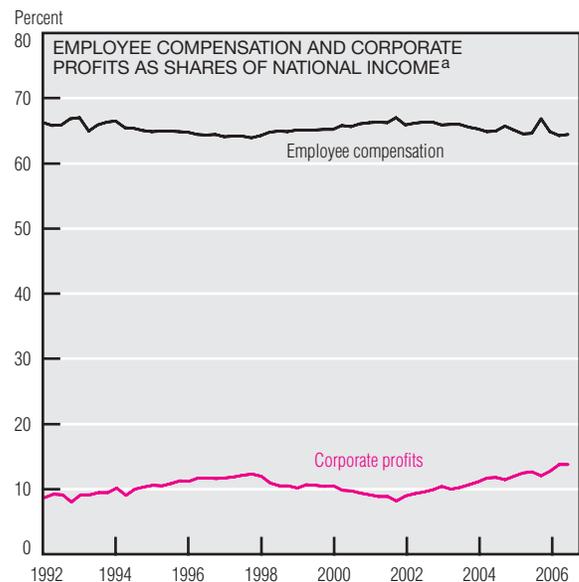
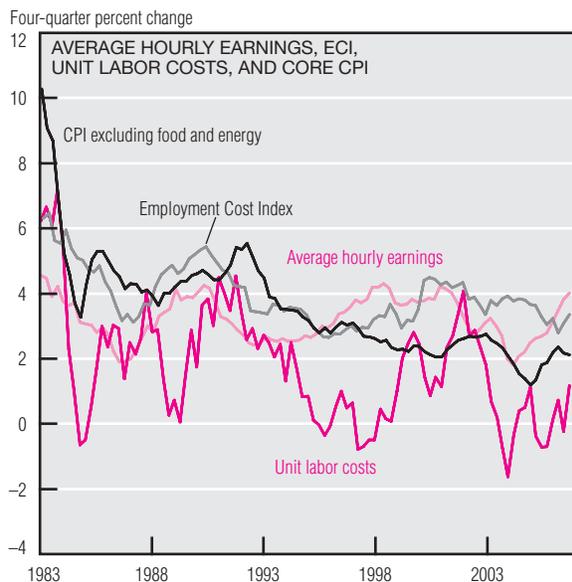
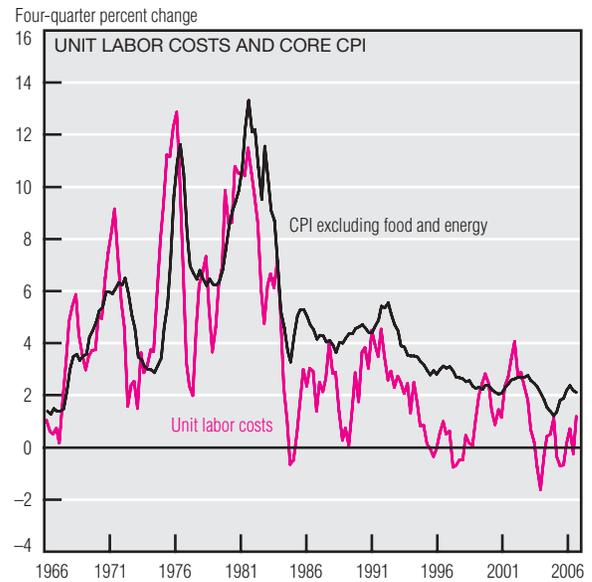
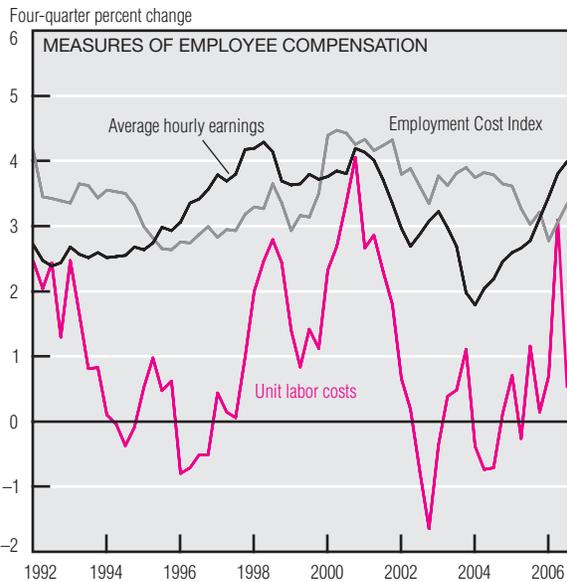


Labor Costs



NOTE: Data are seasonally adjusted.

a. Corporate profits, adjusted for inventory valuation (IVA) and capital consumption (CCA).

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of Economic Analysis.

Unit labor costs, relatively stagnant since 2002, are showing signs of an upward trend. Since the beginning of this year alone, unit labor costs, a productivity-adjusted measure of compensation, have risen nearly 2%, the highest growth rate since 2001. Other measures of compensation include average hourly earnings and the Employment Cost Index. The percent change in average hourly earnings decreased from 4.1% to 1.8% between 2000 and 2004; it has since rebounded and now hovers around 4%. Meanwhile, the ECI, which takes

into account not only wages and salaries but also benefits costs, fell less than either unit labor costs or average hourly earnings; however, it has not rebounded like the other two series. Its annualized growth rate is 3.3%, down from 4.4% in 2000.

Some economists argue that rising labor costs can increase inflation over the long run. This theory seemed to be substantiated in the 1970s, when the core Consumer Price Index was highly correlated with unit labor costs. This correlation, however, has broken down over the last two decades, and unit labor costs are no longer a good

predictor of inflation. In fact, neither average hourly earnings nor the Employment Cost Index is strongly correlated with the core Consumer Price Index.

Employee compensation as a share of national income has remained relatively flat, but corporate profits have been trending upward since 2002. How will firms react if wages continue to rise? Should higher wages cause inflation concerns? Although current data do not answer these questions, they do show that labor costs are poor inflation predictors.