



Investment **Research**

Can the Labor Market Support Higher Inflation?

Ronald Temple, CFA, Managing Director, Co-Head of Multi-Asset and Head of US Equity
Apratim Gautam, Macroeconomic and Policy Analyst

US workers are quitting their jobs at historic rates, and many are enjoying nominal wage increases. But how persistent will such changes be in the medium term? And will they be enough to de-anchor inflation expectations?

In today's tight labor market, it may seem obvious that the American worker is set for years of high nominal wage growth. Starting in 2020, the United States experienced surging demand for goods as consumers enjoyed a windfall of fiscal stimulus and the pandemic shifted spending away from services toward goods. In normal times, supply expansion might have been swift, but during the pandemic, supply chains have been unable to keep pace, leading to rapid growth in inflation, including wage growth.

We are not so sure these changes are permanent, however. Supply chain shortages do not, on their own, imply what the labor market will do in the medium term and whether inflationary pressure now will translate into upward wage pressure over a longer-term horizon. Average nominal wage growth has been muted since the 1970s (Exhibit 1), and the relationship between employment and inflation is murky. In December 2019, for example, unemployment was 3.5%, yet inflation remained below 2%, defying the accepted economic wisdom that tight labor markets inevitably lead to wage-price spirals.

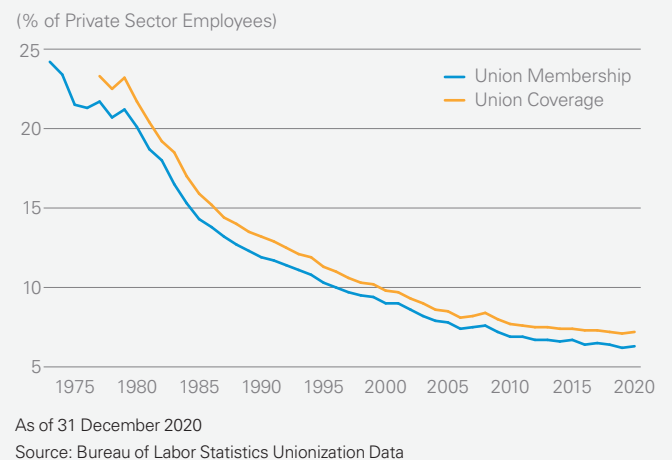
In our view, major structural impediments in the labor market could make the sustained, accelerating wage growth that is the critical ingredient to permanently higher US inflation rates much less likely than it appears today. In this note, we contemplate what could lead to a sustained acceleration in wage growth not over the next 12 months, but in the next three-to-five years. Critically, one-off changes today may not result in consistent medium-term wage growth, precisely because of the structural barriers we highlight. Overall, in our view, fears of a wage-price spiral are overblown, and it may take years before the labor market can sustain an acceleration in nominal wage growth.

To understand the medium-term fate of the labor market and of wages, we review three structural impediments to rising nominal wages: bargaining power, demographics, and labor productivity.

Bargaining Power

Employer power has increased as the US economy became increasingly concentrated. A Federal Trade Commission analysis found that 75% of industries had become more concentrated between 1997 and 2012. The more concentrated a market is, the less firms in that market compete for workers by raising wages, meaning wages do not rise as quickly as in a competitive labor market. This dynamic helps explain why wage inflation has been more muted in the last 20 years than in prior decades. Meanwhile worker bargaining power, as measured by private sector union membership, has been declining since the 1980s, sitting at 6.3% in 2020 (Exhibit 2). There is a payoff to being in a union; private-sector employees not represented by unions earn 10%–20% less on average than unionized employees in the same sector.¹

Exhibit 2
Union Membership Has Fallen Dramatically



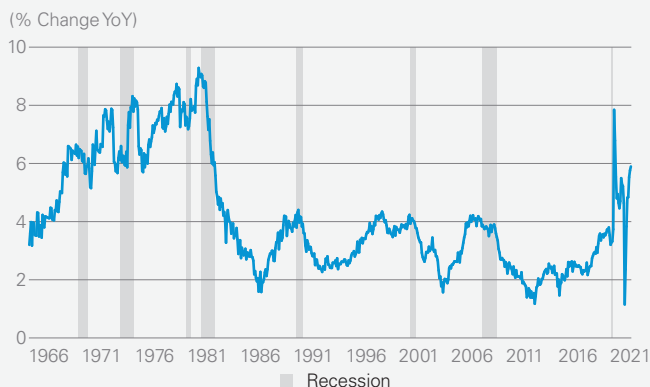
There is limited evidence that developments in either competition for workers or unionization rates are changing in a way that will enable rising wages. While there are an increasing number of strikes and union membership drives, membership rates are still so low that it will take time for momentum to build and to translate into higher bargaining power for workers. Though the Biden administration recently issued several executive orders that are designed to enhance competition and hand some power back to workers, we do not believe the tide has yet turned in a way that would drive sustained wage-growth acceleration.

Inflationary Outlook: Drag on Inflation

Low unionization rates and powerful employers are not conducive to sustained high wage growth. Low unionization rates eliminate a key path for workers to win wage increases, and monopsony purchasers of labor tend to avoid sustained wage increases.

Exhibit 1
Average Hourly Earnings

Production and Non-Supervisory Employees



Demographics and the Labor Force

Like many high-income countries, the United States is experiencing a demographic shift as a greater number of older people require support from fewer younger workers. The precise impact of an aging population on wages and inflation is difficult to pinpoint and, at a minimum, depends on the rate of aging and the size of older cohorts.

On one hand, older people have a higher marginal propensity to consume goods and services but do not typically produce or provide them, which can lead to inflation. Older populations also require greater support from public expenditure in the form of pensions and healthcare, which can create inflationary pressure through expansionary fiscal and monetary policy.

On the other hand, though older cohorts may spend more as a proportion of income, their purchasing power is lower. And older societies typically have lower growth prospects and productivity, which as we will explore in the section below is associated with lower wage growth and inflation expectations.

In part because of the aging of the US population, the labor force participation rate (LFPR) has been dropping over the last three decades (Exhibit 3). Taking a longer-term view, men's LFPR has been declining steadily since the 1950s, and after a rapid ramp-up women's LFPR seems to have peaked in the 1990s. While the prime age workforce (25–54) shows a similar phenomenon, aging population is better captured in the overall LFPR.

COVID-19 exacerbated these trends as people either retired or left the world of work for other reasons, including childcare. As with an aging population, a declining LFPR is not typically supportive of high economic growth. Though falling LFPR could raise wage growth as firms chase fewer workers, lower economic growth would likely offset this. One clear solution to this problem is immigration; a wave of young eager-to-work laborers could reshape an inverting population pyramid.

Inflationary Outlook: Mixed

There are good reasons to think that an aging population and declining LFPR are not supportive of a higher inflationary environment, but there can be partially offsetting inflationary pressures. Overall, the pressure may be slightly more disinflationary, but it may be too early to tell what the net effect will be in the US.

Declining Productivity

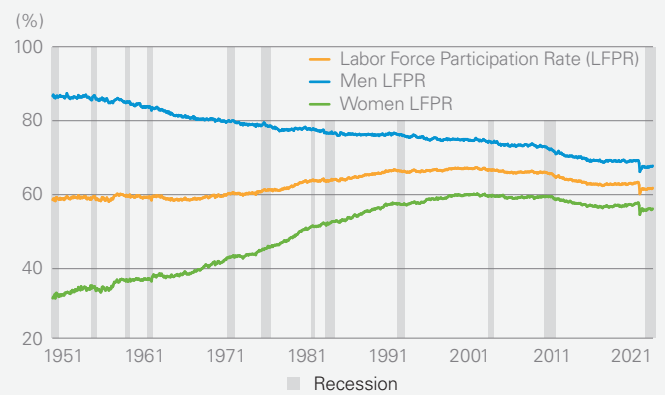
The final major factor that influences wages and thus, inflation, is labor productivity.² The growth of productivity, which is the output per unit of input, has been on a downward trajectory for decades (Exhibit 4). If real wages are to rise, they must be driven by increases in productivity.

How does productivity growth relate to inflation? The relationship can work in two opposing directions. First, decelerating productivity growth typically results in lower real wage growth, which in turn

reduces consumer spending and therefore demand-driven inflation. Second, and in the other direction, lower productivity growth makes it difficult for firms to produce goods and services more efficiently and, therefore, puts upward cost pressure on inflation.

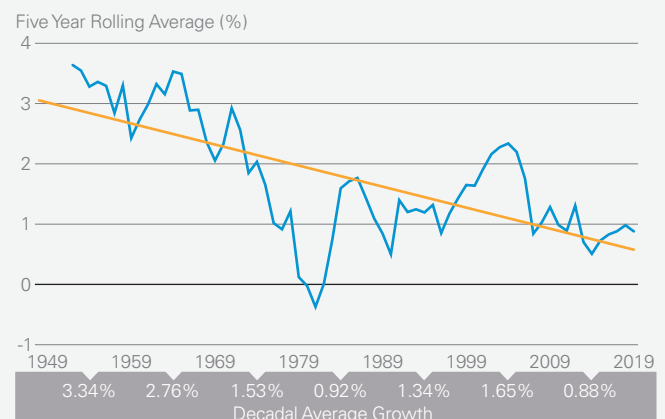
Until the 1970s, wages tracked labor productivity relatively closely (Exhibit 5). After the 1970s, though, wage growth and productivity growth parted ways. Wage growth fell faster than productivity growth, which grew slower, opening a gap between the two that widened since. (Supporters of higher minimum wages point to this as evidence that an increase in minimum hourly wages are well overdue.) While weak bargaining power for workers and demographic trends can stop productivity growth from feeding into wage growth, the stagnation of labor productivity growth is a trickier problem. For real wages to accelerate, both conditions must be addressed. Labor productivity growth must rise *and* the barriers

Exhibit 3
Labor Force Participation Rates



As of 30 November 2021
Source: Federal Reserve Bank

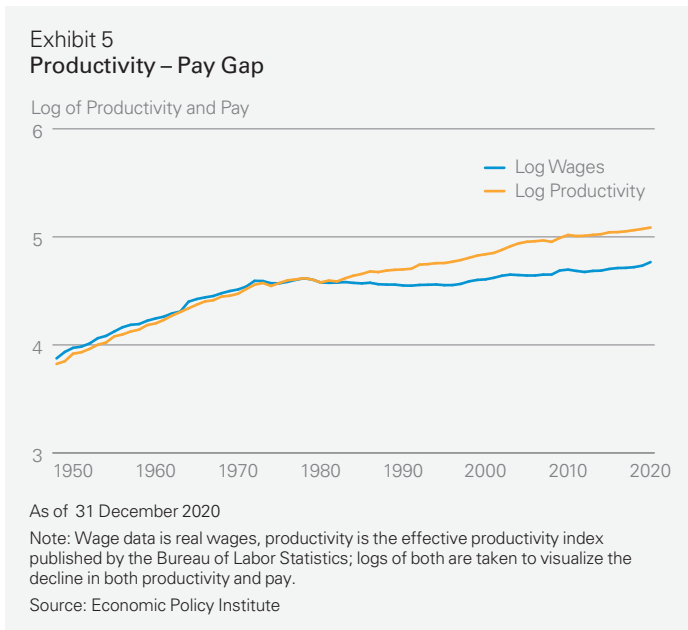
Exhibit 4
Labor Productivity Growth



As of 31 December 2020

Note: Productivity is the effective labor productivity index published by the Bureau of Labor Statistics.

Source: Economic Policy Institute



that are inhibiting productivity growth from translating into wage growth must be removed so wage growth and productivity growth can recouple. Real wage growth in the absence of productivity growth is not sustainable—it would cause major cost increases for companies that would not persist in the medium term.

So, what is holding back productivity growth? We consider here the impact of technology and an assortment of non-economic factors.

Labor-Replacing vs. Labor-Augmenting Technology

One explanation is that productivity-enhancing technology is, counterintuitively, yet to be widely adopted. Many labor productivity-enhancing innovations have yet to be integrated across sectors—where technology is adopted, it often replaces rather than augments labor. While technology can replace labor, it typically creates new secondary tasks—like a technician overseeing a robot on a factory line. Yet, over the last 20 years, more jobs have been displaced by technology than have been created. The specific reasons for this are outside of the scope of this discussion, but research suggests that the reduction in tasks for labor is a new phenomenon that is not inevitable, but rather the consequence of deliberate policy and investment choices. While those who have jobs may experience wage growth as a result of productivity-enhancing technology, the growth would be concentrated in specific sectors that are by themselves unlikely to feed into inflation.³

One illustrative case where technology adoption augmented labor productivity is the widespread adoption of remote work during the COVID-19 pandemic. Research suggests that remote work has boosted productivity for sectors that were able to transition to a work-from-home model during the pandemic. Fewer than 50% of workers in the US were able to shift to remote work, but productivity increases for these workers are estimated to be in the region of

5%–20%.⁴ This increase in productivity may well have a more lasting impact on wage growth than short-term supply limitations.

Yet the pattern of work-from-home productivity gains reflects the structure of the economy—higher paying jobs were typically able to shift to remote work and lower paying ones weren't. It may be the case that, in aggregate, the wages for the top earners grow through productivity gains from remote work but not in lower-wage cohorts. Because higher-income cohorts have a lower marginal propensity to consume, however, such a skewed shift in wage growth is less likely to feed through to higher sustained inflation.

Headwinds to Labor Productivity Growth: Peaking Education, Income Inequality, and Climate Change

Rising income inequality means that the gains from productivity enhancements are not shared throughout the economy. Rising inequality can also act as a drag on productivity growth itself. As the Organization for Economic Cooperation and Development argues, when income inequality is high, families on the lower rungs may invest less in things like education, health, and nutrition. This makes it harder for lower-income children to climb the social ladder, which in turn reinforces inequality, which leads to even lower levels of investment in human capital. Estimates from the OECD suggest that British and American cumulative GDP growth rates from 1998–2008 could have been six-to-nine percentage points higher if income inequality had not widened.

Lower productivity and lower economic growth are likely to lead to decelerating wage growth, particularly among cohorts with lower educational attainment. In the United States, educational attainment appears to have peaked in the 1990s, and the US economy is becoming more stratified between those who have completed higher education and those who have not. The gains from education are real and profound, but falling educational attainment creates skills mismatches. Generally, that means wages for workers with the right skills will be bid up, but again, these wage gains will be concentrated in particular sectors, rather than generating the kind of broad wage growth that feeds into inflation.

Finally, there is good evidence to think climate change will act as a major supply-side shock and diminish labor supply and labor productivity due to increasing incidences of disease and extreme weather events. We believe climate change is an inflationary force that will increase both the cost of production and the volatility of prices, which is a long-term challenge that could cause serious headwinds to productivity growth and therefore wage growth.

Inflationary Outlook: Mixed

Falling labor productivity can be caused by multiple colliding factors and can create both upward and downward pressure on inflation. Lower labor productivity could put upward pressure on costs as supply chains constrain further. Some of this may be offset

by fewer people producing—but overall, lower productivity will not support broad-based wage growth and may widen inequalities.

Conclusion

Our assessment indicates that the current forces driving higher inflation, including supply chain disruptions, a surge in demand for goods in lieu of services, semiconductor shortages, and higher energy prices, are unlikely to feed into sustained wage growth in the medium term because of key structural barriers. We recognize that the longer supposedly “episodic” drivers of inflation are sustained, the more likely it is that these pressures will feed into higher wages. However, unless the structural impediments to higher wages are resolved, it is difficult to argue that we are nearing a paradigm shift after decades of low stable inflation.

If our analysis seems pessimistic for workers hoping to see sustained wage gains, it is because the changes the American labor market needs in order to support income growth are deep and will take time. Yet we may well be at an inflection point. If labor markets become more competitive, if workers gain greater power, if increased immigration helps shape a younger, more dynamic labor force, and if productivity begins to grow, we will look back at the post-pandemic era as the beginning of the end of a period of muted wage growth. These changes are contingent on policy, and it remains to be seen whether we will see the action needed to support the kind of sustained wage growth the United States hasn't seen in 30 years.

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Notes

- 1 Bureau of Labor Statistics Unionization Data, 2021
- 2 In this section we are primarily concerned with labor productivity; total factor productivity and capital productivity clearly influence inflation too, but here we focus on labor alone because of its relevance to wages.
- 3 For more see, e.g., Acemoglu, Daron, and Pascual Restrepo. 2019. "Automation and New Tasks: How Technology Displaces and Reinstates Labor." *Journal of Economic Perspectives*, 33 (2): 3-30.
- 4 See, e.g., Bloom et al., "Does Working From Home Work? Evidence from a Chinese Experiment," *The Quarterly Journal of Economics*, February 2015. 130(1): 165-218; and ADP Research Institute, "On-site, Remote or Hybrid: Employee Sentiment on the Workplace." 2021.

Important Information

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