Danske Bank

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ECB Research

The profit, wage and productivity triangulation

- The ECB's policy setting is faced with critical questions to assess the appropriate level of monetary policy restrictiveness, due to the risk of inflation stickiness. A key relationship in these questions is the triangulation between the wage growth, productivity growth and profits growth. In this piece, we review recent developments in each component. We conclude that there relies significant uncertainties as regards to the ECB staff's assumptions on the labour market in relation to productivity growth returning to the pre-pandemic trend as well as the assumption that companies are to fully absorb the rising wages without adding upward pressure to inflation. In a growing economy and due to the potential change in labour market dynamics post-covid, these uncertainties warrant monitoring. **All things equal, we conclude that risks to the triangulation implies the risk for inflation (and in turn rates) is skewed to the upside.**
- As recently as last week, Lagarde pointed to the data points mentioned above as key information ahead of the 12 September meeting. The most relevant releases to watch are 14 August (productivity), 22 August (negotiated wages), 6 September (compensation per employee) and 6 September (profits). On top of this, our high frequency profits indicator is set to give early indications through the July earnings season. Current levels (and estimates) points to profits bottoming out in spring 2024.

Wage growth - a story of catch-up

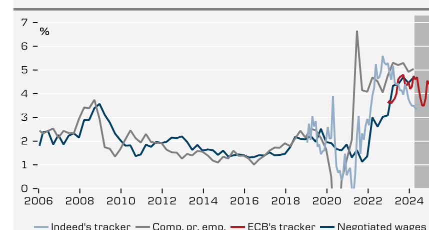
Euro area wages have been growing at a record pace in 2023 and into 2024. The compensation per employee (CpE), which have traditionally been ECB's favourite wage measure, rose in Q1 24 by 5.1% in y/y from 4.9% y/y in Q4 23, where notably a large part has been a compensation due to the catch up of the recent higher inflation episode. This is seen in the increased payments from through one-off schemes, in particular in Germany. We, as well as ECB, have preferred the CpE measure due to its totality of the payment to the employees. That said as the CpE is also impacted by the numbers of hours worked, and as those changed markedly during and after the pandemic, the focus on the negotiated wages has gained prominence. Negotiated wages rose by 4.7% in Q1 24. However, both the negotiated wages and the CpE is only released with a noticeable lag, thus a recent novelty to assess the wage growth has been the invention of a wage growth tracker using real time information from salary listings on the job portal Indeed. This yoy-gauge has now been on a broad decline since late 2022, and now rises at 3.4%, albeit we caution on this measure due to its relatively short history and thus difficult to assess the predictive power (or leads of which) of wage pressure in a post-covid world. ECB also collects a timely (yet not published) data series, including a forward looking aspect, with input from the national central banks. This points to wage growth to fluctuate around 4% mark until year end.

As a result of the higher wage growth and the declining headline inflation, the real wage growth has now turned positive this year, in next to all euro area countries. The euro area real wage growth is now close to historic high levels at 2.3%, as observed around the GFC.

Inflation = wages - productivity

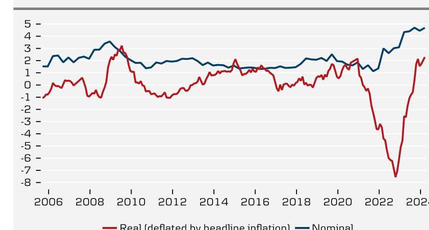
Source: Macrobond and Danske Bank

Euro area wages rising at record pace



Note: ECB's tracker are deduced from Lane's 27 May speech on inflation in the euro area
Source: Macrobond and Danske Bank

Nominal and real wage growth



Source: Macrobond and Danske Bank

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Looking ahead, ECB will mainly concentrate on monitoring how new collective agreements are being settled over the coming quarters. This week, the German IG Metall trade union announced that they will be asking for an 8% pay rise over 12m, and looking at ECB's staff projections for CpE, they assume growth of 4.8% this year, and 3.5% next year, in line with our expectations.

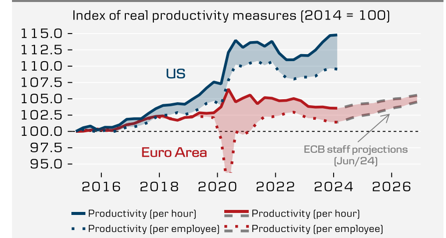
The 'inevitable' rise in productivity

The resurgence of labour productivity in the euro area will be another requirement to bolster the ECB's confidence in the disinflationary process. The euro area has been grappling with sluggish productivity growth since the onset of the pandemic, and this has most likely played a key role in pushing domestic inflation higher due to a stronger passthrough of rising input costs (labour, materials, energy) to consumer prices. In a widely referenced speech earlier this year, ECB board member *Isabel Schnabel* shed light on the productivity gap between US and Europe, where she among others address the differences in capital market structures and its ability to adapt new technologies as part of the productivity gap. We share those drivers for long-run divergence (See *Euro area productivity will keep falling behind*, April 3), albeit we do not find it as the key reason for the sluggish euro area productivity since the pandemic. Looking at the EA vs. US comparison, we see the varying trajectories in productivity when measured per hour and per employee. In the US, we have seen a gradual increase in productivity across both measures (per hour and per employee), albeit when looking at the euro area, this has primarily been stagnating or even marginally declined. The forward-looking aspect of the chart uses the ECB staffs' June projections which shows a productivity growth close to historic trends from here.

One widely accepted explanation for the drop in euro area productivity per employee is the labour hoarding phenomenon. As the pandemic aftermath has resulted in an extraordinarily tight labour market, employers have maintained (or increased) employment levels despite the downturn in activity triggered by the global manufacturing slowdown and the energy crisis. This trend can be observed in the EU Commissions 'Labour Hoarding Indicator' (LHI). The LHI measures the proportion of companies anticipating a decline in output yet still expecting stable or even increasing employment going forward. Labour hoarding is particularly noticeable in the industrial sector, which has faced severe challenges in recent years, as well as due to labour market regulation in Germany promoting labour hording "kurzarbeit". As the pressures stemming from rates and global uncertainty abate and production picks up, we should expect productivity to rise as the value creation per hour worked in the manufacturing sector is usually substantially above that of the broader economy.

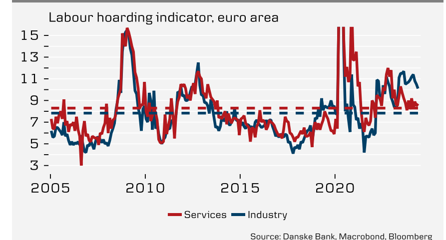
The hoarding argument seems to be a valid reason for the drop in output per employee, but why productivity per hour has experienced a close to similar slowdown remains puzzling. According to Eurostat, a full-time employee (FTE) in the euro area today works 38.9 hours/week, which compares to 40 hours/week pre-covid. The usual assumption would be that productivity per hour will rise as people work less (rising marginal product), but in recent years, that has not been the case. We highlight the rising use of low-skill part-time employment (PTE) as a key driver. As hours worked among FTEs have dropped, using PTEs to fill the gap have gained traction in countries such as Germany in recent years. PTEs accounts for a rising share of total hours worked and total employment in the euro area. Apart from sluggish economic growth, we believe this dynamic has played a role in breaking the usual negative correlation between hourly productivity and hours worked. We also take note of the job creation has primarily been in the service sector as well as the in the public sector, see also *Research Germany What drives the recent divergence between employment and GDP?*, 12 October 2023

ECB expects growth in hourly productivity to pick up



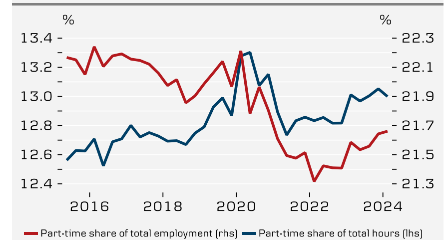
Source: Macrobond and Danske Bank

Hoarding especially pronounced in the industrial sector



Source: Macrobond and Danske Bank

Rising part-time employment has likely pushed output per hour lower



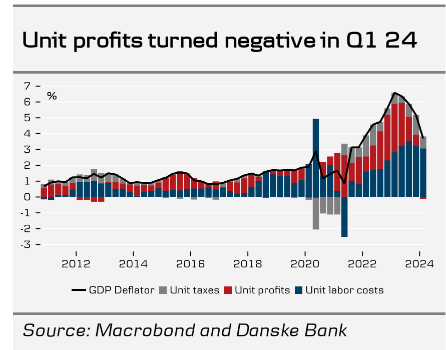
Source: Macrobond and Danske Bank

The pressing question now is whether the surge in real wages will motivate full-time employees to extend their working hours – and in turn boost productivity - as part-time employees are gradually crowded out (albeit we doubt this is set to happen). There is little doubt that productivity in the euro area will eventually have to rise in response to the escalating cost pressures brought on by the increase in real wages, as profit margins are pushed lower. **However, whether this productivity surge will occur due to activity growing faster than hours worked, or alternatively through a decrease in employment, is yet to be seen.**

Profit margins set to fade, but pricing power could surprise us

The GDP deflator offers another perspective into the price pressure of the euro area economy. Breaking down the GDP deflator into the taxes, profits and labour costs as the key contributors to the GDP deflator, we see that the unit profits have now turned negative. Unsurprisingly, the unit profit is usually a positive number as it should be seen as the price level in excess of the input costs which gives the consumers' price in the end. Occasionally this has been negative in recent history, where this has led to consolidation in the businesses. We saw it briefly during the pandemic as well as during EU debt crisis.

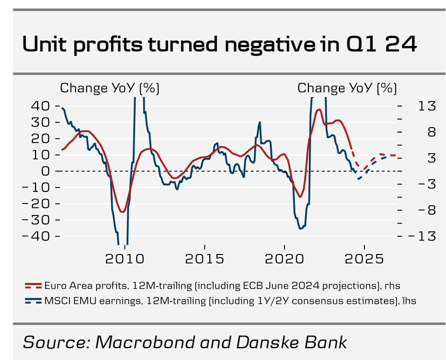
Unit profits turned negative in Q1 24



Source: Macrobond and Danske Bank

As compensation per employee is expected to grow 4.5-5% YoY for the remainder of 2024, ECB assumes unit profit growth will remain in stagnation in the coming quarters and gradually return to the historical 1.5-2.0% range in 2025-26. Looking at the historical relationship between profit growth and earnings reported by the companies included in the MSCI EMU Index, the fading ECB profile for corporate profits presented at the June staff projections seems well-aligned with the reported company earnings growth and the expected trajectory for earnings forecasted by equity analysts (bottom-up). Ahead of the September 6 release of Q2 24 Euro Area unit profits, the July earnings season – and namely company guidance on earnings and prices – could provide early indications on whether the depletion of profit margins is still on track. With the economy strengthening and consumers supported by record-low unemployment and strong growth in real wages, one could fear that the ECB will end up underestimating the pricing power among European corporates – and thereby their ability to shield profit margins. A decline in profit margins is likely a necessary condition for ECB to remove significant restriction of its policy, as the alternative to thinner profit margins will most likely be a new round of wage-induced inflation.

Unit profits turned negative in Q1 24



Source: Macrobond and Danske Bank

Conclusion

Faced with difficult questions to address the stickiness in inflation the triangulation between profits, productivity and wage growth remains a key component to ECB's decision making. As we argued above, the inevitable rise in productivity is welcoming news for the ECB to get inflation in line with the target amid moderating wage growth. However whether the rise in productivity will be due to a pickup in activity or vice versa will be a key determining factor in setting the scene for which new rate level we will settle at. As of now, we see the more frequent shocks facing the economy as providing potential upside risk to inflation, and in turn wages through the tight labour market. Hence, rates will stay at a relatively elevated level in coming quarters ahead – in a goal to restrict the demand in the economy and get the monetary policy restrictiveness to a more neutral stance in 2026. This is holds true, should profits start rising again.

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None

Date of first publication

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