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Labor Market Reports
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Employ America Research Report

The Floor GLI Framework in Today's Context

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Executive Summary

Since its inception, Employ America has maintained an in-house monetary policy model based around a floor for gross labor income growth. During the pandemic, this framework has not been substantially different from many others, given the extreme nature of the recession and recovery. However, now that we have exited the most acute phase of the economic crisis, our framework offers a different view of the tradeoffs available to policymakers. While our framework's criteria for the Fed to begin considering slowing the economy have nearly been met, the Fed seems poised to tighten more and faster than our framework would recommend.

In May 2019, Employ America first presented "Floor GLI," its in-house framework for how the Fed should conduct monetary policy. The goal of this framework was to provide a systematic response to the Fed's most consistent and costly error relative to its legislative mandate - insufficient employment and wages - within a single measure of gross labor income (GLI). While we applauded the welcome revisions to how the Fed would assess maximum employment as well as its ambitious forward guidance a month later, these revisions were made within an inflation-centric framework with the clunky title "Flexible Average Inflation Targeting" (FAIT).

Poor communication has dogged the Fed's implementation of FAIT, but these communication problems have only worsened a core underlying flaw of inflation-based monetary policy. At the end of the day, Fed policy has a more direct impact on nominal income growth dynamics than price inflation dynamics. Where nominal income growth tends to track the business cycle, price inflation stems from a wider array of causes, including some highly acyclical dynamics.

Here, we provide an update on what our in-house monetary policy framework suggests about the appropriate trajectory for monetary policy using more reliable "real-time" measures of gross labor income. Given the scale of the jobs and income gap since the onset of the pandemic, the policy guidance provided by our in-house framework has been broadly similar to other monetary policy frameworks and the Fed's forward guidance. Against a backdrop of elevated inflation and a recovering labor market, prescriptions among frameworks have begun to meaningfully diverge. We present our model here again today to emphasize how important it is for policymakers and commentators to understand the mechanisms and policy tradeoffs embedded in their choice of monetary policy framework.

Floor GLI in Theory

No framework is perfect, but we think it is sensible to stick with our in-house Floor GLI framework, even as the current macroeconomic dynamics are historically unique. A successful framework should be robust to a variety of macroeconomic landscapes. While it is true that ad-hoc dynamics and measurement issues may sometimes demonstrate the need for revisions to our framework, we do not see a compelling need to revise or override its prescriptions today.

The core of the Floor GLI approach is a state-contingent nominal anchor. In lay terms, this means Floor GLI is a policy rule designed to raise labor income growth when the economy is running cold, and to slow down price inflation if both labor income growth and price inflation are running hot.

To accomplish this, the Floor GLI Framework runs a three-step process.

1. If, following a recession, interest rates are at the zero lower bound, policy should target a level of gross labor income sufficient for the economy to win back the jobs and wages lost during the recession. This is the labor market's key "level target."

2. Outside of temporary level-targeting at the zero lower bound, the question then shifts to whether gross labor income growth is expected to be below the baseline "floor" growth rate. If so, policy should still be incrementally easing until income growth strengthens to a rate higher than that baseline "floor."

3. If gross labor income is expected to grow faster than the baseline floor, Fed policy should grow more sensitive to how inflation is performing relative to the Fed's target, and adjust policy incrementally to achieve its goals.

Unlike many other frameworks, the Floor GLI approach is up front about the fact that the decision to tighten monetary policy is a decision to slow down job growth and wage growth. This should force those looking for tighter Fed policy to own the fact that they are asking for Americans to see their paychecks grow more slowly. Although there are other ways that prices can fall even as jobs and wages rise, this is the main mechanism through which Fed policy has a discernible effect on consumer price inflation. The fact that the framework only makes strong judgments in terms of "slowing down" and "speeding up" the economy helps it stay robust to the fact that we can rarely say with certainty what counts as "tight" or "accommodative" monetary policy. Monetary policy effects on financial conditions and the real economy are hard to estimate and vary over time. We can only confidently say that moving interest rates, financial conditions and risk premiums in a tightening direction will decelerate the economy versus the counterfactual.

Contrary to the suggestions of some models, price inflation does not automatically happen when labor income growth is expected to be strong. The second half of the 1990s are an instructive example of this. Yet, in the current moment, a robust recovery in labor income growth is coinciding with elevated inflation and inflation forecasts. The challenge for monetary policy is in parsing the full suite of causal mechanisms that will affect future inflation while remaining mindful of what roles the Fed can (or can't) play in offsetting such dynamics. Our framework aims to cut out the hawkish policy errors driven by excessive fixation with lagging or idiosyncratic inflation dynamics, and instead focuses on labor income dynamics that are more broadly representative of business cycle dynamics, and even future inflation dynamics.

Level targets have an important intuitive purpose during recoveries from recessions. If the Fed is going to act to slow down total job and wage *growth* (which is the Fed's primary mechanism for slowing down inflation), such action should at least be made conditional on achieving a requisite *level* of jobs and wages first. **Actions to tighten monetary or fiscal policy prematurely–before jobs and wages have the chance to make a full recovery from recessionary damage–set the conditions for "locking out" millions of Americans from the opportunity to earn a labor market income, a phenomenon that is visible not just in the 2010s, but even in the mid-2000s and the mid-1990s.** This is an especially perverse choice given that the Fed's actions affect the labor market far more reliably than inflation, and when Fed actions influence inflation, it does so primarily through the labor market.

Some may criticize the focus on level-targeting: one fluke dynamic can throw your readings way off course for reasons that aren't economically important. Path-dependence and hysteresis are important for understanding not only of the labor market dynamics experienced by the unemployed, but also the impact of recessions on the investment programmes of whole sectors.

Whereas the Fed has talked a lot about "average inflation targeting," our framework uses level targets as a temporary remedy when the zero lower bound constrains monetary policy during and following recessions. Moreover, because the Fed's mandate with respect to real activity is specified in terms of "maximum employment," it is critical to calibrate that temporary level target in terms of jobs and wages. Our preferred framework is not based on misguided notions of "set it and forget it" level targeting regimes that presume to hold true for all economies at all times. Instead, it sees the pre-recession labor market as the goal for a real recovery. The more one abstracts away from these concrete measures, the more one risks tightening for reasons unrelated to cyclical labor market dynamics.

Monetary policy is not just a fickle beast, in the sense that not every rate hike or rate cut is equal. Even worse: it is a fickle beast in a shifting economic forest. Sometimes the smallest, simplest push for "liftoff" from the zero lower bound, as in 2015-16, can help break the camel's back. Sometimes speedy and proactive rate cuts can do little to help the growth outlook, as was the case in the first two weeks of March 2020.

Floor GLI in Practice

So, what does the Floor GLI framework have to say about policy today? **As it stands, the three-part checklist for considering slowing down the economy is nearly met.**

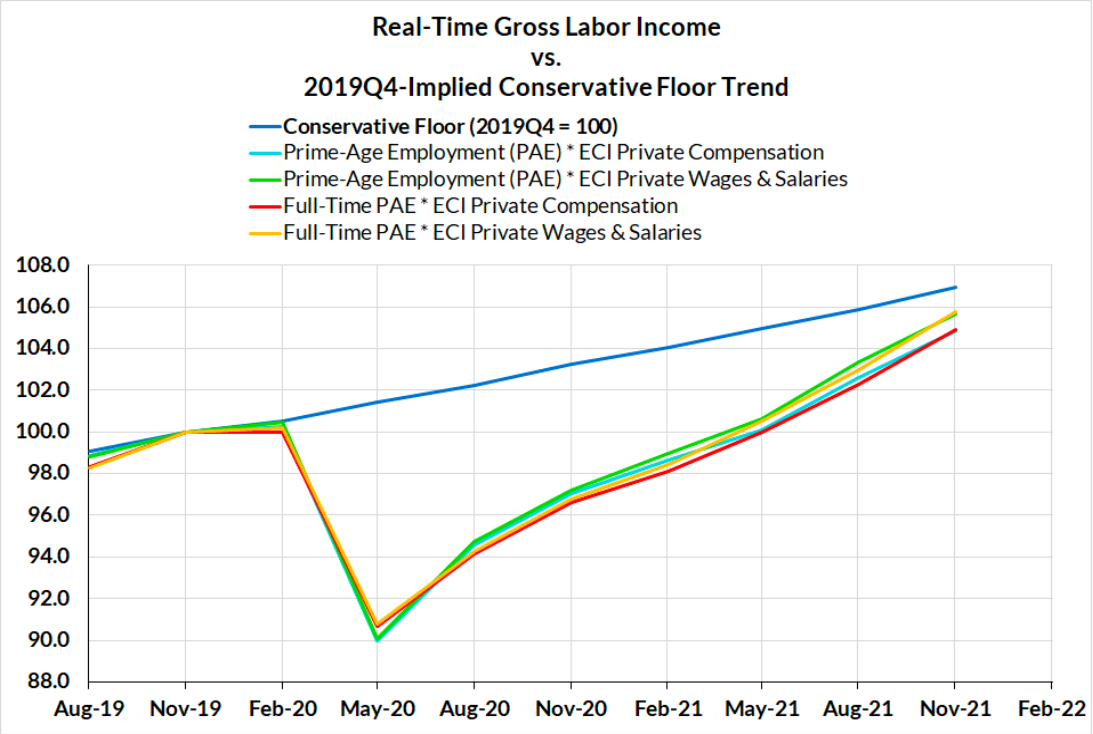
While we have yet to achieve a full recovery on the most robust real-time measures of jobs and wages (the first step mentioned above), these indicators are making great progress in their return to pre-pandemic levels. The current pace in 2021Q3 and 2021Q4 would suggest that real-time gross labor income gap should close some time between late Q1 and the middle of Q2 this year (March and May).

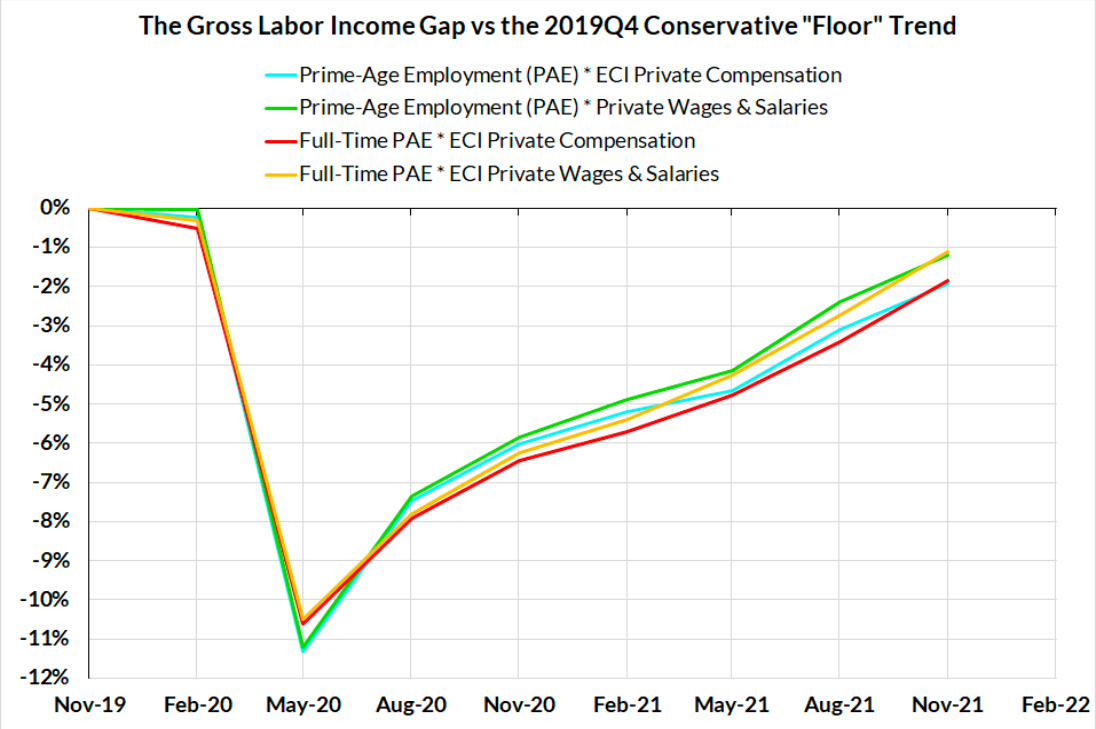
		Gap vs Pre-Pandemic Labor Market		
	Release Date	Current	10/31/2021	7/31/2021
Prime-age Employment Rate (PER) - *(Employment/Population)*	Dec-21	**-1.5%**	-2.4%	-3.3%
Full-Time (FT) PER	Dec-21	-0.9%	-2.2%	-3.0%

Real-Time Gross Labor Income (GLI) Gap vs Pre-COVID Trend				
PER * ECI Total Compensation	2021Q4	**-1.9%**	-3.1%	-4.7%
PER * ECI Wages & Salaries	2021Q4	**-1.2%**	-2.4%	-4.2%
FT PER * ECI Total Compensation	2021Q4	-1.9%	-3.4%	-4.8%
FT PER * ECI Wages & Salaries	2021Q4	-1.1%	-2.7%	-4.3%

Using two different measures of labor utilization - a prime-age employment rate and its full-time analogue - and two different measures of wages - the Employment Cost Indices for total compensation and just for wages & salaries - we see that the gap between the realized and floor growth rates of income have substantially closed as of Q4, which would roughly coincide with November data on a hypothetical monthly basis. Prime-age employment rates are particularly important because shifts in the population structure and who gets classified as "not participating" reflect subtle shifts over time that the headlines tend to mask.

These measures also have the important and underrated benefit of not being subject to retroactive revisions, unlike national accounts measures of GLI or GDP and unlike estimates of nonfarm payrolls and average hourly earnings. These revisions can play dangerous tricks when policymakers have to evaluate data and act in real time, without the benefit of hindsight. While we haven't yet got all of "the jobs and wages back" from the pandemic, we're getting close on a cumulative basis.

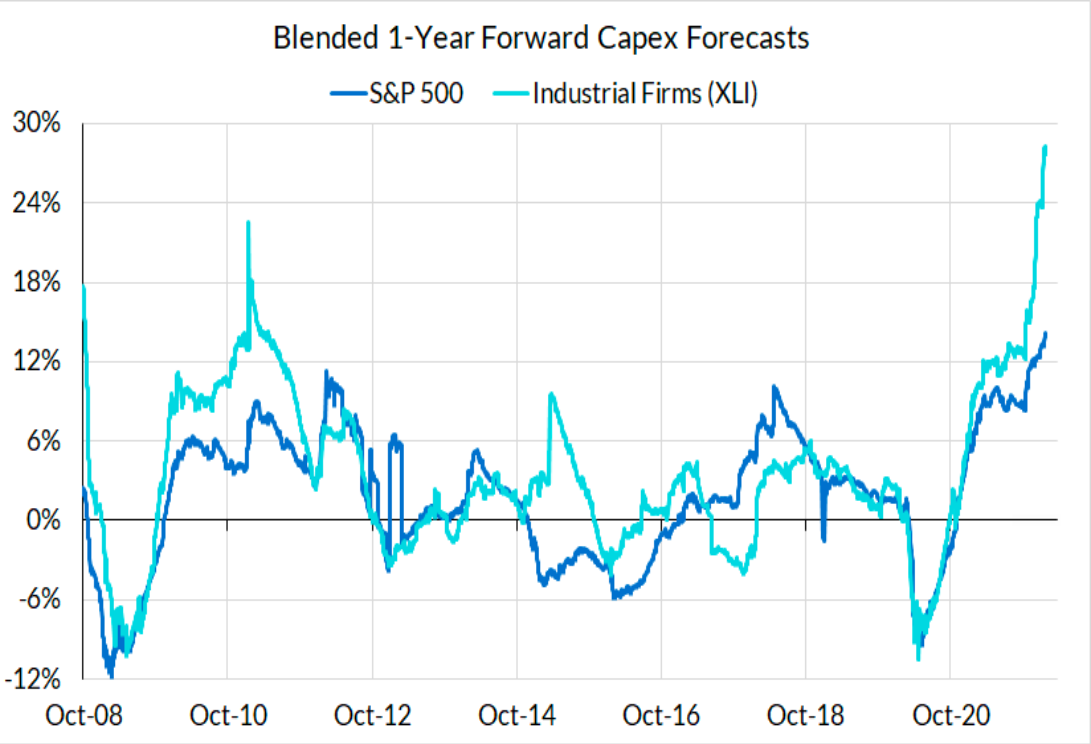




Moving to our second step, the current and forward dynamics of labor income growth suggest strength. The momentum of labor income growth is exceptionally strong and some of it should carry forward into Q1 despite the likely effects of the Omicron variant in December and January. Capital spending forecasts at the firm-level suggest that firms' propensity to spend in the current environment

remains quite strong, especially relative to the more anemic performance visible throughout the 2010s.

Pace of Labor Market Improvement		Annualized Rates of Change (Quarterly Aggregation)				
		1-Quarter	2-Quarter	3-Quarter	YoY	YoY 3m Ago
Prime-age Employment Rate (PER) - *Change*	Dec-21	2.8%	3.1%	2.8%	2.7%	3.2%
Full-Time (FT) PER - Change	Dec-21	3.7%	3.1%	3.0%	2.7%	3.0%
Employment Cost Index - Total Compensation	2021Q4	4.7%	5.2%	4.5%	4.4%	4.0%
Employment Cost Index - Wages & Salaries	2021Q4	5.0%	5.7%	5.1%	5.0%	4.6%
Conservative GLI Floor Growth Rate		3.9%	3.8%	3.7%	3.6%	3.6%
PER * ECI Total Compensation	2021Q4	9.0%	9.7%	8.4%	8.1%	8.5%
PER * ECI Wages & Salaries	2021Q4	9.2%	10.3%	9.1%	8.7%	9.1%
FT PER * ECI Total Compensation	2021Q4	10.8%	10.2%	9.3%	8.6%	8.6%
FT PER * ECI Wages & Salaries	2021Q4	11.1%	10.7%	10.0%	9.2%	9.3%
Compensation of Employees (Nat'l Acccounts)	Dec-21	12.2%	9.6%	10.6%	10.6%	10.5%
Wages & Salaries (Nat'l Accts)	Dec-21	9.5%	10.7%	7.4%	7.4%	6.9%

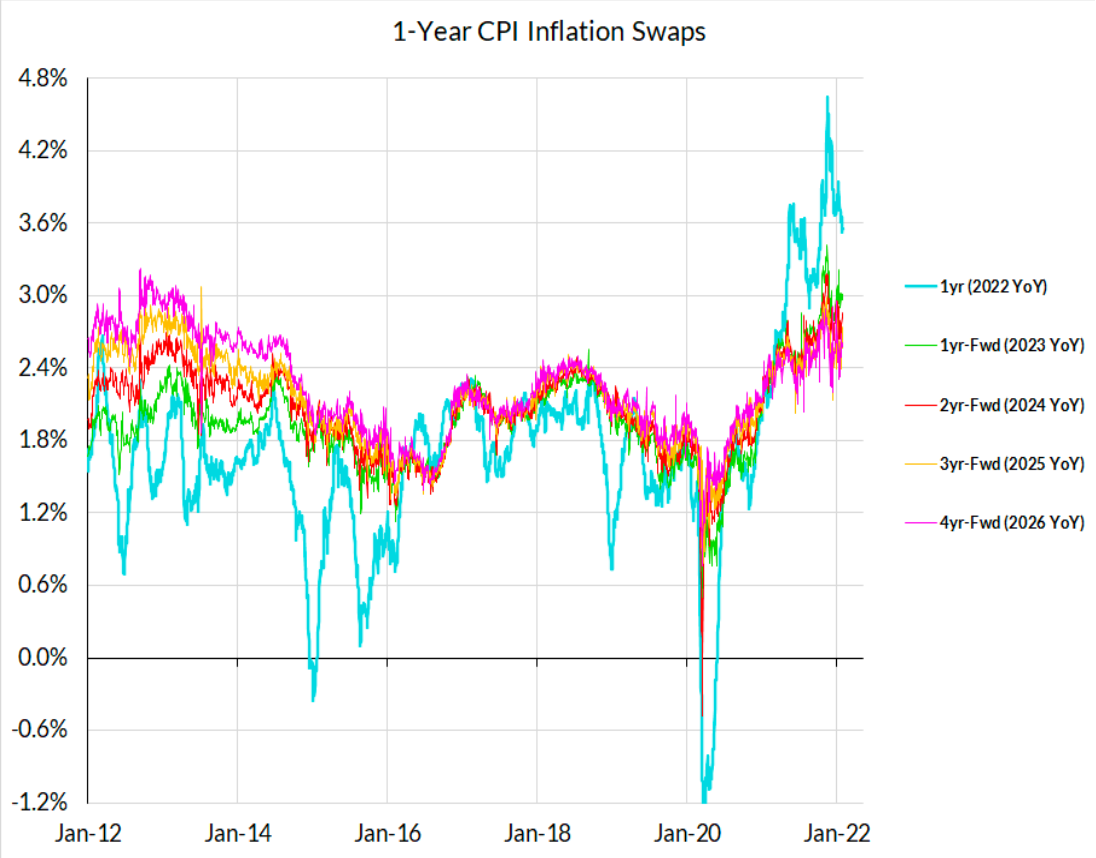


On the other hand, financial conditions are already tightening: 1) short and long-term Treasury yields are higher, 2) mortgage rates and corporate borrowing costs are higher, 3) credit spreads, and equity risk premiums are also higher, and 4) the dollar is continuing to appreciate. The impulse from reopening and fiscal policy are also set to substantially dissipate over the course of 2022. While financial conditions and data developments can still shift, the baseline outlook should be

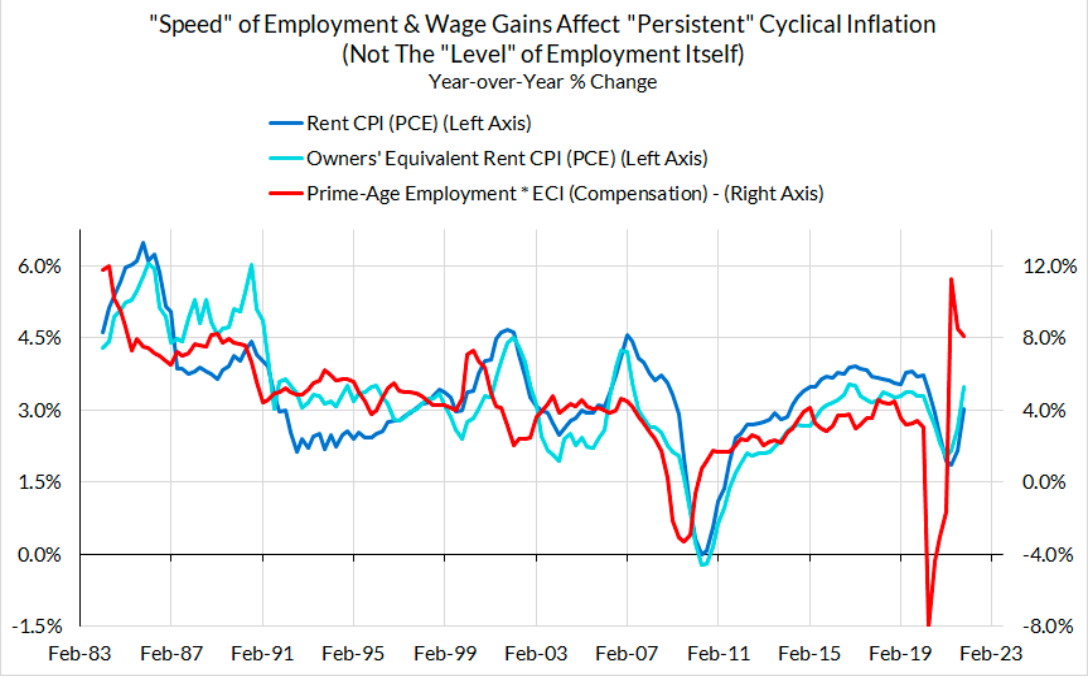
for labor income growth to perform above what a conservative baseline rate would suggest.

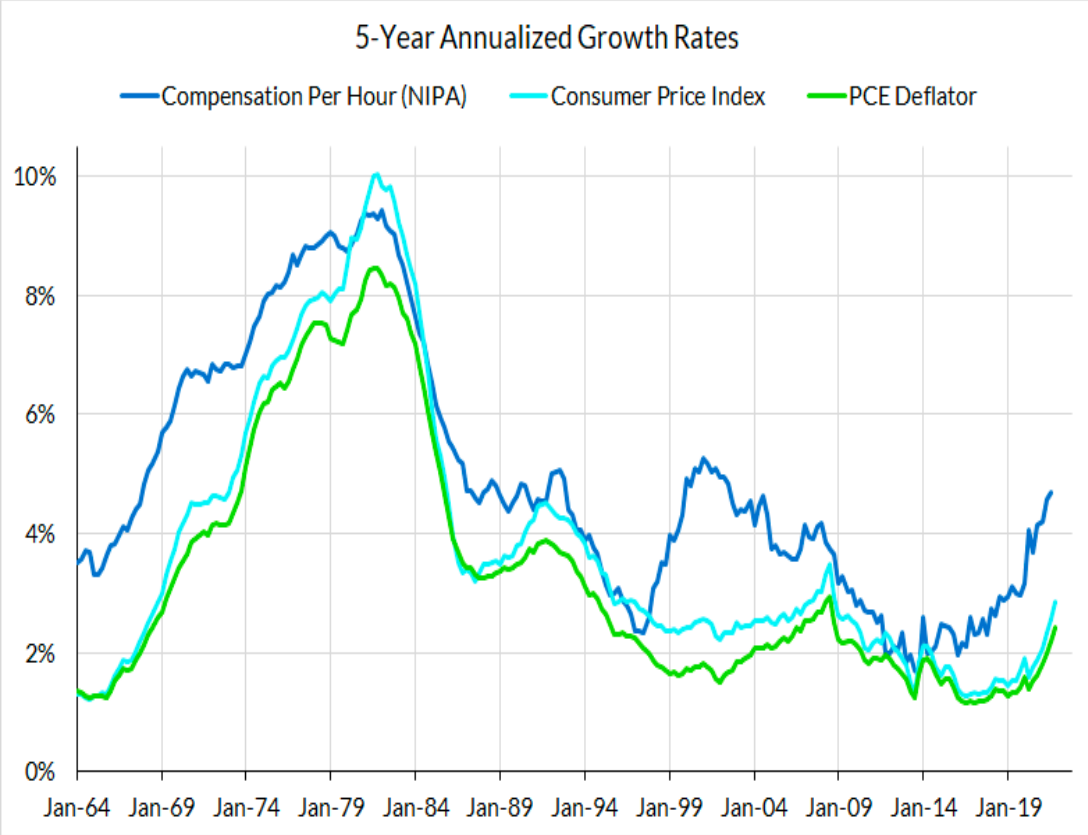
Green = Easing		Change Since	
Red = Tightening	1/28/22	9/30/21	1/2/20
S&P 500 (Price)	4516	4.8%	38.6%
Equity Risk Premium	5.5%	-0.1%	0.1%
VIX (20-day MA)	22.8	2.8	9.3
CDX HY Spread Index	3.43%	0.42%	0.69%
High Yield Corp OAS	3.45%	0.56%	0.14%
BBB Corp OAS	1.28%	0.24%	0.06%
AAA Corp OAS	0.68%	0.21%	0.14%
Mortgage OAS	0.19%	-0.08%	-0.20%
MOVE (20-day MA)	80.3	23.8	21.5
10yr UST Yield	1.77%	0.28%	-0.11%
2yr UST Yield	1.16%	0.89%	-0.41%
Trade-Weight $		2.26%	-1.64%

On the other side of the framework, the current trajectory of inflation suggests that inflation is likely to remain above target in the near-term. Market-based measures like front-end inflation swaps and TIPS indicate that inflation is liable to a further overshoot of the Fed's 2% target. These measures are not without their flaws and have a highly sensitive liquidity risk premium, but they are still the best starting point for thinking about the potential ballpark for inflation readings. Market-implied forward inflation measures appear more benign, but at least for 2022, core and headline PCE dynamics appear on track for something close to 3% (assuming a slightly higher CPI-PCE wedge than the 0.5% wedge that existed before the pandemic).



If inflation dynamics and forecasts turn, the direction of policy should turn as well, even if income growth remains strong. As we argued a year ago - before the bulk of today's inflationary pressures made themselves known - income dynamics are the most reliable indicator as to which ballpark inflation readings will land in.





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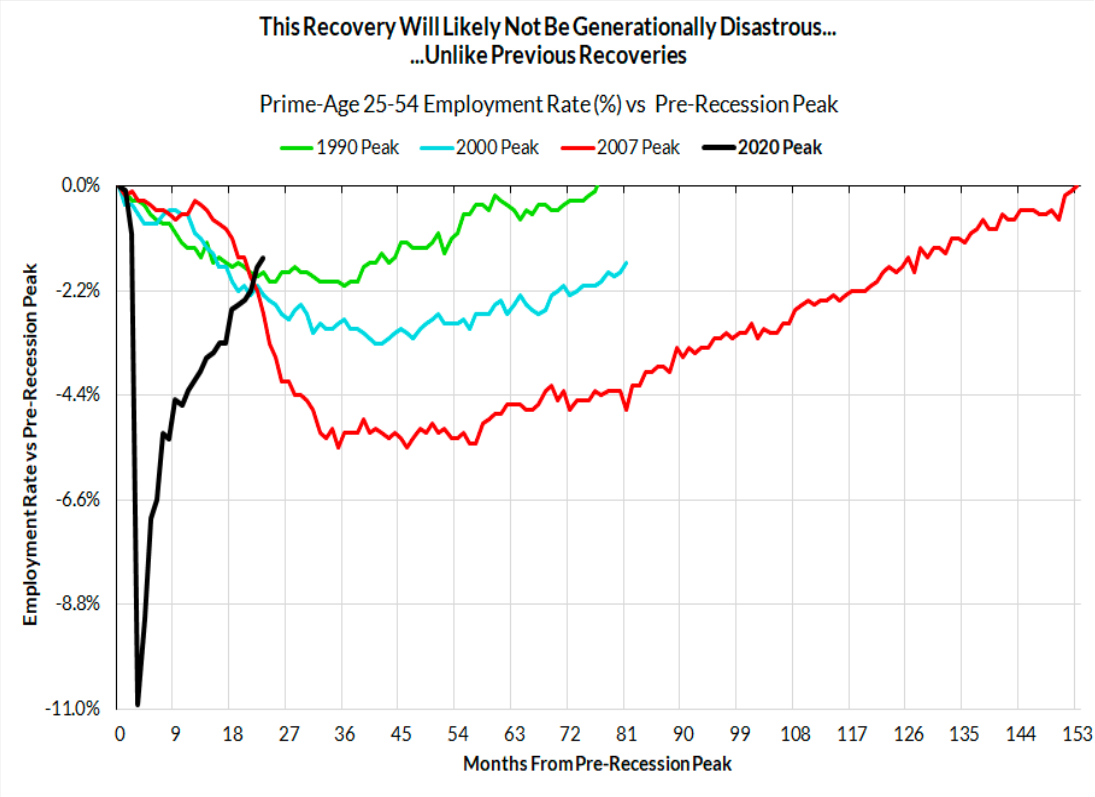
Of course the challenge is that on a short-run year-over-year basis, that income-driven ballpark can still be quite substantial and income growth dynamics are still likely to see substantial volatility over the coming year. Some of the strength in the Q4 Employment Cost Index data appears to be based on one-time incentive-based compensation that likely will not replicate itself in 2022. As the dynamics and data reveal the underlying causal mechanisms guiding inflation, the Fed should be nimble enough in its forecasts, such that if inflation dissipates, the need to tighten monetary policy and financial conditions should correspondingly dissipate.

The Fed will likely tighten policy sooner and more quickly than our framework suggests it should–though hopefully not drastically so. Thankfully, the labor market has already managed to recover most of the jobs and wages lost in the pandemic recession. This is something that cannot be said for the "recoveries" that followed the 2001 recession or the Great Recession. Each of those

"recoveries" that followed the 2001 recession or the Great Recession. Each of those "recoveries" are better understood as generational disasters, at least in terms of labor market performance.



What the whole pandemic experience should finally make clear to everyone is the fact that the causal mechanisms behind inflation have always been highly complex, and the Fed can only influence these mechanisms through oblique and perverse channels. If inflation is not coming from an overheated domestic labor market - and instead stemming from dynamics of high import-intensity and physical capacity deficiency - tighter financial conditions might, ironically, help sustain certain inflationary bottlenecks for longer. The highly rate-sensitive US oil & gas sector offers a micro example of how this dynamic can play out: higher rates can lead to a higher cost of capital, discouraging investment and preventing new supply from coming online. Fed tightening doesn't just slow business expenditure on labor at the margin, but capital too. Businesses that find it harder and more costly to finance necessary inventory and capacity expansions may pass on those costs to households in the form of higher prices.

One of the most instructive aspects about the current episode is what it can tell us about the notion of Fed control. Economics textbooks teach simplified "money supply" and "money demand" charts, even though the Fed does not control any functionally useful definition of "money supply." The Fed has direct control over short-term interest rates, which in turn shape a variety of financial conditions

to varying degrees and at varying times. Financial conditions have a pretty identifiable effect on business expenditure dynamics (including labor expenditure), especially during periods of volatile risk sentiment, but the influence over price-setting and inflation outcomes is far weaker.

With the level of labor incomes moving closer to recovery and the outlook for growth also looking solid for the time being, the case for using monetary policy to help cool down business spending and household income growth appears more defensible under our preferred framework. Critical above all else is for the Fed to stay nimble to the set of dynamics that are driving inflation, all while ensuring that labor income stays above a baseline “floor” growth rate.