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Labor costs pose the biggest threat to prices and profit margins

06 September 2022

Despite a contraction in overall real GDP, consumption in services industries has kept the economy afloat in 2022, fuelling growth in labor demand and wages. Ongoing labor shortages will continue to drive up wages, maintaining upward price pressures as consumption falls. Combined with low productivity growth, per unit labor costs have reached a 40-year high. Corporate profit margins will likely be impacted as a result, with labor's share of business income now hovering around 60 percent. For wage growth to slow and for inflation to reach the Fed's two percent target, the demand for labor must fall.

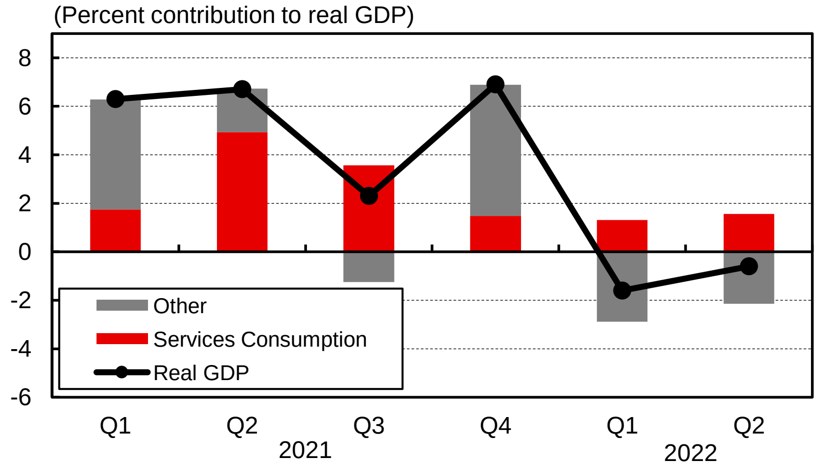
Services drove employment and fuelled wages in 2022

Overall GDP contracted in the first two quarters of 2022, but employment expanded at a steady rate. Meanwhile, inflation remained at a high level and wages accelerated. Indeed, much of this apparent disconnect between output and employment in recent months can be explained by the services sector and the tight labor market.

Services consumption has accounted for over 40 percent of overall GDP since 1992. And in 2022, consumption on services remained positive while the rest of the economy contracted. Personal consumption on services contributed positive 1.31 percentage points to real GDP in the first quarter (Q1), whereas all other components contributed negative 2.88 percentage points. Services contributed positive 1.78 percentage points in the second quarter (Q2) and all other components negative 2.71 percentage points.

Service-providing industries are typically more labor intensive relative to goods-providing industries, especially in-person services. And with elevated consumption, the labor market continued to grow to meet demand. Labor demand will likely remain high in industries that have yet to recover jobs lost since the pandemic.

SERVICES CONSUMPTION HAS REMAINED POSITIVE IN 2022



Source: BEA, MUFG Bank Economic Research

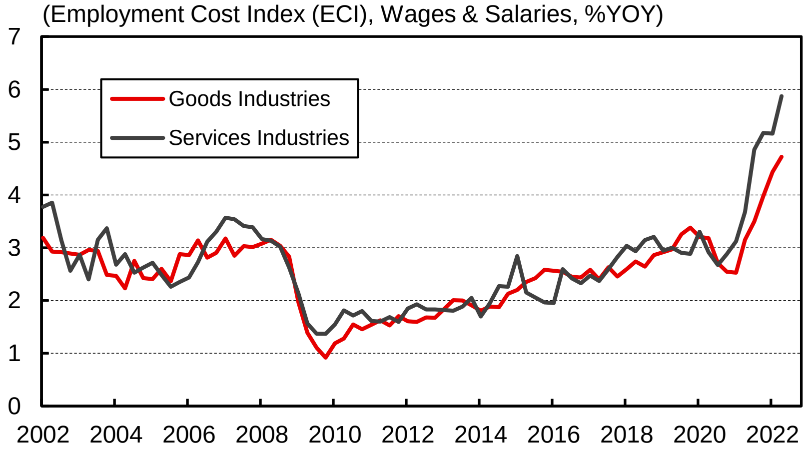
The labor market has remained historically tight in 2022. Firms have been unable to increase productivity and as a result, wages have accelerated as firms struggled to attract and retain workers to meet demand. Even as overall economic activity slows, stagnant labor force participation and a 3.7 percent unemployment rate ensures that the US will continue to experience labor shortages and subsequent wage growth.

Labor costs are accelerating

Average hourly earnings of production and nonsupervisory employees signals a slowdown in wage growth. Post-pandemic year-over-year growth peaked in March 2022 at 6.7 percent and has since fallen to 6.1 percent. Average hourly earnings, however, do not account for changes in employment distribution between high and low wage industries or occupations, or transitory effects. The composition of workers continues to change since the pandemic recovery began, impacting aggregate earnings and hours worked.

The Employment Cost Index (ECI) provides a more reliable metric, representing labor costs for the same job over time. Unlike average hourly earnings, the ECI for wages and salaries of private industry workers accelerated, growing 5.7 percent (year-over-year) in Q2 of 2022, compared to 5.2 percent in Q1. Wages and salaries grew 5.9 percent year-over-year in Q2 in services industries, where labor shortages are most pronounced, and 4.7 percent in goods-industries.

WAGES ACCELERATED IN 2022, ESPECIALLY IN SERVICES INDUSTRIES



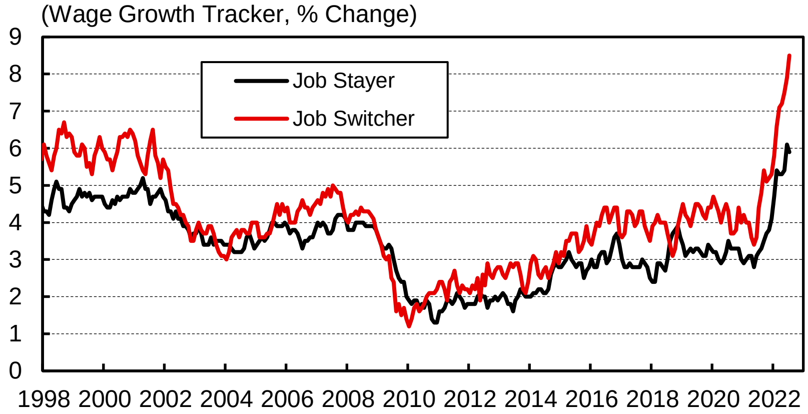
Source: BLS, MUFG Bank Economic Research

Total benefits have also accelerated. The ECI for total benefits increased 5.3 percent year-over-year in Q2, up from 4.1 percent in Q1. Overall employee compensation costs (wages, salaries, and benefits) are up 5.5 percent year-over-year in Q2, compared to 4.7 percent in Q1.

Much of private industry in the US is currently reflective of a dynamic labor market, where wages, salaries and benefits adjust quickly to market conditions. But not all workers are experiencing immediate effects. Union workers are more likely to experience lagged effects, since wages are more ridged and salary negotiations occur periodically. While only around 6 percent of private workers have union membership, down from nearly 17 percent in 1983, aggregate wages will still likely be impacted once union salaries fully adjust to market conditions.

Job switchers, on the other hand, are experiencing more immediate effects of the historically tight labor market. The Federal Reserve Bank of Atlanta Wage Growth Tracker shows that wages for job switchers continues to accelerate, growing 8.5 percent in July 2022, up from 7.9 percent in June. Though not as rapidly, wages for job stayers are growing as well, up 5.9 percent in July.

JOB SWITCHERS EXPERIENCED THE GREATEST WAGE GAINS



Note: Three-month moving average of median wage growth, hourly data
Source: Federal Reserve Bank of Atlanta, BLS, MUFG Bank Economic Research

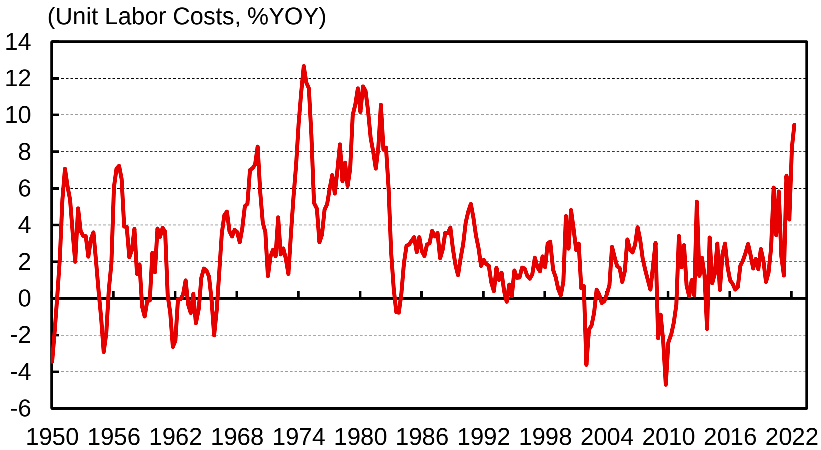
Despite some reports of slowing wage growth, wages have accelerated in 2022. Labor demand must fall or labor productivity must improve for wage growth to slow. But job openings remain historically high, layoffs remain historically low, and productivity has not improved.

Price pressures from rising input costs will slow as supply constraints ease and demand will fall in credit markets as interest rates rise. Labor shortages, however, will remain and labor costs will pose a threat to prices and profit margins.

Labor costs will squeeze corporate profits

The rate at which businesses are paying workers to produce a unit of output has reached a 4-decade high. Unit labor costs grew 9.5 percent, year-over-year, in Q2 of 2022, up from 8.2 percent in Q1. These surging costs will likely impact markups as overall demand in the economy continues to fall and corporate profits stagnate.

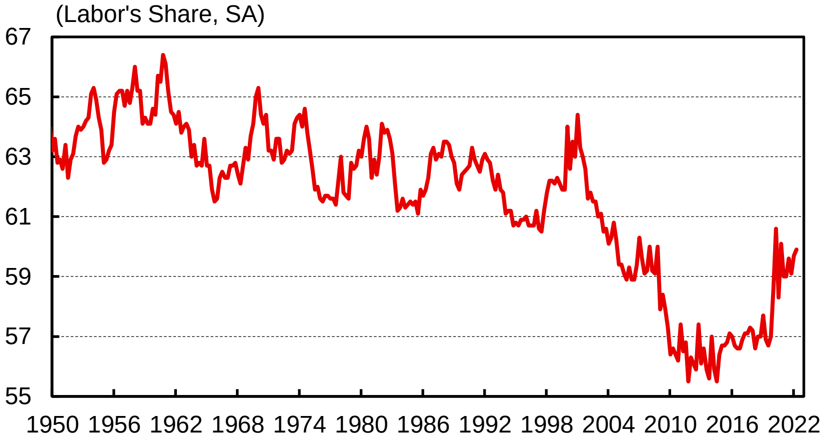
UNIT LABOR COSTS HAVE HIT A 4-DECADE HIGH



Source: BLS, MUFG Bank Economic Research

Labor costs are likely to impact profit margins since they represent the largest share of business expenses. From 1950 to 1970, labor's share of business income averaged 64 percent. By the 1990s, that share fell to an average of 62 percent and then down to as low as 56 percent between 2010 and 2020. Only since the pandemic began has this trend reversed, with the labor's share now hovering around 60 percent.

LABOR'S SHARE OF INCOME HAS BEEN GROWING SINCE THE PANDEMIC



Source: BLS, MUFG Bank Economic Research

Corporate profits and markups reached historic levels in 2021 – made possible by high consumer demand, despite rising input and labor costs. Wages have not risen at the same rate as prices, leading some to blame corporate greed at the expense of workers as the cause of inflation in the post-pandemic era. However, the labor's share of business income has been growing since the pandemic, reversing a decades long declining trend.

Elevated demand for goods and services has allowed firms to raise prices beyond the rising costs of labor and inputs. In 2022, demand has slowed and is expected to continue falling. The second half of the year and early 2023 will test if firms can continue to raise prices to maintain markups as surging labor costs squeeze corporate profits.

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