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The Upshot

RECOVERY IN NEED OF RECOVERY

Jobs Report Highlights the Wage Growth Puzzle

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The latest round of labor market data released Friday add to an emerging puzzle whose resolution will be central to the future of the recovery.

We learned that employment is growing at a healthy clip, with 248,000 jobs created this month, and an average of 220,000 jobs created each month over the past year. Moreover, unemployment has fallen both further and faster than most had anticipated. The latest reading suggests that unemployment is down to 5.9 percent, and has fallen about a full percentage point in each of the past three years. These are all symptoms of a healthy economic expansion.

Normally, this would lead to faster wage growth. When workers feel their jobs are secure, they're better positioned to ask for a raise. Likewise, when there are fewer people unemployed, companies need to pay better wages in order to attract talented workers.

Yet average hourly wages in the private sector were roughly flat in September (they fell by a penny), and they've grown at a rate of only around 2 percent over the past year. Alternative indicators also suggest that wage growth remains subdued.

This puzzle isn't entirely new, as the usual link between unemployment and the rate of wage growth has totally broken down over recent years.

The recent data have made a sharp departure from the usual textbook analysis in which a tighter labor market leads to faster wage growth, and subsequent cost pressures feed through to higher inflation. Even as the recession threw millions of people out of work, wage growth barely slowed despite the textbook prediction to the contrary. Then through the ensuing recovery, unemployment fell rapidly, but again, wage growth has barely moved.

By the usual analysis, the key variable is how much "slack" there is in the labor market. When unemployment gets too low — toward what economists call the "natural rate" (don't be fooled, there's nothing natural about it) — there's no more slack, and inflationary pressures start to build. This is the key reason the Federal Reserve has historically been nervous about keeping its foot pressed on the accelerator when unemployment got this low.

The problem is that economists don't actually know how much slack there is in the economy, because we don't know what unemployment rate the economy can sustain without sparking inflationary pressures. The Fed's current guess is that the natural rate is around 5¼ or 5½ percent, although really, this is just a guess based on historical patterns. But it's a critically important guess, because while unemployment's not yet that low, the current trajectory puts us there soon. Indeed, this is the key reason the Federal Reserve policy makers have been talking about raising interest rates.

Given how starkly the latest episode has deviated from historical patterns, the wisdom of relying on past patterns repeating themselves seems questionable.

Indeed, the lack of any wage pressure right now stands starkly at odds with the view that the economy is about to run out of slack. Two explanations spring to mind. Perhaps the unemployment rate is giving us a false signal, and there are millions more workers waiting to return to the labor market than suggested by the official statistics. That is, the jobless will return when the jobs return. Or perhaps the natural rate is really much lower than most economists estimate. After all, at the end of the Clinton administration, unemployment was below 4 percent, while inflation remained low and stable.

Rather than guessing whether the labor market has run out of slack, why not look for more direct evidence? Perhaps we should be using current rates of wage growth to infer whether the economy is nearly out of slack. By this view, the expansion has still got quite a way to run.

To get a sense for this, realize that businesses will feel the need to start raising prices faster only if wage growth starts to exceed the rate of inflation, plus the rate of productivity growth. Given that the Fed is targeting inflation of 2 percent, and productivity typically grows at 1 to 2 percent, this suggests we should infer that the economy is about out of slack only when wage growth hits 3 to 4 percent.

The fact that the labor market isn't delivering wage growth anywhere near this danger zone suggests that there remains a lot of slack left in the economy.

While many workers are no doubt frustrated that they're not seeing wage gains, there's a sunnier implication in all this for the jobless. Subdued wage growth is telling policy makers it would be premature to hang the "mission accomplished" banner above this recovery. We can do a lot better than an economy in which 9.3 million people remain unemployed.

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