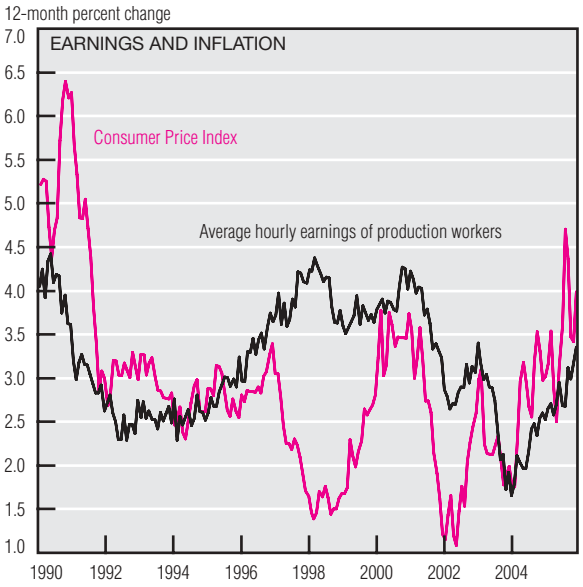
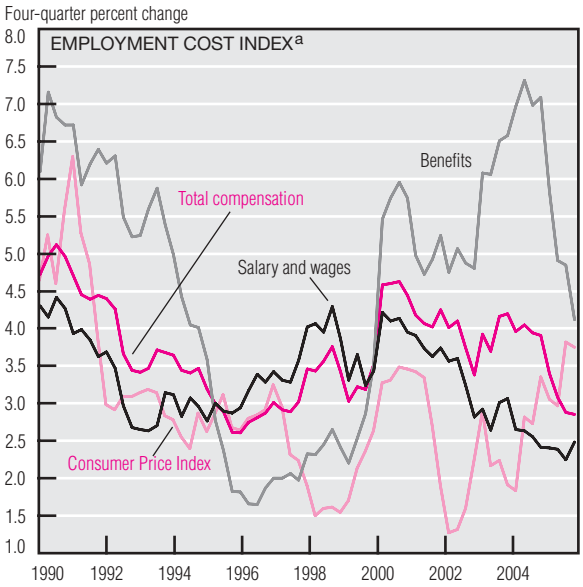
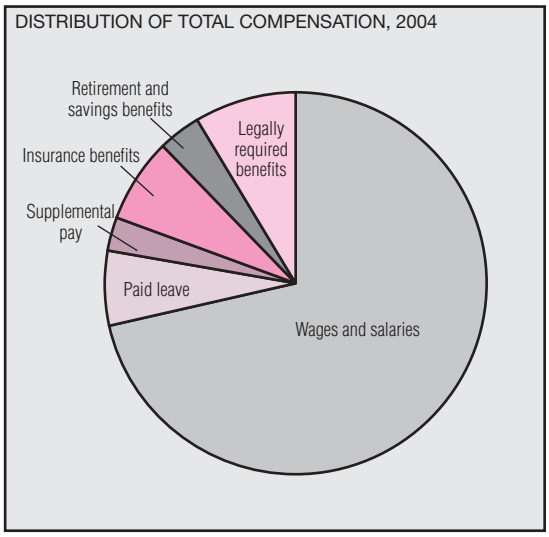
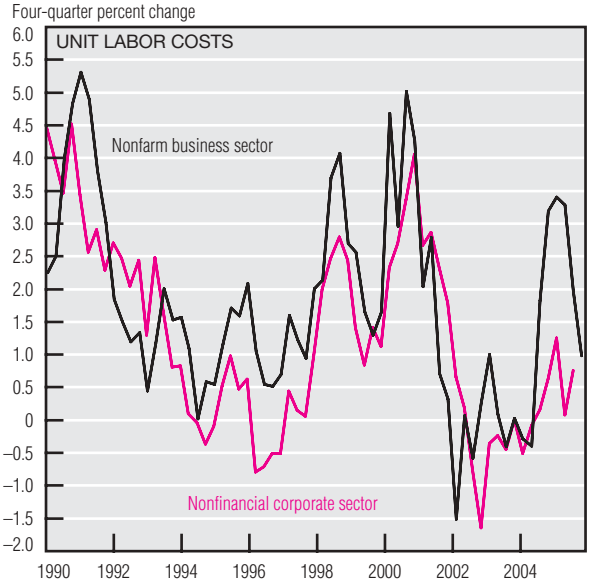
Labor Costs









a. Private industry workers.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Labor costs account for roughly 70% of firms' production costs. For this reason, logic suggests that rising labor costs might signal potential inflation pressure should firms try to recoup labor cost increases by raising their product prices. However, measuring labor cost inflation is a challenge, and there are several ways to do it.

Average hourly earnings of production and nonsupervisory workers provide the timeliest measure. Although inflation growth has generally exceeded average hourly earnings growth for about two years, earnings growth has more than doubled since 2004, rising 3.3% on a year-over-year basis in January 2006. However, this measure is limited because it reflects only changes in hourly wage rates and pay for overtime. Moreover, it captures only the wages of production and nonsupervisory workers, who historically have accounted for roughly 70% of all private employees. Finally, average hourly earnings cannot control for movement across industries and occupations; thus, increased earnings may reflect a shift toward higher-paying industries rather than wage inflation.

The Employment Cost Index (ECI) is a more comprehensive measure. It comprises many important elements of labor compensation, including benefits such as paid leave, bonuses, insurance, payroll taxes paid by employers, and retirement and savings benefits: When combined, these benefits account for nearly 30% of total compensation. Furthermore, the ECI computes total compensation based on a fixed mixture of industries and

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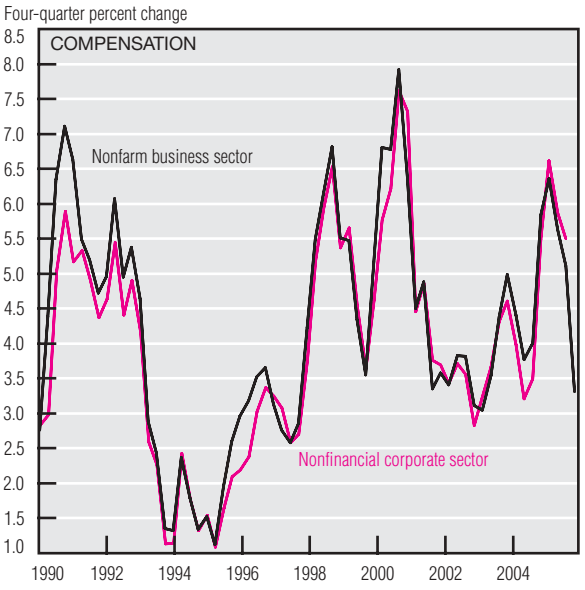
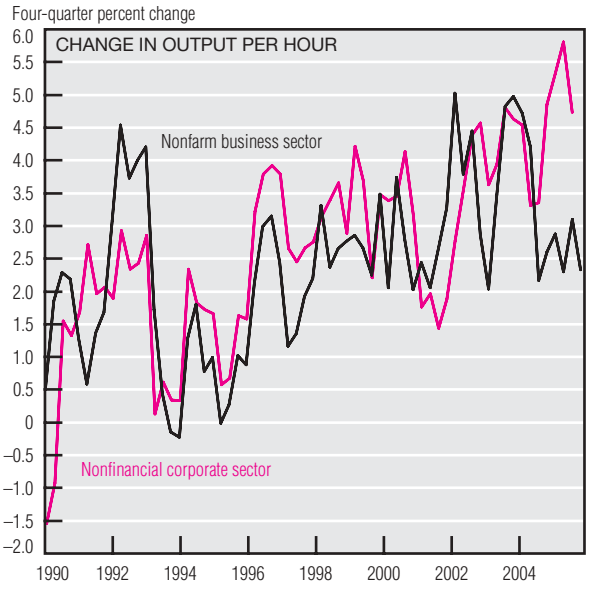
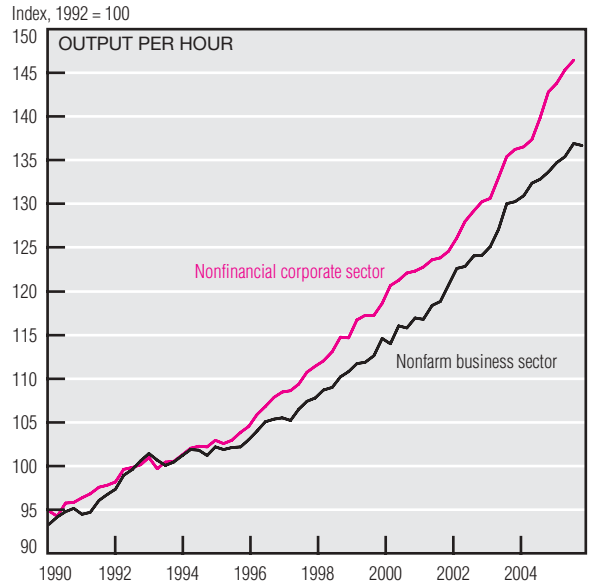
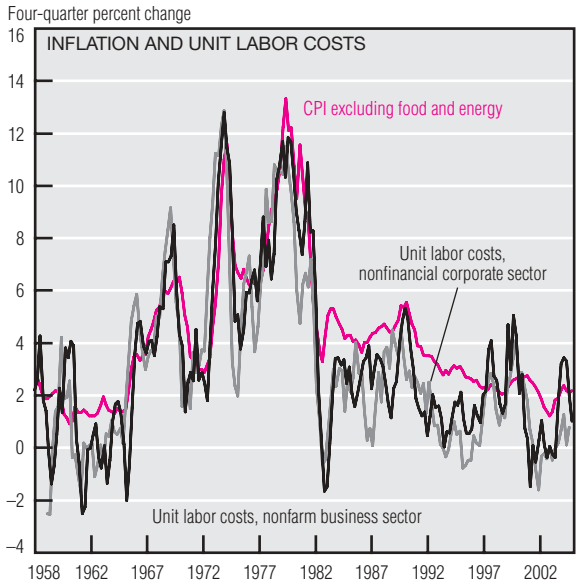
Labor Costs *(cont.)*









SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

occupations, in order to distinguish labor cost growth from growth caused by shifts in industrial and occupational structure over time. The ECI suggests that labor cost growth has decelerated since 2000, registering 2.8% year-over-year in 2005:IVQ. The ECI is a straightforward measure of labor costs, but it does not account for productivity.

Finally, unit labor costs for nonfarm business, a compensation measure that is adjusted for labor productivity, is decelerating after a period of unusually elevated growth. From 2004:IVQ to 2005:IVQ, unit labor costs for nonfarm business rose a mere 1.0%. Inflation in unit labor costs for the nonfinancial corporate sector has been relatively modest over the past two years, generally ranging between –0.5% and 1.0%. Since these sectors have similar compensation, the difference in their unit labor costs reflects a relatively higher level and faster growth in labor productivity in the nonfinancial corporate business sector. Some contend that this sector provides a better measure of labor cost inflation because it excludes noncorporate entities, whose productivity is difficult to measure.

Although labor costs are an important part of production costs, the historical link between employment cost pressures—as measured by unit labor costs—and core inflation, which was strong during the higher-inflation 1970s, has become less reliable. In recent years, unit labor costs in both nonfarm business and the nonfinancial corporate sector have been poor indicators of changing inflation rates.