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INSIGHT

Is the U.S. Experiencing a Wage-Price Spiral?

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Recent high inflation and nominal wage growth has sparked a debate about whether the United States is currently in a *wage-price spiral*. A wage-price spiral is said to occur when expectations of inflation become embedded in decisionmaking on the part of workers, who demand higher wages to compensate themselves for perceived future price increases in a way that creates more inflation, creating a cycle that results in persistently increasing inflation. A consensus definition of *wage-price spiral* does not exist among economists, and, to some extent, debate about whether or not the United States may be experiencing one would depend upon the definition used. For the purposes of this CRS Insight, a wage-price spiral can be ruled out if nominal wage increases do not meet or exceed price increases.

For more information about recent wage trends, see CRS Report R47380, *Average Wage Growth and Related Economic Trends in 2022*, by Lida R. Weinstock.

The Connection Between Wages and Inflation

Economists distinguish between nominal wages, which are the actual wages that workers receive at any given time, and real wages, which are adjusted for inflation so purchasing power can be compared over time. When negotiating wages, one factor that employers and workers are considering is the prices they think they will face in the future. If employers think they will be able to get more money for their products or services in coming months or years, they may be willing to raise wages, all else equal. If employees think things they buy will cost more in the future, they may request higher wages.

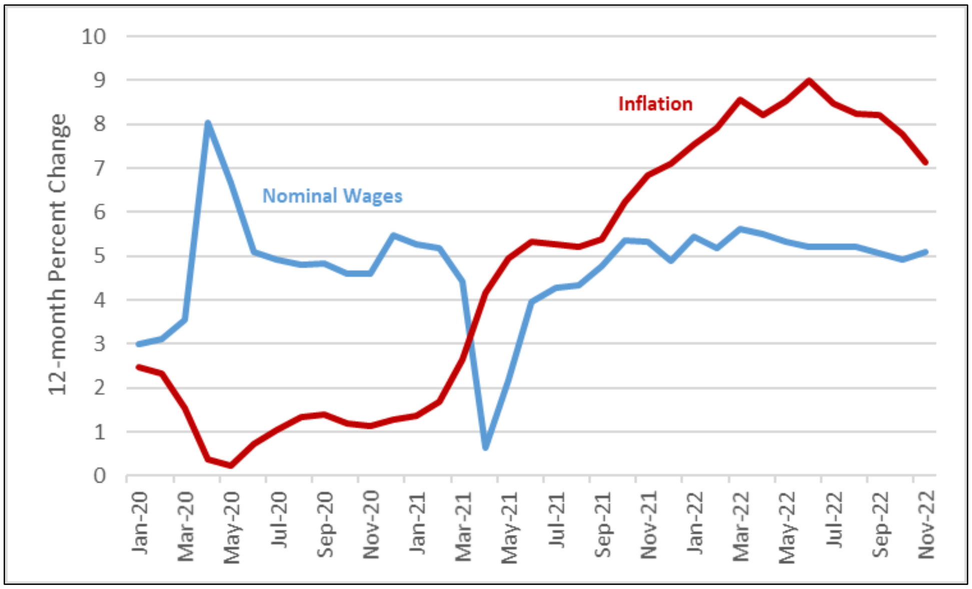
In a wage-price spiral, workers are able to negotiate higher pay in excess of productivity and inflation, causing the costs of businesses to increase as a result. In response, those businesses increase the prices of their products in order to cover those increased costs (assuming businesses do not reduce profit margins instead), causing inflation. Workers see that prices have increased, fulfilling their expectations and therefore further embedding their belief that prices will continue to increase. Once embedded, this self-fulfilling prophecy can prove difficult to break.

Is There Evidence of a Wage-Price Spiral?

Current high inflation and nominal wage growth has some spectators worried that the United States could be on the verge of a wage-price spiral or that, at the very least, rising wages are playing some role in high inflation. **Figure 1** below shows nominal wage growth and inflation since 2020. While nominal wage growth has been relatively high during this period, inflation began to outpace wage growth in March 2021, resulting in negative real wage growth. Given the fairly persistent reduction in real wages, it is unlikely that the United States is currently experiencing a wage-price spiral. Although workers have taken advantage of a tight labor market to increase their wage demands, the fact that, on average, workers' real wages have not increased could indicate several things. It is possible that workers may not have fully anticipated inflation, but it could also be evidence of frictions in the labor market such as a mismatch in bargaining power or a lag in the wage response to tight labor market conditions.

Figure 1. Wages and Inflation

January 2020 to November 2022



Source: BLS CES and CPI data.

Even if the United States has not, to this point, experienced a wage-price spiral, it is possible that it will enter one in the near term. Looking to larger labor market and macroeconomic conditions can help determine if this is likely. One the one hand, cost-of-living adjustments and other automatic wage indexation are not as prevalent in the United States as they were in the past, and some literature suggests that the pass-through of wages to inflation has declined over time. On the other hand, U.S. labor markets have been fairly tight in recent months (although there are some indications they may be loosening). Workers typically have more bargaining power in a tight labor market than in a loose one, thus enabling them to either more quickly renegotiate higher wages or negotiate more significant wage increases than they would have been able to in a weaker market.

Inflation expectations, which generally determine the level of wage increase workers desire, show mixed evidence. According to the Federal Reserve's Survey of Consumer Finance, the median one-year-ahead expected inflation rate rose significantly in 2021 and remained high in 2021, although it has decreased for the past couple of months. In contrast, the median three-year-ahead expected inflation rate has remained relatively anchored throughout 2021 and 2022. A recent Federal Reserve Bank of San Francisco working paper found the role of inflation expectations in wage changes to have increased over the course of the pandemic, with a one-to-one relationship between the increase in expected inflation and resultant increase in wages currently. All told, if expectations do become unambiguously unanchored, a wage-price spiral would be more likely.

Regardless of whether the United States enters a wage-price spiral in the near future, nominal wage growth is likely contributing to high inflation in some part. Without a loosening of labor market conditions and a deceleration in nominal wage growth, inflation may be unlikely to return to a low and stable level. Federal Reserve Chair Jerome Powell characterized this idea in recent remarks: "In the labor market, demand for workers far exceeds the supply of available workers, and nominal wages have been growing at a pace well above what would be consistent with 2 percent inflation over time. Thus, another condition we are looking for is the restoration of balance between supply and demand in the labor market."

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