AGRON NICAJ
US Economist

Economic Research Office

anicaj@us.mufg.jp

MUFG Bank, Ltd.
A member of MUFG, a global financial group

Strong jobs growth but weak productivity

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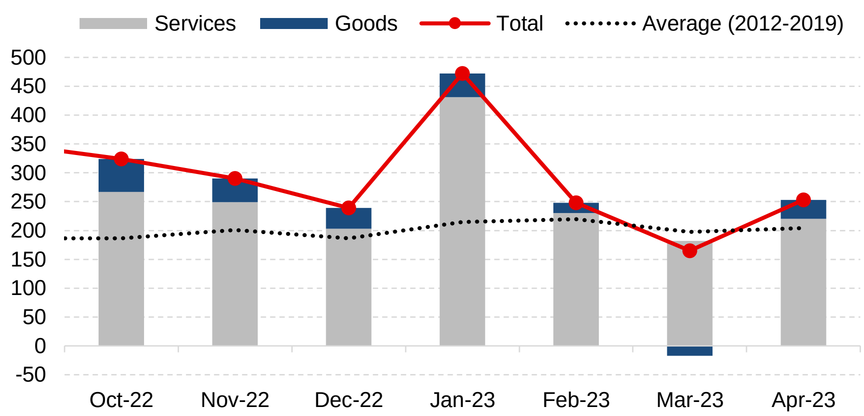
- Once again, the labor market defied expectations. Jobs growth was strong in April with goods industries rebounding, and the unemployment rate continued to hover near historic lows. The labor force participation rate remained steady all while March job openings plummeted.
- Employment growth has become much less dispersed across industries compared to the past 3 years, potentially indicating less mismatch in the labor market. This has likely helped loosen the labor market without increasing the unemployment rate, but the trend may be reversing. Jobs growth has gotten more concentrated in fewer industries over the past 3 months, and if this continues, it's difficult to conceive job openings falling to pre-pandemic levels without a rise in unemployment.
- Annual growth in labor productivity has fallen for 5 straight quarters, and with rising wages, growth in unit labor costs exceeded inflation in Q1 2023. This will add to inflationary pressures for the rest of the year, making the Fed's job of reaching 2% inflation even more difficult.

The second quarter starts off strong

Average jobs growth has indeed slowed compared to 2022 but it remains strong by historical standards. Nonfarm payroll employment expanded by 253,000 jobs in April, up from a downwardly revised 165,000 in March. Services industries grew at a slightly faster pace in April, but the biggest difference came from goods industries which went from losing 17,000 jobs in March to gaining 33,000 jobs in April. Despite this, goods industries are still projecting a more significant slowdown than services industries, having only added 34,000 jobs in total over the past 3 months.

Employment growth in April was strongest in services industries such as professional and business services, healthcare, leisure and hospitality, and financial activities. In goods industries, manufacturing and construction grew little (+11,000 and +15,000 respectively), and mining added a relatively large number of jobs (+7,000).

Jobs growth in goods industries rebounded in April, but the overall trend is showing a significant slowdown
Nonfarm payroll employment change, thousands



Source: BLS, MUFG Bank Economic Research

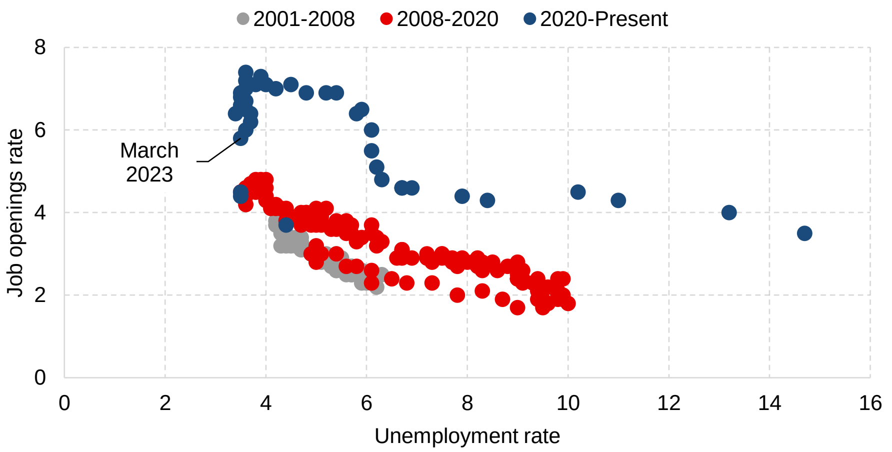
The unemployment rate was little changed in April at 3.4% and the labor force participation rate remained at 62.6%. The participation rate for prime-age workers (25-54) rose to 83.3% and is above the pre-pandemic rate and trend. However, this growth was offset by a decline in the participation rate of older workers (55 and over).

The "immaculate cooling"

As Fed Chairman Powell noted during the media Q&A on May 3, it was inconceivable for job openings to fall without unemployment rising. Though his words may have been a bit of an overstatement, they do capture the general opinion that most economists had in 2022. The large outward shift in the Beveridge Curve post-2020 pointed to a large degree of mismatch between what employers needed and what the labor force could provide. For the curve to shift downward, meaning a drop in job openings and little to no change in unemployment, the labor market would have to become much more efficient at allocating labor. This seemed unlikely due, in part, to the large dispersion of employment that occurred across industries in 2020 and 2021.

The Beveridge Curve is shifting downward, pointing to less mismatch in the labor market

Job openings rate and unemployment rate, %

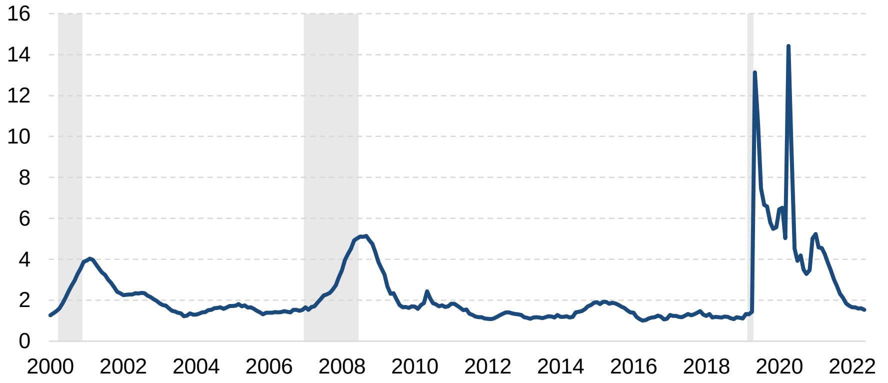


Source: BLS, MUFG Bank Economic Research

However, the Beveridge Curve has shifted downward in 2023 with job openings falling considerably for 3 consecutive months and the unemployment rate remaining essentially flat. Jobs growth has gotten much less dispersed compared to 2020 and 2021, evidenced by the weighted standard deviation of 12-month employment growth across 14 industry sectors. Unfortunately, the rate of decline has slowed since December 2022, and it may begin to increase in the next 6-months.

Jobs growth has gotten less dispersed across industries

industry dispersion of employment growth, %



Note: Calculated as the weighted standard deviation of 12-month employment growth across 14 industries

Source: BLS, MUFG Bank Economic Research

Rising interest rates have had a disproportionate impact on industries, but that hasn't really materialized in the labor market until recently. The disproportionate growth in the labor market is expected to continue given consumption, manufacturing, and construction trends, leading to a less efficient allocation of labor demand and supply. And an inefficient labor market makes an "immaculate cooling" less likely, where job openings continue to fall without unemployment rising.

Rising labor costs and low productivity

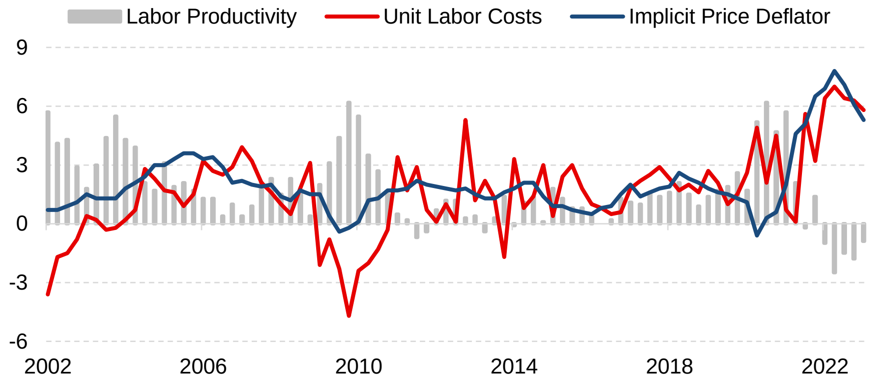
Labor productivity is arguably the most important economic indicator as it drives long-term economic growth. Combined with labor costs, it can be a predictor of inflation. In the last 5 quarters, labor productivity has been weak with negative annual growth while wages have accelerated. This has led to unit labor costs reaching a 40-year high.

Unit labor costs measure the cost of labor per unit of production, rather than per hour. This measure determines how much employer costs are rising while taking productivity growth into account. Rising wages but lagging productivity suggest shrinking employer margins and increased inflation pressures.

Research of inflation cycles show that unit labor cost growth has a median lead of 5 months at peaks, but a median lag of 2 months at troughs. This indicates that unit labor costs can be a leading indicator of inflation peaks but lagging indicator of inflation troughs. Given this and the current trends in wages and productivity, labor costs are unlikely to lead to accelerating price growth, but they can keep inflation elevated at a level above the Fed's 2% target.

Weak productivity growth in Q1 2023 has growth in unit labor costs exceeding inflation

Annual growth, %



Source: BLS, MUFG Bank Economic Research

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