OECD on wages and profits: Unusually higher profits allow wages to recover without risking an inflationary wage-price spiral

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A recent OECD policy brief updates the 2023 Employment Outlook analysis on wages, profits and inflation. Besides showing that real wages have started to recover from the cost-of-living crisis, the OECD insists that this should not be seen as an inflationary wage-price spiral. This has important implications for monetary policy.

1. Real wage dynamics have turned the corner but losses in purchasing power remain

After significantly declining in previous years, real wages are on the increase in many economies. In the third quarter of 2023, real wages expanded over the past year in a majority (24) of the 34 OECD countries in the analysis. Countries with higher pay rises were h Mexico and the Baltics recording over 5% real wage increases, followed closely by the BENELUX countries, Greece and Spain. Across the 34 OECD countries, real wages increased by an average of 1.27% over this period (see graph A).

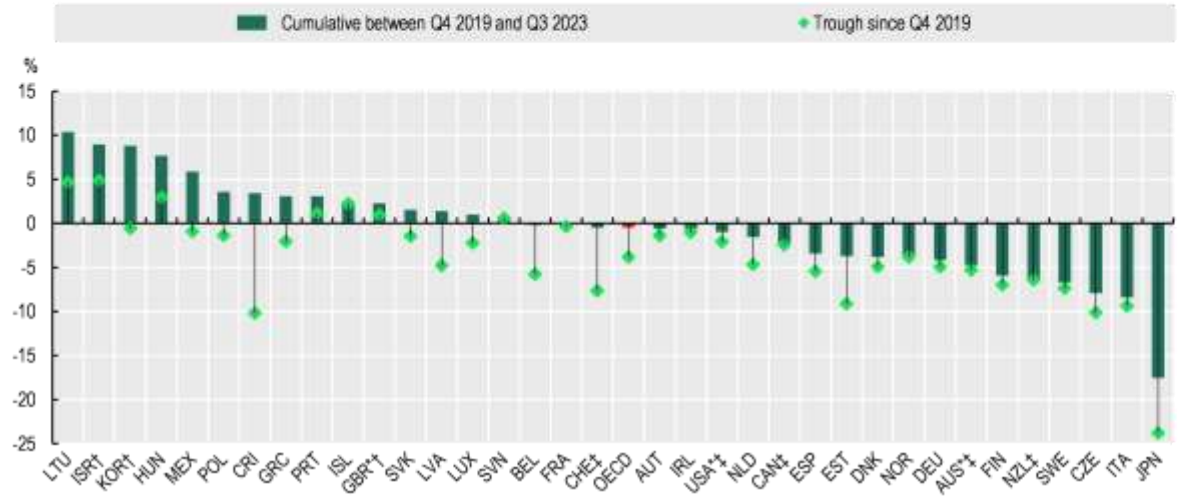
Graph A: Percentage change in nominal and real wages (year-on-year, Q3 2023)

This still leaves ten OECD economies where the purchasing power of wages continued to fall. Cuts are worst in Sweden and Italy.

The recent positive change in real wage dynamics only partly offsets previous real wage cuts. Countries where (real) wages fell the most are usually also those where these failed to catch up with the pre-pandemic level. For example, real wages remain more than 5% below their pre-pandemic level in Japan, Italy, Czech Republic, Sweden, New Zealand and Finland (graph B).

Graph B: Real wages still remain below pre-pandemic level.

Percentage change in real hourly wages



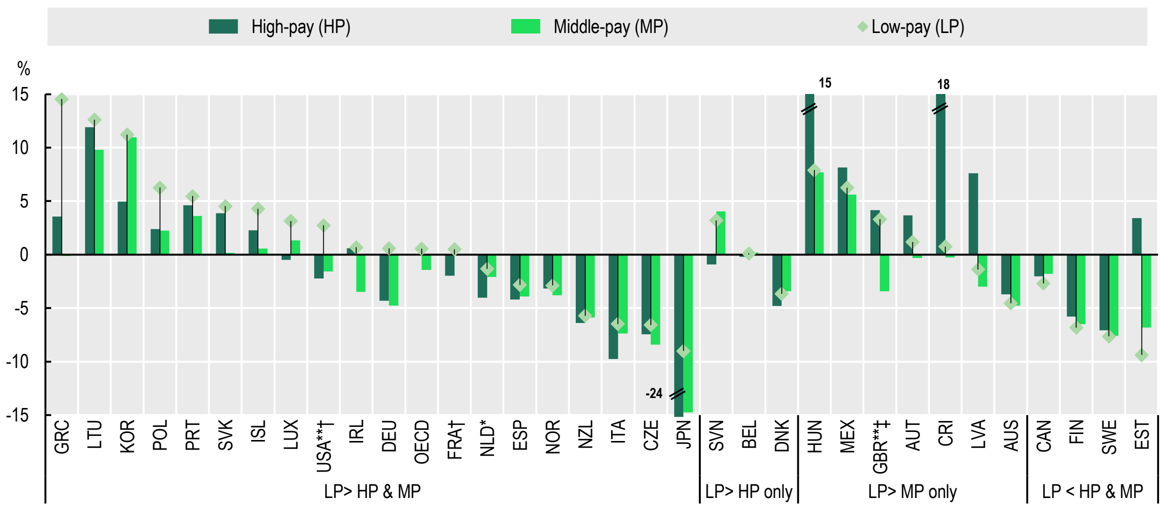
I. 2. Low pay

The OECD also finds that real wages performed better at the bottom of the wage distribution. This is not limited to the US where workers in low pay industries recorded real wage gains whereas workers in high – and middle pay sectors lost purchasing power. Another 18 OECD economies (out of a total of 33 countries with available data) saw real wages perform better in low- pay industries than in higher pay sectors.

However, and as can be seen from graph C, in many cases this does not mean wages in low pay sectors increasing purchasing power but instead real wages declining less compared to higher pay sectors. In Japan, for example, real wages in low-pay sectors fell by 10% while wages in high-pay sectors plummeted by 24%. Estonia provides the counter example: similar to Japan, real low-pay fell by 10% but real wages of high-pay sectors increased.

Graph C: Real wages in low-pay industries performing relatively better in many countries.

Percentage change in real hourly wages between Q4 2019 and Q3 2023



3. Why real wages catching up does not risk inflation.

The 2023 Employment Outlook pointed to the staggered nature of collective bargaining. Negotiated wages do not immediately and fully adjust to unexpected inflation but remain at their level until new negotiations take place. Adjusting to a sudden or unforeseen increase in prices takes place over several years, with subsequent collective bargaining setting higher-than usual nominal wage increases to gradually catch up with the increased cost-of-living.

As the OECD argues, equating this process with an inflationary wage-price spiral is not correct. First, once the catch-up has been achieved, wage growth is expected to go back down to more moderate rates.

Second, during the catch-up, the impact of higher-than-usual wage growth will be offset by declining prices in global energy and other critical inputs, allowing inflation to continue its descent.

Third, as businesses have more flexibility to increase the price of their products and services than workers have to change already negotiated wages, they were able to increase prices much earlier and more than justified by the increase in input costs. Higher profit margins then provide space to absorb higher-than-usual wage increases without the latter driving inflation.

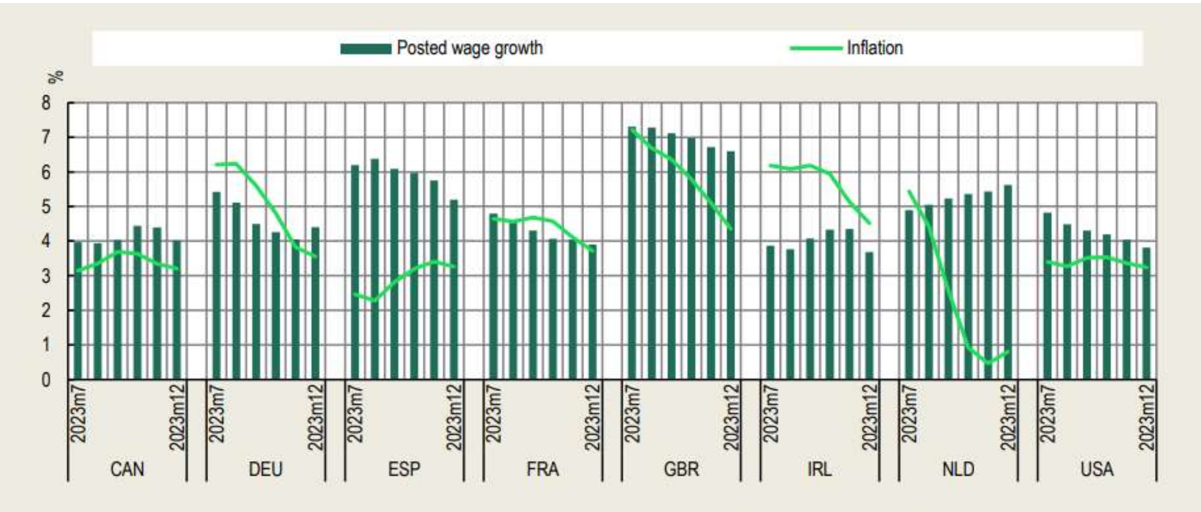
The 2023 Employment Outlook already documented the evidence for these three processes interrupting the connection between wages and inflation. For example, it calculated that profits margins (estimated as profits per unit of output) had increased 20% from quarter four of 2019 to quarter one of 2023.

The latest OECD wage bulletin confirms that two of these processes are at play.

Looking at leading wage indicators, such as the wages advertised by companies when posting vacancies, reveals that a substantial decline of wage dynamics is in the pipeline or that wages, in the case of the US and Canada, have returned to a more moderate rate of growth (see graph IV). Another indication, referred to but not shown in the OECD publication, is the ECB's wage tracker. It reports that collective bargaining agreements concluded in the last quarter of 2023, are estimated to trigger 3.5% nominal structural wage growth over the next year. This is substantially down from around 5% wage growth concluded in previous 2023 bargaining rounds.

Graph D: Posted wages point to a recent slowdown in nominal wage growth.

Year-on-year percentage changes, three month moving average, from July 2023 to December 2023



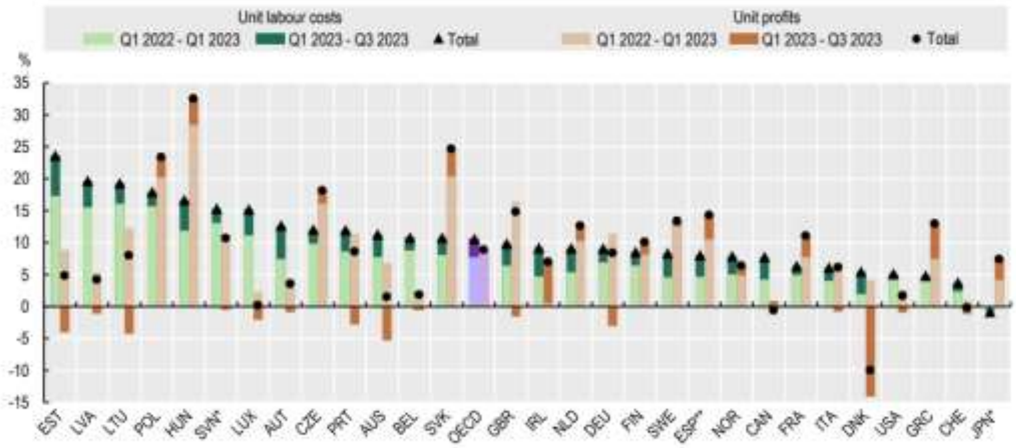
Note: The posted wages are the average year-on-year percentage changes in wages and salaries advertised by job postings on Indeed.
Source: Indeed Wage Tracker (https://github.com/hiring-lab/indeed-wage-tracker); OECD (2024), "Prices: Consumer prices", Main Economi
Indicators (database), https://doi.org/10.1787/0f2e8000-en (accessed on 21 February 2024).

The OECD wage bulletin goes deeper into the extent to which increased profit margins act as a buffer to finance non-inflationary wage growth. While the turnaround in real wage dynamics is lifting unit labour cost growth, profits per unit of output have fallen in 17 countries over the first three quarters of 2023 (graph E, note the orange bars going into negative territory).

At the same time, graph E also shows that the recent fall in profit margins in these 17 countries still leave room for profits to prevent price pressures from the process of real wage catch-up. As the OECD states "Unit profits remained above their levels of early 2022 in all countries with available data, except Canada, Denmark and Switzerland" (note the round black dots in the graph, with the majority of black dots in positive territory, indicating that the increase in profit margins since the start of 2022 has still not been completely dialled back).

Graph E: Profits are beginning to buffer some of the increases in labour costs

Percentage changes, seasonally adjusted



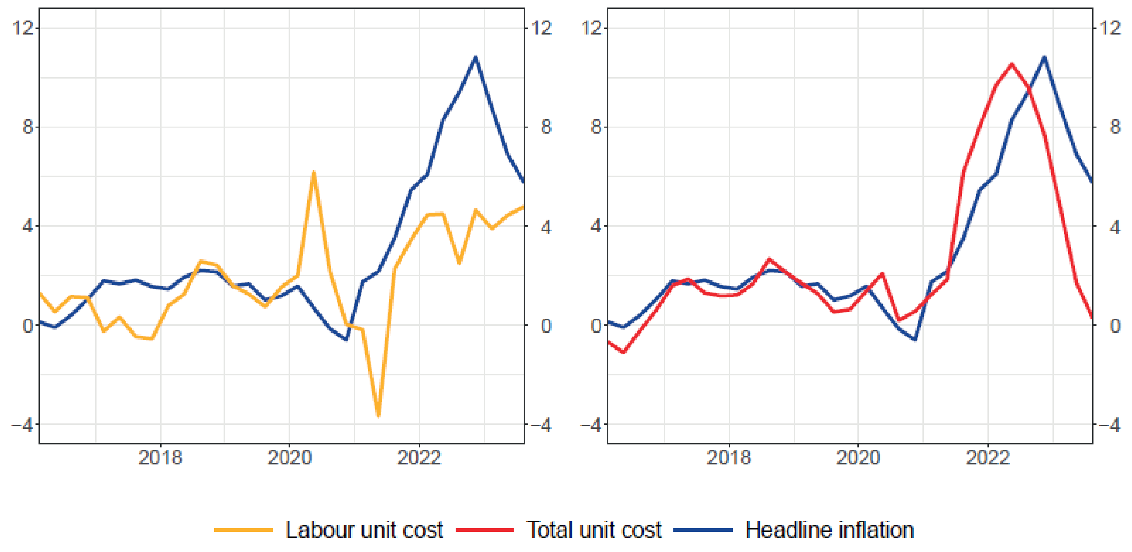
Note: OECD is an unweighted average of the countries shown above. For countries marked with * changes refer to the period from Q1 2022 to Q2 2023. For countries marked with ** changes refer to the period from Q1 2022 to Q4 2023. For Norway, the data are based on mainland Norway. Unit labour costs and unit profits are calculated by dividing compensation of employees and gross operating surplus respectively, by real GDP. For Japan and Norway, gross operating surplus is approximated by deducting compensation of employees from nominal GDP – and

4. The OECD should have taken one more step

What about the remaining mechanism whereby the decline in the price of critical inputs also provides room for wages to temporarily grow faster and catch up with purchasing power lost? The OECD update unfortunately does not refer to this. However, a recent estimate from the Bank of Italy, focussing on three main euro area countries (Italy, Germany, France) is illuminating (see graph EF. Recalling that wages account for a relatively smaller share of overall business costs (40%) than energy and intermediary goods and services (60%), the Bank of Italy notes that total unit costs have recently come to a standstill. Unit labour costs are rising by 4% in these euro area economies but are fully offset by falling prices of non-labour inputs. This strengthens the conclusion that robust wage growth making up for past purchasing power losses will not trigger a wage-price spiral. In future work, the OECD would be advised to broaden their analysis to look at the role total unit costs play in determining inflation outcomes for all OECD countries.

Total unit cost, labour unit cost and headline inflation in the euro area (1)

(percentage changes on year-earlier period)



Sources: Based on data from Destatis, Eurostat, Insee and Istat.
(1) Quarterly data. Percentage changes compared with the year-earlier period. Estimates based on the data for France, Germany and Italy. Unit costs are calculated as the ratio of total costs to total output in real terms.

Conclusion

This publication from the OECD's Employment, Labour and Social affairs department is valuable to get monetary policy right. Currently, , central banks intend to keep monetary policy restrictive, even if inflation has already come down substantially, as they argue that there is a risk of strong wage dynamics feeding inflation. The OECD analysis shows that this concern is not justified and that both declining input prices and unusually high profit margins provide space for wages to catch up without risking inflation. Monetary policy makers should use his information to rebalance their approach: the focus needs to shift from imaginary inflationary wage-price spirals to real risks to jobs, economic activity and financial stability created by keeping interest rates high for longer.

Finally, requiring wages to stay low and not regain lost purchasing power is not distributionally neutral. Businesses are very unlikely to pass falling non-labour input costs onto sales prices. If wages do not increase, businesses will have another round of corporate greedflation by pocketing falling non-labour costs as extra profits.