FT BIG READ. GLOBAL ECONOMY

Will wage deals prolong inflation?

Price growth remains stubbornly high and central bankers worry that pay settlements will keep it that way, necessitating potentially recession-inducing interest rate rises.
By Delphine Strauss

A protest last month in Paris. Workers around the world have been pushing for better wages and demonstrating against reforms that would affect their hours or retirement conditions
Benjamin Girette/Bloomberg

More than 340,000 Americans will see an increase in their monthly pay cheque today after Walmart, the biggest private-sector employer in the US, raised its minimum hourly wage to $14. The retailer's move will in effect set a new floor for pay in many US states.

On the other side of the Atlantic, as many as half a million UK public sector workers have taken industrial action over pay and Germany's public sector unions are also calling strikes.

Even in Japan, where many people have not had a pay rise for decades, big employers are weighing a shake-up of seniority-based salary structures that could put money in workers' pockets.

Whether the world's workers can press home their demands for better pay is the single biggest question facing central bankers around the world this year as they fight to curb the rates at which prices are rising.

"Even after energy and pandemic factors fade . . . wage inflation will be a primary driver of price inflation over the next several years," Philip Lane, chief economist at the European Central Bank, warned in November.

Central banks do not yet face the kind of "wage price spiral" that took hold in the US in the 1970s. Then, employees won inflation-busting pay rises, fuelling further price rises until Paul Volcker's arrival at the US Federal Reserve. Volcker quashed inflation, but at the cost of a deep recession.

"You don't see [a wage-price spiral] yet. But the whole point is . . . once you see it, you have a serious problem," Jay Powell, the US Federal Reserve chair, told reporters after the Fed's latest interest rate increase, adding: "That's what we can't allow to happen."

The worry, though, is that a year of rocketing prices may have triggered a lasting change in the expectations and behaviour of workers, employers and consumers. This could lead to something better described as "wage-price persistence" — where a strong jobs market allows service sector workers to demand bigger pay rises, and companies to pass on the costs to households bolstered by high employment rates and government support.

Even relatively moderate-looking wage settlements could stop inflation falling back towards central banks' 2 per cent targets — unless they jack up interest rates further to potentially recession-inducing levels.

Demand, energy and productivity

The inflation problems facing the Fed and ECB are different. In the US, inflation has been driven chiefly by a stimulus-fuelled surge in demand after the end of lockdowns. The question for policymakers is whether higher wages can be justified by improved productivity.

In the eurozone and UK, the dominant issue is the energy price shock caused by Russia's invasion of Ukraine. Dramatically higher spending on energy has made societies poorer overall, and the question is how that cost is shared between companies, workers and taxpayers. In this context, even if wages lag behind inflation, they could still be too high for companies to bear without raising prices further.

On both sides of the Atlantic, headline rates of inflation are set to slow as gas prices have eased and higher borrowing costs are starting to moderate demand. But most workers have suffered a big hit to their living standards in the past year, because pay settlements that would look generous in normal times are still well short of inflation. Wage gains will be futile if they simply perpetuate high inflation, but workers want their pay to catch up with prices.

They are well placed for that fight. In many countries unemployment is near record lows, labour shortages are widespread and employers are intent on retaining staff even in a downturn.

In this context, monetary policymakers worry that even pay growth of 4 or 5 per cent will be too strong for them to bring inflation sustainably back towards their 2 per cent targets — given the absence, so far, of any significant pick-up in workers' productivity.

Wage growth has not yet peaked

The big unknown now is whether jobs markets are already slowing enough to take the edge off wage growth — or whether central banks will feel the need to raise interest rates further and keep them high for longer.

"Given tight labour markets, it is clear that central banks want to see convincing signs that the economy is turning down and subsequently that unemployment will turn up," says Bill Diviney, economist at ABN Amro.

Both hawks and doves can point to evidence that bolsters their case. Take US jobs data; February's payroll numbers will be announced tomorrow, but January saw an unexpected surge in hiring, with more than half a million workers joining payrolls. In the same month, annual growth in average hourly earnings slowed from 4.8 to 4.4 per cent.

The combination of blockbuster job creation and slowing wage growth could vindicate those who believe the Fed can engineer a soft landing for the economy, taming inflation without the need to increase rates to a point that will cause widespread lay-offs.

"If you want to know what a full employment economy looks like, this is a good start. Strong but not over-strong nominal wage growth, plentiful jobs, many people climbing the jobs ladder, broad-based prosperity," tweeted Arin Dube, a professor at the University of Massachusetts.

His argument is that wage gains reflect a genuine change in the structure of the US labour market because pandemic lockdowns, and the hiring surge that followed them, prompted workers to move out of low-paying service jobs into more productive sectors.

Others take a less optimistic view on productivity. Jason Furman, a fellow at the Peterson Institute for International Economics, says that after factoring in revisions to figures for earlier months, "the pattern looks less like a slowdown in wage growth within 2022 and more like steady growth that is roughly consistent with 3.5 per cent inflation".

More recent data has made economists worry that even after raising US interest rates at the fastest rate in history over the past year, the Fed has not yet done enough to take the heat out of the labour market.

One closely watched indicator of price inflation — which strips out volatile food, energy and housing costs and is therefore strongly influenced by service sector wages — accelerated in January.

Furman says this shows that while the effects of the pandemic on the prices of timber, microchips or shipping are over, "demand and self-fulfilling wage-price persistence are still with us. As is very elevated inflation."

> 'Given tight labour markets, it is clear that central banks want to see convincing signs that the economy is turning down'

The latest data from France, Germany and Spain also points to persistent inflationary pressures in the eurozone. There, wage growth was surprisingly muted in 2022 but is expected to pick up this year as unions renegotiate multi-year sectoral deals that cover a big share of the workforce in some countries.

Economists describe the deal struck in November by IG Metall, Germany's biggest union, as a "Goldilocks" scenario balancing the risks to growth and inflation. It combined pay rises over two years with one-off payments to help with the rising cost of energy bills.

But German public sector unions are now seeking a double digit wage rise and Dutch unions are agreeing pay awards of 5 or 6 per cent, well above historical norms. Spain's central bank has flagged concerns over the use of indexation clauses, pegging pay rises to inflation.

300,000	12%
Number of workers who have left the UK workforce since the start of Covid	Average rise in statutory minimum wages across the EU in 2022

Erwan Gautier, an economist at the Banque de France, found that scores of industries had revisited their sectoral deals in the course of 2022, sometimes twice or more, to keep up with the minimum wage, which in France adjusts automatically when inflation is high. Others are still catching up, suggesting wage growth will accelerate in 2023.

Christine Lagarde, the ECB president, said last week the central bank was "looking at wages and negotiated wages very, very closely". Isabel Schnabel, a member of its executive board, has warned that probable wage growth between 4 and 5 per cent in the years to come is "too high to be consistent with our 2 per cent inflation target" and could persist longer in the eurozone than in the US, due to the wider use of centralised wage bargaining processes.

One factor could limit wage pressures in the eurozone, however. In most of the bloc's major economies, better job opportunities have drawn more people into the workforce, with economic activity above its pre-pandemic rate in France, Germany and Spain.

UK rates: higher for longer

This is in sharp contrast with the situation in the UK, where the workforce has shrunk by more than 300,000 since Covid hit. The Bank of England sees little prospect of this changing, unless immigration rises, because it has been caused by people who are too sick to work or have chosen to leave the workforce. Even if this legacy of the pandemic fades over time, employers will increasingly run into the constraints imposed by an ageing population.

Employers bidding for increasingly scarce workers is a key reason why interest rates could remain higher for longer in the UK than elsewhere — and why Andrew Bailey, the BoE governor, has warned of consequences for inflation and monetary policy if the government agrees to pay public sector workers more without raising taxes to fund it.

In all countries, though, there is a growing tension between central banks' concern over inflation and governments' wish to protect voters' living standards and avoid social conflict.

In Europe, many administrations have tried to resolve this by boosting pay for those at the bottom. Statutory minimum wages rose by 12 per cent on average across the EU in 2022, double the rate of the previous year. This was partly due to a catch-up in eastern and central European states, but the wage floor also rose by 22 per cent in Germany, 12 per cent in the Netherlands and around 5 to 8 per cent elsewhere in the core of the bloc.

Both France and Germany have also offered tax breaks that incentivise companies to make up for below-inflation wage rises with big one-off bonuses. These will have a more transient effect, but still bolster consumer spending and so increase companies' pricing power.

And while the Fed frets that the US labour market may be running too hot,

> 'Wage inflation will be a primary driver of price inflation over the next several years'

the Biden administration is celebrating an economic environment that has helped marginalised groups and low-wage workers climb the jobs ladder.

"Our country is back to work," the Treasury secretary Janet Yellen said last month, noting unemployment was near record lows for Black and Hispanic Americans and people with disabilities.

The job of taming inflation

Some argue that a scarcity of workers is driving a much-needed correction in the balance of power between capital and labour, and that pay should rise to protect living standards. But this could only happen if companies absorbed the shock through lower profits, something that has rarely happened before.

At present — except in the energy sector, where profits have soared — both workers and employers are feeling the squeeze. As Torsten Bell, at the UK's Resolution Foundation, puts it: "The scale of the pain is so big there's more than enough of it to lead to both profits and wages falling."

This tension could make life tough for central banks if they press on with interest rate rises to stop wage pressures lingering before they are able to see the full effect of the tightening they have already delivered.

"Governments facing constant social demand for indexation . . . may increasingly resent a monetary policy tightening, and so do businesses squeezed between rising labour and funding costs," says Gilles Moëc, chief economist at Axa Group.

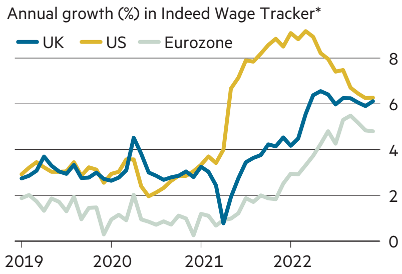
Raising interest rates remains the standard prescription for dealing with these pressures — choking off economic growth until workers become too scared of losing their jobs to press for higher wages and companies too fearful of losing customers to raise prices.

Olivier Blanchard, former chief economist at the IMF, has argued that this is "a highly inefficient way" to deal with inflation, which he describes as the result of a "distributional conflict, between firms, workers and taxpayers".

The OECD is in favour of governments using minimum wages to help the poorest manage rising prices but has also urged greater use of collective bargaining mechanisms, which help to share the costs of inflation fairly between workers at different income levels, and also allow for trade-offs between wages and other benefits that workers value.

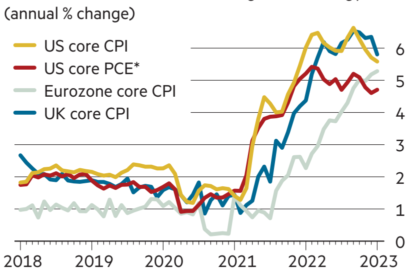
But in practice, Blanchard notes, it is almost always central banks that are left to resolve the conflict. "One can dream of a negotiation between workers, firms and the state, in which the outcome is achieved without triggering inflation and requiring a painful slowdown . . . Unfortunately, this requires more trust than can be hoped for and just does not happen."

Wage growth remains high but has been slowing in the US
Annual growth (%) in Indeed Wage Tracker*



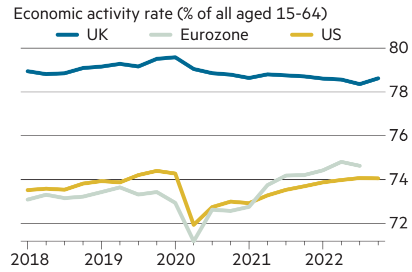
* measures growth in wages advertised in job postings on Indeed
Source: Indeed.com

Core inflation has not decisively peaked
'Core' inflation measures, excluding food & energy (annual % change)



* Personal consumption expenditure deflator
Source: Refinitiv

Labour force participation trends have varied since the pandemic
Economic activity rate (% of all aged 15-64)



Source: OECD