2023: The Labor Market Holds Firm and 2024: Tracking Policy-Rate Transmission

Global Chief Economist Paul Gruenwald's Year-End Reflections

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This report does not constitute a rating action

For the final 2023 edition of our Essential Economics newsletter, we asked each S&P Global Ratings chief economist to share insights on following questions:

- What was the biggest surprise for you in 2023 and what are the takeaways?
- What will you be watching most closely in 2024, and why?

Contacts

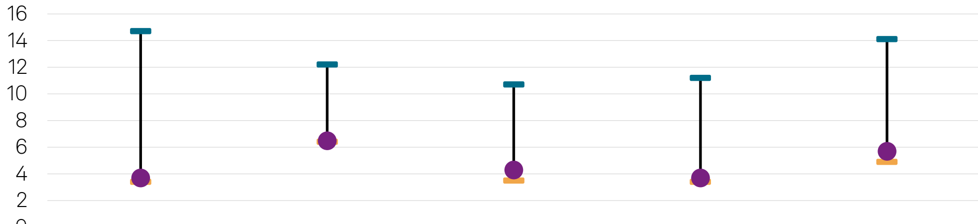
Paul Gruenwald
New York
paul.gruenwald
@spglobal.com

2023: Labor Market Resilience

My biggest surprise in 2023 was labor market resilience in the face of steep policy rate hikes. We had been expecting a meaningful slowdown in labor demand because of the rate rises. While attention was mostly on the advanced economies, this resilience was on display almost everywhere. It was also largely independent of GDP growth outcomes. To give a prominent example: the unemployment rate was sticky both in the U.S., where growth remained above trend, and in Europe, where growth fell to close to zero. Part of this story reflects the composition of growth, which remains skewed toward services where labor demand is higher. But it also reflects companies' desire to hold on to workers after the choppy rebound from COVID-19. In that period, matching workers to firms turned out to be difficult and costly, and firms seem reluctant (for now) to go through that process again.

Low unemployment in 2023 reflects companies' desire to retain workers, and strong services demand

Unemployment rate ranges 1990-2023 (%)



	U.S.	Euro area	U.K.	Australia	Canada
High	14.7	12.2	10.7	11.2	14.1
Low	3.4	6.4	3.5	3.4	4.9
Latest	3.7	6.5	4.3	3.7	5.7

Sources: FRED, S&P Global Ratings Economics.

Takeaways: The key variable for our soft-landing baseline is the labor market and signs have been encouraging to date. Layoffs remain low and payrolls are falling gently, at least so far. We are fully aware that in the post-war period, soft landings have been few and far between. The last one took place in the mid-1990s. Unemployment rates should move higher as monetary conditions tighten and demand cools, but that is a lagging indicator. Quits, vacancies, and payrolls will receive most of our attention.

2024: Monetary Policy Transmission

Next year, I will be tracking how the sharp rise in policy rates over the past two years transmits to the real economy. As is well known, the (statistical) link between policy rates and the real economy is weak. The transmission from policy rates to the real economy happens through financial conditions: lending rates, spreads, asset prices, and exchange rates. This transmission process does not happen at uniform speed across economies. Those with a higher proportion of floating rates or short maturities will experience a faster passthrough of higher rates; financial conditions will tighten; demand will slow earlier--and vice versa. In this respect, transmission reflects the idea of "long and variable" lags for policy. It also underscores why central banking is difficult. Next year, policymakers will need to balance their actions: bringing inflation back to target, while simultaneously being mindful of real economy effects.

What to watch: While policy rates were raised broadly in tandem across the advanced economies, the transmission of these rates will not happen in tandem. The passthrough depends greatly on maturity structures, including the well-documented maturity walls. The European Central Bank has stated that the eurozone passthrough is relatively quick. We would note that in the U.S., owing to the prevalence of longer-dated fixed rate loans, the passthrough will be slower. In general, we have a spectrum of potential outcomes. This suggests that the slowdown and recovery of advanced economies could be out of phase, something we are seeing already, which could complicate the macro call next year.