Inflation on the rise: will wages follow?

In recent months we have seen inflation rise to historic levels on both sides of the Atlantic. In addition, in the US the rising prices have been accompanied by substantial wage increases, a worrying trend given the danger of a feedback loop. In addition to this is the inflationary pressure exerted by the war between Russia and Ukraine, on the one hand through the rise in energy prices and, on the other, due to the effect that uncertainty could have on the economic recovery, especially in Europe. This set of elements undoubtedly complicates what is already a complex process of monetary normalisation for the Fed and the ECB, following the ultra-accommodative measures they introduced back in March 2020. Of all these elements, in this article we will look at the dangers of a possible wage-price spiral in the current context.

Rising inflation: the pandemic and energy

Inflation rates in the US and the euro area have reached levels not seen in recent decades (8.5% and 7.5%, respectively, in March 2022). This situation is largely due to a series of imbalances generated by the pandemic. In particular, the reopening of the economy in 2021, coupled with relatively strong demand thanks to the support provided by economic policies, has come up against a supply that has been weakened by the disruptions associated with COVID. Although this imbalance between supply and demand ought to fade thanks to the improvement in the health context, the fact is that it has persisted for longer than expected. Moreover, new lockdowns in China in the face of recent outbreaks may increase tensions in global supply chains, thus affecting supply.

This situation of high inflation has also been fuelled by sharp rises in energy prices in global markets since 2021, which in turn have been driven by factors such as low gas reserves in Europe, at a time when Russia was reducing its supply in the gas spot market, and an increase in China's energy imports due to problems at its coal mines – factors which have only been exacerbated this year with the war in Ukraine. The futures markets anticipate that the pressure on energy prices is here to stay.

Wages and inflation: a two-way relationship

With these recent high inflation rates and the prospect of a certain degree of continuity during the remainder of 2022, one of the current concerns lies in the much-feared «second-round effects». That is, workers demand higher wages in order to maintain their purchasing power (in the face of past and/or future price increases). In the current context of supply shortages and rising logistics and energy costs, such wage increases add pressure to already dwindling business margins. Thus, firms could end up raising prices, which in turn would lead to renewed wage demands, triggering a «wage-price spiral» like that of the 1970s in the US.

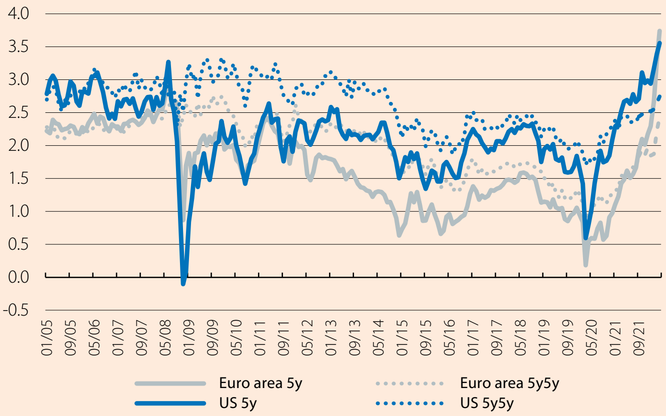
In this two-way relationship between wages and prices, one of the key elements is that of inflation expectations, since the expected evolution of prices in the future is what drives wage demands. That is why the central banks pay such close attention to these expectations and strive to keep them anchored (or stable), close to their inflation target.

What has happened to inflation expectations in recent months? Very long-term inflation expectations based on financial instruments have risen, both in the euro area and in the US, but still within a reasonable range. In the US, longer-term expectations (five-year five-year) have risen from around 2% in December 2019 (before the pandemic) to around 2.7% at the end of April 2022. In the euro area, the rise has been larger still, from 1.3% to 2.4% over the same period. However, although they have increased, we could say they have remained relatively well-anchored, (see left-hand panel of the first chart).

Nevertheless, expectations according to consumer surveys (particularly relevant when assessing the risk of wage-price spirals) have increased more substantially, although the rise is more pronounced in the case of short-term expectations (1 year in the future) than in

US and euro area: long-term inflation expectations

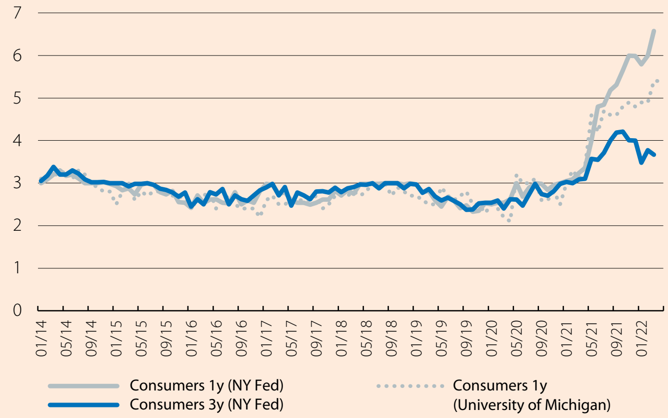
(%)



Note: Expectations based on 5-year (5y) financial instruments and 5-year 5-year (5y5y) financial instruments.
Source: CaixaBank Research, based on data from Bloomberg.

US: consumer inflation expectations (1-year and 3-year)

(%)



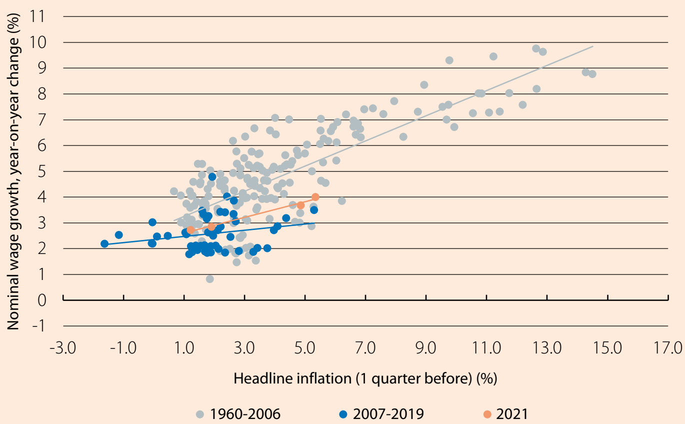
Notes: Expectations based on consumer surveys: what they expect 1 year (1y) in the future and 3 years (3y) in the future.
Source: CaixaBank Research, based on data from the Fed and the University of Michigan, via Refinitiv.

medium-term expectations (3 years in the future), providing some peace of mind (at least for now). In particular, in the case of the US, where consumer surveys ask respondents about their expectations for both of these time horizons, at the end of 2019 the responses for both 1-year and 3-year expectations were around 2.5%. Today, in contrast, 1-year expectations are just over 6.5%, compared to just over 3.5% in the case of 3-year expectations (see right-hand panel of the first chart). In the euro area, the European Commission's consumer surveys only ask about 1-year expectations, and in this case the average value has risen from 4.5% in Q4 2019 to around 9% in Q1 2022. This increase in short-term expectations is due to the fact that they are more closely linked to current events (such as the bottlenecks or the Ukraine crisis). In contrast, medium-term expectations are often more closely linked to central banks' credibility and their ability to meet their objectives.

Wages and inflation: other contributing factors

The recent path of inflation and future price expectations are not the only elements we must look at when analysing the current risks of second-round effects. There are other factors that also play an important role. Firstly, in recent decades the relationship between nominal wages and prices (or price expectations) has weakened due to phenomena such as globalisation, technology and the reduction in the proportion of workers employed in highly unionised sectors, all of which have reduced workers' bargaining power (see second chart). Also, the slowdown in labour productivity in advanced countries has contributed to the weakening of the price-wage relationship. Current developments in some of these factors, such as a slowdown in the process of globalisation (or even some reversal) or an increase in the relative weight of unions in a country like the US, could restrengthen the wage-price relationship. Others, such as the new technological advances as part of the Industrial Revolution 4.0, will continue to weaken the relationship.

US: nominal wage growth versus inflation



Notes: *Quarterly data. Historical data on nominal wages based on employee compensation and total employees. From 2007 to 2019, wage data from the BLS. The data for 2021 correspond to the employment cost index, with a constant composition of employment. Inflation corresponds to the CPI. The lines correspond to the linear relationship between the two variables in the different time periods.*
Source: *CaixaBank Research, based on data from the BLS and the BEA, via Refinitiv.*

On the other hand, it is important to differentiate between what is going on in Europe versus the US. Specifically, the biggest nominal wage increases seen so far in advanced countries have been fairly limited to the US. In the euro area, hourly wage costs in Q4 2021 rose by 1.9% year-on-year (in the EU as a whole they rose by just over 2%, while in Spain they increased by 1.2%), and the latest collective wage negotiations do not show substantial increases (2.4%, for example, in the case of Spain in March, a figure which incorporates both new negotiations and agreements already negotiated previously). In the US, meanwhile, in March 2022 wages rose by 5.6% year-on-year, according to the establishment survey conducted by the US Bureau of Labor Statistics (BLS). These differences reflect the fact that the US labour market is currently tightened due to the rigidity of the supply of labour in recent months – a phenomenon that is rare in a market as efficient as the US and which has not materialised in most European countries.[1]

Even in the case of the US, however, the figures should be taken with caution. Some wage surveys are severely affected when there are significant inflows (and outflows) of workers, as has been the case during the pandemic. To avoid this variability, for a number of years now the BLS itself has been developing an employment cost index which keeps the composition of the labour force constant, thus providing a more reliable picture of changes in wages. According to this index, although the growth rate of this wage measure has increased, it is at somewhat more contained levels than those of other wage indicators, at around 4% as of the end of 2021.

Despite the latest increases, in real terms the remuneration of American workers is below pre-COVID levels and lies around 3% below where it would have been had the pre-pandemic growth trend continued. Also, since the 1980s the real wages of low- and mid-low-income workers in the US have barely increased.[2] In fact, even in recent years the wages in real terms of many workers in Europe, such as in Italy, Spain and Portugal, have remained flat.[3]

In short, in a context in which companies are suffering a decline in their margins as a result of the energy shock and the disruptions in global supply chains, and with workers affected by the recent high inflation rates as well as by more structural phenomena that have moderated their wage rises in recent years, a balanced deal between wage increases and corporate margins is needed. However, balancing the different preferences of all the agents involved will not be an easy task, given that we are still far from regaining normality following the series of shocks endured over the last two years.

Clàudia Canals

1. See the Focus «The Great Resignation: paradigm shift in the US labour market?» in the MR02/2022.
2. See S.A. Donovan and D.H. Bradley (2019). «Real Wage Trends, 1979–2018». Washington DC: Congressional Research Service.
3. In the case of Italy and Spain, real wages actually declined between 2000 and 2020 (according to OECD data: https://stats.oecd.org/viewhtml.aspx?datasetcode=AV_AN_WAGE&lang=en).