Economic Indicator — July 31, 2025

ECI: Firmer Q2, but Labor Costs Continue to Ease on Trend

Summary

Employment cost growth rose 0.9% in the second quarter and 3.6% over the past year. Costs for wages & salaries rose 1.0% over the quarter with broad-based strength, but the rise was not enough to buck the slower trend over the past year. Overall compensation growth is more or less consistent with the Fed's inflation goal once accounting for the recent trend in labor productivity, keeping us of the view that the labor market is not a source of significant inflationary pressure at present.

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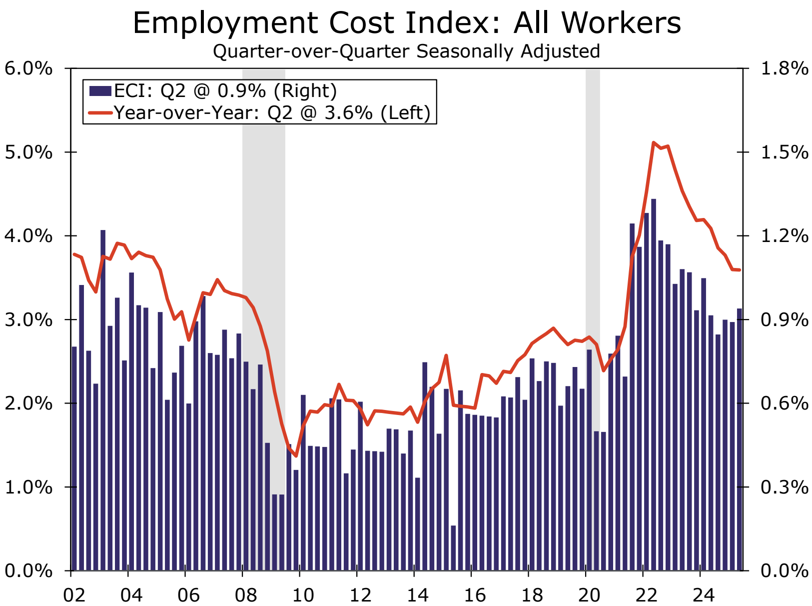


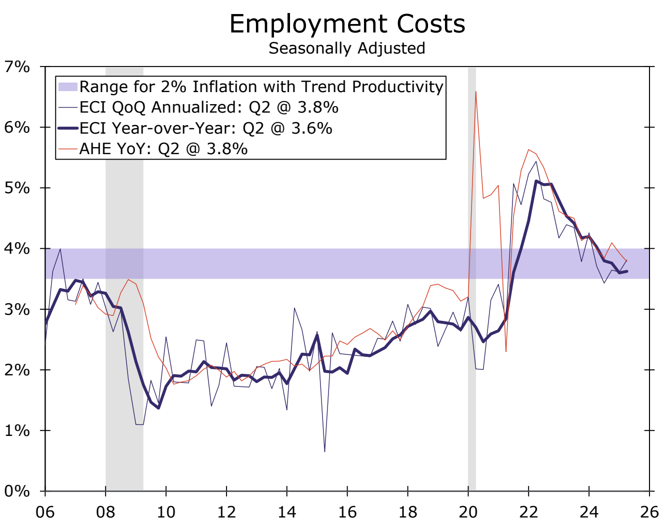
Source: U.S. Department of Labor and Wells Fargo Economics

Solid Wage & Salary Gains in Q2

Labor cost growth picked up slightly in the second quarter. The Employment Cost Index rose 0.9% in the three months through June. The slight strengthening over Q2 contrasts with the more timely data on average hourly earnings growth, which decelerated during the quarter after having strengthened early in Q1.

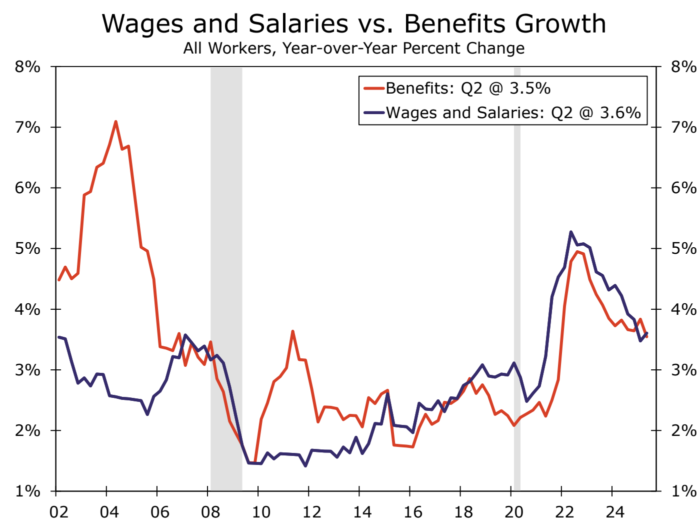
The Employment Cost Index is generally considered a better barometer of labor cost growth. Unlike average hourly earnings, it controls for compositional shifts in employment, while also capturing benefit costs and public sector compensation trends. But both series suggest that the cooler picture of labor costs remains intact as the jobs market is no longer overheated, and that the labor market is not a meaningful constraint on the Fed's efforts to return inflation to its 2.0% target. Over the past year, employment costs and average hourly earning are up 3.6% and 3.8%, respectively, roughly on par with the nominal pace needed to hit the Fed's inflation target once accounting for growth in labor productivity (Figure 1).

Figure 1



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

Figure 2

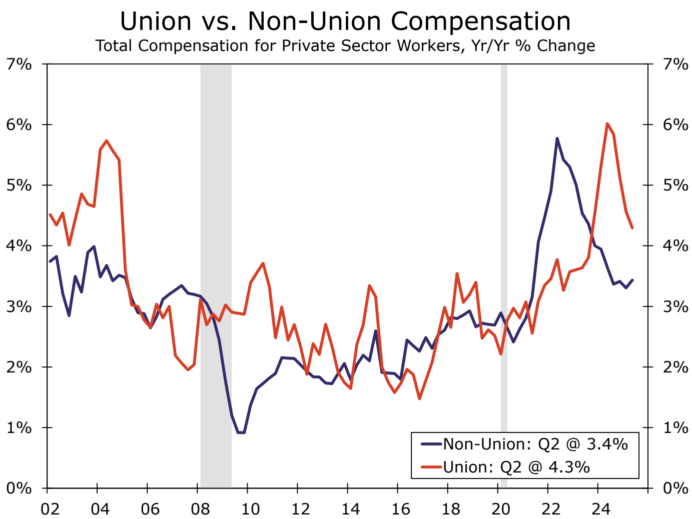


Source: U.S. Department of Labor and Wells Fargo Economics

Wages and salaries rose a solid 1.0% over the quarter, lifting the year-over-year rate up a tenth to 3.6% (Figure 2). While solid gains among incentive paid-occupations helped bolster the second quarter's outturn, strength was widespread. Meantime, benefit costs rose 0.7%, a notable moderation from the first quarter's increase of 1.2%. The increase in benefit costs over the past year (3.5%) is roughly in line with wages & salaries, suggesting some of the solid growth in total compensation is tied to sources other than disposable income.

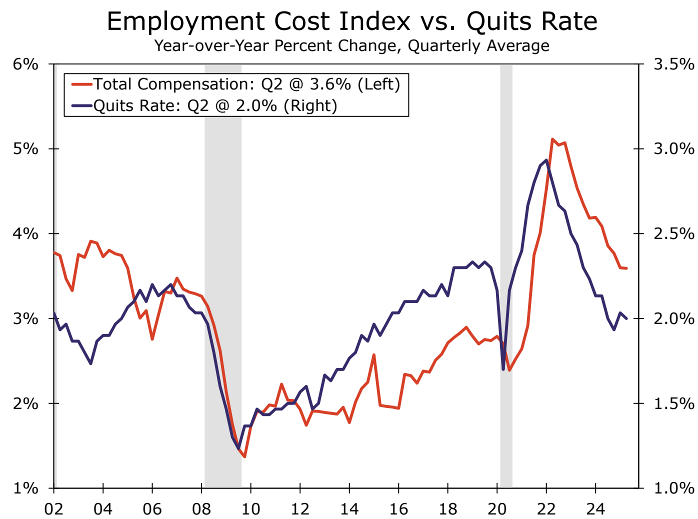
Despite widespread strength in Q2, the overall trend in private-sector wage growth continues to be flattered by recent pay gains among unionized workers (Figure 3). Similarly, pay growth has been firmer within the public sector, with wages & salaries among state & local workers up 3.9% over the past year. Government employees have higher union representation than private sector and are likely seeing stronger wage growth today due to the lag that typically comes with union wage contract negotiations.

Figure 3



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

Figure 4



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

As the tailwinds from excess liquidity built up during the pandemic have largely run their course, income growth has become the primary determinant of consumption growth. Coupled with higher inflation, the slower trend in employment and wages & salaries growth ushers in a constraint consumer purchasing power and is making it difficult for businesses to fully pass on the cost of tariffs. We expect labor costs growth to moderate slightly further over the second half of the year as tepid interest in hiring and low turnover limits upward pressure on compensation cost growth (Figure 4). In short, we remain of the view that the labor market is not a source of significant inflationary pressure at present.

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