

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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Reframing the Phillips Curve Why Low Unemployment Has Not Led To Wage Inflation

The December jobs report once again raises questions about our grasp of how a modern, hi-tech economy functions. Indeed, these questions seem to loom larger with the release of each new set of data points.

Who would have thought an economic expansion well into its record 11th year would still generate minuscule inflation? How can it be that years of historically low interest in the US (and negative rates abroad) would have so little impact on reviving economic activity?

And then there is the enigma we confronted this morning with the December employment report. The jobless rate at the start of 2019 stood at 4%. But it has steadily declined to its 50-year low of 3.5% by year-end. Normally, with the labor market tightening to half-century lows, one would expect more serious upward pressure in wages. Instead we face another incongruity in economics. Average hourly earnings, which rose at a 3.4% annual rate early last year, faded to a mere 2.9% increase in last month.

This is contrary to the long-standing orthodoxy of the Phillips Curve upon which most economic models rests. Under this economic principle, when the pool of available workers shrinks, companies would bid up the price of labor. But this relationship between the unemployment rate and wage inflation appears to have weakened greatly, or become defunct altogether. As a result, many experts have begun to classify the Phillips Curve as an anachronism, one that should be tossed into the trash bin of history.

But I disagree. There is something more significant going on here. What's needed is a whole new mindset of how a technologically innovative, globally integrated, demographically changing economy operates. In other words it's not the Phillips

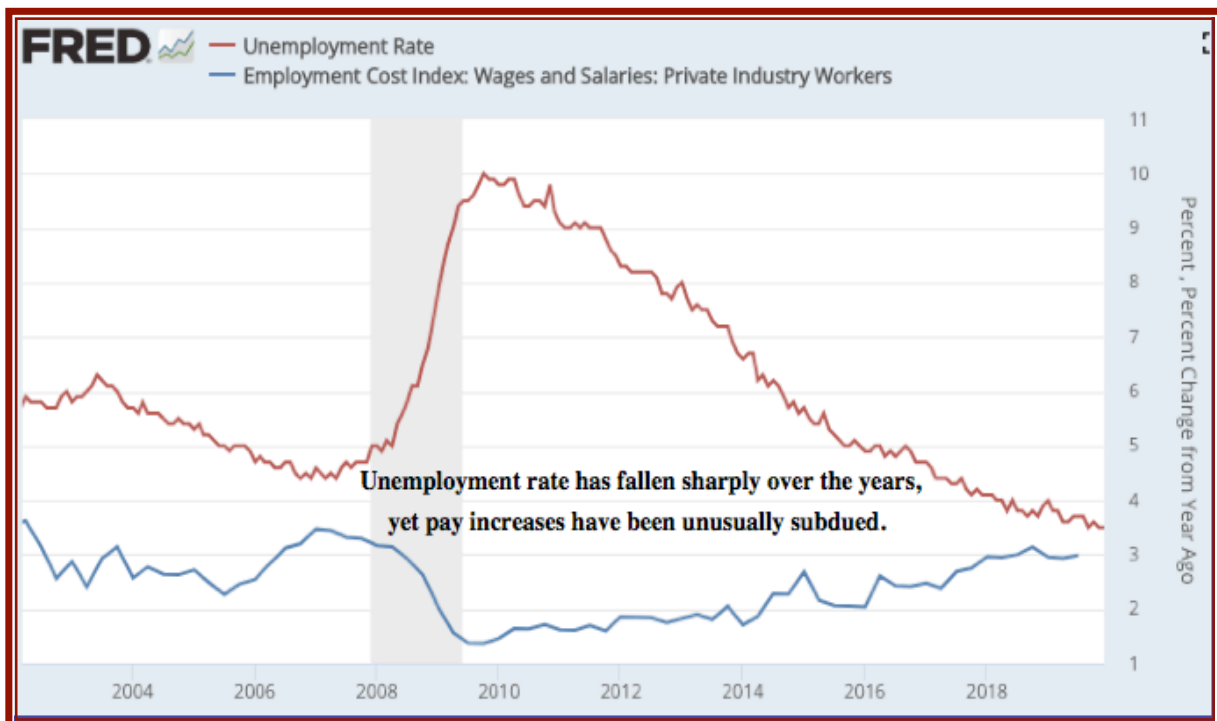
Curve that is malfunctioning, since in the final analysis it simply reflects the law of supply and demand. When a commodity in high demand is scarce, its price is supposed to go up. That remains a central and valid part of economics.

What needs to be done, however, is reassess how we quantify three key components inherent in the Phillips Curve: the size of the labor force (commodity); the strength of the demand (unemployment rate); and what do mean by compensation these days (wage inflation)?

So let's return to the latest example. December's nonfarm payrolls rose by 145,000, the smallest increase since last May. For all of 2019 there were 2.1 million net new hires, not as high as the previous seven years but it's still an impressive achievement for an aging expansion.

At the same time, however, the growth in labor force was much smaller, just 1.45 million last year. Employers meanwhile are seeking to fill 7.27 million job openings at a time when there are just 5.75 million people unemployed who are looking for work. As a result, companies have been digging deeper into the labor pool for new hires. Case in point: The jobless rate even for those without a high school diploma plummeted from 15.8% in 2010, to 5.2% last month.

So it makes perfect sense that the competition for a limited supply of labor AND efforts to retain one's current workforce (quit rates are now at record highs) should result in average hourly earnings growing at a faster rate.



What has changed this dynamic?

(1) Quantifying the size of the labor force may be more problematic in the late stage of a business cycle. We believe the pool of available workers is actually larger and more fungible than the official data. One hint of that can be seen by the broader

underemployment rate (U-6), which dropped to 6.7% in December, the lowest ever recorded.

Secondly, the unemployment rate is based on feedback the BLS gets from just 60,000 households. Because of its relatively small sample, the margin of error can be huge. But the BLS considers swings only above 500,000 as being statistically significant. Yet even an error of 500,000 can be quite large when companies are dealing with a diminishing supply of labor.

Third, sizing up those marginally attached to the labor force (e.g., persons not looking for work, or are in the underground economy, or part time gig workers preferring full time employment, plus persons not working but have looked in the last 12 months) can be especially challenging late in the expansion. By our assessment, the size of the marginally attached workforce is much larger and can transition more quickly into the active labor force given the current high demand for labor and more lucrative compensation.

(2) That gets us to the question of pay. The issue here is how is compensation defined? Average hourly earnings is probably not the best metric under current circumstances.

Take personal income, for example. Its growth has hovered in the 4% to 5% range all last year, according the BEA. In November, the most recent available, personal income jumped 4.9% over the past 12 month, the fastest increase we have seen so far in 2019. Our own forecast calls for wages and salaries, the biggest component in personal income, to climb 5.5% this year, versus 5.0% in 2018 and 4.7% in 2017.

However, there is also another dimension to compensation often overlooked. Current and prospective workers may value certain benefits above that of pay. One is flex time. Employees may be willing to give up pay increases in exchange for the freedom to choose their own hours at the office, or work more from home. Such options have become more commonplace as firms seek new, creative ways to lure qualified people. These features not only help keep labor costs down but also save firms money by reducing the need for office real estate.

Dismissing the Phillips Curve as old school is simplistic and unwarranted. It is still a valid concept. But it requires revisiting how we calculate the available labor force. By our measure, there is still an ample supply of unemployed people, which means that both the U-3 and U-6 unemployment rates are very likely higher than the official data. At the same we need to redefine compensation so it includes the growing popularity of non-financial benefits.

A new framework is called for on how we view both the potential size of the workforce and the way it is are being paid. After all, this country is now in uncharted waters with respect to the expansion. The economy is clearly undergoing profound changes. While the behavior of the Phillips Curve has been baffling lately, it doesn't deserve annulment. What is needed is a better understanding of the dynamics that shape labor markets and determine compensation.

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United States

	I 2019	II 2019	III 2019	IV 2019	I 2020	II 2020	III 2020	IV 2020	I 2021	II 2021	III 2021	IV 2021	I 2022	II 2022	III 2022	IV 2022
Real Gross Domestic Product (GDP):																
%	3.1	2.0	2.1	2.2	1.9	2.8	2.5	2.3	2.4	3.3	2.4	2.5	1.5	2.2	2.0	2.1
Personal Consumption Expenditures:																
PCE %	1.1	4.6	3.2	2.8	2.2	4.3	3.0	2.5	1.9	4.1	3.0	2.7	1.6	2.4	2.2	2.0
Inflation, end of period, year-over-year:																
CPI %	1.9	1.6	1.7	2.1	2.2	2.4	2.5	2.6	2.6	2.5	2.6	2.4	2.4	2.5	2.3	2.2
Unemployment Rate (end of period):																
%	3.8	3.7	3.5	3.5	3.5	3.4	3.3	3.3	3.5	3.5	3.6	3.7	3.7	3.9	4.0	4.2
Non-farm Payrolls, monthly avg. thousand:																
	174	152	188	184	180	165	155	150	140	155	155	140	135	120	110	115
Treasury 10-yr Note Yield % (end of period):																
	2.42	2.00	1.65	1.88	2.00	2.15	2.50	2.80	3.10	3.20	3.45	3.50	3.75	3.75	3.85	4.10
Federal funds rate % (end of period):																
	2.38	2.38	1.88	1.63	1.63	1.63	1.63	1.63	1.88	2.13	2.38	2.38	2.38	2.38	2.38	2.13

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
US	2.6	1.6	2.2	1.8	2.5	2.9	1.6	2.4	2.9	2.3	2.4	2.7	1.9
Eurozone	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	1.9	0.9	1.4	1.6	1.3
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.8	1.4	1.0	1.5	1.7	1.3
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.9	0.8	0.9	0.9	1.5	1.0
Canada	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.0	1.9	1.5	1.8	2.3	1.5
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	6.5	6.6	7.3	0.0
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	5.9	5.8	5.8	5.7
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.1	1.1	1.0	1.5	1.9	1.7
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.0	0.2	1.4	1.7	1.2
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.8	2.2	2.6	2.3
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	1.2	1.5	1.7	0.9
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.6	3.0	3.2	3.0

