THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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Collapse of the Phillips Curve: The Decoupling of Employment and Inflation

If there is one overriding lesson to come out of the stunning 517,000 jump in January's nonfarm payrolls it is that we have a dismal understanding of how this post-pandemic economy works.

The powerful surge in hiring, which helped lower the unemployment rate to a 54-year low of 3.4%, screams for a full reassessment of the dynamics that drive the job market AND its relationship to inflation. Otherwise there is nothing about this economy that can be predetermined with any degree of accuracy or confidence.

With the release of this extraordinary employment report, the danger is the Federal Reserve may feel pressure to turn more aggressive and ratchet up interest rates until it chokes off the demand for workers. But such a policy stance only highlights the flawed theory and models the Fed works with. Instead, we should celebrate the strength of the current labor market and accept the fact that an economy can actually enjoy both robust job growth and lower inflation.

The belief that having both violates some fundamental law in economic science is no longer tenable.

Unfortunately there is a commonly held belief among economists, both in and outside the Fed, that labor market conditions are so out of balance that the only way to slash inflation is to cool the demand for workers and depress pay increases. This is antiquated thinking brought on by a cultish-like devotion to the Phillips Curve.

So let's get some history right here. The inverse relationship between unemployment rates and inflation, as depicted in the Phillips Curve, did hold up well during the 1960s, 70s and 80s. However that relationship has been shattered the last two decades because of several emerging variables that relegated the Phillips Curve to an anachronism.

Among the intervening variables are labor productivity, price competitiveness in an eCommerce world, changing demographics and a growing inclination of firms to prioritize market share over maximizing profit. These factors have worked to unshackle the link between employment and inflation.

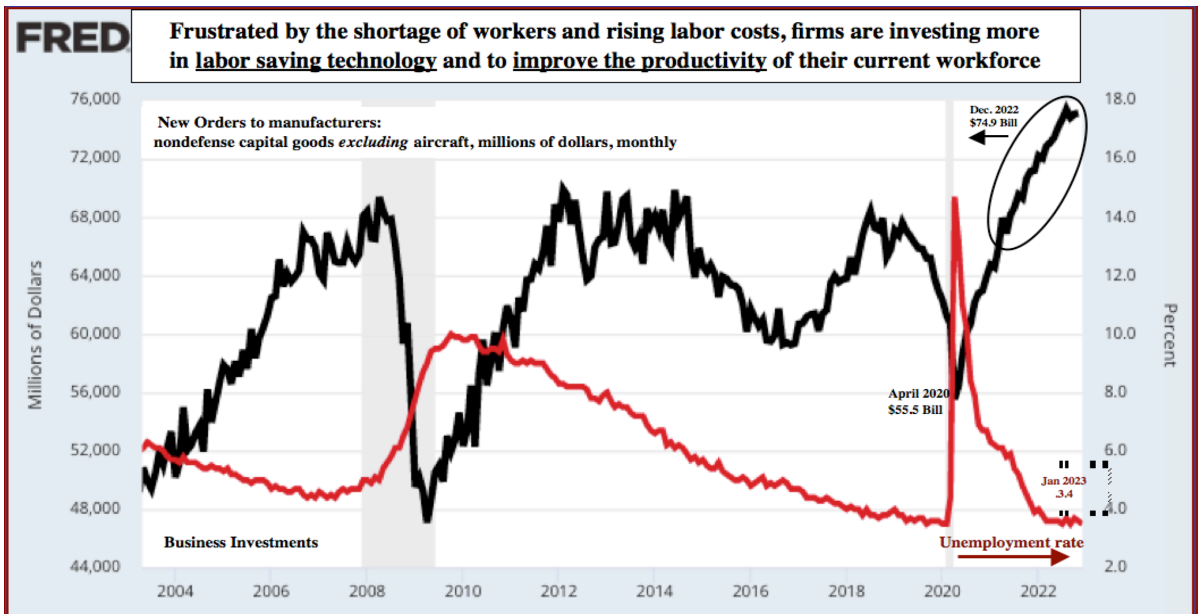
Look no further than the latest trend in average hourly earnings. Since peaking this cycle at a 5.9% rate last March, annual wage inflation has been consistently falling and dropped in January to 4.4%, the lowest since August 2021. And this decline occurred even as labor market conditions were getting tighter! The gap between job openings and Americans looking work is now wider than ever! (December's job openings stood at 11 million, but there were only 5.7 million people who were seeking employment.)

Nor is this combination of falling inflation and labor scarcity some freak aberration from the Phillips Curve. On the contrary, the aberration now *is* the Phillips Curve itself.

In the years just prior to the outbreak of the pandemic, the economy also enjoyed a strong labor market --- yet inflation was largely dormant. Back in 2018 and 2019, for example, the demand for workers greatly exceed the number of people unemployed for the first time in US history. That unprecedented tightening in the job market did not lead to a surge in wages or fire up inflation. In fact, using the Fed's favorite inflation metric, the personal consumption expenditure price index, inflation averaged less than 2% those two years!

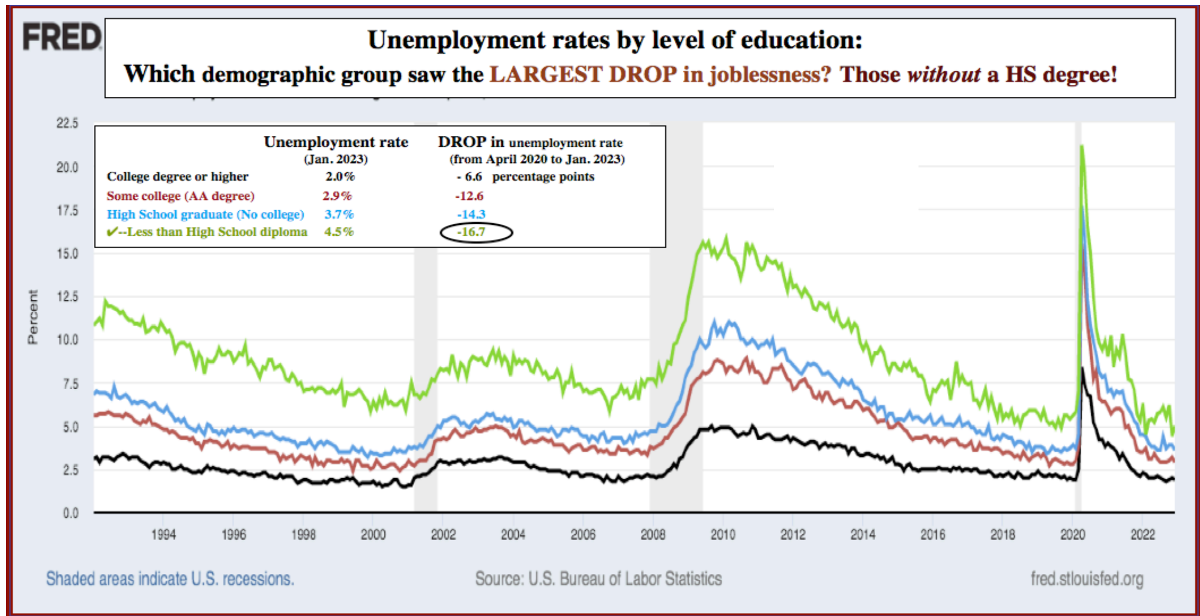
It would thus be a tragic mistake if the Federal Reserve continues to view the Phillips Curve as some infallible doctrine. What the Fed should focus on are its two mandates --- achieving maximum employment and price stability. The former has been achieved and the latter is well on its way toward getting inflation back to the Fed's 2% target. The CPI continues its downward slide; it fell in December to 6.5%, from 9.1% in June. The personal consumption price expenditure price index has been on a similar track, dropping to 5.0% at the end of 2022, well off the 7% pace last summer. Core inflation measures for both are also moving down in tandem.

Table 1.



The Fed cannot ignore or dismiss the forces working to dampen inflation. Labor productivity has rebounded in the second half of last year. Businesses are ramping up core capital spending to offset rising labor costs (Table 1). Supply chain networks are normalizing. Demographics are changing as more baby boomers retire and spend less. Companies, concerned about an economic slowdown, are prioritizing market share over maximizing profits. Recruiters are seeking out workers on the fringes of the labor market to keep costs down (Table 2). And finally, what we believe is the single greatest price competitive force in modern history, consumers and businesses increasingly turn eCommerce when purchasing goods and services.

Table 2.



These are just a few of the forces that have worked to unshackle inflation from labor market trends. If only Fed economists were bold enough to appreciate these structural changes and reformulate their economic models accordingly.

Finally, we expect the job market to remain robust through 2023, along with tame inflation. If so, one can confidently reject the prospect of an economic downturn. There is simply no such thing as a jobs-full recession; it's an oxymoron.

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