



Insight

Whatever Happened to the Phillips Curve?



Image of A.W. Phillips

-Manchester Capital Management Strategy Group

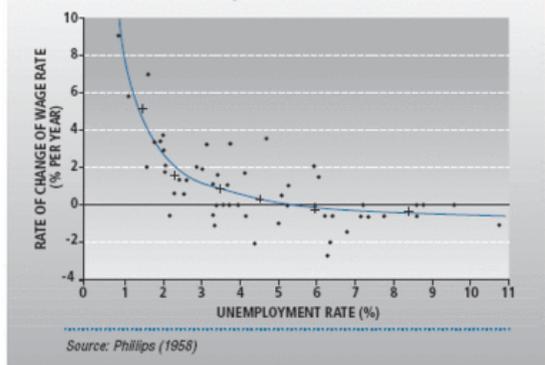
The Phillips Curve is an economic concept developed in 1958 by A.W. Phillips, a professor at the London School of Economics, theorizing that there is an inverse relationship between unemployment and inflation.¹ Simply stated, a drop in unemployment leads to wage increases and inflation, and vice versa. As demand for labor increases, the pool of unemployed workers decreases, and companies increase wages in an effort to compete for the dwindling number of available workers. So with the unemployment rate currently sitting at 3.8%, the lowest it has been since April 2000, shouldn't we be seeing wages and inflation increasing? If not, why not?

In his seminal analysis, Mr. Phillips used wage growth as a proxy for inflation and demonstrated a statistically significant relationship between inflation and the unemployment rate. Because wage growth has lagged—the significant drop in the unemployment rate from 10.0% in October 2009 to 3.8% today—many wonder if the Phillips Curve still works. The Curve has been a valuable input in setting monetary policy, so discussing its current relevance is not purely an academic exercise.

The most commonly used measure of wage growth, Average Hourly Earnings of Production Employees, was as low as 1.2% in October 2012, and is now 2.6%. While an improvement, the growth is not as rapid as in past periods with a sub-4% unemployment rate. It's important to remember that the curve is not linear. Its slope increases markedly at lower rates of unemployment, which would argue that wages are poised to accelerate.

What may be holding back wages? With the increase in global trade, wages are set globally. As more jobs are created in emerging economies, where pay is lower, wages in the U.S. may not rise as rapidly as the Curve would suggest. Trade, however, is not growing at the rate it had been through the 2008 financial crisis. According to the World Trade Organization, trade in 2016 of \$16.1 trillion is substantially lower than 2014's peak of \$19.2 trillion, arguing that disinflation related to trade growth may be behind us. This is particularly true if the trends toward nationalism, protectionism, and tariffs persist.

Figure 1: Inflation-Unemployment Relationship in the United Kingdom, 1861-1913



What if we were to use a different measure of wage growth? New workers entering the labor market may have lower wages than incumbents, and most likely lower than workers who are retiring from the workforce after decades of service. Retirements of highly-paid employees automatically reduce the average wage. A better income series may be the Atlanta Fed Wage Growth Tracker, which measures the median percent change in hourly wages of the same individuals, observed twelve months apart. This index shows the median wage having increased 3.2% in May 2018, a number which “feels” better considering the low unemployment rate.

Is there a better measure to gauge unemployment than the widely-quoted “U-3” unemployment rate? This “official” rate does not account for workers who are likely underemployed. These people are either working part-time for economic reasons or are discouraged workers who have quit looking for a job. The “U-6” unemployment rate captures these workers and may be a better measure of our employment situation.² This measure has declined from a high of 17.1% in October 2009 to 7.6% currently.

The National Bank of Canada published a report last September, mapping the U-6 rate (with a four-quarter lag) against the Atlanta Fed Wage Growth Tracker from 1998-2017. The correlation between the two series was 95%, and they concluded that the Phillips Curve still works, provided you use the right variables.³ As an aside, their curve suggests that we will see median wage growth close to 5% in a year given the current U-6 rate.

Of course, to do justice to the inflation debate we should consider other factors that can disguise the Phillips Curve such as the entry of China into global trade, the deflationary impact of a fall in energy prices from 2015-2017, and the “Amazon effect” on retail prices. But then, these are not factors Mr. Phillips could have foreseen in 1958.

ENDNOTES

1. *The Relation between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom*, *Economics*, New Series, Vol. 25 No. 100, November 1958

2. “The (non)disappearing Phillips Curve,” *Gavyn Davies*, *Financial Times*, October 29, 2017

3. *National Bank of Canada Financial Markets, Special Report*, September 15, 2017

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