Don’t Fear Higher Wages

One of the indicators that spooked the markets last week was an upward revision in the growth of compensation per hour. Hourly compensation in the first quarter was revised up to an annualized growth rate of 2.8% from a previous estimate of 2.3%. Meanwhile, the growth rate of compensation in the fourth quarter was revised to 11.2% from 8.5%.

With the unemployment rate at 4.5%, and improving prospects for strong economic growth, some analysts are worried that compensation growth will accelerate further. Their fears are still in an embryonic stage, but are based on a theory of wage-push inflation – a Keynesian, demand-side argument.

We believe these fears are misguided despite the fact that we think inflation is headed higher and so are interest rates across the maturity spectrum. In our view, monetary policy was too loose for too long and is still not tight enough to bring down inflation.

An overly rapid increase in the money supply temporarily boosts economic activity and eventually lifts inflation. Both of these can increase compensation. But, it is Fed policy that causes inflation, not rising wages. Moreover, wages can also rise or fall faster than GDP, or corporate profits because of the business cycle.

For every dollar of Gross Domestic Product (production), someone (or something) gets a dollar of income. Income includes profits, earnings by small businesses, rents, and government transfer payments. It also includes the income earned by employees, which is known as labor compensation. This includes wages, salaries, bonuses, and fringe benefits, such as health insurance and pension contributions.

In the past forty years, labor has earned an average of 58.2% of total income, with a high of 60.1% in 1980 and a low of 56.6% in 2006.

Over time, workers earn the value of what they produce, otherwise markets move to bring this relationship back into equilibrium. For example, when workers are earning a relatively small share of total income – which usually, like recently, coincides with high corporate profits – firms have an incentive to hire more workers and are willing to bid up wages in the process. This is what we believe is happening now.

In the first few years of the current recovery, much as it did in the expansion of the 1990s, labor compensation has fallen as a share of GDP. And just like the 1990s, now that the unemployment rate is in the mid-4’s we expect that trend to reverse. We look for hourly compensation to grow faster than inflation plus productivity growth. This is not inflationary and nothing to fear. Instead, it is great news for the American worker.