Is the Labor Market on the Verge of Overheating?

Household and business spending have decelerated markedly over recent months, but the December employment report indicates that the service sector continues to generate solid payroll gains. Moreover, these latest data confirm that the labor market still has plenty of room to strengthen further.

About a million Americans have joined the labor force since September. The good news is that nearly all of those individuals have succeeded in finding jobs, which is how the unemployment rate has remained steady at 5 percent. These developments contradict the notion that people who’ve been out of the labor force for an extended period have lost their skills and are no longer employable.

Nonetheless, labor-force participation rates for youths and prime-age adults remain well below pre-recession levels. Recent analysis by the Congressional Budget Office indicates that the labor force is substantially smaller than its full-employment level and that about 2 million Americans can be expected to rejoin the labor force as long as the job market continues to strengthen.¹

Friday’s numbers also indicate that nominal wage growth remains subdued. The chart above shows the recent evolution of average hourly earnings for all employees. The annualized six-month growth rate has been remarkably steady for the last two years at around 2.2%. It’s worth noting that this measure of earnings can vary significantly from month to month. For example, the one-month growth rate spiked last January, reversing the previous month’s decline, and that fluctuation accounts for the bump in the latest 12-month growth rate (not shown); however, that bump will disappear next month. Consequently, these wage data provide further evidence that the labor market is not on the verge of overheating.

Sustained payroll gains will be crucial for closing the employment gap. If the economy were to slide into a recession over coming quarters, nonfarm payrolls would be likely to shrink and nominal wage growth might well decline. Conversely, if the economic recovery stays on track and keeps generating payrolls gains of at least 200,000 jobs per month, the economy should reach full employment sometime next year, and nominal wage growth should also pick up moderately.

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