The Economist

Finance and economics | Recession response

Europe's economy is in a bad way. Policymakers need to react

Wage growth now appears to be fizzling out

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IMAGE: GETTY IMAGES

European stocks and bonds have had a lot to deal with in recent years, not least war, an energy crisis and surging inflation. Now things are looking up. Germany's dax index of shares has added 11% since the start of November. Yields on French ten-year government bonds have dropped from 3.5% in October to 2.8%. Even Italian yields briefly fell below 4%, from 5% in mid-October. Investors are upbeat in part because inflation is falling faster than expected. Yet their mood also reflects a grimmer reality: the economy is so weak that surely interest-rate cuts are not far away.

Will policymakers follow through? In November inflation stood at just 2.4%, within a whisker of the European Central Bank's 2% target. Markets are pricing in two cuts by June, and another three by October, to bring down the main rate to 2.75%, from 4% (see chart 1). Economists are less sure—they expect only the first cut by June. "The most recent inflation number has made a further rate increase rather unlikely," admitted Isabel Schnabel, a hawkish member of the ecb's executive board, recently. But there have been no hints of cuts. Certainly nobody expects one at the meeting on December 14th. At a time when Europe's economy is weakening quickly, officials risk being slow to react.

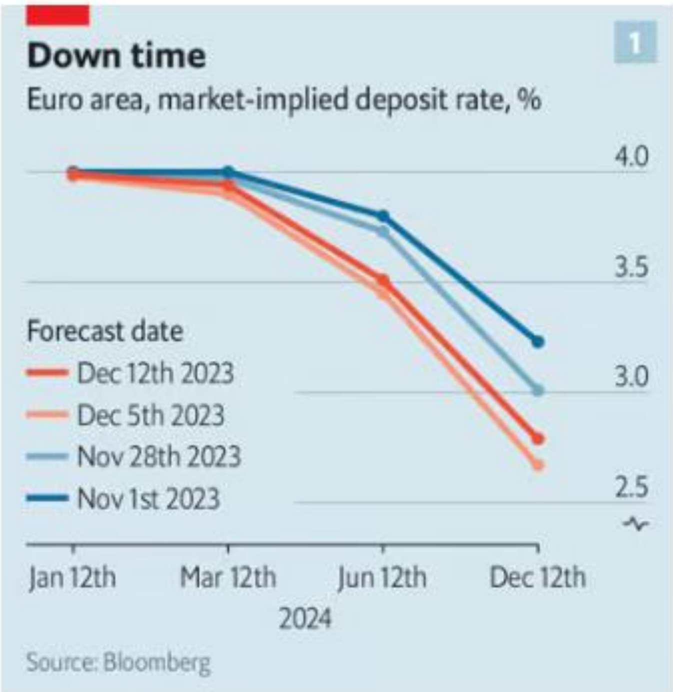

IMAGE: THE ECONOMIST

There are two reasons for particular concern. The first is wage growth. Initially, euro-zone inflation was driven by rising energy prices and snarled supply chains, which pushed up the price of goods. Since pay deals are often agreed for a number of years in Europe's unionised labour market, wages and prices of services took longer to respond. As a result, by the third quarter of 2023 German real wages had fallen to roughly their level in 2015. Now they are recovering lost ground. Similarly, Dutch collectively bargained wages grew by almost 7% in October and November, compared with a year earlier, even as inflation hovered around zero. Overall wage growth in euro-zone countries is about 5%.

IMAGE: THE ECONOMIST

If such wage growth continues, inflation might tick up in 2024—the ecb's great fear. Yet there are signs that it has already started to slow. Indeed, a hiring platform, tracks wages in job advertisements. It finds that pay growth on listings has come down (see chart 2), suggesting that wages will soon follow. Moreover, wage growth does not always lead to inflation. Corporate profits, which saw a bump in 2022 when demand was high and wages were low, might take a hit. There is some indication that margins have started to shrink.

The second reason for concern is the health of the overall economy. It has struggled with weak international demand, including from China, and high energy prices. Now surveys suggest that both manufacturing and services are in a mild recession. A consumption boom in parts of Europe is already fading: monetary policy itself is weighing on bigger debt-financed purchases and mortgage-holders are scaling back to meet larger monthly payments.

Declining market interest rates ought to ease financial conditions for both consumers and investors, and therefore reduce the need for the ecb's officials to move quickly. However, there is a catch. As Davide Oneglia of ts Lombard, a research firm, points out, these lower market interest rates mostly reflect falling inflation, and so do not produce lower real rates. As a result, they are unlikely to do all that much to stimulate demand.

There is one more reason for policymakers to get a move on. Interest-rate changes affect the economy with a delay: it takes time for higher rates to alter investment and spending decisions, and thus to lower demand. The full brunt of changes in rates usually takes a year or more to be felt, which means that many of the ecb's rate rises are still to feed through. Policymakers have probably tightened too much.

The flip side is that rate cuts in the next few months would not affect the economy until towards the end of 2024, by which time few analysts expect inflation still to be a problem and many expect the economy still to be struggling. By then, the ecb's policymakers will want to be close to the bloc's "neutral" interest rate, which is somewhere between 1.5 and 2%, reckons Mr Oneglia, lest they continue to push down demand. Starting early would mean that the ecb would avoid having to cut too aggressively during the summer of 2024.

January's inflation data could be volatile, in part because government-assistance schemes introduced during the energy crisis are being phased out. An increase would make the ecb even more cautious. Wage data is published with a long lag in Europe, and officials are often reluctant to rely on real-time indicators, such as the data published by Indeed. That is why economists do not expect rate cuts until June, much later than suggested by current market pricing. The ecb was too slow to react to rising inflation. Now it runs the risk of being too slow on the way down as well.

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