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PICTET WEALTH MANAGEMENT

Euro area wages

Falling wage growth in Q2 seals deal for September rate cut

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AUTHORS
NADIA GHARBI
ngharbi@pictet.com
ALAN LEMANGNEN
alemangnen@pictet.com

FLASH NOTE

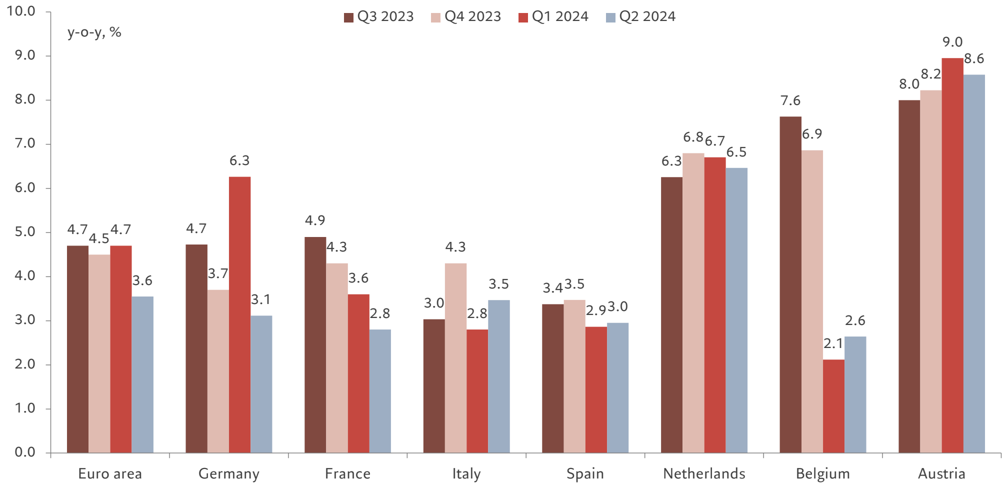
SUMMARY

- Negotiated wage growth in the Euro area slowed to 3.6% year-on-year in Q2, down from 4.7% in Q1 2024, with Germany being the main driver of the slowdown. Looking ahead, a potential re-acceleration cannot be ruled out in H2 2024 given high trade union demands in Germany but Q1 might still have marked the peak in our view.
- Overall, wage growth remains high, but the disinflation process remains firmly on track. In the short term, rising productivity and falling unit profits will help to dampen the upward impact of unit labour costs on domestic prices. In 2025, declining wage growth will be the main driver of further domestic price moderation.
- As long as the "wage, productivity and profits" story holds, the ECB might put less weight on specific data points, especially as we could see a renewed acceleration in negotiated wage growth. Thus, we continue to expect the ECB to cut its policy rate by 25bp in September and in December this year, bringing the deposit rate to 3.25%

WAGE GROWTH SLOWED DOWN IN Q2, BUT COULD ACCELERATE IN Q3

Negotiated wage growth in the Euro area slowed to 3.6% y-o-y in Q2, down from 4.7% in Q1 2024. The dynamics across countries from Q1 to Q2 remained mixed, but much of the deceleration was primarily driven by Germany (see chart 1). Wage growth also fell in France, the Netherlands and Austria, although it remained high in the latter two countries. It increased in Italy and Belgium (from low levels in Belgium) and was almost stable in Spain.

Chart 1: Negotiated wages in the key euro area economies



Source: Pictet Wealth Management, national sources, as of 22.08.2024

This slowdown at the euro area level is likely to be temporary. In Germany, monthly data already indicate a potential acceleration in negotiated wages in Q3. Additionally, significant trade union negotiations are scheduled for H2 2024. In its July report, the Bundesbank emphasised that unions' demands for upcoming wage agreements remain extremely high, "currently ranging from 7% to 19% for 12-month contracts", with wage demands in the services sector standing out as unions seek lasting compensation for real wage losses accumulated over recent years.

That said, even if a potential acceleration in German negotiated wages could lead to renewed growth in aggregate euro area data in H2 2024, Q1 might still have marked the peak in our view. In this regard, more timely indicators such as wage and price expectations from business surveys send encouraging signals.

DISINFLATION PROCESS REMAINS FIRMLY ON TRACK DESPITE ELEVATED WAGES

The persistence of high growth in negotiated wages is not calling into question the moderation of domestic price dynamics seen by the ECB staff, which is a key factor in the overall disinflation process. Domestic prices are driven by wages, productivity and profits, which ECB President Christine Lagarde called the "WPP" at the July press conference. Rising productivity mitigates the upward pressure of high wage growth on unit labour costs (the ratio of employees' compensation to the volume of gross value added) and domestic prices. Declining growth in unit profits (the ratio of gross operating surplus to the volume of gross value added) can absorb the rise in unit labour costs and limit pressure on domestic prices.

In its June projections, the staff sees this combination of rising productivity and declining unit profit growth as the key driver of easing domestic price pressures, a view that we share. On the one hand, productivity should rise after two years of decline as growth picks up and employment decelerates. On the other hand, unit profit growth should fall, and even turn negative, after two strong years, as demand has weakened after two years of persistently high inflation, and firms' pricing power has eroded subsequently.

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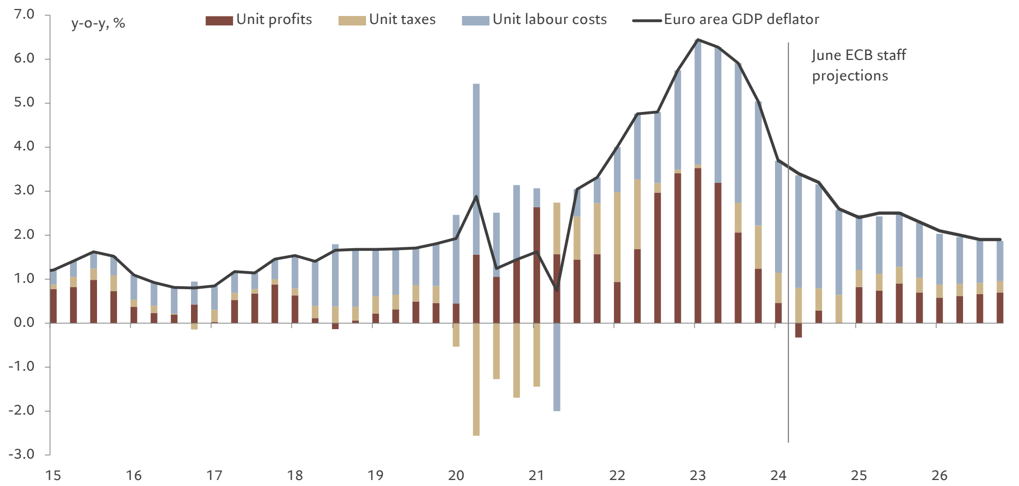
Looking ahead, the Governing Council (GC) also appears to be increasingly confident that wage growth will slow significantly in 2025, becoming the main driver of declining domestic price pressures. Referring to the ECB's wage tracker - a leading indicator of future negotiated wage growth developments based on national wage agreements - Christine Lagarde mentioned at the June press conference that the tracker pointed to "much lower wage growth in 2025". She also mentioned the June Survey on Access to Finance for Enterprises (SAFE) at the July press conference, which showed that firms expect wages to rise by 3.3% over the next 12 months, down from 3.8% in March 2024.

Chart 2: Euro area breakdown of domestic price dynamics



Source: Pictet Wealth Management, Eurostat, ECB, as of 22.08.2024

In other words, as long as the "WPP" story embedded in the staff projections holds, the GC should remain confident that domestic price pressures will continue to ease, barring any exogenous shock. This would be consistent with falling services inflation - the last stronghold resisting the disinflation process - and with both headline and core inflation remaining on target by end-2025 in the staff projections, a key condition for further interest rate cuts. This suggests that the GC might put less weight on specific data points, especially as we might see a renewed acceleration in negotiated wage growth in the second half of 2024. **In short, the ECB may have recently become more forward-looking and less data-dependent in its assessment of the inflation outlook than many market participants would like to believe**. We continue to expect the ECB to cut its policy rate by 25bp in September and in December this year, bringing the deposit rate to 3.25%.

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