



Paradise Lost

By John H. Makin

“Yet from those flames

No light, but rather darkness visible.”

—John Milton, *Paradise Lost*, Book I, Lines 62–63

It sure was wonderful while it lasted. Last year was a halcyon period of higher growth and lower inflation, when annualized productivity increases of over 5 percent during the last two quarters gave us GDP growth averaging over 6 percent, while inflation and interest rates fell and earnings surged. These conditions were wonderful for the stock market. Fourth-quarter 2003 corporate profits were more than 20 percent above year earlier levels—nearly four times the average rate of increase over the past decade. The S&P rose over 40 percent between April 2003 and January 2004.

Yet, to hear Democratic politicians talk, you might have thought the U.S. economy was in recession. They focused on the lack of job growth, forgetting or not realizing that productivity-driven growth should be savored while it is happening since the laws of economics dictate that it will not last. More capital can only enhance labor productivity for a while.

Stronger employment data and stronger demand growth have emerged as we enter the spring of 2004. The shift from growth driven by supply and by productivity to growth driven by demand may leave markets and policymakers wondering why they were not even more pleased with last year's higher growth–lower inflation combination. They may well be asking by summer, “What is so great about lower growth and higher inflation?”

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The March Payroll Employment report was significant, both statistically and in terms of the outlook for the economy and markets. It strongly suggested that firms have shifted toward hiring more workers as opposed to relying on longer hours and further investment as the low-cost way to increase output. If employment increases remain at about 175,000 per month (the three-month average through March was 171,000), the economy will approach a more normal picture with about 1 percentage point of growth coming from higher employment and 2.5 to 3 percentage points of growth coming from higher productivity.

Add to the pickup in employment growth a surge in U.S. retail sales signaling stronger consumption, and you have a rapid shift from a U.S. supply-driven growth pattern to a more typical demand-driven growth picture. The benign, faster growth with lower inflation during the second half of 2003 has become a slower growth, higher inflation pattern. Higher inflation was the clear message in the March Consumer Price Index (CPI) report. Core CPI inflation (excluding food and surging energy prices) rose 0.4 percent, pushing the first quarter annual inflation rate to almost 3 percent. Coupled with an accelerating boom in China, which is boosting prices of industrial commodities and underscoring the rise in inflation pressure globally, the low growth, higher inflation picture will create problems for markets and policymakers.

The market implications of the shift to lower productivity growth and more “normal” employment growth coupled with higher inflation (as demand growth surges) is likely to be weaker

stocks and a lower dollar, rising interest rates, and a steepening yield curve as the Federal Reserve remains on hold, at least until August, awaiting further information on the path of the economy and confirmation that employment growth has accelerated to a sustained rate of over 150,000 per month. Stocks will be depressed by negative pressure on profits as costs rise for both labor and materials. Higher interest rates will depress stock prices as well. Odds are even that rates will rise by 50 basis points in August; such an increase would probably be telegraphed in Chairman Greenspan's July Humphrey-Hawkins testimony.

More Workers, Weaker Earnings

The statistical significance of the March Payroll Employment Report is clear: 277,000 workers were added to private payrolls against a forecast of a heretofore successful model that had called for 53,000—including 13,000 returning grocery strikers. That is a miss of more than 2.5 standard deviations, which therefore strongly confirms a move to higher employment growth. The quarterly employment gain of 513,000 jobs is consistent with the prediction of standard employment-forecasting models that rely on output growth and past employment growth to predict quarterly employment growth. That model has over-estimated future employment growth for the past year-and-a-half, and a quarter's worth of data back in line with the more traditional employment forecasting model suggests a return to a more typical pattern of employment growth relative to GDP growth.

The rise in March employment in the firm survey suggests a change in behavior by producers as momentum of demand growth picks up, as indicated by strong first quarter retail sales reported on April 13. Firms probably have reached a stage in the business cycle where it is cheaper to add lower-cost labor to raise output than it is to push further on overtime employment by more productive workers or to continue to add to the capital stock. The increase in the marginal product of labor that results from a steadily rising capital-labor ratio diminishes over time, and we have probably reached the point where further output gains can be achieved at lower costs by a

shift to hiring more workers. That said, weekly hours and hourly earnings actually fell during March so that weekly earnings dropped by 0.2 percent. That left weekly earnings rising at a 1.5 percent year-over-year rate—down from 1.9 percent a month ago. These figures underscore the notion that firms found it less expensive to sustain production by hiring lower-priced, perhaps long-unemployed labor than with extended overtime by more skilled workers. Labor-saving technological change does have its limits.

The notion that the shift to more hiring was a firm-driven decision is underscored by the weakness in the household survey. Household nonagricultural employment fell by 44,000 in March, while full-time employment fell by 86,000 and the ranks of part-time workers (people who want to full-time work but can only find part-time) rose by 294,000. The unemployed count rose by 182,000 because of a sharp rise in the number of permanent job losers. These figures underscore the probable shift of firms to the rehiring of less productive workers laid-off over the past several years.

This shift to employment of less productive workers will depress productivity growth and raise unit-labor costs. The implication for profits going forward and therefore, other things equal, for stock

prices, is negative.

The initial impact of higher employment growth has been to raise longer-term interest rates, thereby steepening the yield curve as the Fed awaits confirmation that higher employment growth will be sustained. That said, going forward, markets will be more sensitive to any deterioration of the core inflation outlook. In fact, the move toward growth driven by more workers, as opposed to the manna from heaven implicit in higher productivity growth, is a slightly stagflationary event. Such a move steepens the yield curve and leaves the Fed in an uncomfortable position if inflation picks up while growth actually moderates, as it probably will in the second half of the year.

Clouds in the Second-Half Outlook

A second-half demand-growth slowdown is likely to arise from a withdrawal of fiscal stimulus after May, a rising "tax" from higher oil prices, and the drag from

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higher interest rates. Higher energy prices have already amounted to a tax on consumers of between \$15 and \$25 billion, largely if not entirely offsetting the expected boost from higher tax refunds during the first half. Higher interest rates and a reduction in debt refinancings, coupled with higher energy prices, will constrain growth of real disposable income for households by late in the second quarter and add to the loss of momentum for growth going into the second half of this year.

Higher employment growth—to repeat, averaging about 175,000 per month—may add to wage and salary income, provided that the reduction in hours and hourly earnings that emerged from the March report is reversed. Given that firms will be attempting to maintain profit margins in the face of rising raw materials prices and falling productivity gains, the increase in wage and salary income cannot be taken as a given.

The modestly stagflationary outlook for the U.S. economy, coupled with less spending on investment as firms shift to use more labor to increase output as opposed to using more overtime and capital, will weaken the dollar. The consumption-driven U.S. economy will boost the current-account deficit while reducing the incentive for foreign investors to place funds in the United States—especially in view of the continuing boom in Asia. That boom, driven by China's runaway economy, is being reflected in Japan's more liquid financial markets through rising stocks and interest rates there. Dollar weakness will probably be more pronounced against the yen than against the euro, which may even weaken, given Europe's worsening growth prospects. Japan's newfound tolerance for a stronger yen may also be tied to an attempt to temper rising interest rates and a steepening yield curve at home. But reduction in purchases of U.S. Treasury securities by foreign central banks in Asia may accentuate the premium on longer-term yields in the United States and dollar weakness against the yen and other Asian currencies.

China Booms

A steepening yield curve for the United States, lower stock prices, and a weaker dollar could all be exacerbated by continued increases in commodity prices. The

Chinese economy is growing rapidly—to the point of overheating—but it appears unlikely that China's central government can or will reign in the rapid growth. Provincial governments and the private sector are just too hard to control, and China's leadership, while competent, is probably not politically strong enough to risk a sharp slowdown that would accompany heavy-handed application of administrative controls on lending, China's usual method for slowing the economy. Meanwhile, China's dollar peg produces a steadily falling renminbi against other Asian currencies, as the dollar weakens, thereby further stimulating Chinese overheating. China's rapid growth will continue to boost commodity prices. Energy prices will continue to rise—driven by rising energy consumption in China and OPEC's use of the pricing leverage that that creates. The weaker dollar will underscore OPEC's desire to boost dollar prices of oil, thereby further raising the energy tax on American households.

Now the Hard Part for the Fed

Viewed broadly, the change in hiring behavior indicated by the strong March Payroll Employment Report, together with stronger spending, is probably good news for marginal workers who have been seeking jobs. It is also good news for President George W. Bush, and this, in turn, may provide some support for the stock market to offset the fundamental negatives arising from a tendency toward stagflation in the U.S. economy as we move into the second half of the year. That said, markets have never really priced the possibility of a Bush loss, so the positive impact from an increased chance for a Bush election victory in November may be limited.

We probably now have reached the long-awaited rise in employment, just before the stimulus from tax cuts and refinancings is wearing off. Just as the period of growth driven by higher productivity resulted in lower interest rates and higher stock prices, while a weaker dollar helped to sustain U.S. export growth, the move to a more typical late-cycle expansion accompanied by more employment, lower productivity growth, higher inflation, and downward pressure on profits may see lower stock prices and higher interest rates. Add to this the likelihood that stronger Chinese growth

will make Asia more tolerant of a weaker dollar and less inclined to purchase dollars and U.S. Treasuries, and we may find that the best part of the economic recovery that began three years ago in the spring of 2001 is behind us, as interest rates rise while the dollar and equity prices fall. The resulting whiff of stagflation may force the Fed to raise U.S. interest rates while

growth is slowing, inflation is rising, and stock prices are falling.

In short, we may be nearing the end of a benign, unusual period of faster growth and lower inflation and moving into a period of slower growth and higher inflation. It will take a little time to adjust—both for markets and policymakers.