

Labor Market Slack and Wage Growth

Justin Wolfers
Peterson Institute for International Economics and
University of Michigan (on leave)

Peterson Institute Conference on Labor Market Slack, September 24 2014.

Is there a puzzle?

Wage growth and the cycle:

1. Wage growth is too low, suggesting slack is higher
2. Wage growth is about right
3. Wage growth is totally puzzling

Labor force participation and the cycle

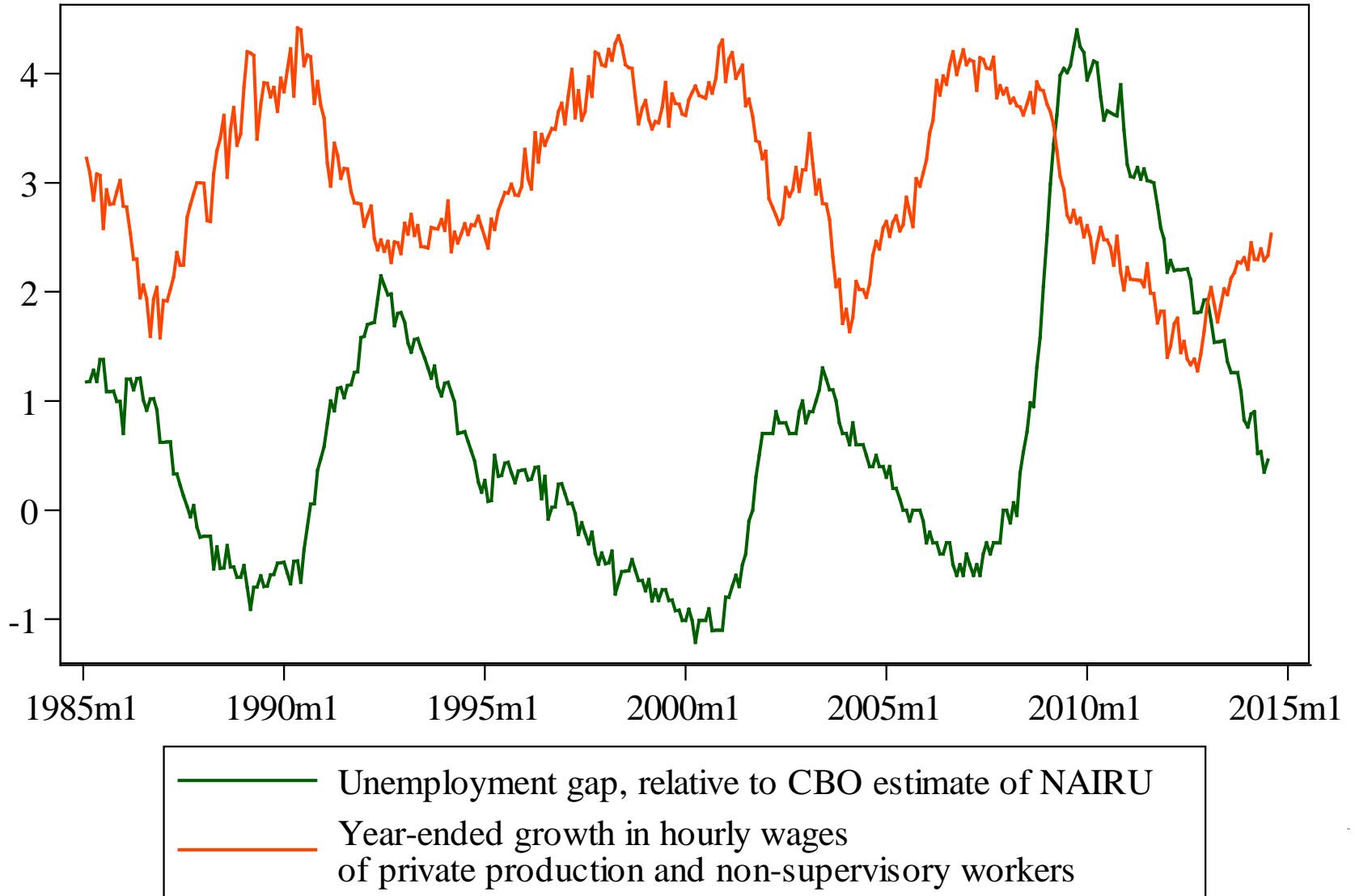
Argument #1: Wage growth is too low

□ Slack:

- ▶ Labor market is “close” to normal
 - Unemployment = 6.1%
 - Natural rate = 5.5% (CBO)
 - Gap “only” 0.6%
- ▶ We expect wage growth to be 3-4%:
 - Expected inflation: 2%
 - + Trend productivity growth: 1-2%
 - + Cyclical factors: $-\frac{1}{2}$ * unemployment gap: $-\frac{1}{4}$ %
- ▶ Wage growth is actually around 2%:
 - Employment cost index +2.0%
 - Average hourly earnings, private workers +2.1%
 - Production & non-supervisory employees +2.5%
 - Median usual weekly earnings of full-time wage & salary workers +0.8%

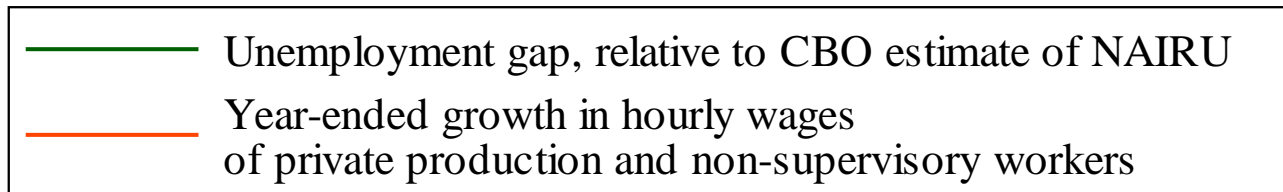
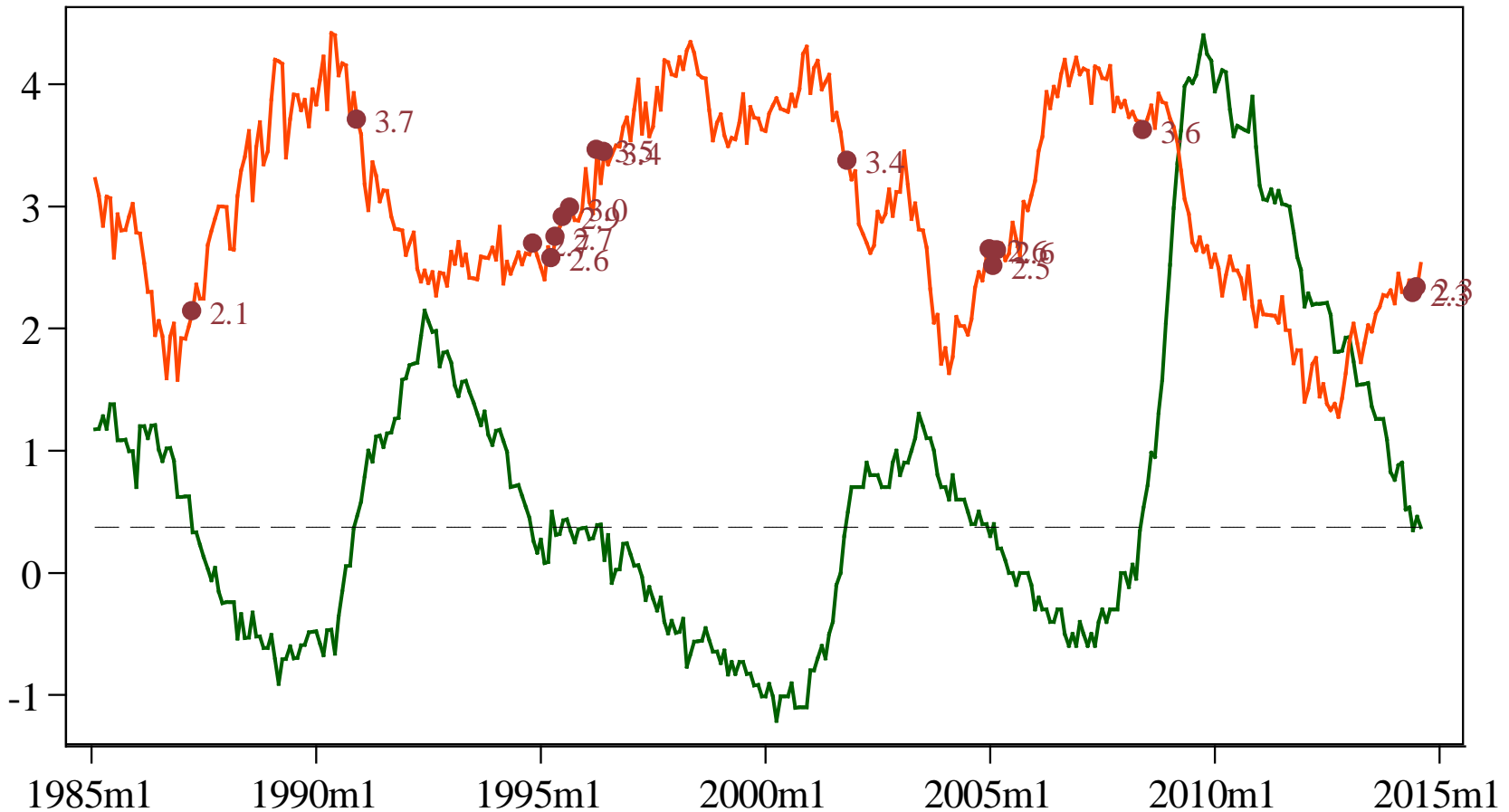
Argument #2: Wage growth is “about right”

Unemployment Gap and Nominal Wage Growth



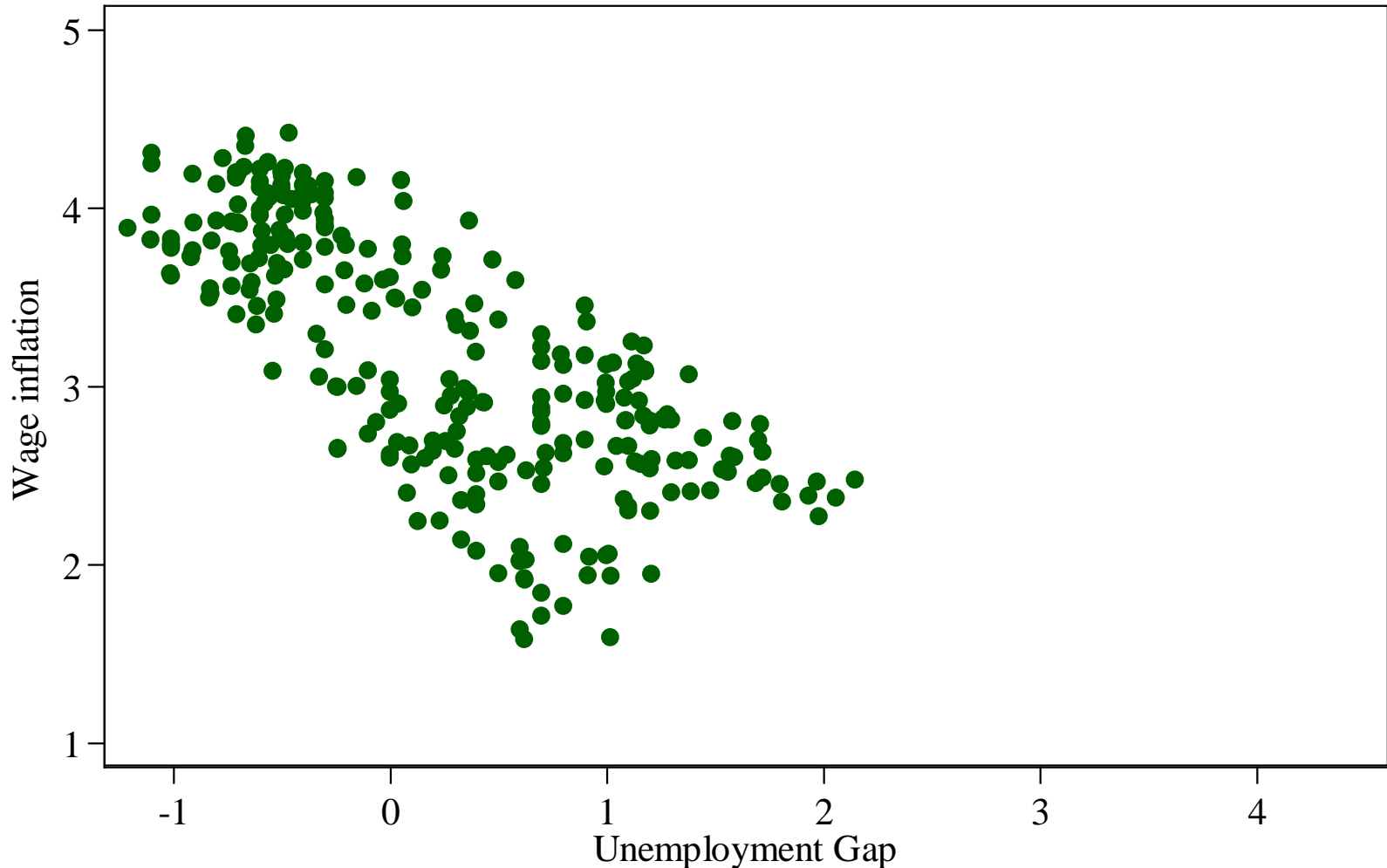
Argument #2: Wage growth is “about right”

Unemployment Gap and Nominal Wage Growth



Argument #3: Wage growth is totally puzzling

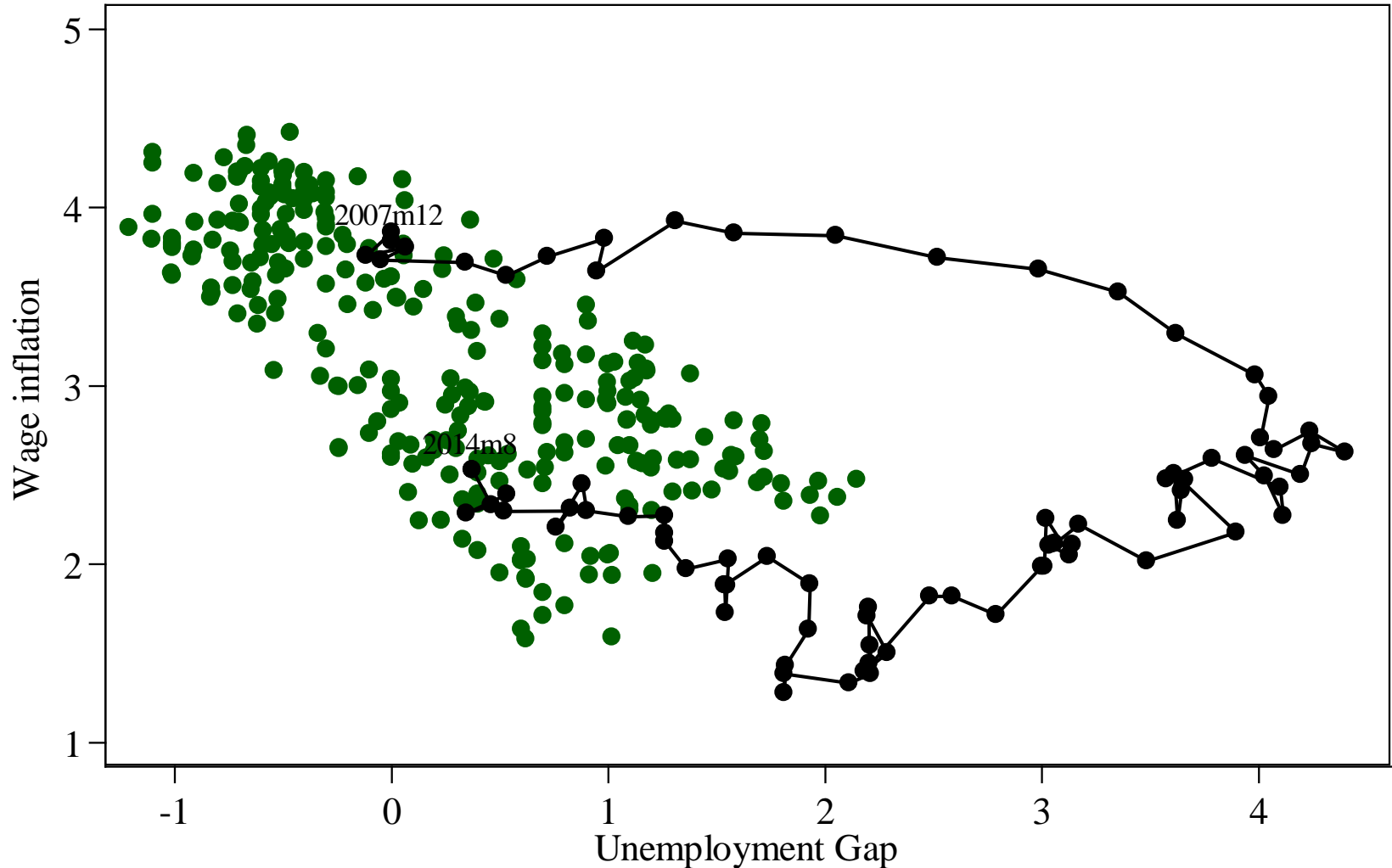
Wage Phillips Curve



Unemployment gap: Unemployment rate relative to CBO estimate of NAIRU
Wage inflation is year-ended growth in hourly wages of private production and non-supervisory workers
Sample: January 1985 - Present

Argument #3: Wage growth is totally puzzling

Wage Phillips Curve



Unemployment gap: Unemployment rate relative to CBO estimate of NAIRU
Wage inflation is year-ended growth in hourly wages of private production and non-supervisory workers
Sample: January 1985 - Present

Is there a puzzle?

Wage growth and the cycle:

1. Wage growth is too low, suggesting slack is higher
2. Wage growth is about right
3. Wage growth is totally puzzling

Labor force participation and the cycle

Should we expect participation to rebound?

$$\textit{Participation rate} = \beta * \textit{Slack}$$

- ❑ If $\beta = 0$, then participation isn't cyclical
 - ▶ No reason to think it will rebound
- ❑ If β is large, then participation is highly cyclical
 - ▶ The weak economy has suppressed participation
 - ⇒ Participation will rebound
 - ⇒ Unemployment understates slack
- ❑ But if your measure of slack is the unemployment gap:
 - ▶ Unemployment = 6.1%; CBO's estimate of natural rate = 5.5%
 - ⇒ You've assumed $\textit{slack} \approx 0 \Rightarrow \beta * \textit{Slack} \approx 0$
 - ⇒ Participation won't rebound
 - ⇒ Unemployment accurately measures slack (Circular reasoning)

Is Labor Force Participation Cyclical?

Table 3: Panel Regression Results, CPS Microdata, Annual Frequency

Dependent variable: LFPR	(1) 1978- 2013	(2) 1978- 2013	(3) 1978- 2013	(4) 1978- 2013	(5) 1990- 2013	(6) 1978- 2007
LFPR _{t-1}				0.44*** (0.03)	0.35*** (0.03)	0.39*** (0.03)
<u>Cyclical parameters</u>						
Unemp. rate _t	-0.17*** (0.05)	-0.01 (0.05)	-0.07 (0.04)	-0.08** (0.04)	-0.02 (0.04)	-0.10** (0.04)
Unemp. rate _{t-1}		-0.10*** (0.03)	-0.06* (0.03)	-0.07* (0.04)	-0.06 (0.05)	-0.08** (0.04)
Unemp. rate _{t-2}		-0.09*** (0.03)	-0.07** (0.03)	-0.04 (0.04)	-0.03 (0.05)	-0.03 (0.04)
Unemp. rate _{t-3}		-0.25*** (0.04)	-0.17*** (0.03)	-0.07** (0.03)	-0.10** (0.04)	-0.08** (0.04)
Contrib. of trend, 2007 to 2013	-2.34	-1.10	-1.45	-1.35	-1.53	
Implied cyclical shortfall, 2014Q2	-0.12	-1.40	-1.02	-1.08	-1.02	-1.18
Observations	1836	1683	1683	1683	1224	1377
Number of states	51	51	51	51	51	51
Demographic controls	NO	NO	YES	YES	YES	YES

Weighted by state population. Standard errors clustered at the state level in parentheses.

*** denotes $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.