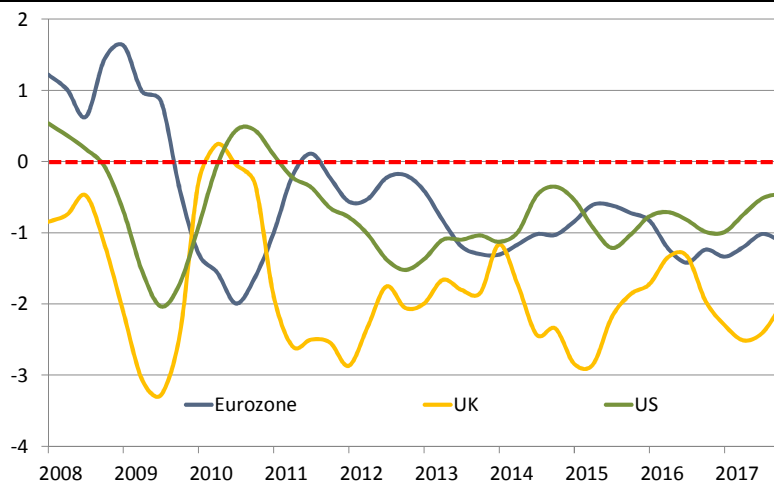




9 February 2018

Wage growth: still way off the danger zone

No heat yet: US, Eurozone and UK annual wage growth minus 2003-07 average (ppt)



Quarterly data. Source: Bureau of Labor Statistics, Statistical Office of the European Communities, Office for National Statistics, Berenberg calculations. Data show two quarter moving average.

- In markets, good news can sometimes be bad news:** After years of frustratingly low wage growth across major parts of the advanced world, surely an upside surprise in US household earnings would be welcome? Apparently not. Instead of seeing the positive impact that faster wage growth would have on product demand and company revenues, markets seem to have focused on the potential inflationary risks and the prospect of a quicker-than-expected monetary tightening. This risk underpinned the aggressive selling in equity markets in the past week.
- But in economics, good news is usually good news:** Across the advanced world, the synchronised improvement in economic fundamentals that began in late-2016 continues to gather healthy momentum. The recent modest acceleration in wages in the US, the Eurozone and the UK reflects a steady return to the old normal: strengthening demand, rising productivity-augmenting investment and less cautious wage bargaining by workers. Rising central bank rates that simply reflect the improving economic fundamentals need not be a cause for serious concern.
- Could wages hit the danger zone soon?** As our chart shows, wage growth remains well below the pre-Lehman average. The recent jump in US wage growth to 2.9% yoy in January is not sufficiently high that the Fed would worry it could overshoot the 2% target soon. Depending on how productivity performs, the danger zone for US wages is probably 3.25% or higher. In Europe, where the economic speed limit is bit slower than in the US, the danger zone could be a little lower. Wage growth in the Eurozone (1.7%) and the UK (2.5%) still has a long way to go.
- Productivity matters:** By itself, firming wage growth need not be inflationary. What matters for inflation is how much of the wage rise firms pass on as higher prices. Unit labour costs – the difference between wage growth and work productivity – determine the pass through of higher wage costs to consumer prices. Annual unit labour cost growth in the US (1.3%), the Eurozone (0.9%) and the UK (1.3%) are well below current rates of wage growth. As we recently outlined in [Can productivity growth keep inflation at bay?](#), in the coming years rising investment should boost productivity growth, further dampening the pass through of wage growth to the general price level.
- Central banks – steady as it goes:** The current modest pick-up in wage growth is consistent with central banks withdrawing their stimulus at a continued gradual pace. Expect four 25bp hikes from the Fed this year, followed by two hikes next year. The ECB will likely end its QE in September, before raising rates for the first time early next year. Meanwhile, the BoE will probably hike twice this year and once in 2019. Even though economic growth is above-potential in the US and Europe, the ongoing wage acceleration is only modest. The risk of excess inflation still remains low. Wage growth will need to get much closer to the danger zones before central banks would feel the need to slam the brakes on the upswing. Despite serious market correction, the healthy economic recovery is unlikely to be derailed. But in the unlikely case of noticeable slowdown, inflation risks would be even more subdued and central banks could take it even easier.

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