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ECONOMIC TALKING POINTS

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Desperate for workers? Yes!
Willing to raise wages at attract new hires? No, and here's why!

If we are to take February's jobs report at face value, the story it tells is essentially this: Employers are struggling to find and hire qualified workers. But are these same employers willing to offer more pay to attract skilled candidates and retain their current workforce? The answer appears to be a firm no!

What's behind this unusual combination? Has the law of supply and demand, and its impact on pricing been repealed?

Before we seek any answers, let's back up a little. February's payroll jumped by a much higher than expected 313,000, the biggest monthly increase since October 2015. The private sector accounted for 287,000 of those hires, while federal, state and local governments took on 26,000. So the pace of hiring clearly shifted into higher gear. Moreover, the Labor Department reported that December and January's payrolls were revised up by an additional 54,000.

Chart 1. Unemployment rate, seasonally adjusted, February 2016 – February 2018

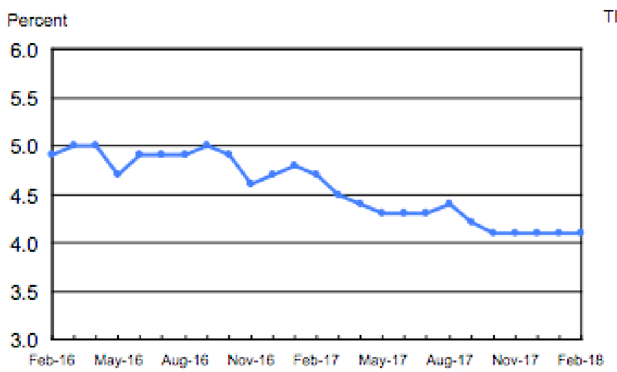
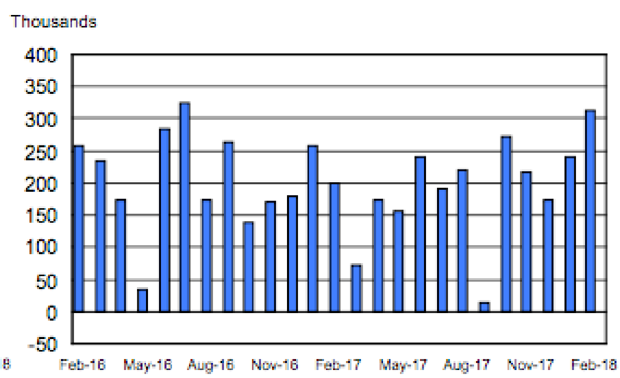


Chart 2. Nonfarm payroll employment over-the-month change, seasonally adjusted, February 2016 – February 2018



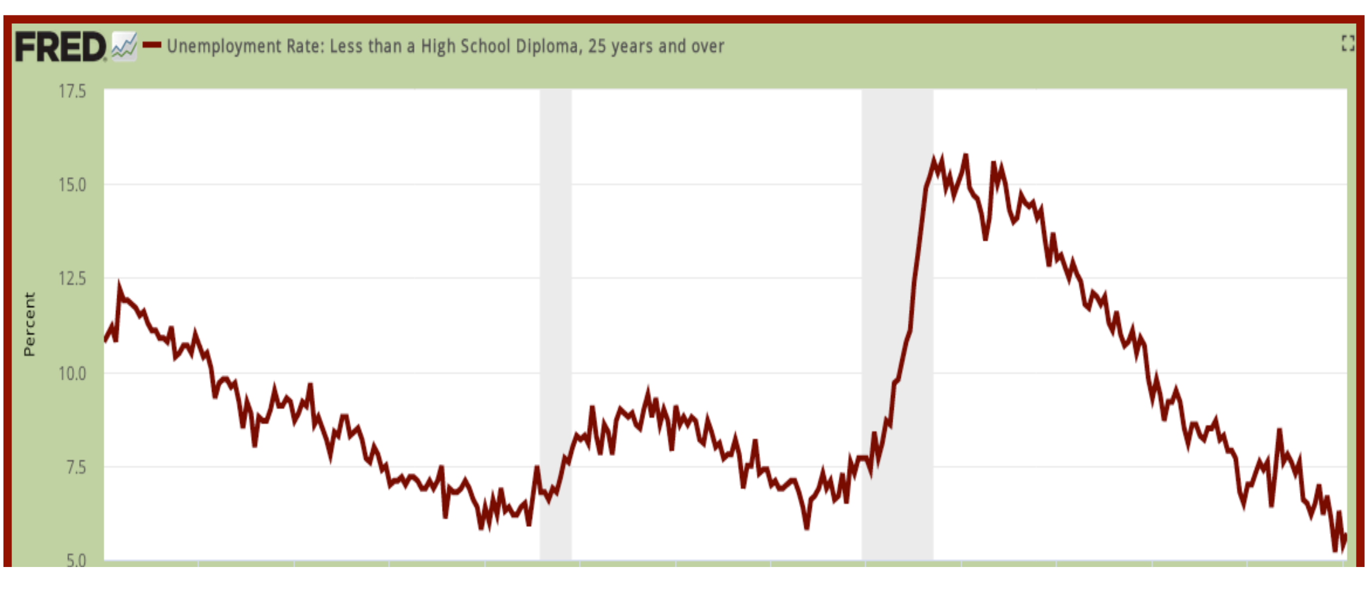
These are all impressive numbers. Time and time again we hear the economy is operating at or near full employment. But if that were true, we should have seen wages accelerate by now. If in fact there is a severe shortage of labor at a time when employers are desperately seeking to fill nearly 6 million job openings every month, then the annual growth in average hourly earnings should have broken out of its narrow range of 2.6% to 2.9% long ago.

Is there something about the US labor market that we're missing? If the reservoir of unemployed workers has essentially dried up, why are wages still languishing?

Here are a few possible explanations.

(1) It's possible we have long underestimated the number of workers who have remained outside the official labor force. The Great Recession, for example, forced millions of Americans to earn income by entering the underground economy. (We're not talking about illicit activity like drug sales or organized crime.) These are workers who quietly receive cash payments as private carpenters, tutors, livery drivers, flea market vendors, home repair specialists, with many settling into a life style that suited them in terms of independence and pay. But getting an accurate size of this population group has always been difficult. Theirs is mostly a cash business and these people prefer to stay clear of the government's eyes. This shadow economy turns out to be quite large in scope. It has been estimated to make up about 10% of US GDP, or $2 trillion, which means its underlying workforce is probably much bigger than we imagined. So what has changed? Well, with economic recovery into its ninth year, we believe more of these workers have emerged from the shadow economy because they now see opportunities to receive better benefits, steady pay and job security. By actively seeking and getting employment, they have by definition re-entered the official labor force.

There's yet an additional dynamic to consider. Employers are more open to hiring and training those who lack a high school diploma. Typically, this population group has the greatest difficulty securing steady, well-paying jobs. Yet companies are seeking them out to fill vacant posts. The labor force participation rate for those without a high school degree jumped by two full percentage points to 46.8% in February. Over the last four month, their unemployment rate has hovered between 5.2% and 5.7%, a range not seen in 48 years!



The point I'm making is we may have chronically underestimated the potential supply of unemployed and underemployed workers in the economy. It may well be when demand for workers is exceptionally high --- and these periods are fairly rare in economic history --- that we can better understand what the potential size of the US workforce really is.

(2) If demand for labor is so strong, why aren't we seeing a corresponding increase in pay? Average hourly earnings over the last 12 months dropped to 2.6% from 2.9% in January. The lack of wage inflation has undoubtedly puzzled many economists, both in and out of government. My own assessment as to why companies have been so stingy with pay may be the result of several factors.

First, nonfarm productivity growth has been dismal. In fact, there was zero labor productivity in the final quarter of last year and a miserly 1.1% increase for all of 2017. Since the cost of labor represents about two–thirds of production expenses, the poor growth in productivity leaves little room to increase pay without cutting into profit margins.

Another factor is that severe competition from online shopping and big box stores, like Costco and Sam's Cub, have greatly limited the pricing power of all sorts of businesses. So if you are unable to offset higher wages with either stronger productivity or raise prices, then you're less likely to boost worker salaries.

The third factor is that the recent tax cuts have incentivized companies to use more of their earnings to increase capital expenditures. Purchasing new and more efficient equipment, which can now be written off the first year, would improve productivity and thus future earnings. In other words, companies have placed a greater priority on allocating funds to boost output per hour of work, rather than lifting wages.

(3) Finally, there is one other perspective to consider. The tightness in the labor market and simultaneous weak wage growth would seem to undermine, if not utterly destroy, the validity of the Phillips Curve. This long-held economic concept describes an inverse relationship between unemployment levels and the rate of inflation. Its core argument is that when an economy approaches full employment, wage inflation invariably rises. The problem is we haven't seen any evidence of that in this business cycle. Neither have Europe or Japan for that matter.

We have discussed the Phillips Curve in previous reports and have concluded that the relationship between unemployment and inflation can no longer be seen simply as a dynamic within a single country. Technology and globalization have broadened the horizon within which the Philips Curve operates. The US, for example, is more integrated than ever into the world economy, which means labor, technology and capital have to be viewed as global resources, not simply what a single country can supply.

Now, let me throw some cold water on all I discussed above. All this analysis above may soon become irrelevant because the White House has just thrown a massive wrench into the economy. President Trump's latest retreat from globalization by increasing tariffs on steel, aluminum, solar panels and washing

machines, could invite foreign retaliation and lead to a trade war. If so, February's powerful jobs report could prove to be one of the last gasps of an economy noted for its healthy employment growth and little inflation. What a shame it would be to lose that trend because an act of folly.

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Key Economic Forecasts

- Actual
- Forecast

United States

	I 2017	II 2017	III 2017	IV 2017	I 2018	II 2018	III 2018	IV 2018	I 2019	II 2019	III 2019	IV 2019
Real Gross Domestic Product (GDP):												
%	1.2	3.1	3.2	2.5	1.8	3.5	2.8	2.7	1.9	2.2	2.0	2.4
Personal Consumption Expenditures:												
PCE %	1.9	3.3	2.2	3.8	2.2	3.3	2.8	2.4	2.2	2.1	2.3	2.7
Inflation, end of period, year-over-year:												
CPI %	2.4	1.6	2.2	2.1	2.2	2.2	2.3	2.3	2.4	2.4	2.5	2.7
Unemployment Rate (end of period):												
%	4.5	4.4	4.2	4.1	4.0	3.7	3.7	3.9	4.2	4.4	4.4	4.5
Non-farm Payrolls, monthly avg. thousand:												
	166	187	128	204	190	185	160	160	150	145	140	140
Treasury 10-yr Note Yield % (end of period):												
	2.39	2.30	2.33	2.41	2.90	3.00	3.05	3.05	3.35	3.25	3.10	3.10
Federal funds rate % (end of period):												
	0.88	1.13	1.13	1.38	1.63	1.63	1.88	2.13	2.38	2.63	2.63	2.63

GDP Growth - Global Economy

Country	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
US	-2.8	2.5	1.6	2.2	1.7	2.6	2.9	1.5	2.3	2.7	2.1
Eurozone	-4.1	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	2.4	1.7
United Kingdom	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.8	1.0	1.4
Japan	-5.4	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.6	1.7	0.9
Canada	-2.8	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.2	2.7	2.5
India	6.3	8.4	8.6	6.7	4.9	7.4	7.9	7.1	6.8	7.5	7.5
China	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.9	6.6	6.3
Brazil	-0.3	7.5	2.7	0.9	2.3	0.1	-3.8	-3.6	1.2	2.3	2.8
Mexico	-4.7	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.0	2.5
Australia	1.2	2.8	2.6	3.6	2.4	2.6	2.4	2.4	2.7	2.8	3.0
Russia	-7.9	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.5	2.1	2.0
World	-1.9	4.2	3.0	2.6	2.9	3.0	2.7	2.4	3.5	3.4	3.2