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Yellen: Slack = 2% Wage Rise

Federal Reserve Chair Janet Yellen at the March 19 post-FOMC press conference reiterated her views about still considerable labor market slack but with a new twist. She added that the recent only 2% y/y wage gains were around half of what would be normal in a healthy labor market with much less unemployment. However, we believe that at least some FOMC members will start to question that viewpoint as reported wage gains accelerate somewhat in 2014 and 2015.

Faster rising average hourly earnings

The 0.4% m/m private sector average hourly earnings gain in February was double consensus estimates and raised the 12-month change to 2.2%--the top of its range over the past year. For hourly paid nonsupervisory and production workers, the 12-month change is now up to 2.5%. (See Figures 1-2.) The surprising February gain has prompted questions about accelerating wage inflation. To be sure, average hourly earnings are an imperfect proxy for hourly wage rates, which many economists believe are better represented by the wage and salary component of the Employment Cost Index (ECI). However, is the recent average hourly earnings acceleration foreshadowing a pickup in the Q1(14) private sector wage and salary ECI to be reported on April 30? (Note in Figures 1-2 that the ECI and both average hourly earnings measures often move together.) Also, will accelerating wage and salary gains convince the FOMC that the Non-Accelerating Inflation Rate of Unemployment (NAIRU) is higher than the around 5 ½% currently estimated by FOMC members? We foresee private sector average hourly earnings increases accelerating on a Q4/Q4 basis from 2.1% last year to 2.4% this year and 2.8% in 2015 as the quarterly average unemployment rate slips to 6.4% by the end of this year and to 5.9% by the end of 2015.

Less slack or weather effects?

An alternative explanation of the February m/m average hourly earnings gain is that the data were distorted by the unusually inclement winter weather during the month. Specifically, it has been argued that some hourly wage workers still were paid even if the weather prevented them from working. If that were the case and if the hours worked of such workers were reported as down, reported average hourly earnings statistics would be upward biased. However, we have at least tentatively rejected that hypothesis. When we compared average hourly earnings changes and average workweek changes across industries in February, we did not observe the negative correlation implied by the hypothesis.

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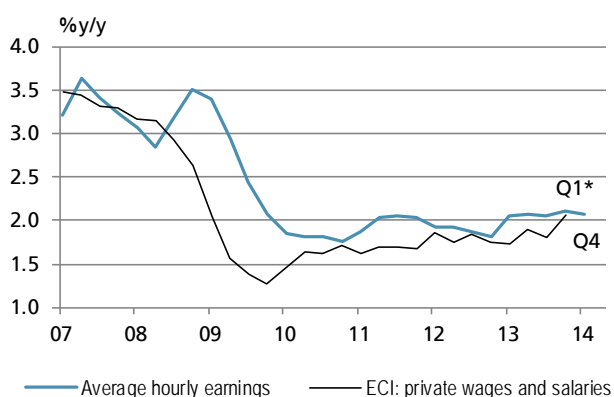
Some corroborating evidence of accelerating labor costs is provided in the recent National Federation of Independent Business (NFIB) Small Business Optimism Index monthly surveys. The seasonally adjusted net percentage of respondents reporting compensation increases has risen in recent months from around 0.0% in the earlier stages of the current business expansion to a current cyclical high of 19% versus cyclical peaks of around 30% and 35%, respectively, in the two previous business expansions. And the pervasiveness of compensation gains at smaller firms often signals faster subsequent changes in both average hourly earnings and the private sector wage and salary component of the ECI. (See Figures 3-4.)

Compensation gains at small firms becoming more pervasive

Faster rising average hourly earnings and more pervasive compensation gains reflect a somewhat tighter labor market as the unemployment rate has declined. Evidence comes from a rising net percentage of small firms reporting few or no qualified applicants for job openings. (See Figures 5-6.)

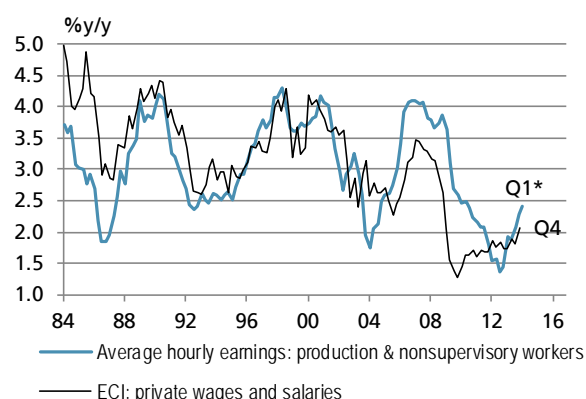
More small firms citing difficulties in finding qualified job applicants

Figure 1: Gains in *overall* average hourly earnings and the Employment Cost Index (ECI) are picking up.



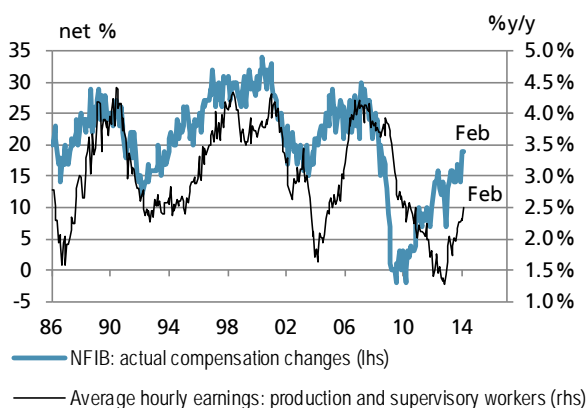
* Average of Jan/Feb. All other history is quarterly. Source: Bureau of Labor Statistics

Figure 2: *Wage workers'* average hourly earnings gains from a year earlier have accelerated to around 2 ½%.



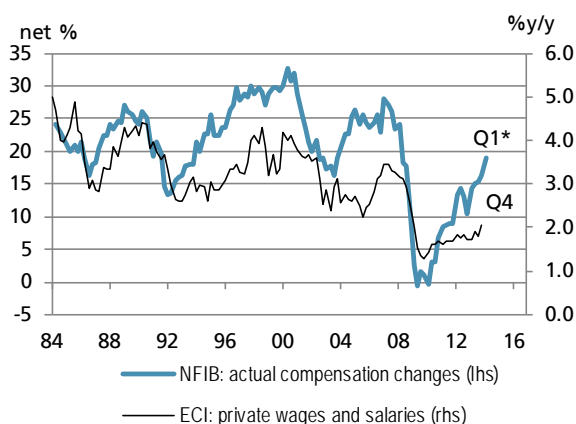
* Average of Jan/Feb. All other history is quarterly. Source: Bureau of Labor Statistics

Figure 3: More pervasive small firms' compensation gains



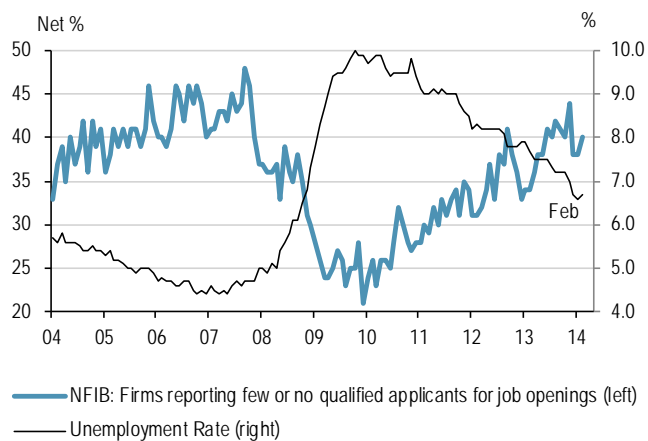
Source: National Federation of Independent Business and Bureau of Labor Statistics

Figure 4: Small firms' wage gains signaling rising ECI?



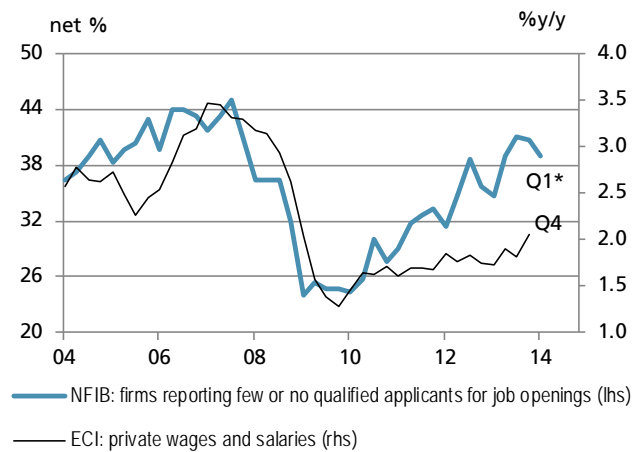
* Jan/Feb average. All other history are quarterly. Source: National Federation of Independent Business and Bureau of Labor Statistics

Figure 5: Finding qualified applicants becoming more difficult at small firms.



Source: National Federation of Independent Business and Bureau of Labor Statistics

Figure 6: Tighter market for qualified applicants suggest accelerating ECI gains.



* Average of Jan/Feb. All other history is quarterly. Source: Bureau of Labor Statistics and National Federation of Independent Business

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