

# Misinterpreting the Monthly Employment Report

**Author :** James Annable

**Date :** Jun 7, 2019

The Bureau of Labor Statistics released its monthly Employment Situation report this morning. The report is a recurring opportunity for the press to misinterpret what is going on in the U.S. economy. From the on-line edition of *The Wall Street Journal*: “The economy added 75,000 jobs in May, marking the 104th straight month of gains, but pulling back from two months of solid hiring.... The jobless rate held steady at 3.6%, a near 50-year low.... Wages were up 3.1% on the year in May. Annual pay gains appear to be stabilizing in the low 3% range rather than accelerating in a tight labor market.”

## The First Mistake

The first mistake, which almost all early reports made, is attaching way too much significance to month-to-month movements in total employment. In this case, The *WSJ* jumps from the May slowdown to speculating about an almost immediate rate-cut by the Federal Reserve. “U.S. Federal Reserve officials signaled this week they are paying close attention to the risks of a sharper-than-expected economic slowdown. The dimming outlook makes an interest-rate cut possible this summer-if not at their meeting on June 18-19, then possibly later.” The initial caution here is that month-to-month payroll-job changes are notoriously volatile and subject to revisions that can change the message. The Fed smooths out the volatility by focusing on the three-month moving average, which in May is showing a 152,000 gain, certainly not indicative of the need to ease credit conditions.

A lesser known caution about the likelihood or desirability of a near-term rate cut is that U.S. post-baby-boom demographics are consistent with trend, smoothing out cyclical influences, monthly employment growth in the neighborhood of 75,000. Maybe you did not know that, but the Fed does. (As do GEM Blog readers, see the 9/9/2016 post.) The message is that once cyclical influences play out (the low unemployment rate suggests that they have) monthly job gains must slow substantially from their current pace. Given what they know about employment dynamics, how in the world could the Fed at its June meeting contemplate cutting its already low (for a full-employment economy) target interest rate?

## The Second Mistake

Again from today’s *WSJ*: “Low unemployment is creating a competitive landscape for companies, who must fill job openings but face an increasingly scarce supply of workers to choose from. That should translate into higher pay, on average, for Americans. In May, private-sector workers saw average hourly earnings up 3.1% from a year earlier, a solid pace but one that offers few signs of a breakout. By comparison, in May 2018, wages climbed 2.9% annually.”

The press gets this mistake, assuming a robust relationship between unemployment and wage growth, directly from mainstream economists, who are befuddled why low joblessness has not induced a rapid acceleration in nominal wage growth. Followers of the GEM Blog are neither confused nor surprised. They benefit from the insightful generalized exchange model of labor-market behavior. By contrast, the commenting economists rely on the mainstream market-centric general-equilibrium theory that has, in their lifetimes, never been much good at explaining the important labor-related evidence,

The relevant data are, where the first column is the annual growth in nominal wages, the second the civilian unemployment rate, and the third the consumer price index:

2009	1.4%	9.3%	2.7%
2010	2.0%	9.6%	1.5%
2011	2.0%	8.9%	3.0%
2012	1.9%	7.9%	1.7%

2013	2.0%	7.4%	1.5%
2014	2.2%	6.2%	0.8%
2015	2.0%	5.3%	0.7%
2016	2.2%	4.9%	2.1%
2017	2.6%	4.3%	2.1%
2018	2.9%	3.9%	1.9%

The overall picture is steady recovery from the 2007-09 Great Recession but with laggard wage improvement. GEM macroeconomics has little trouble explaining what is going on, while mainstream analysts are at sea.

The relevant differences in the academy's consensus single-venue and the GEM two-venue theories are captured in their respective Phillips wage equations. (For elaboration, see the 3/10/2019 post.) The former is the famous rational-expectations (RE) theory, which confines wage determination wholly to the marketplace:

$$w(t) = a_0 + a_1(U^N - U(t)) + E_t p(t+1) + \varepsilon(t),$$

where  $w$  denotes average nominal wage change,  $U^N$  and  $U$  are the natural and actual rates of unemployment,  $p$  is the price inflation, and  $E$  denotes expectations rationally constructed on the cost-effective use of available information. Decades later, the generalization of rational exchange from the marketplace to information-challenged workplaces enabled the derivation of the GEM Phillips curve:

$$w(t) = b_0 + b_1(U^N - U(t)) + b_2 p_t(t) + b_3(E_t p^M(t+1) - E_{t-1} p^M(t)) + e(t).$$

This equation introduces powerful innovations.  $\ell$  is the price-inflation lag structure ( $t-k$  to  $t$ ) rooted in rational wage catch-up and  $p^M$  denotes the central bank's trend inflation objective. The central difference is the GEM equation's melding of two (marketplace and workplace) venues of rational wage determination. The workplace venue crucially incorporates large-firm bureaucratic labor-pricing and resulting meaningful wage rigidity into the reduced-form model.

The mainstream RE formulation captures a central message of market-centric thinking. When the central bank's price inflation objective is both stable and credible, cyclical nominal wage growth is wholly driven by movement in the jobless rate. There is no other influence available. By contrast the two-venue model introduces the complexity of information-challenged workplaces, which in the single-equation wage model are captured in the careful specification of  $b_i$ . Most important for the purposes of this post,  $b_1$  incorporates that only wage determination in the small-establishment venue (SEV) is influenced by the contemporaneous jobless rate, reducing the influence of cyclical unemployment by roughly half. Cyclical wage determination in the large-establishment venue (LEV) is mostly influenced by lagged price inflation.

What are the implications of the two Phillips wage equations, both of which are motivated by rational behavior in the context of their underlying single- and two-venue models? The mainstream market-centric theory implies relatively rapid wage growth once the economy enters the full-employment zone, which the evidence indicates is a jobless rate below 5%. That the sharp acceleration didn't show up in the economy-wide data is largely the result of half of wages being insensitive to the cyclical movements in unemployment. LEV labor pricing has been following a more stable path, tracking the relatively small overall variations in consumer price inflation. The recent uptick in inflation has combined with low unemployment to indicate the small, but significant, wage-growth improvement that has indeed occurred,

If low unemployment persists, it will gradually close the two-venue wage gap. Reducing labor rents will eventually put upward pressure on LEV wage growth. If we want to consider trend, not cyclical labor pricing, our analysis must recognize a fundamental economic fact that is true in both single- and two-venue models. Trend real wage growth must be rooted in relevant productivity growth.

Blog Type: Policy/Topical Saint Joseph, Michigan