Euro area wages: the final check

Wage growth surprised to the upside at the start of the year, but leading indicators suggest it has peaked, and will ease further in 2024

23.05.2024, CIO OFFICE & MACRO RESEARCH

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SUMMARY

- Euro area negotiated wage growth surprised to the upside in Q1, rising to 4.7% YoY from 4.5% in Q4 2023. Germany was the only driver for the stickiness in wages, reflecting the delayed effect of recent wage deals catching up with higher inflation.
- Looking ahead, we argue that the disinflation process remains firmly on track, and that concerns over a wage-price spiral are misplaced.
- That said, given the noise and the lags in wage data, the ECB is likely to move slowly initially before it becomes more confident that inflation is converging towards the target over the medium-term. We expect the ECB to cut rates in June but pause in July, before resuming its easing cycle in September.

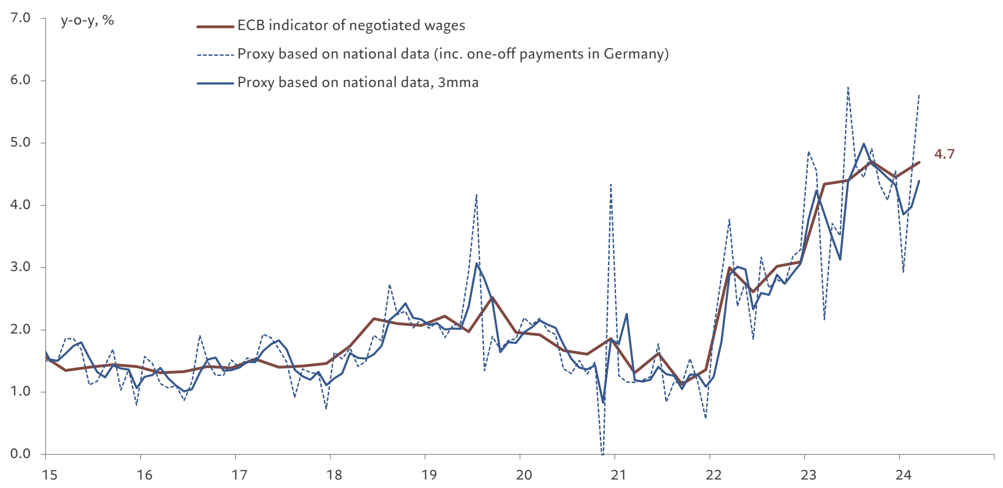
DELAYED CATCH-UP IN GERMAN WAGES IS INFLATING THE EURO AREA AVERAGE

At the ECB Watchers conference in March, President Christine Lagarde laid out the conditions for the ECB to start easing policy, including “two important pieces of evidence”: the upcoming staff projections for inflation, and Q1 negotiated wage growth. Since then, inflation has come in either in line with, or slightly below ECB staff projections, further strengthening the case for what the ECB politely calls “dialling back the restrictive policy stance”. Indeed, the Governing Council seems to unanimously back a first rate cut in June, with the hawks focusing on the outlook beyond June.

This has put the onus on wage dynamics as an important driver of the *pace* of monetary easing going forward. In a recent interview, Executive board member Isabel Schnabel made it clear that if the data did not confirm the easing in wage growth, the recovery in productivity, or the absorption of higher wage costs through profits, the ECB would have to move more cautiously than markets currently assume. Meanwhile, the accounts of the April meeting further stressed the importance of wages but also the difficulty in assessing their underlying dynamics. The ECB warned that the reduction in wage pressures would "not follow a linear trend" because of lags in the catch-up process to higher inflation as well as one-off payments in countries like Germany.

Euro area wages had been generally weaker than feared until the end of 2023, but they surprised to the upside at the start of this year. Negotiated wages including one-off payments rose by 4.7% YoY in Q1, up from 4.5% in the previous quarter, and arguably above the ECB's expectations (although technically the ECB staff makes projections for compensation per employee). However, Germany was the only driver for the upside surprise in Q1, with negotiated rising by roughly 6% YoY including one-offs (a bit more according to the Bundesbank, but a bit less according to statistics office Destatis).

Chart 1: euro area negotiated wages and bottom-up estimates



Source: Pictet Wealth Management, ECB, National statistics offices, as of 23.05.2024

EURO AREA WAGE GROWTH HAS PEAKED, AND IS EXPECTED TO EASE IN 2024

Looking at the broader picture, **we believe that the disinflation process remains firmly on track, and that concerns over a wage-price spiral are misplaced**.

- **Outside Germany**, wage growth has been easing faster than expected despite resilient growth in the services sector and the still tight labour market.
- **Germany is a case in point for the delayed catch-up in wages** to higher inflation as several wage agreements with longer timeframes have been renegotiated later than in other countries. Moreover, a growing component of these deals include bonuses and one-offs, making the series even more volatile with large differences between the various measures of euro area and German wage growth (Chart 2). Moreover, the bulk of wage increases was concentrated in the public sector and specific industrial sectors, but they remained contained overall in construction and services. Looking forward, we expect these special effects to fade, and wage growth to normalise from a higher level.

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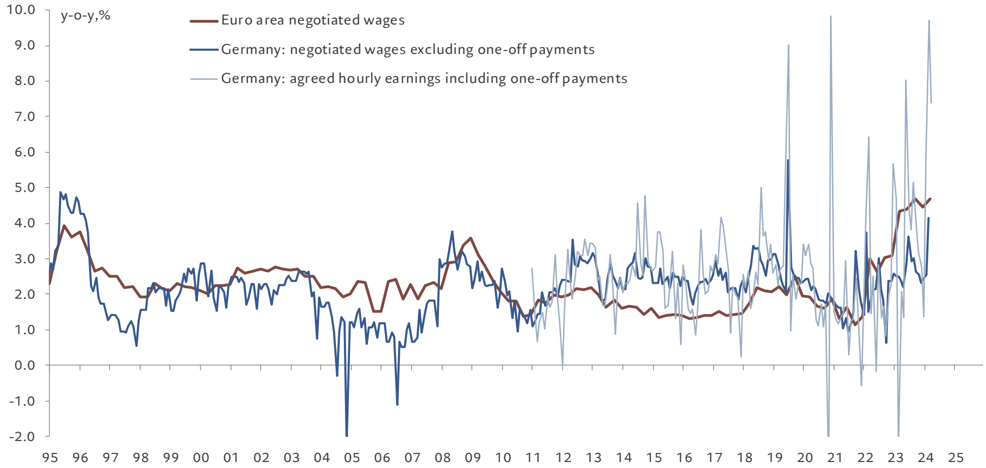
- Euro area HICP headline has come down in line, if not slightly faster than the ECB's projections. This suggests that future negotiated wages will continue to normalise, in part because of **implicit or explicit indexation** to past inflation (Chart 3).
- Indeed (sic), more timely leading indicators such as the **Indeed wage data,** which the ECB uses as inputs into its own wage tracker, have eased further since the start of the year. Meanwhile wage and price expectations from **business surveys** send a similarly encouraging signal, including from companies in the services making extensive use of short-term work which tend to be more sensitive to the cost of labour (charts 4 and 5).
- Lastly, the ECB remains confident that domestic inflation will continue to normalise as **corporate profit margins decline**, effectively "absorbing" a large part of the increase in wages (charts 6 and 7). One risk may come from productivity growth which has remained subdued so far, keeping unit labour costs higher than aggregate wage growth.

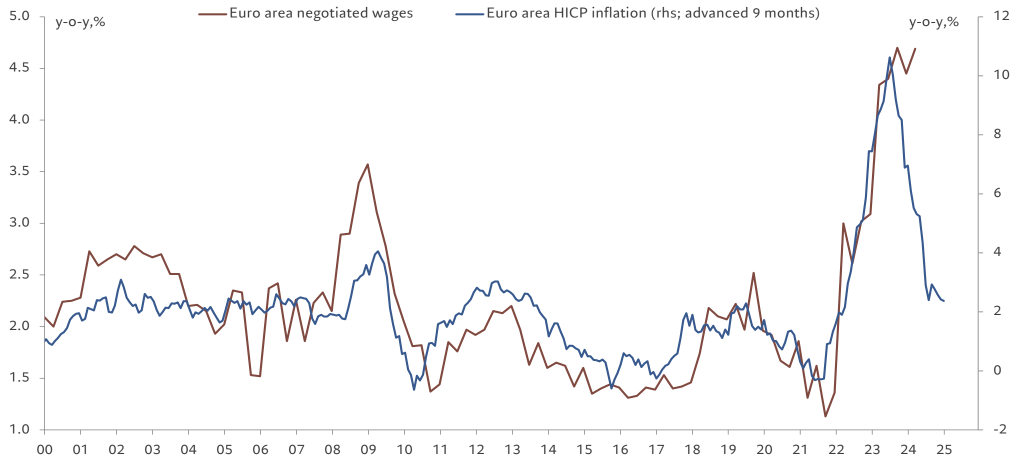
In the end, the near-term implications for monetary policy look pretty straightforward. **The ECB will likely deliver a first rate cut at its 6 June meeting but then pause in July**, on the back of sticky wages but also services inflation which we expect to remain elevated on a sequential basis in May not least due to base effects in Germany. **Looking ahead, we still expect the ECB to resume its easing cycle from September.** If services inflation and wages continue to normalise in line with our forecast, the case should build for the ECB to cut rates at every meeting in Q4.

Chart 2: euro area and German negotiated wage growth



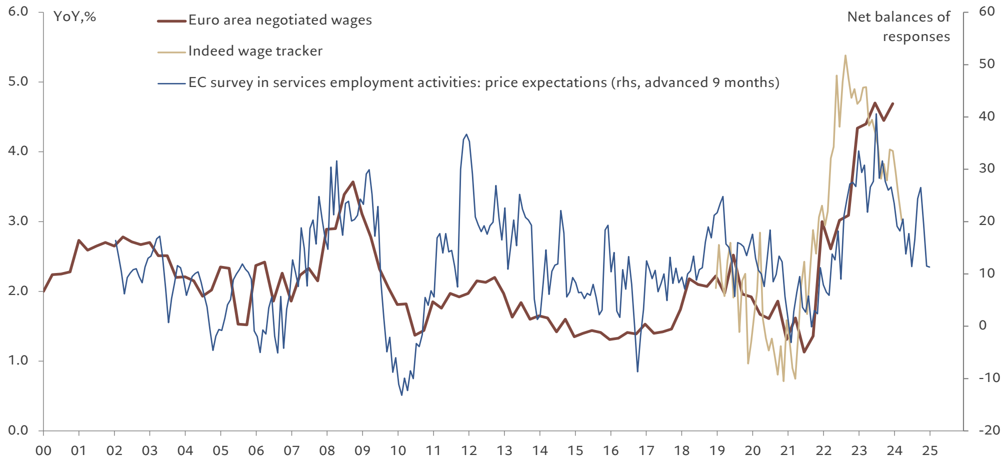
Source: Pictet Wealth Management, ECB, Destatis, as of 23.05.2024

Chart 3: euro area negotiated wage growth and HICP inflation



Source: Pictet Wealth Management, ECB, Eurostat, as of 23.05.2024

Chart 4: euro area negotiated wage growth, *Indeed* wage tracker, and European Commission survey in services employment activities (staffing companies)



Source: Pictet Wealth Management, ECB, European Commission, Indeed, as of 23.05.2024

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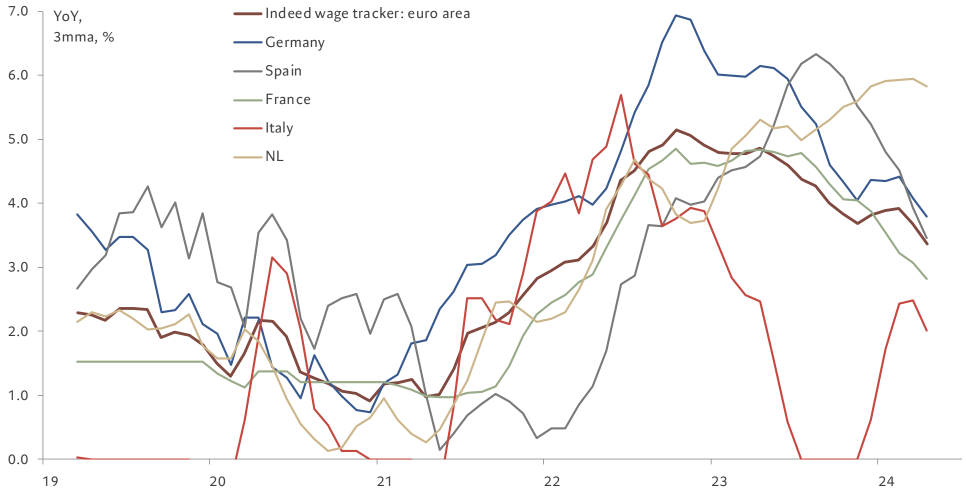
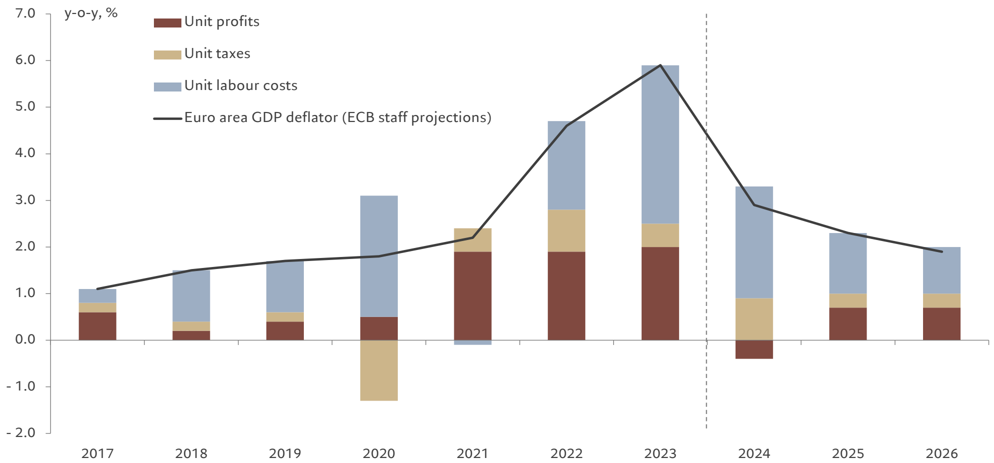
Chart 5: national *Indeed* wage trackers



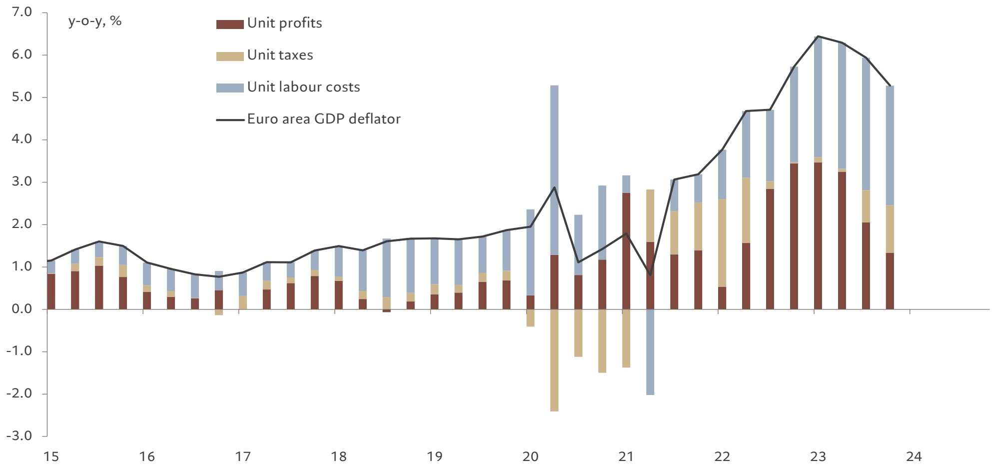
Source: Pictet Wealth Management, Indeed, as of 23.05.2024

Chart 6: euro area GDP deflator income side breakdown (ECB staff projections)



Source: Pictet Wealth Management, ECB, Eurostat, as of 23.05.2024

Chart 7: euro area GDP deflator income side breakdown (what has happened so far)



Source: Pictet Wealth Management, ECB, Eurostat, as of 23.05.2024

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