ECONOMIC UPDATE

REGIONS

April 28, 2017

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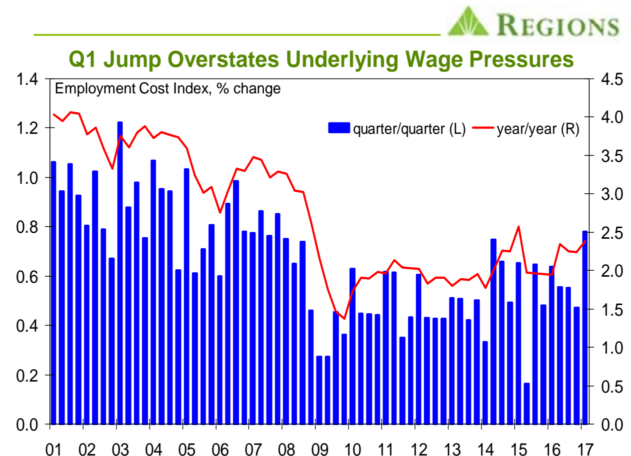
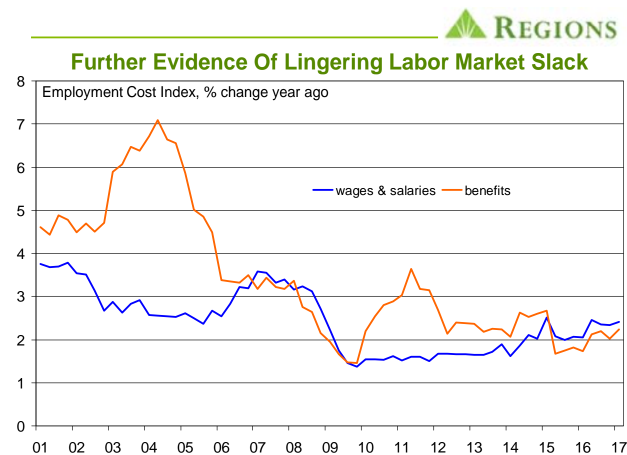
Q1 2017 Employment Cost Index: Q1 Jump Overstates Underlying Wage Pressures

- The total ECI was up 0.8 percent in Q1 2017, with the wages/salaries component up 0.8 percent and the benefits component up 0.7 percent.
- Year-on-year, the total ECI was up by 2.4 percent in Q1 with wage costs up 2.5 percent and benefit costs up 2.2 percent.

Total compensation costs, as measured by the Employment Cost Index (ECI), rose by 0.8 percent in Q1 2017, the largest increase since Q4 2007. The wage component of the ECI was up 0.8 percent in Q1 while the benefits component rose 0.7 percent. On an over-the-year basis, the total ECI was up 2.4 percent, with the wage component up 2.5 percent and the benefits component up 2.2 percent. While the jump in the ECI in Q1 is a seemingly nice fit with the narrative of an economy at full employment, we do not believe this to be the case and breaking down the growth in the ECI by industry supports our contention. Moreover, as of Q1 year-on-year growth in the ECI remains below the pace that would be seen in a fully healthy labor market, which is consistent with our view that there is more slack remaining in the labor market than implied by the headline unemployment rate.

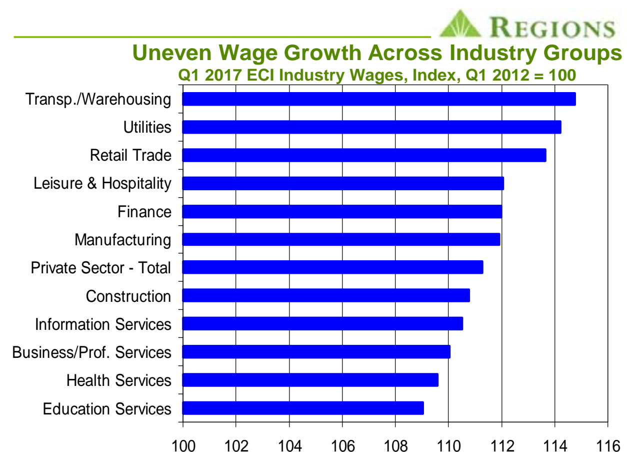


The ECI is one of the three main data series – the others being average hourly earnings from the monthly employment report and unit labor costs from the quarterly labor productivity and costs report – showing trends in labor costs. The ECI tends to get less attention than its two counterparts but to us is the most meaningful of the three series. The ECI is designed to measure changes in total labor costs, for both money wages and salaries and noncash fringe benefits (such as health insurance and pensions). One distinction between the wage component of the ECI and the more widely followed average hourly earnings metric is the ECI is not affected by shifts in the composition of employment across industry groups. Instead, the wage component of the ECI effectively measures wage costs for the same jobs over time and the total ECI measures labor costs (i.e., wages and benefits) for the same jobs over time. One drawback of the average hourly earnings metric is that it is skewed by changes in the composition of employment and hence will mask differentials in earnings across industry groups. These differences aside, the alternative series are at present indicating some acceleration in wage growth but at the same time showing growth remains well below what we would expect to see in a fully healthy labor market or, if you prefer, at full employment.



It is telling to look at the industry breakout of the ECI data. In Q1, the largest increases in wages, as measured by the ECI, were seen in leisure & hospitality services (up 1.9 percent) and retail trade (up 1.4 percent), which reflects increases in minimum wages in a number of states at the start of 2017. It is worth noting that the reported jump in wages in retail trade comes at a time when retail payrolls are under intense downward pressure. Also notable in Q1 is the 1.0 percent increase in wages in construction. Wage growth in construction has been steadily accelerating, but nonetheless seems slower than is consistent with what has been a long-running narrative of shortages of construction labor.

As seen in our bottom chart, there is a good deal of variance in wage growth across private sector industry groups. Since Q1 2012, wages in transportation/warehousing, utilities, and finance have grown the fastest, while at the other end of the spectrum wages in education services, health care, and business services have logged the slowest growth, despite these three industries posting some of the most rapid job growth over the same period. It is worth noting that some of the fastest wage growth has come in retail trade and leisure & hospitality services which, again, largely reflects higher minimum wages in many parts of the U.S. and also what have been voluntary boosts in entry level wages on the part of several national chains, increases that have filtered up the pay scale to more experienced workers.



What we are waiting for, however, are signs that genuinely tighter labor market conditions are pushing wage growth higher across all industry groups, which is the manner in which upward pressure on wages would be sustained over time. We have argued it will not be until at least late-2017 that wage growth approaches what would be considered normal. To the extent the Q1 jump in the ECI does overstate the degree of underlying wage pressures, firms will continue to face fairly steady growth in total comp costs.

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