ECONOMIC UPDATE

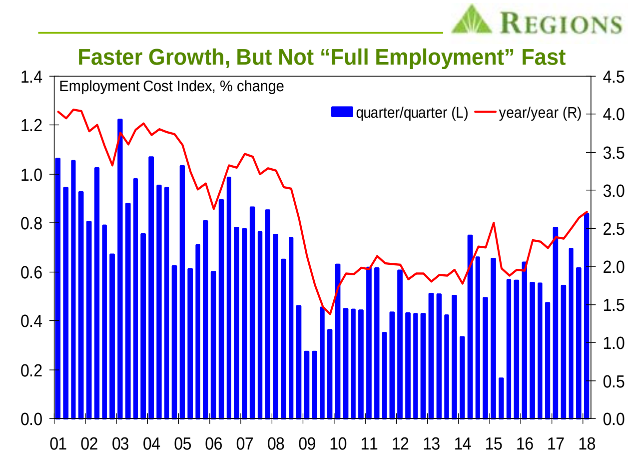
REGIONS

April 27, 2018

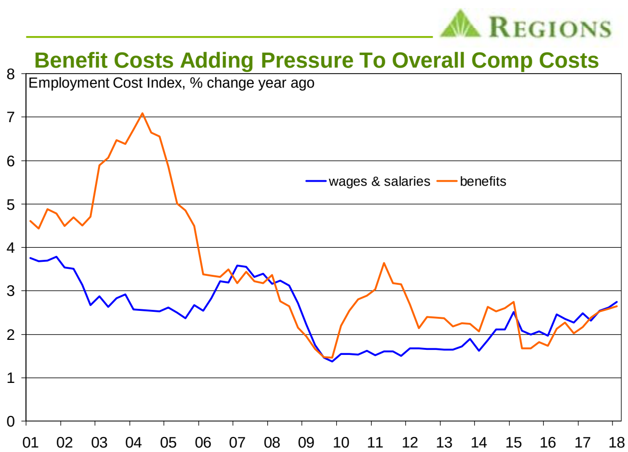
Q1 2018 Employment Cost Index: Faster Growth, But Not "Full Employment" Fast

- The total ECI was up 0.8 percent in Q1 2018, with the wages/salaries component up 0.9 percent and the benefits component up 0.7 percent.
- Year-on-year, the total ECI was up by 2.7 percent in Q4 with wage costs up 2.7 percent and benefit costs up 2.6 percent.

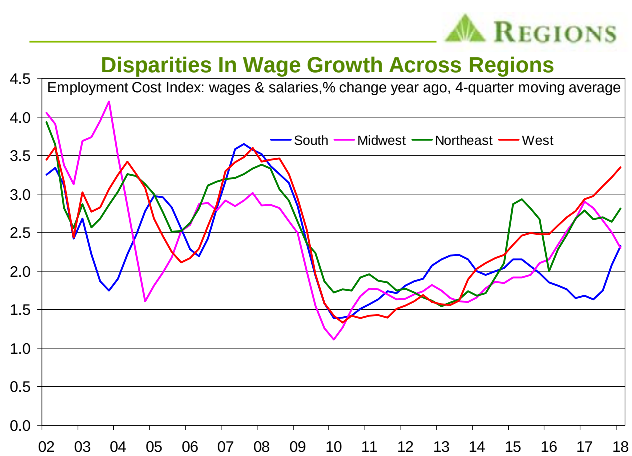
Total compensation costs, as measured by the Employment Cost Index (ECI), rose by 0.8 percent in Q1, ahead of the 0.7 percent we and the consensus expected. Wage costs as measured in the ECI were up 0.9 percent in Q1, the largest quarterly increase since Q1 2007, while benefit costs were up 0.7 percent. As of Q1, the total ECI is up 2.7 percent year-on-year, with wage costs up 2.7 percent and benefit costs up 2.6 percent. Growth in labor costs has clearly been accelerating, as would be expected given what has been a prolonged period of steady improvement in labor market conditions. At the same time, however, the ECI data do not paint the picture of a labor market on the boil despite an unemployment rate on the verge of falling below 4.0 percent.



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 showing moderately accelerating wage growth.



To many observers, today's ECI report was thought to be of far more significance to the FOMC than was today's initial report on Q1 GDP. Real GDP growth was expected to have slowed in Q1 and it is well known that the Q1 GDP data in any given year are clouded by the residual seasonality issue, meaning that whatever the headline print on the Q1 GDP report, it would be highly discounted. Of more interest to the FOMC as members get set to gather next week is growth in labor costs. Many FOMC members still seem wedded to the Phillips Curve even though the Phillips Curve has been divorced from reality for quite some time now, so any signs that wage growth is accelerating, such as the Q1 ECI data, are sure to raise more than a few eyebrows amongst FOMC members. We would point out, however, that the GDP data do not have a monopoly on residual seasonality, as the wage data in the ECI in the first quarter of any given year tend to be biased higher by bonus payments and, of more relevance in recent years, higher minimum wages that take effect in January of any given year. Evidence of bonus effects can be seen in wage growth in finance, up 1.8 percent in Q1 and up 3.8 percent year-on-year, while evidence of minimum wage effects can be seen in retail trade (wages up 1.2 percent) and leisure & hospitality services (wages up 1.3 percent). As such, the key will be the extent to which the faster growth in wages reported in the Q1 ECI data will be sustained.



Aside from differentials in wage growth across industry groups, there are also significant divergences in wage growth across geographies, as seen in our bottom chart. For some time now wage growth has been faster in the West region than in the other three broad regions. Wage growth in the Midwest and South regions came together in Q1 but clearly is moving in opposite directions. The geographic splits reflect not only the different mix of industries from one region to the next but also underlying labor market conditions.

The ECI data are consistent with other measures showing accelerating labor costs. This acceleration will continue as the labor market tightens further. FOMC members will be closely watching whether the pace of growth seen in the Q1 ECI data will be sustained. We think not, but if so, they will likely push the Fed funds rate higher at a faster pace.

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