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THE FED'S PHANTOM MENACE

FALSE FEARS ABOUT WAGE GROWTH THREATEN TO SLOW EXPANSION

by Jared Bernstein

Federal Reserve Chairman Alan Greenspan has all but assured the public that an increase in the Fed's targeted interest rate is forthcoming. His most commonly cited rationale for the rate increase is that the labor market is just about stretched to its limit—unless economic growth slows, the Fed fears that increasing wages will set off an inflationary spiral.

There are, however, two reasons why the Fed does not need to act preemptively to slow the current economy. First, as for fears of wage-driven inflation, increases in productivity have been sufficient to pay for recent wage gains. Around 1996, the labor market moved onto what has proven to be a sustainable path of noninflationary wage growth (which was due in part to the Fed's *lowering* of interest rates). Since that time, low- and middle-wage workers have benefited from sustained real wage growth for the first time in over two decades. None of the evidence indicates that this wage growth is threatening to accelerate to a point that would spark inflation.

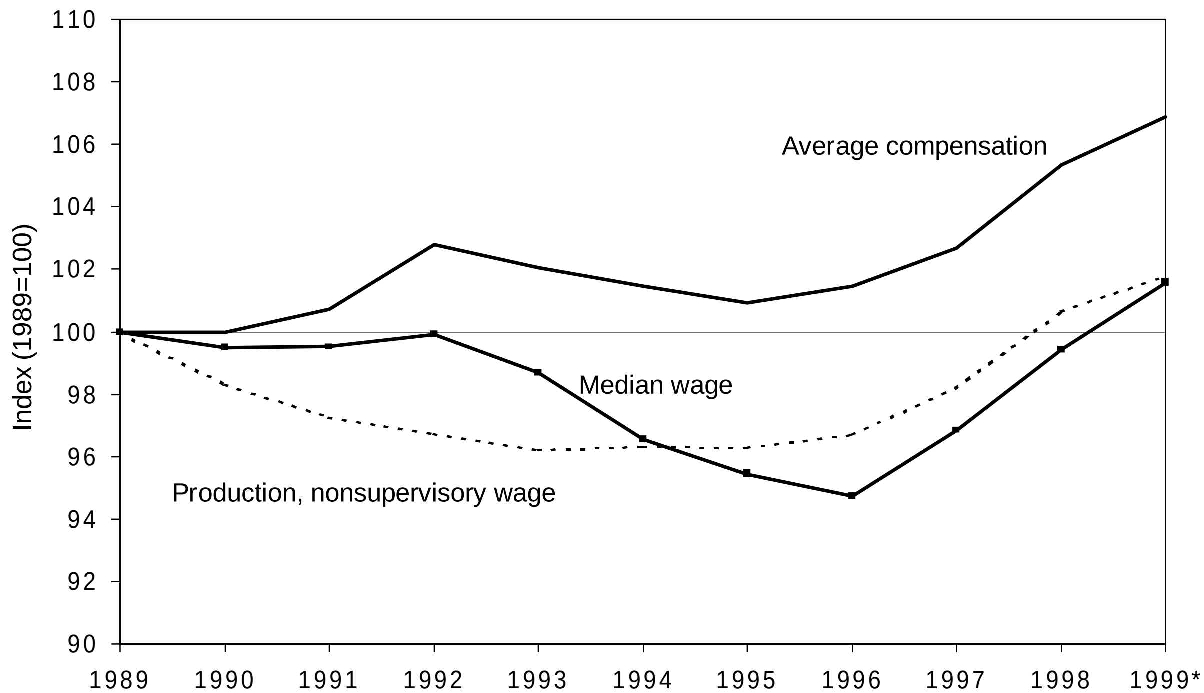
Second, even if inflation were to accelerate, the Fed has the ability to step in and slow down the economy at any point. There is no reason to do so prematurely, especially when there is much to be gained by allowing the recovery to proceed apace.

Wage growth in the 1990s

Figure 1, which charts wage and compensation growth (adjusted for inflation and indexed to 1989), shows that the median wage actually fell over much of the recovery, only regaining its 1989 peak level in 1999. Thus, despite eight years of solid overall economic growth, the typical worker is back only to where he or she started at the peak of the last business cycle.

More troublesome to the Fed, however, is the obvious acceleration in real wages that began in 1996, when unemployment dropped below 5.5% and continued falling. The acceleration of wage growth, in tandem with this

FIGURE 1: Real wage and compensation growth, 1989-99



* Average compensation and median wages are for 1999 (1st qtr.). Production, nonsupervisory wage is the average of the first five months of 1999.

Source: Bureau of Labor Statistics; median wage is from EPI analysis of CPS data.

labor market tightening, is behind the Fed's plans to raise rates. Its fear, frequently expressed by Chairman Greenspan, is that, as the supply of labor is exhausted, workers will push for ever greater wage hikes, with employers passing these increases in their labor costs forward to consumers, generating price inflation.[1]

However, as shown in **Figure 2**, nominal wage growth, at least among the 80% of the workforce in production or nonsupervisory occupations, appears to have decelerated in recent months. If the scenario described above was accurate, then nominal wage growth would be accelerating.[2]

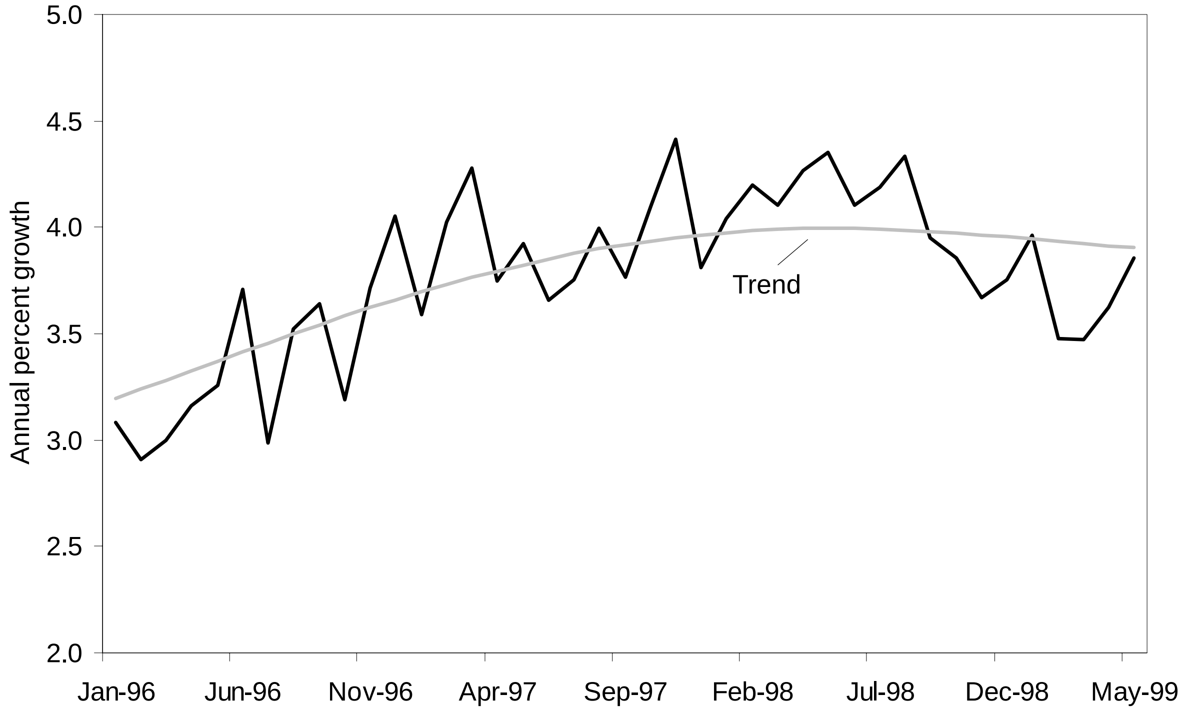
Productivity gains

One of the most salutary aspects of the current economy is the strong rate of productivity growth. This key indicator—output divided by hours—measures the efficiency with which the labor force is converting inputs into outputs. Productivity has been rising about one percent above the expected trend since 1996,[3] which means that the economic pie has been expanding faster, allowing for larger real wage increases without price pressures.

The key question is whether compensation has been outpacing productivity growth. To answer this question, economists turn to unit labor costs (ULCs), which compare the growth of nominal compensation to productivity. If ULCs are accelerating, the implication is that compensation is rising more rapidly than productivity, and this can be taken as a harbinger of incipient price pressures.

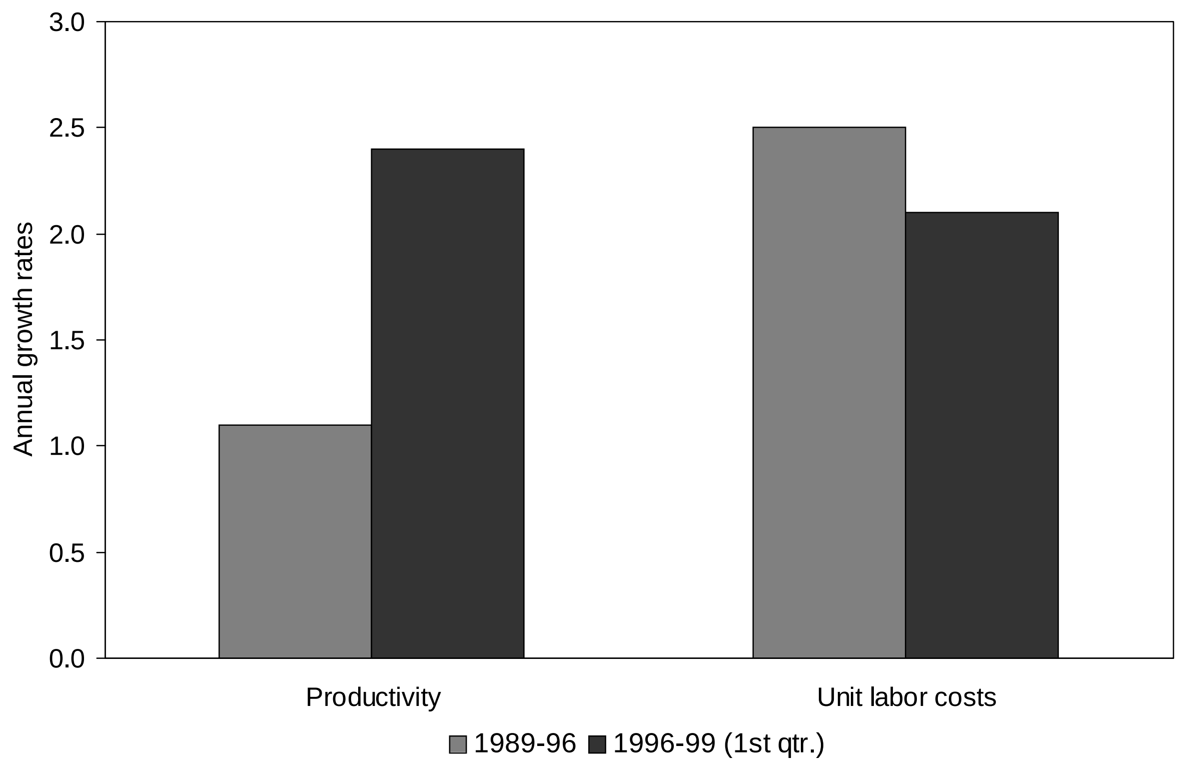
Figure 3 shows that this is not the case. As the first set of bars shows, productivity growth has clearly

FIGURE 2: Annual wage growth, production, nonsupervisory workers, Jan 1996 - May 1999



Source: Bureau of Labor Statistics. Trend added.

FIGURE 3: Productivity and unit labor costs, 1989-99 (1st qtr.)



Source: Bureau of Labor Statistics. Data are for nonfarm business sector.

accelerated in the post-1996 period. The second set of bars shows that ULC growth has decelerated since 1996.

Finally, most economists predict that productivity growth will remain strong. Robust productivity growth in the current quarter is virtually assured, as aggregate hours worked have slowed significantly in the first two months of the second quarter, while output shows no signs of lagging.

Other sources of noninflationary wage growth

Two other recent developments have helped keep inflation at bay. First, wage growth has been redistributive within labor's share of national income; that is, in recent quarters, wages at the bottom of the wage scale have grown faster than those at the top. Besides being noninflationary (since it does not lead to accelerating *average* wage growth), this pattern also helps to ameliorate the significant problem of wage inequality.

Second, between 1993 and 1996 there was a historically large shift in national income from labor's share (including wage and nonwage compensation) to capital's share (including interest, dividends, and rents).[4] As **Figure 4** shows, after falling steeply through much of the recovery, labor's share of national income flattened and has since increased only slightly since 1997. But even so, labor's share remains 2.5 percentage points below its 1989 peak as of last quarter. This implies that noninflationary wage growth could be financed by a shift in national income from capital to labor.

No need for a preemptive strike

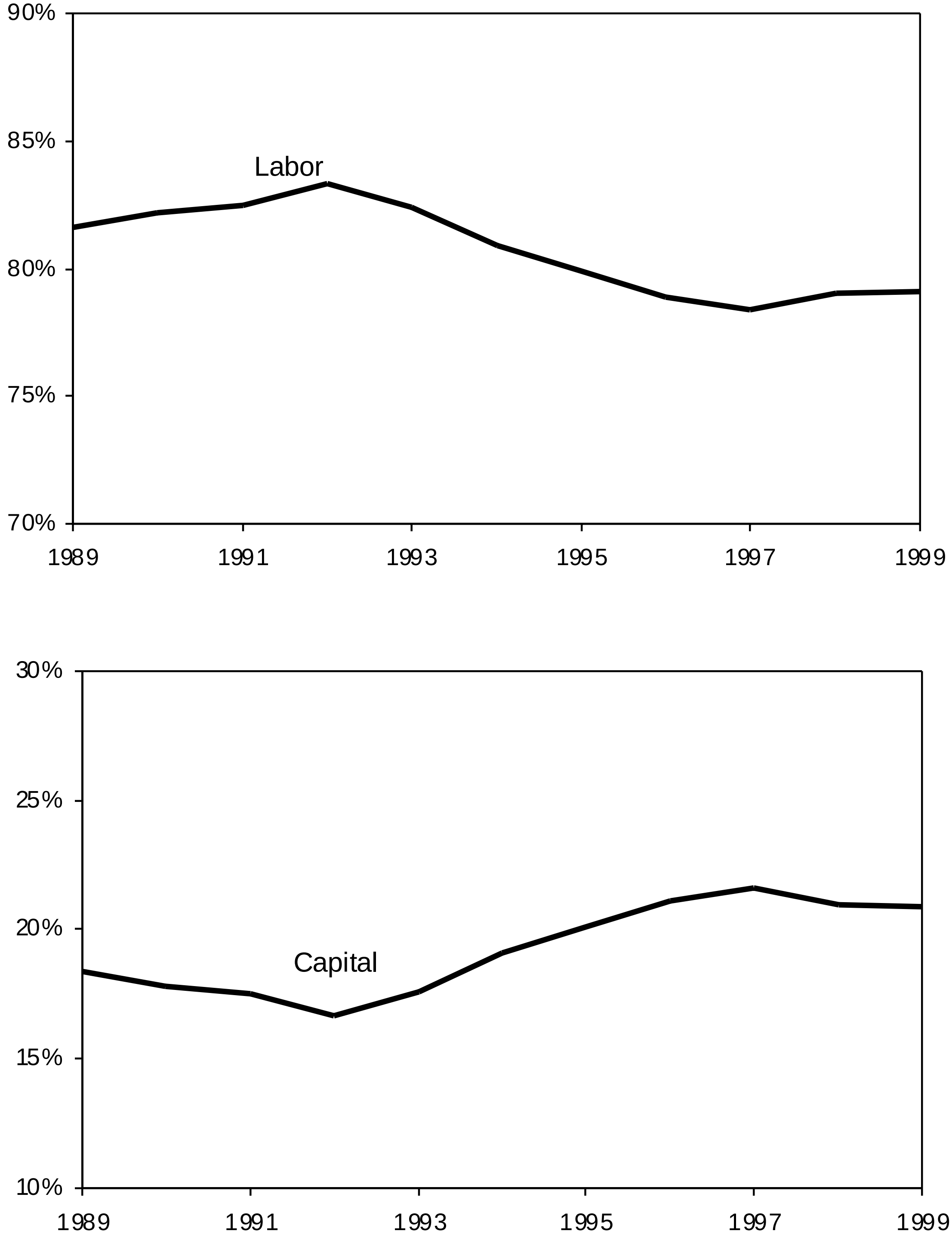
The evidence presented above suggests that current labor market conditions appear to be consistent with stable prices, and inflation has been extremely tame in recent months. But with close to full employment and growth throughout the wage scale, wage-push inflation is a future possibility.

In the near term, though, an upward shift in the price level is unlikely. First, productivity growth would have to slow, which appears unlikely. Also, recent corporate reports show that firms have been expanding their profit margins in the last few quarters, which adds another buffer. In today's competitive product market, before passing wage increases on to consumers, firms are more likely to tap their profits.

So if faster inflation is not a near-term threat, why does the Fed need to act *prior* to evidence of faster price growth? In earlier periods, Fed officials believed that interest rate policy operated at a lag—rate hikes put in place today would not be operative until many months hence. Thus, in order to slow anticipated price pressures, the Fed believed it had to strike preemptively. But recent evidence suggests this is no longer the case. Statements by the Fed are scrutinized daily, and their recent rate hikes were absorbed almost instantaneously by the financial markets and only slightly less quickly by the housing market. If prices were to begin to grow more quickly (and there is no obvious reason why the economy could not grow prosperously with inflation slightly ahead of its current rate), it is well within the Fed's power to slow the economy at that point and avoid accelerating price growth.

Until that time, though, the benefits of sustained full employment—growing labor market opportunities, flush public coffers, and falling crime rates—are too precious and have been too long-awaited to be unnecessarily sacrificed.

FIGURE 4: Income shares in the corporate sector, 1989-99 (1st qtr.)



Source: Bureau of Economic Analysis.

Endnotes

1. Beyond this, the theory behind the Fed's action is that, once prices increase, workers' inflation-adjusted wage rates will stumble. They will then push for even higher nominal wages, thus starting an inflationary spiral.

2. The growth pattern in Figure 2 raises the question of why wage growth slowed, even as the labor market has hovered near full employment. One potential explanation is that employers' wage offers finally caught up with the lower levels of inflation that have prevailed since the mid-1990s. Evidence for this claim is that prior to 1998, real wage growth was mostly driven by nominal wage acceleration; since 1998, real wage growth has been driven more by price deceleration than by nominal wage acceleration.

3. As Baker (1999) has pointed out, as much as half of this acceleration in productivity growth is a function of measurement changes; consistently measured, productivity growth is probably about one-half point above trend.

4. Capital shares in these data do not include either realized or unrealized capital gains; thus, they do not reflect the large increase in the value of stock prices over this period.

References

Baker, Dean. 1999. *What's new in the 1990s*. Washington, D.C.: Preamble Center.

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