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Commentary

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MLI Labour Market Report for Q2, 2018

Feeling It in Our Wallets: What Surprisingly Poor Wage Figures Tell Us About Canada's Labour Economy

Philip Cross

While Canadians have traditionally focused intensely on the unemployment rate as an indicator of economic health, in recent years it has become an increasingly incomplete and misleading reflection of how the labour market and the economy are faring. For example, in early 2018, while many were celebrating historically low unemployment rates, there were already many signs of weakness in the economy that we are now beginning to see more clearly.

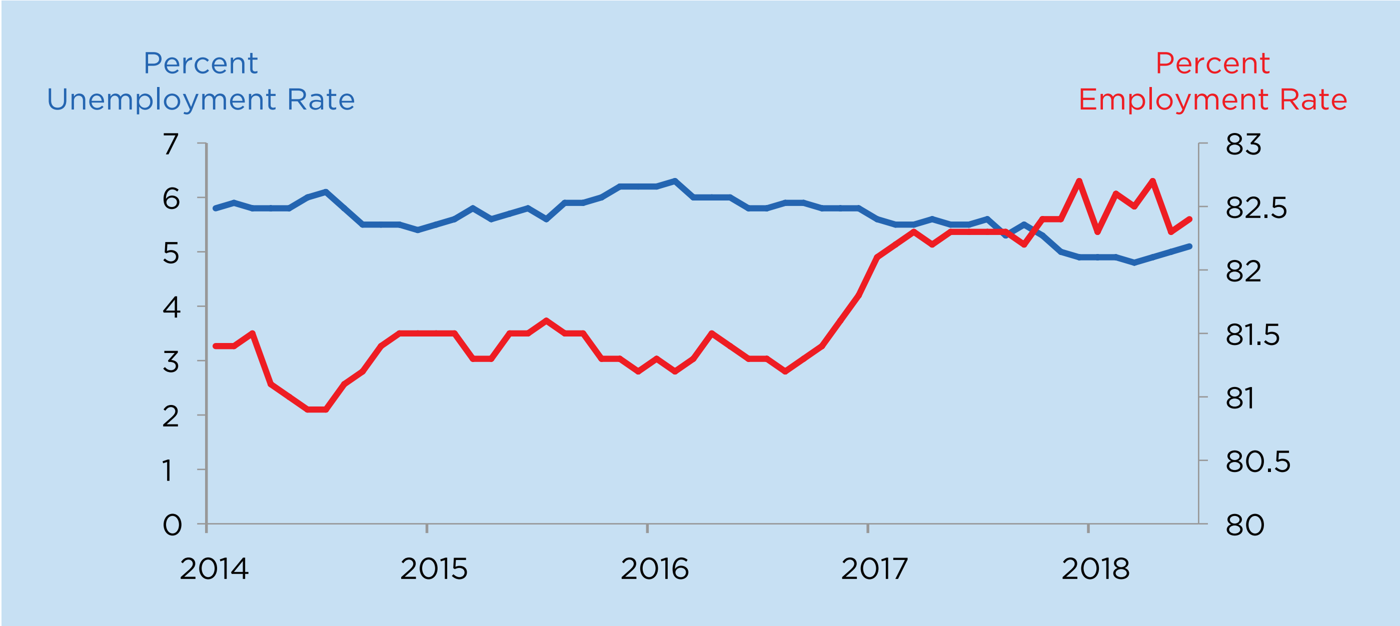
In this series of commentaries, MLI Munk Senior Fellow Philip Cross, former Statistics Canada chief economic analyst, dives into the data to reveal what's really going on with jobs and wages in Canada, so policy-makers can better understand who is gaining and who is losing, and what it means for the economy as a whole.

Labour market conditions weaken

All the major indicators of Canada's labour market deteriorated in the first half of 2018. Employment fell a net 0.1 percent in the first six months. The employment-to-population ratio for prime-aged adults retreated slightly from its peak, while the unemployment rate edged up.

The employment rate graphically shows the evolution of the economy in recent years better than any other macroeconomic measure (Figure 1), and definitely better than the unemployment rate. The share of adult Canadians holding a job was little changed between 2014 and mid-2016, apart from a brief dip in 2014 when the economy absorbed the shock of lower oil prices. The share of employed Canadians then rapidly increased over a full percentage point between August 2016 and March 2017, leading many analysts to claim that the recovery had finally reached take-off velocity of sustained real GDP growth well above 2 percent. However, these hopes were quickly dashed after March 2017 when the employment rate levelled off between 82.0 and 82.5 percent while GDP growth subsided below a 2 percent annual rate.

Figure 1: Employment and Unemployment Rate



Source: Statistics Canada CANSIM Table 14-10-0287-01

It is worth recalling that the sudden upturn in the employment rate between mid-2016 and early 2017 accompanied little change in the unemployment rate. While other macroeconomic indicators such as real GDP improved noticeably during this period (GDP growth rose above an annual rate of 4 percent), the unemployment rate barely moved.

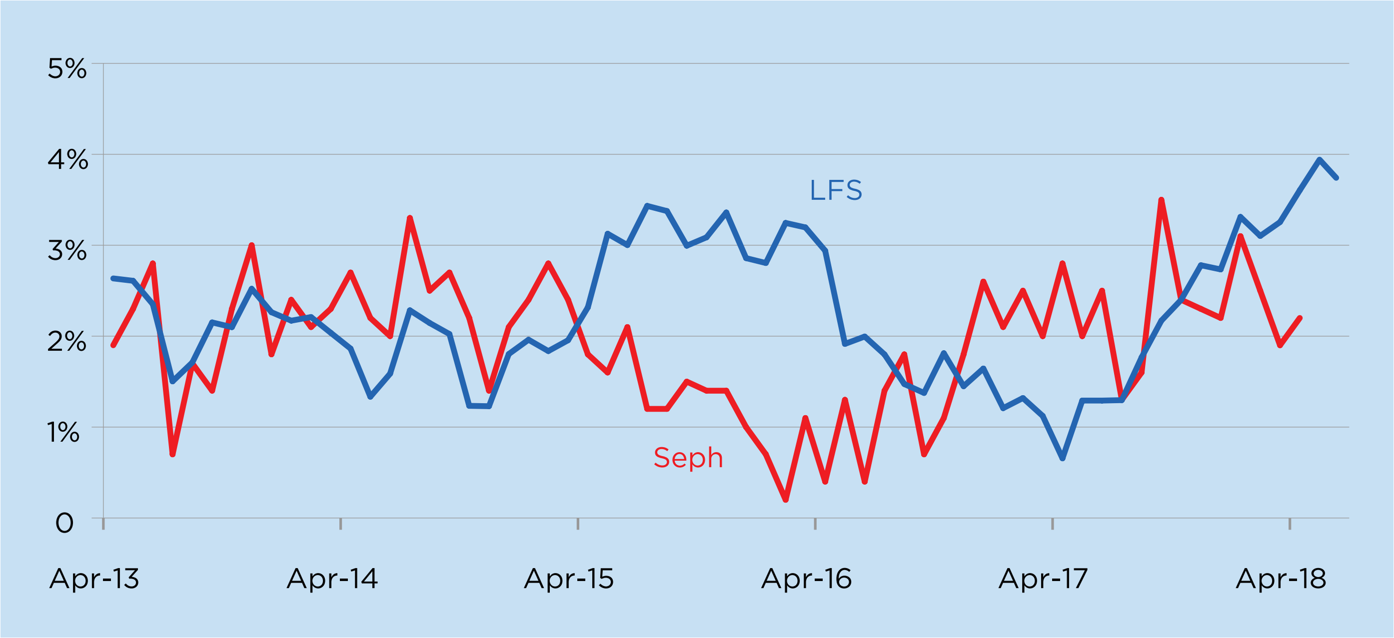
In fact, the unemployment rate fell twice as fast after mid-2017 even as the economy slowed. This is another demonstration that the unemployment rate is not always a good indicator of the performance of the macroeconomy, as demonstrated in a recent paper from the Macdonald-Laurier Institute (Cross 2018a) launching this series of quarterly updates on Canada's labour market. The softening of labour market conditions confirms the weakness predicted by the Macdonald-Laurier Institute Leading Economic Indicator (see, for example, Cross 2018b), and is borne out by the steady slowdown in the growth of real GDP since mid-2017.

Wages are the focus of this quarterly report on Canada's labour market. Specifically, the report examines whether earnings growth in Canada is accelerating, as some claim, or stagnating. It concludes that earnings growth is barely keeping pace with price inflation, implying no improvement in real wages. This immediately raises the question of why low unemployment is not reflected in higher wages, the basis of the Phillips Curve trade-off that has guided macroeconomic policy for much of the post-war era.

Divergent trends in wage growth

Some analysts point to an acceleration of average hourly earnings in Statistics Canada's Labour Force Survey (LFS) as symptomatic of a tight labour market (Figure 2). The year-over-year increase in LFS earnings was 3.6 percent in June, well above its 1 percent growth a year ago.

Figure 2: Annual Change in Average Hourly Earnings



Source: Statistics Canada CANSIM Table 14-10-0223-01 and -0320-01

But there are at least two problems with the assessment that wages are accelerating. First, most of the recent acceleration simply recoups a pronounced deceleration between the spring of 2016 and April 2017, leaving wage increases where they were in much of 2015 and early 2016 when the labour market was struggling to absorb the oil price shock. What is surprising about the LFS measure of earnings was the sharp slowdown to less than 1 percent growth early in 2017, despite all the evidence that the economy was improving markedly at that time.

Part of the problem reflects the great deal of inertia in the LFS measure of earnings; respondents are only asked their wage in the month they enter the survey, after which their wage is assumed to be unchanged for the next five months they remain in the survey before rotating out. Since wages are assumed to be unchanged for five out of every six people in the sample, the LFS measure changes very slowly.

Second, the labour market slowdown and its dampening impact on wages are more believably captured in the more comprehensive data from the Survey of Employment, Payrolls and Hours (Seph). This measure of earnings did decelerate after 2014 in response to the oil price shock before recovering to between 2 and 3 percent growth in 2017.

The Seph data show annual hourly earnings in April 2018 up only 2.2 percent from a year earlier, just keeping pace with inflation as measured by the consumer price index, implying no increase in real wages. The Bank of Canada's latest economic assessment noted the divergence in wage changes between the Labour Force Survey, the Seph, and other measures, arguing that the underlying trend of wage growth likely was about 2.3 percent, “indicating less wage pressure than would be expected in a labour market with no slack” (Bank of Canada 2018, 11).

It is worth clarifying the difference among the many measures of wages and incomes published by statistical agencies such as Statistics Canada. The broadest measure is total labour income, which includes the effect of the earnings of people working, the number of hours they work, and the wide range of supplementary labour income they earn. This last measure includes non-wage benefits that are not included in earnings such as a wide range of benefits for employees including supplementary health benefits and irregular payouts such as year-end bonuses and stock options. With the aging of the population, these supplementary benefits are a rising part of employee compensation, implying that conventional measures of wages and salaries (such as hourly or weekly earnings) are becoming less representative of incomes.[1]

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The LFS picture of rising wages contradicts the relative weakness of Canada’s economy compared to the United States. Despite having a lower unemployment rate than Canada, hourly earnings in the US are rising by about 2.5 percent. It would be hard to explain earnings growth in Canada accelerating above US growth when unemployment is higher in Canada (4.9 percent in Canada versus 4.0 percent in the US when measured on the same basis).

The Seph data on earnings in Canada also show that the sharp hike in minimum wages in Ontario starting in January had no significant impact on overall wages. While the increase in minimum wages did boost earnings in industries where minimum wage work proliferates (such as retail trade and accommodation and food), there is no obvious evidence that this raised wages for other workers. However, there is a prima facie case that higher minimum wages did help suppress jobs in Ontario in the first half of the year while higher labour costs forced firms to raise prices.

Finally, weak consumer spending does not support the notion that wages are improving. Personal expenditure growth has slowed in every quarter over the past year, from 1.1 percent in the second quarter of 2017 to just 0.3 percent in the first quarter of 2018, despite Ontario’s sharp hike in minimum wages (housing demand has decelerated even more dramatically, but this is more related to new regulations on mortgages).

The second quarter saw the weakening trend continue, as retail sales in April and May recouped less than half of their first-quarter decline. Any rebound in June will be limited by a sharp drop in consumer confidence at the end of May, according to the Bloomberg index of consumer sentiment (a component of the MLI Leading Economic Indicator), when the US slapped high tariffs on its imports of steel and aluminum. (The Bank of Canada estimates that these tariffs will reduce Canadian exports by $3.6 billion, mostly in the second half of 2018 (Bank of Canada 2018, 13).)

The failure of wages in Canada and the US to respond to low unemployment reflects several factors. One is that the unemployment rate is no longer the best measure of labour market conditions. More broadly, there is growing skepticism about the stability of the relationship between wages and the unemployment rate, as most famously described by the Phillips Curve.

Is the Phillips Curve obsolete?

The number one conundrum facing central banks in North America is how low they can push the unemployment rate before sparking higher inflation; economists call this the Non-Accelerating Inflation Rate of Unemployment, or NAIRU. Robert Gordon of the National Bureau of Economic Research (NBER) in 2013 estimated that the NAIRU was 6.5 percent while more recently the Congressional Budget Office evaluated it at 5.4 percent. Nevertheless, the US unemployment rate has fallen below these estimates without sparking higher inflation. One of the fundamental problems with predicting what level of unemployment triggers higher inflation is that there is no theoretical guide to what level of unemployment is the NAIRU.

A stable trade-off between inflation and unemployment has been one of the foundations of macroeconomics. In North America, low unemployment rates were expected to have boosted inflation and wages long ago, but this has failed to materialize. Indeed, the Phillips Curve relationship implied that the severe recession at the height of the financial crisis in 2008-2009 should have resulted in deflation. This marked the beginning of a series of predictions by the Phillips Curve that have not materialized over the past decade, a reflection of the uncharted territory that unconventional macroeconomic policies have entered.

The Phillips Curve was named for A.W. Phillips, who in 1958 observed that over the previous century employers in England bid up wages when workers became scarce. In 1960, Robert Solow and Paul Samuelson, two pillars of Keynesian analysis, coined the term "Phillips Curve" and made a trade-off between inflation and the unemployment rate part of mainstream economics (Spencer and Macpherson 2017, 165). Keynesians seized on the idea of the Phillips Curve because it filled a major hole in their theory about the determinants of inflation by linking it to unemployment, the focus of Keynesian models. Meanwhile, policy-makers liked the simplicity it brought to the choice of picking their preferred combination of inflation and unemployment; the Phillips Curve offered a menu of a stable trade-off between the two.

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While immediately popular with Keynesian policy-makers, conservatives such as Milton Friedman, Edmund Phelps, and Robert Lucas, Jr. were skeptical about the Phillips Curve. They said it lacked theoretical foundations – a problem with relying solely on evidence-based research – and rebelled at the implication that money was not the key determinant of inflation. Nor could the Phillips Curve predict the exact level of unemployment that would trigger higher inflation. In his legendary 1967 presidential address to the American Economic Association, Friedman explained why the Phillips Curve would soon break down (Friedman 1968).

Friedman's prediction was borne out before long, when the stagflation of the 1970s proved that both inflation and unemployment could rise at the same time. Soon, the emphasis shifted from inflation to inflationary expectations, which opened the door to the rational expectations theory pioneered by Robert Lucas, Jr. and its searing critique that Keynesian fiscal stimulus would not work when people understood that future taxes would have to increase to pay for the stimulus. William White, formerly Chief Economist of the Bank for International Settlements, called this critique of the Phillips Curve "arguably the most influential theoretical insight of the post war period" in macroeconomics (White 2012).

Despite being undermined during the 1970s, the Phillips Curve has stubbornly remained; it has never gone out of fashion any more than has deficit-financed Keynesian fiscal stimulus. The fundamental importance of the Phillips Curve to Keynesian macroeconomics and policy-making explains why it has been the subject of more studies than any other topic in economics. A 2015 *Wall Street Journal* survey found that two-thirds of economists still believed there was a trade-off between inflation and unemployment, despite the recent experience in the United States when double-digit unemployment rates barely moved the inflation rate (Leubsdorf 2015).

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Not surprisingly, many theories have been advanced to explain why wages have not accelerated as expected. One is that the threat of globalization and possibly losing one's job to cheaper labour overseas has capped wage demands. A variant is that technological change and automation is having the same effect. Many analysts have noted that financial crises, such as the one from 2008-2010, historically have had a dampening effect on growth for years, creating hidden unemployment and curbing wage demands. Another theory is that our aging population is distorting the measurement of wages; as aging and higher-paid boomers retire, they are being replaced by lower-paid millennials. Others speculate that increased industrial concentration, especially in technology areas dominated by Amazon, Apple, and Google, means there is less competitive bidding for workers.

The most interesting explanation comes from the Bank of International Settlements, one of the foremost critics of macroeconomics today. Its analysts argue that in fact prices have risen more than policy-makers believe, because conventional economists wrongly focus on just the price of goods and services in the CPI and do not factor in prices in asset markets such as stocks, bonds, and housing, all of which have been soaring. Still, this does not explain why wages remain depressed. The most likely conclusion is that Friedman was right in questioning whether the trade-off between inflation and unemployment is stable enough to underpin macroeconomic policy.

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Endnotes

1 For a complete discussion of the measures of wages and incomes, see the Appendix of Sheikh and Cross 2015.

About the Author

Philip Cross is a Munk Senior Fellow at the Macdonald-Laurier Institute. Prior to joining MLI, Mr. Cross spent 36 years at Statistics Canada specializing in macroeconomics. He was appointed Chief Economic Analyst in 2008 and was responsible for ensuring quality and coherency of all major economic statistics. During his career, he also wrote the "Current Economic Conditions" section of the Canadian Economic Observer, which provides Statistics Canada's view of the economy. He is a frequent commentator on the economy and interpreter of Statistics Canada reports for the media and general public. He is also a member of the CD Howe Business Cycle Dating Committee.

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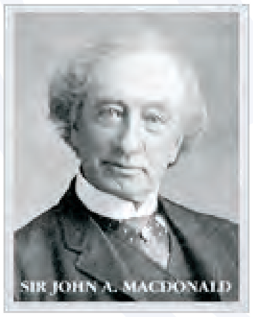

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