

1 April 2022

Euro inflation notes

The wage conundrum

- The euro area labour market is less tight than in the US and UK, but labour demand has picked up noticeably with the recovery from the pandemic.
- In light of unions' improved bargaining position and real income security as the prime focus for this year's bargaining rounds, we expect negotiated wage growth to pick up to rates of 3-3.5% in late-2022/2023. That should allow ECB to continue on its path of gradual policy normalisation.

The chicken and the egg: wages and core inflation

While upside risks from commodity price movements dominate the near-term outlook for euro inflation, **wage developments will have important implications how durable inflation pressures will remain in 2023 and beyond**, when negative base effects from high food and energy prices will likely again start to weigh on headline inflation. This will also have important repercussions on the pace and degree of policy tightening enacted by the ECB. With wages being a crucial cost item, especially for services firms, there has historically existed a close link between wage growth and core inflation. Usually, rising wage growth has filtered through to core inflation with a six to twelve month lag in the euro area. However, rising wages are a *necessary*, but not *sufficient* condition for a sustained rise in core inflation. What ultimately matters for inflation is wage increases relative to productivity growth (i.e. unit labour costs) and unless wage growth accelerates more than two percentage points beyond productivity growth in a sustained manner, inflationary pressures will remain contained. This view is also shared by the *ECB*, with wage growth of around 3% (1% average productivity growth plus 2% inflation) seen as consistent with achieving price stability.

So far euro area wage growth has remained muted, with negotiated wages growing by a meagre 1.6% in Q4 21. Wage growth measured by compensation per employee was slightly higher at 3.5% at the end of 2021, but annual growth rates remain distorted by the impact of furlough schemes (in which some 1.7mio workers are still enrolled in Germany, Italy and France). The lack of imminent wage pressure is one reason why the ECB is pursuing a more gradual policy normalisation pace than e.g. the Fed, but inflation rates well above target throughout the rest of the year raise the risk of higher inflation expectations fuelling wage adjustments down the line.

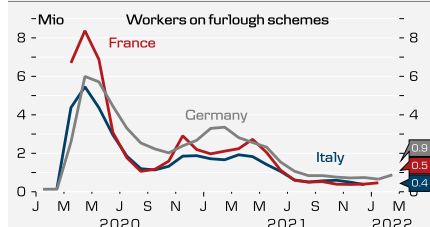
To assess the outlook for wages, a good starting point is taking a closer look at the euro area labour market, which staged a strong rebound from the pandemic. The unemployment rate fell to a new all-time low of 6.8% in January and we expect this benign dynamic to continue in 2022, despite the Ukraine war (although furlough schemes might be used to a greater extent in some affected manufacturing sectors). However, compared to the US the euro area labour market remains less tight, when looking for example at the number of unfilled vacancies and country differences also persist, with reports of labour shortages most prominent in Germany. A broader analysis of labour market conditions also points to the existence of more slack than hits the eye just by looking at the unemployment rate. While GDP and total employment have returned to pre-pandemic levels, total hours worked still stood ca. 2% below the level of end-2021.

Euro area labour market less tight than US



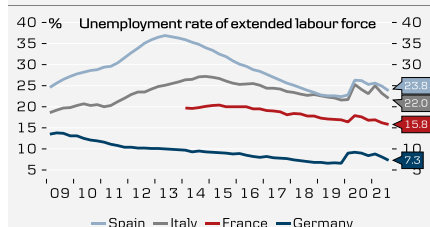
Source: Eurostat, St Louis Fed, Macrobond Financial, Danske Bank

Furlough schemes continue to operate



Source: Macrobond Financial, Danske Bank

More labour market slack when looking at broader unemployment measures



Source: Eurostat, Macrobond Financial, Danske Bank

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All hands on deck: workers are back in demand

While limits to labour supply seem to be less prevalent than in the US and UK, labour demand has picked up noticeably with the recovery from the pandemic. Business surveys point to an increasing willingness of firms to take on new staff in manufacturing and services and reports about labour supply constraining production are at historical highs in many euro area countries. Especially sectors such as hospitality, IT, road transport and construction have seen growing difficulties in filling job vacancies and in light of increased competition for workers, many companies expect wage growth to pick up from around 2% in the recent past to 3% or possibly more this year (see [ECB survey](#)).

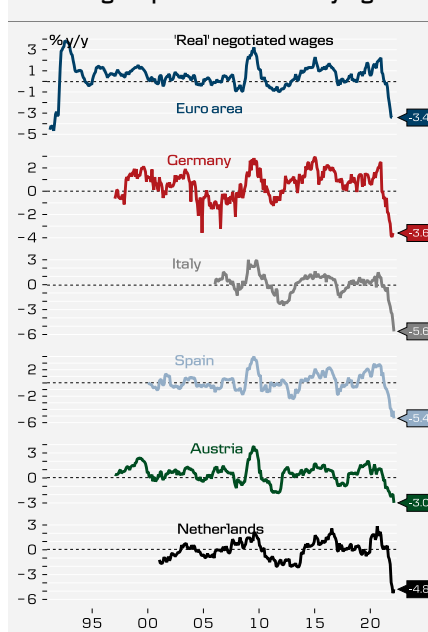
Wage bargaining still plays a central role in continental Europe. About 60% of employees are covered by collective bargaining in the EU, but with wide country differences (98% in France, 80% in Italy, 69% in Spain and 59% in Germany). The upcoming sectoral pay deals will be an important bellwether for wage dynamics, especially in Germany. The latest agreements do not yet provide much optimism for ‘inflation hawks’ (see overview p.4), with settlements mostly still in the low single digits and well below current inflation rates. Surveys also point to some lingering wage restraint among workers, despite soaring inflation (see [here](#)) and even for those workers who are seeking higher pay, the majority are ‘only’ making demands between 2-5%, well below current inflation rates.

In light of unions’ improved bargaining position and real income security as the prime focus for this year’s negotiations, **we expect negotiated wage growth to pick up to rates of 3-3.5% in late-2022/2023, which should support core inflation pressures.** Higher minimum wages will also reinforce the positive dynamic. Germany is enacting a ca. 15% raise in the minimum wage from October 2022 and increases of 3.1% in France, around 2.5% in the Netherlands and Luxembourg and 1.6% in Spain (see overview [here](#)). That said, the inflationary impacts might be small, with [Bundesbank](#) and [IMK](#) expecting only 0.15-0.3% uplift for German inflation in 2023-24.

To what degree higher wage costs are eventually passed on to consumer prices also crucially depends on the extent of firms’ pricing power, profit margins and the general economic backdrop. The environment for passing on higher raw material and energy costs to consumers remains favourable and companies are reacting to this by adjusting prices more frequently than in the past to avoid margin squeezes. However, the euro area growth outlook has clouded since the invasion of Ukraine and companies’ assessment of their competitive position has worsened again in Q1 22. Some [unions](#) have also signalled greater willingness to compromise due to the high geopolitical uncertainty and flexible one-off payments to compensate for the 2022 inflation shock rather than fixed high wage increases could be a good way to avoid the pitfalls of a wage-price-spiral developing. In case of an EU energy embargo on Russia and subsequent idling of production, negotiations might be postponed altogether.

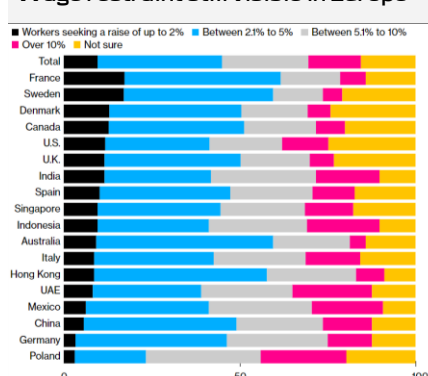
In sum, we expect euro area wage growth to pick up in coming quarters to rates that are consistent with core inflation stabilizing around 2% in 2023 and that should allow ECB to continue on its path of gradual policy normalisation. While negotiated wage increases between 3-4% will not suffice to fully compensate households for the real income erosion observed this year, it could give a moderate boost to private consumption in 2023, when we expect HICP inflation to average only 2%. Risks are skewed to the upside though in our view, especially if people become reluctant to return to the labour market after furlough schemes are phased out and increasing competition for labour is leading to higher wage drift. Consumer inflation expectations are still on the rise and the last significant real wage squeeze episode of the 1990s also provides a cautionary tale, where negotiated wage growth accelerated to rates of 7% in subsequent years, although the German reunification likely also played a role.

Real wage squeeze is intensifying



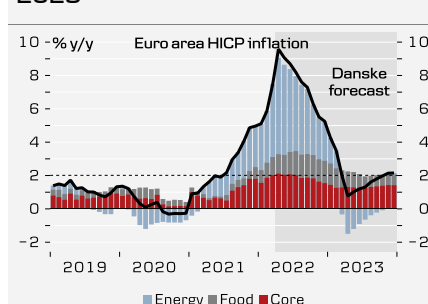
Source: Macrobond Financial, Danske Bank

Wage restraint still visible in Europe



Source: Bloomberg

Headline inflation expected to abate in 2023



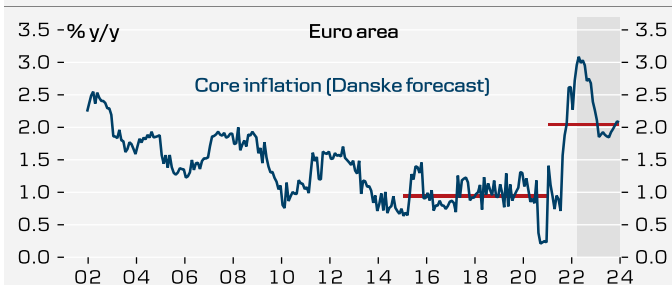
Source: Eurostat, Macrobond Financial, Danske Bank

We expect negotiated wages to pick up in late-2022/2023...



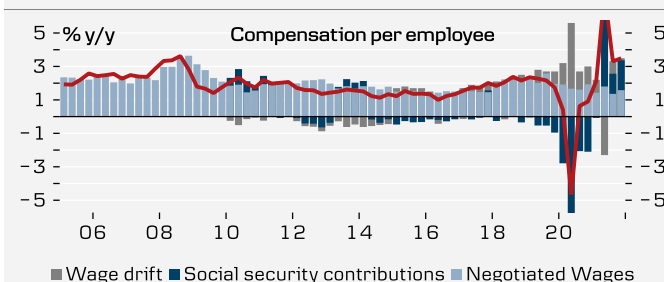
Source: Eurostat, ECB, Macrobond Financial, Danske Bank

... boosting core inflation



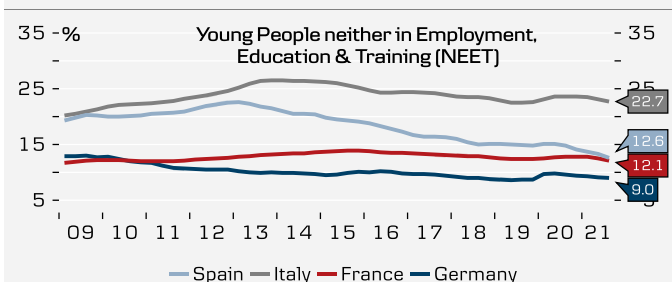
Source: Eurostat, Macrobond Financial, Danske Bank

Upside risks from wage drift



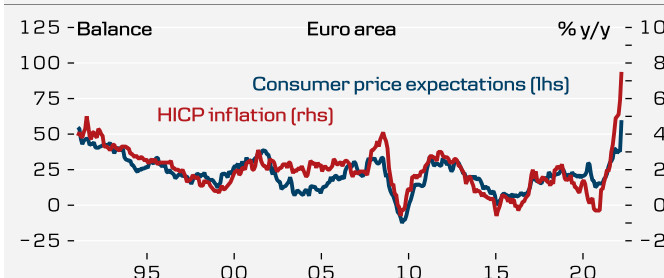
Source: Eurostat, ECB, Macrobond Financial, Danske Bank

Youth unemployment remains an issue



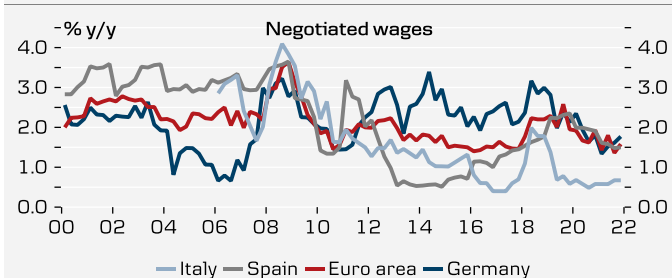
Source: Eurostat, Macrobond Financial, Danske Bank

Consumer price expectations are still on the rise, as headline inflation has yet to peak



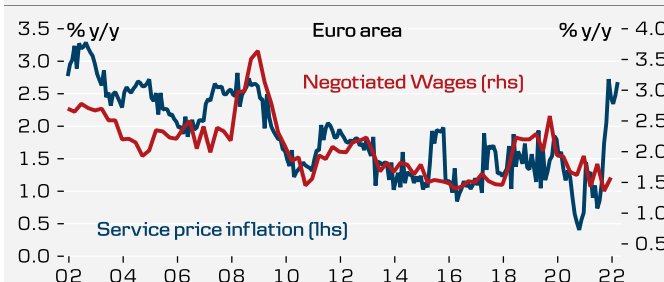
Source: Eurostat, EU Commission, Macrobond Financial, Danske Bank

Negotiated wage growth remains muted so far



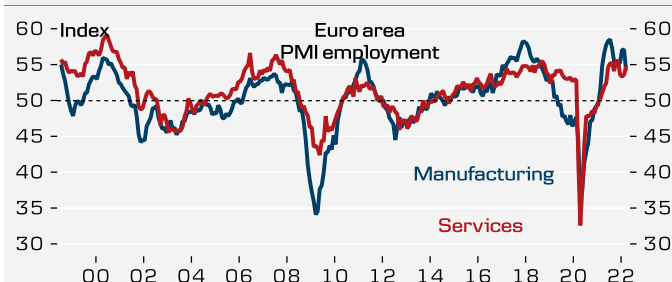
Source: ECB, Macrobond Financial, Danske Bank

Wage growth is an important ingredient for core inflation



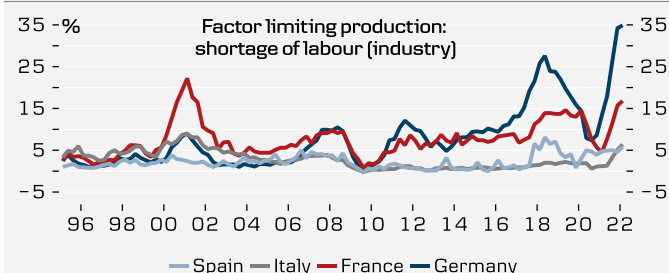
Source: Eurostat, ECB, Macrobond Financial, Danske Bank

Hiring continues across services and manufacturing



Source: Markit, Macrobond Financial, Danske Bank

Labour shortages are becoming more prominent...



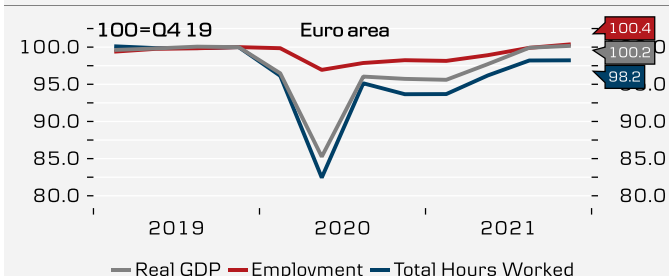
Source: EU Commission, Macrobond Financial, Danske Bank

... strengthening unions' bargaining position



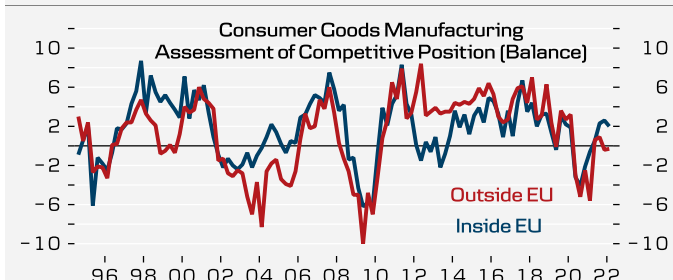
Source: EU Commission, ECB, Macrobond Financial, Danske Bank

Hours worked have lagged the recovery in GDP, as furlough schemes still remain in place



Source: Eurostat, Macrobond Financial, Danske Bank

Clouding economic outlook and concerns about competitive position could limit price increases



Source: EU Commission, Macrobond Financial, Danske Bank

Overview of recent negotiated wage agreements

Month	Country	Wage agreement	Number of affected workers (thousand)
November	Germany	Public sector workers seal 2.8% pay hike until end-2022	1,100
		Railway workers reach agreement of a wage increase of 3.7%	50
	Austria	Food and beverage industry workers agree on monthly salary, supplements and allowances to be increased by 2.7%	
		Metal industry workers agree on 3.55% pay rise over one year	190
December	Germany	17% pay raise for carpenters over three years	32
	Italy	Government and medical sector workers agree on average €90/month pay increase backdated to January 2021	250
	Netherlands	Pay increase between 7-9% over a period of three years for mental health care workers	100
	Germany	Hotel and restaurant industry workers get 17% wage increase in 2022, followed by 3.5% in 2023	
January	Spain	Collective agreement for public sector extended until end-2022 (2% pay rise)	
February	Spain	Minimum wage increased from from €965 to €1,000 backdated to January 2022	
	Germany	Postbank workers receive 5.2% wage rise over 2022/23 and €1,500 one-off bonus	15
	Germany	Airport security personnel receive pay rise between 4.4-7.8% in 2022	25

Source: Wageindicator, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Aila Mihr, Senior Analyst.

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