ECONOMIC RESEARCH

Working Paper 193

November 10, 2015

MACROECONOMICS | FINANCIAL MARKETS | ECONOMIC POLICY | SECTORS

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USA: Unemployment to drop further without accelerated wage growth?

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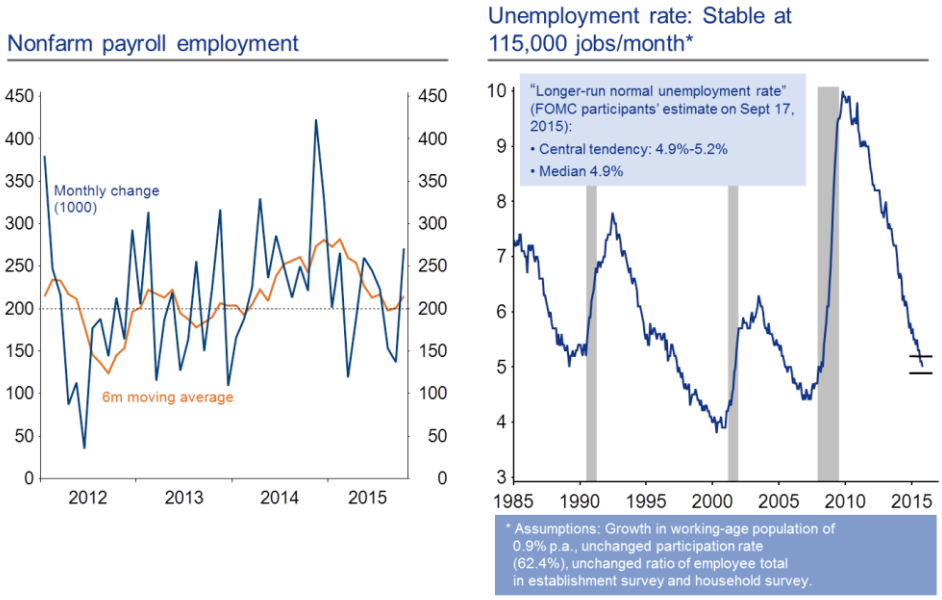
USA: Unemployment to drop further without accelerated wage growth?

The core inflation rate of the price index for personal consumption expenditures remained subdued in the third quarter of this year at 1.3%. Developments on the labor market are of major significance for the inflation process as the unemployment gap is viewed as a key indicator of home-grown inflationary pressure. The main reasons behind the absence of a pickup in wage growth to date are seen in the peculiarities of the US wage mechanism and the fact that the "standard" jobless rate figure might understate the actual amount of slack in the labor market. Meanwhile, however, the US economy is increasingly heading for full employment. The indications in the October jobs report that wage growth is firming up should be confirmed unambiguously in the coming quarters. However, with productivity growth to date still very moderate, the scale of the wage increases is likely to be limited. The solid labor market data bolster our expectation that the Fed will start raising key rates in December. The pace of monetary policy normalization is likely to be measured, particularly if the external backdrop remains difficult.

Unemployment set to fall further

Having peaked at close to 10% at the end of 2009, the US unemployment rate has since been falling more or less steadily. In recent months it had already reached territory deemed by the Fed to be the longer-run normal level (4.9%-5.2%). Following the rebound in job growth in October, the unemployment rate slipped to 5%. With the economic recovery set to continue, it is highly likely to fall well below the 5% mark in the coming months.



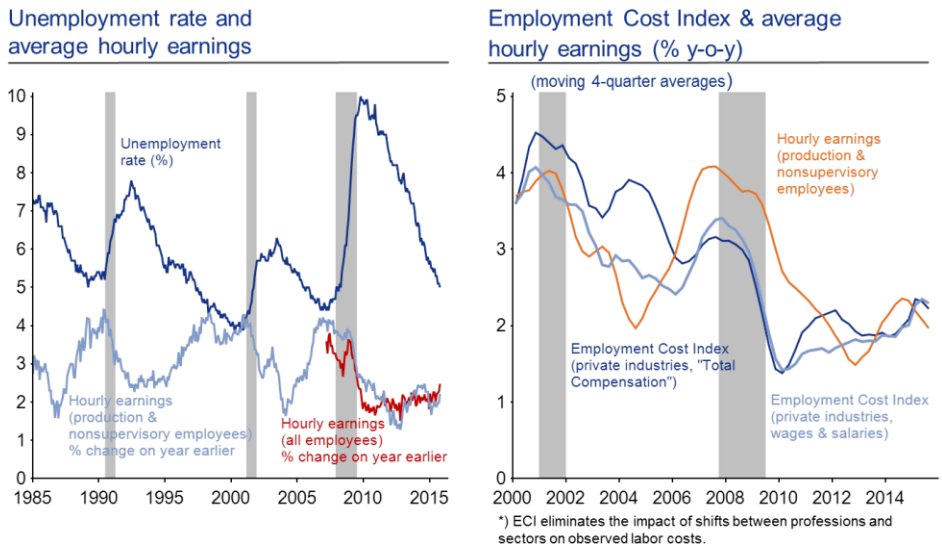
Sources: EcoWin, own calculations.

Given the average figures observed in recent months on the increase in the working-age population and the current labor force participation rate, monthly jobs growth of 115,000 would suffice to keep the unemployment rate stable over the next twelve months.

Pent-up wage deflation

Although the unemployment rate has fallen to a level that would normally start exerting upward pressure on wages, there is little evidence of this so far. Rather, for some time now the rate of increase shown by the standard measures of wage growth has been hovering around the 2% level. The low responsiveness of wage growth against the backdrop of an improving labor market is one of the unusual developments of recent years and is therefore naturally a focus of the monetary policy debate.

Inelastic wage growth to date



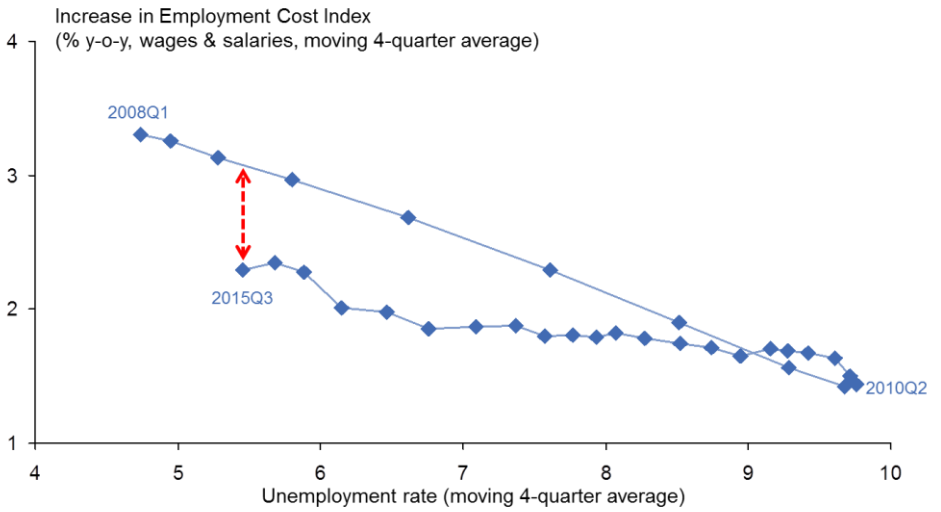
Source: EcoWin.

Among other things, the inelasticity of wages seen in the recent past is attributed to pent-up wage deflation which can alter the usually negative correlation between wage growth and the unemployment rate. The main reason for this is downward nominal wage rigidity. This can arise if companies have to fear that employee morale, and thus productivity, would be undermined if they cut wages. As employers are keen to swiftly adjust costs to declining sales in a recession, downward nominal wage rigidity means that the adjustment in labor compensation is achieved largely via lay-offs, pushing up unemployment. In the recovery phase the downward pressure on wages eases, but the pent-up need for correction lingers. Accordingly, businesses put off wage increases until economic conditions bring wages back closer to the level warranted. As a result, wage growth remains subdued for a while even as the labor market recovers.

The chart below highlights the role wage rigidities might have played. It shows the connection between unemployment and wage inflation (measured by the employment cost index) since the beginning of 2008. During the recession the increase in the unemployment rate by a good 5 percentage points was accompanied by a slowdown in wage growth by around 2 percentage points. In the recovery to date wage growth has not increased as much as it declined during the downturn. Wage inflation is currently around 0.7 percentage points lower than was the case given a comparable unemployment rate during the downturn phase. The wage Phillips curve has flattened.

Wage Phillips Curve

2008 Q1 – 2015 Q3

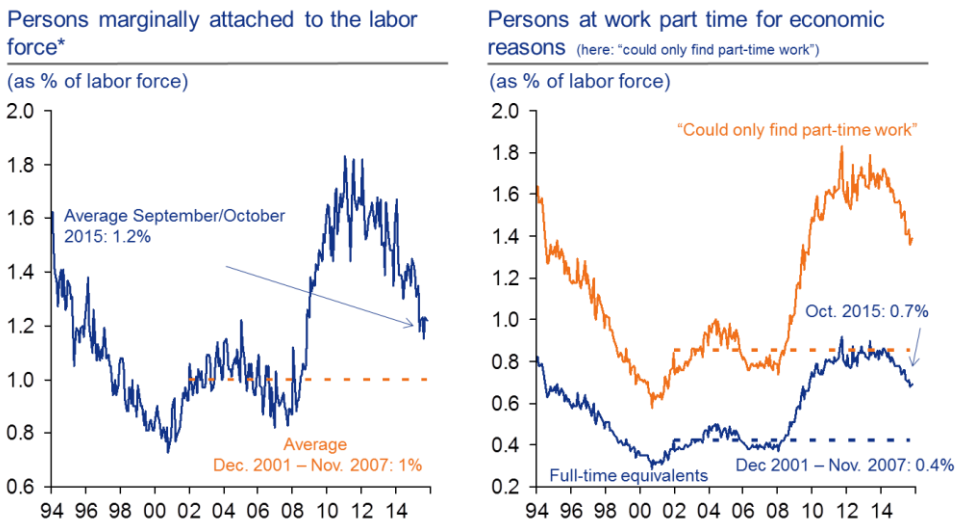


Sources: EcoWin, own calculations.

If pent-up wage deflation is significant, this calls for caution on the monetary policy front. Clear signs of inflationary pressure might emerge later than usual as the economy heads towards maximum employment. But wages could quickly gather momentum once the wage deflation built up in the recession is absorbed. It would be inappropriate to maintain generous monetary policy accommodation until inflationary pressure emerges.

Unemployment versus underemployment /Underutilization of labor resources

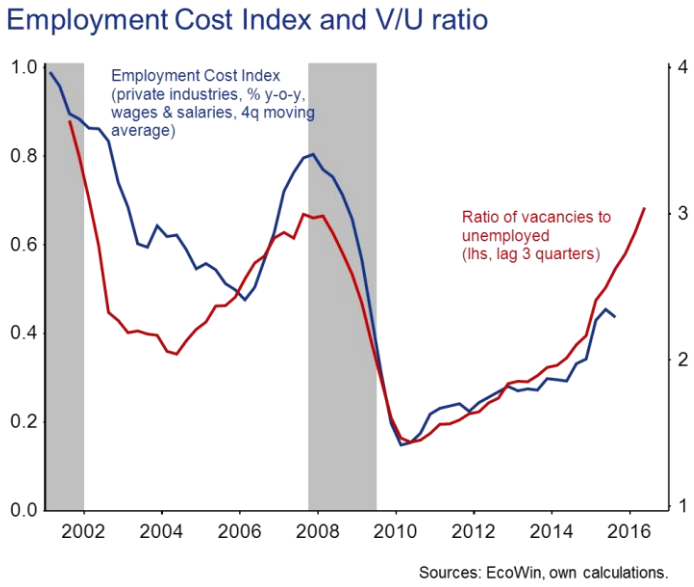
A further explanation for low wage growth draws on the measurement of joblessness. In speeches by central bank governors as well as in FOMC statements reference is made to the underutilization of labor resources in addition to developments in unemployment. This reflects the view that the unemployment rate understates the residual scale of underemployment. A look at broader-based underemployment measures renders the persistence of low wage growth more plausible. To this end we can compare the more broadly defined U6 unemployment rate with the traditionally monitored U3 unemployment rate. In addition to those classified as unemployed, the U6 unemployment rate includes all marginally attached workers plus those employed part time for economic reasons. The difference between the two rates is still above the long-term pre-crisis average. Looking at part-time work, it is not questioned that this could move up due to structural factors. However, the steep increase during the recession and the subsequent slow decline suggest that cyclical aspects also play a significant role. To get a rough indication of the residual "underemployment gap", for the respective categories we take the average for the preceding upturn (December 2001-November 2007) as the reference value. In addition, we confine our observation of those employed part time for economic reasons to those who state that they could only find part-time work. While heading downwards, these forms of underemployment contributed only 0.5 percentage points to the overall gap of late.



*"Marginally attached to the labor force". Belong to the non-working population. Includes discouraged workers. Broadly: People who want a job, have looked for work in the past twelve months and in the reference week were available for work but had not looked for work in the past 4 weeks. .

Sources: Bureau of Labor Statistics, own calculations..

Federal Reserve President Yellen recently suggested that in order to get, for instance, discouraged workers back into the workforce and reduce (involuntary) part-time work it might require a period of especially plentiful job opportunities in which the unemployment rate drops below the level gauged as normal in empirical studies. But the US economy has probably already reached this stage since, if the average job growth seen over the past three months (187,000) is maintained, the unemployment rate will fall to 4½% over the coming twelve months under the assumptions outlined above.



Sources: EcoWin, own calculations.

An alternative measure of labor market tightness is the ratio of vacancies (V) to unemployed (U). This has now reached the highs seen in the previous cycle. Assuming that businesses really intend to fill the vacancies advertised, it could become increasingly difficult to attract new workers without wage hikes. If the correlation of this indicator with the change in the Employment Cost Index observed in the past is confirmed, wage inflation is likely to pick up noticeably in the course of next year.

Productivity

However, with productivity growth still very moderate to date, the scale of the wage increases is likely to be limited. As a rule, wage growth follows trend growth in labor productivity with a time lag. In annual average terms, growth in real output per hour worked in the non-farm business sector during the recession was not negative. But this was largely due to the sharp adjustment in employment. At the end of the recession and in the first two quarters of the recovery, i.e. from the second to the fourth quarter 2009, we actually saw annualized increase rates averaging around 6% before the return to jobs growth led to more moderate, but still solid rates of close to 2%. 2009 and 2010 both saw average productivity growth of 3¼%. Since then productivity has increased by an average of just 0.5% a year. On balance, the average annual increase since end-2007 has been only 1.2%. On a positive note for the outlook for productivity growth, real private spending on research and development has risen appreciably in recent quarters. In the first three quarters of this year it was up by a good 7% on a year earlier, thus far outstripping GDP growth (2.5%).

These assessments are, as always, subject to the disclaimer provided below.