Economics

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Economic Indicator — January 31, 2025

Slower Labor Cost Growth Continues to Help the Inflation Fight

Summary

The fourth quarter Employment Cost Index (ECI) gave another indication that the labor market is no longer a major threat to the Fed achieving its 2% inflation goal. The ECI advanced 0.9% in the fourth quarter, boosted in part by further solid increases in private union and public sector pay. Yet the ECI slowed to 3.8% year-over-year, which is near the realm consistent with the Fed's 2% inflation target once accounting for the stronger pace of productivity this cycle.

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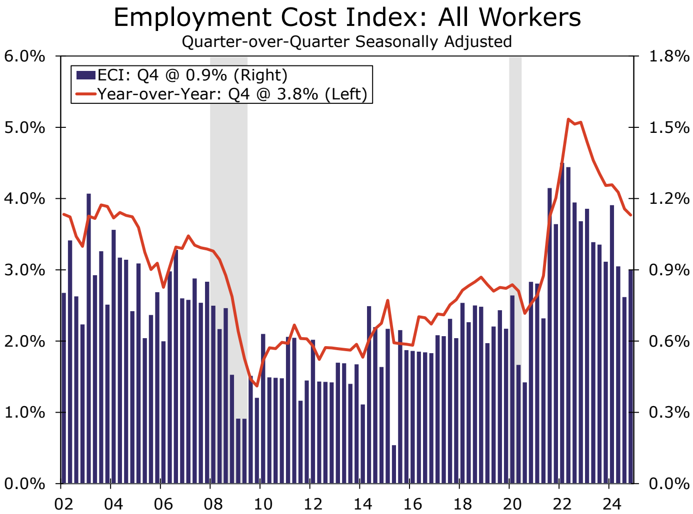
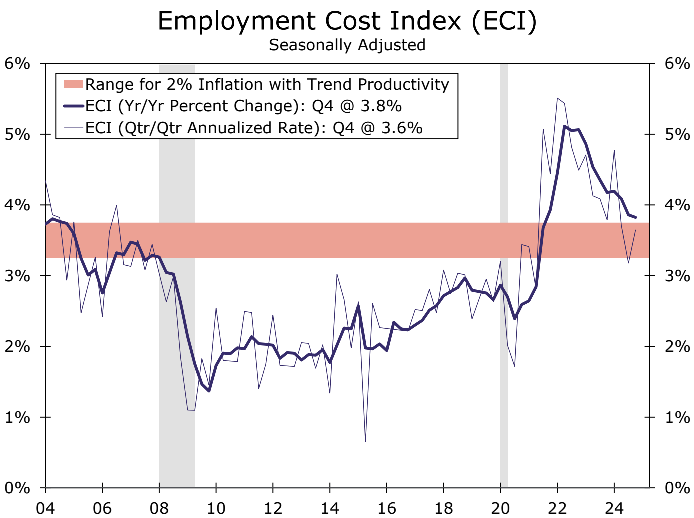


Source: U.S. Department of Labor and Wells Fargo Economics

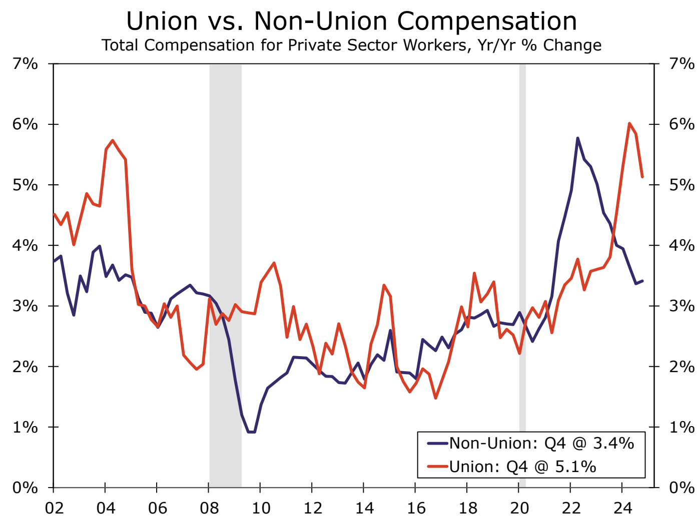
Compensation Costs Continue to Ease

The fourth quarter reading on the employment cost index (ECI) offered further evidence that the cooler jobs market is reducing upward pressure on inflation. Employment costs rose 0.9% in the fourth quarter, in line with expectations. Over the past year, compensation costs have risen 3.8% (chart). While that remains notably stronger than the past cycle's peak of 3.0%, it has neared the realm consistent with the Fed's 2% inflation target once accounting for the stronger pace of productivity this cycle (productivity growth allows businesses to raise compensation faster than selling prices).

The continued moderation in the ECI, the Fed's preferred barometer of compensation cost growth, looks a little friendlier for the Fed's inflation fight than the most recent readings of average hourly earnings (AHE) from the monthly Employment Situation report. Annual growth in hourly earnings averaged 4.0% in the fourth quarter, up two tenths from the prior quarter. Unlike the more volatile AHE figures, however, the ECI controls for compositional shifts in the employment base along industry and occupational lines. It also includes state and local government workers as well as benefits (about 30% of compensation), making it a more encompassing measure of labor costs.



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

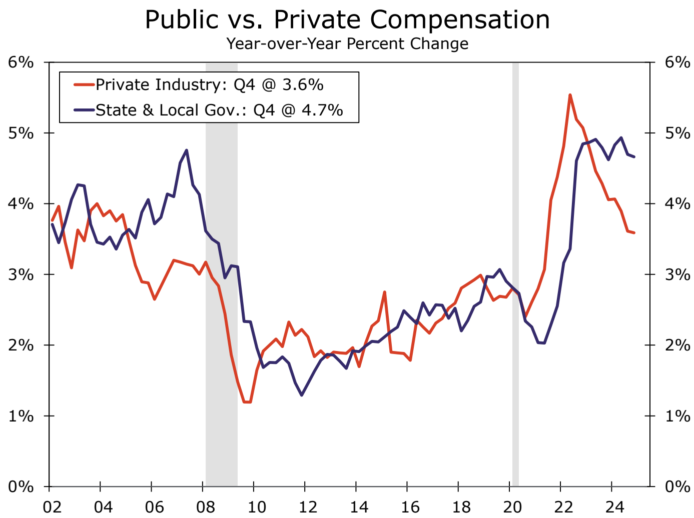


Source: U.S. Department of Labor and Wells Fargo Economics

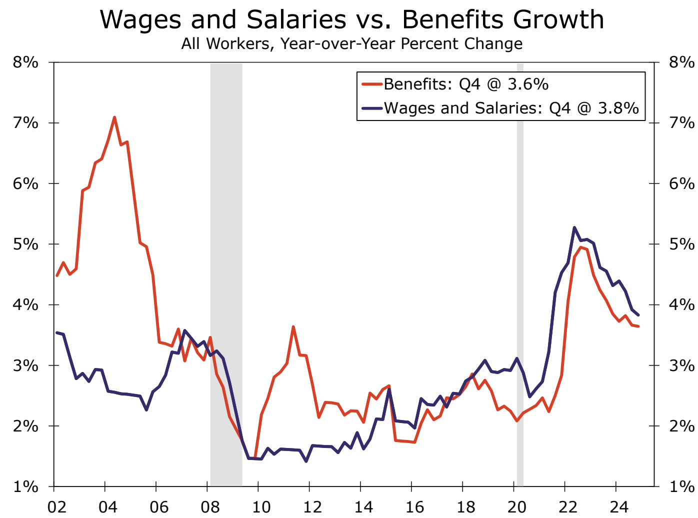
Some lingering strength in the employment cost index appears due to compensation growth among unions catching up to the rapid pace of growth experienced by more flexible corners of the labor market since the pandemic (chart). Total compensation in the aircraft manufacturing industry jumped 2.6% in the fourth quarter, reflective of the new IAM union contract covering over 30,000 workers at Boeing. Over the past year, compensation for private-sector union workers has risen 5.1% compared to 3.4% among non-union workers.

Similar dynamics are playing out in public versus private sector labor costs. Over the past year, total compensation among state and local government workers has outpaced that of private workers (chart). Labor costs among government workers tends to lag their private-sector counterparts due, in part, to higher union representation that requires time for wage and benefit contract renegotiation.

Wages & salaries among all workers increased 0.9% over the quarter, allowing the year-ago rate to ease a tenth to 3.8%. The cooling in the ECI's measure of wage growth stands at odds with the modest tick up in AHE but comes amid ongoing slowing in the Atlanta Fed's Wage Growth Tracker, which is sitting at its lowest annual pace (4.2% in December) since late 2021. Meantime, benefit costs were 3.6% higher over the past year in the fourth quarter, easing alongside wages & salaries (chart).



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



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

Fed Chair Powell in his post-FOMC meeting press conference on Wednesday reiterated that "the labor market is not a source of significant inflationary pressures." Today's ECI report will not change that view. We look for employment cost growth to slow somewhat further this year, reaching a 3.6% year-over-year rate in Q4, as the softening in hiring conditions over the past year continue to feed through compensation growth. Yet with labor supply growth also expected to ease and a firmer trend in productivity growth this cycle, growth in wages & salaries should continue to outpace inflation and keep consumer spending plowing ahead.

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