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# Wage growth has likely peaked, but risks remain

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The Employment Cost Index (ECI) for wages and salaries decelerated for both goods and services industries in Q4 2022. This news is welcomed in the ongoing battle against inflation as it signals decreasing price pressures, but the fight is not over. Wage growth is still above 5 percent and greater than the annual rate in Q1 2022. The Fed should be cautious when taking their foot off the gas at risk of creating a rebound in demand.

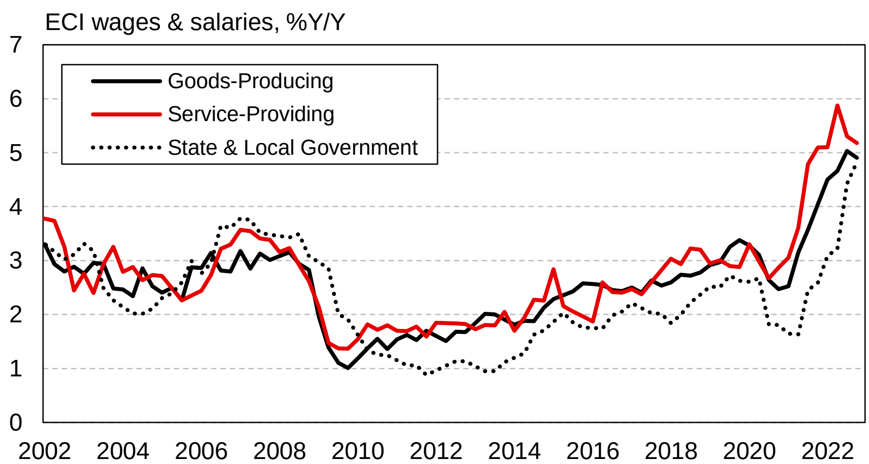
### The wage growth trend is starting to become unanimous

For several months, Average Hourly Earnings (AHE) has been showing declining wage growth but the Employment Cost Index (ECI) has been showing the opposite. Finally, as of Q4 2022, the ECI wages and salaries index decelerated for two consecutive quarters after 9 quarters of accelerating growth. Comparatively, median wage growth (weighted, 3-month moving average) from the Atlanta Fed's Wage Growth Tracker has also decelerated for 6 straight months. Overall, it appears as though peak wage growth has been reached.

Private industry workers experienced 5.1 percent annual growth in Q4, down from 5.7 percent in Q2 and 5.3 percent in Q3. Quarterly growth came in at 1 percent, the slowest growth rate since Q2 2021. Wages decelerated for both goods and services industries, with annual growth rates of 4.9 percent and 5.2 percent respectively. Wages for state and local government continue to climb, but they represent a smaller share of the workforce, and they typically lag private sector growth rates.

This latest data release is certainly good news for the Fed, but it shouldn't be interpreted as a sign that the job is done. Wage growth is still well above what it needs to be for inflation to fall to 2 percent. All else equal, nominal annual wages growth will likely need to be less than 4 percent for the Fed to reach their target.

WAGE GROWTH IS FINALLY TRENDING DOWNWARD

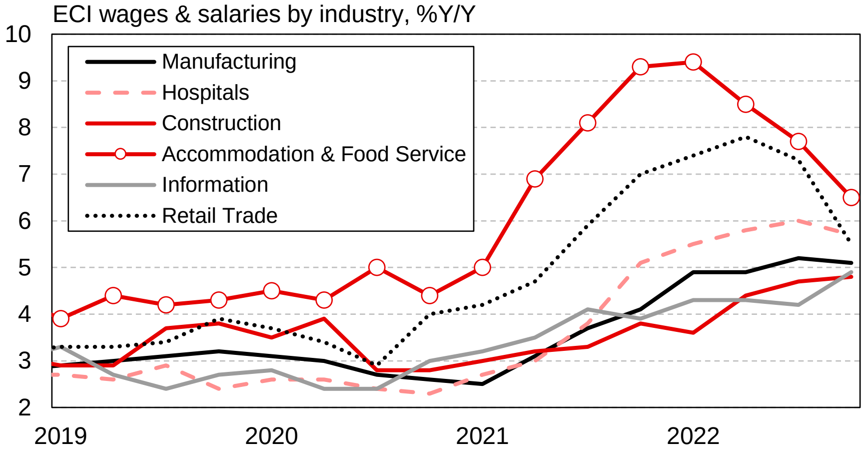



Source: BLS, MUFG Bank Economic Research

**Not all industries are experiencing the same trend**

Industries that have experienced some of the strongest wage gains in 2021 have seen growth decline in 2022. Accommodation and food services industries have experienced peak wage growth in Q1 2022 and retail trade industries in Q2. In many ways, wage growth is "normalizing" for these industries after an unsustainable 2021. Additionally, employment growth has been strong in these industries throughout 2022, which has helped ease labor supply issues. However, consumption is beginning to slow, and it is poised to slow further in 2023. This will give workers less bargaining power as demand for these services shrinks.

WAGE GROWTH IS SLOWING FOR SOME BUT GROWING FOR OTHERS




Source: BLS, MUFG Bank Economic Research

Economic growth in manufacturing and construction industries is also slowing, and will continue to shrink in 2023, but wage growth has been steadily accelerating. Labor shortages are still severe in these industries despite robust jobs growth in 2022, and employers have been forced to raise wages to entice workers.

**Is a wage-price spiral still possible?**

Wage growth does not need to exceed inflation for a wage-price spiral to occur. The conventional definition is that workers demand wage increases to keep up with inflation, thus driving more inflation and creating a feedback loop. The bargaining power of workers is a key driver, but this phenomenon ultimately depends on the private sector's ability to pass rising costs onto consumers.

Fundamentally, prices rise when companies are *able* to charge more for their goods and services without negatively impacting profits. When input and labor costs rise, employers will increase prices to maintain or grow profit margins. However, raising prices may negatively impact profits if economic demand is shrinking.

For example, wages are steadily rising in manufacturing, but durable goods industries are facing especially strong economic headwinds. The ability to continue passing rising costs onto consumers is shrinking as already high prices and consumer pessimism start to hamper consumption. Profit margins are likely to be negatively impacted as a result. And if companies can't raise prices to improve margins, then cost cutting in the form of layoffs is the alternative. For this reason, we may begin to see employment fall and the unemployment rate rise in the next 5 months.

The Fed should be conscious of this potential reality. Taking their foot off the gas by too much can risk a demand rebound, making a wage-price spiral a reality. Labor shortages will continue upward wage pressures in these industries, and if demand is strong enough, prices will rise to compensate.

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