

## The stars are aligning for a eurozone wage growth rebound

Labour shortages, high inflation, increased minimum wages: 2022 is set for a decent recovery in nominal wage growth. For the European Central Bank, this will add to medium-term inflation pressures, likely serving as a key argument for a first rate hike in early 2023



The placard reads 'Increase salaries 400 euros per month' at a demonstration in Paris last month

Everyone in Frankfurt and well beyond is looking at the labour market to see whether second-round effects of the current inflation shock are already visible in the data. We don't yet see evidence of that as the ECB's index for negotiated wages actually reached its lowest wage growth figure in decades in the third quarter of last year (1.3% YoY). However, if the labour market is a lagging indicator, wage developments are the *mother* of all lagging indicators. Looking ahead, we expect wage growth to significantly accelerate in 2022 and 2023 to around 3 ½% as most important wage growth drivers point to a sharp increase.

### Labour shortages continue to rise

The past few months have seen rapid declines in unemployment, much more so than expected. The economy recovered more quickly than expected, which resulted in a stronger-than-expected labour market rebound. Furlough schemes – key for keeping unemployment relatively low in 2020

– saw a sharp decline in take-up in 2021, even though global supply chain frictions led to renewed demands for furlough schemes in the manufacturing sector. Risk scenarios of a significant increase in structural unemployment have luckily not materialised and we now expect unemployment to continue its downward trend in the coming year as employers' hiring expectations remain very strong for the beginning of 2022.

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### *Labour shortages are set to remain a dominant economic theme of 2022*

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At the end of last year, we wrote in-depth on labour shortages emerging and since then, new data shows that the labour market has tightened further. Vacancy rates are now higher than before the pandemic, while businesses have already indicated for a longer period that worker availability has never been so problematic for their production as we see now. In the eurozone, there are still fewer people active than before the crisis, which means that there is still some slack on the labour market fringes that could help cushion the problems to a degree unless people dropped out of the labour force for good. In any case, it looks as if labour shortages are set to remain a dominant economic theme of 2022.

The relationship between wage growth and unemployment has weakened over the past decade, resulting in a flare-up of the debate about whether the relationship between unemployment and inflation – the Phillips curve – is dead. It looks as if at least the relationship between unemployment and wage growth is still alive, but with a year lag and flatter than seen before. In layman's terms, it's taking longer for wage growth to emerge from low unemployment and it leads to less wage growth as well.

It's important to note that the past decade has seen lacklustre employment developments and mild shortages. Now that labour market tightness has become more pressing, it seems logical that this will have more impact on wage growth once again. Look back at 2019 for example, when shortages also resulted in a modest run-up in wage growth, which was halted by the pandemic. It is possible that with labour shortages back to pre-pandemic levels, wage growth will pick up where it started in 2019.

## **Inflation empowers union demands**

It's not just labour shortages that would point to higher wage growth though. Another key driver in the eurozone is inflation, especially since wage setting in the eurozone is predominantly done through collective bargaining agreements and inflation is an important input used in these negotiations. Purchasing power is currently being squeezed by inflation at its highest level since the 1980s and eurozone negotiated wages closely follow inflation developments historically.

In some countries, like Belgium and France for example, inflation has a direct impact on wage growth through indexation. Other countries see inflation passed through via higher union demands that result, in turn, in better negotiation outcomes for workers. In the past, unions have either used actual inflation rates or the ECB's medium-term inflation target in the bargaining process. Both used to be very close to each other. In the current bargaining rounds, expectations are that current inflation rates and the loss of purchasing power will play a more important role

than in the past. Labour market shortages are likely to add to unions' bargaining powers and make positions preferring job security over higher wages less likely.

Overall, the relevance of wage settlements depends on how much of a country's employment is covered by collective bargaining agreement, and in the eurozone, that's a lot. Also, collective bargaining agreements, centralised or decentralised, have a strong signalling effect on private-sector wage agreements. This results in a strong relationship between overall wage growth and 'negotiated' wage growth.

For the eurozone, we find the correlation between negotiated wages and inflation to be the strongest with a two quarters' lead for inflation. This means that wage growth historically trails inflation by about half a year.

## Corporate profits have been strong, allowing for wage growth

Besides factors like labour shortages and purchasing power maintenance, another important driver of wage growth in the eurozone is whether businesses can *afford* any salary increases. If corporate profits have weakened, stronger wage growth can be expected. However, healthy corporate profits should increase the likelihood of wage increases, sharing corporate profits with employees. The relationship historically shows a lag of some five quarters. Right now, corporate profits have shown a particularly strong rebound since the reopening of economies in mid-2020, suggesting ample room for higher labour compensation over the course of 2022.

## Minimum wage increases have been generous this year

Another important factor contributing to higher wage growth in 2022 is the sizeable increase in minimum wages in several countries. Germany is the most notable, with an expected increase to 12 euros per hour promised by the new coalition (an almost 30% increase). Other countries also see minimum wages increase, think of Portugal with a rise of 6%, and France and Belgium corrected for inflation, which will result in a sizeable jump. The Netherlands has also agreed to increase the minimum wage by 7.5% but will do so in steps throughout the government's term. The impact of higher minimum wages works through to the average of course, also because it generally impacts wage categories above the minimum as well.

## Wage growth to accelerate to 3% and more

A simple empirical model that has performed well historically would suggest nominal wage growth to recover to about 3-3.5% over the course of 2022, but relationships in economics are rarely mechanical. We have to keep in mind that Germany has a relatively small amount of wage negotiations coming up, which dampens the growth in negotiated wages. Also, a key question is whether unions – whose positions have weakened over recent decades – can convert the better negotiation positions into higher wage growth. On the other hand, overall wage growth in sectors without collective bargaining seems to already be outpacing negotiated wages significantly in some eurozone markets but data on this is severely distorted at the moment due to compositional effects in the labour cost index data. Overall, we think that wage growth of around 3% seems like a fair number to rebound to, possibly over the next two years.

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So, is the Phillips curve alive and kicking then? It seems so, although it looks like it needed supply shock therapy to be revived. The current high inflation is of course hardly a result of low unemployment, but will in turn feed through to the wage growth channel which in turn boosts medium-term inflation estimates. It's very early days, but it looks like the relationship between unemployment and inflation is becoming more significant again.

For the ECB, this will be an important argument for a rate hike in early 2023. For the current inflation spike, policy is not so relevant. The ECB can hardly fill gas reserves or add to the container shortage. What it can do is act on cyclical developments that look favourable, with an economy recovering quicker than expected and wage growth which is set to rebound this year. With inflation expectations of around 2%, Lagarde will have the luxury that Draghi never had: hiking interest rates.

### Author

#### **Carsten Brzeski**

Global Head of Macro

[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

#### **Bert Colijn**

Chief Economist, Netherlands

[bert.colijn@ing.com](mailto:bert.colijn@ing.com)

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