



## **On the danger of euro area wages to price stability and the danger of a monetary overkill**

### **A study from the ETUC**

Since end 2005, the ECB has set in motion a cycle of interest rate increases and the ECB is widely expected to raise interest rates again on the 5<sup>th</sup> October as well as by the end of this year. To justify this tightening up of monetary policy, the ECB claims that the risks to price stability are skewed towards the upside. Price stability is seen to be threatened over the short, medium as well as over the long term. Wages appear to be key in the threat to price stability as perceived by the ECB. The ECB fears that hikes in indirect taxes, against the background of a gradual improvement in labour markets, would result in stronger than expected wage increases. In this way, second round effects turn what would otherwise have been a temporary hike in inflation into a permanent one.

Does this analysis from the ECB correspond with reality and is inflation indeed around the corner?

#### **I. No sign of a general acceleration of wages at this moment**

Let's start by taking a look at present wage behaviour, including collective bargaining agreements running well into 2007.

While the rate of increase in total wage costs (including employers' social security contributions) has been 2,4% over 2004 and 2005, wages and salaries themselves have been running at an even more modest pace of 2,2-2,3%. In the first two quarters of 2006, wages and salaries continue to do so. With a 2,5% increase in the first and a 2,4% increase in the second quarter, one can not talk about a clear acceleration of the pace of wage increases at the beginning of 2006.

For the remainder of 2006 many collective bargaining agreements have already been concluded and these agreements also co-determine the pace of negotiated wage increases in 2007.

Focussing first on Germany, which has played a major role over the past years in pushing down the average wage statistic for the euro area, it appears that the 2006 average negotiated wage increase remains limited to 1,5% (WSI 2006), actually down from last years' figure of 1,6%!

Even more importantly, the most recent agreements in Germany extend well into 2007 so that looking at these agreements tells us something about what kind of wage statistic we can reasonably expect in the coming period. As shown in the table below, the picture is one of continued low wage increases.

It should be underlined that some collective agreements might appear considerable at first sight. But when account is taken of the fact that these deals cover substantially more than 12 months and when we calculate the annual rate of wage increases, then these pay agreements become modest again. Consider the example of the German steel sector, where a wage increase over 17 months turns into a 2,6% wage increase on an annual basis. The metal sector with a 2,8% annual rate of increase is another example. All other sectors conclude agreements below the metal and steel agreement with retail, paper and hotels concluding a (annualised) wage increase below inflation and the 2% price stability threshold. German public sector does not increase wages structurally but only pays a one-off premium.

**Table I: recent collective agreements in Germany covering 2006 and 2007**

	Concluded percentage	Number of months	Ending in...	Annual rate of wage increases
Metal	3%	13	March 2007	2,8%
Steel	3,7%	17	January 2008	2,6%
Banks	4,5%	25	June 2008	2,2%
Deutsche Telekom	3%	16	July 2007	2,25%
Deutsche Post	5,5%	24	April 2008	2,75%
Wood,plastics	2,5%	12	April 2007	2,5%
Retail	1%	13	July 2007	0,9%
Paper	3,5%	24	March 2008	1,5%
Hotels	2,9%	24	March 2008	1,5%
Textiles	4,5%	22		2,5%
Energy	2,7%	13	March 2007	2,5%
Construction	1%			Negative since 40 hour week re-introduced
Public services	One off payments, in January 2008 2,9% structural increase		July 2008	

Source: WSI

What is happening in other countries of the euro area? Pretty much of the same thing. With the exception of a few (mostly small) countries, the rule is continuing modesty in wage bargaining (see table below).

**Table II: 2006 bargaining in the rest of the euro area**

	2005	2006
Netherlands coordination rule	1,25	2
Netherlands-metal	1,1	1,1
Spanish guideline		Below 3%
Outcome in Spain first quarter 2006		3
Belgian national guideline	2,25	2,25
Finish national agreement	2,5	2,1
Austrian metal and banking	2,5 (metal)	3
Italian metal		2,4%
France		3% rise in minimum wage
Ireland		10% over 27 months (4,5% annual basis)

## II. Price-wage spirals in Germany? Not likely

Will bargaining and wage formation react to the expected upturn in inflation beginning 2007?

Germany, again, is key. If average inflation in the euro area is expected to accelerate at the beginning of 2007, the reason is the rise in indirect taxes in Germany from the 1st of January on. German inflation however can be expected to return to normality over time unless wage bargaining would react by trying to recover the loss in wages' purchasing power. So what can German wage formation be expected to do?

A first to note from table I is that quite a number of collective agreements already have avoided this problem by covering a period ending way beyond end 2006/January 2007. This means that the worst effects of the hike in indirect taxes on headline inflation will already have been diluted when these agreements are again coming up for negotiation. The danger of wage negotiations basing themselves on a high inflation rate of the past and not on a lower inflation rate to be expected in the future is thereby minimal.

What about the other sectors, up for re-negotiation in the first quarter of 2007? For these agreements, another factor will come into play. The hike in indirect taxes does not only have a price effect. With production being carried over from 2007 into 2006, it will also depress demand and economic activity, thereby putting pressure on workers to moderate wage claims. In the past we have seen that wage formation,

particularly in Germany, is rather sensitive to this. Workers' concern about higher inflation will be overshadowed by concerns about jobs, making a 'higher than expected acceleration of wages' (as the ECB puts it) rather unlikely. In fact, the reason why the German metal agreement has a relatively short duration of 13 months, around an annual 2.5/2.7% increase, German metal employers seem to prefer this one year deal, implicitly counting on the fact that a renewed downturn in Germany at the start of 2007 would strengthen their bargaining position negotiating in March-April 2007.

### **III. Price-wage spirals and indexation systems in the rest of the euro area**

Whereas indirect tax hikes are expected to have a much lower impact on inflation in the rest of the euro area, the ECB still fears that high oil prices and high inflation over 2006 would enter into wage formation, in particular through systems of automatic indexation or through hikes of minimum wages being based on the 2006 higher inflation rates.

These fears are once again exaggerated. In the majority of euro area member states, systems of automatic wage indexation have disappeared and the inflation component of wage demands and agreements is based on explicit bargaining. This allows to take into account the general economic situation and needs of the economy at particular times.

In those member states, where wage indexation systems continue to play some kind of a role, the modalities of these systems are such that the danger of (temporary) inflation spilling over into wages is very limited:

- Italy, since replacing its 'scala mobile' systems in the 1993 incomes agreement, has a system whereby the inflation component in upcoming sectoral agreements is set by a guideline, defined by national social partners. The point of departure here is the 2% price stability target of the central bank. Although the national wage guideline can be augmented to take into account past inflation being higher than was initially expected, this remains a rather limited practice. For example, after some years of total wage increases being below inflation in Italy, the new 2006 agreement tabled on a rise in wages of 2.3%, marginally above the price stability target.
- In Spain, many collective agreements contain a 'revision' clause by which additional wages are paid out to take account of the fact that inflation was higher than initially foreseen. (Traditionally, national intersectoral guidelines in Spain are also based on the 2% price stability target). However, indexation is not complete and does not cover one quarter of the workforce, while there are many in the remaining three quarters of the workforce where the compensation for unforeseen inflation is limited and not complete. Underlying this situation is the fact that the 'revision' clause in Spain is a kind of counterpart for allowing opening clauses in sectoral agreements. The logic is that if firms in difficulties are allowed to deviate from the sectoral bargaining agreement, then firms in good shape should at least uphold the real purchasing power of their employees.

- In Belgium and Luxemburg, automatic wage indexation systems still exist but also there, fundamental changes have been made in the way they operate. In Belgium for example, indexation is done on the basis of a ‘health’ index excluding the prices of tobacco, alcohol and car fuels. Luxembourg recently introduced a similar system. Moreover, in both countries, national wage guidelines as highlighted by the Belgian law on competitiveness and wage formation force social partners to take into account wage increases that are deviating from the wage increases in Germany, France and the Netherlands. This, along with punctual action by government to bring inflation back down by reducing specific taxes, makes it rather improbable for inflation and wages to derail.
- Finally, the ECB also questions systems of minimum wages which adapt the minimum wage level to inflation. If these systems of statutory minimum wages have a big influence, they might in this way sustain an inflationary spiral. But even in France, where a high proportion of workers (between 17 to 35%) is paid at minimum wage levels, studies estimate that a 1% increase in the minimum wage only translates into an increase in the average wage by 0.1% only. Again, practical reality contradicts the fears from the ECB. Moreover, in the absence of widespread collective bargaining in France, the system of minimum wage (and public sector wage) makes it possible to coordinate aspects of the wage formation system with the general needs and objectives of the macro-economy. For example, over the past years, wages in France have been one of the few exceptions inside the euro area by establishing a certain, although limited increase in purchasing power of wages. The growth of the minimum wage (which was temporarily boosted as a consequence of the 35-hour week) has, to a certain extent, been contributing to the rise in purchasing power. As a result, France has scored better results than other euro area members in terms of domestic demand and growth. It is not so hard to imagine that this kind of ‘stability oriented’ wage formation could also be used in future, especially since there is no longer a need to equalise the different categories of minimum wages that were created by the introduction of the 35-hour week.

#### **V. Inflationary wage developments from improved labour market conditions? A long, long way off**

Aside oil prices and indirect taxes disturbing the real and underlying inflation picture in a temporary way, the fundamental issue is whether an economic upturn triggering falling unemployment would rapidly trigger wage increases that are unsustainable from an inflationary point of view.

There are two things to be noted here. The first one is that wage increases are starting out from a very low level. Wage increases are now substantially below the pace at which they would become an inflationary threat. The second one is that experience over the last decade learns that wage formation has become much less sensitive to cyclical upturns and falling unemployment, thereby prolonging the spell of time over which unemployment can fall before wages bump against the upper threshold of inflationary wage developments.

*Wage expansion compatible with 2% inflation. Calculating the upper limits*

The ECB seems to take the view that any acceleration of wages as a bad sign for inflation. However, such an approach is not really correct. A lot depends on the starting position. If the rate of wage increases is substantially below the rate compatible with low inflation, then the pace of wage increases can indeed accelerate without triggering higher inflation. What happens then is simply that inflation, which would have fallen much further otherwise, remains stable or only falls a little bit.

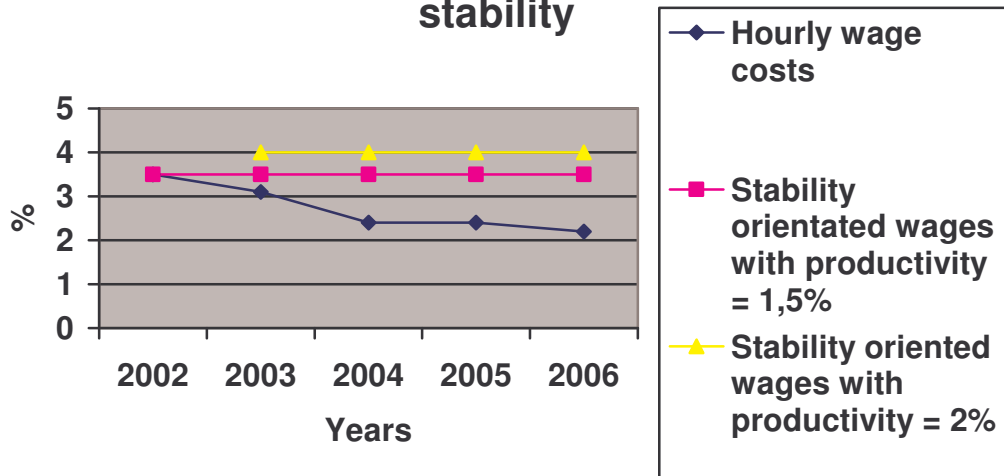
How to define that rate of wage increases compatible with low and stable inflation. One basic rule of thumb is to say that wages should evolve in line with the sum of the central bank's inflation target plus the rate of productivity increases.

This, in the case of the euro area, results in the following :

- With the price stability target at 2% and trend hourly productivity growth around 1,5%, the reference figure for price stability compatible wage increases is 3,5% for the euro area.
- However, if the economy turns the corner, productivity growth may get an extra boost (in much of the same way as productivity got depressed by the continuing slump in growth over the past 6 years). This would raise our estimate of non-inflationary wage growth from 3,5 to 4,5%.
- Moreover, profits have soared during the big European slump in growth so that a certain buffer exists that can shield price stability from wage pushes as high as 4,5 -5%.

The graph below presents the bandwidth of wage increases compatible with a 2% price stability target and shows that there is ample room for an acceleration of wages before wage behaviour turns from contributing to disinflation towards working in an inflationary way.

## Wage formation compatible with 2% price stability



*Does the Philips cuve still exist in the euro area?*

Traditional economic theory supposes that there is trade off in the short run between unemployment and the pace of wage increases. The inescapable logic from the Philips curb is that wages rise if unemployment falls.

However, experience with wage formation in the euro area puts this traditional economic theory to the test. The graph below, taken from the recent IMF study on the euro area, shows that real wage behaviour in the euro area has been basically flat since 1995. Although unemployment moved up and down with the cycle while showing a trend fall over the different cycles, real wage growth hardly reacted. One explanation for this is that, technically, the euro area finds itself in what is called the 'flat' part of the Philips curb: Wage growth is that low that it cannot get much lower, unless workers take a cut in nominal wages. With workers known to resist such a cut in nominal wages, wage formation becomes somewhat resilient to changes in unemployment. This however works in both ways. Rising unemployment does not trigger that much of a slowdown in wage growth. But neither does falling unemployment then initiate much of an accelerated pace of wage increases. Basically, wage growth in the euro area is finding itself on a low and stable path of growth,. Disregarding the business cycle, disregarding the trend fall in unemployment, real wage increases remain modest or are even non-existent.

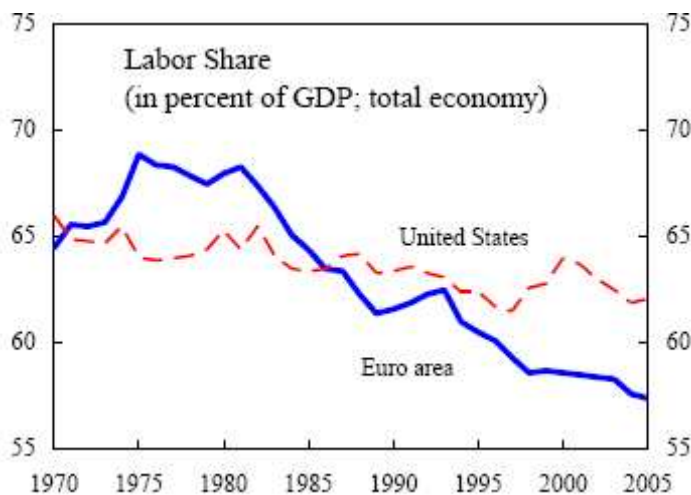
**Does the Philips curve still exist in the euro area?**



Source: IMF

Another way of looking at this is to note that the share of wages in GDP in the euro area has been falling over the years. Any cyclical upturn in wage behaviour is then overshadowed by this structural falling trend in the wage share (see graph below).

**Trend overshadowing any remaining cyclical wage behaviour**



Source:IMF

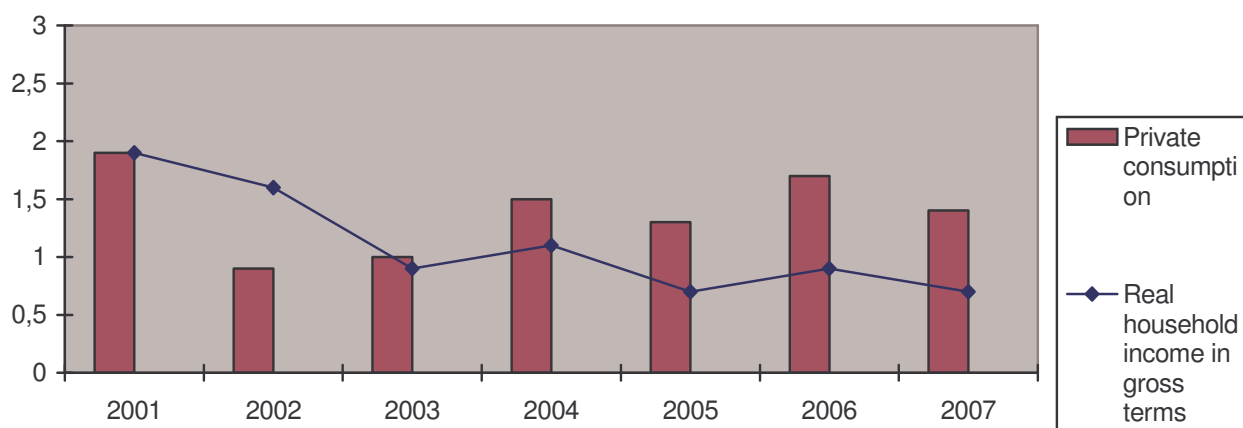
Finally, it is worth mentioning the IMF – estimate on the reactivity of wage formation to growth of GDP in the euro area. The IMF estimates that an additional demand driven growth in GDP of 1% would result in an extra wage increase of 0,2%. This means that the euro area is indeed ‘light years away’ from inflationary developments. If wages accelerate at such a low pace in response to higher GDP growth, then several years of very high growth are necessary before wages have run up from 2,5% at present to the 3,5-4% band of wage increases compatible with low and stable inflation.

#### **IV. Conclusion: Implications for monetary policy**

The ECB is fearing higher than expected wage increases. This study shows that these fears are highly exaggerated and that inflation is not at all around the corner.

There is however another risk that should be kept in mind. It concerns the risk to growth continuing at a reasonable high pace. To understand this it needs to be kept in mind that consumption demand in the euro area has been driven over the past years by additional financial margins for households coming from lower interest payments on their mortgages. As the graph below shows, consumption demand over the past years has not been supported by the real wage income households receive. Instead, lower long term interest rates have been used by households to refinance their mortgage lending and pay less to the banks.

## Household real wage income is not supporting private consumption:



However, this pillar of financial support for household consumption is weakening. Long term interest rates are not falling anymore but have risen. And if the ECB continues to hike short term interest rates, long term rates will be pushed further and higher.

This would not be a problem if real wage growth, together with the creation of good jobs, would take over and would provide households with the financial room that is no longer forthcoming from low and falling capital interest rates. However, as we have seen, wage growth can not be expected to rise in a spectacular way. The danger is therefore that the ECB, by taking into account unrealistic wage developments, is creating a mismatch by driving interest rates so high so that real wage increases cannot compensate the negative impact on households' budget constraints. If so, this implies that the economy is heading for another downturn in the coming period. In fact, forerunning indicators (OECD, IFO, NBB) unfortunately already point in such a direction. The conclusion from this is clear: The ECB should stop its series of interest rate hikes as soon as possible.

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