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Fed Ponders Rising Wages as It Considers Interest Rate Hike

Issue in Depth

- Federal Reserve

By RICHARD W. STEVENSON

WASHINGTON -- Frank Ciotola, a restaurant owner in Columbus, Ohio, is paying dishwashers $8 an hour nowadays, up from $6 two years ago. And he is spending more money placing help-wanted ads than he is promoting the restaurant itself.

The proportion of his total costs accounted for by labor has crept up to 29 percent from 24 percent during the last few years, and though he has clamped down on other expenses as much as possible, Ciotola said he has reached the point where customers at his restaurant, Da Vinci, will have to pick up some of the tab if wages keep rising rapidly.

"It's just about as tight as it's going to get," Ciotola said. "Any additional increases we face, we'll just have to pass along in terms of menu prices or I'm not going to make any money."

The nation's low and still declining unemployment rate -- it fell to 4.1 percent in October, the lowest in almost 30 years -- has been great news for Ciotola's 75 employees and workers in most industries all over the country.

But the shrinking pool of available labor, and the possibility that upward pressure on wages could spur inflation, seem to be the biggest issues on the minds of Federal Reserve officials as they debate whether to raise interest rates a third time this year when they meet on Tuesday.

So far, employment cost increases have remained restrained despite the drop in unemployment. Moreover, to the degree that those costs have surged, from such hot industries as computer software and telecommunications to more traditional sectors like retailing, businesses have proved remarkably successful in absorbing them without sacrificing profits or raising prices.

The reasons range from new trends in compensation, like the rising use of stock options in the place of salary increases, to an upturn in the growth rate of productivity, or each worker's output each hour. The question is how long such forces can keep a lid on the pressures that might force up wages and prices.

Productivity improvements can continue, one Fed official said recently, "but it defies all logic to assume you won't get increases in prices and wages at some point."

Nobody knows precisely when that point will be reached, though, making the decision about whether to raise rates next week a particularly close call for the central bank, which pushed its benchmark Federal funds target rate up by a quarter of a percentage point in August, to 5.25 percent, after an earlier quarter-point increase in June.

There is clearly a case for the Fed to take no action next week. By most measures, inflation remains reasonably well contained. The economy is showing some signs of slowing in response to earlier interest rate increases. Many stocks are down from their highs this summer. Alan Greenspan, the Federal Reserve chairman, and other Fed officials are increasingly convinced that the improvement in productivity growth reflects structural changes in the way businesses operate, not just a brief cyclical upturn.

"If they do raise rates, I'd really like to know why," said Ian Shepherdson, an economist at High Frequency Economics, a consulting firm in Valhalla, N.Y. "The only rationale is that growth is strong, and I think the Fed has moved beyond the idea that growth by itself is something to be afraid of."

The case in favor of another rate increase next week is built largely on the idea that the nation is running out of workers, and that at some point a simple supply-and-demand situation will lead to a surge in wages and then, perhaps, prices. In this view, the Fed should stay ahead of the trend by slowing the economy a bit more to keep the labor market from getting even tighter.

"Even in the absence of a rise in core inflation, developments in the labor market are likely to result in the Fed instituting more pre-emptive rate hikes," said Ian Morris, an economist at HSBC Securities in New York.

In a report last month, John Youngdahl, an economist at Goldman, Sachs & Company, took an in-depth look at the strains in the labor market. He said that even the broadest measure of available labor -- including not just people who are officially unemployed but some part-time workers and others who might be tempted back into the labor market -- had declined steeply, to 7 percent in September from 7.6 percent a year earlier.

Joblessness among adults, 3.5 percent in October, is near a three-decade low. Overall labor force participation is stagnant or down, and the growth of the labor force is slowing somewhat.

Youngdahl concluded that there appeared to be growing sentiment at the Fed that it is "not only the small size but the inflexibility of the margin in labor supply that creates potential for an appreciable upward shift in labor expense growth."

In his public appearances, Greenspan has alluded repeatedly to tight labor markets. Speaking to a group of business executives last month, Greenspan said that the number of people being drawn into the work force beyond those due to normal population trends -- in other words, people who had previously chosen not to work -- was accounting for roughly half a percentage point of economic growth.

Eventually, Greenspan said, the economy would have to revert back to a growth rate reflecting normal labor force growth and the long-term rate of productivity gains.

"Clearly, the growth in gross domestic product cannot exceed the sum of growth in structural productivity and in the working-age population indefinitely," Greenspan said. "Market pressures must eventually emerge that work to contain such unsustainable growth."

There is plenty of anecdotal evidence of mounting pressures in the labor markets. **Sears, Roebuck** & Company said that in some cities it had to pay cash bonuses to attract and even retain employees in its stores and that regional managers had discretion to raise wages if needed.

James H. Keyes, chairman of **Johnson Controls**, a manufacturer based in Milwaukee, said his company now often drew new employees from lower-paying, less-skilled jobs in the service sector, and must spend money and time training them. Moreover, Johnson's customers in industries like automobiles demand decreasing prices on some of its products, putting additional pressure on the company to offset rising labor costs with productivity improvements.

And at the loftiest reaches of the employment scale, experienced executives going into senior jobs at technology start-ups are able to

demand and get richer packages of stock and options in addition to cash compensation.

"We're living in the middle of an unprecedented supply-and-demand imbalance," said David B. Kixmiller, a partner in the Silicon Valley office of Heidrick & Struggles, the executive search firm.

To hold down labor costs in that kind of environment, companies have become more imaginative. Some use one-time cash bonuses to reward workers without permanently raising wage rates. Others are offering more equity-based pay programs like stock options that do not show up in traditional measures of wage and salary growth. Others are offering expensive gifts, extra time off and other benefits in an effort to lure new employees and hold onto the ones they have.

Some analysts also think that workers themselves are less aggressive in pushing for pay increases than they were in previous business cycles when unemployment dipped to low levels. The reason, they speculate, is that the combination of global competition and the relentless corporate push to cut costs hasleft workers somewhat insecure about their jobs -- even if they are relatively confident that they could find another if they did become unemployed.

The pressure on labor costs could well ease if the economy is indeed slowing. But the economy has repeatedly defied projections of a slowdown, and at this point continued strong growth could send unemployment down to levels the nation has not seen since 1969.

Morris of HSBC calculated recently that if labor force growth remains at its current annual rate of roughly 1 percent, labor force participation remains steady at around 67 percent and the economy creates an average of 250,000 nonfarm jobs a month, the unemployment rate will decline to as low as 3.5 percent by the middle of next year.

If job growth averages 200,000 a month -- it has been running at an average of 192,000 a month this year -- it would push the unemployment rate down to as low as 3.9 percent by mid-2000, Morris said.

Fed officials will no doubt scrutinize new reports on retail sales and productivity that are to be released on Friday, the last major economic indicators before their meeting next Tuesday. And while they have given few clues in the last few weeks as to their thinking about the arguments for and against a rate increase, they have made clear that they are very much on alert.

"One should not assume that the business cycle is dead," William McDonough, president of the New York Federal Reserve Bank, told reporters in Vienna today after delivering a speech there. "One

should not assume that the American economy can keep growing faster without inflation."

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