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Abstract: Reports on data released regarding employment in the United States for the month of April 2005. Review of the jobs report, which states that the U.S. economy generated approximately 274,000 jobs in April; Author's view that increased employment and upward revisions to February and March payroll data bolster the idea that fears about the weakening of economic expansion are unfounded.

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A Job Market This Strong Comes with Strings

Productivity growth is slowing, and inflation fears may not be misplaced

The April employment report took the "stag" out of stagflation worries. News that the economy had generated a larger-than-expected 274,000 new jobs last month, along with upward revisions to the February and March payroll data, bolster the idea that fears about the expansion weakening are unfounded.

More important, the jobs report galvanized some crucial points about the outlook. The recent jump in energy costs has not caused businesses to shelve their expansion plans. Consumers should have the income growth to support future increases in spending. And with the expansion on firm ground, the Federal Reserve will continue to lift short-term interest rates, instead of pausing in the summer to see how its past eight hikes have affected the economy.

Other recent reports also trumpeted positive news about the economy. So far this year, more banks are seeing stronger demand for business loans. And in March the trade deficit narrowed by a surprisingly large $5.6 billion, to $55 billion, as imports lurched downward after jumping sharply in January and February. The smaller gap suggests an upward revision to the first quarter 3.1% growth in real gross domestic product. If there was any yellow flag in the jobs numbers, it came in the manufacturing sector, where payrolls have been flat for a year and output is slowing.

But what about the other half of those stagflation worries, inflation? Attention was focused on the nickel rise in hourly wages in April from March. But that increase was exaggerated by unusually large gains in two sectors. What is more critical for the inflation outlook is unit labor costs. Although productivity growth is slowing, a trend typical for this stage of an expansion, businesses will still need to keep efficiency gains strong enough to partially offset future increases in compensation. How much inflation ultimately picks up depends, to a great extent, on how successful companies will be in holding down their costs or in passing their higher costs along to customers via price increases.

THE JOB NUMBERS argue the economy is much stronger than earlier weak March reports had suggested. Given that the revisions to February and March payrolls totaled 93,000, the monthly pace so far this year is now a healthy 211,000. Plus, the percentage of the adult population in the labor force edged up from 65.8% to 66%, a sign that Americans are rejoining the workforce because they think more jobs are available.

Construction payrolls bounced back by a strong 47,000 in April. That suggests that the 17.6% plunge in housing starts in March was a weather-related fluke and that starts rebounded last month. Other sectors that hired big in April included retailing, health care, and food services, indicating consumer demand regained ground after an oil-related respite in March.

Manufacturing, though, shed another 6,000 jobs in April. Last May factory jobs were up for three months in a row, raising hopes of a sustainable sector recovery. But factory jobs have fallen in 9 of the past 11 months, and last quarter output grew at its lowest pace in nearly two years. Interestingly, the Labor Dept.'s data show that jobs in its category for health care and social services now outnumber manufacturing payrolls, 14.4 million vs. 14.3 million. As recently as 1999, factory jobs outnumbered health and social service slots by 5 million.

NOT ONLY DID PAYROLLS increase in April, but so did many paychecks. The average hourly wage for production and nonsupervisory workers rose 0.3%. Pay gains of more than 1% were recorded in natural resources and mining and information industries. The natural-resource raise very likely reflects the demand for workers to search and pump more oil. Information pay popped up as hiring in that field turned positive after four years of layoffs.

Over the past year total hourly pay is up 2.7%. While that's better than the 2.2% yearly increase of April, 2004, the rate is less than the rise in total consumer prices, thanks to the jump in energy prices. But given the advance in jobs and a 12-minute extension in the workweek, total personal income probably increased by a healthy amount in April. That gain will support consumer spending in the second quarter.

For now, the labor markets remain too loose for any huge upward push on wages. Remember that back in the late 1990s, the jobless rate fell below 4.5% before yearly pay raises approached 3.5% or more and wage-related cost pressures became a concern. Indeed, today's labor-related inflation pressures are not being driven so much by tighter job markets or faster rising wages as they are by the easing in productivity growth and the resulting acceleration in unit labor costs.

Among private nonfarm businesses, wages, salaries, and benefits have not sped up in the past year. But productivity growth has slowed from a 5.5% yearly pace in early 2004 to 2.5% in early 2005, putting upward pressure on the cost of producing each unit of output. In the first quarter nonfarm unit labor costs rose 2.5% from the previous year, the fastest advance in four years. So far, at least, prices have kept pace, also accelerating to a 2.5% pace, from 0.8% this time last year.

Clearly by historical standards, productivity growth of 2.5% a year is a healthy pace. But the inflation danger is that efficiency gains slow even further in the coming year, while a strong economy continues to tighten job markets, adding upward pressure on compensation.

PRODUCTIVITY, MEASURED AS output per hour worked, may in fact be slowing sharply in this quarter. The April employment report shows that hours worked surged 0.9% from March, the largest monthly increase in eight years. Even if hours don't rise in May and June, which is unlikely, they would still advance at a 4.3% annual rate for the quarter. So if the economy also expands at a 4.3% pace, productivity growth would be zero, and all of the second-quarter increases in compensation would feed directly into unit labor costs.

Another reason the productivity slowdown is worrisome for the inflation outlook is because the last time the labor markets were tightening, in the late 1990s, strong productivity and intense global competition helped curb inflation. This time, productivity growth and the dollar are moving in opposite directions, offering less restraint on U.S. pricing trends.

The area most vulnerable to price pressure is the huge service sector, where demand is strong and global competition is less intense compared with manufacturing. Given that unit labor costs in manufacturing were up only 1.4% in the past year, it would appear that unit costs in the service sector are rising even faster than the 2.5% pace for all nonfarm industries.

In coming months, expect the Fed to keep tightly focused on the labor markets. The sharp rise in April payrolls puts jobs back on a pace, if maintained, to send the unemployment rate below 5% by the end of 2005. If so, wage pressure will intensify, and inflation concerns will remain uppermost in the minds of both policymakers and investors.

GRAPH: THE FUEL FOR MORE SPENDING: AVERAGE WEEKLY PAY (PRIVATE NONFARM PAYROLLS)

GRAPH: WILL PRICES KEEP FOLLOWING COSTS UP?: UNIT LABOR COSTS/PRICES

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