The Economy Gathers Momentum

By Stephen Slifer *Thu, Aug 9, 2018*

'The Fed should maintain the interest rate glide path it has described, which will boost the funds rate to the 3.2% mark by the end of next year and on to 3.4% by mid-2020,' writes our guest columnist.

In the past couple of weeks, we have learned that the economy may be growing more quickly than we had anticipated. That raises the fear that inflation could begin to rise more rapidly which, in turn, could cause the Fed to accelerate its previously - described path towards higher interest rates.

But, thus far, the inflation rate has remained very much in check, which should keep the Fed on a go-slow approach towards higher rates.

Second quarter GDP growth came in at a solid 4.1%. But we should not forget that first quarter growth was relatively anemic at 2.2%. Thus, GDP growth in the first half of the year now stands at 3.1%. In the past year GDP growth has averaged 2.8%. So, while growth appears to be gathering some momentum, the economy does not appear to be in danger of overheating. Consistent GDP growth of 4.0% would be a problem; growth of 3.0% is sustainable.

Some economists are quick to point out that the trade gap narrowed significantly in the second quarter as businesses adjusted the timing of their exports and imports in advance of the implementation of tariffs. As a result, trade boosted GDP growth by 1.2% in the second quarter. It will not do that again in subsequent quarters, so they conclude that second quarter growth was an aberration. Their comments about the trade component’s contribution to GDP growth are accurate.

However, business inventories declined $27.9 billion in the second quarter and subtracted 1.0% from GDP growth in that quarter. That, too, will not be repeated later this year. In the third and fourth quarters rebounding inventory levels should boost GDP growth by as much as they subtracted from GDP growth in the second quarter. We have no hard data yet for the third quarter. However, we will take a stab at third quarter GDP growth of 3.1% and something like that in the fourth quarter. If all of that is correct, GDP growth in 2018 will be

3.1% compared to a 2.5% growth rate last year.

The second piece of robust economic news was the employment report for July. While employment climbed by a modest 157,000 in July, upward revisions to May and June mean that in the past three months payroll employment has risen 224,000 per month. That is steamy. Given a steady died of robust gains in employment and an unemployment rate that is currently 3.9% and falling, shouldn't we worry about escalating wage pressures? Yes. But it does not necessarily follow that upward pressure on wages will translate into a problematical increase in inflation. Here's why.

This past week we also got the employment cost index, which measures the gains in wages, benefits, and total labor costs. Total employment costs rose 2.4% in the second quarter and they have climbed 2.8% in the past year as both wages and benefits are on the rise. The tightness in the labor market is causing upward pressure on labor costs.

However, as we have noted on numerous occasions, we should be looking at labor costs adjusted for the increase in productivity, which economists call "unit labor costs." Why? Because higher labor costs can be offset by increased productivity. If an employer pays its workers 3.0% higher wages because they are 3.0% more productive, he or she really does not care. The firm is getting more output. The worker has earned his fatter paycheck. In that case, unit labor costs, or labor costs adjusted for the increase in productivity are unchanged, and there will be absolutely no reason for that employer to raise prices. So, what is happening to unit labor costs currently?

The productivity report points out that compensation has risen 2.5% in the past year, but recent quarters have been around the 3.2% mark.

If compensation in the past four quarters has risen 2.5% and productivity has climbed by 1.3%, then unit labor costs in that same time have risen 1.2%. Remember, the Fed has a 2.0% inflation target. If labor costs after adjustment for productivity are rising 1.2%, there is no way the current degree of tightness in the labor market will push the inflation rate higher.

For what it is worth, we expect compensation to increase 3.5% in 2018 as the tightness in the labor market pushes wage compensation steadily higher. But we also expect productivity to rise 1.3%. This means that labor costs this year should rise just 2.2%. It does not appear that the tightness in the labor market will cause a problem for inflation any time soon.

If all the above is true, the Fed is not going to be concerned about the combination of faster GDP growth and rising wages. It needs to have some reason to think that the inflation rate is going to pick up substantially. We believe that the “core” personal consumption expenditures deflator will rise 2.2% this year compared to the Fed’s target of 2.0%. The Fed will not regard that as a problem.

Having said that, the Fed should maintain the interest rate glide path it has described, which will boost the funds rate to the 3.2% mark by the end of next year and on to 3.4% by mid-2020.