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National Economic Trends

Inflation and Labor Cost

In discussing inflation trends in the U.S. economy, many analysts study growth in compensation paid to workers. The usual thinking is that a faster rate of increase in wages (plus benefits) might be a harbinger of higher inflation in the not-too-distant future. Thus, markets often interpret reports of faster wage growth as bearish inflation news. Is such an interpretation reasonable? What does wage growth tell us about inflation prospects?

The chart shows an employee compensation measure—the employment cost index for private industry workers—measured as a percentage change from one year earlier. The consumer price index inflation rate is also shown in the chart. These two series do tend to move together over long periods of time, and this probably helps explain why analysts watch wages closely when thinking about inflation prospects. However, there does not appear to be any clear indication that changes in the pace of growth of the employment cost index precede or help predict subsequent changes in the rate of inflation. Thus, the typical market interpretation of employee compensation news should be viewed with caution. This impression from the chart—that wage data do little to help predict future inflation—is borne out in some recent econometric analysis.[1]

It may strike the reader as a compelling idea that increases in wages should signal changes in future inflation. But there are at least two reasons to doubt this story. One is productivity growth. Standard economic theories suggest that real wages are determined largely by productivity, so that increases in productivity alone should lead to increases in compensation for employees. Even if we lived in a zero inflation world, we would still expect compensation to increase in line with productivity growth over long periods of time. In addition, the pace of productivity growth is uneven, sometimes increasing more rapidly and other times slowly. In the chart, the rate of increase in the employment cost index is therefore mixing variable productivity increases with increases due solely to inflation.

A second reason for doubt is the question of causality. Is wage growth driving inflation, or is inflation driving the nonproductivity portion of wage gains? One might suspect the latter. Compensation is often set with a view to future inflation prospects, so that wages reflect an expected inflation component, or with cost-of-living allowances, which ties changes to past inflation rates. We might then expect compensation to increase more rapidly because of a recent or expected future increase in inflation. Thus, inflation or expected inflation would be the cause of wage growth—not the other way around.

–James Bullard

[1] For more details see K. Emery and C-P Chang, “Do Wages Help Predict Inflation?” Federal Reserve Bank of Dallas *Economic Review*, First Quarter 1996.

CPI Inflation and Labor Cost