Current Economic Conditions

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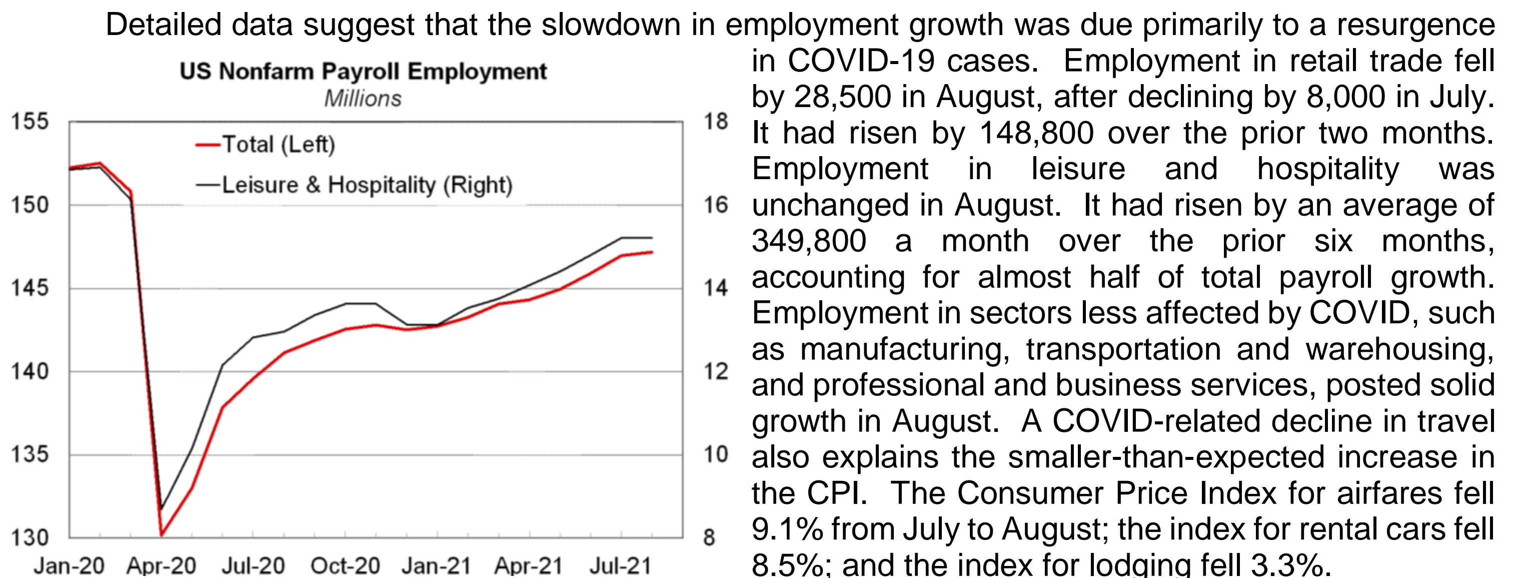
AUGUST SLOWDOWN IN EMPLOYMENT AND INFLATION LIKELY TRANSITORY

Smaller-than-expected increases in payroll employment and the Consumer Price Index suggest that growth and inflation slowed sharply in August, but other data suggest that the respective slowdowns are temporary, i.e., “transitory.” Payroll employment rose by just 235,000, down from an average of more than one million per month over the prior two months. The Consumer Price Index rose 0.3% in August. That was the smallest increase since January (but still 3.3% at an annualized rate). The “core” CPI, which excludes food and energy prices, rose just 0.1% in August, the smallest increase since February.

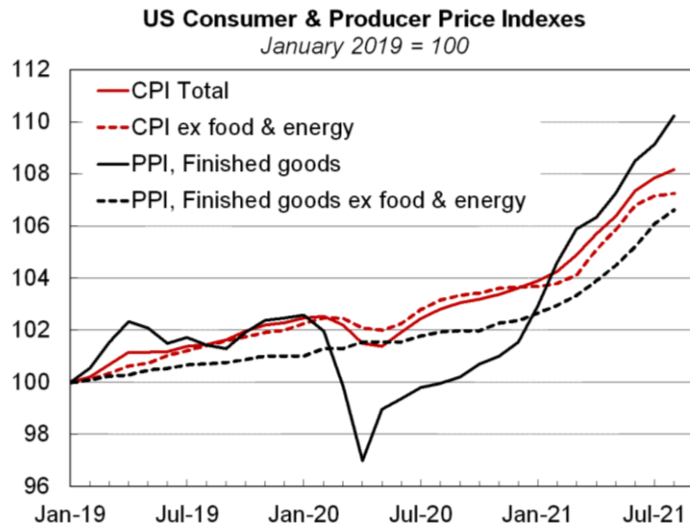
Industrial production in U.S. manufacturing rose just 0.2% in August, but the Federal Reserve estimated that if would have risen 0.4% if not for shutdowns of chemical and plastics plants and oil refineries caused by Hurricane Ida. Retail sales surged a stronger-than-expected 0.7% in August, despite a big decline in motor vehicle sales. Excluding motor vehicle dealers and gas stations, retail sales rose 2.0%. However, the August increase in retail sales was just a partial recovery from July’s big (downwardly revised) decline. To the extent the slowdown in employment growth in August was a lagged response to the decline in retail sales in July, we should expect a rebound in employment growth in September.

Detailed data suggest that the slowdown in employment growth was due primarily to a resurgence in COVID-19 cases. Employment in retail trade fell by 28,500 in August, after declining by 8,000 in July. It had risen by 148,800 over the prior two months. Employment in leisure and hospitality was unchanged in August. It had risen by an average of 349,800 a month over the prior six months, accounting for almost half of total payroll growth. Employment in sectors less affected by COVID, such as manufacturing, transportation and warehousing, and professional and business services, posted solid growth in August. A COVID-related decline in travel also explains the smaller-than-expected increase in the CPI. The Consumer Price Index for airfares fell 9.1% from July to August; the index for rental cars fell 8.5%; and the index for lodging fell 3.3%.



The August weakness in employment growth is unlikely to persist. The seven-day moving average of new COVID-19 cases in the United States peaked on September 2. It rose briefly after Labor Day but is declining again and is likely to trend down going forward as more people acquire immunity/resistance through vaccinations or infections. As people resume traveling, employment in leisure and hospitality is likely to grow again. Employment is also likely to increase in response to the nationwide expiration of enhanced unemployment insurance benefits on September 5. Some studies purport to show that early expiration of UI benefits in 26 states did not result in large increases in employment, but econometric problems with the analyses and the short time period analyzed make me skeptical of the results and more optimistic that employment will rise significantly in September and/or October.

Similarly, the smaller-than-expected increase in the CPI in August was more likely a one-off aberration than a persistent downshift in inflation. Airfares, hotel room rates, and rental car prices are likely to go back up if people resume travel as COVID cases decline. Prices of used cars and trucks, which had accounted for a significant share of the increase in the CPI this year, fell 1.5% in August. That might have signaled the beginning of a meaningful decline from unsustainable ("bubble") levels, but Hurricane Ida destroyed about 300,000 vehicles. That will boost demand for already-scarce vehicles, putting renewed upward pressure on vehicle prices. The disparity between the CPI and other measures of prices also makes the August CPI print look like an aberration. The headline Producer Price Index for final demand rose 0.7% in August, just slightly below the average monthly increase of 0.9% over the prior seven months. The PPI for finished goods, an older series that I prefer, rose 1.0%, exactly equal to the average monthly increase over the prior seven months. Commodity prices, particularly for aluminum, coal, lithium, and natural gas have surged to multi-year highs. Unless commodity prices and producer prices more generally come back down, retailers will either have to raise prices to consumers or suffer a decline in profit margins.



Demand is likely to remain strong enough to allow businesses to pass their cost increases on to their customers. The personal saving rate has averaged 16.5% since March 2020 and was still at an elevated 9.6% in July. Over the previous business cycle (2008-2020), it averaged 6.9%. Households have saved much of the "stimulus" they've received during the pandemic or used it to pay down debt, which, macroeconomically, is equivalent to saving. Unless households decide to permanently maintain higher savings or lower debt than in the past – which would not be a bad thing – the accumulation of "surplus" saving means that consumer spending has much further to rise over coming quarters. Growth in wages and salaries is also likely to boost consumer spending. Wages are rising, as you would expect when job openings – at a record 10.9 million at the end of July – exceed the number of people looking for work. But so far, prices have risen even more. That can't persist. Tight labor markets should lead to rising **real** (inflation-adjusted) wages. I suspect that future data on wages (or revisions to past data) will show bigger wage increases than we've seen so far. That's good for continued strong growth, but risks propagating the kind of wage-price spiral that would be very difficult to stop without a recession.

So far, September looks better than August, at least in terms of employment and manufacturing output. New claims for unemployment insurance hit a post-recession low of 310,000 in the week ending September 4. Manufacturing indexes produced by the Federal Reserve Banks of New York and Philadelphia surged in September. Those indexes and the rebound in production of chemicals, plastics, and petroleum products after Hurricane Ida auger well for industrial production in September.

With COVID cases peaking, households sitting on mountains of "surplus" savings, and wage-and-salary income likely to rise strongly, growth is likely to reaccelerate after the August slowdown. What could go wrong? First, if the current COVID wave is serious and persistent enough to cause widespread school closures, labor shortages will worsen and economic activity will be curtailed. Second, the persistent global shortage of semiconductors is limiting production of computers, appliances, and motor vehicles. Light vehicle sales fell to a 13.1 million seasonally adjusted annual rate in August, down from an 18.3 million rate in April. Finally, COVID waves in the rest of world could limit demand for U.S. exports and supply of needed materials and components. Despite the risks, I expect U.S. demand for goods and services to remain strong. To the extent supply can meet the demand, that means strong growth. To the extent it can't meet the demand, it means high inflation. Despite the soft August data, I expect more of both.

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