DALLASFED Economic Update
National

Economic Gains Likely to Tighten Job Market, Push Up Wages

August 8, 2014

Economic indicators released over the past two months present a picture of modest growth thus far in 2014. In its first estimate, second-quarter gross domestic product (GDP) growth came in at an annualized 4 percent, putting first-half average growth at 0.9 percent. Job gains decelerated slightly from June to July, but payrolls are still expanding at a healthy pace. Meanwhile, the unemployment rate increased slightly to 6.2 percent in July.

Output Growth Rebounds in Second Quarter

Among major components, the lone negative contributor to real GDP growth in the second quarter was net exports, subtracting 0.6 percentage points (*Chart 1*). Real personal consumption expenditures (PCE) added the most to growth (1.69 percentage points). Positive contributions from residential (0.2 percentage points) and nonresidential fixed investment (0.7) were a welcome turnaround from weaker contributions in the prior quarter that were caused by unusually harsh winter weather. The volatile inventory investment component contributed 1.66 percentage points, which indicates downside risk to growth if upheld in future estimates.

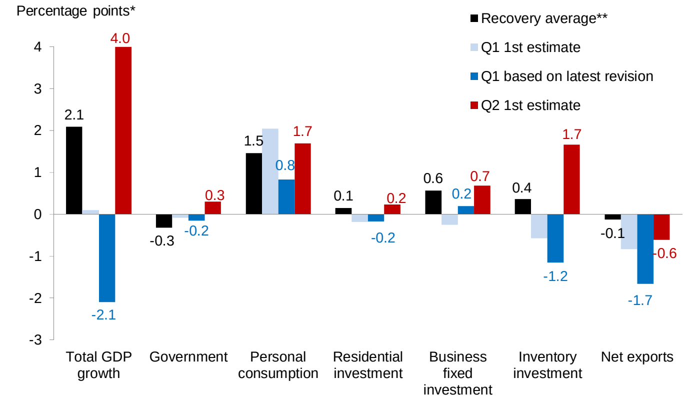
The estimate of strong second-quarter output growth contrasts with the contractionary growth of the first quarter. As can be seen in Chart 1, the downward revision to first-quarter real GDP growth was mostly the result of a drop in real PCE. This was due largely to an overestimate of expenditures on medical services in the first and second releases (the possibility of which was suggested in May's National Economic Update).[1]

Wage Growth to Accelerate Over Next Four Quarters

The payroll survey showed modest improvement in labor market conditions. Total nonfarm employment grew by 209,000 in July. Private sector nonfarm payrolls increased by 198,000, while the government sector added 11,000 jobs. Additionally, the strong gains over the previous two months were revised upward by 15,000. Since the start of 2014, nonfarm payroll gains have averaged 230,000 per month.

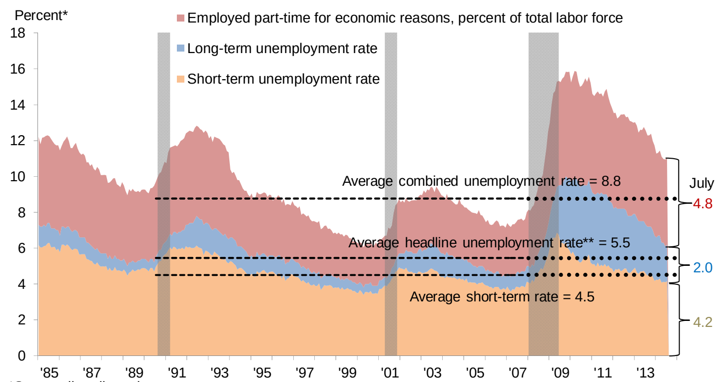
According to the household survey, the headline unemployment rate increased 0.1 percentage points from

Chart 1
Second-Quarter GDP Growth Rebounds Sharply



*Contribution to percent change in GDP growth; quarter/quarter, seasonally adjusted.
**Through 2014:Q1.
SOURCE: Bureau of Economic Analysis.

Chart 2
Three Alternate Measures of Slack Tell Different Stories

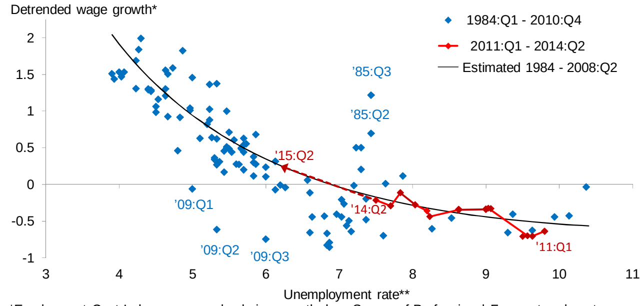


*Seasonally adjusted.
**Headline unemployment rate = short-term rate + long-term rate.
NOTE: Shaded bars indicate U.S. recessions.
SOURCES: Bureau of Labor Statistics; National Bureau of Economic Research.

June. However, this coincided with an increase in the labor force participation rate from 62.8 to 62.9 percent. Based on quarterly averages, the unemployment rate has fallen 1.3 percentage points over the past year—the largest year-to-year decrease since the 1980s—and is at levels not seen since late 2008.

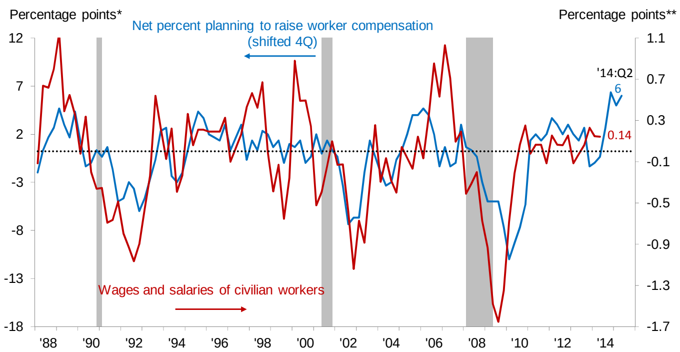
This downward progress has given rise to discussion among analysts about how much slack (excess labor supply) remains in the labor market and how well the headline rate

Chart 3
Wage Growth to Increase Gradually



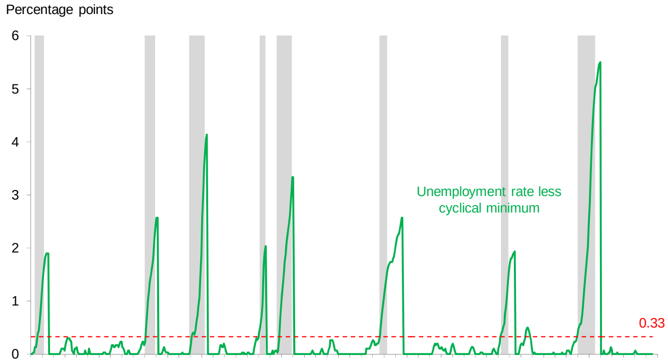
*Employment Cost Index wages and salaries growth, less Survey of Professional Forecasters long-term inflation expectations, year/year.
**Lagged four quarters, seasonally adjusted.
SOURCES: Bureau of Labor Statistics; Survey of Professional Forecasters.

Chart 4
Another Sign of Increased Wage Pressures



*Year/year change.
**Year/year change in year/year growth.
NOTE: Shaded bars indicate U.S. recessions.
SOURCES: Bureau of Labor Statistics; National Federation of Independent Business; National Bureau of Economic Research.

Chart 5
Small Increase in Unemployment Rate Nearly Always Means Recession



NOTES: Shaded bars indicate U.S. recessions. The dashed line is the threshold beyond which recession is likely.
SOURCES: Bureau of Labor Statistics; National Bureau of Economic Research.

communicates slack, which is often measured by wage growth. Some question whether the longer-term unemployed (six months or more) fail to exert a restraining influence on wage growth—and thus poorly represent slack—because firms overlook them. Some also question whether those employed part-time for economic reasons (the underemployed) do exert a restraining influence on wage growth because they may be willing to trade lower wages for more hours, among other things. The issue is particularly relevant because the short-term unemployment rate has fallen below its longer-run average, while the headline unemployment rate and the combined rate (those unemployed and underemployed) are above their respective averages (*Chart 2*).[2]

So, given the different measures of unemployment shown in Chart 2, how useful is the headline unemployment rate by itself as a measure of slack? If the headline rate substantially misrepresents slack in the labor market, there should be a breakdown in the historical relationship between it and wage inflation. Accounting for inflation expectations, the recent data show wage inflation moving in line (or in curve) with the headline unemployment rate (*Chart 3*).[3] Assuming no significant deviation from the relationship shown in Chart 3, wage inflation will likely accelerate close to 0.5 percentage points by second quarter 2015. This suggests that there is plenty of room for the unemployment rate to fall before wage inflation takes off.

Chart 4 gives further credence to this forecast. It shows the year-to-year change in the National Federation of Independent Business survey, which asks what percent of small businesses, on net, plan to raise worker compensation. It also shows the year-to-year change in year-over-year growth in wages and salaries of civilian workers, measured by the Bureau of Labor Statistics' Employment Cost Index. The strong relationship between these two series suggests wage growth will accelerate by roughly half a percentage point during the next four quarters.

When to Water Down the Punch

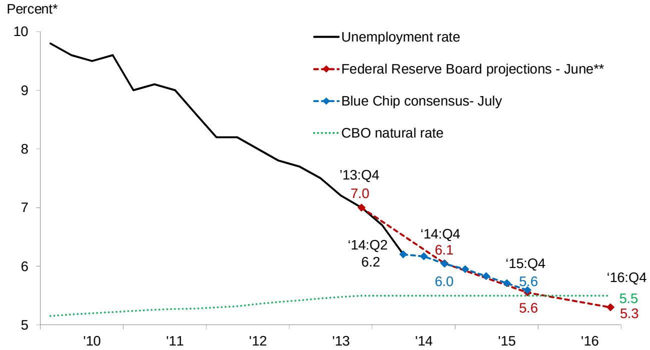
Another question emerges given the downward trend of the unemployment rate: How far should it be allowed to fall before monetary policy waters down some of the punch?[4] Specifically, is there a risk in continuing monetary policy accommodation once the economy has reached full employment?

Chart 5 provides an answer to this question. It plots the difference between the three-month average of the unemployment rate and the unemployment rate's "cyclical minimum."[5] Over the past 50 years, with one exception, whenever the unemployment rate has risen more than a few tenths of a percentage point, a recession has occurred. The implication is that, if the unemployment rate falls below a level consistent with full employment, it is difficult to reverse course without triggering a recession.

Outlook Is Positive

The economic outlook for the remainder of 2014 is positive, according to both public and private sector forecasts. The Blue Chip consensus and Federal Reserve Board forecasts show that the unemployment rate is expected to continue its decline (*Chart 6*). The Blue Chip consensus projects 3.1 percent annualized output growth over the

Chart 6
Unemployment Rate Projections Show Continued Decline



*Seasonally adjusted.
**Midpoint of central tendency.
SOURCES: Blue Chip consensus; Bureau of Labor Statistics; Congressional Budget Office (CBO); Federal Reserve Board.

second half, and the Blue Chip and Federal Reserve Board forecasts call for 2.9 and 3.1 percent growth, respectively, in 2015.

With expectations of solid economic growth over the coming year or so, labor market slack will likely be further diminished and wage growth and inflation will accordingly continue to edge higher.

—Alan Armen

Notes

1. Federal Reserve Bank of Dallas National Economic Update, May 2014
2. The longer-run averages are calculated by taking the averages of the series from July 1990 to December 2007.
3. The curve is the so-called wage Phillips curve, which expresses that wage growth is expected to rise at an increasing rate as the rate of unemployment falls.
4. "The Federal Reserve, as one writer put it … is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up," from speech by former Federal Reserve Chairman William McChesney Martin Jr., Oct. 19, 1955.
5. The cyclical minimum is the lowest value of the unemployment rate's three-month moving average since its first post-recession decline. For example, from the February 2003 unemployment rate, subtract the lowest value since July 2002.

About the Author

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