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Economic Indicator — January 31, 2023

Q4 ECI: Further Good News for Inflation's Descent

Summary

Add the Employment Cost Index to the list of inflation readings over which he Fed is breathing a little easier. The ECI slowed for a third consecutive quarter, rising 1.0% in Q4. Still, employment costs are rising at a 4.0% annualized pace in what remains a tight labor market. While this report further supports inflation moving back toward 2%, labor cost growth remains too strong to be consistent with it staying there for the long-haul. We think more slowing will be needed before the FOMC feels comfortable declaring victory on inflation.

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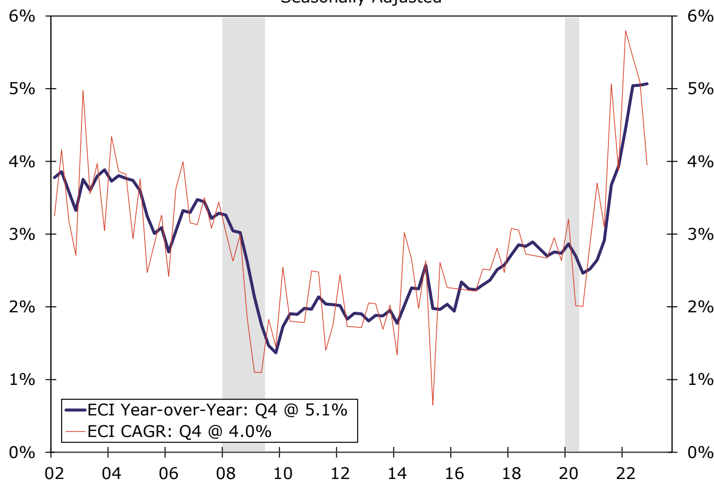
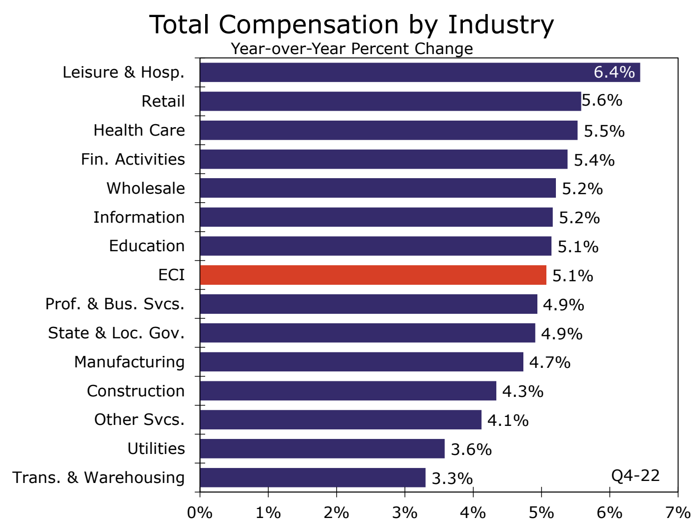


Source: U.S. Department of Labor and Wells Fargo Economics

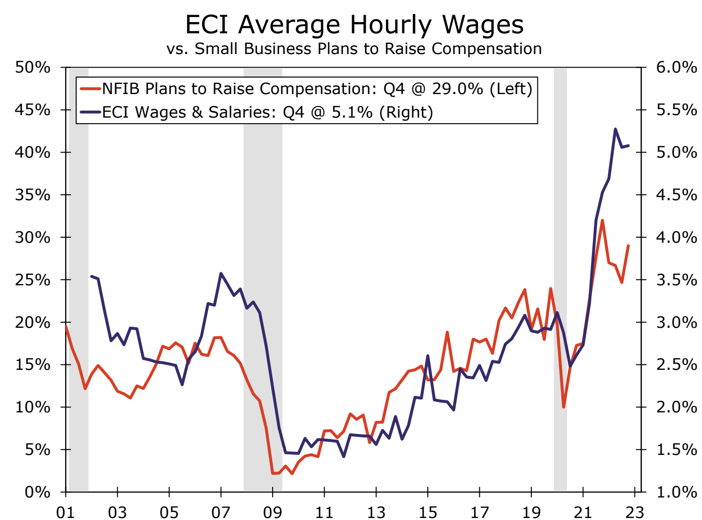
Gradual Cooling in Labor Cost Growth Continues

Inflation pressures emanating from the labor market are cooling. The Employment Cost Index, the broadest measure of labor costs, rose 1.0% (not annualized) over the fourth quarter. The increase was a bit softer than the consensus expectation of 1.1% and marks the third straight quarter in which total employment cost growth slowed. Although up 5.1% on a year-over-year basis, the quarter's gain translates to a more modest annualized pace of 4.0% (chart). The softening is consistent with other recent wage data, such as average hourly earnings and the median rate of wage growth, that labor cost growth has likely peaked and a dreaded wage-price spiral has been avoided.

Employment costs for private sector workers and state and local government employees both increased by 1.0% in Q4. By sector, leisure and hospitality wage growth cooled, from 1.8% in Q3 to 0.9% in Q4, though over the 12 months ending in December the increase was a sizable 6.4% (chart). Labor cost pressures remained firm in the health care and social assistance sector (+1.3%), and the information sector also showed few signs of decelerating wages despite the ongoing challenges in the technology industry (+1.3%). Compensation growth was flat at 0.9% for the cyclically-sensitive goods-producing categories of manufacturing and construction.



Source: U.S. Department of Labor and Wells Fargo Economics



Source: U.S. Department of Labor, NFIB and Wells Fargo Economics

The ECI is a more comprehensive and less noisy measure of labor cost growth than many other closely followed wage indicators, such as the average hourly earnings data in the monthly employment report. Not only does the ECI include benefits, which account on average for a little over 30% of employment costs, but it also includes public sector employees. Unlike average hourly earnings, the ECI controls for compositional shifts in the labor market.

Thus, the ECI report offers the FOMC one of its cleanest looks at how a tight labor market is translating into elevated wage pressures. Before the pandemic, employment cost growth was running at just shy of a 3% pace alongside core PCE inflation that was similarly just below 2%. The 5.1% increase in the ECI over the past year and 4.0% annualized increase in Q4 suggest that labor costs are still growing about a percentage point above what would be consistent with the FOMC's 2% inflation target given trend-like productivity growth. Even as supply chain pressures ease, commodity prices cool and housing costs temper, we think the FOMC still wants to see a bit more slowing in wage growth before the Committee feels confident inflation is firmly headed to 2% over the medium term.

Looking ahead, we see scope for that further slowing. The "Great Resignation" is past its zenith, with the quit rate trending lower over the course of last year. With retention less of an issue and clouds gathering over the outlook, plans to increase compensation have come off their record highs (chart).

But when it comes to inflation, easing labor cost growth should not be conflated with benign labor cost growth. The labor market remains incredibly tight. Plenty of household-name companies have announced layoffs over the past few months, but initial jobless claims continue to hover near record lows, and more independent businesses report having a hard time to filling jobs than at any point before COVID. Therefore, while the deceleration in labor costs is a welcome development from the

Fed's perspective and further sign that inflation is headed back *toward* 2%, it is too soon to declare that it will *stay* there for the long-haul.

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