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Insight

Where is the Wage Growth?

-Manchester Capital Management Strategy Group

The most recent report from the Bureau of Labor Statistics showed average hourly earnings for all employees on private nonfarm payrolls rising 2.4% year over year. While a decent number, it barely exceeds inflation and continues a trend of stagnating real wage gains. In the past, an unemployment rate in the range of 4% has corresponded to wage growth of more than 4% as tight labor markets result in accelerating wages. Why has this cycle been different? A few pictures may tell the story. First, the fall in the unemployment rate since 2009 has been dramatic.

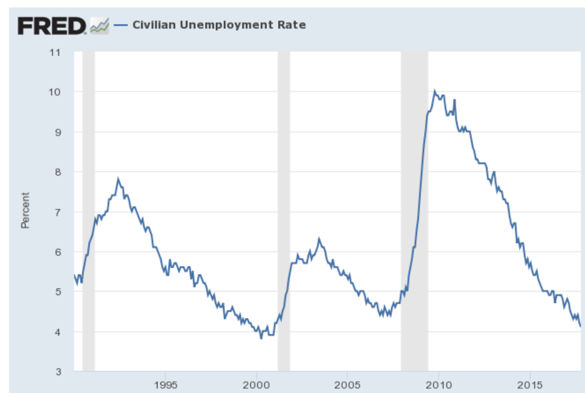

Figure 1: U.S. Bureau of Labor Statistics, Civilian Unemployment Rate [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UNRATE

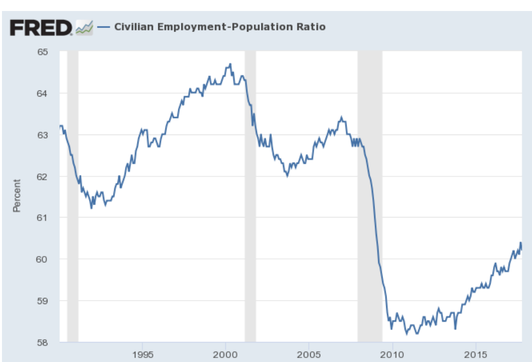

Figure 2: U.S. Bureau of Labor Statistics, Civilian Employment-Population Ratio [EMRATIO], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/EMRATIO

The unemployment rate typically rises during recessions (the gray shaded areas in the graph) as companies cut costs by laying off workers and falls post-recession as the economy recovers. Similarly, the employment-to-population ratio (shown on the left), or the percentage of people aged 16 or older who are employed, rises during recoveries.

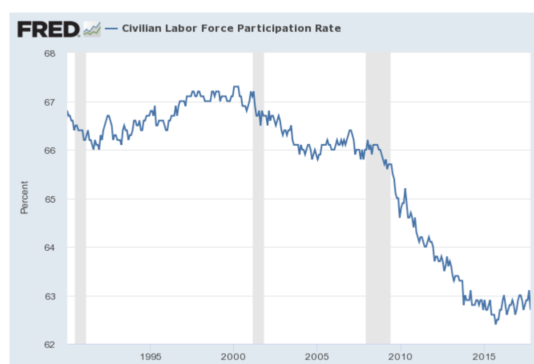

Figure 3: U.S. Bureau of Labor Statistics, Civilian Labor Force Participation Rate [CIVPART], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CIVPART

The fact that the rise in the employment-to-population ratio is not as steep as the recovery in the unemployment rate can be explained by the labor participation rate, or the percentage of the population that is working or unemployed and looking for work, which has not recovered. See figure 3 to the right.

In July, 2014, the Council of Economic Advisors authored a paper titled "The Labor Force Participation Rate Since 2007: Causes and Policy Implications." In it, they concluded that about half the fall in the participation rate since 2008 is due to "baby boomers" beginning to exit the workforce via retirement. They attribute the other half of the drop to the severity of the Great Recession and an unusual pattern of long-term unemployment.

The Bureau of Labor Statistics compared the composition of those classified as "not in the labor force" between the years 2004 and 2014. Of the roughly 16 million person increase in those not in the labor force over that decade, about 42% of the rise was due to retirement, 30% due to an increase in those in school, and 23% was attributed to illness or disability. Figure 4 below overlays the unemployment rate with the employment-to-population ratio.

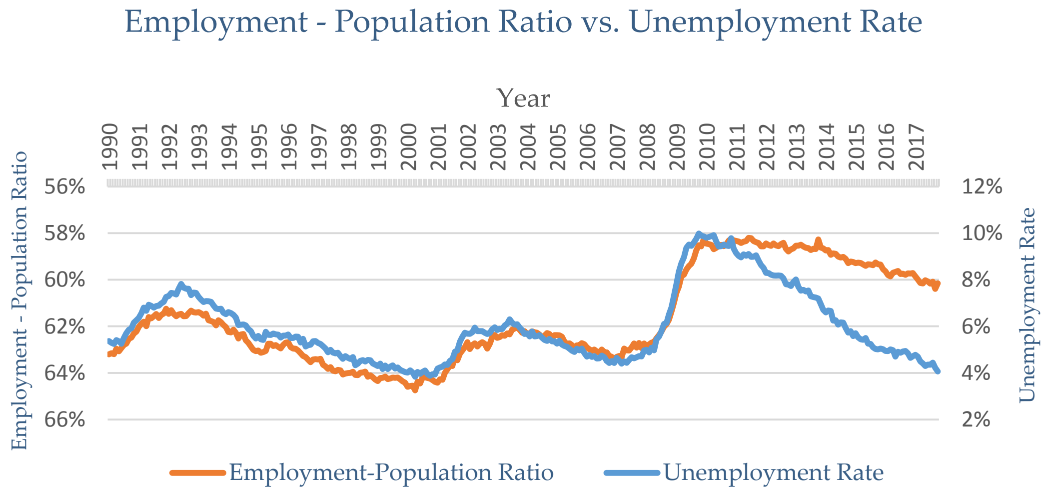

Figure 4: Source: U.S. Bureau of Labor Statistics

In past cycles there was a strong correlation between the two ratios: a drop in the unemployment rate meant a greater portion of the population was employed. A quick glance at the chart shows a break in this trend and yields one of two conclusions: with only 60% of the population employed, the unemployment rate should be 8%, or with a 4% unemployment rate, the employment-population ratio should be around 64%. Focusing on the latter, if we were to take the aging of baby boomers as a given since we cannot reverse time, and we hold the number of people in school or on disability steady at historical percentages, then in fact around 64% of the population would be employed.

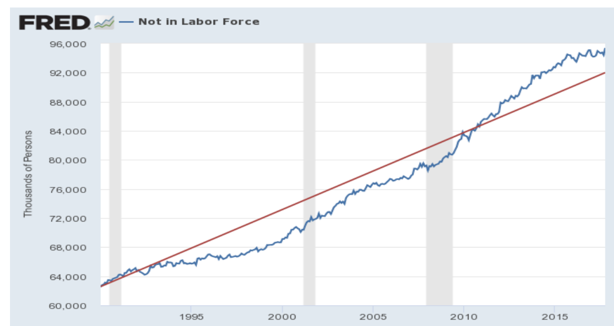

Figure 5: U.S. Bureau of Labor Statistics, Not in Labor Force [LNS15000000], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/LNS15000000

Figure 5 on the right shows the absolute number of persons not in the labor force. The number of people not in the labor force is currently 95.3 million. Since the unemployment rate peaked at 10.0% in October 2009, roughly 15 million people have left the labor force. Looking at recent trends, we can attribute 50-60% of the rise to an increase in retirees. If we were to hold the number of people in school or on disability at historical levels as a percent of the population, the number of people not in the labor force would drop by 3.5 million to 91.8 million. This number is depicted by the red line in the chart. There is a school of thought that the large increase in disabled workers is due to permanently displaced workers, formerly from manufacturing, being "hidden" by collecting disability payments and not counted as part of the labor force. There is some merit to this argument; advances in medical technology that have allowed Americans to live healthier, better, and longer lives and increased workplace-safety regulations are not consistent with a large increase in disabled workers. If we count this subset of 3.5 million as unemployed instead of disabled, the unemployment rate would be 6.2%. This may explain why we are seeing more slack in wage growth than the low unemployment rate of 4.1% would suggest, as in reality the employment situation is not as tight as the headline rate makes it seem. This explanation also suggests that unemployment must fall further, well below the "natural" or "frictional" unemployment rate of 4% before we will see meaningful competition for workers and pressure on wages.