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To the point!

Cross-Asset- and Strategy-Research

A postcard from New York

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Moritz Kraemer -- Chief Economist

LBBWResearch@LBBW.de

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The overheating U.S. labor market is driving inflation

This week, for the first time since the outbreak of the pandemic, I am back in the United States for talks with clients and economist colleagues. Life on New York's streets is pulsating again almost as it always has, apart from the lack of tourists from Asia. Even the Wall Street Heart Charity Run is taking place again today in downtown Manhattan. Please keep your fingers crossed for the participating LBBW team!

But beneath the sunny, spring-like surface, the mood is tense. This is expressed not only in the sell-off of U.S. stocks in the recent past. The benchmark S&P 500 index has lost more than 10% in the last four weeks alone. Concerns are rife that the rampant labor shortage will force the Federal Reserve, the U.S. central bank, to intensify the interest rate hike campaign that began in late 2021. In the past, belated attempts to deal with runaway inflation have typically led to recession.

Price and wage increases everywhere you look

Inflation at the highest level for 40 years

Inflation in the USA has been above 5% for a year now. In April, it fell slightly for the first time, but at 8.3% remained far beyond what the central bank considers acceptable.

The wage-price spiral is turning faster and faster

But the population is also unwilling to accept the loss of purchasing power caused by inflation. Unit labor costs rose by more than 7% year-on-year in the first quarter. Another record! Unlike in the euro zone, the word "wage restraint" no longer appears in the US dictionary.

Why should it? In April, the unemployment rate remained at a pre-crisis level of 3.6%. The opening of the economy after the Corona restrictions is shifting demand in the direction of services. However, these are often particularly labor-intensive, which fuels labor shortages and wage inflation. In the hotel and restaurant sector, wages recently rose by 11%.

Untargeted deficit spending pours oil on the inflationary fire

The U.S. government responded to the pandemic with a veritable fireworks display of spending. And it did not stop even after the labor market had long since returned to a robust recovery path. Since March 2020, Washington has stimulated the economy with almost 30% of GDP, three times as much as in Germany, for example. And much of the spending went into generous transfers rather than investment spending, for example to rehabilitate the often ailing infrastructure.

Washington stimulated the economy with almost 30% of GDP - far too much

The Fed is trying to get ahead of the curve again

The Fed no longer has a choice. It must now fight inflation with all its might. We expect another 200 basis points of rate hikes by the end of the year, to then 3%. That may not be enough. The risk of recession is increasing accordingly. Fed Chairman Powell has emphasized in the past that the central bank is aiming for an "inclusive recovery" that will also benefit the socially disadvantaged. While the intention is to be welcomed, it overlooks the fact that in a recession it is precisely the low-income households that suffer most.