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INSIGHT

The Post-Pandemic Labor Market and Rising Inflation

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As measured by the Consumer Price Index (CPI), published by the Bureau of Labor Statistics (BLS), inflation has increased relatively quickly during the first several months of 2021. In June 2021, CPI inflation was 5.4% (measured by the percent change from June 2020), significantly higher than the sub 2% inflation that had become commonplace since the 2008 financial crisis. There are several reasons this could be occurring, and some have pointed to the labor market as an explanation. This Insight discusses the theoretical connection between the state of the labor market and inflation, recent trends in the labor market, and the dynamics between current labor market conditions and rising inflation in the economy.

Inflation and the Labor Market

Inflation is typically attributed to any number of causes, one of which is increasing production costs. Put simply, if it costs businesses more to produce goods and services, they will, under most market conditions, charge more for the final products. There are several inputs in the production process, including land, labor, and capital, among others. If the price of labor—often measured in wages—increases, then producers are not able to produce their goods or services at the same price and quantity as profitably. Given this, and depending on market characteristics, producers may increase prices of final goods and services, often referred to as cost-push inflation.

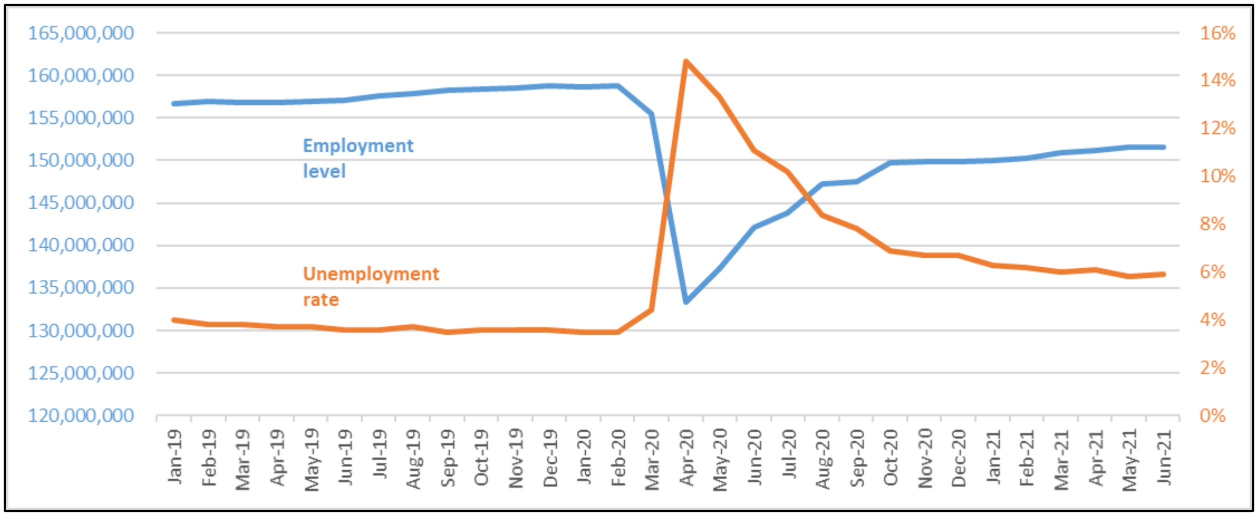
In addition, increased wages leave workers with higher disposable income, which, all else equal, can lead to a rise in aggregate demand. Depending on the increase in demand relative to the productive capacity of the economy, a rise in prices may result, known as a wage-price spiral. The magnitude of the effect of increasing wages depends on several factors, including the uniformity of the increase in wages across all sectors and the state of the economy at the time of the increase in wages.

Labor Market Trends

As shown in **Figure 1**, the level of employment was relatively high and the unemployment rate relatively low prior to the COVID-19 pandemic. Following the start of the pandemic, the unemployment rate increased rapidly to levels not seen since the Great Depression. Employment levels dropped over 20 million in April 2020 alone. While the employment situation has improved since April 2020, the unemployment rate as of June 2021 remains about 3 percentage points higher than in February 2020, before the pandemic began, and the number of employed persons remains about 7 million lower over the same period. All else equal, this would imply a "looser" labor market—that is, one featuring a high amount of available labor relative to job openings and less upward wage pressure—in 2021 than in 2019.

Figure 1. Employment and Unemployment Situation

January 2019 to June 2021



Source: Bureau of Labor Statistics (BLS), Current Population Survey.

Despite the relatively "loose" conditions in the labor market overall, certain industries have shown characteristics of a "tighter" labor market, such as difficulty in hiring, increased bargaining power, and nominal wage growth. To illustrate with an example, **Figure 2** shows the average hourly earnings (i.e., wages) of all employees in the private sector and employees in the leisure and hospitality sector, an industry that took relatively severe employment losses and has yet to recover in terms of employment levels.

Average hourly earnings increased substantially in April 2020 as lower-wage workers lost their jobs at a higher rate than higher-wage workers at the onset of the pandemic, thereby increasing the average wage. Wages began to normalize somewhat in May, when overall hourly earnings dropped quickly, but remained elevated compared to what they would have been had they continued on their pre-pandemic trajectory. Earnings growth largely returned to its previous long-term rate beginning in June 2020, although growth has been especially strong in recent months. It is, as of yet, too early to know if this recent increased rate will be sustained.

In contrast, leisure and hospitality earnings losses following the early spike were more severe, and the early recovery less robust, as demand for in-person services was significantly dampened by restrictions and concerns over the spread of the virus. However, wages in this sector have increased at a more rapid rate in 2021 than the private average. In this case, the increase in wages is, in large part, an effort to attract workers, some of whom switched jobs during the pandemic or are taking advantage of current labor market conditions to switch industries.

Figure 2. Nominal Average Hourly Earnings

January 2019 to June 2021

Source: BLS, Current Employment Survey.

Wage Growth and Inflation in 2021

The data above may suggest demand for labor amidst the recovery from the pandemic could be putting some upward pressure on wages. This, in turn, could put upward pressure on prices. While inflation refers to the general increase in prices across the economy, and wages and prices are not increasing across all sectors and industries, increased prices in specific industries can significantly affect inflation in the short run. For example, BLS attributed more than a third of the increase in overall prices in the month of June to a 10.5% increase in the price of used cars and trucks over the same period.

Whether higher inflation will be sustained is uncertain. It is possible that inflation will slow as supply becomes less constrained by pandemic disruptions, as many (including Federal Reserve Chair Powell) believe. Wage growth may also slow should supply become less constrained. That said, the relationship between wages and inflation is not unidirectional. Increased wages have the ability to put upward pressure on prices, but increased prices also have the ability to signal to workers that they should demand higher wages to compensate themselves for inflation. Should expectations of high inflation become ingrained in the public, it is likely that workers would do so, thereby putting further upward pressure on prices. Overall wage gains have not outstripped inflation yet and are thus unlikely to contribute to sustained increases in inflation at this point.

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