Economic Watch

US

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Economic Analysis

US

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An Update on Wage Pressures

Four Years Past the Recession yet Wage Growth Remains Subdued

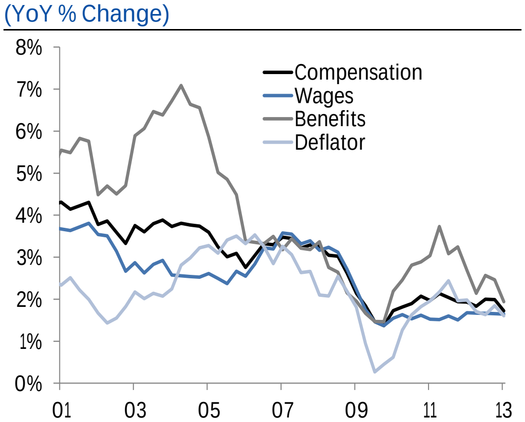
- Various measures suggest relatively flat wage inflation for the near future
- Significant resource slack continues to exert downward pressure on wage growth
- A slow-growth environment until 2015 implies subdued inflationary pressures

The current economic recovery has been anything but ordinary. As we approach the 4-year anniversary of the official end to the recession, we are still facing economic headwinds that threaten a strengthening recovery in the coming years. Real GDP is currently only 3.3% higher than it was at the start of the recession, and both businesses and consumers alike are still weary to admit to a more optimistic outlook.

Fiscal and monetary policy have been key components of the recovery, with the former threatening a double-dip recession and the latter doing its best to offset this drag on activity. The Federal Reserve's policy targets both price stability and maximum employment, but in this slow-growth environment, inflation has remained under control. Thus, the Fed has focused its monetary policy accommodation mostly on lowering unemployment, both with the three rounds of quantitative easing and an extended period of near-zero interest rates.

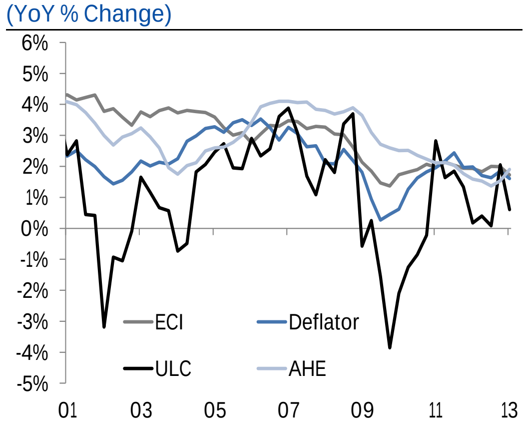
The central point of this dual mandate is wage growth, which simultaneously reflects labor market conditions as well as underlying inflationary pressures in the economy. In general, wage pressures represent a confirmation of inflation expectations but are not necessarily a strong predictor of overall inflation. Still, the data can be extremely helpful for the Fed to monitor in order to estimate the future evolution of inflation. Currently, with long-term inflation expectations stable and significant resource slack in the labor market, there has been little pressure for businesses to increase wages. Wage growth has definitely made some progress since the crisis, but annual rates are still very subdued compared to the late 1990s and early 2000s.

Chart 1
Employment Cost Index & GDP Deflator (YoY % Change)



Source: BLS, BEA, & BBVA Research

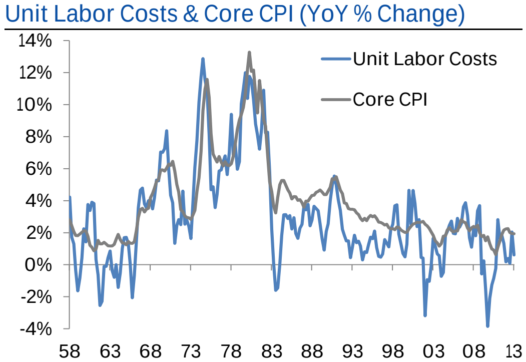
Chart 2
Wage Metrics & Inflation (YoY % Change)



Source: BLS, BEA, & BBVA Research

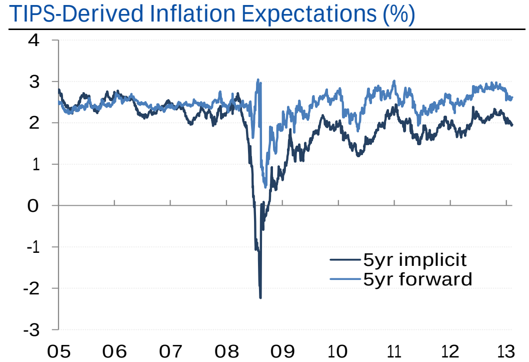
Following up on research we presented at the end of 2011 (see brief "Under Pressure?"), we can adjust for somewhat unexpected changes in economic activity. At that time, our models were suggesting that wage growth would accelerate sometime in 2013, though at a slightly slower pace than before the crisis hit. Now, our models show a similar story, just delayed another year or two, with wage growth not really accelerating until 2015. Back in 2011, most wage-related indicators were showing signs of a stabilizing trend, although the rising cost of benefits was causing some concern when assessing the Employment Cost Index (ECI) in particular. Soon after we released the brief, the benefits component of the ECI began to decelerate very sharply, while the wages component remained mostly flat. Similarly, average hourly earnings have only recently started to shift back to an upward trend, although at an extremely slow pace. Another measure of wages, unit labor costs, followed pretty closely with core CPI inflation up until the 1990s but recently has shown much more volatile swings. Core CPI has decelerated slightly throughout the past year, with unit labor costs following suit in 1Q13. While the data has been harder to read as of late, we see no indications that wage growth, or overall inflation for that matter, will accelerate significantly throughout the next few years. This slow-growth environment will linger on until at least 2015, when we reach a point where economic growth is strong enough to generate jobs on its own without the help of the Fed's highly accommodative monetary policy stance.

Chart 3
Unit Labor Costs & Core CPI (YoY % Change)



Source: BLS & BBVA Research

Chart 4
TIPS-Derived Inflation Expectations (%)

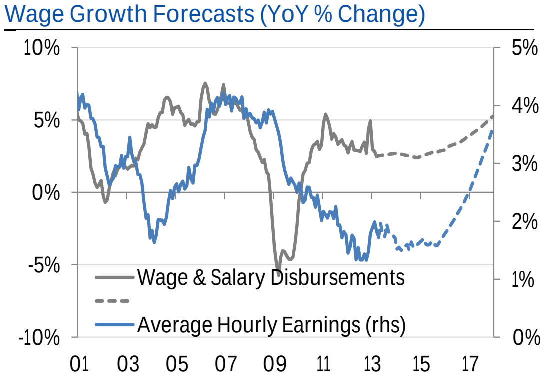


Source: Federal Reserve & BBVA Research

Bottom Line: Checking in with Wages Two Years Later, the Story Remains Unchanged

The past two years have been full of ups and downs in regards to economic activity, much of this dependent on the uncertainty surrounding fiscal policy. Even with the Fed's third round of quantitative easing, which many felt would result in rising prices, inflation expectations have remained very stable. In fact, the past few months have seen declining prices which have brought back talk of deflation in the market. While we don't expect these deflationary concerns to last much longer, the current slow-growth environment will help to keep prices at bay, especially as the Fed begins to draw back its accommodation towards the end of this year. Wages in particular will continue to support stable inflation expectations while labor market dynamics struggle to return to pre-crisis ranks.

Chart 5
Wage Growth Forecasts (YoY % Change)



Source: BLS, BEA, & BBVA Research