Gains in Wages Expected to Give Economy a Lift

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Wage increases for employees at almost all income levels are giving important and unexpected support to the nation's economy. If the gains continue, they offer hope that the rapid economic expansion of recent months could prove more durable than other spurts of growth over the last two years.

Forecasters expect the Commerce Department to say in its quarterly report on Thursday that the economy grew about 6 percent in the three-month period ending in September, which would be the fastest pace since 1999. Most of that growth stemmed from a sharp rise in consumer spending, driven largely by a continuing boom in mortgage refinancing and checks that were mailed out as part of the recent tax cut.

With those forces receding and business spending still slack, the economy will depend increasingly on regular paychecks, analysts say. Hourly wages have already surprised most economists by growing more quickly than inflation since 2001 in spite of the worst decline in employment in 20 years.

The wage gains have not been enough to overcome the economy's problems, however. Many families still have less income than they did a year ago because companies have reduced their workers' hours, and health care costs have risen rapidly. But economists say that the wage raises have provided a buffer, allowing consumer spending to continue rising every quarter for the last 12 years, according to the Commerce Department.

The contradictory mix of high unemployment with fast growth and resilient wages is part of the conundrum that the Federal Reserve will face tomorrow, when its monetary policy committee meets to set interest rates.

Fed officials have signaled that they will keep short-term rates at just 1 percent and repeat their cautious economic outlook because they remain worried about the slow pace of job growth and the risk of a deflationary price spiral.

According to an analysis of Labor Department data by the Economic Policy Institute, a Washington research group, hourly wages have increased more sharply than at any time since early 2002 — more than 2 percent, after being adjusted for inflation — for a median of about $14 an hour.

Another government survey suggests that wage growth is falling but remains above the annual inflation rate, which is roughly 2 percent. Wage increases trailed inflation for long periods during the 1980's and early 90's.

"What seems to be happening is that companies that are staying in business want to hold onto the people they have," Stephen R. Sleigh, director of strategic resources at the International Association of Machinists and Aerospace Workers, which has negotiated annual pay increases of more than 3 percent on most recent contracts. "It's a very unusual labor market right now."

As companies have reacted to the increasing competition of a global economy and figured out how they can use
technology smartly, they have become more efficient in recent years, ending decades of slow productivity growth. This productivity surge has contributed to the lack of hiring since 2001, because companies can make more goods without adding new workers, but it has also left a larger amount of revenue to be split between hourly wages and corporate profits.

"We all talk about the dark side of productivity growth," Richard Berner, the chief United States economist at Morgan Stanley, said. "This is the positive side. Companies couldn't afford to pay more if they weren't getting more out of their workers."

With the help of the money from refinancing and the tax cut, retail sales surged last month; Gap, Neiman Marcus, Nordstrom and other chains reported some of their best results since last year.

The increase in wages "has been a hallmark of the last several years and a cushion for the consumer," Mr. Berner said. "It's an important and often overlooked aspect of what's going on."

Thursday's report on economic growth will offer clear political advantages for the White House, adding legitimacy to its argument that the recent tax cut has turned around the economy. But many economists, including some at the Fed, caution that major parts of the current growth spurt are unsustainable.

Laurence H. Meyer, an economist and a former Fed governor, estimates that the combination of tax cuts and bigger government spending, mostly for the military, essentially doubled the pace of economic growth in the third quarter, to 6 percent from 3 percent. But Mr. Meyer said that that effect is already wearing off and that the fiscal policy will actually become a drag on growth by the end of next year.

Interest rates are also likely to rise as the economy recovers, as John W. Snow, the Treasury secretary, pointed out in closely followed remarks last week. That could cause a big decline in mortgage refinancing.

The best hope for a run of solid economic growth that lasts more than a few months, which has not happened since the late 90's, lies in corporate America, where many executives remain too circumspect to invest significantly in new buildings, equipment or technology. Should that change, employment could begin growing at a healthy rate again and income and consumer spending could rise with it, creating a virtuous cycle, economists say.

The economy added jobs in September for the first time since January, but the new hiring was not strong enough to cause a drop in the unemployment rate.

The key is "the whole hand-off from consumers to business," said Robert V. DiClemente, chief United States economist at Citigroup. "The business sector has to promote growth by restocking, hiring, advertising, contributing to income growth," he said.

Most forecasters predict that the current recovery will take hold, even if the gaudy growth of the third quarter does not last.

But Wall Street and government economists have repeatedly been too optimistic over the last two years, and a few analysts remain concerned that companies are still working off the excess of the late-90's bubble in stock prices and technology spending.

If employment does not begin growing at a healthy pace soon, the wage increases will probably not last, many economists say. Changes in pay often lag other parts of the economy.

The recent wage increases appear to grow out of both the sharp recent increases in the nation's productivity and the
relative strength of the labor market, compared with its condition in the aftermath of other recessions.

With the jobless rate at 6.1 percent last month, compared with a peak of almost 11 percent during the 80's, companies also have less bargaining power than they had during other periods of slow economic growth. A survey of employers by Watson Wyatt, a consulting firm, found that they plan to pay average salary increases of 3.4 percent next year, up from 3.2 percent this year.

SAS, a software maker based in Cary, N.C., has reduced the amount of money it pays to employees from its profit-sharing plan as business has weakened in the last two years. But SAS has increased salaries 4 to 5 percent a year on average, with most of the raises going to the employees whom executives fear losing the most, said Jeff Chambers, vice president of human resources at the company, which employs 5,000 people in this country.

"We've made money available to people who have the magic — the critical performers in the critical roles," Mr. Chambers said.

Other significant pay increases this year have included raises of almost 10 percent for public school teachers and administrators in Washington and raises of almost 30 percent for nurses, who are still in high demand nationwide, at Tenet Healthcare.

But the picture is hardly uniform. Airline and steel workers have agreed to pay cuts as their companies struggle to avoid or emerge from bankruptcy. In August, President Bush announced that he was cutting the raises of more than one million federal workers, to 2 percent from 2.7 percent, to help pay for military actions and to avoid the need for other spending cuts.

Over all, workers at the very bottom of the income distribution are among the only ones whose hourly wages have trailed inflation recently. Congress has not raised the minimum wage since 1997, and its buying power has been slowly eroded by inflation.

Workers in the middle have received somewhat larger increases than those at the top, according to Jared Bernstein, an economist at the Economic Policy Institute. Men's wages grew in the third quarter of 2003 for the first time in a year, Mr. Bernstein said, based on his analysis of a survey of households conducted by the Census Bureau.