# Good News *for the* Fed

*Wage inflation is beginning to turn up, but Yellen will still run the economy "hot."*

BY RICHARD H. CLARIDA

Coming into to its March meeting, there was little mystery about what the Fed would do—nothing—but a lot of interest and a wide range of opinion about how it would communicate a decision to keep rates on hold. Speculation focused on three key communications:

- The "dot plot"—that is, the Federal Open Market Committee participants' assessments of the appropriate policy rate over the coming years;
- The balance of risk assessment; and
- The Summary of Economic Projections for inflation, unemployment, and NAIRU (non-accelerating inflation rate of unemployment).

The biggest surprise on Fed day was that the median of the dots now indicates only two more rate hikes for 2016, down from the four hikes in 2016 projected at December's meeting. This had the effect of moving the Fed dot plot liftoff path for 2016 and 2017 closer to market pricing, but with the latter still well below the former. As for balance of risk, whereas in January the Fed said that it was "closely monitoring" global developments and was "assessing" their implications, in the March statement the Fed has apparently finished their assessment and now concludes that "global economic and

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financial developments continue to pose risks." The SEP projections now show somewhat less inflation in 2016 and slightly less inflation in 2017 than was projected in December, and the median estimate of NAIRU has shifted down by one-tenth of a percentage point to 4.8 percent. What has attracted somewhat less attention is that, notwithstanding this downward adjustment to the NAIRU, the Fed projects that its policy of increasing the Federal Funds rate towards a "new equilibrium" destination at a "gradual" pace will continue to provide accommodation sufficient to push the unemployment rate

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*below* the NAIRU later this year and keep it there through at least 2018 (Figure 1). In other words, the Fed wants to run the economy—at least a little—hot and to keep the unemployment rate "lower than the NAIRU and for longer" than is typical in Fed rate hike cycles.

Given the initial conditions that Janet Yellen inherited upon becoming Fed chair in February 2014 and the Phillips curve lens through which she and key members of the Committee interpret the labor market, setting a policy path that will allow the labor market to "run hot" is an understandable choice. As shown in Figure 2, U.S. inflation as measured by the PCE deflator has consistently remained below the Fed's 2 percent target since that target was first announced in January 2012. In the Fed's model, holding constant expected

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**Figure 1 The Fed wants to run the economy at least a little hot**

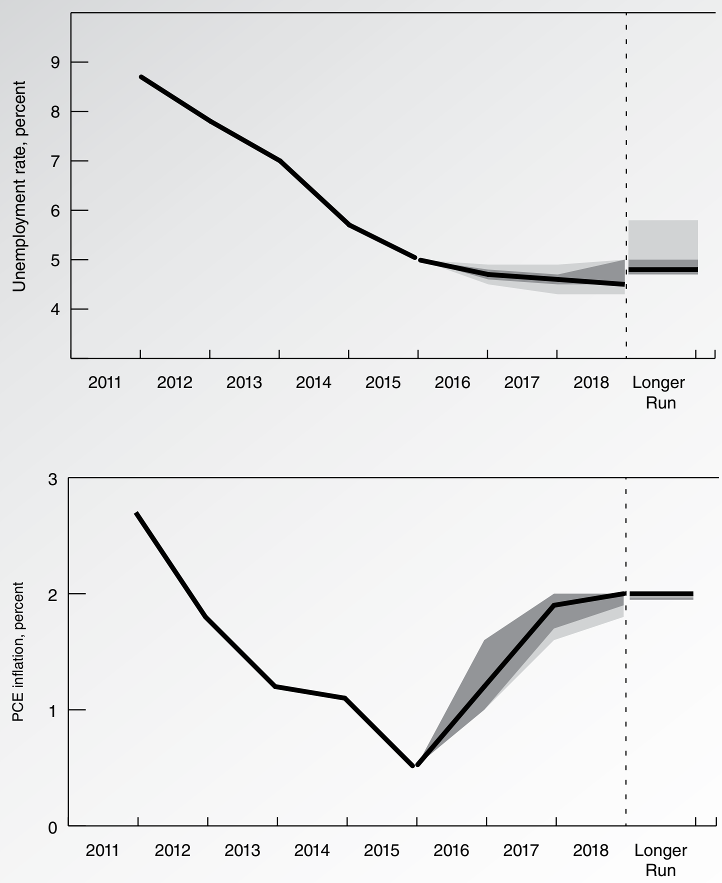
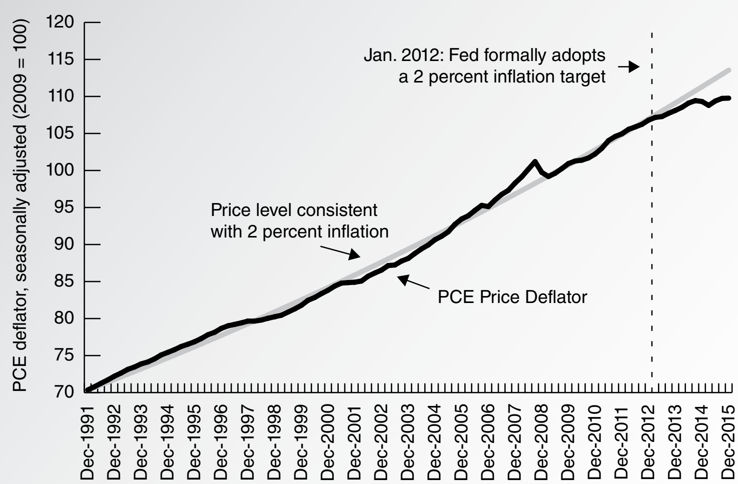



**Figure 2 PCE inflation running below Fed's target**



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inflation, the only way to get inflation moving up to the 2 percent target is for the unemployment rate to be pushed below the NAIRU.

A second motive for the Fed to run the labor market hot is, I suspect, driven by the Committee's concern over

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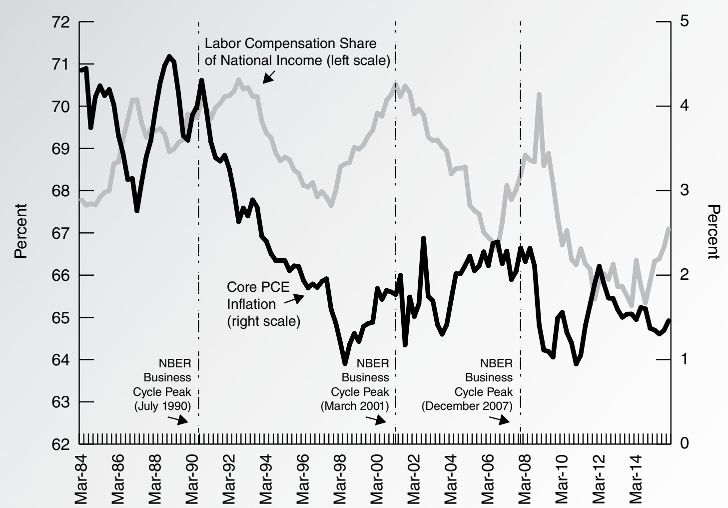
recent declines in various measures of inflation expectations which have not in recent years respected the "holding constant" assumption. For example, both the respected Michigan survey of household inflation expectations as well as break-even inflation rates derived from the TIPS market fell below their historic averages in 2014 and have remained below those averages since then. By projecting a baseline policy path for gradual lift-off with a Fed Funds rate trajectory that is lagging behind projected inflation throughout 2016 and almost all of 2017, the Fed hopes to steer inflation expectations higher by projecting a baseline scenario for lift-off under which real interest rates at the short end of the yield curve will remain negative for at least two years. A challenge the Fed will face as it tries to engineer a "dovish" rate hike cycle is that investors, households, and firms are conditioned by experience to associate Fed rate hike cycles with efforts by the Fed to either reduce inflation or, as was the case in 1994 and 2004, to prevent inflation from rising above 2 percent. Chair Yellen herself expressed during her press conference some doubts about the upward momentum in core inflation, saying, "I'm wary and haven't yet concluded that we have seen any significant uptick that will be lasting in, for example, core inflation … [However] with continuing improvement in the labor market, I think we will see upward pressure on inflation."

In August 2014, I published an essay entitled "Share and Share Alike" in which I reported and interpreted the

**Figure 3 Labor's share of national income rising steadily**




historical data on labor share of U.S. national income and documented the underappreciated pro-cyclicality of labor's share toward the midpoint of past economic cycles. At that time I wrote:

> *Much commentary and public concern have focused on the evident trend decline in the share of U.S. national income flowing to labor and the corresponding trend rise in the share of U.S. national income flowing to capital… While it is too soon to tell if the current expansion will—like prior expansions—feature a rise in labor's share back toward the historical average, there is some evidence of an acceleration in wages that is beginning to emerge in tandem with the ongoing decline in the unemployment rate. If and when labor's share of national income and wages rises and unemployment continues to fall, what will be the implications for inflation and, in turn, the Fed?*

As is shown in Figure 3, since I wrote that article in the summer of 2014, labor's share of national income has increased materially in tandem with the much more widely documented and discussed decline in the unemployment rate. As of the fourth quarter of 2015, it stands just north of 67 percent, reaching a share last observed (on the upswing) in December 2006. Note that this pattern of a mid-cycle rebound in labor's share is typical of past U.S. recoveries. In the three expansions during the "Great Moderation"—the quarter-century after then-Fed Chair Paul Volcker broke the back of inflation—labor's share of income initially fell during the early days of recovery and then began to rebound during the expansion phase of the business cycle. Importantly, this rise in labor's share occurred before, and usually well before, the business cycle peak and continued as the economy fell into recession. The rise in labor's share that occurs during recessions is well known and is usually attributed to the desire of firms to "hoard" labor initially in downturns as sales decline—holding off on firing workers until the decline in demand is clearly expected to persist. What is less appreciated is the phenomenon of labor's rising share of income well in advance of the peak in economic activity and for reasons unrelated to labor hoarding.

## BOTTOM LINE

So although it took a while to kick in, it does appear that this recovery from the Great Recession has returned to the pattern of past cycles in which labor's share of the pie begins to rise—and of course capital's profit share of national income begins to decline. These facts are worth remembering next time you see the anchors on financial television bemoaning sluggish gains in corporate earnings. Especially in a low productivity growth world, gains in labor's share will come, at least to some extent, out of profit growth. The extent to which this happens will of course depend upon how much of the higher labor cost bill is passed through to prices. The Fed wants higher inflation from today's levels so it will not be inclined to run a hawkish policy that would prevent it. That said, the Fed is always reminding us that 2 percent is a target, not a ceiling, and that it does not want to run a policy that keeps average inflation below 2 percent. The SEP projections do not acknowledge a baseline scenario in which inflation overshoots the 2 percent target after falling short of it since 2012. That is the Fed's story and they are sticking to it. I suspect, however, that at least several prominent members of the Committee would not be unhappy with a modest overshoot of the 2 percent inflation target—say 2.25 percent for a year or two—especially if it is a result of labor share rising toward its historic average. ◆

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