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There is still a demand problem in the US

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For evidence of excess demand in the US economy, look no further than the labor market. Employment growth was strong again in December while the unemployment rate fell back down to 3.5 percent and job openings held steady. Labor shortages continue to plague the labor market, and shrinking demand is the only solution that doesn't risk keeping price growth elevated.

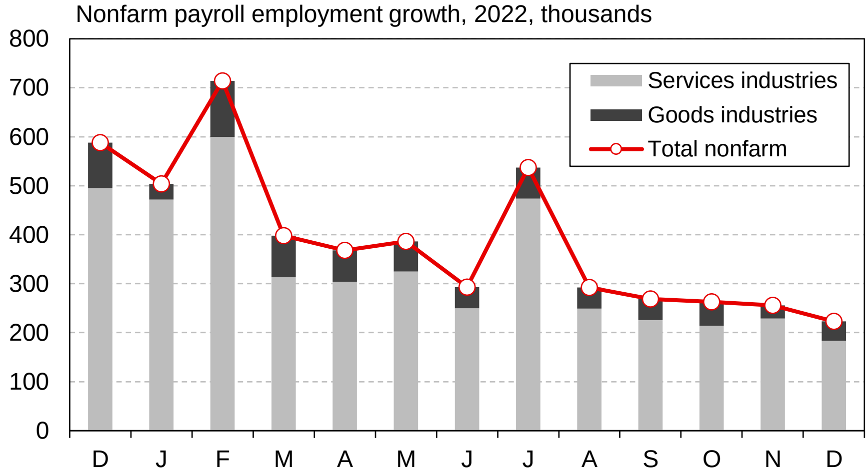
Employment growth is strong in key services industries

The US added 223,000 jobs in December, slightly below the average of the prior three months (+263,000). While seemingly good news, the growth came in above expectations and the difference from prior months is well within the range for monthly revisions. The labor market is still expanding at a historically strong rate.

The health care industry continues to grow, adding 55,000 jobs in December. Though employment in health care has exceeded its pre-pandemic level, demand in the industry outweighs the supply of labor, making labor shortages especially prominent and wage growth strong. Average hourly earnings for hospital workers grew at an average of 7.3 percent YOY from January to November 2022, compared to an average of 5.2 percent for all industries. Wage growth is expected to feed into health care inflation in early 2023.

Health care is particularly problematic for the Fed because consumption in the industry is relatively immune to economic conditions. The impact of rising interest rates will likely not pass through to health care to the extent that it will in other industries. Given the significant weight that consumption in health care has on the PCE Price Index (the Fed's preferred measure of inflation), the Fed's "war" on inflation must be decisively won in other industries to ensure aggregate inflation reaches 2 percent.

EMPLOYMENT CONTINUES TO EXPAND AT A STEADY RATE



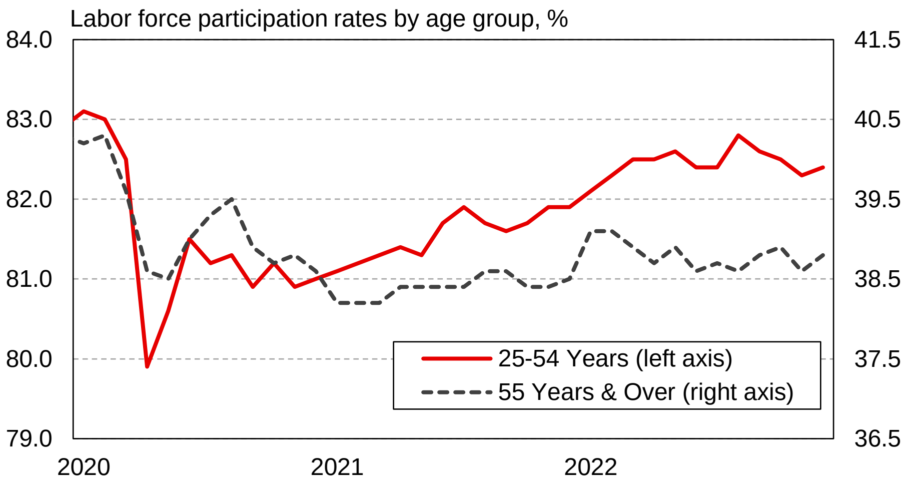
Source: BLS, MUFG Bank Economic Research

Notable job gains also occurred in leisure and hospitality (+67,000) where employment is still down 5.5 percent from February 2020. The construction industry added 28,000 jobs despite rising interest rates. Construction of single-family homes has been significantly impacted but building of multi-family units remains relatively strong as demand for apartments stays elevated.

Increasing labor supply is not the answer

There continues to be a significant mismatch between the supply and demand for labor. The labor force participation rate increased slightly for both prime-age (25-54) and older (55 and older) workers, but there have not been significant gains compared to the early months of 2022. While this does not bode well for labor shortages, increasing the labor supply is not necessarily ideal in this inflationary environment.

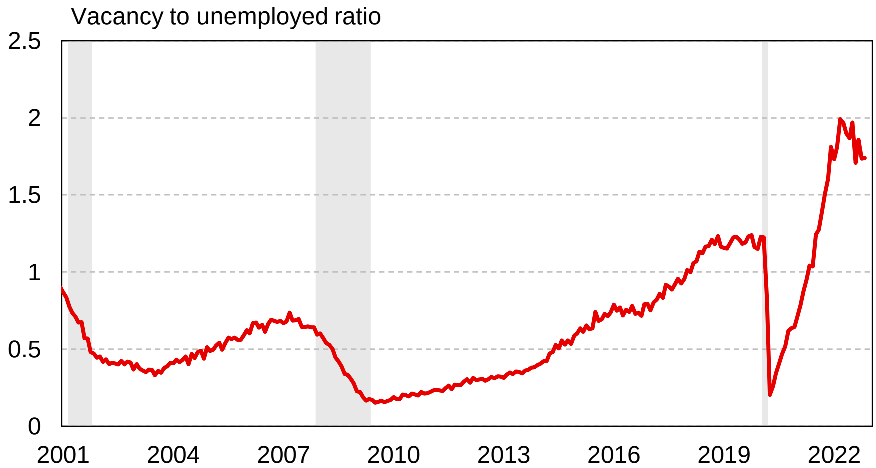
PROGRESS HAS MOSTLY STALLED FOR LABOR FORCE PARTICIPATION



Source: BLS, MUFG Bank Economic Research

Battling labor shortages without increasing inflationary pressures would mean focusing on labor demand. Job openings remain excessively high as of November (10.5 million), and there are 1.7 vacancies for every unemployed persons. While vacancies are down 1.4 million from their peak in March 2022, they are still up 2.6 million from their pre-pandemic level (February 2020). If labor supply were to approach these near historic levels of labor demand, aggregate income would rise and overall spending would increase, driving demand side inflation.

JOB OPENINGS CONTINUE TO EXCEED JOB SEEKERS



Source: BLS, MUFG Bank Economic Research

Over the past year, the civilian labor force has been slowly rising and the number of unemployed persons has been slowly falling, keeping the unemployment rate between 3.5 and 3.7 percent. And though other factors are at play, the relationship between unemployment and prices has not disappeared despite what the years following the Great Recession may suggest. Intuitively, it makes sense that as more people are working, more money is circulating in the economy and being spent. Increasing the labor supply would maintain a low unemployment rate and exacerbate excess demand in the economy.

The current state of the labor market is a precarious one. Labor shortages are still severe in some industries which is applying significant upward wage pressures, especially in services industries. And given the "sticky" nature of service prices, there is likely to be a lag from when rising wages feed into inflation. On one hand, increasing the labor supply would surely decrease wage pressures and therefore inflation pressures. But on the other hand, it would likely increase spending in the economy and apply upward demand pressure on inflation.

Ultimately, labor supply is unlikely to significantly rise in the coming months unless immigration reform occurs. We can, however, expect modest increases in the labor force as recession fears intensify in the general population. Labor demand remains as the major hurdle and this latest jobs report suggests that the Fed has more to do to cool the labor market.

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