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Economics Group

Special Commentary

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Working Hard or Hardly Working?

Executive Summary

Robust job growth amidst weak GDP growth may not make sense, but it has been the reality the past few years. The mismatch has already changed the way the Fed sees the world in terms of potential growth and the appropriate fed funds rate for the longer term. In this special report, we discuss how this dynamic will remain a key issue for interest rates and monetary policy and we identify what to watch to gain a better understanding of implications for both.

For the sake of context, we take into account the late-cycle dynamics that influence business hiring and investment decisions, as well as the unique factors at play given recent challenges in the industrial sector. The weaker productivity backdrop bears some responsibility for this disconnect. Wage gains are often highlighted as a potential upside of a tight labor market, but without productivity improvement, those gains come with the trade-off of lower corporate profits or higher inflation. The bottom line is that without stronger productivity growth, the apparent disconnect between employment and output growth can persist. Inflation would strengthen sooner under this dynamic, forcing the Fed to raise rates earlier, but ultimately not as high.

The mismatch between GDP and job growth has changed the Fed's view of potential growth and interest rates.

Disconnect: Strong Labor Market and a Weak Economy

The job market is on solid footing, as evidenced by U.S. employers adding another 255,000 employees to their payrolls in July. It was the second straight better-than-expected report for the labor market and it put to rest—at least for now—questions about the sustainability of job growth that arose after a disappointing print in the May jobs report (Figure 1).

Figure 1

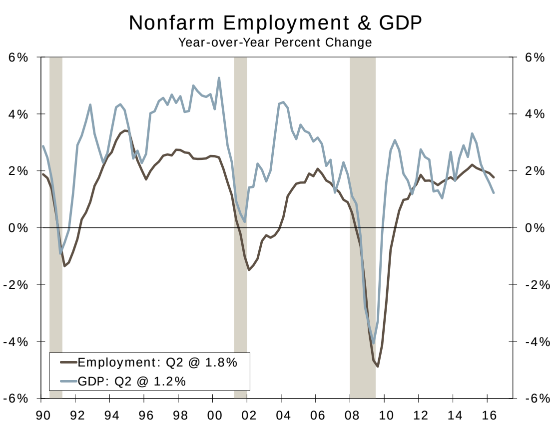
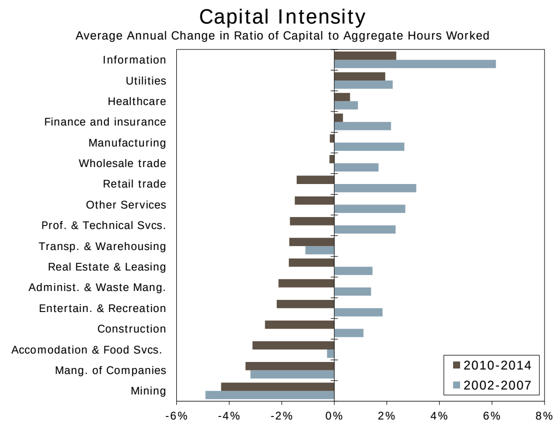


Figure 2



Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities

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That is not to say that those concerns about the staying power of the labor market growth were unwarranted. The U.S. economy grew at annualized rate of only 0.9 percent in the fourth quarter of 2015 and just 0.8 percent in the first quarter of 2016. Yet despite that weakness in growth, the economy added a healthy 239,000 jobs per month on average during that six-month span. More recently, GDP growth was just 1.2 percent in the second quarter even as the last two monthly jobs reports have showed a combined increase of over half a million jobs. What explains this disconnect? Are we working hard or hardly working?

What's Driving the Wedge Between Employment and GDP Growth?

Given the trials of the industrial sector over the past two years, it is reasonable to believe that the divergence between growth and employment may simply be a sector story. The 75 percent drop in oil prices, 20 percent rise in the dollar and the weakest pace of global growth since the financial crisis have all weighed heavily on activity in mining and manufacturing, two of the most capital-intensive industries. Business fixed investment has fallen for three straight quarters—a rarity outside of a recession. Yet, while accounting for roughly 16 percent of capital, these industries account for just 11 percent of employment. Therefore the weakness in manufacturing and mining over the past year has taken a greater toll on growth figures than employment.

That said, the greater reliance on labor is not just a byproduct of recent industry performance. Capital intensity—the amount of capital relative to hours worked—has grown more slowly or declined outright during this expansion for all industries (Figure 2). The weakening trend in capital intensity implied by the latest GDP and employment figures is not atypical for the mid- to late- phase of the business cycle.

Slower productivity growth is driving the hiring/GDP disconnect.

As we wrote in a previous report, the relatively weak pace of capital investment has been one factor behind the ongoing weakness in labor productivity.[1] Labor productivity is defined as output per hour worked, and therefore by definition has weakened as economic growth and employment have diverged. That said, total factor productivity, which reflects how well technology combines capital and labor, has also slowed (Figure 3).[2] As a result, employers are relying more heavily on labor as the economic cycle matures to maintain output growth.

Figure 3

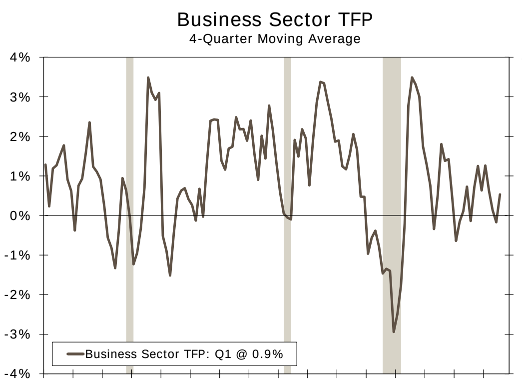
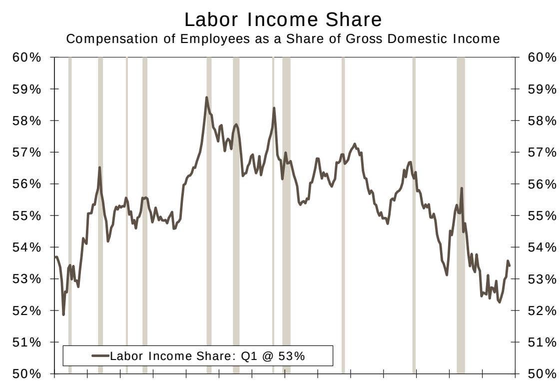


Figure 4



Source: Fernald (2014), U.S. Department of Commerce and Wells Fargo Securities

Measurement issues may also be exacerbating the split between growth and employment. While measuring the number of jobs in the economy is by no means easy, counting people is much easier than counting output. GDP accounting was designed to capture output in an era when goods production was more prevalent. As the economy has become more service-based, GDP has had to account for less tangible products, in addition to making quality and price adjustments.

[1] See "Idled: What Happened to Productivity?" (Jul. 6, 2015), available on request.

[2] Fernald, John G. (2014). "Productivity and Potential Output Before, During and After the Great Recession." Federal Reserve Bank of San Francisco Working Paper Series.

Swings in inventory growth, trade and even weather can make GDP growth volatile from quarter, making employment a better gauge of trend growth in the short run.

The national accounts by themselves, however, indicate labor has performed relatively well over the past two years. After hitting a 64-year low in mid-2014, the share of national income derived from labor has been rising (Figure 4). The gain has come at the expense of corporate profits, while capital consumption has been fairly stable. In many ways this follows the typical cyclical pattern. After laying-off workers in a recession, firms are reluctant to hire. As growth rebounds, firms rely on existing "hoarded" workers to meet demand, helping to boost profits/the share of income derived from capital. As the labor market tightens and wage growth strengthens, as we have seen over the past year, labor's share of income tends to rise until another recession strikes.

Does the Split Even Matter?

The dichotomy between weak GDP and strong jobs has many explanations from falling productivity to factors unique to certain sectors, or simply the fact that it is easier to count jobs than economic output. Regardless of the rationale for how we got here and what is behind it, there are a number of implications of the labor/GDP disconnect. As with most things in economics, there will be winners and losers.

One factor that is likely to be impacted is wage growth. Periods of strong hiring and periods of falling unemployment tend to be associated with faster wage growth (Figure 5). While that relationship has not completely broken down in this cycle, wage gains have been uninspiring. A tighter labor market may lead employers to bid up wages, but without commensurate gains in productivity, real wage growth can only come at the expense of profits. In other words, the only way to achieve sustained real wage gains is through stronger productivity or a shift in the distribution of income (Figure 6).

Without productivity, real wage growth can only come at the expense of profits.

Figure 5

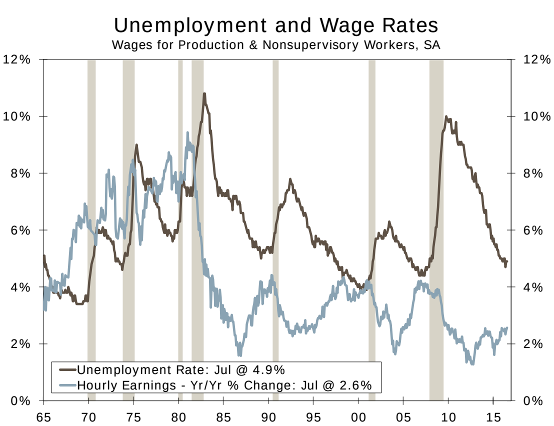
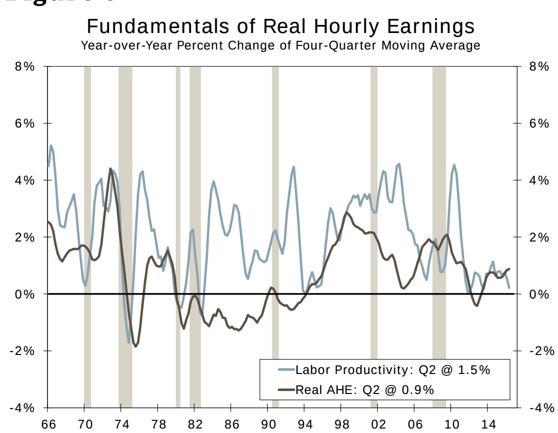


Figure 6



Source: U.S. Department of Labor and Wells Fargo Securities

Given the growing concern about rising income inequality in the United States in recent years, a shift toward wage-earners could be a welcome development. A near-term concern, however, could be the resultant pressure on margins and therefore corporate profits. Corporate profits have fallen over the past year, and the skittish state of markets may mean that further pressure on earnings could negatively impact financial asset values. The hit to household wealth would in turn weigh on consumer spending. In addition, as labor gets more expensive, capital investment may look relatively more attractive to firms, particularly if it would help boost labor productivity.

The real income issues surrounding poor productivity is not going unnoticed by the Fed. In June, Chair Yellen said that "recent weak productivity growth likely helps account for the disappointing pace of wage gains during this economic expansion."[3] The speech at which she made those comments occurred before we learned that productivity fell for a third time in the second quarter. Understanding this productivity question is—according to Yellen—a "crucial part of the economic outlook" as well as a "difficult question, and economists are divided." She went on to espouse her own view that weak productivity gains are the lingering effects of the recession which have diminished business investment and reduced the number of start-up business formations. Other prominent economists on the subject, however, believe the weakness in productivity is more likely to be long lasting.[4]

Fed Implications: Is Okun Broken?

The strong labor/weak output dynamic is a symptom of weaker productivity growth and it has already shaped monetary policy. The Fed has lowered its long-term projections for potential growth by about half a percentage point since 2012 and has reduced its forecast for the long-term fed funds rate by more than a full percentage points over the same time period (Figures 7 & 8).

Figure 7

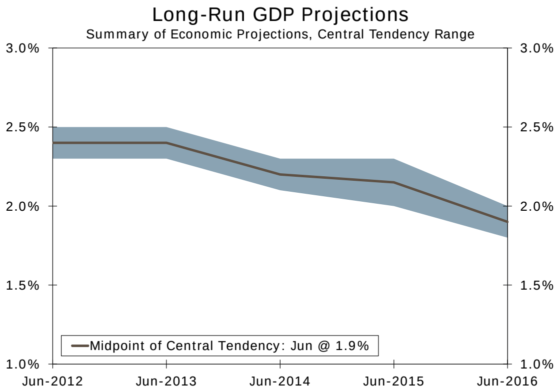
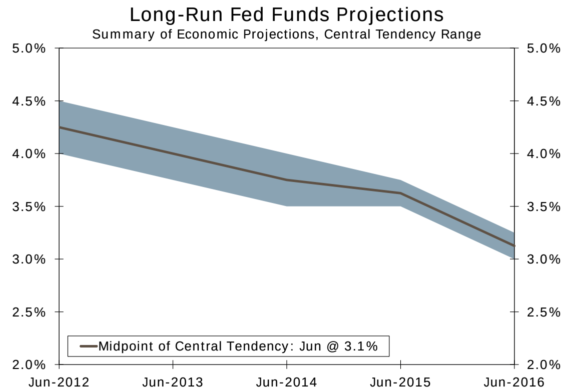


Figure 8



Source: Federal Reserve Board and Wells Fargo Securities

According to former Fed Chair Ben Bernanke, estimates of potential growth have declined primarily for two reasons: weakened productivity growth and the fact that "Fed forecasters have been...too *pessimistic* [his emphasis] about unemployment which has fallen faster than expected."[5] Bernanke goes on to explain Okun's Law, which essentially states that a declining unemployment rate generally occurs when output grows faster than its potential.

Slower potential growth means the Fed should not be overly worried about the split in GDP and job growth.

In other words, the falling unemployment rate amidst weak GDP growth we have seen in this cycle can only be consistent with Okun's law if potential GDP growth has also fallen. So the strong labor/weak GDP disconnect explains the downshift in Fed projections for growth and the fed funds rate over the past four years. This disconnect also implies that because potential growth is lower, a strong labor market and historically slow GDP growth are not so disconnected after all if productivity is also weak. If that is the case, the Fed should not overreact in an attempt to "fix" slower GDP growth by keeping rates too low for too long.

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[3] **Current Conditions and the Outlook for the Economy, Comments by Janet Yellen at the World Affairs Council of Philadelphia, June 6, 2016, http://www.federalreserve.gov/newsevents/speech/yellen20160606a.htm**

[4] **Gordon, Robert. (2012). "Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds" National Bureau of Economic Research Working Paper #18315**

[5] **"The Fed's shifting perspective on the economy and its implications for monetary policy" Ben Bernanke, Brookings, August 8, 2016, https://www.brookings.edu/2016/08/08/the-feds-shifting-perspective-on-the-economy-and-its-implications-for-monetary-policy/**

Conclusion: Living Up to Low Potential

At first glance, the weak rate of GDP growth may seem to be at odds with the sustained gains in hiring. Is employment growth set to slow to better align with GDP growth, or does hiring signal that firms believe recent weakness in GDP growth is only temporary? Rather than one being wrong, both can be right.

Rather than GDP or hiring being wrong, both can be right.

The split between GDP growth and employment growth highlights the economy's ongoing productivity problem. Weaker productivity growth has lowered the potential rate of GDP, meaning slack in the labor market will be absorbed more quickly for a given rate of growth. Strong hiring helps the Fed achieve its employment mandate, while slow GDP growth still helps with its inflation mandate by putting upward pressure on wages and inflation. Wage growth has moved higher over the past year, but inflation has remained tame as higher labor costs have been absorbed by reducing margins. This has led to a shift in the allocation of income toward labor, but without stronger productivity growth, real wage and profit growth will remain weak.

For the Fed, whether employment can continue to grow at such a brisk clip amid sluggish GDP growth will send an important signal about productivity and potential GDP. The Fed will still be driven by its dual mandate (stable inflation and full employment), but the dynamic between hiring and GDP growth will be a key consideration for inflation as well as the equilibrium fed funds rate. If the apparent disconnect between hiring and GDP growth continues, expect the Fed to hike sooner rather than later...but for interest rates to ultimately remain lower than in previous periods.

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