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Labor Costs Rise - Job Creation Grows Right Alongside

Rising labor costs is a key inflationary measure to which the Fed pays close attention. Typically employers pass along rising labor costs to the customer, and the fed reacts by increasing interest rates. But despite this quarter's increase in labor costs, employers are still hiring away and core inflation still remains low.

Labor cost is measured as the total cost of labor attached to each unit produced by a company. In Q1 of '05, labor costs rose 2.2%, while only growing .4% in all of 2004. The increased cost is partly based on compensation, but comes from rising benefit rates as well. These labor costs don't represent anything unusual for an economy enjoying a steady upward trend, however, as companies are currently more focused on growth than on cutting costs (back when the US was only teetering on the brink of recovery, companies were forced to cut costs in order to stay alive).

Productivity rates will also level out when a recovery moves towards maturity. Measured as output per hour worked, productivity grew at a 2.6% rate in the first quarter of '05. While higher than the previous two quarters, the sizable increase is dwarfed by the 4.5% productivity increase covering the years between late 2001, and the 2nd quarter of 2004. At the end of 2001, companies could squeeze labor costs with hiring freezes and stunted wage raises, all while demanding higher productivity from employees. But now the landscape has changed and employment is more readily available. Treasury Secretary John Snow comments that the current productivity increase is actually higher than it was at this same point along past economic cycles.

Consistent with labor cost increases and productivity declines in the improving economy, job creation is quite healthy. The April Jobs report boasts an increase of 274,000 jobs, which totals 100,000 more jobs than predicted. Furthermore, a recent revision to past reports indicates that an additional ±100,000 jobs were created between March and April. Before the April report came out, Hoenig & Co. Economist, Robert Barbera, noted that job growth hasn't been commensurate with US company profit growth. Barbera reasoned that while companies were flush with capital, they were increasing production overseas for products sold in the US.

Despite the portent of increased inflation and overseas jobs, Secretary John Snow is optimistic about the economy and continued job creation. In an interview on May 6 covered by CNBC, Snow states that the underlying fundamentals of the economy are good. With low core inflation, decent productivity, and good capital spending, "there is good strong non-inflationary growth that will create lots of jobs going forward."

Sources:
Jon E. Hilsenrath, *Labor Costs Rise at 2.2% Rate, Creating Inflationary Pressure*: WSJ 5/6/05
Justin Lahart, *Ahead of the Tape – Speed Bumps*: WSJ 4/27/05
CNBC Interview with John Snow, 5/6/06

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