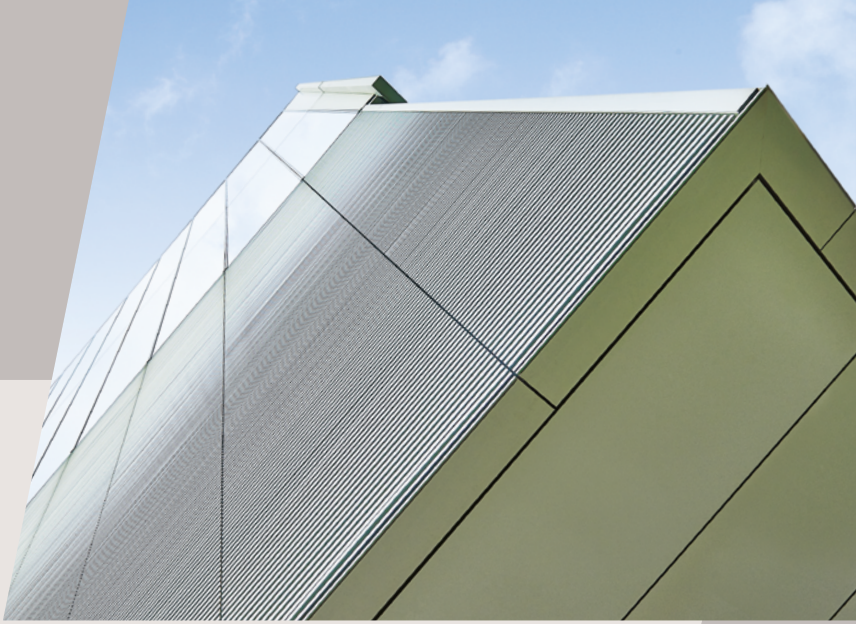
ECO–NOTE

Understanding the risk of a wage-price spiral

Vol.02
July 2023

Rothschild & Co
Asset Management

Rothschild & Co
Asset Management



Independence, high standards and know-how... The asset management expertise of the Rothschild & Co group

Over time, our teams develop investment solutions and services designed to meet the needs of our institutional clients, financial intermediaries and independant financial advisers.

am.fr.rothschildandco.com

Rothschild & Co Asset Management, a portfolio management company with capital of 1,818,181.89 euros, 29, avenue de Messine - 75008 Paris. AMF approval no. GP 17000014, RCS Paris 824 540 173.

Wage and price setting mechanisms play an important role in the evolution of monetary policy. Although investors are convinced inflation will soon return to targets, how the dynamics of inflation evolve will depend on different underlying assumptions, thus impacting central banks' decisions.

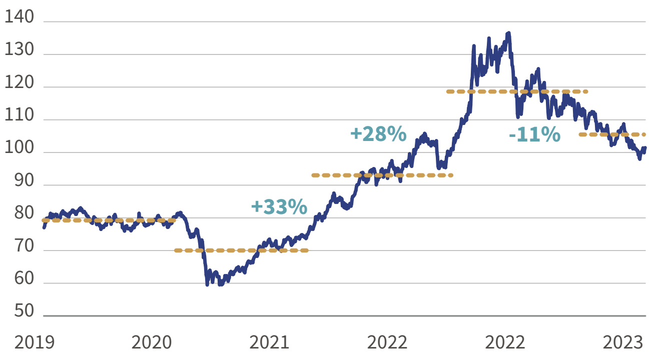
Marc-Antoine Collard
Chief Economist & Head of Research

This is not the 1970's...

The commodity price surge in the wake of Russia's invasion of Ukraine has exacerbated already elevated inflationary pressures driven by the pandemic's supply disruptions. In that regard, the situation resembles the 1970's supply oil shocks. Furthermore, then and now, monetary policy was highly accommodative in the run-up to these shocks.

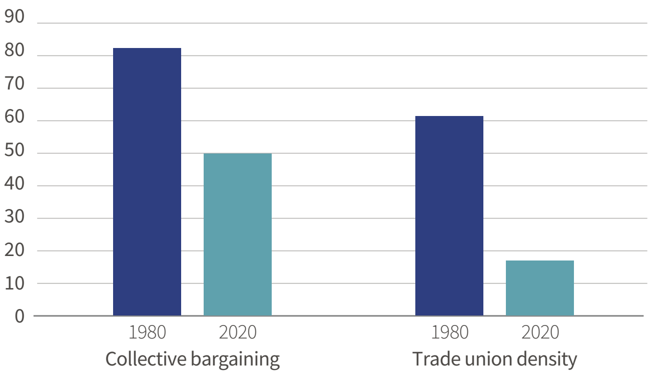
However, in the 1970s, general wage indexation was a powerful force in the price-wage loop: when consumer prices rose by 1%, wages automatically rose by 1%, which increased firms' costs in proportion to their wage bill, pushing up prices. But in the 1980's, most countries have decided to stop/ban indexation clauses. Furthermore, there has been a paradigm shift in monetary policy frameworks since the 1970s. At that time, central bank mandates incorporated multiple competing objectives, including for output and employment, and policymakers were inclined to attribute rising inflation to special factors, underestimating the pervasive and lasting impact of excess aggregate demand pressures. In contrast, today's central banks have clear mandates for price stability, expressed as an explicit inflation target, and have established a credible track record of achieving their targets. As a result, inflation – in particular, core inflation – has become much less sensitive to inflation shocks.

World – Commodity index
Bloomberg index, dotted lines = average



Source: Bloomberg, Rothschild & Co Asset Management, July 2023.

World – Labor market flexibility
in %



Source: Wolrd Bank, Rothschild & Co Asset Management, July 2023

The wage-setting (WS) curve gives the real wage necessary at each level of economy-wide employment to provide workers with incentives to work hard and well. The price-setting (PS) curve gives the real wage paid when firms choose their profit-maximizing price.

In fact, investors are convinced inflation will return to targets. Indeed, after decades of building credibility, inflation expectations are likely to remain well anchored. Also, as central banks tighten monetary policy and pandemic-related fiscal stimulus is unwound, demand will slow. Simultaneously, as the supply disruptions caused by the war in Ukraine ease, commodity prices will stabilise, and as global production lines and logistics adjust, so will supply bottlenecks.

… but the labour market will play a key role in the inflation outlook

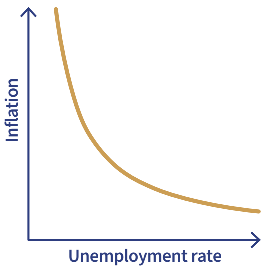
Yet, how the dynamics of inflation evolve will depend on different underlying assumptions, especially regarding the labour market. In that regard, the WS/PS model[1] is a good starting point. In particular, there are four factors that could determine the speed at which inflation is likely to converge toward central banks targets:

A. The extent of real wage catchup

In theory, the lower the unemployment rate, the higher nominal wage growth. However, if actual inflation turned out to exceed expected inflation, real wages (or purchasing power) will end up being lower than worker’s assumptions. In the next year, will this loss be irrelevant for wage setting, or will workers want to catch up? Obviously, which of the two paths is relevant does strongly affect the dynamics of inflation

(1) Layard, R., Nickell, S., Jackman, R., “Unemployment, macroeconomic performance and the labour market”, Oxford University Press, 1991

The Phillips curve



B. The degree of anchoring of inflation expectations

The anchoring of inflation expectations is a necessary condition for central banks to maintain price stability, as it prevents temporary shocks to inflation from feeding into the mechanisms of wage and price formation.

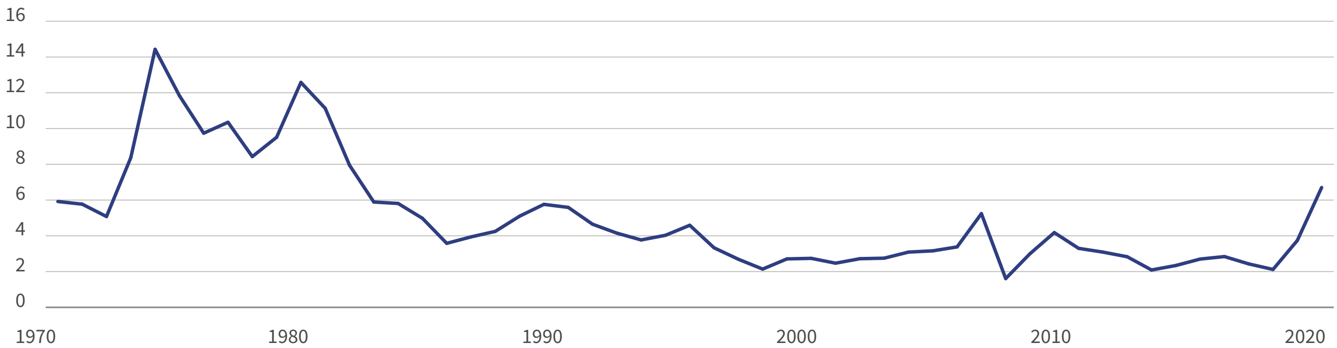
On the one hand, whatever happened to inflation in the past, wages could be set on the basis of a constant expected rate of inflation (i.e. the central bank's inflation target). In that case, the credibility of the central bank is very strong. On the other hand, the more expectations are de-anchored, the more inflation last year will affect inflation this year as the credibility of the central bank is called into question.

C. The slope of the Phillips curve

The Phillips curve illustrates a negative relationship between the unemployment rate and inflation. Thus, when the unemployment rate is low, the inflation rate tends to be high since workers' bargaining power is strong and businesses tend to hold a high pricing power.

If one assumes that the slope is relatively flat, then even very tight labour markets have a limited effect on wage inflation, all else equal. However, if the relation is nonlinear, then the effect of unemployment becomes increasingly relevant, and overheating may lead to substantial pressure on wage inflation.

World – Inflation
in %



Source: World Bank, Rothschild & Co Asset Management, July 2023

D. The response of wage to prices

Are movements in wages, or more specifically movements in unit labour costs, being passed through fully to prices? Do businesses have a strong pricing power?

The jury is still out

Based on data going back a few decades, the empirical evidence suggests: no catchup in real wages, anchored expectations, and a relatively flat Phillips curve[(2)]. In that regard, investors might well be right in expecting a rather smooth return of inflation to target. However, several elements merit closer examination.

First, the past few decades were characterized by stable inflation and no relevant labour market or goods negative supply shocks, and thus might not be a reliable guide to the future. In fact, when nominal wages rarely lag substantially behind prices – i.e. when there is no significant loss of purchasing power – then workers may not focus on catching up and may not take variations in inflation into account. Yet, when inflation is substantially higher, workers may very well start paying attention and demand a catch up for the loss in purchasing power, especially when inflation is too high for too long. And they may be able to obtain such wage increases thanks to elevated bargaining power in a very tight labour market.

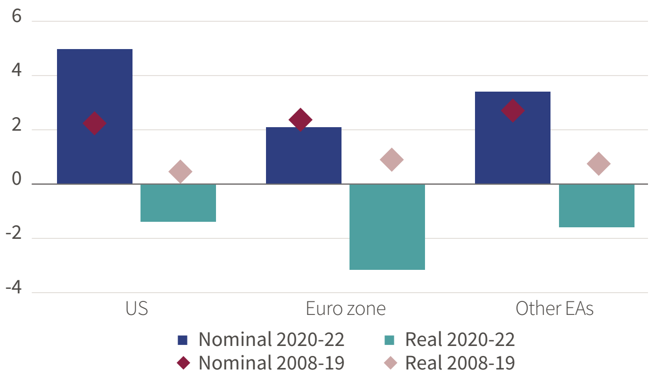
Indeed, vacant jobs in many countries have been hard to fill as COVID-19 which can be explained in part by a change of workers' job preferences. For instance, in the US, resignations have risen beyond what their historical relationship with vacancies would imply, suggesting that workers are not just seizing opportunities, but also searching for better working conditions. In addition, COVID-19 have produced sectoral and occupational mismatch that could have increased labour market tightness as workers take longer to find employment in new sectors and firms. Labour markets tightness also reflects a slow post-pandemic recovery in supply, with, in particular, fewer older workers participating in the labour force. In some countries, lower-skilled workers previously employed in contact-intensive industries have remained outside of the labour force, shrinking the pool of available job seekers[(3)].

Furthermore, the 1970's showed that inflation expectations ultimately became de-anchored because of persistently elevated inflation and repeated inflationary shocks, although in an environment of higher inflation and a less credible central bank compared to today. Still, wider and faster diffusion of information could serve as a catalyst for looser inflation expectations. In that case, the interest rate path required to bring inflation back to target will be greater than those currently anticipated by financial markets. This raises the spectre of the steep increases in interest rates that brought inflation under control but also triggered a global recession in 1982.

(2) Olivier Blkanchard, "Why I worry about inflation, interest rates, and unemployment", PIIE, 2022

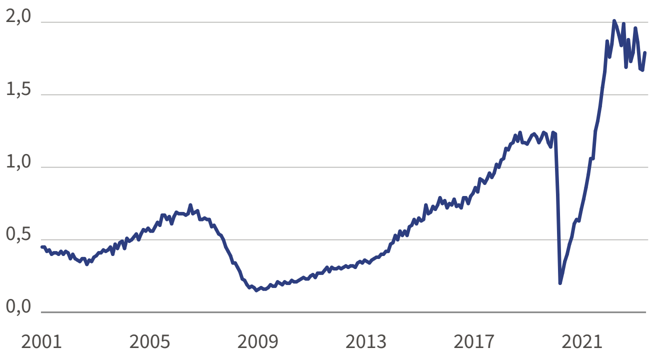
(3) IMF, "Labor Market Tightness in Advanced Economies", 2022

Adv. economies – Wages
in %



Source: BIS, Rothschild & Co Asset Management, July 2023

US – Job vacancies per unemployed
ratio



Source: Macrobond, Rothschild & Co Asset Management, July 2023

Meanwhile, much research shows a link between unit labour cost (ULC) and price inflation, although the interaction is non-linear. Unsurprisingly, the relationship is weak at shorter horizons. It is also affected by the anchoring of inflation expectations as the credibility of the monetary policy seem to have played a larger role for price setting than cost pressures.

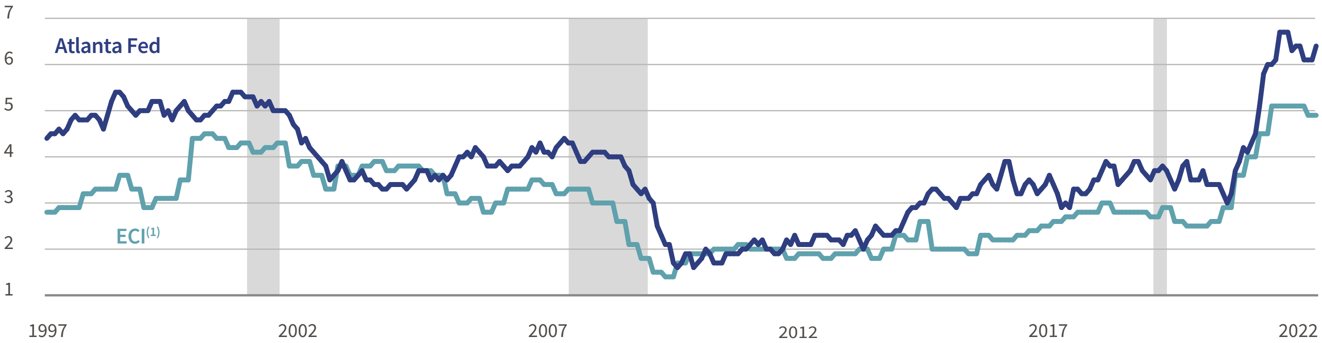
However, academic literature also suggest that the link depends on the inflation regime prevailing in the economy: when inflation is high, the relationship becomes stronger[4]. In fact, when coming from a prolonged period of low inflation, this pass-through could be moderate, but when inflation is too high for too long, it may become more significant.

Meanwhile, ULC depends on labour costs, but also on productivity. Businesses can absorb higher labour costs via lower profits or by using automation and other methods to improve efficiency. Higher wages combined with robust productivity would in fact prevent an acceleration in ULC, and thus in inflationary pressures.

(4) Bobeica, E., Ciccarelli, M., Vansteenkiste, I., "The link between labor cost and price inflation in the euro area", ECB Working paper, 2019

US – Wage growth

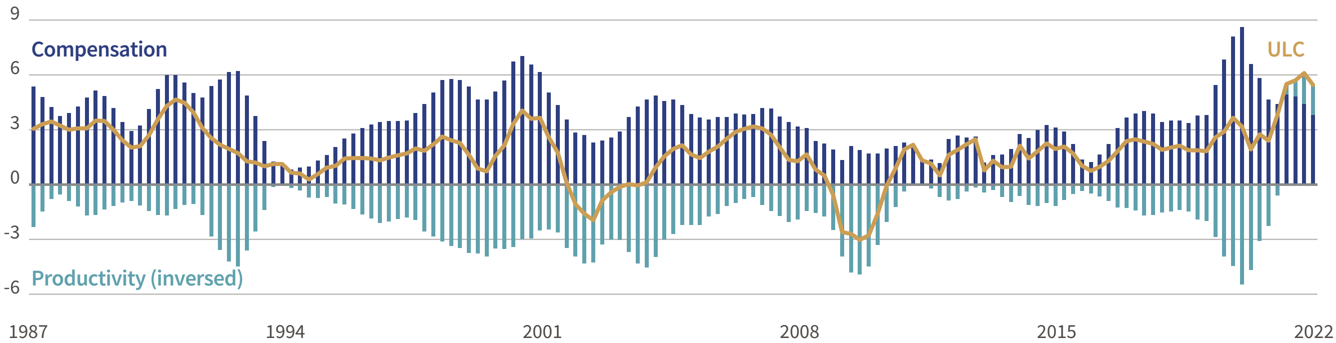
in %, y/y



Source: Macrobond, Rothschild & Co Asset Management, July 20223
(1) Employment Cost Index

US – Unit labour costs

en %, a/a, mm 4t

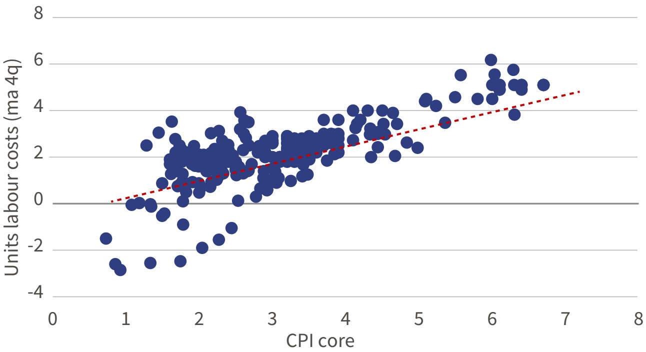


Source: Macrobond, Rothschild & Co Asset Management, July 2023

Yet, the pandemic struck the global economy after a decade that witnessed a broad-based decline in productivity growth, and that trend persists. Therefore, a tight labour market combined with disappointing productivity growth is a toxic environment for the inflation outlook. In this context, investors' scenario of a relatively painless return of inflation rates to targets could prove highly uncertain. In that regard, history shows that in the early 1980s, Fed Chairman Paul Volcker was forced to deteriorate the US labour market to curb inflation. More generally, the tightening of monetary policies around the world contributed to the global recession of 1982, but global inflation fell to around 5% per year, on average, during the rest of the 1980s, from more than 11% during the previous decade. Short term pain, but long term gain.

US – Unit labour costs & CPI core

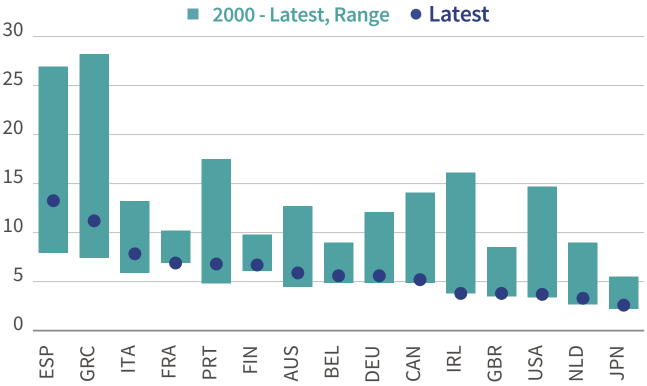
in %, y/y, 1986-2023



Source: Macrobond, Rothschild & Co Asset Management, July 2023

World – Unemployment rate

in %



Source: Macrobond, Rothschild & Co Asset Management, July 2023

About the Asset Management's division of Rothschild & Co

As the specialised asset management division of the Rothschild & Co group, we offer personalised asset management services to a broad client base of institutional investors, financial intermediaries and distributors.

Our development is focused on a range of open-ended funds, marketed under five strong brands: Conviction, Valor, Thematic, 4Change and OPAL, leveraging our long-term expertise in active management with conviction as well as in delegated management. Based in Paris and established in 9 European countries, we manage more than 26 billion euros and employ nearly 160 people.

More information at www.am.eu.rothschildandco.com

Contacts

France

29, Avenue de Messine
75008 Paris
+33 1 40 74 40 74

Switzerland

Equitas SA
Rue de la Corraterie 6
1204 Geneva
+41 22 818 59 00

Germany – Austria

Börsenstraße 2 - 4
Frankfurt am Main 60313
+49 69 299 8840

Belgium – Netherlands – Luxembourg

Avenue Louise 166
1050 Bruxelles
+32 2 627 77 30

Italy

Via Santa Radegonda 8
Milano 20121
+39 02 7244 31

Spain

Paseo de la Castellana 40 bis
28046 Madrid
+39 02 7244 31

Published by Rothschild & Co Asset Management, a portfolio management company with capital of €1,818,181.89, 29, avenue de Messine - 75008 Paris. AMF approval no. GP 17000014, RCS Paris 824 540 173.

Rothschild & Co
Asset Management

A portfolio management company with capital of €1,818,181.89,
29 avenue de Messine 75008 Paris.
AMF approval no.GP 17000014, RCS Paris 824540173.

For further information
am.eu.rothschildandco.com

Join us n **LinkedIn**

Rothschild & Co
Asset Management