Whatever Happens to Inflation, Workers Lose

For the first time in the life of anyone under the age of 40, inflation has become an issue. After averaging just under 2% per year for the last several years, inflation hit 8.6% in May, 2022. What causes prices to increase and how much of a problem is it?

The easiest way to understand inflation is to imagine the huge pool of money being spent in our economy. Prices are determined by the size of that pool of money being spent relative to the size of the pool of all goods and services (what I call “stuff”) for sale. If the amount of money being spent grows faster than the pool of stuff, there is inflation. If it grows slower, there is deflation (or, negative inflation). If it grows at the same rate, prices are stable. Inflation, as economists like to say, is essentially too much money chasing too few goods.

The recent increase in inflation is generally attributed to more spending due to the hundreds of billions of dollars of pandemic assistance and less stuff due to production difficulties caused by the coronavirus pandemic (often called “supply chain disruptions”) and oil supply issues caused by war in Ukraine. As people finish spending their pandemic assistance and the production issues get sorted out, the upward pressure on prices is expected to abate.

To determine how much of a problem inflation poses, we need to keep in mind that inflation is an *average* increase in prices and includes the cost of *all* of the millions of goods and services in our economy, *including* the cost of labor. Since labor costs are the most significant production cost, rising inflation should *on average* raise wages and salaries. As with any average, however, some will be above and some will be below, sometimes far above and far below. If there is a wide variation, an average can be very misleading. Think about the fact that the “average” adult human being has one breast and one testicle.

The main problem with modest inflation and even the kind of inflation we are now experiencing is that the wages of many workers in the middle and low end of the pay scale aren’t increasing as fast as those of workers at the high end (remember CEOs and Wall Street executives are “workers” and what they earn are “wages”). Business concentration, outsourcing, automation, declining union membership and the economies of scale e-commerce provides are causing all but the highest earners to get insignificant wage gains — they are turning our economy into more of a “winner-take-all” system. In other words, inflation *by itself* is not the problem — again, it is just an average. Whether inflation is high, low, zero or negative, some workers will have their wages go up more than the average and some will not. The problem is not the average change in wages, but who gets more than the average and by how much and who gets less than the average and by how much.

So, what is happening to wages? Whatever inflation may be, employers are generally unable to lower the number of dollars they pay employees. Anyone who has ever gone into an annual review at their job or waited for the outcome of a union negotiation can confirm that lowering wages rates would be extremely unusual. The worst virtually all employees expect is no increase in the number of dollars they earn. This is why economists say wages are “sticky-down” — they mean wages can move up, but can move down only with great difficulty. Inflation, however, changes this dynamic and makes wage reductions not only possible, but common. How?

Inflation reduces the value of money so that if there is 10% inflation from one year to the next, an employee earning $60,000 in both years can afford 10% less stuff in the second year. Whatever that person spent $60,000 on in the first year, now costs $66,000 and that person is going to have to have to cross 10% of the things they bought last year off this year’s shopping list. It is just as if the employer cut that person’s wages by 10% — something most employers could not get away with without inflation. Economists call this the “money illusion” and it means that people are sensitive to the number of dollars they earn, but are less sensitive to the amount of stuff those dollars will buy, which is what really matters.

Aside from facilitating real wage reductions, often for the employees who can least afford a tighter budget, inflation injects some uncertainty into the economy. For example, people who lend money at a fixed rate get paid back in less valuable dollars. Most of these costs, however, are not bourn by those who can least afford them since less wealthy people are more likely to be borrowers rather than lenders — therefore, they would actually benefit from paying back a loan in less valuable dollars. In any event, lenders can easily protect themselves from this problem by making loans with interest rates that vary with inflation, like adjustable rate mortgage loans.

Historically, the main danger from inflation is that it gets out of hand. This disaster scenario is called “hyperinflation,” which means accelerating and out-of-control price increases which ultimately render money worthless. How does this happen? Rather than raising taxes (which is unpopular, to say the least) or borrowing (which can be difficult or expensive), a nation’s government simply creates or prints money to cover the cost of new or growing government programs, especially programs they think will help keep them in power. Creating new money in this way creates inflation, which raises the cost of the programs. So, the government creates even more money to cover the increasingly expensive programs. But then inflation increases even more, so the government has to create an even larger amount of money, resulting in a death spiral for the nation’s money.

For now, we can say that notwithstanding the cries of some politicians trying to justify cuts in government spending, there is no indication that hyperinflation, and the out-of-control increase in the money supply that would produce it, are anywhere on the horizon. The Federal Reserve, not the politicians in Congress, remains firmly in control of our money supply. In fact, the Fed is currently doing the exact opposite of what causes hyperinflation — they are raising interest rates, thereby reducing borrowing, the amount of money being spent and, eventually, inflation.

The cost to workers of the Fed’s actions to lower inflation (namely, less spending and a slower economy) may become more painfully obvious than the cost to workers of higher inflation (namely, wages that have reduced buying power). A slower economy means fewer jobs, more unemployment and less leverage for workers. Investors may be hurt by lower stock prices due to lower corporate profits, but profits have a way of creeping back up and, in the meantime, investors can earn higher interest on their money thanks to the Fed’s jacking up interest rates.

An argument can be made that the cure for inflation (a slowing economy) is worse than the disease (higher prices). The latter could be addressed if workers (or those who represent them) saw through the money illusion and insisted on increasing wages by the amount of inflation through cost-of-living wage increases. This would maintain their real buying power — prices would go up, but their incomes would go up by at least the same percentage. Nevertheless, the Fed has prioritized price stability.

So, how can workers win? For a start, they can support a more progressive tax system, easier rules for unionizing, and more government support for education and training which makes workers and the entire economy more productive. In the meantime, they will pay more than their fair share for the recent increase in inflation as well as for the Fed’s actions to bring it down — something they should have no illusion about.

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