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GERMAN WAGE NEGOTIATIONS IN PERSPECTIVE

This year's wage negotiations in Germany are threatening to be a much more protracted affair than the deliberations of recent years. German company order books are strong, profit mark-ups have soared, but in real terms, wages are still falling. It is notable that even the politicians, including economics minister Michael Glos, have weighed in on the debate, suggesting higher wage settlements would help spur a recovery in consumer demand. The first public sector strike in 14 years underlines the increased willingness of unions to flex their muscle. IG Metall may well secure more than the 2.7% increase seen last year. But the ECB should not be worried. Even Mr Trichet noted yesterday that "eurozone economies had proved more flexible in adjusting their relative cost competitiveness than previously thought". Strong growth in manufacturing productivity suggests the potential growth path for German at least is someway above the 2.0% widely assumed for Euroland. Instead, the ECB's focus should remain on the continuing acceleration in credit growth, rising commodity prices, and the subsequent impact on credit risks in leveraged sectors of the economy, highlighted in its December Financial Stability Review (FSR). These are more pertinent reasons for hiking rates again next month.

IG Metall In The Driving Seat, But..

After one of the longest stretches of contracting real wages since current records began, German unions are flexing their muscle, and the ECB is watching. This year's negotiations will commence tomorrow, with IG Metall and the employer's group Gesamtmetall some distance apart. Last year's higher than expected inflation reduced the final value of the 2.7% settlement secured during the second year of the 2004 agreement. That in part contributed to the sharp downturn in the real hourly wage data published by the Bundesbank (see chart). However, in nominal terms, the growth in hourly wage rates has continued to slow, dropping to a new low for 2005 of 0.3% y/y. The two combined meant that real wage rates were falling by a record annual rate of 1.6% y/y during the three months to November. This is comfortably the longest decline since current records began. Indeed, IG Metall should consider itself rather fortunate. The average increase in negotiated wages for 2005 was just 1.2% within industry and 1.3% for white-collar employees, less than half that secured by IG Metall, and some way below the 2.0% inflation rate recorded last year.

Of course, part of the decline reflects successful attempts by a number of employers to extend working hours without extra pay, in return for job security. German companies have been using the leverage obtained by the extension of the EU to 25 countries, to good effect. However, the squeeze in real wage rates is not just a reflection of longer working hours. In aggregate terms, national account data show that wages fell in every quarter through 2005. Indeed, the annual rate of decline accelerated from 0.2% y/y in Q1 to 0.5% y/y by Q3. In real terms, that translated into a fall of 1.9% y/y. This was enough to pull the real gain in disposable incomes down to just 0.1% y/y by Q3, compared with a rise of 2.1% y/y at the end of 2004. Self-employed incomes have been strong, and were up 5.1% y/y in Q3. But that was offset by the drop in wages, which fell by a nominal 0.7% in Q2/Q3 on a seasonally adjusted basis.

Against this backdrop, it is hard to see why the ECB would be that concerned if IG Metall secured a modestly bigger rise than last year. Something in the region of 3.0 - 3.5% ought not to be that much of an issue, particularly with manufacturing productivity growth accelerating.

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Latest figures from the Bundesbank show that industry productivity, or output per person hour, was rising at an annual rate of 6.6% in November (compared to 4.1% in the US in Q4 2005). As a result, wages and salaries per unit of output fell by an impressive 5.8% y/y. Furthermore, German companies show no sign of relenting in their battle to squeeze non-wage costs. Friday's announcement of a deal between IG Metall and Volkswagen, which has paved the way for potentially significant job cuts - up to 30,000 according to one company executive - is a case in point.

The continuing squeeze on real wages might, of course, help to explain the perennial disappointment over German consumer spending, with retail sales falling below expectations in December. There has been some doubt over the reliability of the preliminary numbers, which showed a huge fall of 1.4% m/m and a 1.6% y/y decline. The numbers were certainly softer than should have been expected in light of the positive impressions provided by the retailers association, HDE. But even if the numbers are revised up, doubts will remain that consumer demand in Euroland's biggest economy will continue to be held back by real wage deflation.

Indeed, yesterday's news that the retail PMI had fallen back below 50.0 to 49.7 last month reinforced fears that Euroland's recovery could yet stall. The sharp drop reported for France from 51.5 to 46.2 was particularly worrying, but the Italian and German PMIs dipped too. The mood of caution was reinforced by the German new orders data for December, which also fell short of expectations. In mitigation, the 1.6% m/m drop followed three strong months, during which new orders rose by a cumulative 6.2%. Furthermore, the 3m/3m annualised change fell back from 15.4% to 12.9%, but that is still historically very high. Indeed, the 3m/3m annualised rate in domestic orders - which has been lagging the upturn in foreign demand - nudged higher, from 6.2% to 7.2%. And while foreign orders dipped - the 3m/3m annualised rate dropped back from 25.1% to 18.7% - that was still well up from last year's low-point in May, when orders fell 2.2% on a comparable basis.

Nevertheless, the improvement in company order books will make for an intriguing backdrop to this year's wage negotiations. In essence, the success of German companies in forcing through significant restructuring is paying dividends, as the country cements its position as the world's leading exporter and dominant supplier of capital goods. But equally, it may make the Gesamtmetall more pliable, to concede a settlement significantly above last year's 2.7%. For the ECB, that may constitute one reason to accelerate the pace of rate hikes. But in many respects, the ECB should take note from the Ben Bernanke doctrine of high profit mark-ups. In an important speech delivered in early January 2004, the new Fed chairman suggested strong productivity gains and historically high profit margins could provide a significant buffer against rising core inflation. It might be said that it is too early to judge if he was correct, with core inflation in the US accelerating gently. Nevertheless, the transformation in Euroland's economy over the past two or three years could mean that higher raw material costs inflation does not translate into higher core price pressures. The ECB may well may be too pessimistic in assuming that the potential growth path for Euroland's economy is still only 2.0%.

However, it does suggest the ECB should perhaps be focussing their attention elsewhere, most notably, the acceleration in credit growth. The December money supply report showed no let up in the pace of lending, which hit a new high of 9.1% y/y. Lending to households was up 9.4% y/y, but the pick-up in loan growth to corporates has been quite pronounced of late, albeit from a lower starting point. Corporate sector lending was up 8.0% y/y, up from 5.4% y/y a year earlier. And in this respect, Mr Bernanke's assessment of inflation risks in an environment of high mark-ups highlights where the real threat facing Euroland's recovery from rising commodity prices lie. Credit risks are rising in a number of sectors where, according to the FSR, earnings growth has already slowed in cyclical consumer goods, non-cyclcial services and IT.