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Joseph Lavorgna, Chief US Economist | 212.610.1741 | joseph.lavorgna@smbcnikko-si.com

A Couple of Questions for the Fed

The Fed believes that rising wages cause inflation, or at least that the super core sub-measure of inflation does, given labor's disproportionate impact in providing these services. Since late last year, **the Powell led Fed has become fixated on the core PCE services deflator excluding housing**. "Because wages make up the largest cost in delivering these services, the labor market holds the key to understanding inflation."

To wit, when wages rise, firms need to raise their prices all else being equal. If they do not, then profit margins will deteriorate. This is the theory underlying the Fed's view. But is this really what happens?

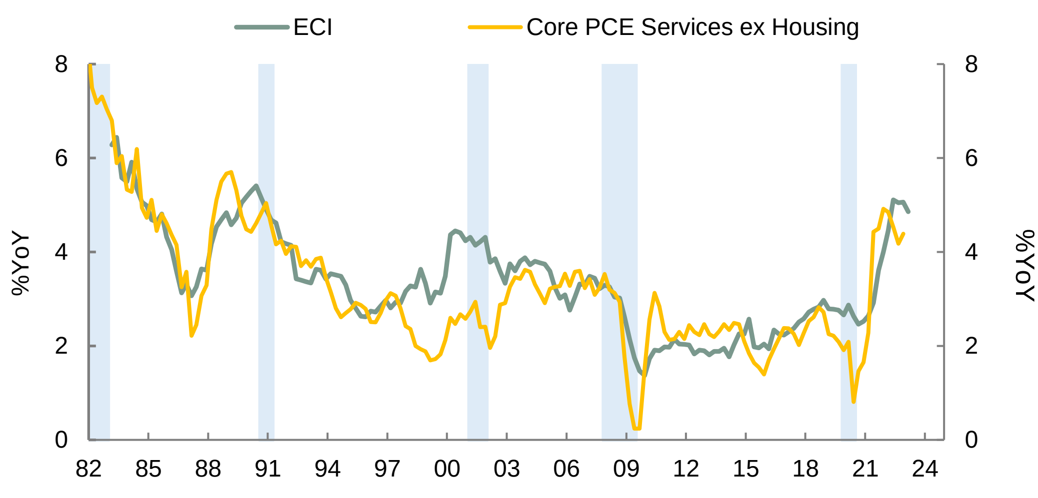
The chart below shows the employment cost index (ECI) which traditionally has been the Fed's favorite measure of labor costs. Unlike average hourly earnings, the ECI is not distorted by compositional shifts in the workforce. Moreover, it captures benefits such as healthcare as well as variable pay such as bonuses and sales commissions which are excluded from the average hourly earnings data. Additionally, the ECI is less noisy than the compensation figures in productivity data. Consequently, **the ECI is the best labor metric we have** and for good reason.

The year-over-year growth in the ECI which starts in 1983 is shown alongside the year-over-year growth in the "super core" metric as it is commonly referred to in financial markets. Visually it is clear that both series tend to move together, rising and falling in unison. Indeed, the correlation coefficient between the two variables is 0.81, which is reasonably high.

But **there is no evidence that changes in the ECI cause changes in the super core**. It is equally likely that rising inflation causes workers to bargain for higher wages to maintain living standards. The highest correlation between the two series is when they are measured contemporaneously meaning there are no lags or leads on either series.

However, if we look at just the last decade or so, **we can see that the super core actually leads the ECI and not the other way round**. Look at the recent peaks. The super core topped out before the ECI in 2010, 2014, 2018 and again in 2021. Bottom line: When inflation falls, wages follow. The Fed has it backward. If so, the Fed's approach is deeply flawed. And because of this, monetary policymakers run the risk of keeping rates too high for too long, risking a much deeper and longer downturn as they wait for wages for fall more noticeably.

This leads us to ask: Why is the Fed giving short shrift to money and credit creation? Why focus solely on the labor market as the determinant of inflation? Maybe someone will ask Chair Powell at next week's press conference.



Sources: BLS, BEA, NBER, Haver SMBC Nikko

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