New Wage Growth Will Influence Fed's Interest Rate Decisions

Although employment cost growth is slowing, it's likely not doing so fast enough for the Fed.

By Erik Sherman

As many are waiting to see what the Federal Open Market Committee of the Federal Reserve has decided about interest rates, their eyes should be on employment costs. Those are one way of discussing wage growth, and that figure is seriously on the Fed's mind.

On Tuesday, the Bureau of Labor Statistics released the monthly employment cost index summary.

"Compensation costs for civilian workers increased 5.1 percent for the 12-month period ending in December 2022 and increased 4.0 percent [for the 12-month period ending] in December 2021," the report said. "Wages and salaries increased 5.1 percent for the 12-month period ending in December 2022 and increased 4.5 percent for the 12-month period ending in December 2021. Benefit costs increased 4.9 percent over the year and increased 2.8 percent for the 12-month period ending in December 2021."

The FOMC is unlikely to perceive this as particularly good news, when 2021 ended with 4.0% annual private employment compensation growth and 2022 was up to 5.1%. The Fed's communications so far have been that it wants an average inflation rate of 2%. Take a step back to December 2022, as the New York Times reported Fed Chair Jerome Powell saying, "It's not that we don't want wage increases, we want strong wage increases. It's just that we want them to be consistent with 2 percent inflation."

Many economists question the value of the so-called Phillips Curve that relates inflation to employment. It is not a natural law — there have been big examples of the theory falling apart, like during stagflation of the 1970s — but an observation of correlation.

The FOMC, however takes the relationship seriously, and the members may not take the report as a sign of a better economic environment, or at least one slowing down to the degree they think is prudent.

It seems unlikely that absent a significant recession the wage front may not come down as quickly as the Fed would like. The 5.1% annual growth in December 2022 was in current dollars — not adjusted for inflation. Looking at the results in constant dollars, workers on the average had 1.3% less income than they had the previous year at the same time.

This means that people are losing pace compared to inflation. Even presuming that price hikes come under some form of control, millions of people will have less purchasing power than the did a year or two back. That is going to continue to fuel desire for more pay, and given that the roughly 5.7 million unemployed people aren't nearly enough to fill the 10.5 million jobs open as of November, employers are unlikely to suddenly see significant leverage to push wages down further.