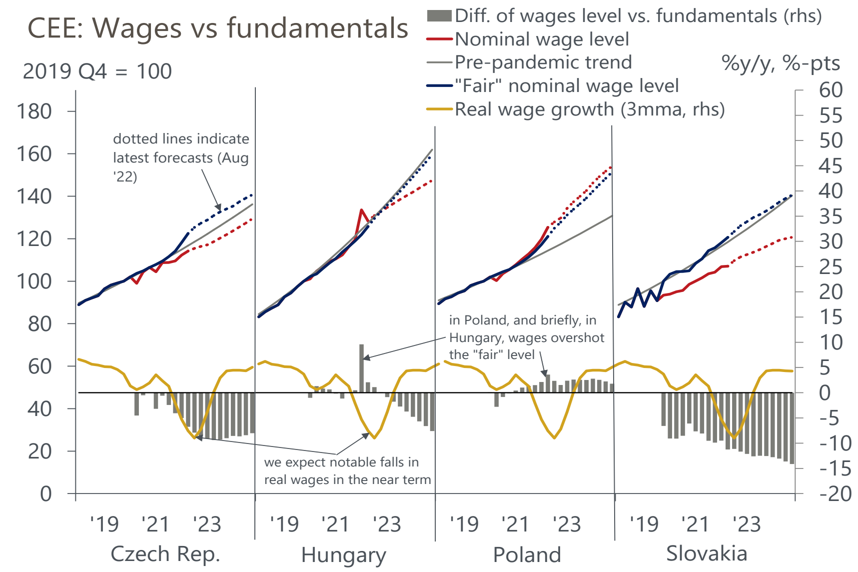
Research Briefing | Europe

Why wage-price spirals will not persist in the CEE

- **The acceleration in nominal wage growth rates in Central and Eastern European (CEE) economies over the past couple of quarters has sparked growing fears of wage-price spirals taking hold in the region. We think such fears are overblown. That said, while we don't expect the self-reinforcing cycles of higher inflation and wage growth to persist, earnings growth is likely to remain elevated, keeping core inflation in the CEE higher for longer.**
- **Several factors mitigate the probability of wages keeping pace with – not to mention exceeding – inflation in the near-term. Historically, high CEE inflation has been associated with subdued growth, and even declines in real wages. This was primarily due to weak labour market institutions, as collective bargaining schemes and indexation remain uncommon. While record-tight labour markets bolster workers' negotiation power, we don't think it will be enough to fuel a sustained wage-price spiral over the coming quarters.**
- **Notably, even if rising inflation is partly responsible for the acceleration in wage growth in CEE post-pandemic, the rebound in activity since 2020 has also played a role, with unit labour cost growth being curbed by rising productivity. But our analysis reveals divergent trends in the region. While wage growth in the Czech Republic and Slovakia strongly underperformed relative to fundamentals to date, pay growth in Poland and Hungary overshot "fair" estimates.**
- **We think the ongoing slowdown in activity will take some pressure off labour markets in CEE. But even without an expectations-based wage-price spiral, the risk of nominal wage growth staying elevated is material, especially in Poland and Hungary, where the breadth of wage pressure and scale of inflation expectations are higher. That is likely to keep core price pressures higher for longer, pressuring the zloty and forint. But if currencies do not weaken in line, the export-reliant CEE economies might see some of the cost competitiveness evaporate, weighing on growth outlook.**

Chart 1: CEE has seen regional differences in nominal wage growth decoupling from fundamentals



Source: Oxford Economics/Haver Analytics

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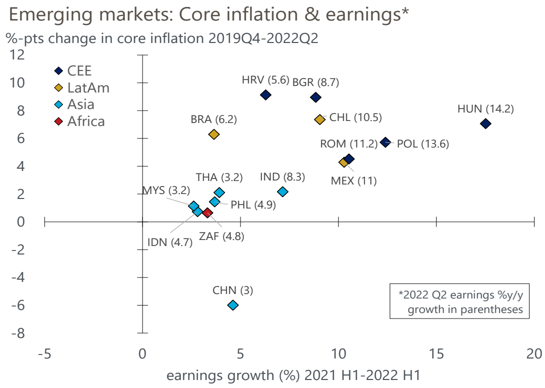
Wage pressures have intensified, feeding fears of a wage-price spiral

Nominal wage growth in CEE (defined here as the Visegrad-4 countries and Romania) has surged over the course of late 2021 and H1 2022. The pickup was remarkable, especially compared to more muted compensation growth increases in AEs and other EMs (Chart 2). In June, nominal wage growth was in the double digits in Hungary (15.4% y/y), Poland (13%), and Romania (11%), with the Czech Republic and Slovakia seeing a bit less pressure (8.1% and 9.8% y/y, respectively).

As inflationary pressures grew and broadened in CEE well beyond those seen in the eurozone (a process we have reported on in the past, see here and here), accelerating wage growth has sparked fears of wage-price spirals, a self-reinforcing process in which workers respond to rising inflation by demanding higher nominal wages, which leads to further price increases, taking hold in the region. We think such fears are largely overblown.

Chart 2: The pickup in wage growth and core inflation in CEE was stronger than in other EMs



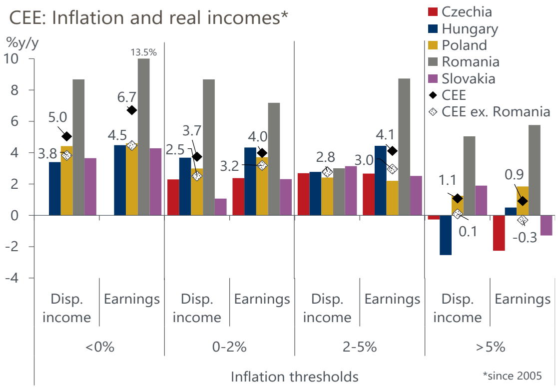
Source: Oxford Economics/Haver Analytics

High inflation in CEE historically leads to lower real wages

Despite nascent signs of wage-price spirals emerging in parts of the CEE, especially Poland and Hungary, we remain sceptical that they will persist. For one, historical experience in the region, in this respect broadly similar to more advanced economies since the 1990s, is that in periods of elevated inflation, nominal wages – and therefore disposable incomes – usually fail to match inflation rates, let alone exceed them. This leads to stagnating, or even declining real (inflation-adjusted) wages and incomes.

Moderate inflation in CEE – that is, between 0%-5% – has historically resulted in growth rates for real earnings and disposable incomes of around 2.8%-3.7% and 4%-4.1% p.a., respectively. But scores tend to be lower once the 5% inflation threshold is breached, with annual growth rates of real wages and disposable incomes dropping to around 1% p.a. and in some cases even below zero (Chart 3).

Chart 3: High inflation in CEE historically curb real-income growth



Source: Oxford Economics/Haver Analytics

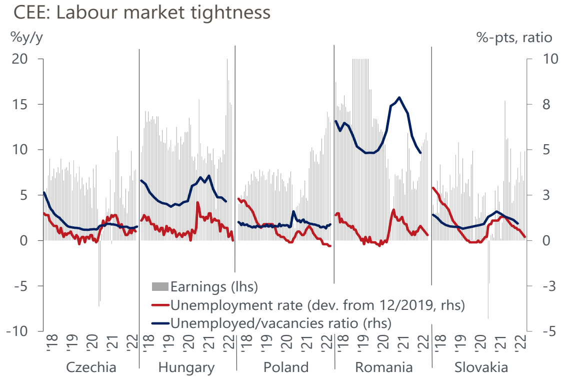
Thus, in the past workers in CEE have struggled to maintain, let alone boost, purchasing power in elevated inflation environments. Let us remember that the ongoing inflationary shock is much more pronounced, with inflation well in the double digits in the region. So, if history is any guide, we would expect a marked fall in inflation-adjusted compensation and income measures.

Tight labour markets are not enough to fuel a spiral

Some argue this time is different, however, due to record-tight labour markets and the scale of the inflationary shock, which may boost the pass-through of wage costs to prices.

Granted, judging by most metrics, labour markets in CEE are record tight, a result of a pickup in the demand for labour following the eurozone sovereign crisis. This led to unemployment rates reaching local troughs shortly before the pandemic, and although the 2020 recession led to a slight rise in joblessness, the rebound in activity has pushed back jobless rates to pre-crisis levels and in some cases even below those levels (Chart 4).

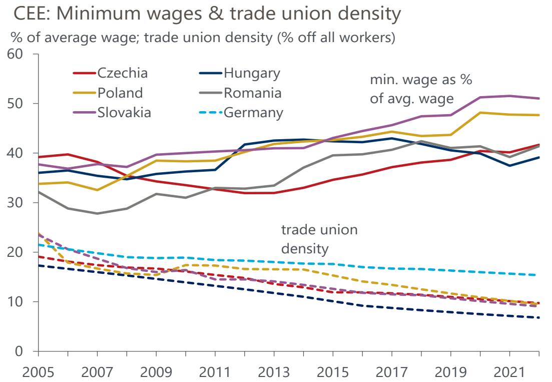
Chart 4: Unemployment rates in CEE remain historically low



Source: Oxford Economics/Haver Analytics

One reason why we don't expect a wage-price spiral to take hold despite record-tight labour markets is the fact that trade unions are less powerful in CEE, compared, for example, to Germany. That means wage negotiations are more decentralized (with only around a third of workers covered by collective bargaining in CEE compared to over 70% in the EU) and workers have less bargaining power. To compensate for the imbalance, governments have used minimum wage legislation, which translated into a growing ratios of minimum-to-average earnings in the region (so-called Kaitz index, Chart 5).

Chart 5: Trade union density in CEE is lower than in Germany



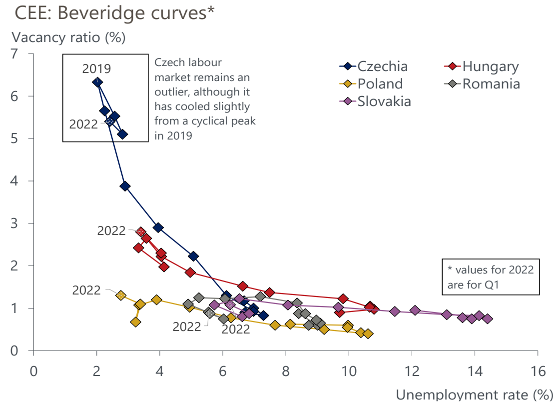
Source: Oxford Economics/Haver Analytics

But minimum-wage adjustments, despite spilling over beyond the lower end of the income spectrum, occur infrequently and, more importantly, are often implemented in a backward-looking fashion. This means that although they partly cushion worker purchasing power, they are broadly insufficient to support a full-fledged wage-price spiral.

Furthermore, a quick look at the Beveridge Curve, which depicts the inverse relationship between the unemployment and vacancy rates, proves informative. As we have explained in detail here, movement to the top left (bottom right) along the curve indicates a tightening labour market, while inward movements of the curve signal a more limber labour market.

Interestingly, in CEE countries where the nominal wage growth picked up most, such as Hungary, and, even more so, Poland, the movement along the curve has been largely horizontal, meaning that the tightening did not trigger a pickup in vacancy ratios (Chart 6). Crucially, given that Czechs have seen milder wage pressure despite elevated vacancy ratios suggests that labour market measures alone do not satisfactorily explain wage growth patterns we have witnessed.

Chart 6: Similar unemployment rates correspond to varying vacancy ratios in CEE



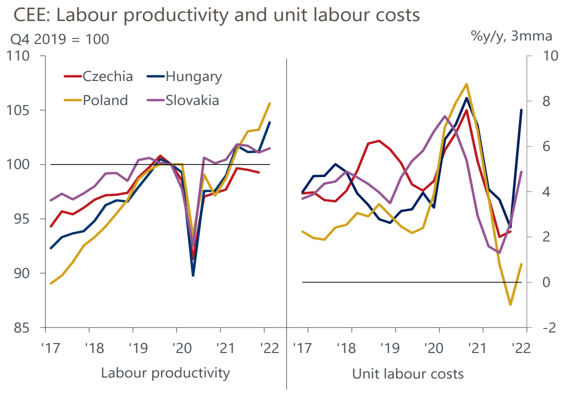
Source: Oxford Economics/Haver Analytics

Seen from this angle, labour markets in Hungary and Poland have a relatively shallow "buffers" in the form of vacancies, and the ongoing slowdown in activity - and therefore labour demand - might quickly translate to a pickup in unemployment, weighing on nominal wage growth. Again, this lowers the likelihood of a wage-price spiral in the near term. In the **Box**, we elaborate on the sectoral dimension of the labour market tightness and wage growth in CEE.

Recent data do not point to a decoupling from fundamentals

A closer look at the recent data suggests that wage growth has not decoupled from economic fundamentals, which is a precondition for a wage-price spiral. First, unit labour costs, which account for changes in labour productivity, grew more slowly in H1 2022 compared to the prepandemic years in the CEE countries. One exception is Hungary, where unit labour cost growth in Q1 2022 was skewed by the generous pre-election bonuses for some public sector employees. Overall, this indicates that some of the recent nominal wage growth pickup can be attributed to the solid rebound in region's output since the pandemic trough (Chart 7).

Chart 7: A rebound in productivity has kept a lid on unit labour costs



Source: Oxford Economics/Haver Analytics

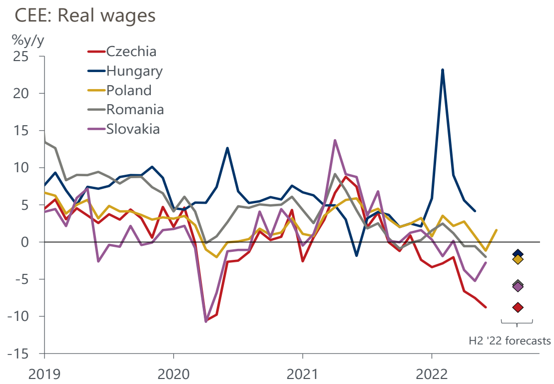
Furthermore, in order to gauge whether the recent acceleration in nominal wage growth has decoupled from fundamentals (core wage pressures, labour market tightness, and output gaps), we have turned to our in-house Global Economic Model (GEM). For each CEE economy, we have generated an alternate path for earnings growth, to see what would happen if wages were driven purely by the model equations. In this way, we were able to calculate the fundamentals-consistent response of wages to the shocks hitting region's economy since Q1 2020 and compare it to the realised values.

The results point to a stark divergence in the region, with wages in Czech Republic and Slovakia staying well below the levels warranted by fundamental factors. On the other hand, Poland, and, more recently, Hungary, have seen wage levels exceeding the benchmark. While the overshoot (relative to the "fair" level) has been limited (Chart 1), at 3.6% and 2.1% for Poland and Hungary, respectively, (both having peaked in Q2 2022, if we ignore Hungarian elections-distorted spike in Q1), it highlights the risk of wage growth staying higher for longer in the two countries.

Elevated wage growth will prolong the fall in core inflation

What does this tell us about the pickup in CEE wage and inflation and its prospects? We think that regional inflation has mostly been driven by external factors (as explained in here), with higher energy and food prices driving inflation. But tight labour markets have allowed wages to keep up with inflation and preserve workers' purchasing power for longer than would otherwise be the case. That, in turn, has supported core inflation, which keeps hitting new highs.

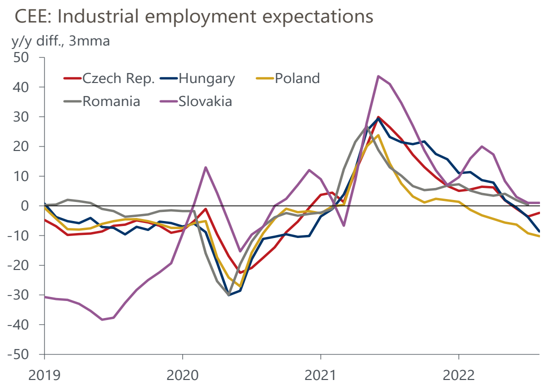
Chart 8: Real wages are either already falling, or will start falling soon in CEE



Source: Oxford Economics/Haver Analytics

And while we expect the ongoing slowdown in activity – with most of the region's economies entering a technical recession in H2 – and policy tightening to gradually cool labour markets in the region and curtail real earnings growth (Chart 8, Chart 9), elevated nominal wage growth will continue to support underlying price pressures.

Chart 9: Employment expectations are worsening in CEE

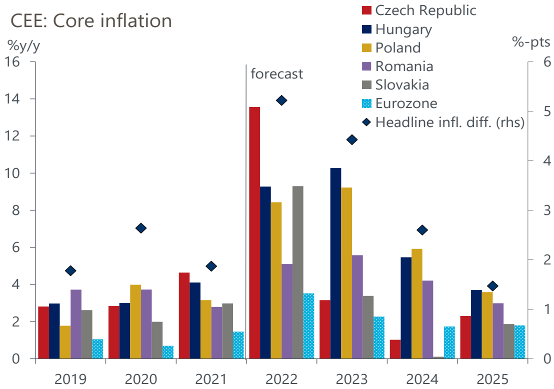


Source: Oxford Economics/Haver Analytics

The effect will be strongest in Poland and Hungary, where wage pressures are broad across sectors (including manufacturing, from where it tends to spill over to other sectors) and where central banks struggle to re-anchor inflation expectations.

Importantly, if our forecast of a deceleration of inflation in the eurozone materialises, this will result in a substantial divergence of inflation levels in 2023-2024 between the eurozone and the CEE (Chart 10). That will keep region's assets under pressure and likely necessitate maintaining a restrictive monetary policy stance for longer. Finally, if region's currencies do not weaken in line, thus keeping real exchange rates steady, the export-reliant CEE economies might see some of the cost competitiveness evaporate, weighing on growth prospects in the medium term.

Chart 10: We expect core inflation to stay elevated in CEE



Source: Oxford Economics/Haver Analytics

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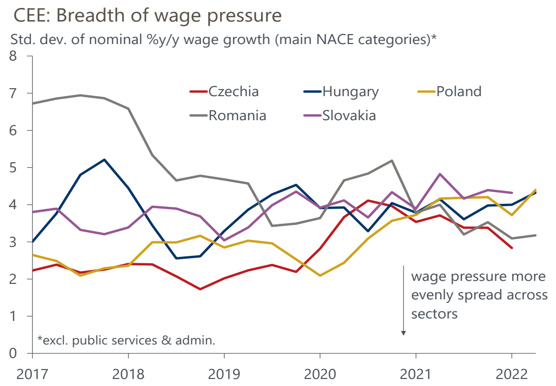
Box 1: CEE labour markets - sectoral perspective

What's going on under the hood of the national aggregates? Arguably, if wage growth is high but concentrated in a few industries, then the overall wage pressure is weaker than implied by the headline number. But a quick look at the measures of compensation dispersion across CEE indicates that this is only partly true for the regional outliers. In Hungary, the standard deviation of wage growth in the private sector of the economy has been moving sideways since mid-2019, indicating that the outsized wage hikes are happening across the occupational spectrum. In Poland, wage pressure was spread out evenly at the onset of the pandemic crisis, and although it has become more concentrated over 2020, there has been no notable pickup in the measure throughout 2021 and H1 2022 (Chart 11).

This indicates that the wage pressure is relatively broad in these countries, reaffirming our call that wage growth is going to decay only gradually, supporting core inflation in the near-term.

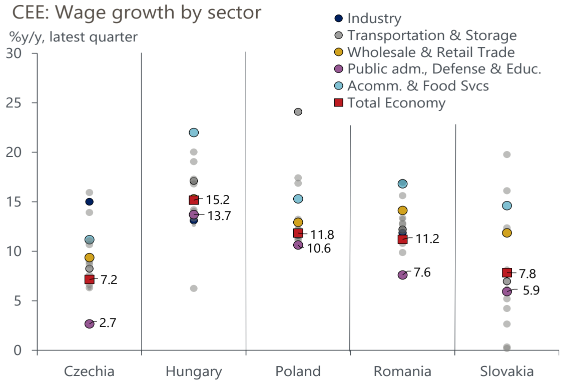
Chart 11: Wage pressure in CEE has not become more concentrated recently



Source: Oxford Economics/Haver Analytics

Furthermore, it is informative to check whether the public sector is not fuelling wage adjustments throughout economy. Again, evidence for that is scant: compensation growth in the public sector has recently been lower than the average in all analysed countries (although the scale of the undershoot varies). Going forward, we expect this state of affairs to continue, as new fiscal commitments, triggered primarily by the energy crisis and new military spending commitments, limit the room for substantial public wage hikes.

Chart 12: Public sector wage hikes have not been the cause of high wage pressure in CEE



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