ETUC COLLECTIVE BARGAINING INFORMATION BULLETIN 2008/3

WHY EURO AREA WAGE DEVELOPMENTS DO NOT WARRANT AN INCREASE IN INTEREST RATES

I. Introduction

It is becoming somewhat of a tradition for the ECB to view wage developments as problematic for inflation. Already back in 2005, when the ECB embarked on a two year cycle of interest rate hikes, the motivation for this was that, as the ECB worded it, 'wage outcomes could be higher than expected'[1].

At present, the ECB's approach to wages is becoming even more alarming. The ECB is now deeply concerned that the ongoing acceleration of wages would intensify further over the rest of the year. High headline inflation rates, together with tight labour markets are seen as working to push wage growth further up, thereby triggering 'excessive' wage developments causing inflationary second-round effects. To avoid this high inflation scenario from taking place, the ECB has announced its intention to raise interest rates at its next meeting beginning of July. Thus, the ECB is actually *tightening* monetary policy even further[2], and this in the face of both a major financial crisis as well as an economic slowdown in the pipeline.

However, there are several reasons that cast serious doubt over the fear that wage developments would turn into a threat for price stability. We review them one by one.

II. Many collective bargaining agreements have already fixed wage developments for the next two years

One fact that the ECB is forgetting about is that many of the collective bargaining agreements that have been concluded recently are multi-annual agreements, already fixing the evolution of collectively bargained wages well up until the end of 2009.

These agreements are characterised by certain logic (see table I). On the one hand, and after several years of excessive wage moderation, trade unions obtain a robust recovery of wage growth in the first year of the agreement. On the other hand, employers receive a de facto insurance that this is not the start of an upwards spiral

[1] However, without specifying what sort of wage outcome was exactly expected and to which extent 'higher than expected wage developments' could be characterised as 'excessive' wage increases. Meanwhile, wage growth over 2006 and well up until end 2007 remained subdued and moderate.

[2] The increase in the ECB's interest rates comes on top of the appreciation of the euro exchange rate and major turmoil in financial markets.

since wage growth decelerates back again in the second year of the collective bargaining agreements to 3%. In the case of the Italian metal, the wage increase at sector level even remains limited to 4.1% over two years… or exactly equal to the ECB's price stability target of the ECB. <u>Given this price stability target of 2% and given a trend productivity increase of 1.5%, it is hard to see how wages growing between 2 and 3% over 2009 are inflationary!</u>

Table I : Overview of recent collective bargaining agreements

	Germany Chemicals	Germany Restaurants	Germany Public Sector	Deutsche Post	Italy Metal	Italy Banks	Netherlands Metal	Finland
2007	3.6%	2.2%	0					
2008	4.4 % (+0.5% one off)	3%	5.1%		19/1: 127 euro or 4.1% over two years	11.5% over three years	3.5% + 400 euro single payment	Two to three years agreements
2009	3%	2.5%	2.8%	4% (Dec 08)	Agreement ends December 2009	3.8% per annum	3% (1 Feb 09) + 400 single payment	worth from 3.3 to 4.2% per annum
2010				3% (Dec 09)				

Source: Eucoban network, information from the ETUC collective bargaining committee, WSI.

III. Upcoming collective bargaining agreements will not be inflationary either

What about the other collective bargaining agreements coming up for renewal at the end of 2009? These also cover important amount of workers such as the German metal and steel agreements or the main Spanish sector agreements which are usually limited to one year agreements only (see table II below).

There are two reasons why the danger of inflationary wage agreements triggering second-round effects can be excluded:

- *The time pattern of inflation*. Inflation, driven by high oil (and foodstuff) prices, is now peaking in the first half of 2008. However, inflation is expected[3] to edge back down to more reasonable rates of increase towards the end of this year. This implies that the wage negotiations taking place by the end of 2008 and beginning 2009 will have substantial lower inflation rates than is the case right now as a reference.

- *Coordination of collective bargaining.* Wage bargaining in many European countries and in the countries of the euro area in particular is not operated in an isolated way with each company and/or sector only looking at its own position. Instead, bargaining is mostly done in a coordinated way. This allows to take the macro economic needs of the entire economy also into due account. In Germany, for example, coordination is achieved by way of 'pattern bargaining': One important sector agreement sets the example for other sectors and companies to follow suit. So, for the 2008 bargaining round, the example of the agreement IG-Metall concluded beginning 2007 and establishing a major wage increase for 2007 followed by a much more limited one in the second year has been followed through by many sectors. In turn, it can be expected that the chemicals and public sector agreements concluded beginning 2008 and defining a rate of wage increases of 3% for 2009 will function as one of the benchmarks to be taken into account when metal and steel wage negotiations start up at the end of 2008.

In countries such as Spain, coordination is done in an explicit way by way of a national cross sector collective agreement setting guidelines to guide the wage negotiations at the sector level. Traditionally, the national wage guidelines advise sectors to negotiate the 2% price stability target plus a productivity premium limited to 1% in the case of Spain.

However, whatever the exact form coordination of collective bargaining takes, the key point to note is that coordinated wage bargaining in many member states will take general economic objectives into due account when negotiating the 2009 wage outcomes. The most likely thing to happen is that a balance will be struck between on the one hand the need to defend workers' purchasing power and on the other hand the need to avoid inflationary second round effects. And to strike such a balance, the 2008 agreements setting a wage increase of

[3] ECB board members such as Christian Noyer from the Banque de France have highlighted this time pattern of inflation in press also.

around 3% for 2009 (see point II above) can be seen as providing an interesting reference for the agreements coming up for renewal.

	German Metal	German Steel	Spain	Belgium	Netherlands	Italy
2008 agreed wage increase	2 - 2.5%	5.2% (14 months)	3% National coordination benchmark	2.5%	3,5% (national benchmark for coordination)	2.5%
Form of coordination	Pattern bargaining	Pattern bargaining	National agreement as guideline for sector negotiations	National Law stipulating national social partners to issue wage guideline	Internal trade union coordination	
Determinants of coordination	Unemployment, profits, company investment decisions	Unemployment, profits,	2% price stability plus up to 1% productivity increase		Inflation, productivity, unemployment	2% price stability target on national sector level

Table II: Collective bargaining agreements to be renewed end 2008, beginning 2009 and coordination of collective bargaining

IV. The ECB's attack on automatic wage indexation: Beside the point

In its May Monthly Bulletin, the ECB reveals and documents its attack on remaining automatic wage indexation systems in Europe. These are seen as leading to wage price spirals in case of upwards shocks to inflation. The ECB calls for such schemes to be avoided, in other words to be deleted.

The Monthly Bulletin traces the existence of such indexation systems in seven euro area member states (Spain, Belgium, Luxemburg, Malta, Cyprus, Slovenia and in the minimum wage system of France). It then adds Italy, Greece and Finland, arguing that in these three countries there exist general guidelines on how to compensate for (past) inflation in wages.

There are several points the ECB is overlooking:

- The extent to which formal wage indexation systems exist in the euro area is very limited. The group of six countries where wage indexation systems are widespread only represents some 16% of the overall euro area economy[4]. It is hard to see how this relatively limited group of workers would trigger an overall wage price spiral throughout the euro area as a whole.
- Moreover, even in those countries with formal wage indexation systems, the system is only a partial one. This was done exactly to avoid generating inflationary spirals. Belgian wage indexation for example does not take into account the increase in prices of car fuel, tobacco, cigarettes and alcohol (the so called 'health index'). In Spain, wage indexation is also limited and only guarantees to maintain the purchasing power of the initial wage and does not include a guarantee to preserve the real wage increase that was agreed upon in the collective agreement. On average, if a Spanish worker is covered by an automatic indexation clause, he or she gets only receives 40% of the difference between the actual inflation rate and the inflation rate that had been used in the initial collective bargaining agreement.
- The entire structure and orientation of collective bargaining and not just formal wage indexation schemes decides whether inflation shocks trigger wage price spirals. If, as is the case in the euro area, there is a systematic trend for productivity growth to be translated into profits instead of wages, then there is a dampening effect on total wage growth. In case of inflationary shocks, this 'reserve' or 'cushion' functions to keep total nominal wage growth compatible with the ECB's price stability target.
- It is especially the case for countries with formal indexation mechanism to have these indexation systems embedded into a strong system of coordination of wage bargaining with a high focus on price stability oriented total wage outcomes. In Belgium, this was done by the 'law on competitiveness', through which social partners each year assess whether wage growth in Belgium stays in line with wage growth of the main competitors. In return for maintaining

[4] If the work force in France benefiting from the indexation of the minimum wage is added, then the total amounts to 20% of the euro area work force. On the other hand, if the 40% of Spanish workers not being covered by an indexation system is subtracted back again, then the total share of wage indexed workers in the euro are falls back to 16%.

indexation, Belgian trade unions were willing to cooperate in this scheme of overall wage coordination. In Spain, the 'inflation revision' clause is also to be seen as a part of a system where overall wage bargaining, through social dialogue, is streamlined in accordance with the macro economic needs of the economy. In Spain, indexation also needs to be seen as a counterpart for trade unions allowing opening clauses in sector agreements. Given this, attacking wage indexation schemes in these countries may actually work to weaken trade union support for coordination of collective bargaining and this at the exact moment when the economy is getting into major difficulties and coordination of wage bargaining could be expected to deliver a forceful and responsible reaction from wage formation.

- Given the previous, it should not come as a surprise that inflation differences between countries having a formal indexation system and countries without such a system are minimal in practice. Over the January 1999- May2008 period, average inflation has reached 2.4% in the group of countries having indexation systems and 2.54% in the group of countries without such a system. And this despite the fact that over this period, the economy was shocked by several oil price hikes, food scares and major increases in indirect taxes
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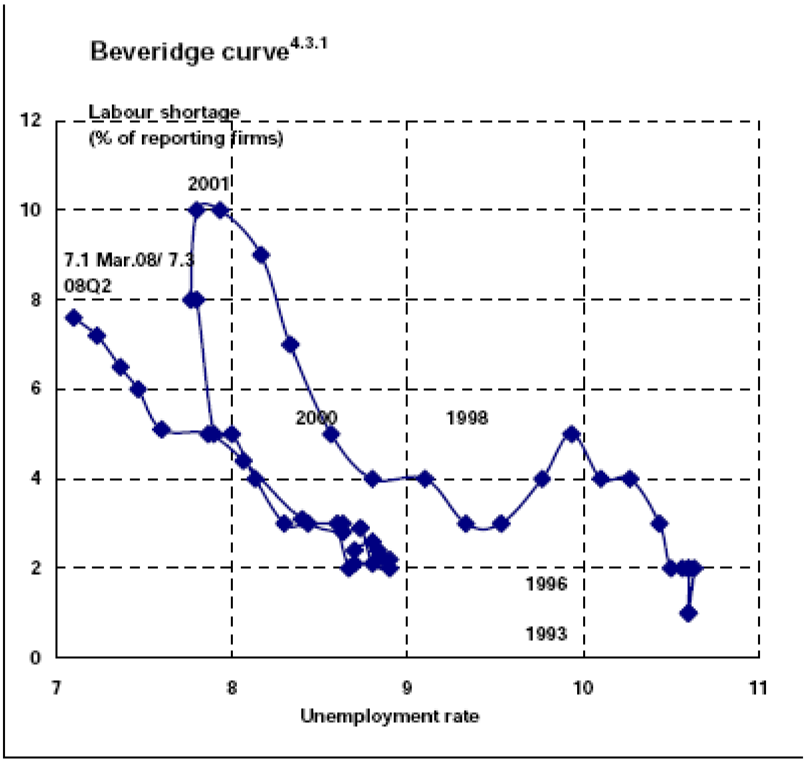
V. Labour market tightness: Not so stressing and already on the way back

Besides collective bargaining, wages are also determined by labour market tightness and lack of qualified labour causing a wage drift on top of collectively bargained wages.
What are the facts? The graph below, taken from the Commission's key indicators for the euro area, allows drawing some interesting and reassuring conclusions:

- The share of firms in the euro area reporting a lack of skilled labour is already falling. In the first quarter 2008, 7.6% of euro area firms were reporting so but their share has now fallen to 7.3% for the second quarter (not shown in the graph).
- The share of firms constrained by a lack of skilled labour in the latest recovery remains well below the peak of the previous business cycle (7.6% now against 10% then).
- A further slowdown of the economy will significantly reduce labour market tightness, as was the case with the 2001 slowdown



VI. "The ongoing acceleration of wages": Behind the statistics

What the ECB is describing as an 'ongoing acceleration of wages' should also be put into perspective. Up until the last quarter of 2007, collectively bargained wage increases have been subdued and have remained limited to a mere 2.1%. Meanwhile, total hourly wages and wage costs have indeed accelerated to 3.7 and 3.3% respectively in the first quarter of 2008. However, quarterly outcomes are highly volatile and, moreover, this acceleration is limited to two countries: Spain and Finland. Other countries, including Germany in the first quarter of 2008, are actually experiencing the opposite – a deceleration of wage growth over the past five quarters, with a particular outspoken deceleration in France.

Hourly wages	Q1 2007	Q2	Q3	Q4	Q1 2008
Euro area	2.4	2.8	2.8	3.2	3.7
BE	3.4	3.3	3.2	3.1	
DE	0.6	1.9	1.5	2.8	2.3
IE	5.2	5.9	4.8	4.4	
EL	9.3	5.7	4.2		
ES	4.1	3.4	4.1	3.7	5.9
FR	4	3.5	3.4	3.3	2.8
IT	1.1	c	C	C	c
AT	2.4	3.2	3.3	3.3	
FI	3	2.4	2	4.9	5.3

Source: Eurostat

This does not appear to constitute a strong basis for wage acceleration to continue: Spain, the only economy staging an acceleration of wages, is getting badly hit by the unwinding of the housing boom and unemployment is rising sharply. A sharp deceleration of Spanish wage growth in the coming period is therefore very likely to happen.

VIII. Conclusion: Hiking interest rates right now is unfounded and dangerous

This analysis has shown that the case to hike interest rates on the basis of the argument that wages are or will become inflationary is a non – case. There are several mechanisms in euro area collective bargaining practice assuring the ECB that inflationary second round effects will not be triggered: Collectively bargained wage increases are to a certain extent already set until end 2009, new bargaining deals to be struck will be made in the context of coordinated wage bargaining with a de facto attention for price stability, indexation systems remain limited and are embedded in wage formation systems focussing on preserving competitiveness or price stability and labour market bottlenecks are already easing.

All of this, together with the facts that the economy is now clearly weakening and that the ongoing financial crisis should not be made worse by intensifying the economic malaise, implies that the ECB should cut interest rates, not increase them and possibly cause a monetary 'overkill'.

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30 June 2008