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‘On a razor’s edge’: A wage-price spiral could derail inflation recovery

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Prices are up. So are wages.

So far, economists say, they are not feeding off of each other in a significant way — meaning the country is avoiding the self-perpetuating wage-price spiral that gutted the economy when inflation surged in the 1970s.

But economists and policymakers in Washington are watching closely for signs that could soon change. If it does, inflation risks spiking even more dramatically than it has already, frustrating voters and handing Democrats a tough card to play just months before the upcoming elections.

The economic effects of the Russian invasion of Ukraine are another uncertain factor.

“We're on a razor's edge here with regard to how this is going to play out,” said Mark Zandi, chief economist of Moody’s Analytics. “It’s prudent to be on high alert because that very much could happen.”

The '70s wage-price spiral was seeded by a surge in government spending to fund the Vietnam War and President Lyndon B. Johnson’s social spending agenda. Consumer demand and in turn, prices, rose — yet former President Richard Nixon pressured the Federal Reserve not to intercede ahead of the 1972 election, keeping interest rates low.

Eventually, employers and employees foresaw nothing but rising costs and began planning for price and wage increases, which drove each to new heights.

Declining union membership and growing import competition could help head off the same cycle this time around. And the Fed is poised to raise interest rates next month. But concerns are great enough that calls for the central bank to act more decisively have grown louder, with moderate Democrats like Sen. Joe Manchin (D-W.Va.) asserting that it needs to “stop pussyfooting around.”

Worker advocates and Democratic allies fear the Fed could react too aggressively, harming workers and — worst case scenario — sparking a recession.

The price of consumer goods like food and electricity rose 0.6 percent in January for a staggering 7.5 percent increase over the previous year, according to the Bureau of Labor Statistics. The same month, average hourly earnings rose 23 cents, a 5.7 percent increase from the year before. Both are bigger jumps than the U.S. has seen decades.

But economists say that — though the two trends are happening in tandem — they have yet to feed off each other in a big way.

Employers haven't significantly hiked prices in response to higher labor costs, and workers have yet to demand bigger paychecks in order to afford more expensive goods, even though inflation has chipped away at — or, in some cases, wiped out — what pay hikes they’ve already received.

“They've mostly been on parallel tracks, and they're not super related yet,” said Josh Bivens, director of research at the left-leaning Economic Policy Institute. “I understand why people connect them in their head, and it is a shame, because I don't think high wage growth is driving the inflation we're seeing today.”

If that changes, experts warn it’s unlikely policymakers will be able to get inflation under control quickly enough to avoid political repercussions for Democrats ahead of the November midterm elections.

Employers would start consistently passing the cost of higher wages along to consumers by raising prices — and workers would begin requesting raises to be able to afford increased prices (and subsequently spend more), which would push prices up even higher.

Fourteen percent of Americans cite inflation as one of their top priorities the government should address, up from 1 percent a year ago, according to a January poll by the Associated Press and the NORC Center for Public Affairs Research. Eight in 10 Americans expect inflation to increase, a Gallup poll found — the highest rate the firm has ever seen.

"If you start to see the headline inflation numbers really start to come down by March, and we spend a summer hearing news about wage growth exceeding inflation, then maybe" Democrats won't catch flak, Bivens said. "But if instead it doesn't happen until like June, July, then it might be too late. It's a real nail-biter."

The pandemic has warped the job market in ways that make it particularly prone to wage inflation. Not only has the government spent billions on Covid-19 relief, but a record-high number of job openings — and the resulting high rate of job-switching — have pushed up wages and, to some extent, prices.

The spike in workers searching for new jobs boosted inflation by 1 percentage point last year, according to the Chicago Federal Reserve. That means job-switching is responsible for 20 percent of the price increases in 2021.

"Employers are struggling to get people to come in the door to fill the positions they have open," said Rachel Greszler, an economist at the right-leaning Heritage Foundation. "They have to pay higher wages."

Experts say the fact that a growing number of jobs can be done remotely only speeds the process: Workers can easily quit and start a new job without ever leaving their home office.

"I've never seen anything like it before," said Adam Hickman, a senior workplace strategist at Gallup. "Pick an industry, you'll find a remote job anywhere."

Bivens points out that some individual sectors that have seen pay hikes have not seen a corresponding increase in prices. Leisure and hospitality, for instance, have seen historic raises — but the cost of goods has not significantly gone up.

Heightened productivity and swollen profit margins have helped delay the feedback loop. But economists warn that could soon change.

"There is very much a potential that a continued strong labor market and with the rising incomes and wages could start feeding more into inflation," said Nick Bunker, an economist at Indeed.

Not only are incomes rising at an unprecedented rate for many workers, but wages are starting to rise more across sectors and income levels — rather than in only a handful. Economists say that if both trends continue, there is a growing likelihood workers could kick off a wage-price spiral.

Right now, "a lot of the pick-up in wage growth isn't as concentrated as it once was," Bunker said. "It seems to be spreading out. All other things equal, that raises the possibility of wages passing through to inflation."

If employees start asking for higher wages, "you get the issue of … what happened in the '60s and '70s, where inflation keeps picking up so there's accelerating inflation," he added. That's "the sort of thing the Fed has vowed to not let happen again."