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HOW DOES A TIGHT LABOR MARKET DRIVE UP PRICES YOU PAY? JUST VISIT YOUR LOCAL HAIR SALON

Many economists expect low unemployment to translate into a pickup in wages. Here's why and where that theory works.

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Step into a Sport Clips Inc. franchise and you can expect to see hairdressers washing, cutting and styling hair. Behind these daily hair-salon operations, a key economic theory is playing out: the Phillips curve.

Multiple franchise owners are jacking up or plan to raise wages to attract scarce hairdressing talent and are increasing haircut prices to compensate for it. This fits the classic Phillips curve model, which predicts wages and inflation will rise in response to a tight labor market. In theory, it should be happening to the overall U.S. economy, but it hasn't.

Economists say powerful factors such as an aging population, technology, sluggish productivity growth and overseas competition could be restraining the relationship between the unemployment rate and inflation.

When the relationship is functioning, here's how it works:

- The low unemployment rate means more competition for workers Sport Clips has to choose from.

- Wages go up to lure or hold on to workers. Debra Sawyer, a Sport Clips franchisee with salons in Richmond, Virginia and Central Florida, said she raised worker wages in February 2017 in response to the labor shortage.

- Pay for team members increased 11 percent to $10 from $9 an hour, while pay for assistant managers rose 20 percent to $12 from $10 and manager paychecks increased 33 percent, to $15 from $11.25. Hourly bonuses also went up dramatically.

- Prices for services rise to cover part or all of the added labor costs. When the Sport Clips franchisee implemented the wage increase, it increased the price of a standard haircut to $20 from $19, a 5 percent bump, and the signature service cut went to $25 from $24. All of these increases went to pay raises and hourly bonuses, said Ms. Sawyer.

The Sport Clips experience should warm the hearts of economists fond of the Phillips curve. But they remain puzzled by the fact that many other sectors aren't following suit. For example, the construction industry, which has struggled nationwide to find workers, has seen average hourly wages in February rise 3.3 percent from a year earlier, which is stronger than overall private-sector wage growth of 2.6 percent but far less than at the hair salon.

Cities with the tightest labor markets have seen above-average wage growth. Minneapolis, where the unemployment rate has been among the lowest for large metro areas in the country, at 3.3 percent in February – below the national rate of 4.1 percent – saw wage growth of 3.3 percent in the year ended that month.

But inflation in the overall U.S. economy has for years run below the Federal Reserve’s 2 percent target – a level policy makers view as consistent with a healthy economy. This surprised Fed officials, who use the Phillips curve as a framework for deciding how to set interest rates. They have held rates very low since the financial crisis in hopes of creating stronger demand for labor and fueling stronger inflation.

Now, with inflation nearing their goal, officials want to raise rates enough to keep price pressures under control but not so much that they snuff them out and curb growth. They are likely to leave rates unchanged at their meeting May 1-2.

Some economists believe the factors holding down pay raises will persist for some time, which would allow the Fed to raise rates very gradually without worrying that low unemployment will fuel excessive inflation. Fed officials’ projections show they think joblessness will fall even lower than it is now through 2020 without sending inflation too high.

David Altig, director of research at the Atlanta Fed, said in an interview the Phillips curve relationship between unemployment and inflation exists, but may not be particularly “lively” now.

“I think it’s premature to announce the death of the Phillips curve. Maybe it’s just resting,” Mr. Altig said. “A lot of people argue the Phillips curve will not be an extremely useful guide to gauging where inflation will go in the future, but don’t completely deny the existence of some sort of relationship.”