Why Higher Wages Reduce Inflation in the New Economy

November 9, 2018
by Rick Rieder
of BlackRock

Contrary to conventional wisdom, Rieder argues that wage growth doesn't lead to higher inflation, and in fact may even hold a dampening impact on inflation over time, which has important implications for how to judge monetary policy today.

In recent weeks, there's been a marked spike in volatility across assets classes and a sharp selloff in most risk assets. It's impossible to pinpoint the exact moment when sentiment turned for the worse, but its genesis may have been the September 7 U.S. employment report, which showed an acceleration in wages well above market expectations. As a result, some of the commentary from Federal Reserve policy makers took a decidedly more hawkish tone, with some central bankers suddenly calling for incremental rate hikes to a destination potentially well above the perceived neutral rate.

Wage growth doesn't lead to inflation in new economy

With policy makers' sentiment emboldened by fears of wage growth leading to higher inflation, corporate sentiment is showing a decided downward shift in this third-quarter earnings season, driven by building pressure on profit margins, *much of which is the result of rising wages*. With the Fed signaling no end in sight for rate hikes, and corporations revealing a potential end to margin expansion, risk assets have experienced acute downward pressure in just a short period of time. Many market commentators have expressed confusion over the reasons for this sudden turn, but to us there's little ambiguity about what's driving it: *markets are screaming that rising wages are doing much of the heavy lifting in tempering cyclical overheating in growth and inflation*, such that incremental Fed tightening on top of narrowing profit margins is too onerous a burden for growth. Ultimately, we believe the FOMC will come to this view as well, which is why we think the Fed will pause its rate hiking cycle early next year.

Paradoxically, wage growth is not only *not inflationary, it actually can have a dampening impact on both growth and inflation in today's economy!* Indeed, rising wages can act as an organic headwind to future growth and inflation if companies rein in expansion plans in the face of higher costs; the same can be true of higher interest rates, both for companies and consumers, even without potentially harmful monetary policy. In addition to this, and very importantly, while labor's new-found pricing power may squeeze corporate profit margins, and therefore dampen growth and inflation at the margin, rising wages are a healthy development for this cycle and not something that policy makers should attempt to curtail.

In reality, a company's pricing power is not driven by the trajectory of wages, and the need to pass through those added costs, but rather by the inherent environmental conditions impacting their overall business. Is it logical to conclude that a company would only endeavor to raise prices if they were being forced to pay higher wages to their employees? If that were true it would imply that – all else equal – companies have heretofore been proactively choosing to accept a lower return-on-equity by not raising prices when possible, a clear breach of fiduciary responsibility to maximize profits for shareholders. To be sure, companies always try to maximize pricing and profits to create an optimal balance between market share and margins.

Taking it a step further, accelerating wages married to other rising input costs (trucking, construction, commodity prices, etc.) for companies, begins to impede the very cash flows that have been targeted to fund capital expenditures to fuel future growth. Eventually, these rising costs curtail a company's desire to hire more workers, and as that dynamic becomes widespread, aggregate demand drops, the economy slows, and ultimately inflation falls. Thus, equilibrium can be restored by capitalistic forces and without the "help" of policy makers. In fact, at this stage, *we think that higher interest rates will merely serve to cut corporate margins further and will accelerate a pullback in spending, particularly in the most interest-rate sensitive sectors of the economy*, such as housing, autos, and small business. This is exactly what we have witnessed with recent data and certain stock market price action in these sectors. Markets are extremely concerned about the pernicious impact of this double-barreled threat to corporate profits and what it means for future growth (and inflation).

Rising wages and reduced goods cost serve social need

Beyond the simple economic implications stemming from rising wages, there are powerful and virtuous societal benefits that are finally now accruing to U.S. workers, which the Fed should look to prolong, not abbreviate. The combination of rising wages and reduced goods prices (led by technological innovations) are paving the way for increased household savings at the very moment when the financial needs of a growing pool of retirees is set to crest and the cost of a college education is becoming ever more of a challenge. In fact, for the first time in a generation, consumer confidence among the lowest-income brackets is rising faster than that of higher-end earners.

For the better part of the last decade, a narrative of wealth and income inequality has been pervasive. Moreover, the share of profit margins that have accrued to workers touched record lows during the post-crisis interval. To us, it’s highly ironic that after years of easy monetary policy that allowed these inequalities to grow through the wealth effect, policy makers are now proactively attempting to squelch the emergence of a broader wage increase that is driving growth in U.S. living standards. With virtually every inflation indicator remaining well behaved, the Fed’s confusing search for a “neutral policy stance,” combined with a vocal intent to ultimately become restrictive, is a policy path devoid of justification. Our advice to policy makers is to listen to the message of the markets. Rising wages can tighten financial conditions organically, and with more positive influences on a broad swath of the population, and we do not need redundant policy reinforcement (further hikes) that risks reversing these nascent societal benefits.

Rick Rieder, Managing Director, is BlackRock’s Chief Investment Officer of Global Fixed Income and is a regular contributor to The Blog.

Investing involves risks, including possible loss of principal.

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are as of November 2018 and may change as subsequent conditions vary. The information and opinions contained in this post are derived from proprietary and non-proprietary sources deemed by BlackRock to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. As such, no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by BlackRock, its officers, employees or agents. This post may contain “forward-looking” information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this post is at the sole discretion of the reader.

Prepared by BlackRock Investments, LLC, member Finra

USR1118U-652349-2024813