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Has the Phillips Curve Flatlined?

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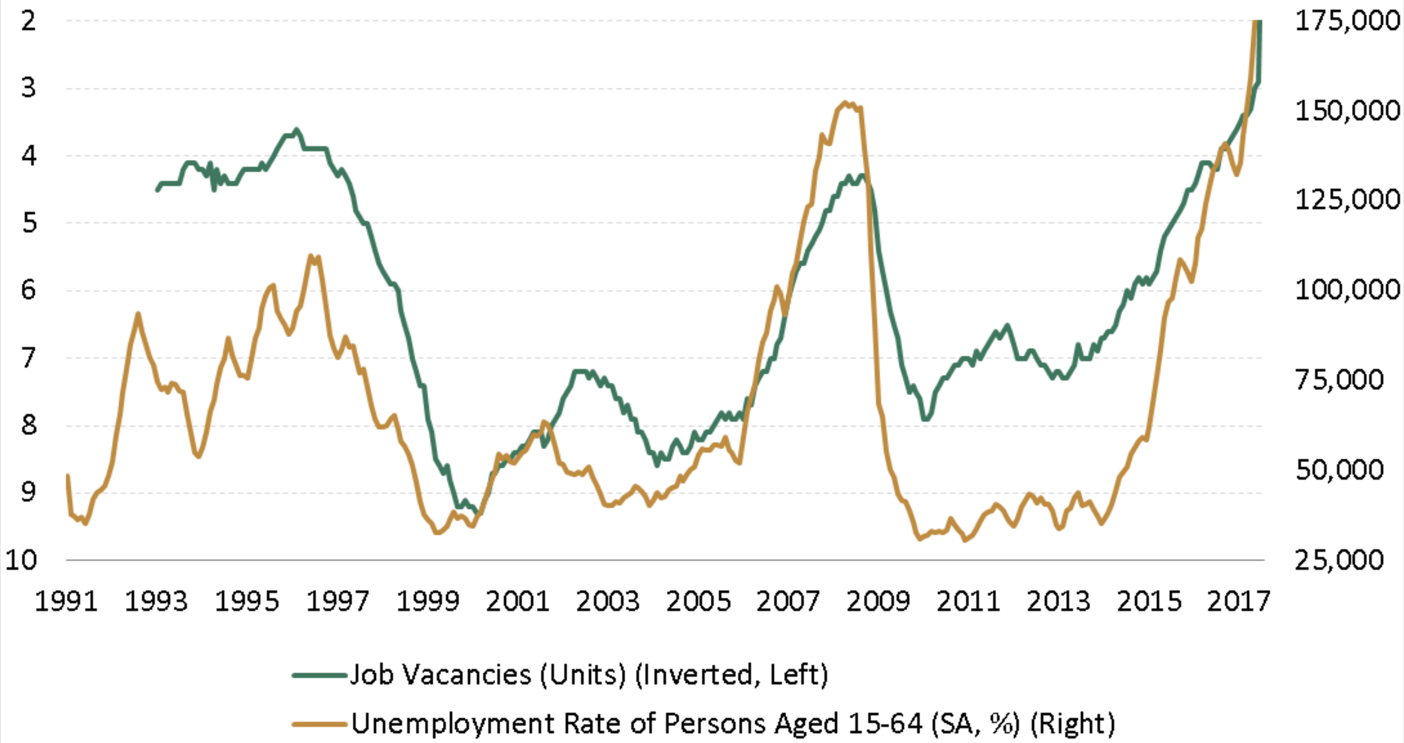
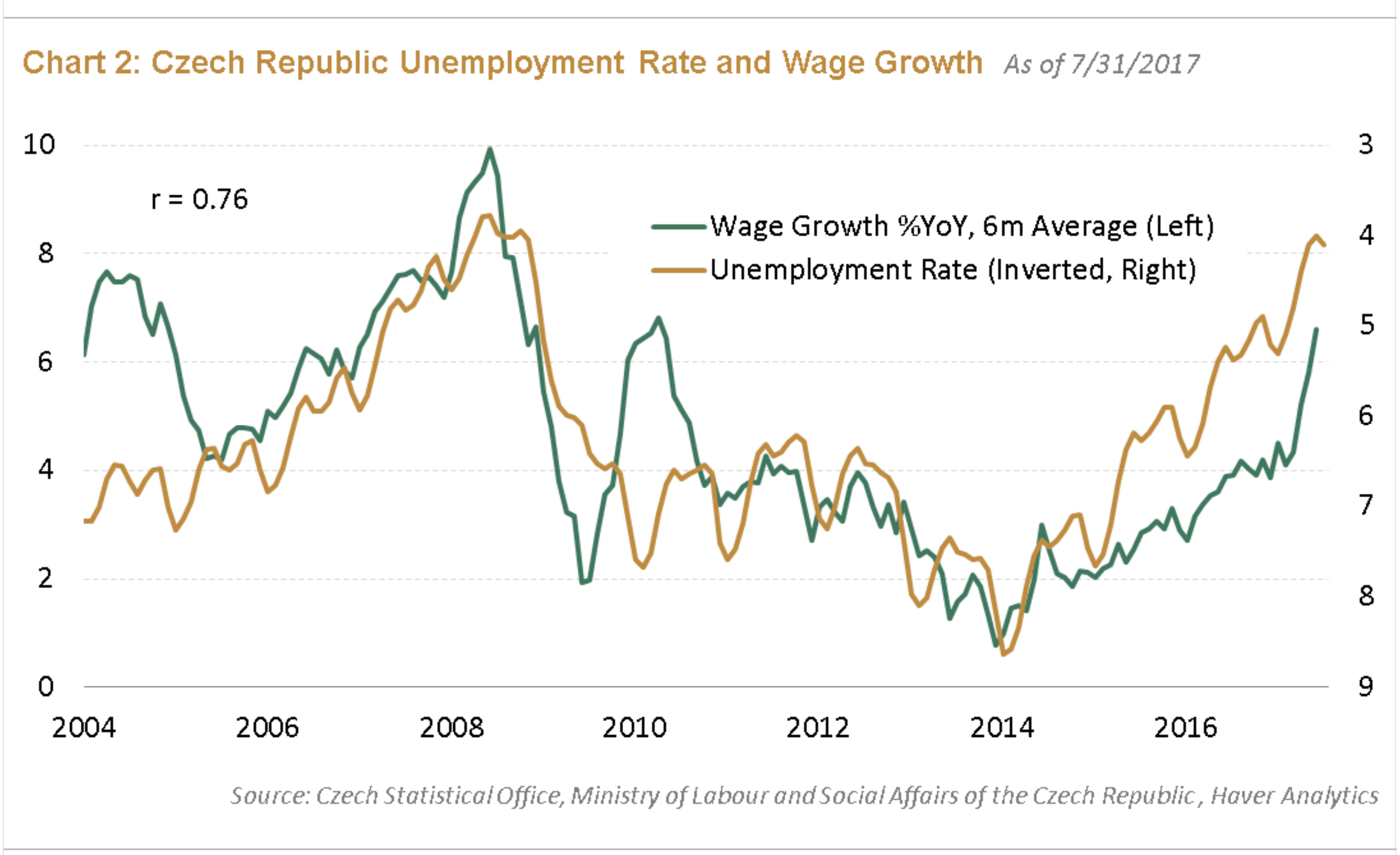
One of the most puzzling aspects of this long, sluggish global recovery has been the pace of increases in average hourly earnings despite seemingly tighter and tighter labor markets across many developed countries, from the U.S. to Japan. My colleague, Anujeet Sareen, wrote about this topic last month. Since his blog, the Federal Reserve Bank (Fed) has decided to discontinue use of its 19-indicator Labor Market Conditions Index, declaring that the indicator "no longer provides a good summary of changes in U.S. labor market conditions" and "including average hourly earnings as an indicator did not provide a meaningful link between labor market conditions and wage growth." Is the Fed's action the final nail in the coffin for the Phillips Curve, the model that describes the relationship between rates of unemployment and rates of inflation in an economy? After all, what use is a tight labor market unless it creates a wage-inflation spiral that reinforces the growth cycle? Of course, this wage-inflation spiral ultimately forces the central bank's hand in terms of tighter monetary policy, thus eventually ending the growth cycle. After all, mean reversion comes to all things.

Unlike the Fed, we are not quite ready to throw in the towel on this theory. The slow, elongated nature of the current business cycle may simply be delaying the Phillips Curve effect; the curve may be lower and shallower than in prior cycles. Witness the Czech Republic, where an increasingly tight labor market has finally started pushing wages higher (see Charts 1 and 2). Inflation is now above the central bank's 2% target, leading Czech policymakers to become the first in Europe to raise rates two weeks ago.

Chart 1: Czech Republic Unemployment Rate and Job Vacancies *As of 7/31/2017*

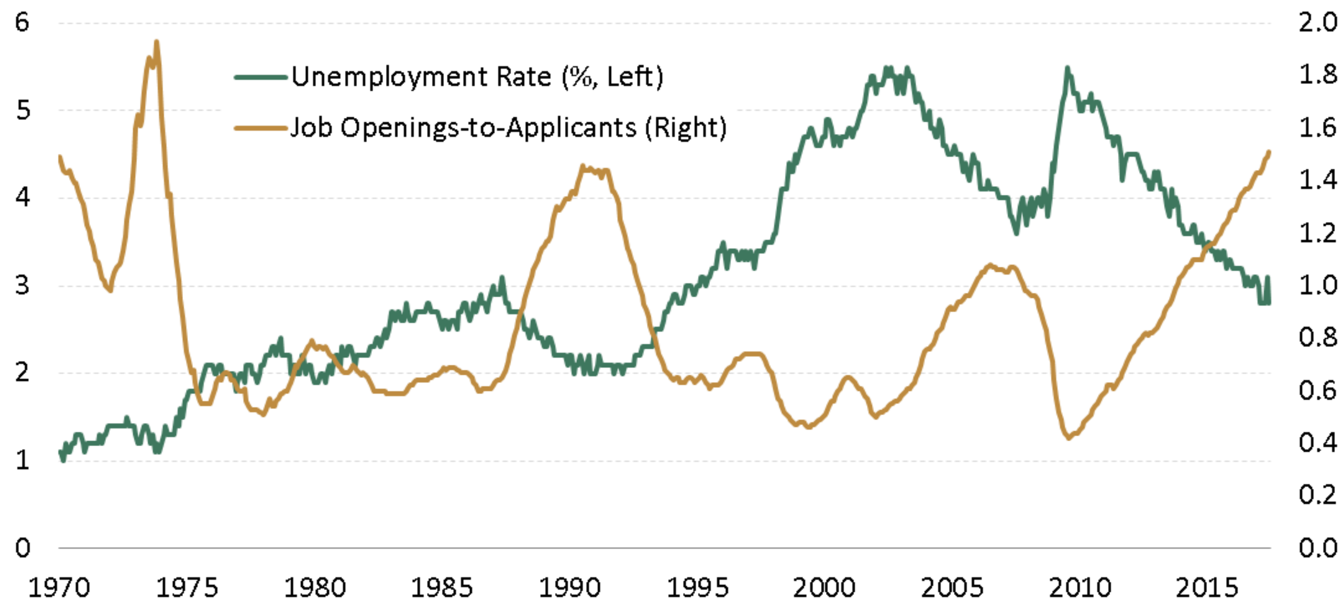


Source: Czech Statistical Office, Ministry of Labour and Social Affairs of the Czech Republic, Haver Analytics



Another country that bears watching is Japan, which by some measures may have the tightest labor markets in the Organisation for Economic Co-operation and Development (OECD). The unemployment rate in Japan has averaged 3% over the past year, the lowest level in 21 years. Meanwhile, its jobs-to-applicants ratio recently hit a 43-year high (see Chart 3).

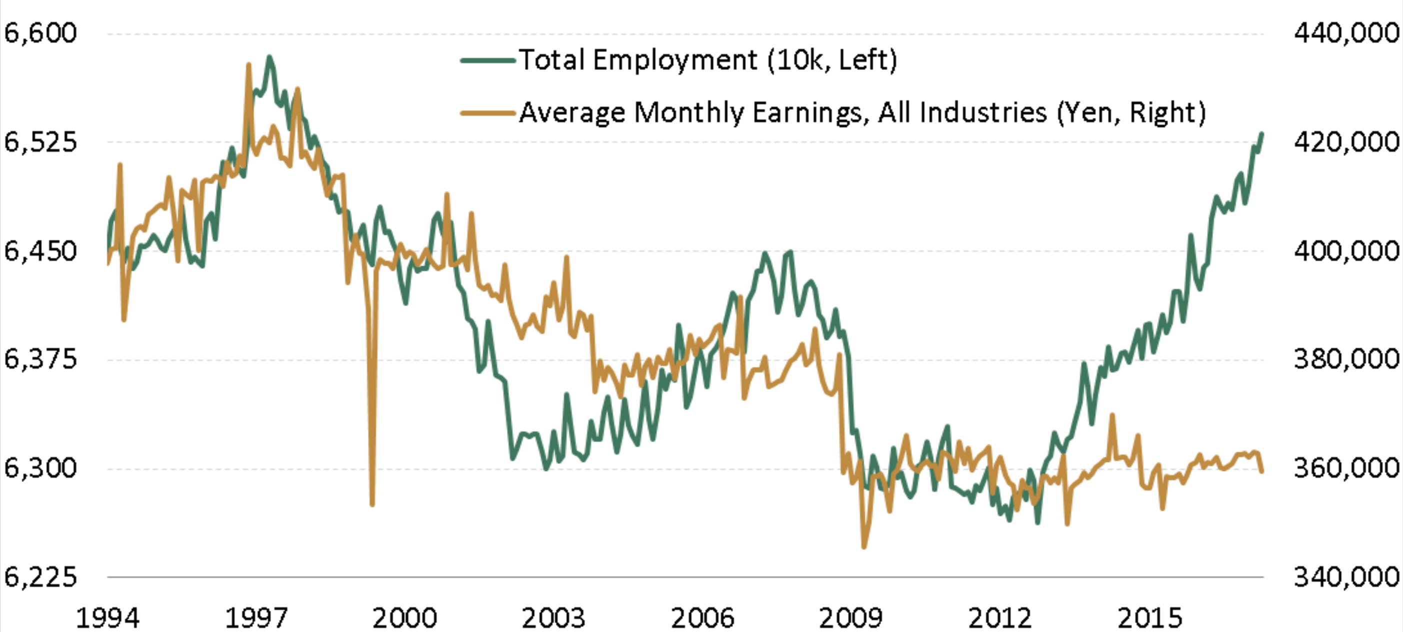
Chart 3: Japanese Unemployment Rate & Job Openings-to-Applicants Ratio *As of 6/30/2017*



Source: Ministry of Health, Labour and Welfare Japan, Haver Analytics

However, consistent with the story in other countries, by some measures, wage growth has been muted relative to the condition of the labor market. Total employment has recovered to a level last seen in 1998 and is still rising, yet wage growth has clearly decoupled (see Chart 4).

Chart 4: Japanese Employment and Average Monthly Earnings Decoupling *As of 6/30/2017*

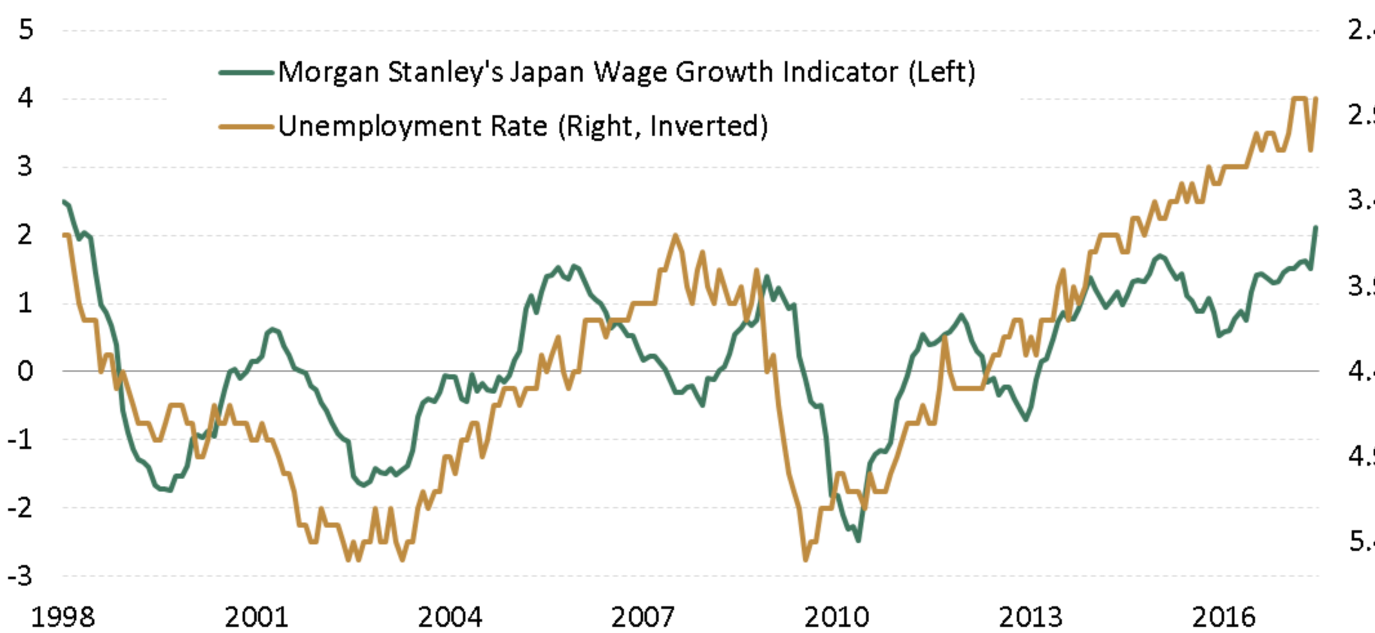


Source: Ministry of Health, Labour and Welfare Japan; Haver Analytics

This phenomenon may be explained by a number of factors. A recent International Monetary Fund (IMF) report discusses structural factors that may be holding wages down: limited labor mobility, lifetime employment, and preference for job security, as well as base pay negotiations guided by current inflation, which remains low. The IMF goes on to suggest that labor market reforms are needed, such as promoting worker mobility between firms and closing gaps in pay and working conditions via contract reform. Furthermore, the average may be suppressed by the low-paying nature of part-time work.

Another factor we are exploring is whether the wage earnings data itself might be distorting the picture. One Japanese wage growth indicator, published by Morgan Stanley, adjusts the standard data for two factors: changes between the composition of full- and part-time workers and labor force participation changes. This indicator has very recently spiked higher to around 2.1% year over year, a level last seen almost 20 years ago (see Chart 5). This adjusted data suggests that wages may be growing faster than we think.

Chart 5: Japanese Wages Versus Unemployment *Percent, As of 6/30/2017*



Source: Morgan Stanley, Thomson Datastream, Haver Analytics

The structural story is also worth noting. Japan's population continues to age at the fastest rate in the OECD, leading to projected declines in the size of the labor force. At the margin, some companies are already responding to this future challenge by starting to recruit talent from overseas. This emerging hiring trend represents a huge cultural shift for Japan where there has been a reluctance to look beyond its borders. The Ministry of Justice also has softened the rules for establishing permanent residency, reducing the minimum residency requirement from 10 years to 3 years. However, changes such as these will take time to become commonly accepted in Japan's uniquely insular culture. Most likely, the already tight labor market could tighten even further before these structural changes have any meaningful impact.

Meanwhile, the economy is in the best shape it has been in for some time with real gross domestic product (GDP) seeing its sixth straight quarterly increase. The output gap has turned positive and capital expenditures are increasing. In a recent survey of Japanese companies, 70% said they were planning price increases over the next year. Minimum wages, which remain amongst the lowest in the OECD, are on target to increase again in excess of 3%, year over year. All of this data suggests some modest upward pressure on wages and inflation.

Is Japan out of the woods on deflation yet? Only time will tell, but we believe that an increasingly tight labor picture may be a critical piece of the inflation puzzle. Perhaps the Phillips Curve is not dead after all.

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