US Macroeconomics

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Why the Fed Thinks it has to do More

The June employment report is released this Friday, and its results should solidify a 25 basis point rate increase at the July 26th FOMC meeting. This would lift the upper end of the range on the fed funds rate to 5.50%, its highest reading since January 2001.

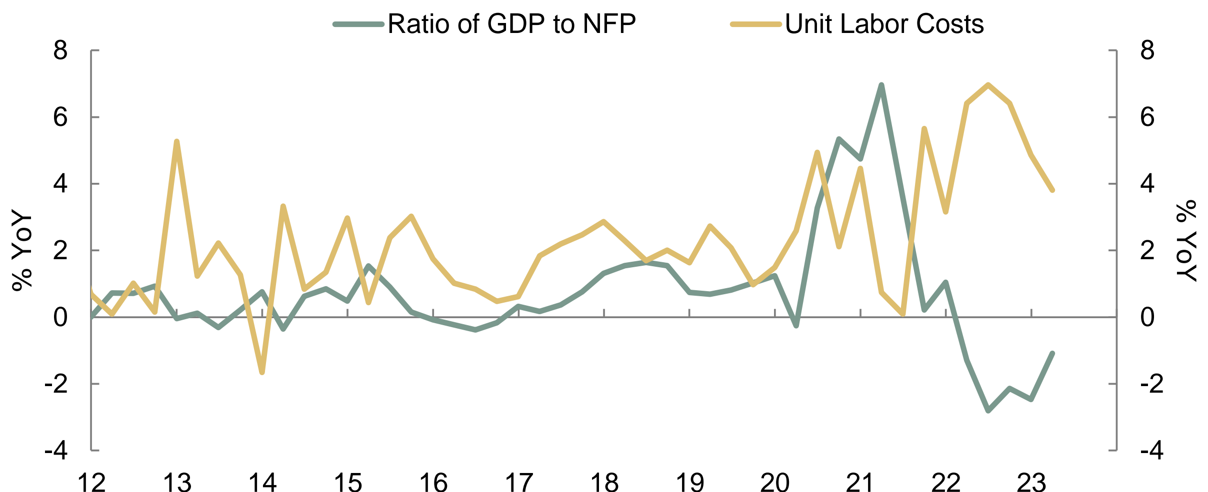
Nonfarm payrolls are expected to come in around 225k, and private jobs are predicted at 200k. While the anticipated gain in June jobs would be the lowest since March (217k), the three-month moving average edges higher to 286k from 283k. Job growth remains too excessive for monetary policymakers.

For example, over the 12 months ending May, headline employment is up 2.7%. And the predicted June increase lowers this rate just a tenth to 2.6%. This remains much faster than underlying real GDP growth, which rose only 1.8% in Q1 2023 from its year earlier level.

Q2 economic output is expected to rise nearly 2% at an annualized rate, which will lift year-over-year output modestly above 2%. But it will still fall short of underlying job growth. This is a major problem for the Fed because **when jobs increase faster than real GDP, implied productivity growth is negative while unit labor cost growth is excessively high**. These trends are illustrated in the chart below.

Over the last four quarters, productivity is down almost 1% while unit labor costs are up nearly 4%. According to the Fed, this is not consistent with long-term price stability. **In the 10 years prior to the onset of the pandemic, when the core PCE deflator grew just 1.6% per annum, unit labor costs grew only 1.4% per annum**. Hence, much more progress needs to be made in lowering unit labor costs and that can happen only one of two ways.

Either productivity growth accelerates from its current depressed reading or job growth rapidly decelerates. However, given the historically tight labor market, it is doubtful output per hour can increase faster than underlying employment. Thus, **the only way to lower unit labor costs is through a rising unemployment rate** because this will push compensation growth lower. However, the consensus of forecasters is looking for the unemployment rate to slip a tenth in June to 3.6% so the Fed has more work to do.



Sources: BLS, Haver, SMBC Nikko

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