Macro Signposts | Counterintuitive Labor Market Shifts Constrain Measured U.S. Wage Gains

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The headline U.S. unemployment rate has been falling for several months, but a closer look at who is leaving the workforce – and who isn't entering or returning to it – reveals why average wages are stagnating, and why labor markets aren't a source of inflationary pressure.

In last week's edition of Macro Signposts, we discussed some counterintuitive trends in the U.S. labor market. Since the beginning of the year, we've seen tandem declines in both the unemployment rate and the employment-to-population ratio – a concurrence without historical precedent (see Macro Signposts, "As Older Workers Retire, Labor Costs Ease").

We argued that this trend is symptomatic of structural changes in the labor market related to demographics, AI, and immigration policy that are all colliding. The result is a labor market that isn't as tight as the headline unemployment rate alone (4.1% as of July 2026, according to the U.S. Bureau of Labor Statistics (BLS)) would suggest. The fact that the unemployment rate is falling while reported wage inflation is also falling confirms this: A tighter labor market theoretically is supposed to firm wage growth, not soften it.

This week, we dig deeper into the BLS household survey data to better understand what is happening beneath the surface of those moderating headline wage trends. We find that a compositional shift in who is leaving employment – and who isn't returning – is pulling measured U.S. wage growth lower even as the jobless rate declines. This shift, combined with rising labor force exits and a declining job-finding rate, paints a picture of a labor market that is not generating a sustained source of inflationary pressure.

Given that labor costs are a large portion of the input costs for the goods and services produced across the U.S. economy, consumer price inflation, which is now elevated, should converge to labor cost trends over time. These labor market trends also argue for central bankers not to be overly reliant on the unemployment rate as a measure of the state of the U.S. labor market.

What economists call the "external margin" in Figure 1 is the net effect of compositional shifts in the makeup of employed people – the difference in wage levels between those entering versus those exiting the labor market. The "internal margin" is the change in the average wage of people who were employed and remained employed. As the chart suggests, a higher rate of people entering employment at lower wages when the economy is doing well tends to put downward pressure on the average wage. During recessions (e.g., the global financial crisis and the COVID pandemic), a greater share of lower-wage workers leaving the workforce tends to put countercyclical upward pressure on wages.

At the same time, the lower job-finding rates from both unemployment and outside the labor market imply we're not experiencing a wave of below-median entrants shifting the wage level distribution toward lower-paying jobs, although a greater portion of the entrants that we have seen are below the average and median wage levels.

In other words, it's complicated – and the net result is a compositional drag on measured wages that is occurring alongside falling labor supply. Figure 3 shows that through July of this year, workers transitioning from full-time to part-time employment have been the greatest drag on average earnings – formerly above-average-wage workers are leaving full-time employment and transitioning to part-time. However, a rising share of individuals transitioning from employment to unemployment are people leaving what were relatively high-paying jobs.

1 Mary C. Daly, Bart Hobijn, and Benjamin Pyle. "What's Up with Wage Growth?" Federal Reserve Bank of San Francisco Economic Letter (March 2016) Return to content

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