

Is There a Wage Growth Puzzle?

BY JOHN A. WEINBERG

The Great Recession saw a weakening of labor markets that was, by some measures, the worst since the Great Depression. On an aggregate level, labor markets have since recovered substantially — the unemployment rate has fallen from a peak of 10 percent to just above 4 percent. At the same time, data on wages and hiring highlight something that has puzzled macroeconomists: As the labor market reaches levels consistent with full employment, wage growth seemingly remains slow.

As the economy recovers and employers start hiring again, the pool of individuals looking for a job should start to shrink relative to the openings created by employers. When that happens, wages should rise in a bid by employers to entice workers to enter the labor market or change jobs. But employers haven't reported the robust wage growth that we might expect. The January 2018 Beige Book, a Fed publication that assembles comments collected by Reserve Banks on local economic conditions from business contacts and other observers, reported "moderate" wage growth, although some employment sectors reported more increases than others.

What could explain the fact that labor markets seem to be tightening while wage growth appears subdued? There are a few possible ways to reconcile this seeming contradiction. The first is to remember to account for inflation when measuring wage growth. Because inflation has been lower recently compared to previous periods, nominal wage growth has also been lower. This contributes to the perception of a sluggish recovery. Researchers at the Brookings Institution's Hamilton Project argue that after adjusting for inflation, wages have actually grown faster in this recovery than during previous expansions going back to 1981.

A second explanation that has been proposed for depressed wage growth is declining productivity growth. The more productive workers are, the more valuable they are to employers, which should lead to higher wages. Historically, wages have grown in tandem with productivity over time. Moreover, economists have found that in recent decades, wage growth seems to be more closely tied to productivity than to measures of labor market slack or tightness like the unemployment rate. Like wages, productivity growth has also slowed since the 2000s. This may partially explain any slowdown in wage growth as well.

In fact, researchers at the Cleveland Fed have found that given low inflation and slow productivity growth, wage growth since late 2014 should have actually been weaker than what we have observed. Additionally, labor's share of income, which is the share of the economy's output that accrues to workers in the form of wages, had been

declining since the early 2000s but recently that decline has flattened and even reversed, another indication that wage growth may be strengthening further.

Of course, these measures tell us about the state of the aggregate labor market on a national level, which may mask differing labor conditions across industries, occupations, and geographic areas. Different parts of the economy can experience different labor supply and demand conditions, and the relative sizes of these parts of the economy may change over time. In this regard, looking at more granular data can be informative. On an aggregate level, strong wage growth in some areas may be offset by weak growth elsewhere.

Indeed, there has recently been some evidence suggesting that wages are growing faster in those metropolitan statistical areas with the lowest rates of unemployment. In the Fifth District, evidence on wage growth has been mixed. Like the other Reserve Banks, the Richmond Fed surveys employers in manufacturing and the service sector every month about business conditions in the Fifth District, including their sales, prices, and wages. Our wage indices for the manufacturing and services surveys, which measure the difference between the share of employers reporting that they increased in wages over the last month and those reporting a decrease, have risen only slightly since 2015.

At the same time, we've heard from some employers across our district that they are having difficulty finding qualified workers and have increased wages. The fact that many employers have expressed difficulty finding workers with the right skills may suggest that some labor market tightness is due to structural factors rather than broad-based recovery. To the extent this is true, workers without the right investments in human capital may not benefit from increasing wages.

From the perspective of monetary policy, the Fed's goal is to achieve maximum employment with stable prices. Both quantitative and qualitative measures suggest that labor markets are tightening. While nominal wage growth has been sluggish, real wage growth seems in line with, or even better than, what we've observed in some previous expansions. A substantial strengthening of wage growth without a corresponding growth in productivity could contribute to an acceleration of inflation. Accordingly, the Fed's monetary policymakers will continue to track both aggregate and regional measures of the labor market to inform their policy decisions. **EF**

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