

Employment, labour costs and the impact on monetary policy

With a very tight labour market, in which unemployment is at a 40-year low and overall employment at an all-time high, we expect labour compensation to increase by 5-6% in the upcoming wage negotiations. This will put a floor under overall inflation and especially core inflation (ex food and energy) of 4-5% for the coming years. The ECB will have to raise interest rates to a level that will have a severe impact on the financial markets if its current (very optimistic) expectations for inflation and the lowering of interest rates do not materialise in 2023.

In our previous Newsletter (#55 – January 2023), we focused on unemployment rates in the EU. Unemployment is of course only one side of the labour market “coin”, the other side being overall employment.

Given the high inflation of the past 12 months, how much are employees likely to demand in this year’s wage and compensation negotiations?

The development in labour costs will have a significant impact, not only on service inflation, but also on goods produced in the EU, and while effectively putting a floor under inflation, restrictions on ECB monetary policy are likely to result.

Employment level and participation rates in the EU

Since the financial crisis of 2008-2009, the employment situation in the EU has never been better than now.

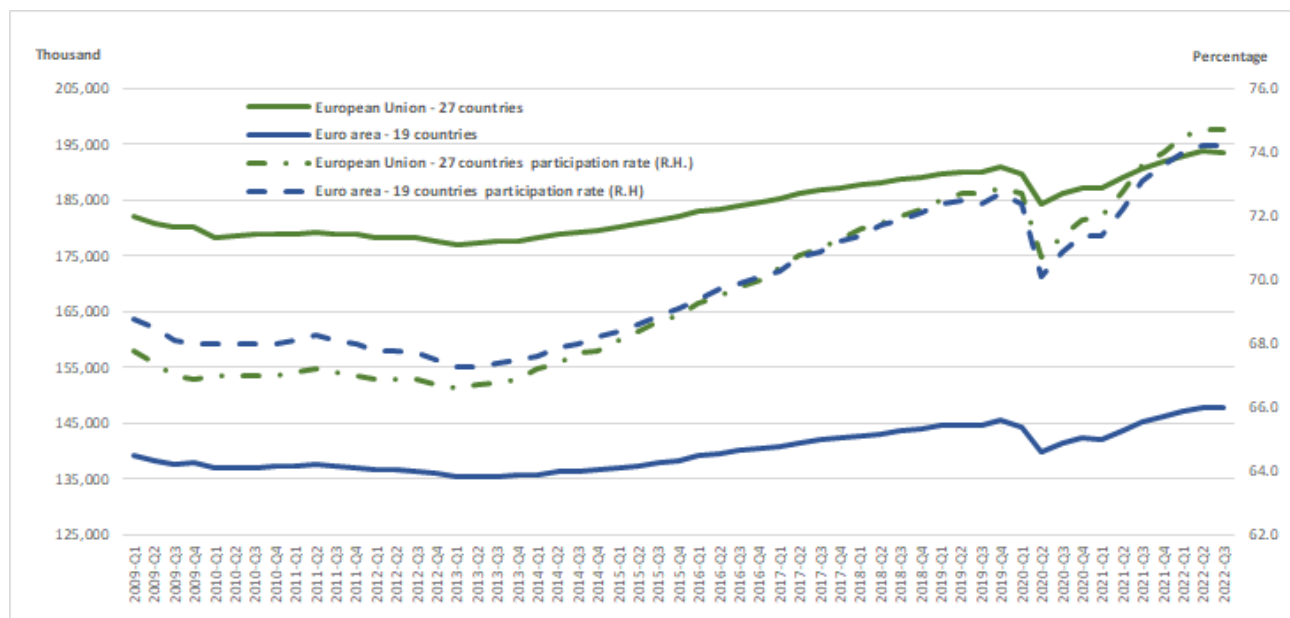
While overall employment for 20-64 year olds dipped during the COVID-19 pandemic, levels have now reverted to the previous trend. Data is currently only available for Q3 2022, so it is possible that overall employment will fall slightly in

Q4 2022, although a large drop is highly unlikely, as unemployment remains at an all-time low.

This leaves overall EU employment at 193.6m persons between 20 and 64, which is only 120k from the all-time high. In the eurozone, the ECB's "primary" focus is only 30k away from the all-time high of 148m (see Figure 1, below).

High employment has significantly influenced participation rates in both the EU and the eurozone. Since 2010, the participation rate for the entire population has increased by 7%-points and 6%-points in the EU and the eurozone, respectively, to a level above 74%.

Figure 1 Total Employment and participation rate from 20 to 64 years in EU and eurozone Source: Eurostat



It will be difficult to increase the participation rate much more, especially in the Northern regions of the EU, since there is always an element within the 20-64 age group that is involved in further education or has issues that limit the ability to hold down a job.

With unemployment at a 40-year low, employment almost at an all-time high and participation rates actually at an all-time high, how has this affected labour costs?

Labour costs in the eurozone

The main component of labour costs is, of course, wages and salaries. (In the following, other costs included in the index, such as recruitment, training and clothing, will be ignored, as they are considered immaterial.)

Since 2002, labour costs in the eurozone have increased in most quarters by between 1% and 4% year-on-year, except for the COVID-19 years of 2020 and 2021 (see Figure 2, below).

Year-on-year inflation in the eurozone since 2002 has remained around 2% for most of the period, and this has been good for employees, as, in most years, they have gained around 1% in terms of real compensation (see Figure 3, below).

Figure 2 Labour cost and HICP inflation in the Euro area source ECB and Eurostat

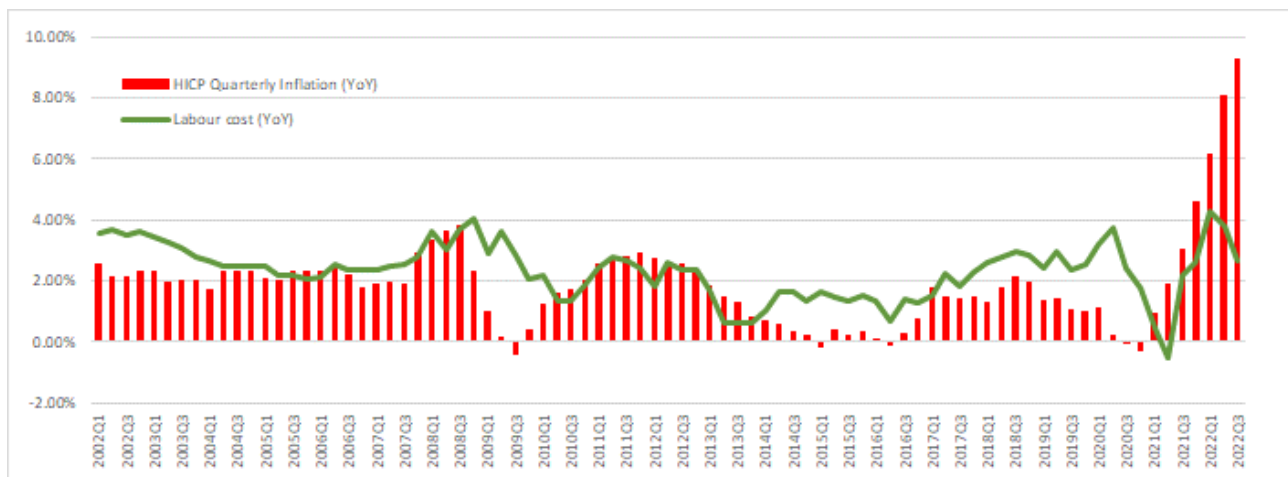
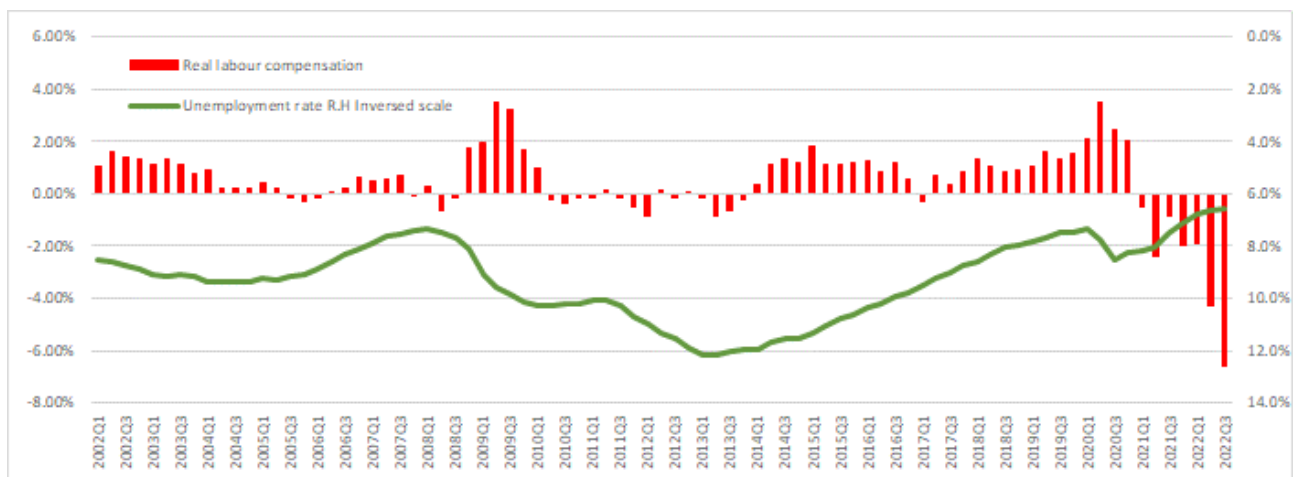


Figure 3 Real labour compensation and unemployment rate in Euro Area source ECB and Eurostat



(Figure 3 shows the unemployment rate in the eurozone on an inverted scale in order to better illustrate the link to labour cost growth.)

Looking at the two green lines in both the above charts, it is clear that when unemployment increases, growth in labour costs falls; and when the unemployment rate falls, growth in labour costs increases. This is hardly a surprising observation.

From 2013 (when the eurozone unemployment rate topped out at more than 12%) until the end of 2022 (when the unemployment rate hit an all-time low), year-on-year growth in labour costs rose from less than 1% to 4%: even in Q3 2022, labour costs increased by 2.7%. Real labour compensation steadily increased during that period, as should be expected, or did so at least until COVID-19 hit in 2020.

As governments increased spending and the ECB lowered interest rates and provided abundant liquidity, inflation spiralled out of control, leading to a significant loss in real compensation for employees. In Q3 2022, this amounted to a loss of more than 6% in real terms.

Real labour compensation going forward.

In the wake of the COVID-19 crisis and the spike in inflation, negotiations in the labour markets about new compensation agreements are only just beginning. Many employees have experienced significant problems with the increased cost of living and they would like to be compensated, given that:

- unemployment is at a 40-year low in the eurozone;
- total employment is just shy of an all-time high;
- participation rates are at an all-time high.

It is of course difficult to guess at what level employers and employees will settle in upcoming negotiations. However, given the conditions mentioned above, there will be a strong case for employees to be compensated for the high inflation rate of the recent past.

Our current expectation is that we are going to see labour costs increase by between 5-6% over the coming 2-3 years, with the possibility that many wage settlements will also include a one-time payment for the loss in real purchasing power over the past 12 months.

Impact on inflation

Increases in labour costs of 5-6% over the next 2-3 years should effectively put a floor under eurozone inflation at least for that period.

Prices for goods and services will not be able to drag inflation down as they have in the past, and energy prices should not impact inflation for much longer.

When the base effect and energy prices have run out of steam, our expectation is that inflation will remain between 4-6% in the EU over coming years if labour costs rise as we anticipate.

ECB monetary policy

The position of the ECB might best be illustrated in this interview with Vice President Luis de Guindos on published in the Süddeutsche Zeitung on 8 February 2023:

“Equity markets are rallying again, as investors are betting on inflation easing and on an imminent end to interest rate hikes.

Financial markets may well be overly optimistic with regard to inflation developments and our monetary policy response.

When will the interest rate hikes come to an end?

We increased our policy rates by 0.5 percentage points last week, and will very likely raise them by another 0.5 percentage points at our next meeting in March. We will then see what we will do. I would not rule out further rate hikes after March. The battle against inflation is not over yet. In the euro area consumer prices still increased by 8.5% in January (considering an estimate for Germany), despite the fall-off in energy prices. At 5.2%, core inflation, which excludes energy and food prices, is at its highest level in the history of the monetary union. That is not good.

Excessively high interest rates could damage the economy. Is the ECB in danger of going too far?

Our mandate is to maintain price stability. That's it. That's the only mandate we have. High inflation harms everyone in society."

<https://www.ecb.europa.eu/press/inter/date/2023/html/ecb.in230208~028be3e58d.en.html>

With labour cost increases creating a floor under inflation in the EU, it is difficult to see a quick return to inflation of 2%. This is a direct challenge to ECB monetary policy.

If our assessment of the situation is correct, we expect the ECB to raise interest rates at a moderate pace towards 4% over the coming 6-12 months.

However, the ECB will continue to provide sufficient liquidity to the financial markets to secure a well-functioning government bond market and thus effectively control the yield curve for government bonds.