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JOBS REPORT

Why You Should Be More Optimistic About Wage Growth

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Commentary on this month's employment report has focused on what's happening to wage growth. Throughout the recovery, wage growth has been disappointing, barely keeping pace with inflation.

Last month, several commentators (not me!) thought that we might have seen a turning point, as wages were reported to have grown by 0.4 percent in November. Friday morning's report revised that number down to a more moderate 0.2 percent, and added the news that wages actually fell by 0.2 percent in December.

That is, wage growth remains muted after all.

My colleague Neil Irwin wrote about this slow wage growth as if it were bad news. I feel much more optimistic. Let me explain how we can read the same numbers differently, and why this is important in the debate about Fed policy and getting more people working.

What's informing Neil's reading is a concern about wage stagnation. Like Neil, I'm concerned that over a period of several decades real wages have barely risen, even as productivity has continued to race ahead. The result is that workers have enjoyed few of the fruits of economic growth.

But realize that the concern about the well-being of workers is a concern about their real wages, which is a measure of what they can buy with their paycheck. Friday morning's report tells us what is happening with nominal or money wages, the total number of dollars in your paycheck, with no adjustment for inflation.

Even if nominal wages were rising quickly, we have no idea how much of that will translate into higher real wages, because we don't know the extent to which businesses will pass through higher labor costs into higher inflation. Likewise, it remains possible that even weak growth in nominal wages will actually yield moderate growth in real wages. Indeed, the recent declines in gas prices are doing exactly that.

To me, the big unknown that these data can speak to is how many of the jobless we will be able to get back to work. Federal Reserve policy makers remain concerned that if unemployment falls too far, wages will start to rise, which might fuel inflation, forcing them to choke off the recovery. Notice that their concerns focus on nominal, rather than real, wages. They worry about the growth in actual labor costs that firms might pass on as higher prices.

In the economic models that inform these debates, wage and price inflation is expected to rise whenever unemployment falls below its so-called natural rate. The problem, though, is that no one really knows what that rate is. Our uncertainty is even greater today than it normally is, because no one knows the extent to which those workers who dropped out of the labor force in response to the financial crisis will return when jobs become plentiful. By this view, today's most important macroeconomic question is what the natural rate actually is.

The latest jobs report helps answer this question. The unemployment rate has fallen to 5.6 percent, and there are still no signs that wage inflation is rising. Indeed, with wage growth running at only 1.7 percent, the economy is telling us that we still have the ability to bring many more of the jobless back into the fold without setting off inflation.

It is only when nominal wage growth exceeds the sum of inflation (about 2 percent) and productivity growth (about 1.5 percent) that the Fed needs to be concerned that the labor market is generating cost pressures that might raise inflation. So the latest wage growth numbers suggest that we are not yet near the natural rate. And that means the Fed should be content to let the recovery continue to generate more new jobs.

Yet the latest survey of Federal Reserve policy makers shows that their estimates of the natural rate range from 5 to 5.8 percent. The most pessimistic of these projections already look mistaken. If the current rate of employment gains continue, then in a few months' time, unemployment will have fallen below most estimates of the natural rate.

The predicament that policy makers will then face is whether to trust their estimates of the natural rate — which would lead them to raise interest rates in an effort to slow the economy — or to reassess just what they think the natural rate is. The longer that moderate growth in nominal wages and lower unemployment show they can peacefully coexist, the stronger the case for believing the natural rate is lower than policy makers currently believe.

So yes, there's good news to be gleaned from reports that nominal wage growth remains muted: It's the economy telling us that it's ready to put more people back to work.

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