The alleged missing link - wage inflation

Dr Robert Gay | Fenwick Advisers | 26 Janurary 2015

Ever since the minutes of the December FOMC meeting were released on 7 January, financial markets have reconsidered the likely timing and aggressiveness of the Fed's inevitable normalisation of short-term interest rates. Futures markets had been expecting the Fed to raise its policy rate to 1.5% by year end, but the minutes and the members' projections seemed to indicate some remaining disagreement among FOMC participants on these momentous issues.

At the heart of the debate is a concern that the US economy is running out of 'slack', notably in the labor market, and what might be the long-term consequences if the economy runs too hot in the years ahead. The critical link in this discourse is what employers will decide to do with wage adjustments as it becomes more difficult to attract and to hold onto skilled workers. So far, the media has gotten this story badly wrong by alleging that US wages remain stagnant.

THE WAGE DATA

As the *New York Times* declared in a recent article, "All eyes are on the wage data". The question is what data does the Fed look at? The answer, of course, is anything they can get their hands on - but not all wage data is equal in their eyes.

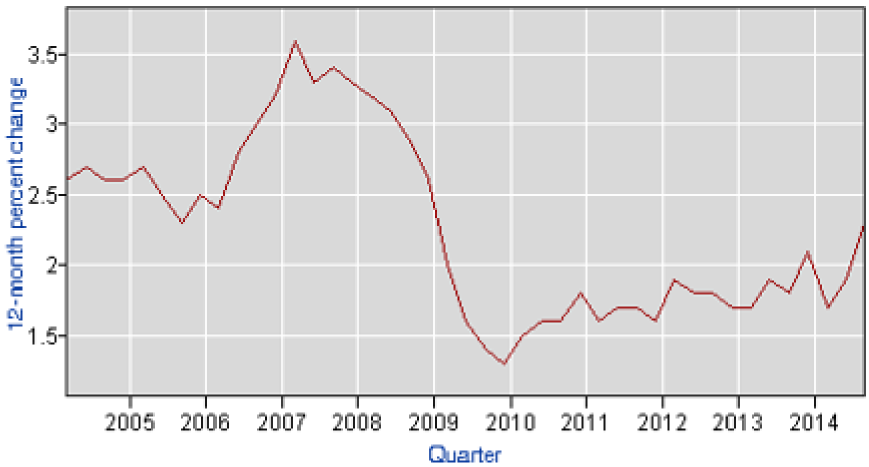
The widely reported data on hourly earnings from the monthly payroll survey often is presumed to be the most timely and hence most relevant. It is not. Indeed, that data has serious flaws for most macro-analytical purposes because it represents the simple average of employers' aggregate payrolls divided by total hours worked. For specific industries or categories of somewhat homogeneous workers, this data can be useful.

However, the overall average wage that often is cited by the media is seriously flawed as an indicator for monetary policy because it is distorted by the mix of workers being hired. For example, almost all the hiring in December was production and nonsupervisory workers whose job prospects had been quite dreary until recent months. Because many of these workers have lower wages than those of professional and technical workers, the average wage actually declined even as more of them were hired. In short, the average hourly earnings data, at least in aggregate, tend to have a serious countercyclical bias that limits its usefulness in quantifying wage pressures as the economy approaches full employment. At best, it is late and backward-looking. The data on compensation per hour in the BLS release on Productivity and Costs has similar shortcomings.

The Fed's preferred wage data in measuring wage pressures comes the Employment Cost Index (ECI), a relatively obscure quarterly report that has not gotten much attention but likely will do so in the months ahead. The great advantage of these data is that they cover both wages and benefits and they are adjusted to remove the bias introduced by the changing composition of the workforce. Granted, these data are not as rich in industry detail but, as a macroeconomic policy tool, they better tell the story of both the state of workers' real incomes and the underlying trends in wage setting.

Figure 1 shows the latest ECI data. Over past year, wages and salaries of workers in private industries have risen 2.2% – not spectacular, but nonetheless much more than indicated by the hourly earnings data. More important, wage and salary adjustments in the ECI have jumped to a 3% annual rate since mid-2014 when domestic final sales began to gain some momentum – a clear breakout after five years when annual pay increases averaged less than 2%.

Figure 1: Employment Cost Index (ECI) – Private Sector Wages and Salaries



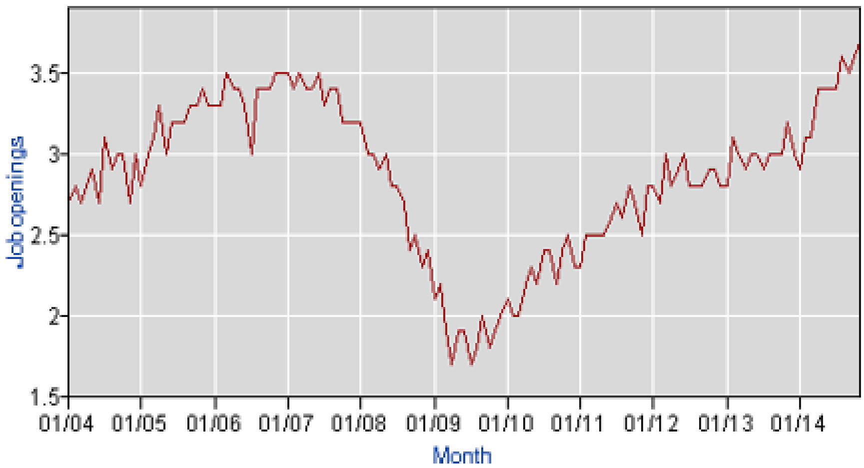
Some observers may wonder if the sudden shift in pay adjustments is because some US states are raising the minimum wage, but most of those legislated hikes had not taken effect this fall. President Obama has proposed a hike in the Federal minimum wage, which has been fixed at $7.25 per hour since 2009. That equates to only 30% of the average hourly wage in the US as a whole – a fraction that is near recent historic lows. As a rough rule of thumb, even low-wage employers often find it necessary to offer more than the Federal minimum when it falls so far relative to the national norm[1]. For example, the average wage for nonsupervisory workers at leisure and hospitality companies, which are the lowest paid industries, is $12.26. In effect, the Federal minimum becomes increasingly irrelevant when it is too low and may be a reason why many of today's youth do not bother to look for employment – that is, their participation rate has fallen, when available jobs pay so little.

Likewise, it is not surprising that numerous US states are looking to raise their own legislated minimums in an effort to retain younger workers.

A closer look at the ECI data reveals larger wage adjustment across a broad swath of professions and industries, not just those at the low end of the spectrum. Moreover, data from other surveys indicate employers in general are struggling to fill vacancies with qualified workers. The strongest such evidence comes from the Labor Department's monthly report on job openings, hiring and firing[2]. In November, US employers reported that they had 4.97 million job openings for immediate hire. The ratio of job openings to desired employment (i.e. openings plus the current number of workers on payroll) is the highest on record for these data that date back to 2002 (Figure 2). Jobs are not getting filled as quickly as normal for whatever reason – people's skills do not match job requirements or the jobs do not meet people's expectations.

Either way, employers will need to adjust the terms of employment to accommodate the shortage of willing workers. That means, among other things, higher wages.

Figure 2: the Job Openings Rate



Other evidence supports this contention. A survey of small businesses conducted by the National Federation of Independent Businesses (NFIB) reported the highest level of optimism since 2006 and the most pervasive expectations of increasing pay since 2007. The proportion of small businesses planning to increase compensation in the next three months exceeded those that planned pay cuts by an exceptionally wide margin of 17 percentage points. As if on cue, one of America's largest insurance companies, Aetna, announced that it would set its minimum hourly pay at $16 which represents an 11% increase for the companies lowest paid employees.

Taken together, this evidence tells a convincing story of structural issues – failings in education, training and the terms of employment – that finally are hampering businesses to the point at which they must attract new workers or risk losing sales to competitors.[3] In the lingo of economists, that is a reasonable definition of incipient wage pressures that arise as the economy approaches full employment.

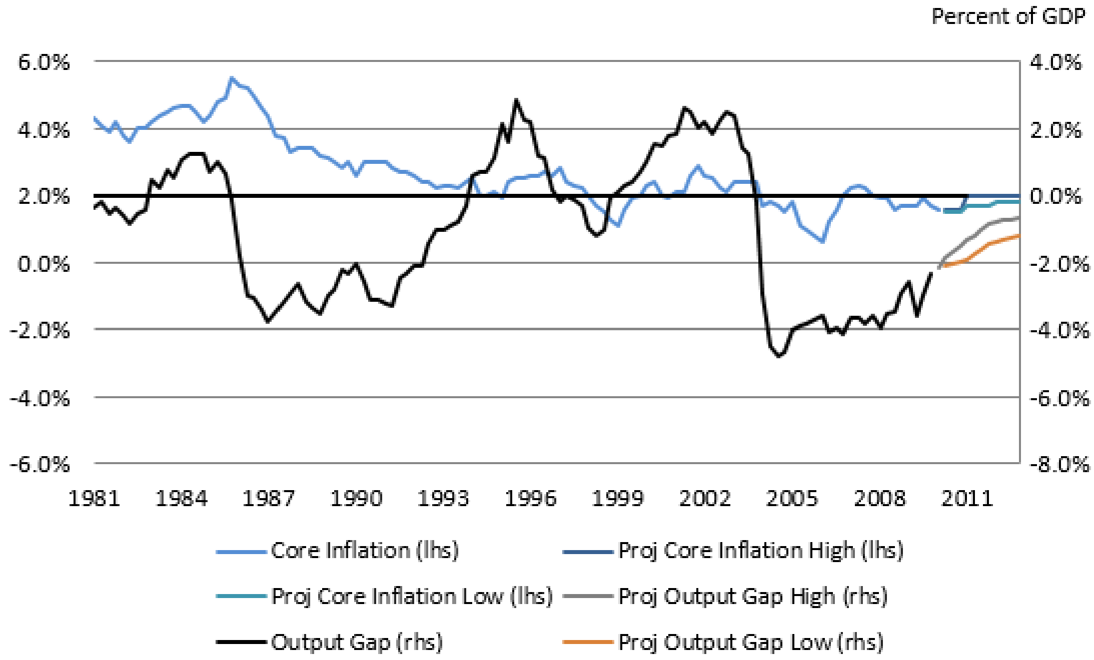
THE FED'S INFLATION FRAMEWORK

Technically, the Fed staff does not use these data to 'define' full employment and hence to draw a line in the sand that requires remediation. Rather, it is used as corroborating evidence for empirical estimates of thresholds that could precipitate subsequent pressures on wages and prices. Monetary policy works with long and variable lags, so early warnings and empirical guidelines are needed to stay ahead of the curve.

Understanding the Fed's inflation framework thus is the key to deciphering its next moves.

Figure 3 shows one such tool – the so-called output gap – and its relationship to core inflation. The output gap is the difference between actual and potential GDP, as a percent of real GDP. A negative number means that real output is below its inflation-stable potential, whereas a positive reading indicates the economy operating above its potential and hence risks overheating. Estimating potential GDP is a complex empirical issue that the Fed staff has refined over the past three decades.[4]

Figure 3: Output Gap and inflation



Sources: US Bureau of Labor Statistics, Bureau of Economic Analysis. Projections are based on consensus estimates from members of the FOMC. Estimates of historical potential output are by Fenwick Advisers.

Unlike the elusive concept of full employment, the output gap has a long and reliable historical relationship to core inflation. Namely, when the output gap as depicted by the black line in Figure 3 is sizeable, core inflation invariably trends lower, albeit with some delay. Conversely, when real GDP exceeds its potential – as was the case in the late 1990s and much of the 2000s – core inflation reverts upward, again with a delay of about one year.

Be forewarned – that hiatus between when the economy reaches full employment and when inflation subsequently turns up often drives a wedge between public perception of inflation risks and the FMOC's policy response to a strengthening economy. More often than not, the Fed has waited too long to tighten policy as the output gap closed and then had to overreact in order to get the economy back to a steady state.

This time seems different, though. Having ventured into the unknowns of quantitative easing, FOMC members appear to be reluctant to risk getting behind the curve as economic activity picks up steam. To their credit, many hawkish members have been correct in anticipating a much stronger recovery in 2014 and 2015, despite five years of plodding growth. If anything, those optimistic expectations were exceeded in the second half of 2014 and the collapse in energy prices coupled with larger pay increases bodes well for real incomes and final sales in 2015. The high and low projections of FOMC members are depicted by the color lines in Figure 3, that also presume potential growth is 2% to 2.25% annually, consistent with the long-term growth assumptions in their published projection tables.[5]

The message from either projection is that whatever noninflationary slack is left in the US economy in effect will be gone as soon as 2016 or 2017 at the latest. If economic growth averages more the FOMC's consensus forecast of 3%, then the day of reckoning will come sooner. As several Fed officials have said recently, monetary policy needs to be a lot closer to normal before the economy reaches its potential. They cannot get to that point from here in a gradual way unless the first rate adjustment comes soon.

Note that the consensus of FOMC participants expects core inflation to revert toward the 2% target over the next two years as well. On that count, I think they will be wrong even if current trends in wage inflation persist. The problem is with the lagged response of prices once the economy overshoots. Besides, an ever-expanding portion of global economy is sinking into deflation and the US is not entirely immune to its consequences. On a brighter note, manufacturers several major nations including Germany, Japan and the US have exercised wage restraint so long that the wage gaps with competitors in China and East Asia have narrowed significantly, thereby relieving one of the root cause of deflationary wage pressures. Those will be the first to see light at the end of the deflationary tunnel.

IMPLICATIONS

Despite the seeming contradiction when inflation is falling everywhere, the Fed cannot avoid the tight timetable imposed by the strong US economy. The output gap already has narrowed to about 2% of GDP, leaving little margin for error. Granted, inflation is not likely pose an immediate challenge but that merely will moderate the rate at which the Fed must normalize its policy rate. Here are the likely next milestones:

- Another strong quarter of growth or a few more months of strong job gains will put considerable pressure on the Fed to initiate a first rate hike of 25 basis, perhaps as soon as 1 April, but not later than 19 June. Contrary to the nervousness among many investors about this eventuality, financial markets are likely to view the early rate adjustments as a sign of strength.
- The next major decision is to cease reinvestment of interest and principal redemption on the Fed's huge portfolio. This decision actually will be more momentous than the first rate adjustment because it will signal the gradual unwinding of the Fed's huge portfolio of Treasuries and mortgages as they mature and are redeemed.
- The third major signal will come with the timing of second rate adjustment. Futures prices now indicate that small rate hikes will occur at every subsequent meeting, whereas low inflation will allow the FOMC to be much more patient than that once the initial adjustment is behind them.
- None of this story assures that strength in the US dollar will continue in 2015. Many emerging market currencies are heavily oversold and most of those economies will benefit from the combination of devaluation and low energy prices. Moreover, currency markets already have overshot the euro and yen on the presumption that the ECB and BOJ are charting a vastly different course the Fed. What is easily forgotten, though, is that the Fed's huge balance will remain far more stimulative than that of either the ECB or BOJ until it begins to passively runoff its asset holdings which may not occur until late 2015 or even 2016. Look for a partial recovery in all those currencies.
- A much bigger risk of deflation and the gradual removal of liquidity will be its impact on the credit quality of the biggest debtors and those borrowers that are most leveraged. Those with the weakest balance sheets and most leverage pose the greatest risks as central banks exit a regime of negative real interest rates.

FOOTNOTES

1. At the other end of the spectrum, most studies indicate that a minimum wage that exceeds 50% wage norms, either nationally or at the state level, tends to thwart hiring and exacerbate unemployment especially among youth and young adults.

2. These data are from the Job Openings and Labor Turnover Survey, often referred to as the JOLTS report.

3. For a discussion of the causes of wage stagnation over the past two decades, see "Report of the Commission on Inclusive Prosperity", Center for American Progress, January 2015.

4. For the staff's latest estimation, see Dave Reifschneider, William Wascher and David Wilcox, "Aggregate Supply in the United States: Recent Developments and Implications for the Conduct of Monetary Policy", presented at the IMF's 14th Jacques Polak Annual Research Conference, 7-8 November, 2013. All three authors are senior staff members at the Board of Governors of the Federal Reserve System.
http://www.imf.org/external/np/res/seminars/2013/arc/pdf/wilcox.pdf.

5. See http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20141217.pdf

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