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Economic Insight

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Production Costs and Wage Growth: The Rising Fear of Persistent Inflation

Earlier this week, Federal Reserve Chairman Jerome Powell testified in front of the House Select Subcommittee on the Coronavirus Crisis. With recent data indicating the highest rise in inflation in more than a decade, coupled with the Federal Open Market Committee's acknowledgement of elevated costs, there was a fair amount of focus on prices, interest-rate hikes and the timing for adjustments to the Fed's bond-buying program. While no specifics were disclosed, the Chairman did concede that the recent bout of inflation, while still expected to prove transitory, was in fact higher than expected and could prove longer lasting than previously anticipated.

Taken together, the Chairman seemed to reassure markets that the current policy position and forecast for inflation remain appropriate and well-founded, while at the same time sprinkling in a dose of reality to reflect the surge in prices being felt by every American business and household. In other words, the Fed Chairman appeared to be speaking out of both sides of his mouth – to be fair, not an unusual talent for economists – suggesting inflation is both persistent *and* transitory.

"What we're seeing now, we believe, is inflation in particular categories of goods and services that are being directly affected by this unique historical event that none of us have ever lived through before."

"I will say that these effects have been larger than we expected, and they may turn out to be more persistent than we have expected."

- Federal Reserve Chairman Jerome Powell, Testimony to the House Select Subcommittee on the Coronavirus Crisis, June 22, 2021

Higher Production Costs

Whether temporary or longer lasting, the fact is, businesses and consumers are facing higher prices. Production costs are on the rise as parts and materials used to make products are becoming more expensive. Labor costs are also edging higher with many firms across a variety of sectors – by force or by choice – offering higher wages, bonuses and other incentives to try and entice employees back to work.

Soaring demand from stimulus-fueled Americans for everything from cars to washing machines to cell phones is leading to a surge in production and trade activity. While the nominal increase in consumers' appetite is startling in and of itself, coupled with a relative shift in demand as consumers adjust from lockdown spending to a more "*normal*" service-heavy palate of consumption, surging demand has created severe supply chain bottlenecks. These disruptions have resulted in a record volume of cargo overwhelming longshoremen, truck drivers, warehouses and railroads, and pushing inflation to its highest level in more than a decade.

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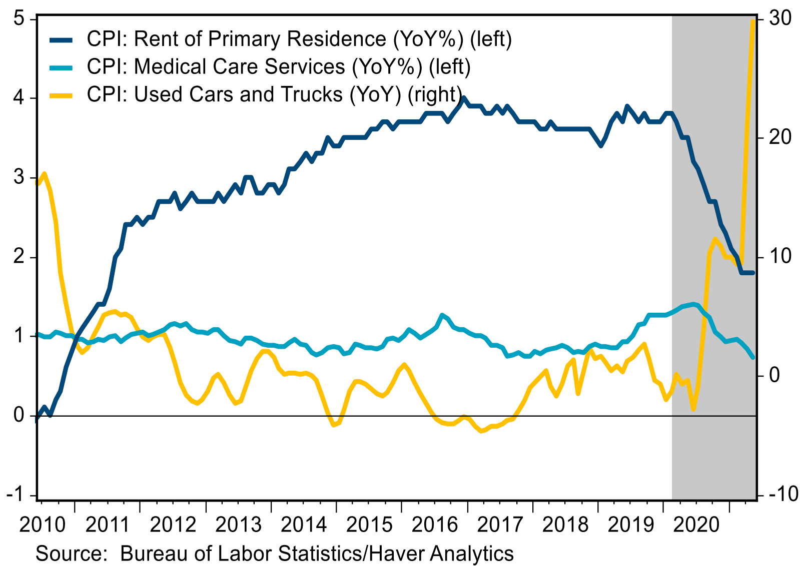


Source: Bureau of Labor Statistics/Haver Analytics

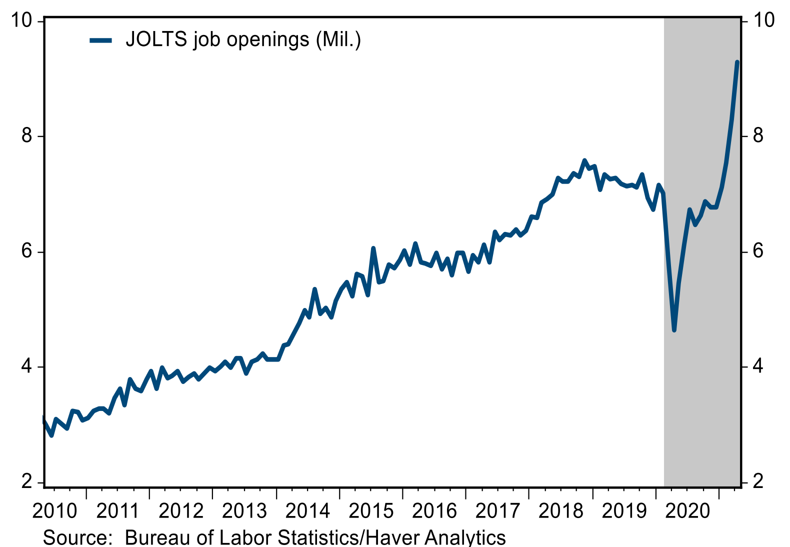
According to Powell, these *"bottleneck effects"* have been larger than he and his colleagues previously anticipated, prompting the central bank to adjust higher its forecast for inflation in 2021 in the latest June report: The median forecast for inflation was elevated from a previous estimate of 2.4% to 3.4% in 2021 and from 2.0% to 2.1% in 2022. Nevertheless, Powell and Co. have expressed confidence that the supply chain constraints, while more *"persistent"* than expected, are far from permanent. As the Chairman explained, the overshoot is driven primarily by categories that are directly affected by the re-opening of the economy, such as used cars and trucks as opposed to medical care costs and rents, which have already slowed their rate of accent or declined outright.

"Prices like that, that have moved up really quickly, because of the shortages and bottlenecks and the like — they should stop going up, and at some point they in some cases should actually go down," Powell told reporters at the June 16 press conference following the Committee's latest policy announcement.

Wage Inflation

According to the Fed's most recent May Beige Book, however, accelerating inflation pressures are also stemming from rising wages, which may prove more *"sticky"* or longer lasting than price hikes due to short-lived disruptions in production materials. Contacts cited ongoing labor shortages persisting even with increased incentives to pull workers back into the labor force. *"Wage growth was moderate, and a growing number of firms offered signing bonuses and increased starting wages to attract and retain workers,"* the report said.

With a record high of over 8 million job openings as reported by the Labor Department and jobs websites, such as Indeed,com, reporting a near 25% increase in listings compared to this time last year, worker demand is clearly on the rise. Furthermore, according to the National Federation of Independent Businesses, a small-business trade group, a record 44% of small businesses have openings they're trying desperately to fill after nearly a year of being shut-in or facing capacity and activity restraints. In spite of this, there remains a disconnect between companies anxious to hire and workers hesitant to reenter the labor force with a reported 8 million unemployed.



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There are several factors contributing to the imbalance between labor demand and labor supply. As expected in the aftermath of a global pandemic, even with a rise in vaccinations, some workers have lingering health concerns or ongoing health impacts resulting from the virus. According to the Bureau of Labor Statistics, as of May, over 2.5 million Americans report they are prevented from looking for work due to the pandemic with nearly 4 million reporting they remained sidelined due to *"worries about getting or spreading the virus."* There are also childcare issues impacting families and in particular, women, with school and daycares still not yet fully reopen in many places and facing staffing issues themselves. The Census Bureau reports more than 7 million people are out of work because they were *"caring for children not in school or daycare."*

Numerous reports have also indicated fiscal policy measures as a barrier to growing the pool of potential labor by creating an incentive to remain outside of the labor force. Enhanced unemployment benefits, for example, offering unemployed workers an additional $300 a week, can in some instances equal or exceed earrings potential in the jobs market. As of the week ending June 19, more than 400k Americans filed for first-time unemployment benefits with more than 3.3 million continuing claims. The Biden administration extended the availability of enhanced benefits beyond the initial termination date of July 2020 and are now slated to continue for another three months until September 6, 2021. In the meantime, half of U.S. states have announced they will discontinue those increased benefits later this month in order to help alleviate labor shortages in their states.

A further expansion of the vaccination process, a reopening of schools in-person full-time, and a rollback of overly generous benefits both partially through a handful of states and eventually nationally, as the program itself expires, will no doubt aid in growing the supply of potential workers serving to unlock a wave of potential production capacity. However, the impact these policies have had on wages may prove more lasting. With a broad-based reopening beginning in May, businesses have for several months now offered increased wages, higher salaries and a growing basket of incentives in order to compete with the government's offerings and be able to source and keep staff. Now going forward, incoming hires are likely to maintain expectations for elevated compensation, reinforcing the *"sticky"* nature of wages. Workers' wages are often considered ridged or resistant to change due to an adjustment in labor market conditions. This is particularly true when the pressure is to the downside.

Unit labor costs, or how much a business pays its workers to produce one unit of output, rose 1.7% in the latest Q1 report. A steady climb since Q3 2020, labor costs are up 4.1% over the past 12 months, following a 6.1% gain the quarter prior. Of course, over the longer-run, productivity growth can help offset input costs and work to ease inflation pressures. Productivity growth, however, while improved from an average of 2.7% in 2020 to 5.4% as of Q1 2021, does not appear to be robust enough to eliminate or override concerns of an ongoing rise in production costs and potentially persistent wage inflation.

Conclusion

While the Fed's assessment of transitory inflation appears appropriate to describe temporary price increases due to supply chain disruptions that will likely be worked out over time, the Chairman's acknowledgement of potentially more persistent inflation pressures also appears accurate as a result of a potential longer-lasting impact of higher wages. In other words, production costs moved up quickly due to supply chain disruptions, but will likely ease in the near to medium-term. Wage pressures, on the other hand, have largely resulted from artificial policy measures disrupting the structural balance of the labor market, the effects of which have not only proven larger than expected, but will likely be more permanent in nature.

-Lindsey Piegza, Ph.D., Chief Economist

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Glossary
CPI – Consumer Price Index
JOLTS – Job Openings and Labor Turnover Survey
YoY – Year over Year

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