WELLS FARGO

Special Commentary — January 28, 2022

Wage Growth Expectations Rise to a 50-Year High

Summary

The probability of high wage growth for next year was 49% in Q4-2021, as competition for workers and rising living costs continued to put upward pressure on wages. In data going back to 1968, this marks the highest likelihood to date. The probability of high wage growth has remained elevated for more than four years, but the pandemic-induced decline in labor supply and the battle against rising inflation led to a sharp increase last year. Although a large increase in the Employment Compensation Index has spooked some fears of a wage-price spiral, structural differences in the economy today and tightening monetary policy should hold off a 1970s-like scenario.

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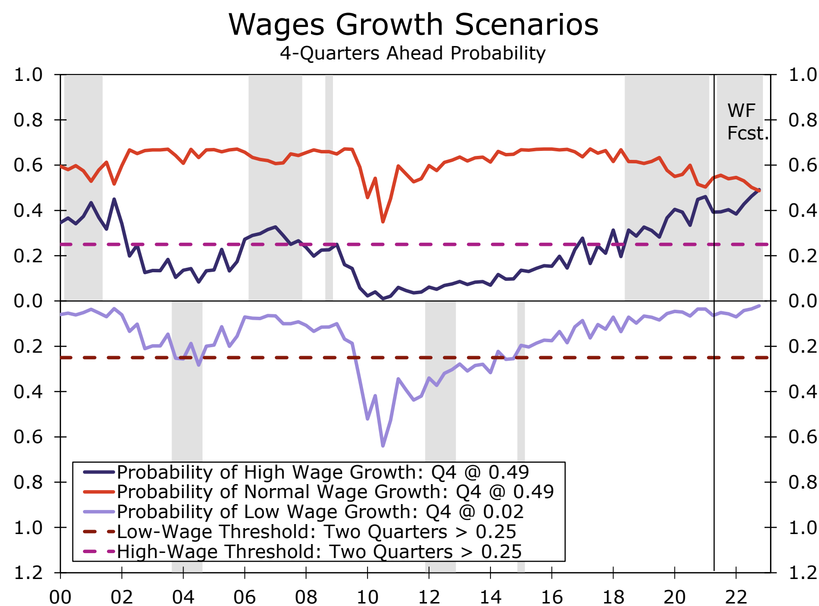
Figure 1



Source: Wells Fargo Economics

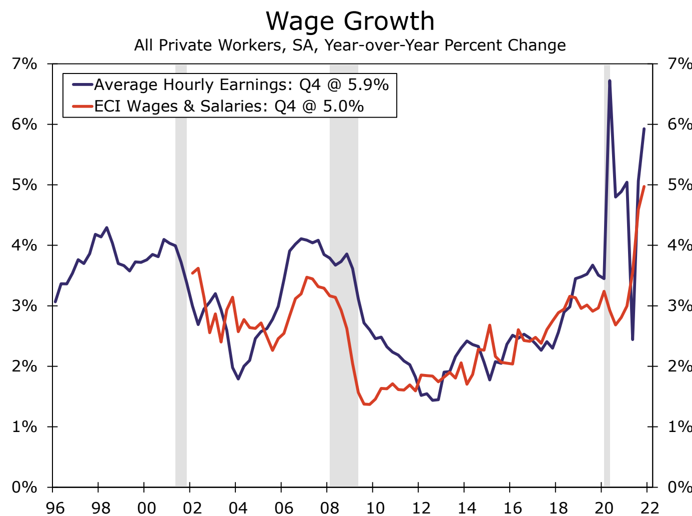
High Wage Growth Looks to Stick Around in 2022

The probability of high wage growth has exceeded our "high wage" threshold for more than four years, but Q4-2021 marks the highest tick in data going back to 1968. This comes amid a tight labor market, leaving employers willing to pay up for the talent they need, as well as high inflation putting pressure on employees' cost of living. Our measure, which captures the probability that average hourly earnings (AHE) growth will exceed 2.9% a year from now, came in at 49% in the final quarter of 2021.[1] Last spring, we introduced our wage growth model to predict trends in AHE in a labor market that underwent significant compositional changes during the pandemic. In this update, we not only ran our usual analysis but also a more stringent scenario that defines "high growth" as a rate of 3.4% or more over the next year, representing not one, but two standard deviations above last cycle's mean pace. Under this parameter, the likelihood of high wage growth in a year stayed elevated at 46%. This sensitivity test underscores that there is risk of wage pressures remaining elevated.

The labor market remains extraordinarily tight. Wages have risen across the board, though low-wage industries have seen some of the most pronounced wage growth during the pandemic. Total private job openings in November were 53.8% above their February 2020 level. Openings in the leisure & hospitality industry remained 56.8% above their pre-pandemic baseline, while other services and manufacturing openings are more than double their pre-COVID levels.

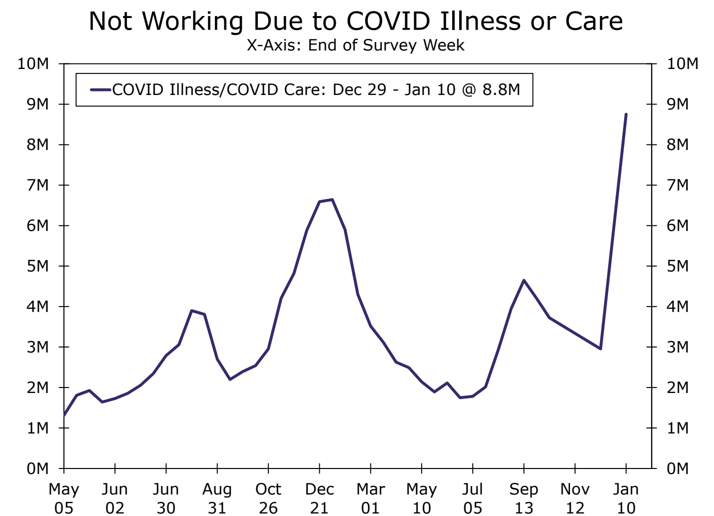
Labor demand remains historically high, but the willingness and ability of many to enter the labor force is limited, exacerbating the supply-demand imbalance. There are 2.8 million fewer people in the labor force now than in February 2020, and that does not account for economic expansion that could have occurred before the pandemic hit. Adjusting for pre-COVID employment trends, there would be approximately 4 million *more* people in the labor force today. Going into 2022, the effect of the Omicron variant has left many out of the workforce, either due to COVID fears, family obligations due to COVID or infection with the virus itself. In the latest Household Pulse Survey, the number of people not working due to fear of COVID increased 26% from the early December to early January. Rising COVID cases can produce second-order labor supply issues, such as school closures forcing parents to stay home to care for their children instead of working.

Figure 2



Source: U.S. Department of Labor and Wells Fargo Economics

Figure 3



Source: U.S. Census Bureau and Wells Fargo Economics

The quits rate rose to 3.0% in November, which means that companies are not only competing to hire to meet growing demand, but also to retain employees who may be seeking employment elsewhere. The Atlanta Fed's Wage Tracker measures the wage raise premium for job-switchers over job-stayers. December's spread between switchers and stayers, 1.3 percentage points (pp), has only been seen twice since the Dot-Com bubble burst, both times in 2018. As workers see financial opportunity in switching jobs, the competition for workers is exacerbated. The Employment Cost Index (ECI) rose 1.0% during the Q4-21, buoyed by a 1.1% gain in wage growth, with a 0.9% rise in non-wage compensation. That tracks the AHE statistic from the employment report. Year-over-year ECI now averages 3.0% over the past 18 quarters, significantly higher than the 1.9% averaged in the first half

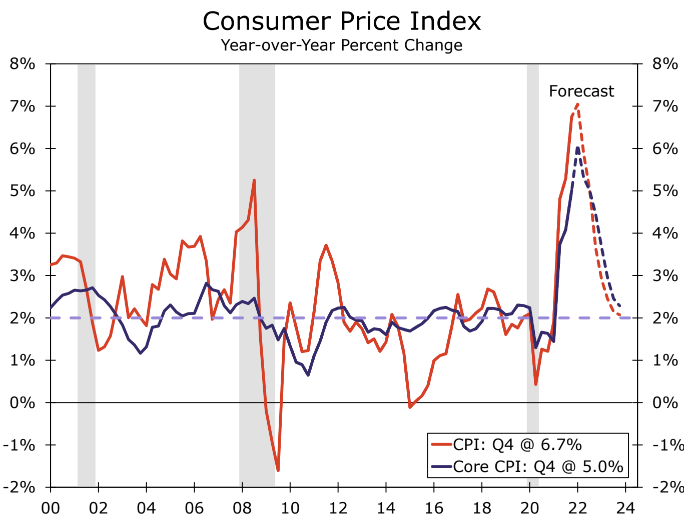
of the business cycle expansion post-Great Recession. With the unemployment rate dropping below 4% in December, a 0.7pp decrease in two months, the pressure on wages is unlikely to ease in the near future.

Inflation Piles on the Pressure, but Don't Worry, This Isn't the 1970s

The competition to attract and retain talent has coincided with inflation diminishing consumers' purchasing power, creating more pressure for employers to hike wages to adjust for workers' higher living costs. High wages and inflation can walk a slippery slope, as they can feed into one another. Such a "wage-price spiral" consists of higher wages leading to subsequently higher prices, which in turn further push up wages. That said, as discussed in our special report, there are some characteristics of today's workforce that may prevent this 1970s phenomenon. For one, workers are less unionized than they were then, and second, very few of today's workers have wages that are automatically indexed to prices.

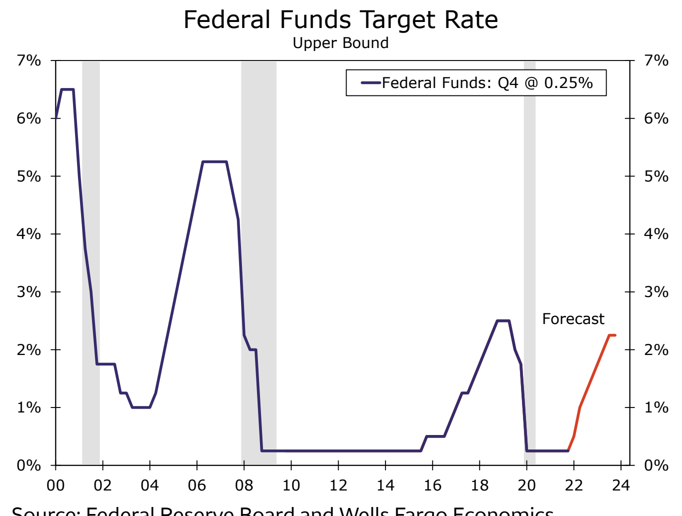
Although we may not be concerned with a vicious, 1970s dynamic between prices and wages, a cooling off in consumer prices could help take the foot off the pedal when it comes to wage growth. We expect inflation to moderate over the course of the year as supply chains normalize and consumer demand shifts into lower gear after a record year of spending. Our most recent forecast has personal consumption expenditures growing near 3.0% over 2022, which is down from the 3.7% we predicted in December. In addition to COVID fears weighing on services spending, lower real income from dwindling stimulus and high inflation may also make consumers think twice about certain purchases. But despite reducing near-term demand, the Omicron variant boosted our inflation estimates for the second half of 2022 and in 2023, as it likely extended some imbalances in the goods sector and weighed on return-to-work plans. We had already anticipated that above-target inflation would persist through the end of this year, but now we see inflation lingering above 2% through the end of our forecast horizon (chart). While we expect Q1 of this year to likely mark peak consumer price growth, we see the employment cost index (ECI) rising further in Q2 to a 4.4% annualized growth rate before slowing down. That said, prices for consumers and employers should begin moderating by the second half of this year.

Figure 4



Source: U.S. Department of Labor and Wells Fargo Economics

Figure 5



Source: Federal Reserve Board and Wells Fargo Economics

FOMC Rate Hikes Could Throw Some Water on Scorching Wage Growth

While high inflation appears to have extended its stay in 2022, the recent shift in tone from the Fed may help tamp down wage growth in the quarters ahead. As of our latest forecast, we expect eight rate hikes over the next two years, five in 2022, beginning in March, and another three in 2023 (chart). The effect these hikes could have on wage growth is multifaceted. For one, the accelerated time line helps to combat the inflation facing consumers, which should slow increases in the cost of living. But on a second note, the reduction in aggregate consumer demand should lower businesses' demand for workers and help bring the supply and demand for labor into better balance. This year's higher wages

have often been put in the context of low labor supply, as many have stayed at home due to COVID fears or have had to care for children, and as we mentioned earlier those issues persist. Undoubtedly, this has been a major cause of businesses' hiring struggles. But the other part of the rapid wage growth we have seen stems from the unprecedented consumer demand and businesses' inability to keep their shelves stocked. Lower demand may mean that businesses are not as overwhelmed and desperate for hires, which could put downward pressure on wage growth later. While the Jan. 26 FOMC meeting included a staunch affirmation that the fed funds rate remains the primary policy instrument of the Federal Reserve, the impending reduction of the Fed's balance sheet will play into the gradually tightening conditions that should reduce inflation. We expect runoff of the Fed's balance sheet to begin in the third quarter this year, contributing to tighter policy.

These decisions still hang in the balance, however, and are combined with existing uncertainty about the future of supply chains as well as the public health scenario and if, or when, COVID may become endemic. While there are opportunities for wage growth to cool further out, our measure is forward-looking and sees the high wage growth as likely through the end of the year. We may not see a noticeable step down in this likelihood until both consumer prices and employers' costs have begun to moderate in the back half of this year.

Endnotes

1 We chose 2.9% as a threshold as it would be more than one standard deviation above the previous business cycle's mean earnings growth. (Return)

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