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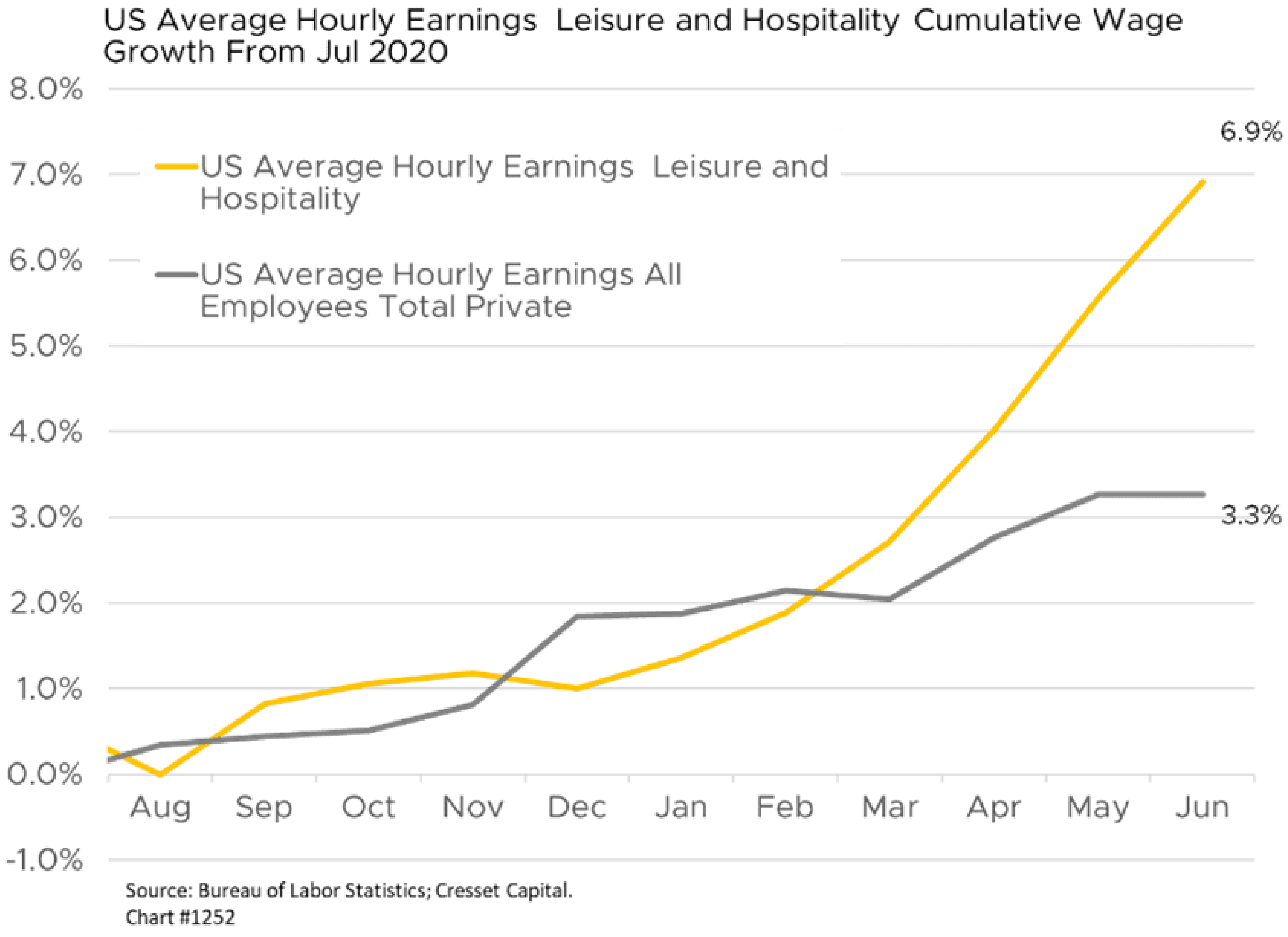
UNDERSTANDING WAGE INFLATION'S ROLE AND OUTLOOK

MARKET COMMENTARY | JACK ABLIN | 6/23/21

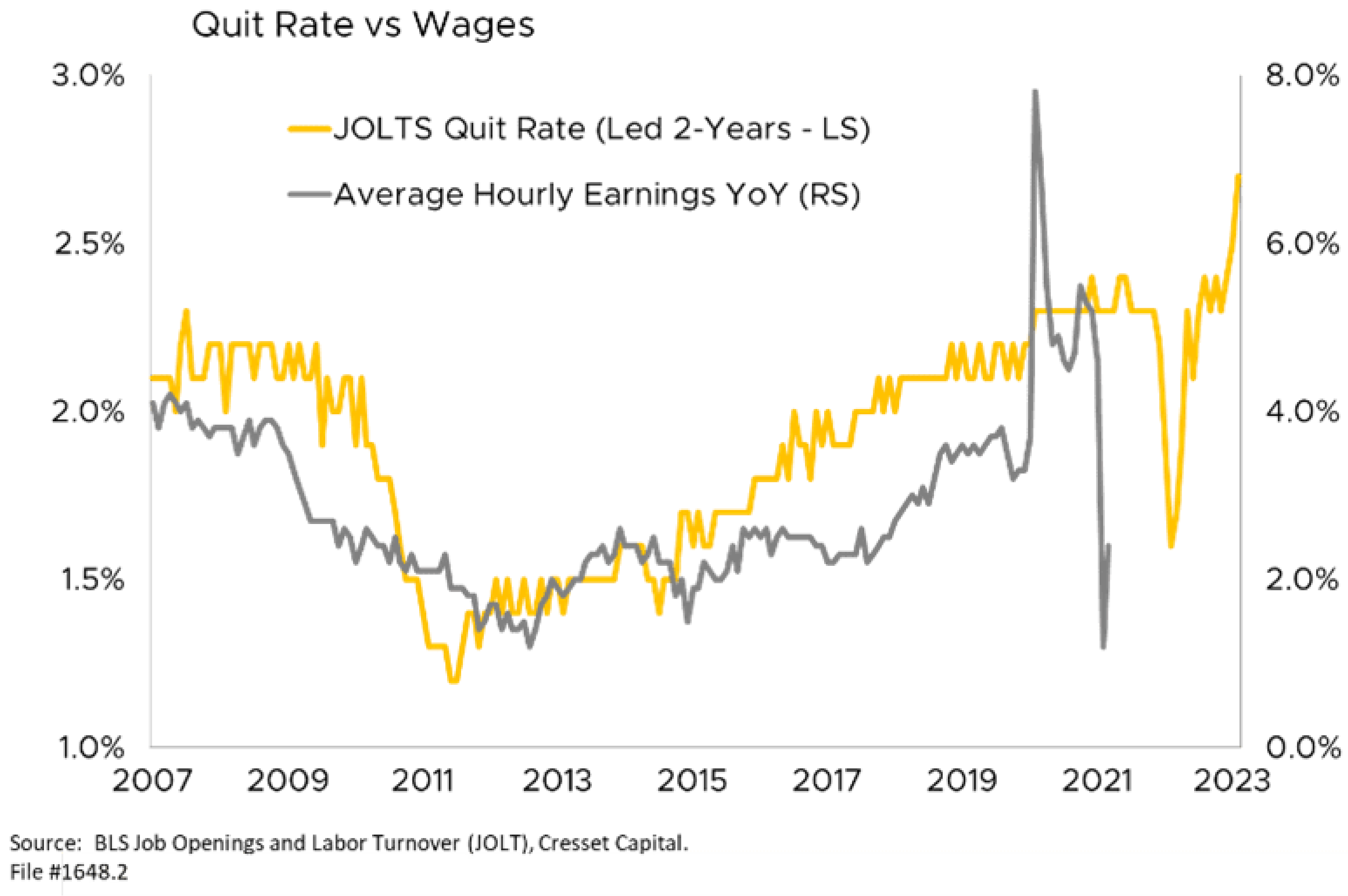
Fed governors flinched last week by accelerating their rate hike timetable. Federal Open Market Committee (FOMC) members, surprised by this spring's inflation spike, are penciling in the possibility of persistently elevated pricing. Many of the recent price hike offenders appear to be transitory, like used cars and hotel rooms. If history is a guide, sustained inflation cannot occur without a wage spiral. That's why understanding the labor market is the key to determining the future path of prices.

FOMC officials believe that maximum employment is a critical condition for raising short-term interest rates. That's a higher bar than full employment, their previous objective. While current labor market conditions suggest inflation could be lifting off, we need to keep in mind that there are still more than 8.8 million unemployed Americans. We are watching several factors in today's labor market that could help determine what happens to prices and the monetary policy response.

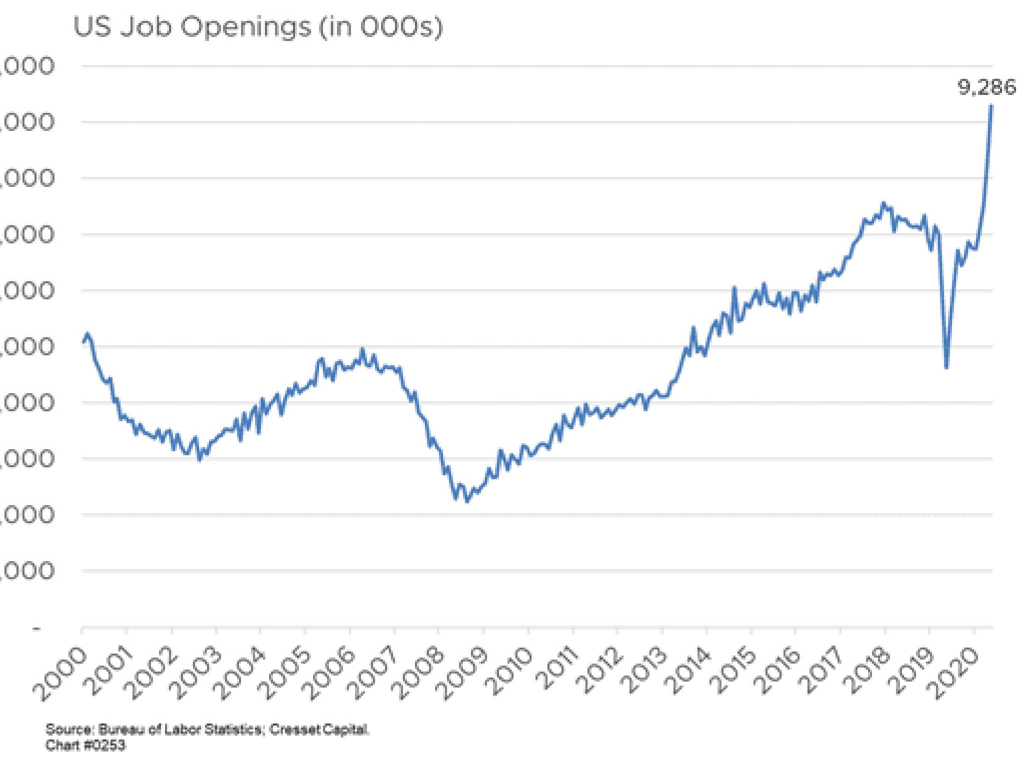
Prompted by tight labor market conditions, Americans are voluntarily leaving their jobs at a rate not seen in decades. This is a very interesting trend to watch. The "quit rate", at 2.7 per cent, is at its highest level in over 20 years, as emboldened workers rethink their professional lives. Low-wage workers, particularly those in the leisure and hospitality industries, are resisting low pay and long hours in sectors that required them to commute and mingle with potentially infectious customers. As a result, employers are being compelled to up the ante. Wages among leisure and hospitality employees, which include restaurant workers, have risen nearly 7 per cent since last July, according to the Labor Department. That dwarfs the 3.3 per cent wage gain among private sector workers in general. McDonalds and other restaurant giants are offering signing bonuses to would-be workers.



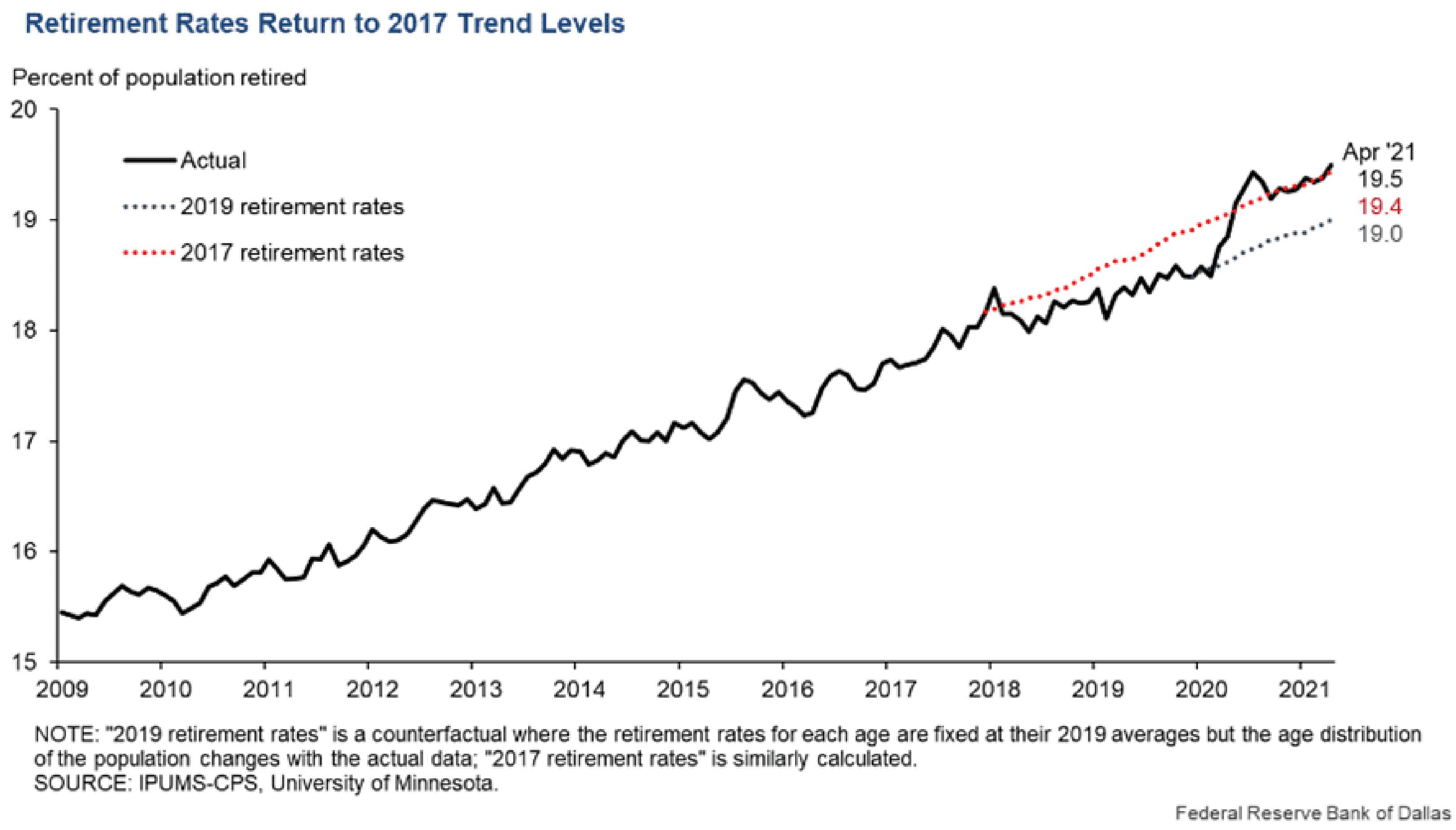
The idea of working from home is appealing to the low-wage service workers who often toil in hot kitchens or tidy up after messy hotel guests. Professional services and technology companies are using remote work as a recruiting tool, an attractive alternative to long commutes or living in cramped apartments in downtown business districts. Most of those positions, however, require a higher skill level than leisure sector work. Historical data show the quit rate tends to lead hourly wage growth by about two years. It should also be noted that the quit rate tends to ebb and flow with current labor market conditions and could easily slip if job opportunities become less abundant.



Another factor influencing the direction of the labor market is the availability of work. As of April there are more than 9 million job openings – an increase of more than 3 million open positions from pre-pandemic levels in February 2020 and the highest number of job openings on record. More than 1.5 million jobs are available in leisure, 1.4 million in education, 1.5 million in professional and business services and 1.6 million jobs in trade, transportation and utilities. Putting it another way, there is currently one job opening for every out-of-work American. Because of the skills mismatch between sidelined workers and current job requirements, the unemployment rate will never reach zero. Job openings are generally cyclical, suggesting a reversal will occur as business conditions slow. However, it should be noted that, with the exception of 2020, job openings have been consistently expanding for most of the last decade.



The pandemic pushed many older Americans into retirement, shrinking the availability of experienced labor. According to a recent study by the Dallas Fed, the hot labor market in 2018 and 2019 likely prompted many older workers to delay retirement, causing the share of the population in retirement to increase more slowly than the rate of aging would have implied. During 2020 and early 2021, the rate of retirement returned to its 2017 trend. Since the pandemic, about 2.6 million Americans reported that they retired, and an additional 1.3 million left the workforce to be caregivers (individuals whose primary activity is taking care of a household or family). It's unlikely to expect the those 2.6 million to return to the workforce. The share of the population in retirement increased from 18.5 per cent in February 2020 to 19.5 per cent in April 2021.

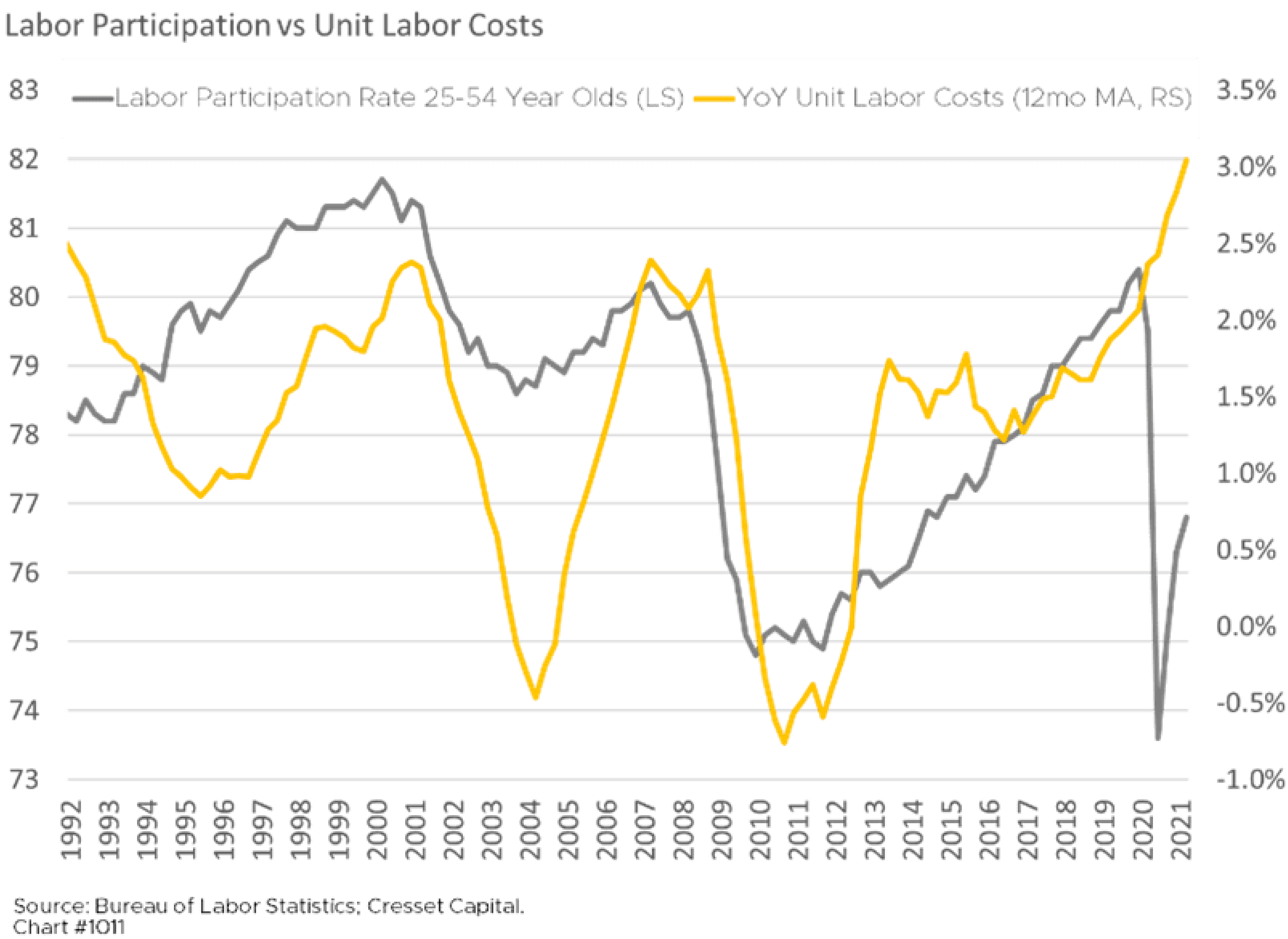


In our view, it's unlikely rising consumer prices will spill over into persistent wage acceleration. Several secular factors weigh in favor of a cyclical wage blip. First is the long-term trend downtrend in organized labor. Labor unions have historically boosted worker compensation, yet union membership, particularly in the private sector, has steadily declined. As of 2019, 5 per cent of the private sector workforce was unionized, down from nearly 12 per cent in 1983. Last year, Amazon fulfillment center workers in Bessemer, Alabama rejected unionization in favor of the company's pay and benefits package. Workers at large employers of unskilled labor, like McDonalds and Walmart, have also failed to organize. It's unlikely unskilled wages will morph into persistent inflation if union participation is declining. CPI escalator clauses built into union wage contracts were probably the key ingredient that transformed the one-time price shock of the 1973 OPEC oil embargo into persistent double-digit inflation that lasted through the end of that decade.

Second, the intransigence among sidelined workers is likely attributable to federal unemployment benefits that were granted as part of the January relief package. State unemployment benefits typically last up to 26 weeks, and amounts vary by state. The US average is $347/week, according to January data from the Labor Department. Under the Pandemic Unemployment Assistance Program, the federal data from the Labor Department. Under the Pandemic Unemployment Assistance Program, the federal government kicked in an additional $300/week to those who qualify. Unemployment benefits, which are

contributing to would-be workers staying home, are set to run out and will likely prod people back into the job market. Nearly 15 million workers claimed unemployment benefits in May, up from about 2 million before the pandemic, according to *The Wall Street Journal*. It's argued that the combination of state and federal unemployment benefits gives workers more than they would likely earn by having a job. Enhanced unemployment benefits are set to expire in September.

Third, productivity gains driven by investments in technology and innovation have tended to offset wage growth historically. Employers facing higher labor costs have made capital investments in cost-saving technology, like software and capital equipment, to raise output per employee. Thanks to technological advances, employers no longer rely on receptionists, stenographers or elevator operators. The Internet has supplanted middlemen, as many producers now sell directly to consumers. The unit labor cost metric is one way the Bureau of Labor Statistics gauges the impact of productivity on labor costs. Unit labor costs, which adjust wage gains by productivity, grew 3 per cent over the last 12 months as wage growth outpaced productivity gains. Unit labor costs tend to respond to labor market conditions, as costs rise in tandem with the labor participation rate. Tight labor markets tend to push labor costs higher, and vice versa. Nowadays, unit labor costs are rising even though labor participation has been slack. Under normal conditions that would be disturbing, but the sudden fall and rebound in labor activity could be distorting the numbers.



Wages are one of the three critical factors of goods and service production, along with commodity prices and capital. We have observed that these three factors tend to offset one another. Much like the air in a balloon, if one input (like interest rates) is pushed or held below fair value, the other two costs (like labor and commodities), have room to expand. We expect financing costs will rise as interest rates trend back to fair value – between 2.8-3.8 per cent – and will crowd out wage growth and commodity prices. However, as long as interest rates remain below fair value, wages have room to rise.

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