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Economics Group

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What Does Wage Growth Tell Us About Full Employment?

After increasing at 2 percent for most of this expansion, wage growth has strengthened over the past year. With low inflation and weak productivity continuing to weigh on wage growth, the recent pickup is telling.

Rising Wages as a Sign of Labor Scarcity

As we have discussed in prior notes, structural changes in the labor market, including declining participation rates and a shift to more part-time employment, can make it difficult to determine whether the economy is at full employment. Wage growth, therefore, can be a useful input into determining the state of the labor market. When labor is plentiful, businesses have little need to boost wages on a widespread basis. Yet, when labor becomes scarce, employers need to offer more compensation to attract and retain workers, leading to a pickup in wage growth.

For most of this expansion, wage growth was absent among the list of labor market indicators making steady, albeit painfully slow, improvement. More recently, however, wage growth has strengthened across a range of measures. Average hourly earnings have increased 2.8 percent over the past year after rising around 2 percent from 2010 to 2015. Growth has been even more pronounced when looking only at the wages of workers who have been employed in the current and prior year, as evidenced by the Atlanta Fed's Wage Tracker (top chart). The Employment Cost Index, which includes both wages and benefits, has also picked up recently.

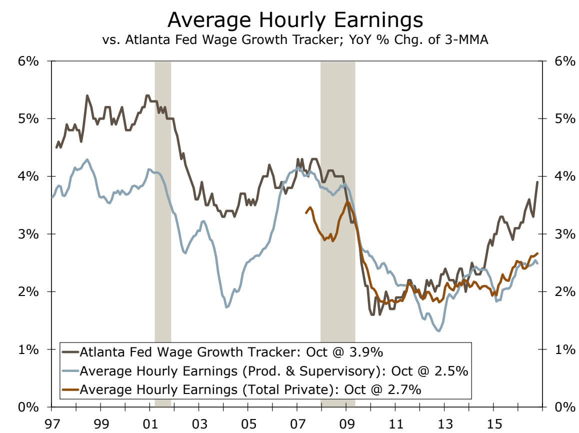
Still, Why So Low? Fundamentals Matter

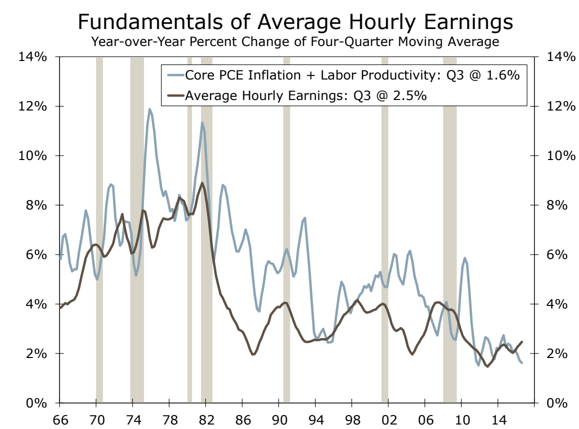
Despite strengthening over the past year, by all measures wage growth remains weak relative to previous cycles. Is this a sign the labor market has further room to run, or are there other factors holding back wage growth?

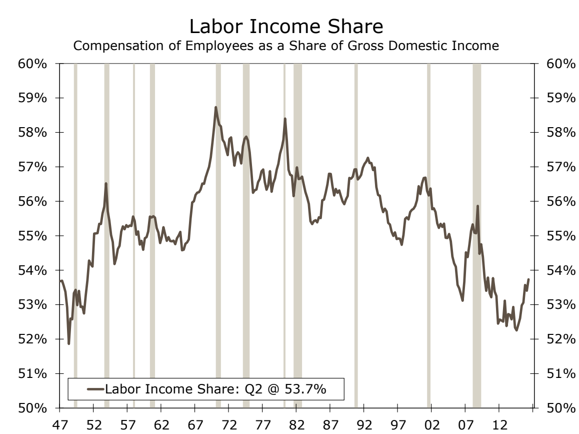
One factor in recent years holding back average hourly earnings and employment costs—both reported in nominal terms—has been the low inflation environment. With prices rising only moderately, most workers have felt little need to push for higher wages.

Nominal wages may also still be held down in part due to the inability of firms to cut real wages in the short run. Researchers at the Federal Reserve Bank of San Francisco show there is still an elevated share of job-stayers who have not received a pay increase over the past year, which likely reflects ongoing real-wage adjustment after the deep recession and sluggish pace of expansion.

Low productivity has been another key holdup to stronger wage growth in this expansion. Over time, real wage gains are driven by the ability of workers to produce more per hour. Given weak productivity growth and low inflation, wage growth does not look as inconsistent with full employment (middle chart). As illustrated in the bottom chart, labor's share of income has risen since 2014, consistent with a tightening labor market. Therefore, while wage growth remains low relative to the past two expansions, the pickup in growth over the past year is telling.







Source: U.S. Dept. of Labor, Federal Reserve Bank of Atlanta, U.S. Dept. of Commerce and Wells Fargo Securities

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