

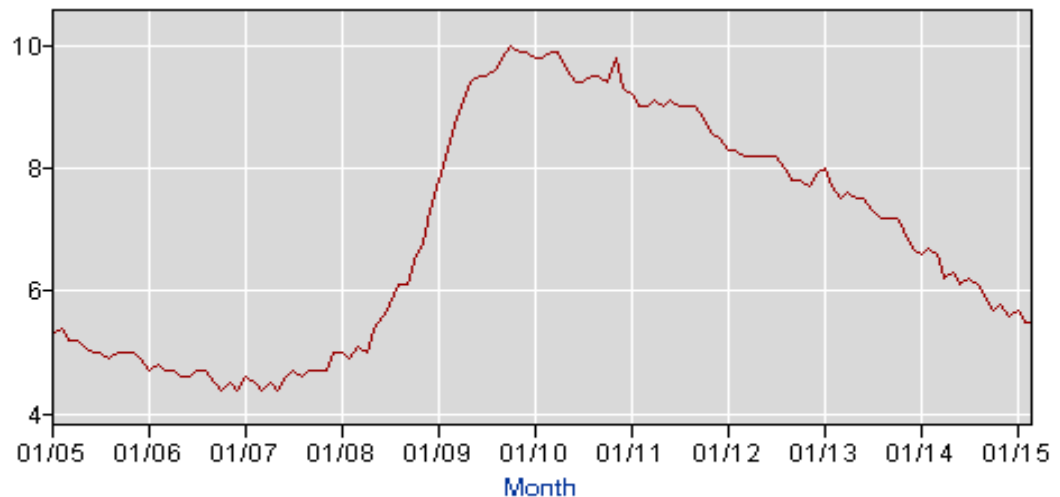
Mitchell's Musings 5-4-15: Phillips is Back

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Back in the day, economists used to debate about the “Phillips Curve,” essentially a prediction that nominal wages would rise more quickly as the unemployment rate fell. There were debates, starting in the late 1960s, over the stability of the relationship and about its lack of theoretical underpinnings. But in some form or other, early empirical forecasting models contained a version of the relationship. It was one of those things that, to paraphrase former Fed chair Ben Bernanke in another context, worked in practice even if not in theory. Today’s forecasters still have some kind of Phillips curve – perhaps much embellished – in their modeling apparatus.

In the years after the Great Recession, however, there developed doubt as to whether we would see a rise in nominal wage growth despite the fall in the unemployment rate. It was noted that other elements of labor market activity measurement, notably the participation rate, seemed to suggest that there was a good deal of hidden or discouraged unemployment. From that perspective, the official unemployment rate was misleadingly low. Even though the official rate had fallen below 6% during 2014, perhaps the labor market wasn’t as tight as that number would suggest.

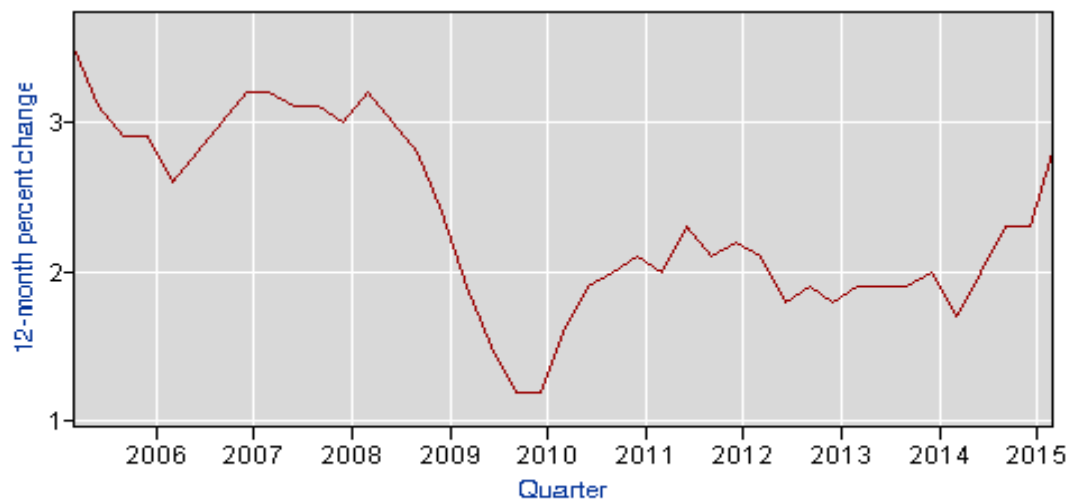
Official Unemployment Rate, Seasonally Adjusted



However, when we now look back over the last year or so, the Phillips Curve seems to be in operation. The chart below shows the 12-month change in the Employment Cost Index for the private sector on a total compensation (wages and benefits) basis.¹ Total annual compensation growth settled into a 2 percentage-ish range until 2014. But as of early 2015, it was getting up toward 3 percent.

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Employment Cost Index, Private Sector, Total Compensation: 12-Month Percent Change



Sometimes, on a short-term basis, benefit costs within the Employment Cost Index can exhibit erratic behavior. In theory, benefit cost growth should largely be offset by reduced wage growth, but in the short-term at least that result may not occur. Nonetheless, on a wage-only basis, more or less the same story emerges as with total comp, as can be seen in the next chart.

¹The Bureau of Labor Statistics released the latest data for the Employment Cost Index (through March 2015) on April 30, 2015.

Employment Cost Index, Private Sector, Wage-Only: 12-Month Change



Of course, an average pay increase is just that – an average within a distribution. Some employees receive more and some less than the average. At present, some of the above-average increase seems to be concentrated in employees receiving pay in the form of incentives. And the charts above refer just to the private sector. Pay in the public sector tends to react more sluggishly for a variety of reasons including bureaucratic inertia. Also significant was that fact that the state and local sector had a prolonged budget crisis in the aftermath of the Great Recession resulting in layoffs and limited pay gains.

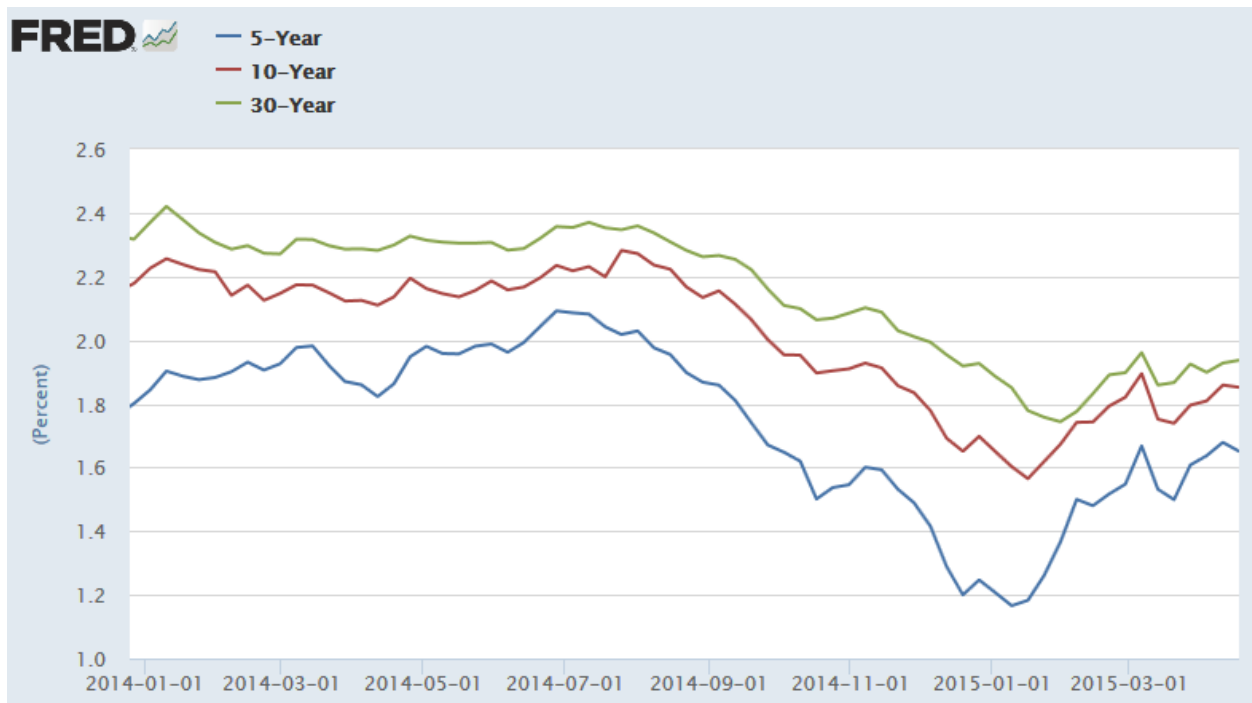
Although the Phillips Curve pay prediction is typically expressed in nominal terms, the recent jump in nominal terms was also mirrored in real (inflation-adjusted) terms. The official Consumer Price Index (CPI-U) growth rate on a 12-month basis ending March 2015 (the latest date available at this writing) was actually slightly negative due to the downturn in oil prices. However, the “core” CPI-U (excluding volatile food and energy) has been running below 2% for the past three years. So, at least as officially measured, pay purchasing power has increased as nominal pay has risen.

What about macro policy? Does the rise in pay mean the Federal Reserve should start raising interest rates? Once upon a time, as we have noted in prior musings, there was much worrying among macroeconomists about “wage-push” inflation. But with unions in the private sector now representing

only a small minority of the workforce, the notion of some kind of autonomous push of wages independent from a more general inflation process seems farfetched. That approach is old economics.

Also under the label old economics has been the continuous warning from monetarists that due to Fed credit expansion in response to the Great Recession, rapid inflation is an imminent threat. But our favorite measure, the spread between inflation-adjusted Treasury securities and conventional (unadjusted) securities – while sometimes volatile – has never been consistent with that forecast. It remains consistent with a multiyear inflation prediction of around 2% per annum as the chart below indicates.²

Core CPI-U inflation is currently below the 2% per annum rate often said to be the Fed’s target. Watchful waiting would seem more prudent as a course of action than an over-hasty reaction to something that has not yet happened and, at least as seen by financial markets, is not expected to happen.



²The chart is derived from the St. Louis Federal Reserve’s FRED database.