Will a Tightening U.S. Labor Market Mean Inflation and Higher Interest Rates?

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Investors are focusing on the potential of rising wages to fuel inflation.

As the U.S. economy continues its slow recovery, investors are focusing their attention on the role that falling unemployment and the potential for rising wages may play in fueling a broader rise in inflation and higher interest rates. BNY Mellon chief economist Richard Hoey says that both wage inflation and core inflation in the U.S. have bottomed. “We believe that they have begun a gradual, multiyear uptrend which will not end until 2017 or 2018 in an environment of restrictive monetary policy,” he says.

BNY Mellon Chief Global Markets Strategist Jack Malvey agrees with Hoey, but he also points out that “there’s definitely some slack in the labor market as measured by the number of structurally unemployed people, which remains high. It’s a very anemic recovery that’s a function of arrested animal spirits in corporate America and reduced spending growth by federal, state and local governments. Old economy companies remain in cost-cutting mode, which effectively means either not increasing employment or cutting it outright.” Weak recovery or not, though, Malvey expects job growth to slowly push the unemployment rate below six percent by the first quarter of 2015 and he believes that this modest job growth will exert similarly modest pressure on both wage and core inflation.

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Hoey believes that the effective supply of labor in the U.S. “may be lower than it appears to be for several reasons, including a faster decline in short-term unemployment than in total unemployment, the permanent withdrawal from the workforce by older workers during several years of a weak labor market and a rise in the effective median marginal tax rate on wage and salary income.”

The share of U.S. national income going to labor is at its lowest in many decades and accordingly Hoey believes that increased wage inflation is likely to be welcomed both by the Obama administration and the public. “We expect a gradual uptrend in wage inflation to be first welcomed and then later tolerated by the Federal Reserve,” he adds. “A well-tolerated gradual upward drift in wage inflation would be consistent both with our expectation that the U.S. is now at the inflection point from a sluggish expansion to a faster pace of growth for the next several years,” Hoey says.

Malvey points to several additional reasons why that upward drift is likely to be gradual. These include the continuing entry of workers living in emerging market countries into the global labor supply, productivity improvements and structural changes in the global economy which he says have constrained inflation more than might have been expected given the extraordinary monetary stimulus over the past six years. “Inflation,” says Malvey, “is more likely to come from geopolitical events, energy shocks and weather, rather than from the labor market. As we’ve seen with Russia and Ukraine, and now Iraq, energy supply disruptions are a real threat. I think that the labor market might be better viewed as lagging indicator, which is historically true in business cycles. Peak employment is usually at the top of the business cycle as measured by GDP and productivity growth rates.”

While a slowly tightening U.S. labor market is likely to spur only modest inflation in the short- to medium-term, Malvey is concerned that inflation is destined to increase as global economic growth quickens to perhaps 4.0% by 2016/2017.

"I think by 2018, 2019 or 2020, current monetary policy will likely lead to some increase in inflation. That's why policymakers have to be so judicious in the way they manage policy normalization. If they wait too long, they could see an eruption in inflation expectations."

Those policymakers appear more likely to accommodate, rather than resist, at least some inflation. Hoey says, "The Fed has indicated that it currently intends a real Federal funds rate (the Federal funds rate minus inflation) well below historical norms when the U.S. economy reaches full employment. We believe that it will follow through on that plan, but the consequence is likely to be a very gradual but persistent upward drift in inflation over the coming years."

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Despite the fairly benign short- to medium-term forecast, Malvey cautions investors—especially defensively postured fixed income investors—not to overlook strategic inflation risk and the possibility of policy errors. "I hope that normalization of monetary policy will be conducted seamlessly," he says. "But given that we're in a monetary policymaking cycle that we've never seen before, it's difficult for anyone to know how to predict exactly the smoothness of the normalization process. There could be interludes of volatility surges for key capital market parameters along the long road to normalization."

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