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Flash Note

Europe chart of the week – Wages

Wage growth pick-up suggests that the Phillips curve is not dead

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Euro area nominal wage growth – an important input in the ECB's reaction function – seems to have picked up in H1, possibly reflecting the lagged impact of the reduction in labour market slack. Annual growth in compensation per employee rose to 1.6% y-o-y in Q2 (highest since Q4 2013), while private hourly wage growth in picked up to 2.2% y-o-y (highest since Q1 2015).

The ECB remains confident that the Phillips curve will steepen and that inflation will respond to a narrowing output gap. Near-term, the ECB staff could be in a position to revise its wage growth projections higher, for the first time since QE started.

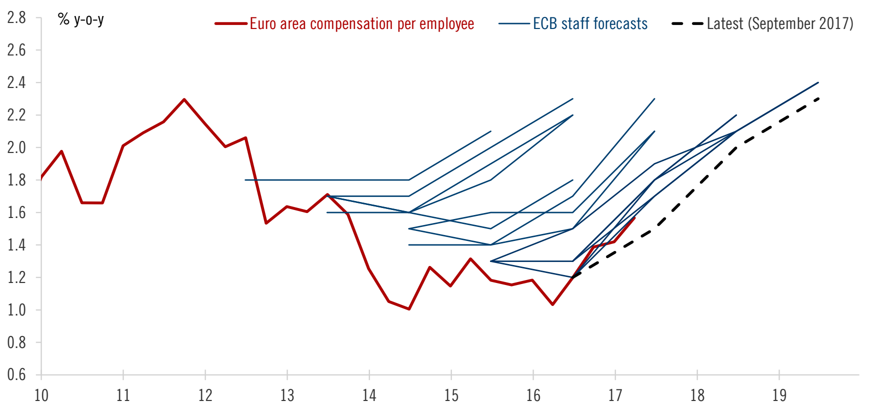
Any further improvement in wage growth, alongside a pick-up in core inflation, will help the ECB to justify an exit from unconventional measures. We continue to expect asset purchases to be scaled down to EUR40bn for six months, between January and June 2018, with risks tilted towards a 'slower for longer' extension.

Wage growth is an important input in the ECB's reaction function, and so far it has failed to respond to the narrowing of the output gap. It could be the normal behaviour of a lagging indicator, especially as labour market slack is likely to be larger than what the drop in headline unemployment would suggest (see ECB's box "Assessing labour market slack", March 2017). Or, it could be that "the slope of the Phillips curve may steepen again when the economy reaches and surpasses full potential", as Mario Draghi said in Sintra. ECB's work suggests that wage and price setting behaviour have changed during the crisis in ways that slow the responsiveness of inflation.

This week's indicators were consistent with a gradual pick-up in wage growth, from low levels. Euro area compensation per employee rose from 1.4% to 1.6% y-o-y in Q2 (its highest level since Q4 2013), alongside with upward revisions which pushed quarterly annualised growth rates close to 2% at the turn of the year. Meanwhile, hourly wage growth in the private sector (excluding construction) increased to from 1.4% to 2.2% y-o-y in Q2, its highest level since Q1 2015.

For the first time since QE started, the ECB staff could be in a position to revise its wage growth projections higher at the December policy meeting. Any further improvement in wage growth, alongside a pick-up in core inflation, will help the ECB to justify an exit from unconventional measures. We still expect asset purchases to be scaled down to EUR40bn for between January and June 2018, with risks tilted towards a 'slower for longer' extension (see "ECB hints at October decision on QE", 2017).

Chart: euro area wage growth and ECB staff projections



Source: Pictet WM – AA&MR, ECB, Eurostat

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