation raise labour supply; and 5) competition has increased from new types of capital – think robots. This all lowers the inflationary pressure from low unemployment. The Phillips curve is not dead, just flatter.
- **Flatter Phillips curve = slower monetary unwind:** In Q2 2017, wage growth picked up to 1.6%, the highest wage growth since Q1 2014. With the eurozone growing at stronger rates this year, this could be the turning point to a modest acceleration in wage growth. Yet the evidence is not clear cut, as the rebound is within the range of the past volatility of the data. The rebound in wage inflation that the chart would suggest, if taken at face value, would be very modest, and fully compatible with the ECB's definition of price stability. In any case, the ECB has to tread carefully as it is not yet clear how the Phillips curve may work on the way up in the post-Lehman age of caution.

Economics

Chart of the week



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