

# European Economics

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## Welcome higher German wages

Solving the periphery economic imbalances does not only rest on the periphery countries' shoulders even if these countries have been asked to bear most of the burden. Part of the effort to re-balance Europe also has to be borne by Germany via its current account.

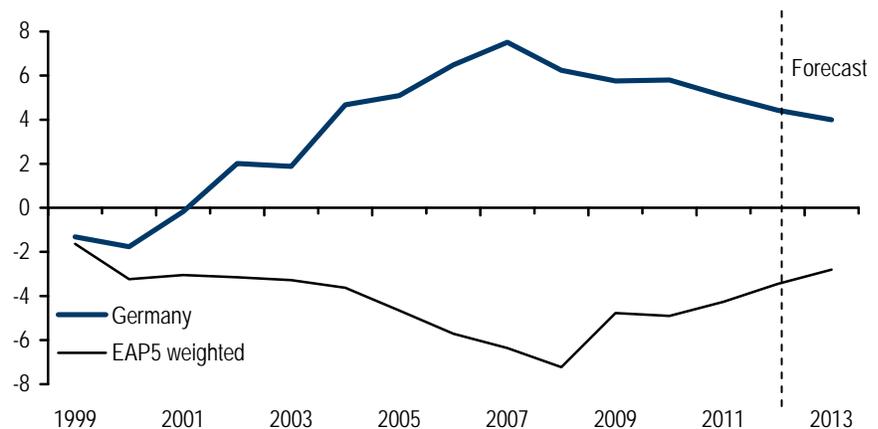
This might be under way. Germany's labour market has tightened – unemployment is at a generational low, and wage demands have risen sharply. The better bargaining position of unions is likely to see a break with the tradition of the last decade, when average wage growth failed to keep up with the cost of living. After an increase of 1.7% last year, we expect average wage growth nearer to 3% this year and next.

Unit labour costs are thus bound to continue increasing, but this is healthy in the bigger picture, which requires the euro area to re-balance. The periphery has started to restore competitiveness in a painful way, and this re-balancing can only be welcome if it is not one-sided but if instead Germany contributes by fostering domestic demand and giving up some competitiveness.

For Germany and the Bundesbank, this also means getting used to the idea that German inflation is likely to exceed the euro area's average inflation, but there will, in our view, be little sympathy from the ECB, which has to take the aggregate into account.

### Exhibit 1: Current account balances

As % of GDP



Source: Thomson Reuters Datastream, Credit Suisse

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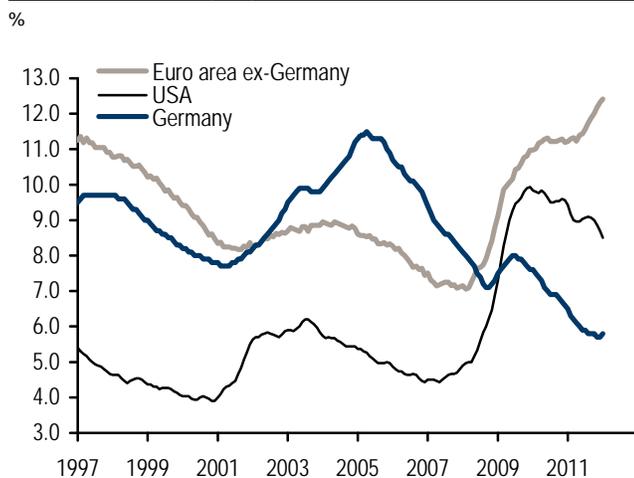
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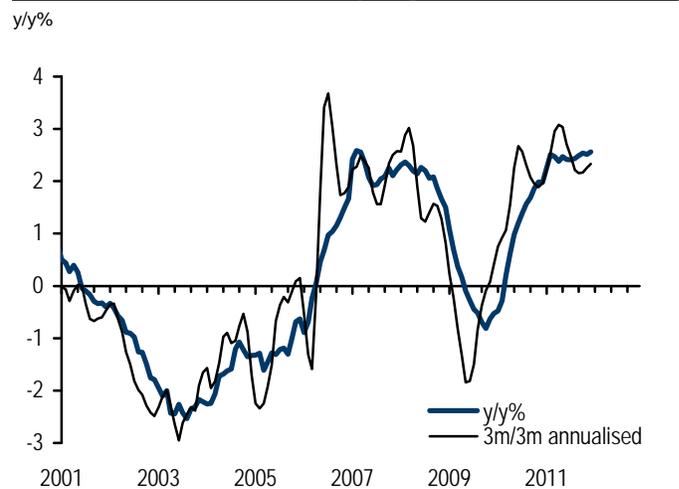
**Germany's labour market reforms, implemented over the last decade, have started to bear fruits.** Record unemployment – the unemployment rate reached over 12% in early 2005, which was the highest since the early 1930s – prompted the government to boost job-search incentives by slashing an array of benefits and early-retirement programmes. Unemployment started to fall consistently as a result. In addition, the current government helped the labour market to weather the recession by heavily subsidising companies that kept workers on, albeit at reduced hours. Since then, the sharp upturn after the recession has been accompanied by a vibrant job market. At just below 6%, according to the ILO concept<sup>1</sup>, the unemployment rate stands at a generational low. Full-time jobs increased by more than 2% last year, and the momentum so far this year, although softening somewhat in recent months, remains positive.

**Exhibit 2: Unemployment rates**



Source: Thomson Reuters Datastream, Credit Suisse

**Exhibit 3: German full-time job growth**



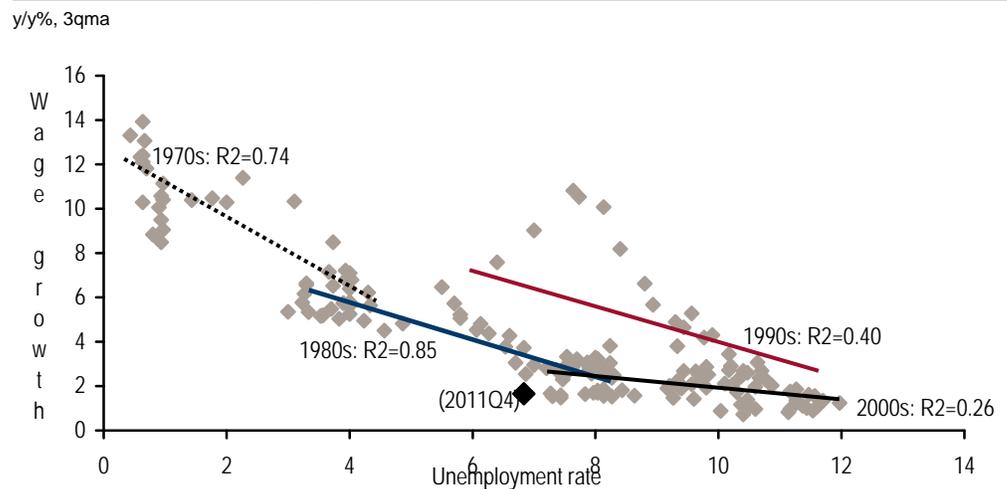
Source: Credit Suisse

<sup>1</sup> When it comes to unemployment, the definition of the International Labour Organisation (ILO) and that of the Federal Employment Agency vary. The latter only takes into account persons registered as unemployed with an employment agency or a local institution and seeking employment for at least 15 hours per week. On average, the unemployment rate of the Federal Employment Agency has been 1 percentage point higher than the ILO data. We have used ILO data for international comparisons but otherwise have used Federal Employment Agency data because long-term historical data is available in that series.

**The tighter labour market is being accompanied by higher wage demands.** This has re-awakened interest in the relationship between wages and the labour market, as originally depicted in the Phillips curve. In Germany, and in line with the experience of other countries, it is difficult to establish a single curve that fits long-term data. Instead, a series of downward-sloping curves can be fitted throughout the decades showing not only outwards shifts in the relationship but also changes in steepness. High unemployment rates and very subdued economic growth in the first half of last decade led to a rather flat curve with a low correlation between labour market and wage growth.

A tightening labour market, however, increases the bargaining power of workers, and we expect the relationship to shift inwards and become steeper again. We thus expect a break with the tradition of the last decade, when average wage growth failed to keep up with the cost of living, and **we expect lower unemployment to be accompanied by average wage growth nearer to 3% this year and next after 1.7% last year.**

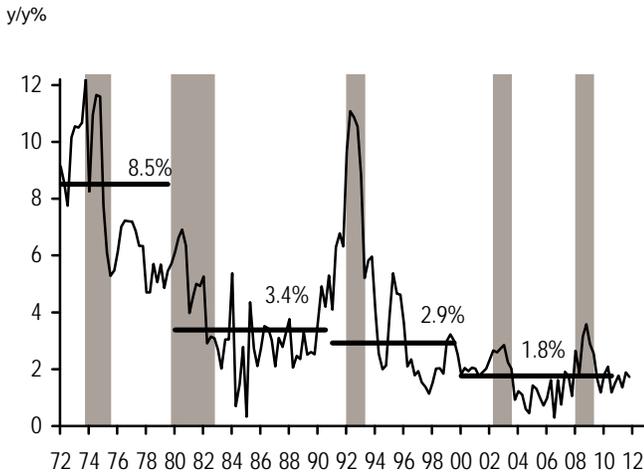
**Exhibit 4: German Phillips curves**



Source: Thomson Reuters Datastream, Credit Suisse

Last year's wage average wage growth of 1.7% was in line with the subdued average nominal growth of 1.8% prevailing in the past decade. But it is worth pointing out that **since 2010 and for the first time in over a decade, actual take-home pay started to exceed negotiated pay.** The positive wage drift has been a result of the sharp recovery from the recession, which was accompanied by a significant increase in hours worked. In addition, many companies, especially those in the export sector, awarded bonus payments. In part, these bonus payments reflect that wage agreements settled during the recession but that in retrospect extended well into the recovery had been very subdued. With higher wage agreements not in the pipeline, we expect this positive drift to be eroded going forward.

**Exhibit 5: German nominal wage growth**



Source: Thomson Reuters Datastream, Credit Suisse

**Exhibit 6: Positive wage drift for the first time**



Source: Thomson Reuters Datastream, Credit Suisse

**Wages are set to go up sharply if the start of this year's wage round is any indication.** This year is one of the so-called 'mega-tariff years', with key unions re-negotiating agreements for over 9 million workers. Traditionally, IG Metall, the metalworkers union, tends to set the benchmark agreement. IG Metall sees agreements for 3.6 million metalworkers expiring at the end of this month.

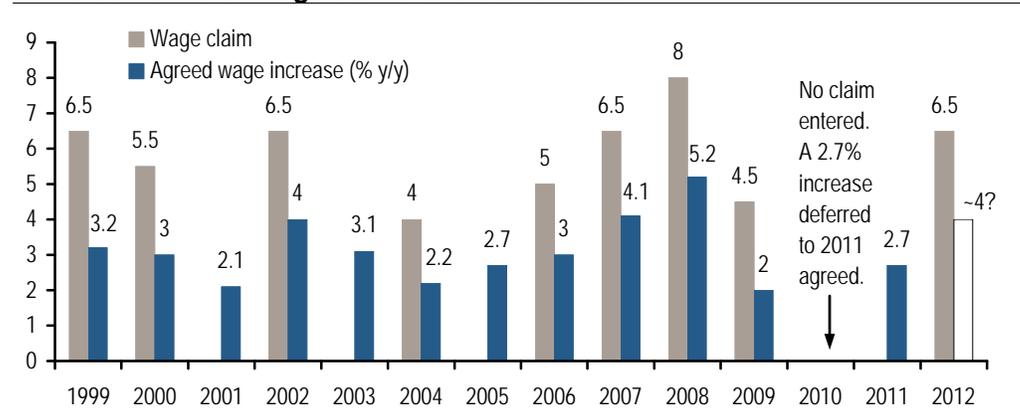
This year, IG Metall is not only likely to set the benchmark agreement, but it also opened this year's wage round by setting a high opening bid of 6.5%. The significant bid is partly due to the union trying to make up for lost ground with metalworkers, who believe that they lost out in the sharp upturn. This because in early 2010 and for the first time in the union's history, IG Metall went into the 2010 wage round with no bid, settling for an extended and very subdued agreement in order to preserve jobs. This year, the union is likely to see wages increasing by around 4%, with IG Metall traditionally settling for around 60% of its opening bid.

**Exhibit 7: 2012 wage round, expiry of key agreements**

Date	Union	Sector
29 Feb 12	ver.di	Public sector: Federal government and local community workers
31 Mar 12	IG Metall	Metal and electrical industry, all states
31 May 12	IG BCE	Chemical industry (North Rhine-Westphalia, Hesse, Rhineland-Palatinate)
30 Jun 12	IG BCE	Chemical industry (Schleswig Holstein, Hamburg, Lower Saxony, Bremen, Baden-Württemberg, Bavaria)
31 Dec 12	ver.di	Public sector: Federal state workers (excluding Berlin)

Source: WSI, Credit Suisse

**Exhibit 8: IG Metall wage claims and settlements**



Source: WSI, Credit Suisse

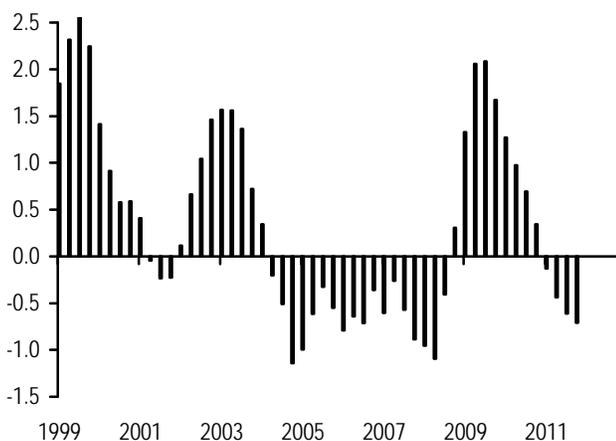
IG Metall's opening bid in early February was swiftly copied by the public-sector union (ver.di). And the chemical industry union has only come in slightly below at 6%, but negotiations with that union don't start until April, at which point metal workers might have achieved or be close to a settlement.

**With real wage growth dipping back into negative territory last year, this round is bound to be aggressive.** A foretaste has already been provided by the public sector, which implemented widespread warning strikes only after the opening negotiation round with public-sector employers. The latter deem the 6.5% demand as unrealistic and are balking at wage increases, which could increase the cost to public local community coffers by up to EUR 6 bn (0.2% of GDP) if the demands are met in full.

But German politicians have also been sympathetic to labour, which wants to continue recouping some of its lost share. Much of the rebound from the generational low reached by labour's share in the last decade already came, however, during the recession, when the substantial government-funded reduction in hours worked significantly limited the impact of the crisis on headcount, sharply increasing unit labour costs and thus eating into profits as a result.

**Exhibit 9: Real wages were negative last year**

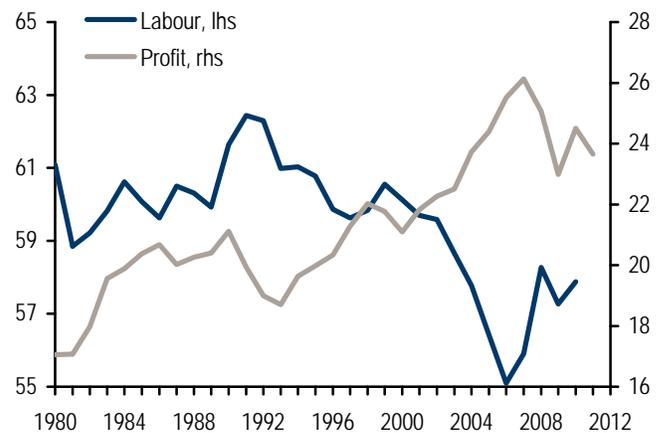
y/y%, 3qma



Source: Thomson Reuters Datastream, Credit Suisse

**Exhibit 10: Profit and labour shares**

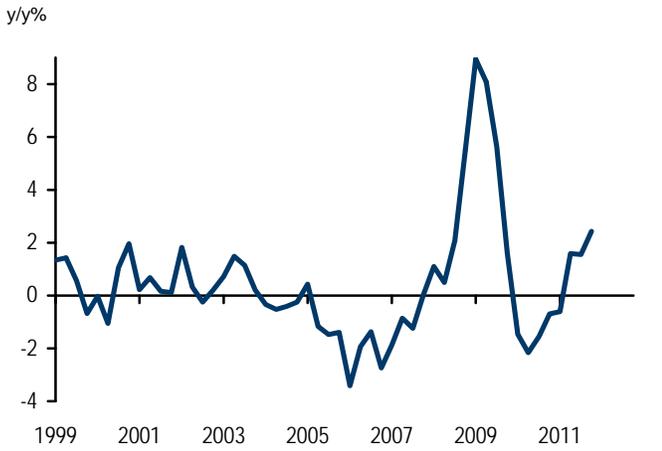
% of GDP



Source: Credit Suisse

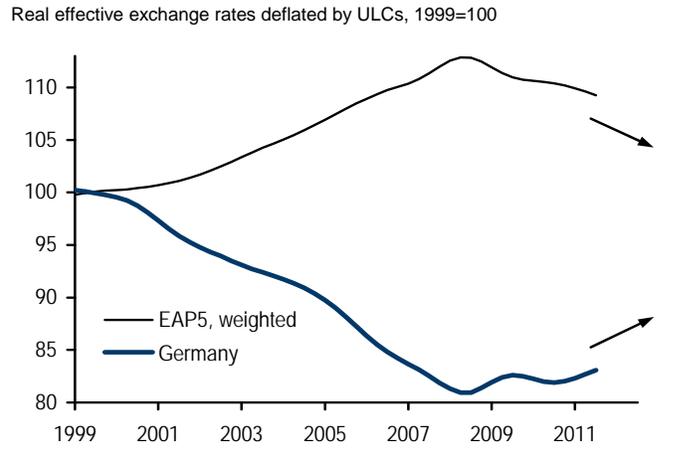
**Unit labour costs are bound to continue increasing on the back of increasing wages and declining productivity,** with the latter losing ground as a result of the labour market normally adjusting to slower economic activity with a lag. **But this is healthy in the bigger picture, which requires the euro area to re-balance.** The euro area periphery has started to restore competitiveness in a painful way, through internal disinflation, with wages being cut in Spain, Portugal and Greece. It can only be welcome if the rebalancing is not one-sided but if instead Germany contributes by fostering private demand through an increase in real income while at the same time giving up some competitiveness in coming years.

**Exhibit 11: German unit labour costs**



Source: Thomson Reuters Datastream, Credit Suisse

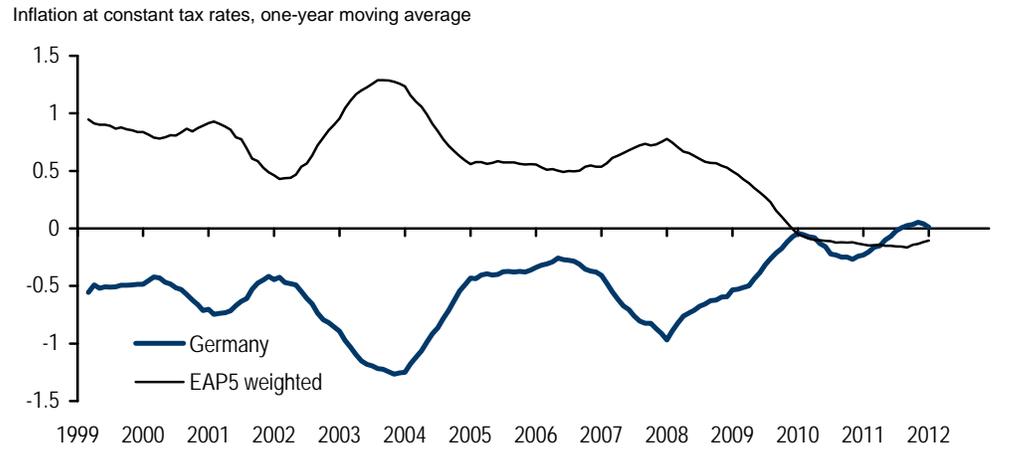
**Exhibit 12: Re-balancing competitiveness**



Source: European Commission, Credit Suisse

**For Germany, this also means getting used to the idea that German inflation is likely to exceed the euro area’s average inflation rate.** For a decade and as a result of very low wage growth and subdued domestic demand, Germany’s cost of living ran well below the euro area average rate. But this has started to change as Germany and the periphery are trading places. We expect this year’s German inflation to be in line with our euro area’s average forecast of 2.1% and expect German inflation to exceed our euro-area average forecast of 1.6% by 0.2 percentage points next year.

**Exhibit 13: German and periphery inflation relative to the euro area**



Source: Thomson Reuters Datastream, Credit Suisse

**The prospect of German inflation exceeding the euro area average is not bound to make the Bundesbank happy. But there will be little sympathy from the ECB,** whose executive board has become more pragmatic. In our view, the ECB will take into account that periphery economies are going through fiscal retrenchment and tough structural adjustments that will keep those economies very subdued in coming years. The ECB has often reminded us that decisions are taken for the aggregate, not for individual countries. Yes, Germany is the largest euro-area country, and higher German inflation would drive the euro-area aggregate higher, but the ECB is unlikely to react in a hurry. Next year’s aggregate inflation forecast complies with the near but lower than 2% price stability objective, and German inflation, while somewhat higher, is unlikely to get out of hand in a country where unions sit on the boards of companies and have learnt that they need to do their part to ensure that jobs continue being created.

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## Disclosure Appendix

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