

Box 2

RECENT DEVELOPMENTS IN EURO AREA WAGE DRIFT

There are several indicators of nominal labour costs in the euro area.¹ In this context, wage drift refers to the part of compensation per employee growth which is not explained by growth in negotiated wages and salaries, and/or social security contributions. Wage drift is therefore an important additional measure of inflationary pressures stemming from the labour market. This box presents an estimate of euro area wage drift and discusses its determinants over the business cycle.

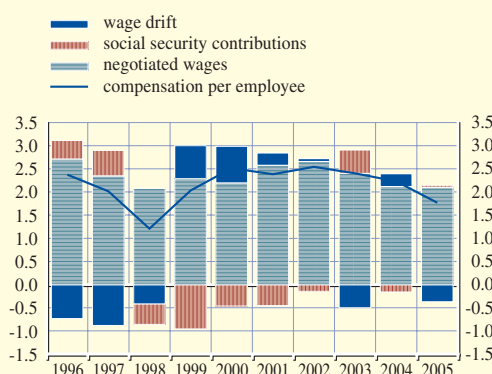
From a conceptual point of view, negotiated wages and salaries can be considered as the basic component of labour costs. During the bargaining process, employees and employers agree on contractual increases in basic pay for a given period of time. This is done on the basis of recent and expected economic developments, such as productivity growth and labour market conditions. However, economic conditions at both the firm and aggregate levels can evolve during the duration of the wage contract. As re-negotiating wage contracts is costly, they therefore often allow for additional elements, such as performance-based bonuses or compensation for overtime. The growth in wages and salaries actually paid thus differs from that of negotiated wages, and the gap between the two is defined as wage drift. The wage drift component is thus more likely to capture the effect of changes in economic conditions, such as improving labour market conditions, in the short term. As a result, measuring and understanding developments in the wage drift becomes particularly important for assessing the short-term wage outlook.

¹ For a discussion of the conceptual and statistical differences between these indicators, see Box 4 entitled “A comparison of the available labour cost indicators in the euro area: conceptual differences and their behaviour in the period 1999-2002”, in the June 2003 issue of the Monthly Bulletin.

Actual data on the wage drift component of compensation are not available and need to be estimated. For the purpose of estimating euro area wage drift, the euro area indicator of negotiated wages as compiled by the ECB is assumed to provide a useful statistical representation of contractual basic pay. However, two caveats of this indicator need to be considered in this context. First, the negotiated wages series is based on an aggregation of non-harmonised national data. Second, in some euro area countries, backward-looking wage indexation clauses that adjust wage growth based on ex post realisations of inflation still exist. These clauses are generally not reflected in the indicator of negotiated wages. As a consequence, in case these clauses are activated, the measured wage drift may also reflect the effects of previously negotiated wage indexation. As regards wages and salaries actually paid, growth in compensation per employee provides the most reliable data source.

Compensation per employee and wage drift in the euro area

(annual percentage changes; annual data)



Sources: Eurostat, ECB and ECB calculations.

Taking these caveats into account, an estimate of the annual growth in the euro area wage drift is constructed as a residual component of annual growth in compensation per employee, after subtracting both growth in employees' and employers' social security contributions, and the growth in negotiated wages. The chart shows the annual growth rate of compensation per employee in the euro area decomposed into these three components, including an estimate of the euro area wage drift from 1996 to 2005. Given the data caveats mentioned above and the fact that the wage drift is measured as a residual item, these estimates should be assessed with caution.

The results of the decomposition show that, compared to negotiated wages, wage drift contributes much less to overall compensation per employee developments. Despite this, the wage drift component provides some information about the cyclical profile of compensation per employee growth. During the recent period of low real GDP growth, the wage drift has been small or negative with a trough at -0.5 percentage point in 2003. Beyond somewhat lower growth in negotiated wages, wage drift has been slightly negative on average in the last four years and is thus estimated to have contributed to moderate nominal wage developments. This negative contribution of wage drift follows three years of positive wage drift between 1999 and 2001 – a period of relatively strong economic activity in the euro area. These developments seem to confirm the nature of wage drift as the wage component that reacts to short-term changes in economic activity and labour market conditions. Beyond the contribution of wage drift, it is worth noting that growth in social security contributions also varies significantly over time. This contribution to overall wage growth was particularly large and negative in the period between 1998 and 2002, to some extent dampening the upward impact of positive wage drift on wage growth.

The short time period available for evaluating the determinants of wage drift makes it difficult to quantitatively pin down what is driving developments in wage drift. As also suggested by the

evidence in the above chart, wage drift is likely to be related to cyclical factors. During economic expansions, as demand and output rise and labour markets tighten, components of the wage drift, such as overtime or bonus payments, are likely to increase faster than basic pay in certain industries, regions or occupations. Furthermore, unexpected developments in factors that determine collectively agreed wages (e.g. deviations from expected productivity growth) and labour market conditions are likely to play an important role. However, owing to the measurement problems mentioned above, the effects of wage indexation clauses are also captured in estimated wage drift. As inflation has in recent years often surprised on the upside, the backward-looking nature of some wage contracts may have caused upward deviations of compensation per employee growth from negotiated wage growth. Lastly, wage drift is also influenced by factors of a more structural nature. For instance, shifts in the composition of the labour force and changes in the coverage of collective bargaining can influence the wage drift.

At the current juncture, little information is available about the extent of wage drift in the first half of 2006. Recent data on labour costs point to a gradual and moderate increase in nominal wage costs. In view of the prevailing economic conditions, close monitoring of the wage outlook is called for, in particular to avoid the emergence of second-round effects from past inflation increases in wage determination.