Worker Compensation Still a Drag On Fed’s Inflation Target

The conventional financial-media headlines said the third-quarter employment cost index, out on Halloween, indicated “Pay Jumped.”

What the headlines did not say (but should have) was, “Employment costs remain a drag on the Federal Reserve’s putative 2% inflation target.”

The employment cost index, a broad measure of workers costs prepared by the Department of Labor that includes pay and benefits, rose 2.8% year-over-year in the third quarter.

Of course, that means productivity gains in excess of 1% annually reduce unit labor costs to *under* 2% annually.

Indeed. A day after the Halloween release, the Department of Labor released its second-quarter unit labor costs report. From a year earlier, unit labor costs are up 1.87%. That is, *below* the Fed’s 2% inflation target.

Moreover, since the third quarter showed a respectable 3.5% GDP growth, it is likely that unit labor costs will remain very subdued. The experience of the 1990s was that solid GDP growth kept unit labor costs in check, as production rose. In part, this is because more output is spread across fixed-labor costs, thus reducing fixed-labor cost per unit. Also, industry has an incentive to invest in new plant and equipment when sales prospects are good, and thus boost productivity.

Worker Pay Increases Cresting?

Another metric of worker pay crested in August of 2017 and has been more or less declining since. The IHS Markit small business monthly survey in October found wages in the US up 2.41% year-over-year, less than the slightly above 3% year-over-year rate increases seen back in 2017. Job hiring is slowing also. The IHS Markit survey also suggests that labor costs, balanced by even modest productivity gains, do not imperil the Fed's 2% inflation target.

Conclusion

It is too soon to put on the Chicken Little costumes. In the US house sales are slumping in the bellwether West; there is slowing wage growth; and sluggish retail sales. If the stock market is a leading indicator, then that is another worrisome clue.

Here is a CNN headline: "Southern California suffers its worst housing slump in over a decade."

Yet the Fed appears to have locked in plans to raise nominal interest rates through next year, and reduce the size of its balance sheet.

Most monetary-policy types constantly speak darkly of the ever-pending risks of runaway inflation. But the shoe has long been on the other foot, as the US and world found out in 2008.

The more prominent risk today is that the Fed, in trying to suffocate prospective inflation, asphyxiates the real economy instead.

Investor beware.