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Editors: Roger Bootle and Jonathan Loynes

Will 'sticky' wages save the euro-zone from deflation?

- **The perceived rigidity of euro-zone labour markets will certainly not prevent a brief period of negative inflation in the region. What's more, with wage growth probably set to drop towards zero in the coming quarters, there is a risk of a more sustained and damaging period of deflation.**
- Admittedly, there is no real evidence *so far* that a 'deflationary wage-price spiral' is building in the euro-zone. Hourly labour costs are still rising at strong annual rates of close to 4%. **Accordingly, the growth of *unit* labour costs, which is a key determinant of underlying price pressures, has accelerated very rapidly as labour productivity has dropped.**
- What's more, the structural features of euro-zone labour markets seem consistent with relatively 'sticky' wage growth. Trade union membership and coverage is higher than elsewhere and minimum wages are comparatively generous. **While such rigidity has been deemed damaging in the past, it *might* mean that the region is less at risk of a period of deflation than other economies.**
- However, while euro-zone wage growth has typically not responded as strongly to conditions in the labour market as in the US, the pick-up in unemployment earlier this decade certainly had an effect. Given the usual lag, it is not surprising that wage growth has yet to respond to the latest rise in unemployment. **But recent trade union deals point to a sharp slowdown to come and we suspect that wage growth will slow to around zero over the course of the next year or so.**
- The implications for inflation will depend on developments in productivity growth. Our forecast for it to recover only modestly, perhaps to annual rates just under 1% by the end of next year, implies that unit labour costs could register small outright falls. If all else was equal, this would point to extremely low core inflation and even a risk that it might turn negative.
- **The upshot is that inflation looks set to massively undershoot the ECB's medium-term target of 2% and its own forecasts in the next couple of years and sustained deflation is a clear and present danger. Accordingly, we think that there is every reason for the Bank to pursue more aggressive unconventional policies to boost demand and activity in the economy.**

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Will 'sticky' wages save the euro-zone from deflation?

The outlook for wages is currently crucial to the prospects for the world's major economies and the euro-zone is no exception. A sharp slowdown in wage growth could turn the recent drop in inflation, which should have a beneficial effect on the economy, into a far more damaging sustained period of deflation.

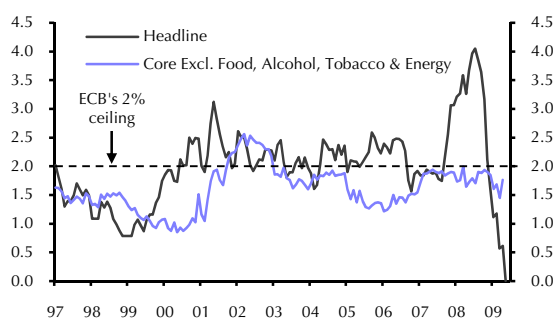
Conventional wisdom has it that labour markets in the euro-zone are relatively rigid, implying that any slowdown in wage growth there will be more modest than elsewhere. In this *Focus*, we consider whether this view is correct before outlining a forecast for wage growth and discussing the implications for prices more generally.

Outlook for wages is now particularly important

In assessing the outlook for the euro-zone economy, we have drawn some comfort from the recent sharp drop in inflation. The annual rate of HICP inflation has plummeted from a peak of 4.0% last summer to stand at zero in May. What's more, it looks set to drop into negative territory as soon as this month, where it should remain for a good few months. This, we have argued, should have a marked positive impact on the growth rate of real household incomes, helping to offset at least part of the recent sharp rise in unemployment.

But while a *short* spell of falling prices should be beneficial, the risk is that the recession prompts a far more damaging and *prolonged* period of deflation. **Policymakers have so far drawn comfort from the fact that the drop in inflation has been driven by transient factors.** Most notably, of course, base effects in the energy component have knocked 2.5 percentage points off the headline inflation rate since last July as earlier sharp rises in the oil price have dropped out of the annual comparison. Meanwhile, a fall in food prices has exerted further downward pressure. Chart 1 shows that *core* HICP inflation, which excludes both components, has been fairly stable.

CHART 1: HICP & CORE HICP (% Y/Y)



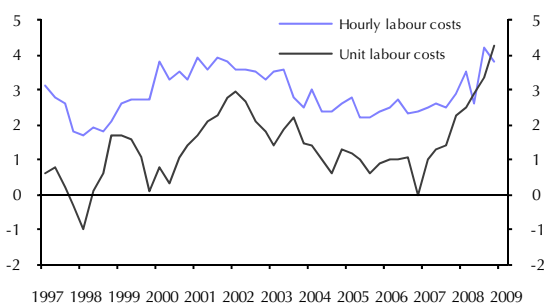
Source –Thomson Datastream

However, there are signs that a broader drop in core inflation is on the horizon. Perhaps most notably, euro-zone unemployment is rising very rapidly and survey measures of hiring intentions point to further job cuts to come. **This suggests that wage growth might fall sharply in the coming months, perhaps leading core inflation to plummet too.** This could prompt a vicious circle in which workers put off spending, causing further falls in prices and wages and leading to a further downturn in spending and so on.

No evidence of a wage-price spiral

So far, though, there are no signs in the hard data that such a 'wage-price spiral' is building. Chart 2 shows that the annual growth rate of euro-zone hourly labour costs stood at 3.8% in Q4 last year, only just below Q3's series-high of 4.2%.

CHART 2: LABOUR COSTS & UNIT LABOUR COSTS (% Y/Y)

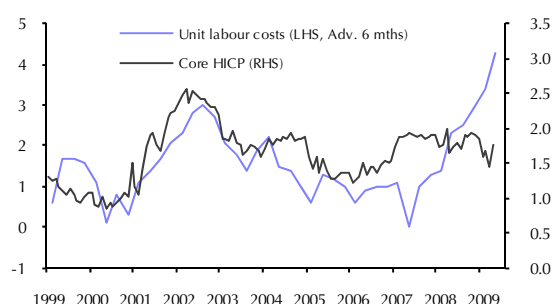


Source –Thomson Datastream

Of course, developments in labour costs per unit of output (or *unit* labour costs) are most important for underlying price pressures. Firms are much more likely to pass any pick-up in labour costs on to their prices if it is not matched by an increase in output and profits.

Chart 2 showed that, as is usual in the initial stages of an economic downturn, unit labour costs have risen very sharply as productivity has dropped. What's more, unit labour costs growth almost certainly accelerated again in Q1 as productivity slumped. While the relationship between unit labour costs and core inflation has never been perfect, the recent pick-up looks consistent with a very sharp rise in inflation. (See Chart 3.) **If anything, then, recent developments in labour costs appear inflationary rather than deflationary.**

CHART 3: UNIT LABOUR COSTS & CORE CPI (% Y/Y)



Source – Thomson Datastream

Of course, if wage growth does not respond strongly to the downturn, this will have its own disadvantages. For a start, if policymakers see a risk of upward pressure on inflation from rising wage growth, they will be far more reluctant to respond to the recession with bold measures to stimulate the economy.

Second, if wage growth remains relatively high, either unemployment or profits (or probably both) will have to bear a heavier brunt. This could have more severe long-term consequences for the economy than a slowdown in wage growth. For example, a sharp and sustained rise in unemployment might cause workers' skills to

degenerate with negative implications for future productivity growth. Meanwhile, weaker profits growth could hit investment and hence the economy's medium-term growth potential.

Labour market rigidity points to 'sticky' wages...

On the face of it at least, the structural features of euro-zone labour markets support the idea that they are relatively rigid, suggesting that wage growth might be unresponsive to weakening economic activity.

For a start, while trade union membership has fallen throughout the developed world over recent years, it remains higher in many euro-zone countries than in the US, UK or Japan. (See Table 1.) The relative prevalence of collective bargaining and threat of strikes might reduce the flexibility of wage growth, particularly to the downside.

TABLE 1: TRADE UNION MEMBERSHIP & COVERAGE

	Trade Union Membership, 2006	Trade Union Coverage, 2006
Belgium	M	H
Finland	M	H
Austria	L	H
Netherlands	L	H
Portugal	L	H
Italy	L	H
Ireland	L	-
France	VL	H
Spain	VL	H
Germany	VL	M
Greece	VL	L
UK	L	L
US	VL	VL
Japan	VL	VL

Source – ECB Working Paper, 'Institutional Features of Wage Bargaining in 25 European Countries, the US and Japan'.

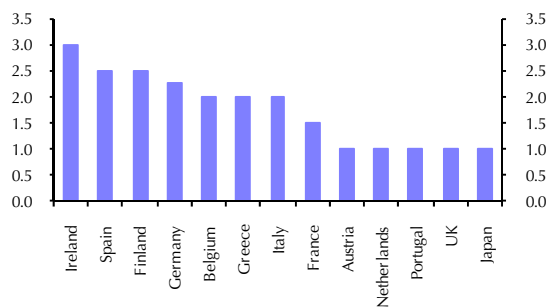
<25% = Very Low (VL), 26%-50% = Low (L)

51%-75% = Moderate (M), 76%-100% = High (H)

What's more, while trade union membership is very low in some of the largest euro-zone economies, wage deals negotiated by unions throughout the region have much higher coverage

than elsewhere. Often, deals struck by trade unions within a sector apply to the entire sector and not just those employees that are members of the union in question. **This implies that trade unions in the euro-zone have more influence on aggregate wage growth than the membership figures alone might suggest.** Note also that collective agreements tend to apply for a relatively long period in the euro-zone, averaging up to 3 years in Ireland. (See Chart 4.)

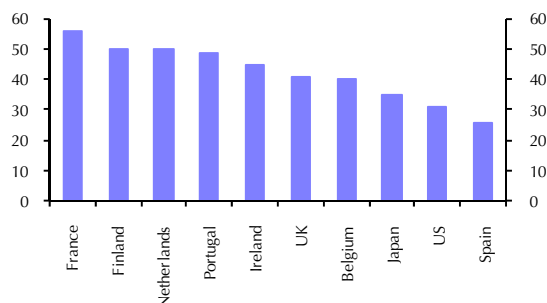
CHART 4: AVERAGE COLLECTIVE AGREEMENT LENGTH (YEARS)



Source – ECB

What's more, where they exist, minimum wages are typically more generous in the euro-zone than in the US, UK or Japan. (See Chart 5.) Even in Germany, where there is no national minimum wage, there are sector-specific minima, which can be as high as 70% of the national average wage.

CHART 5: MINIMUM WAGE AS % OF AVERAGE WAGE



Source – ECB

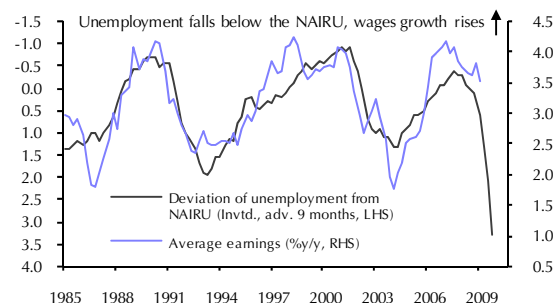
All else being equal, this might suggest that sharp falls in wage growth, or at least pay cuts, are less likely in the euro-zone than in the US or UK. If

wages are sticky at the bottom end of the range due to legal requirements, then firms might struggle to implement wage cuts at any level of the workforce given the need to maintain variations in pay according to levels of experience and training.

...but pay has not been completely inflexible But there are reasons to think that euro-zone labour markets are not completely inflexible. **Importantly, unemployment has already risen far more sharply than might have been expected.** We had argued that this might happen in an earlier *European Economics Focus* (How hard will the downturn hit the labour market?, 16th Oct. 2008) in which we pointed out that employment growth has been surprisingly responsive to changes in economic activity in the past compared to that in the UK and the US.

Admittedly, there is some evidence that wage growth is not as responsive as elsewhere. Chart 6 shows that wage growth in the US has responded very strongly to changes in unemployment relative to the long-run sustainable rate, known as the non-accelerating inflation rate of unemployment or NAIRU. The response has tended to come after a relatively short lag of around nine months. This fits nicely with earlier evidence suggesting that the labour market there is particularly flexible.

CHART 6: US UNEMPLOYMENT & WAGE GROWTH



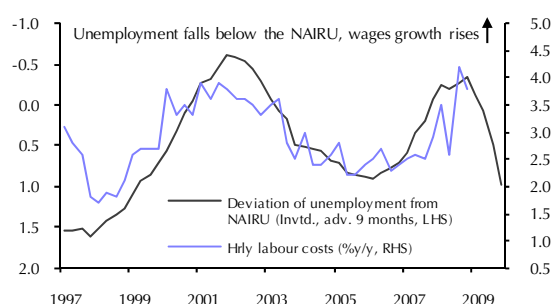
Source – Thomson Datastream

Although data limitations make it difficult to draw a direct comparison with the euro-zone, long-run data on earnings in the manufacturing sector suggest that the relationship between wages and

unemployment there has been considerably weaker than in the US. **Nonetheless, there is a relationship, which also occurs after a lag of around nine months.** Interestingly, the response of wage growth to changes in unemployment seems to have been stronger than in the UK, where conventional thinking (and the evidence on structural features presented earlier) suggests that the labour market is relatively flexible.

What's more, over the past decade or so – the period for which data on economy-wide wage growth are available – Chart 7 shows that there has been a reasonable relationship between wage growth and unemployment in the euro-zone.

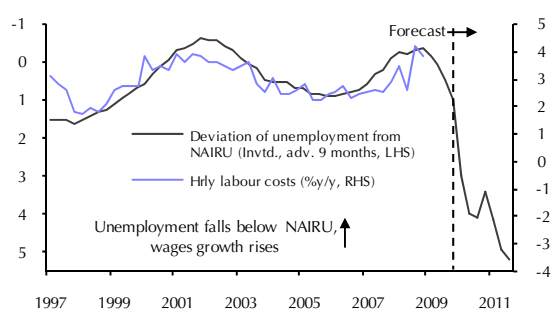
CHART 7: EURO-ZONE UNEMPLOYMENT & WAGE GROWTH



Source – Thomson Datastream

Our forecasts for the unemployment rate to rise from the current level of 8.5% to above 12% in the next year or so are consistent with a very sharp drop in wage growth. **In fact, Chart 8 suggests that we might expect wages to be falling at annual rates of over 3% by 2011!**

CHART 8: UNEMPLOYMENT/FORECAST & WAGE GROWTH



Source – Thomson Datastream, Capital Economics

We would not write off the effect of structural rigidities in the labour market altogether and doubt that wages will fall anywhere near this sharply. After all, the relationship in Chart 7 does not really even incorporate one full economic cycle and therefore cannot be relied upon. Any earlier relationship might easily break down under the current extreme economic circumstances. What's more, even to the extent that the relationship is reliable, it is based on the assumption that the NAIURU is flat in future. It is possible that the recession and associated factors cause the NAIURU to rise, implying that a given increase in unemployment might mean less downward pressure on wages.

Union deals already point to weaker pay gains. Nonetheless, it seems clear, at the very least, that wage growth will slow. The latest information on trade union negotiations in Germany supports this view. Table 2 shows that deals struck for this year and next have typically been for annual wage gains of only around 2%. This is far less generous than the pay rises of closer to 4% achieved in 2008 and also beneath the aggregate annual growth rate of German hourly labour costs of 4.4% recorded in Q4 last year.

TABLE 2: KEY GERMAN UNIONS' RECENT PAY DEALS

Union	Industry	% total workforce	Pay rise	From	To
IG Metall	Metal	2.0	2.1%	Feb. 09	Apr. 09
			2.1%	May 09	Apr. 10
Ver.di	Public services	1.4	3.0%	Mar. 09	Feb. 10
			1.2%	Mar. 10	Dec. 10
Ver.di	Banking	0.6	2.5%	Nov. 08	Apr. 10
Transnet	Rail	0.3	2.5%	Feb. 09	Jan. 10
			2.0%	Jan. 10	Jul. 10

Source – Hans Böckler Foundation

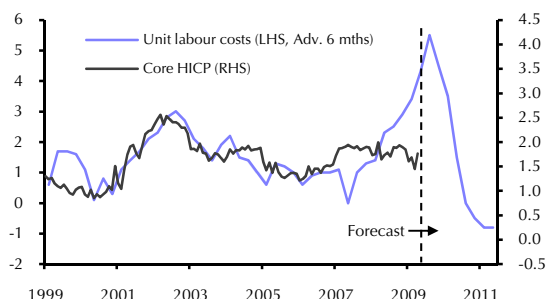
The upshot is that we expect wage growth to slow sharply in the coming months and wages to more or less stagnate in 2010. While we do not envisage outright falls in wages, such an outcome can certainly not be ruled out.

Serious risk of deflation

The likely impact of this forecast on core inflation is difficult to judge, particularly as the relationship with wage growth has been far from perfect in the past. The acceleration in labour costs that we have already seen might yet cause core inflation to *increase*, particularly given that a slump in productivity has caused *unit* labour costs to soar.

But even if that does occur, which we doubt given the current dire economic circumstances, the upward impact will be short-lived. Heading into next year and 2011, wage developments look set to put very heavy *downward* pressure on core inflation. We expect productivity growth to recover to only very modest rates between now and the end of 2010, implying that unit labour costs slip into modestly negative territory by around the middle of next year. (See Chart 9.)

CHART 9: UNIT LABOUR COSTS & CORE INFLATION (% Y/Y)



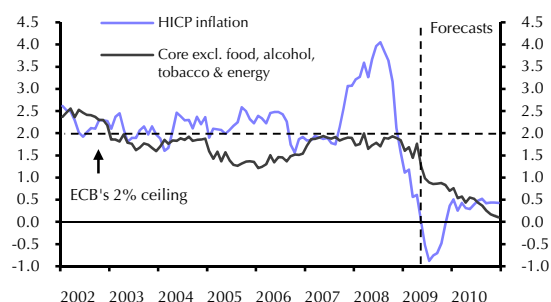
Source – Thomson Datastream, Capital Economics

The loose relationship in the Chart suggests that this would be consistent with core inflation of close to zero, implying extremely modest, albeit just about positive, rates of headline inflation.

Of course, the likely path of inflation will depend on many other factors including firms' non-labour costs, consumers' inflation expectations, interest rates and the exchange rate. We will return to an assessment of these factors, including a more detailed analysis of the amount of spare capacity in the economy, in forthcoming work.

However, unit labour costs are a key driver of inflation and the analysis here certainly suggests that they will exert strong downward pressure in the coming quarters. Accordingly, we see core inflation dropping close to zero next year, implying an average annual headline rate of just 0.3% or so. (See Chart 10.) This is lower than our previous forecast of 0.7% and easily below even the bottom end of the ECB's latest forecast range of 0.6%-1.4%. What's more, given the usual lag between unemployment and wages, there must be a risk of deflation heading into 2011.

CHART 10: HEADLINE & CORE INFLATION (% Y/Y)



Source – Thomson Datastream, Capital Economics

Conclusions

Despite the perceived rigidity of euro-zone labour markets, we expect wage growth to slow very sharply in the coming quarters, probably towards zero. **On balance, we do not expect this to prompt a prolonged period of deflation in the region, but there is a strong risk of such an outcome.** And even assuming that inflation only slows in line with our forecast, very modest wage gains are likely to keep consumer spending growth subdued for some time.

The upshot is that inflation will massively undershoot the ECB's medium-term target of 2% and its own forecasts in the next couple of years and sustained deflation is a clear and present danger. **Accordingly, we think that there is every reason for the Bank to pursue more aggressive unconventional policies to boost demand and activity in the economy.**