



THE EFFECTS OF INFLATION ON LABOR COSTS

by Thomas Galvin
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These days, we can only watch helplessly as the economy sputters along in fits and starts. It confounds consultants, perplexes employers, worries employees and fascinates economists. The unemployment rate is going up, but so has productivity.

The second quarter's gross domestic product grew at an impressive rate of 3.3% but nobody feels safe. At a time of such uncertainty, employers must weather a storm of uncharted territory and be in command of all available data; all hands on deck! Inflation is one economic benchmark that has not been a cause of much concern in the last 15 years. However, it is preparing to rear its ugly head again and can have a major impact on labor costs. This article

"Inflation is taxation without representation"

-Milton Friedman,

Nobel Prize winning economist

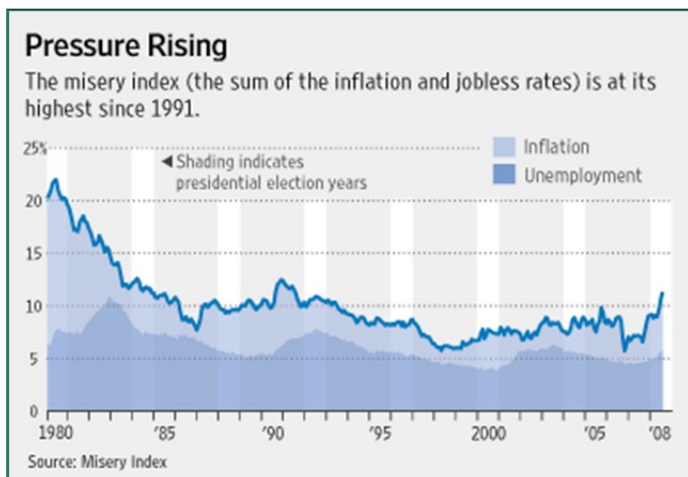
HIGHER COSTS PUNISH BUSINESS

In August, the New York Times pointed out that prices for goods purchased by American companies surged in the summer. The unexpected jump has taken a toll. In the last year, prices

have leaped by a staggering 10 percent. Such an increase has not been seen since 1981. The Labor Department has noted how the higher prices have seeped into all aspects of the economy.

At this rate, businesses will have to make hard decisions in order to counter the inflationary threat. The best way to stave off inflation is to usher in a recession and none of us want that either. If inflation gets its way, wages would have to increase so that consumers can maintain purchasing power. If a recession brings down prices and demand, it would mean that massive layoffs are soon to follow. Many economists are calling upon the Federal Reserve to raise interest rates in order to stave off inflation and prevent it from becoming an out of control phenomenon.

The most dangerous, insidious threat posed by inflation is the wage-price spiral. That nightmare scenario occurs when desperate workers react to higher prices by demanding higher wages. The spiral becomes an economic morass otherwise known as stagflation in which inflation and stagnation combine to choke off the economy's air supply. Stagflation crippled the economy in the 1970s and the effect of its horrors still resonates with many of us today.



MISERY LOVES COMPANY: Inflation plus unemployment equals bad news

will detail the latest information available to us regarding inflation. It will help us explore what inflation can mean for hiring, layoffs, productivity, and wage expectations.

Employers are shedding jobs and are able to keep wages steady despite inflationary pressures. However, the result is that people are earning less than they did a year ago because of cost of living increases. At some point, workers will demand higher wages and many employers will be forced to pass their costs on to consumers. We must be cognizant of the fact that employees have a breaking point and increased productivity rates in conjunction with stable wages are not sustainable for an indefinite period.

TO RAISE OR NOT TO RAISE

Federal Reserve Bank of Dallas President Richard Fisher has sounded the clarion call about inflation. As a 'lone ranger' Fisher has dissented each time the Fed has lowered rates this year. Fisher fears that inflation may be a persistent presence despite an economy that he thinks may not grow at all in the second-half of 2008. Fisher told Dow Jones newswires he believes that if inflation continues to present problems then the Fed will come around to his 'hawkish' outlook and raise rates. But he is not sure that an economic slowdown, or even zero growth, can stop inflation's impact.

Fisher's colleague, Janet Yellen, is more optimistic when it comes to facing inflation's threat. Yellen is buoyed by the drop of prices in commodities, especially oil. As president of the San Francisco Federal Reserve Bank she believes that rates can stay unchanged as inflation worries ease. Monitoring the back-and-forth between Fed governors can give us a clue to how serious they treat the looming inflation threat.

THERE IS SOME GOOD NEWS

In the meantime, productivity is as high as ever. Employers are able to get the most out of their employees while keeping down labor costs. This month, the Labor Department announced that worker output went up by 4.3 percent in the second quarter. It is a remarkable result considering that companies have been shedding

jobs for seven straight months. Thus, employers have been able to counter inflationary pressures by doing more with less.

Improvements in efficiency are the best way to constrain inflation. Businesses can gain a competitive edge by finding a silver lining in the weak economy; the American worker. Employees have responded well to calls for increased output. Bloomberg reports that as workers produce more there are no signs, yet, of inflationary pressures from wages. In fact, the Labor Department reported that labor costs dropped by 0.5 percent in the second quarter and that jobless claims are above expectations.

THE FUTURE

The word inflation was rarely on anyone's lips in the 1990s. Productivity grew at an accelerated rate that decade due to the proliferation of computer and internet use. The Federal Reserve led by Alan Greenspan astutely noted that inflation would not be much of a worry because technological advances would keep it in check, despite rapid growth. In addition, the nation was nearly at full employment. Therefore, the Fed rarely changed rates at the end of the '90s. Inflation scares had nearly receded from our memory as a faded relic of the dreary 1970s.

Today, we face new as well as familiar challenges. Inflation is making a comeback and employers must take notice. Consumers account for two-thirds of the economy and are affected by price increases when they are at the supermarket, gas pump or restaurant. The effects of a slow economy may stem inflationary pressures but a contraction in the economy is not on anyone's wish list.

In order to discern if inflation is a serious threat we must be on the lookout for a couple of telltale signs from the Fed and economic indicators. If core inflation (excludes food and energy) continues to rise and if the Fed raises rates, inflation just might be on everyone's lips again.

ABOUT THE AUTHOR:

Thomas Galvin is an Analyst for the Labor Analytics Group (LAG) and studies labor markets across the nation. His responsibilities include acquiring essential information and working with the group in providing clients with site selection advisory services. Thomas interacts with employers, economic development councils and staffing agencies in support of the group's market evaluation efforts.

Prior to joining CBRE, Thomas was an associate with the redeveloper RockWater Partners. Thomas worked directly with the president, analyzed potential transactions and played a key role in business development. Prior to RockWater, Thomas was development manager for Foursite Development. His responsibilities involved the construction management of a state-of-the-art storage facility, C3 Modern Storage.

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