The Daily Dish

Inflation Pressures and the Labor Market

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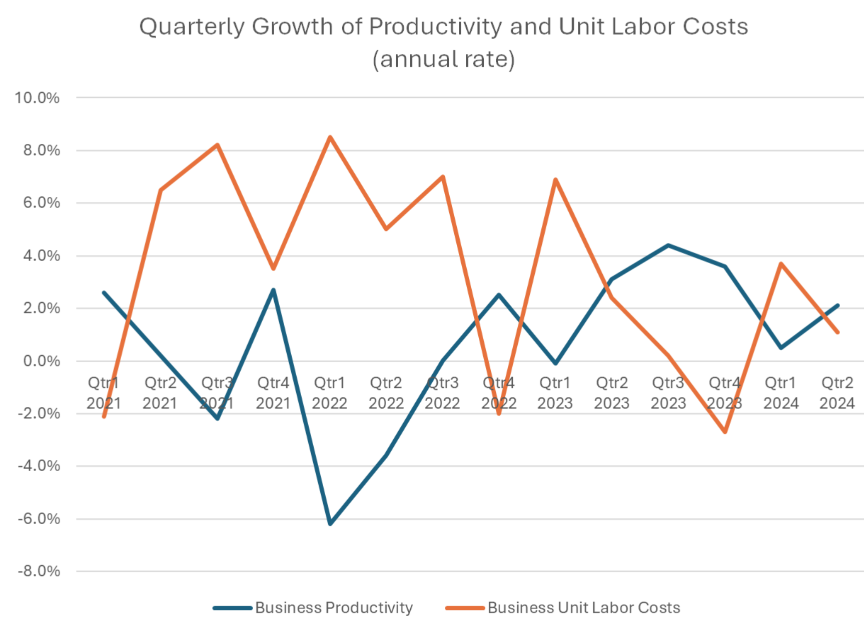
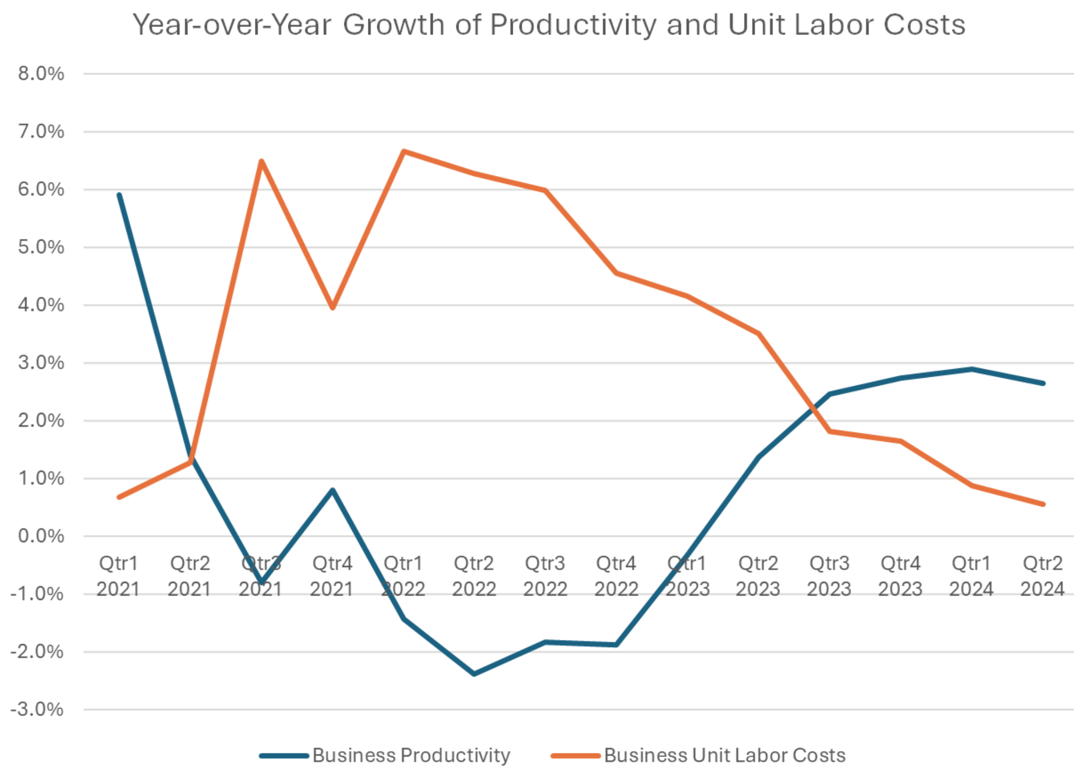
One of the most important developments in the data released this past week was the Bureau of Labor Statistics release showing productivity growth rebounded from 0.4 percent (annual rate) in the first quarter of 2024 to 2.3 percent in the second quarter (blue line in graph below).

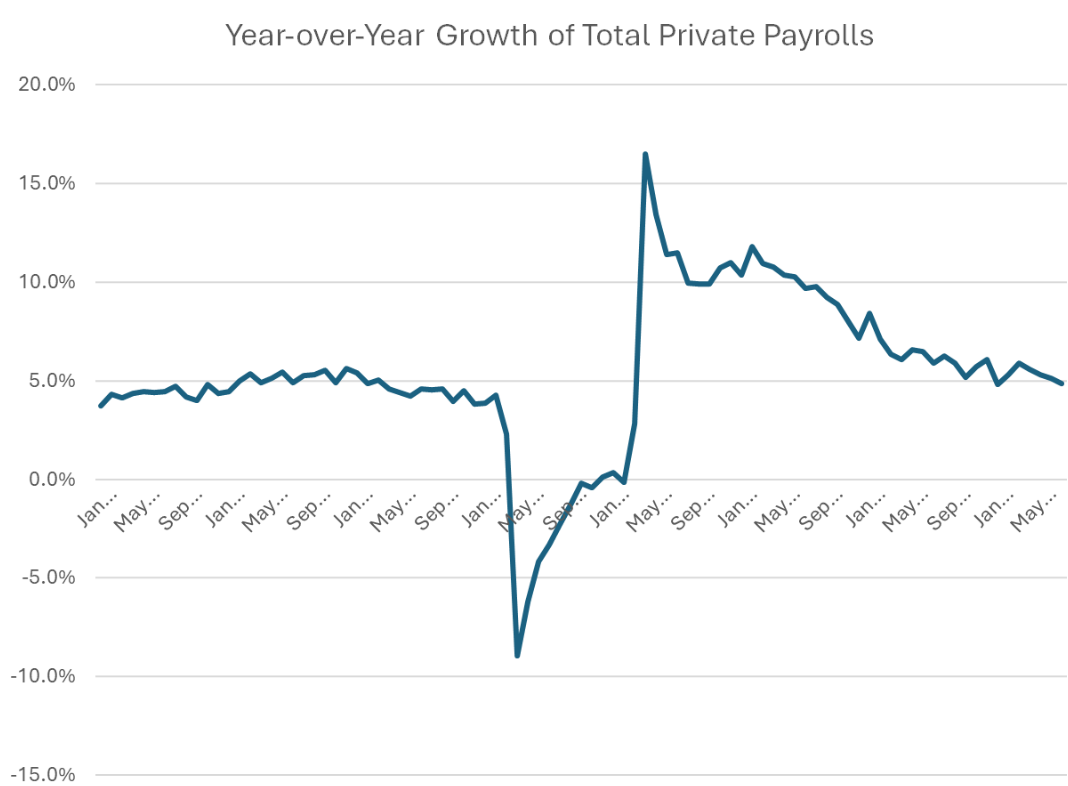
With the rise in productivity, the growth of unit labor costs (orange line) dropped sharply in the second quarter. Looking at the chart, these movements explain a great deal of the Fed's success in achieving lower inflation during 2023. Reduced growth in unit labor costs decreases the need for price increases to cover them, a beneficial dynamic that went away at the start of 2024 but returned between April and June.



The next chart clarifies the trends by looking at year-over-year inflation – effectively smoothing out the noisy quarterly fluctuations. In contrast to the inflation-plagued years of 2021 and 2022, the period since has been characterized by positive productivity growth and much slower growth of unit labor costs. These supply characteristics (along with a helpful surge in immigration) have made the Fed's job a lot easier.



Finally, one can think of aggregate payrolls as a crude measure of the demand for labor – firms' willingness to hire workers, employ them for hours each week, and pay them per hour. The final chart shows year-over-year growth in aggregate payrolls. As the graph indicates, the excessive labor demand of past years has dissipated and growth has returned to roughly the pre-pandemic trend.



With the labor market now cooler, but not frigid, labor demand and supply are now roughly in balance (or close). This suggests that monetary policy should be set to neither stimulate nor restrict employment growth. This is the argument for a Fed rate cut that would move policy to a less restrictive stance.

That, however, views the issue only through the lens of the employment mandate. What about price stability? Put differently, will inflation cooperate and continue to fall to 2 percent and remain there? The argument against a pre-emptive cut rests on one’s view of this issue.

The Fed will get both the August report on consumer prices and the August employment report prior to the September meeting. With one more reading of each part of the dual mandate, the decision will hopefully be clearer.