

GIES OCCASIONAL PAPER

The Global Energy Crisis | January 2023

ANOTHER WAGE PRICE SPIRAL IN THE MAKING?

A comparison between the 2020s and 1970s

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In the wake of pandemic-induced disruptions of global supply chains and skyrocketing energy prices, inflation soared to levels unseen since the 1970s. This caused concern among central bankers and policymakers that advanced economies might get caught in a *wage price spiral* – a vicious cycle of rising wages and prices that many believe was at the centre of the 1970s stagflation crisis. A draconic increase in real interest rates was required to put wage growth and inflation back in check: in 1979, the Volcker Shock, named after then-chairman of the United States’ central bank (the Federal Reserve or Fed), eventually pushed up unemployment rates in the United States (US) and Europe to their highest levels since the end of World War II.

More than 40 years later, central bankers are keen to prevent a rerun of these dynamics. On February 4th 2022, the Bank of England (BoE) was the first major advanced central bank to raise its benchmark short-term interest rates since the eruption of the pandemic. A day later in an interview with the BBC, Andrew Bailey, governor of the BoE, urged British workers to show some “restraint in pay bargaining, otherwise it will get out of control.” In the same interview, Bailey described the labour market in the United Kingdom as “extraordinarily tight”, adding that labour shortages were the “first, second and third thing people want to talk about” when he visits businesses across the country.¹ Other central bankers

have been similarly worried about the inflationary effects of tight labour markets. When the Fed raised the federal funds rate in March 2022, chairman Jerome Powell claimed that US labour markets had become “tight to an unhealthy level”: the Fed’s planned rate hikes were meant to reduce inflationary pressures by “moving down the number of job openings” in the US economy and creating “less upward pressure on wages, less of a labour shortage.”² In the Eurozone, Isabel Schnabel of the Executive Board of the European Central Bank (ECB) observed “a shift in the bargaining power of unions and workers”: “Record-high inflation and acute labour shortages seem to have strengthened workers’ resolve to protect their purchasing power.”³ In this context, as its president Christine Lagarde made clear, the ECB would “need to monitor inflation expectations and wage negotiations very carefully to ensure that wage growth does not settle persistently at levels that are incompatible with our target.”⁴

These statements expose an inconvenient truth about the politics of inflation: central banks’ rate hikes are supposed to make borrowing more expensive in ways that make firms less willing to invest and create new vacancies, weakening the bargaining power of workers to bid up their wages to sustain their living standards in the face of rising inflation. By doing so, monetary tightening effectively serves to deflect the burden of adjustment to the rising inflation onto the working

classes, whose nominal wages fail to keep up with inflation and productivity growth: real wages –adjusted for inflation– have even been falling in 2022. In this contribution I provide a Kaleckian interpretation of the role of central banks in containing inflation, comparing the current episode with the 1970s stagflation crisis.

A Kaleckian reading of the 1970s stagflation crisis

The commitment of central bankers to raise interest rates and even engineer a recession at the expense of real wage growth nicely fits with a Kaleckian reading of inflation. As the Post-Keynesian/neo-Marxist economist Michal Kalecki argued more than 50 years ago: persistent inflation results from conflicting claims on income made by workers and firms. Furthermore, the bargaining power of workers to increase their income claims critically depends on the level of unemployment and the tightness of the labour market: the lower the number of unemployed people per job opening, the more firms need to compete for workers and the easier it becomes for workers to switch to higher-paying jobs. In short, employers need to offer higher wages to attract workers and stay competitive when the level of unemployment is very low.⁵

This observation was a key reason for why Kalecki doubted that the post-war Keynesian macroeconomic regime of full employment would be politically sustainable. In a famous 1943 article, Kalecki predicted that the reduction in unemployment and the resulting scarcity of labour would ultimately strengthen the position of workers and labour unions to such an extent that they would become increasingly assertive in their wage claims.⁶ Real wage growth would exceed productivity growth and erode the profits of firms and their capitalist owners, who would then revolt against the regime of full employment. Growing tensions between capital and labour since the end of the 1960s seemed to confirm Kalecki's predictions. From a historical perspective, the post-war years stand out as a period during which the position of workers in distributive conflicts was stronger than ever before in the industrialized world. Accordingly, industrial disputes

proliferated in the late 1960s. These conflicts greatly intensified after the first oil shock in the beginning of the 1970s, when workers sought to secure their living standards by pushing through higher wages. Faced with falling profit margins, private firms raised prices even further and embarked on investment strikes, postponing their spending on new capital goods to extract concessions from workers and governments.

A common interpretation in the more critical traditions of the comparative and international political economy (CPE and IPE) literature is that higher unemployment rates in the second half of the 1970s at least partly reflected “attempts by business and conservative interests to reshape relations of power and patterns of redistribution prevailing during the full employment era into more favourable ones from their point of view.”⁷ Unemployment came to be seen as a solution to what was seen as the most pressing problem: rising inflation. Central banks restricted the supply of money and allowed interest rates to soar to historically high levels, causing the severest recession since the 1930s Great Depression. Rising unemployment increased demands on social security systems and drained state coffers. Surging interest payments fed the perception that the amount of government spending and size of fiscal deficits had become unsustainable. A regime of quasi-permanent austerity and welfare state restructuring took shape in the 1980s and 1990s. Central banks became politically independent from governments to strengthen their inflation-fighting credibility.

This new macroeconomic regime particularly affected low-income workers most dependent on tight labour markets, given that they are the first to be fired during recessions and the last to be hired during recoveries. Across the industrialised world, central banks contributed to the weakening of their bargaining power by prematurely raising interest rates during economic recoveries: monetary policy was “persistently biased so as to depress aggregate demand late in the business cycle, before workers at the bottom of the distribution see a labour market that is tight enough to allow them to bargain for higher wages.”⁸ There

is a broad consensus in the Marxist and post-Keynesian literature that central banks' strategy of pre-emptive tightening has played a direct role in the secular decline in the bargaining power of workers vis-à-vis the owners of capital and contributed to the fall in the labour share of GDP – a universal trend in the industrialized world.

Wage or profit price spiral?

Are we in the midst of a new wage price spiral? One obvious similarity between the 1970s inflation crisis and the current one is the central role played by soaring energy prices, in turn fuelled by geopolitical conflicts. Of all the categories of the Consumer Price Index (CPI), energy is the most important for overall price stability, given its key role as production input: firms will usually raise their prices in response to persistent increases in energy prices to protect their profit margins, broadening the inflationary pressures to other sectors of the economy. Just like during the 1970s, core CPI –excluding more volatile energy and food prices– has been way above central banks' two percent target.

But that does not necessarily mean another wage price spiral is around the corner. In the current moment, a key missing ingredient is the bargaining strength of the labour movement, which is structurally weakened by the disinflation policies of the 1980s and the ensuing liberalization of labour markets. In the Anglo-Saxon economies, liberalization took the form of outright labour market deregulation and a frontal assault on labour unions. In the Eurozone economies with stronger traditions in collective bargaining, union density declined almost as sharply. Even if collective bargaining coverage remains relatively high, agreements have increasingly moved to the firm level where workers have less bargaining power. Deindustrialization also pushed governments to flexibilize jobs in the service sectors of the economy, where a growing number of workers are employed in precarious jobs unprotected by social legislation and/or collective bargaining agreements. In manufacturing sectors most exposed to international trade and investment, unions became more responsive to the needs of employers to remain competitive in globalized markets and

restrained their wage demands to contain unit labour costs.⁹

Central bankers are aware of these developments. At the Federal Reserve, economists and policymakers have noted how the decline in workers bargaining power and the fall in the labour share of GDP have made it easier to pursue expansionary monetary policy without fuelling inflation: both trends contributed to the flattening of the Phillips curve – the inverse relationship between unemployment and inflation that has informed their strategy of pre-emptively raising interest rates to prevent unemployment from falling below a supposedly inflationary threshold.¹⁰ At the ECB, both Lagarde and Schnabel have similarly observed how “structural changes in labour markets”¹¹ and “the secular erosion of workers' bargaining power”¹² implied that “receding slack fed more slowly into wage growth”¹³: “Despite a historically tight labour market, a substantial decline in real consumer wages is weighing on the labour share of income” – a situation “fundamentally different from the experience of the 1970s when real wages and the labour share of income increased measurably in response to rising energy prices.”¹⁴ ECB economists have attributed this difference to changes in labour market institutions, such as less wage indexation and a lower degree of unionisation).¹⁵

Central bankers have also acknowledged that rising profit margins have played a role in fuelling inflation. At the Fed, Governor Lael Brainard has noted how “reductions in markups could make an important contribution to reduced pricing pressures”, given that “measures of profits in the non-financial sector relative to GDP remained near the post-war peak reached [in 2021].”¹⁶ At the ECB, Schnabel recognised that “firms have so far been able to increase their prices beyond the increase in nominal wages, and in many cases even beyond the increase in energy costs.”¹⁷ Lagarde has similarly observed that “when inflation is high everywhere and supply is constrained, firms can more easily pass on cost increases to customers without losing market share to their competitors.”¹⁸

Labour shortages: curse or blessing?

Given these observations, why are both central banks still concerned about a return of a 1970s wage price spiral? The most likely explanation is that they fear that persistent labour shortages will unleash a new regime of de-anchoring inflation expectations. As economists of the Bank of International Settlements have noted, “one trigger for [this] could be nominal wage increases beyond price increases and productivity gains,” which is much more likely “if labour markets continue to tighten, raising workers’ bargaining power.”¹⁹ There is a common apprehension among central bankers that labour markets are “overheating” and could *eventually* lead to “excessive wage growth”, making high inflation more persistent by de-anchoring expectations about the future path of the general price level. Thus, raising interest rates is deemed necessary to prevent this from happening.

A signpost for these risks, in their view, is the broadening of inflation to the labour-intensive services sector. Since the 1970s stagflation crisis the share of workers employed in services has increased exponentially in the advanced economies, reaching more than 70 percent, and in some countries such as the United States even 80 percent of the workforce. At the Fed, Jerome Powell has been concerned about inflation “moving sideways” to the core (non-housing) services where “wages make up the largest cost” and “the labour market holds the key to understanding inflation.” These core services are usually the most de-unionised sector of the economy where tight labour markets and labour shortages are the last vestiges of workers’ bargaining power.

Raising rates is particularly important, central bankers believe, to restore their credibility as inflation fighters. Monetary policy has been extraordinarily supportive during the pandemic years and central bankers have been criticized for responding too slow to escalating inflation. Persistent undershooting of their inflation target since the global financial crisis of 2008 led both central banks to believe that too-low inflation had become a greater risk than too-high inflation: to avoid a downward de-anchoring of inflation

expectations, both central banks have recently revised their monetary policy frameworks. In the Summer of 2020, the Fed announced that it would from now on allow inflation to temporarily run above its 2 percent target to “makeup” for inflation having been persistently too low since 2008. One year later, the ECB raised its target to 2 percent – instead of “below, but close to, two percent” – and announced it would undertake “forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched”, even if it would lead to “a transitory period in which inflation is moderately above target.”²⁰

These revisions suggested that the Fed and ECB had become more lenient toward higher inflation. At the Fed, this newfound leniency was matched by a much stronger commitment to pursue “maximum employment” – the second pillar of its dual mandate. Under its new framework, the Fed committed to no longer pre-emptively tighten monetary policy to prevent unemployment falling below its estimates of the “natural rate” – the level supposedly consistent with stable inflation. As such, the Fed would be more willing to actively chase hot labour markets and promote a “high-pressure economy.” Empirical research has highlighted a variety of benefits of such a strategy.²¹ Tight labour markets enable involuntarily part-time workers to find full-time jobs and draws back discouraged workers who detached from the labour market during previous recessions but are still looking for jobs. They also reduce labour market inequalities by (a) improving job opportunities for disadvantaged (especially non-white and older workers), (b) boosting wages of low-skilled workers, and (c) allowing workers more generally to experience greater upward mobility and better job matches. Finally, labour shortages can even induce firms to invest in labour-saving technologies, lifting the longer-term growth potential of the economy by raising labour productivity.

The Fed’s new framework facilitated the incoming Biden administration’s spending programmes. The American Rescue Plan, which offered US workers and businesses fiscal support to the tune

of 1.9 trillion dollars, sought to return as fast as possible to the extraordinary tight labour markets of 2019.²² A central objective of Biden's more general economic policy programme was to create an inclusive wage-led growth model based on strong labour markets and a strengthened working class. Even reputable left-wing scholars believed a new era of macroeconomic expansionism was in the air. Josh Mason called Biden's agenda "a big break with prevailing orthodoxy."²³ Cédric Durand even identified it as "1979 in reverse" – "an unambiguous departure from the fiscal moderation of the Obama Administration and the dogmatic austerity of the EU" whose "ideological significance should not be underestimated."²⁴

Restoring credibility at all costs?

Despite the potential benefits of hot labour markets, the goal to create a high-pressure economy became increasingly contested by prominent elite economists who believed the inflation surge confirmed their concerns that Biden's and the Fed's stimulus measures had been "excessive" and would lead to an "overheating economy."²⁵ The Fed's new framework was seen as complicit in facilitating this overheating and in fuelling an upward de-anchoring of inflation expectations. By the end of 2021 the Fed began to share some of these concerns. Given that "strong demand and a very tight labour market have also contributed to inflation pressures", it was agreed that the Fed "can help alleviate those pressures by removing the extraordinary monetary policy accommodation that is no longer needed."²⁶

Raising interest rates is a blunt mechanism to contain contemporary inflationary pressures, however, especially if they are primarily linked to supply-side shortages rather than demand-side excesses.²⁷ It seeks to cool down labour markets that have relatively been most beneficial for low wage workers. A recent study has shown that lowest-paid have enjoyed the sharpest real wage growth in the United States since the start of the pandemic (and the only group that experienced positive real wage growth in 2022), partly reversing decades of rising wage inequality.²⁸ To the extent that it results from workers switching to

higher-paying jobs at more productive firms, real wage growth is not necessarily inflationary. Rate hikes can actually "lock-in" current supply side problems: higher credit costs discourage producers from investing further in additional capacity. As Josh Mason and Lauren Melodia have put it, it amounts to "a decision to keep society poor enough that we can only afford what businesses are currently able to produce" by reducing demand "to the temporarily lower level of supply."²⁹ Maintaining a high-pressure economy, in contrast, is based on the idea that inflation is a temporary cost of adjustment to a new higher level of capacity.

This does not necessarily mean that nothing should be done to curb inflation in the short term. But if inflation is seen mainly as a distributional conflict, it makes more sense to entrust solutions to governments and legislators who have more democratic legitimacy to identify winners and losers in this conflict than unelected central bankers. They have the capacity to subsidize energy costs – partly funded perhaps by taxing windfall profits – and limit the erosion of workers' purchasing power and the pressure on nominal wages. They can also fight inflation through targeted price controls and regulatory action to contain monopoly power and financial speculation. To alleviate long-term inflationary pressures, they could also take more decisive measures to boost investments in sustainable technologies and renewable energies.

From a Kaleckian perspective, one thing is clear: relying on central bank rate hikes to fight inflation will especially harm low wage workers most dependent on tight labour markets. If governments and legislators are serious about their desire to minimize the effects of the energy and inflation crisis on the most vulnerable members of their society, other solutions ought to be considered.

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