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POLICY FORUM OPEN ACCESS

Reducing the NAIRU and Achieving Full Employment

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1 | Introduction: The Importance of Full Employment

Genuine full employment is a pivotal economic objective around which others move. It has important implications for distributional equity and raises productivity. Keeping the economy at the highest rate of labour utilisation possible, without domestic inflationary pressures pushing inflation consistently above the target range, will tend to reduce the non-accelerating rate of unemployment (NAIRU) over time, raise labour force participation and raise national incomes and output. It also reduces the budget deficit by reducing government spending and raising government revenue.¹

It is wise to implement policies to reduce the NAIRU to the lowest level consistent with avoiding inflation accelerating above the target range and staying there, and to operate the economy with unemployment at the NAIRU. Various micro-economic policies can lower the NAIRU by improving the matching of labour demand and labour supply, and enhancing the performance of the education and training system. Macro-economic policy can reduce the NAIRU by steadily increasing aggregate demand through moderate monetary and fiscal policy when inflation and inflation expectations are in the target range of 2–3 per cent (or approaching that range from above) and reducing unemployment until wage pressures in the labour market are starting to cause an acceleration of inflation persistently to above the target range. This was implicitly the approach to macroeconomic policy for a short period in the early 2020s when unemployment was reduced to 3.4 per cent.

We recommend adopting that approach now, alongside policies to improve the efficiency of the labour market. That is the best way to reduce the NAIRU and to find out what it is.

The alternative approach, relying on econometric estimates using historical data, can only provide ballpark estimates of where the NAIRU has been in the past and may differ significantly from the lowest levels consistent with avoiding acceleration of inflation in current circumstances.

2 | Defining the NAIRU

The NAIRU concept was introduced in the mid-1970s by Modigliani and Papademos (1975) as an alternative to the older concept of the ‘natural rate of unemployment’. It was defined as the level of unemployment below which price expectations would fuel wage rises that led to accelerating inflation.

Australian econometric estimates of the NAIRU in the 1980s and 1990s had increased in the 1970s and were of the order of 5–7 per cent (Gruen et al. 1999). It was understood that inflation expectations had increased and been built into wage setting. Labour market institutions at that time encouraged wage-price spirals. The Accord, followed by a period of labour market reforms and reductions in union power changed the wage-setting environment. This and sustained low inflation after the deep recession of 1990–91 produced lower econometric estimates, which have been in the range of 4–5 per cent in recent times (Australian Treasury 2021; Heather et al. 2021)

Econometric estimates can only provide ballpark estimates and can differ significantly from the current NAIRU. Macro-economic policy (combined with microeconomic policy to increase the efficiency of the labour market) should aim to get the unemployment rate as low as possible without creating pressures from the labour market that could give rise to accelerating inflation above the target range. We agree with the

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statement by the former Assistant Governor of the RBA in the 2019 Freebairn Lecture, ‘We know we have an unemployment rate below the NAIRU when wage pressures are raising inflation’ (Ellis 1999).

The fiscal and monetary response to the COVID pandemic led to an unemployment rate of around 3.5 per cent for over a year and a low point of 3.4 per cent without causing pressures for inflationary wage increases. The subsequent inflation spike was caused largely by exogenous shocks at a time of strong demand and disrupted supply in global product markets. The ‘natural experiment’ in driving unemployment down until inflationary pressures from the labour market revealed that the NAIRU was terminated to avoid the exogenous price shock being transmitted into persistent domestic inflation. We do not know yet whether 3.4 per cent or lower unemployment could have been maintained without causing economically unwarranted wage pressures. We can only find out by running policy that continues to reduce unemployment until there are signs of the beginning of significant inflationary pressures. We would be surprised if that occurs before unemployment reaches around 3.5 per cent.

3 | The Past 20 Years: An Interpretation

Figure 1 shows how the Phillips curve has shifted down after 2016 (Borland 2023). Wage pressures associated with any given level of labour utilisation have decreased significantly.

This does not appear to have been understood at the time by the Reserve Bank of Australia, which quarter after quarter for over 7 years forecast wage inflation to be much higher than it turned

out to be (Reserve Banks of Australia (RBA) 2013–20). This led to tighter monetary policy than was consistent with full employment and to inflation persistently below the target range (Figure 2). Unemployment remained well above the NAIRU (Figure 2), coming down very slowly to about 5 per cent before the pandemic shock.

Once COVID hit and unemployment spiked in 2021, there was a strong fiscal and monetary policy response. This brought the unemployment rate down to an average well below 4 per cent for a year and a half and to a low of 3.4 per cent without any sign of a wage breakout.

In 2021/2022, exogenous price shocks from supply chain effects of COVID 19 and the Russia-Ukraine war led to an outbreak of significant price inflation. This reached about 7 to 8 per cent in annual terms on all groups and the Trimmed mean CPI (Figure 2).

There was no sign that the inflationary pressures had their origin in the labour market. The WPI annual increases of 3.2 per cent or more since 2022 can be attributed to a lagged adjustment in the big increases in the CPI that preceded them. The increase in wage inflation was relatively modest, peaking at 4.3 per cent. There were large reductions in real wages (Figure 3). Real wages have only recently begun to recover lost ground in circumstances in which developments in the real economy do not suggest falls in equilibrium real wages. The WPI is currently running at 3.4 per cent per annum, and the CPI is now back in the target range of 2–3 per cent.

When wage inflation hit its peak of 4.2 per cent, price inflation was well on its way down and also at 4.2 per cent. Since that

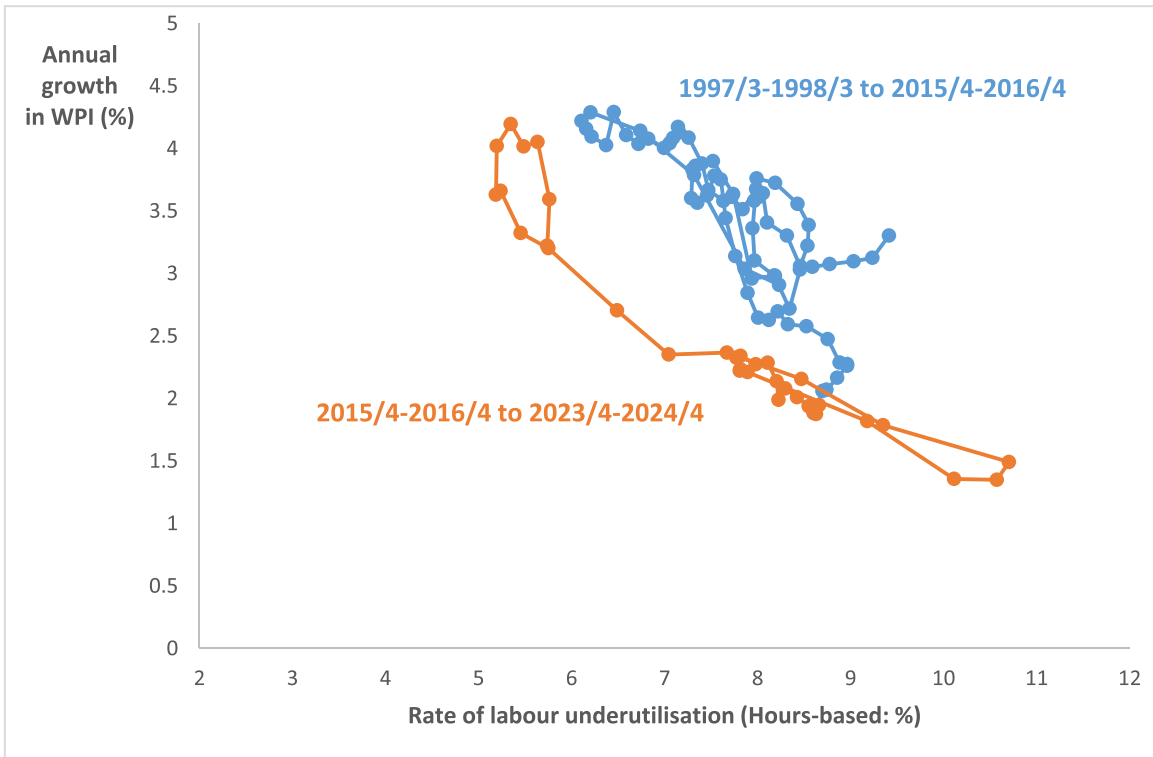


FIGURE 1 | The Phillips curve 1998–2024 (annual wage growth).Source: Borland (2023).

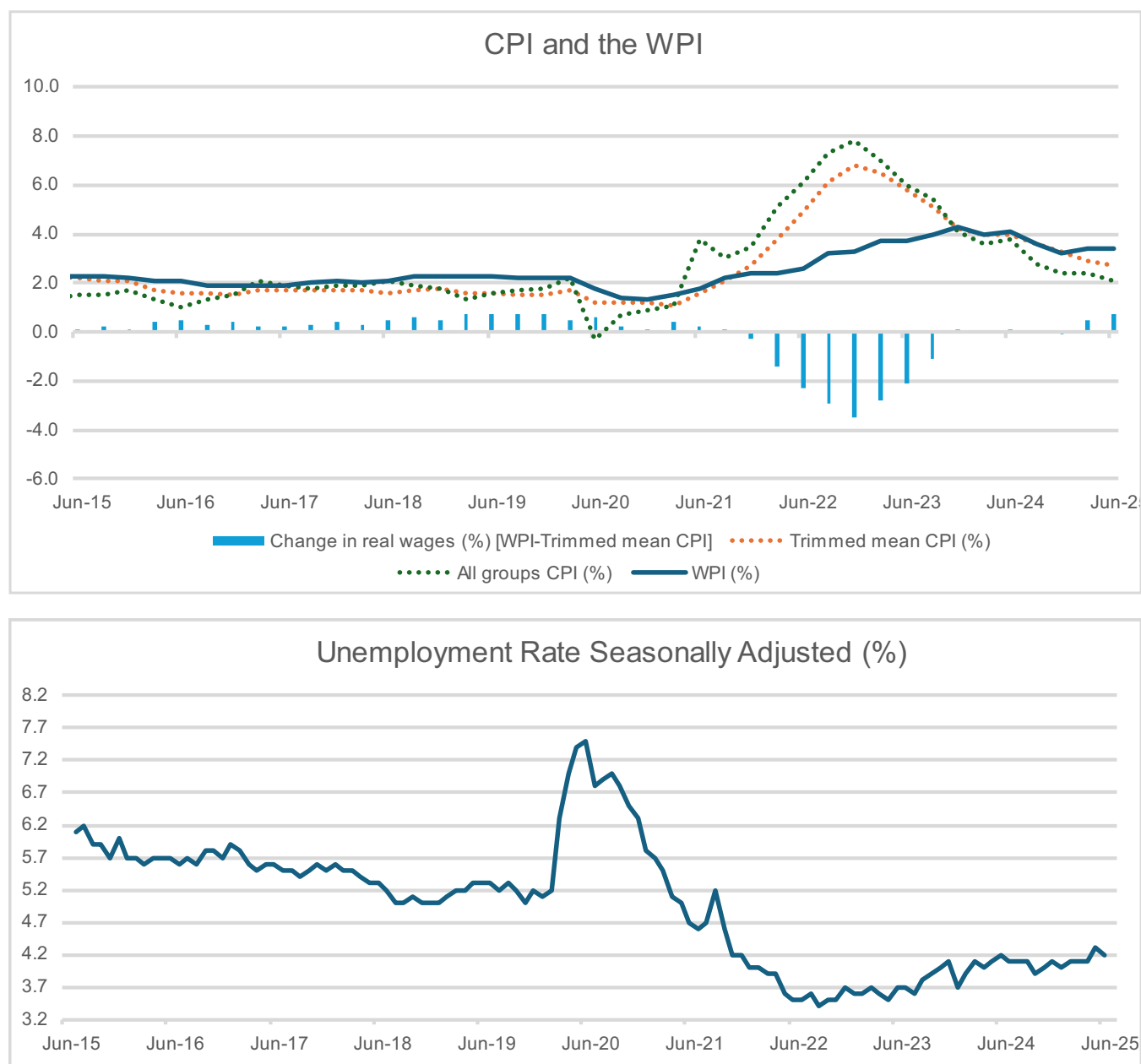


FIGURE 2 | CPI, WPI and unemployment (2015–2025). Source: ABS Consumer Price Index, Wage Price Index and Labour Force Survey.

time, wage and price inflation have been trending down together. A small lift in the WPI in the March 2025 quarter was caused by particular enterprise agreements especially in the aged care and childcare sector, and was not broad-based. The particular increases were supported by government because they were due to chronic rather than cyclical shortages. The increase in the WPI in the June quarter stayed at 3.4 per cent.

It is important to keep monitoring wage inflation in the months and years ahead. There is no evidence at present of rising inflationary expectations fuelling wage rises and triggering a wage-price spiral in the way that would be predicted if the unemployment rate was below the NAIRU. The data in Figure 2 tells us that the unemployment rate is above the NAIRU.

Figure 3 shows the contribution of different wage-setting processes to growth in the WPI. During this period, in which wages

have been rising slightly faster than prices, individual agreements made the greatest contribution, followed by enterprise bargaining agreements and then awards. Individual agreements went up first as they are the quickest to respond to the economic environment. However, all three types are now trending down, though there was a slight reversal in the EBA series in March 2025 due to some new state-based agreements in the care sector.

4 | Conclusions

This paper has highlighted the centrality of genuine full employment in achieving the economy's full potential. It has been noted that the NAIRU has fallen substantially since it reached its highest level in the 1970s and early 1980s. The economic policy authorities should continue to reduce the NAIRU through a combination of microeconomic and macroeconomic

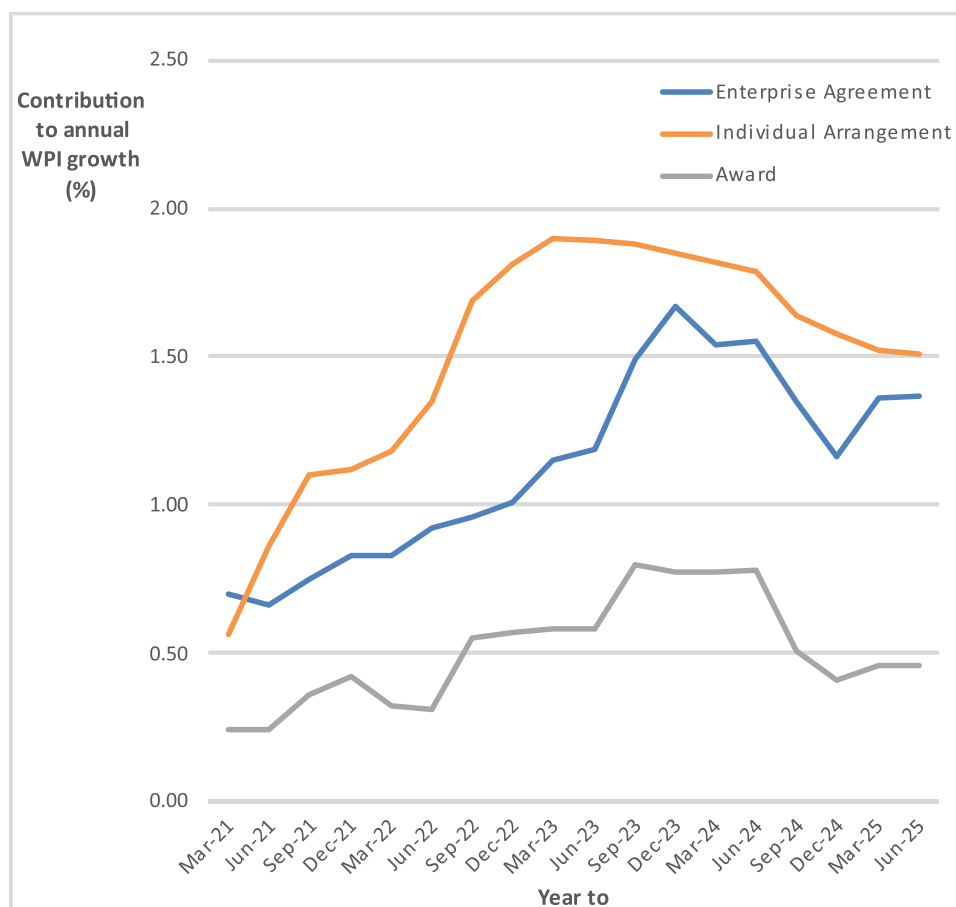


FIGURE 3 | Annual rate of growth in WPI: contributions of agreements and awards. Source: ABS Wage Price Index (main features section).

policies. The microeconomic include policies to increase the efficiency of the labour market. The macroeconomic involves steadily reducing the unemployment rate until we reach the level of unemployment at which inflationary pressures threaten our ability to keep the inflation rate in the target range of 2–3 per cent. We know that we have reached the current NAIRU when inflationary pressure from the labour market is driving inflation above the target range and keeping it there.

We have the benefit of a recent policy experiment on which to draw. The fiscal and monetary policy response to the outbreak of the COVID-19 pandemic resulted in the unemployment rate falling well below 4 per cent for an extended period and to as low as 3.4 per cent. Macroeconomic policy at that time seemed comfortable about reducing unemployment until inflationary pressures emerged in the labour market. Inflationary pressures did not emerge. This should provide confidence that unemployment can again be reduced towards 3.4 per cent without risking an acceleration of inflation to above the target range.

Exogenous price shocks resulting from pandemic supply chain disruption and the Russia–Ukraine war in 2021–22 led to an outbreak of price inflation at a time of strong aggregate demand. Understandably, but for too long, the RBA terminated that policy experiment. Interest rates were raised substantially. The outbreak of price inflation led with a lag to wages increasing faster than usual, although real wages declined substantially. Eventually, price inflation subsided back into the Reserve

Bank's target range. Wage inflation has also subsided and is now running at about 3.4 per cent. Real wages are starting to rise, but at a rate at which it would take many years before they returned to their pre-pandemic levels. The Reserve Bank began to ease monetary policy to reduce interest rates in early 2025. They remain above the neutral rate, and will need to continue to fall if movement towards unemployment at the NAIRU is to be restored.

With the external inflationary shock having abated, now is a good time to lower unemployment as far as possible without creating pressure in the labour market for accelerating inflation—that is, to reduce the unemployment rate to the NAIRU. Current national focus on productivity is one of the several good reasons for the RBA to steadily reduce interest rates and unemployment until there is evidence of inflationary pressures emerging in the labour market. At the same time, microeconomic policies to increase the efficiency of the labour market and the national skills system should be pursued to complement macroeconomic expansion. These policies together will lower the NAIRU as they reduce unemployment to that level.

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Endnotes

¹For an elaboration of this argument, see Dawkins and Garnaut (2022, 35).

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