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A Snapshot of Major Economy Productivity and Costs

Summary

One important theme during 2024 has been the transition of G10 central banks toward easier monetary policy. That said, even as major central banks have transitioned to rate cuts, many have continued to highlight concerns around wages and services inflation as well as a lack of productivity. In this report, we examine wage, productivity and labor cost trends across the G10 economies to offer insight into how inflationary pressures could evolve and how respective central banks may approach their monetary easing cycles.

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Table of Contents

G10 Central Banks Cautiously Transition Toward Monetary Easing

One important theme so far during 2024 has been a significant, albeit cautious, change in approach to monetary policy from major economy central banks as they have started to get the upper hand in their respective inflation battles. After a pronounced global tightening cycle and a sustained period of restrictive monetary policy, an ebbing of inflation pressures has allowed many G10 central banks to begin lowering policy interest rates. The Swiss National Bank was the first major economy central bank to deliver a rate cut in March, and has been joined by many other peer major economy central banks since. However, even as G10 central banks transition to monetary easing, some have continued to express concern about elevated wage growth and lingering inflation pressures, especially in the services sector. Over time, the views of select central banks have evolved, with the focus of concern shifting from elevated inflation to unexpected weakness in employment and economic growth. In that context, market participants continue to question how quickly monetary easing of various G10 central banks will progress. In this article, we examine major economy productivity and labor costs with the aim of offering insights into the potential pace of G10 central bank monetary easing.

The evolving central bank landscape is best illustrated by the evolution of policymaker commentary over the past several months and quarters:

- Early this year the Federal Reserve was attentive to inflation risks and needed “greater confidence” that inflation was moving sustainably toward its target. Given some easing in wage growth and a pickup in productivity, the Fed no longer views the labor market as a source of elevated inflationary pressures. With an increased focus on the employment aspect of its dual mandate, the Fed appears to be on the cusp of easing monetary policy.
- The European Central Bank (ECB) and Bank of England (BoE) have both delivered initial rate cuts; however, even as both central banks have begun their monetary easing cycles they remain concerned about underlying inflation pressures—including those from services inflation and wage growth—which might lend itself to more gradual paces of monetary easing.
- The Bank of Canada (BoC) and Reserve Bank of Australia (RBA) are two other central banks that have expressed an attentiveness toward the ways that labor market developments—such as wage or productivity growth—can affect the inflation outlook. The BoC has cut rates by a cumulative 75 bps so far, though continues to express some caution toward wage growth and services inflation. While noting improving inflation trends, the BoC has said “wage growth remains elevated relative to productivity.” Finally, the RBA has remained vigilant on wage and productivity growth. The central bank has said inflation remains high and sticky, and that there are upside risks to inflation due to high unit labor costs, as wage growth is “above the level that can be sustained given trend productivity growth.”

Other central banks have also focused on wage, productivity and cost trends at times in their monetary policy announcements. Certainly from a theoretical perspective the interaction of wages, productivity and unit labor costs is a relevant influence behind cental banks' assessment of inflationary pressures. Wage gains that are not matched by productivity increases could make the production of goods and services more costly, input cost pressures that firms could potentially pass onto consumers in the form of higher prices. In contrast, a combination of slowing wage growth or rising productivity could reduce cost pressures, potentially leading to lessening inflation trends over time.

Measuring Wages, Productivity and Unit Labor Costs

Having established the significance and relevance of productivity and labor costs for G10 central bank policymakers, a comparison of these productivity and cost developments can potentially offer insight into how different central banks from different countries may approach their respective monetary easing cycles.

Of course, the main difficulty, in our view, in providing a snapshot of productivity and costs across countries is identifying data that is comparable and timely enough in order to provide sufficiently useful insight. By necessity, there will always be some-tradeoffs involved. For our purposes, we believe the productivity and cost figures produced by the Organization for Economic Cooperation and Development (OECD) offer the best compromise. The data are quarterly in frequency, and include:

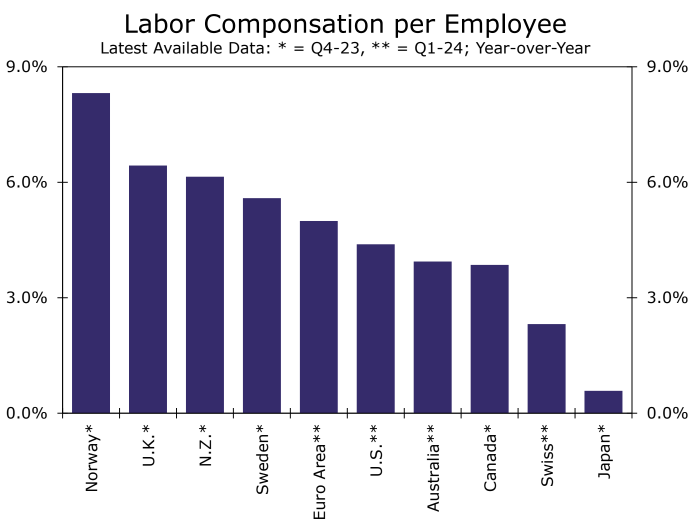
- Labor compensation per employee (a proxy for wage growth)
- GDP per person employed (a proxy for productivity)

- Unit labor costs (employment based)

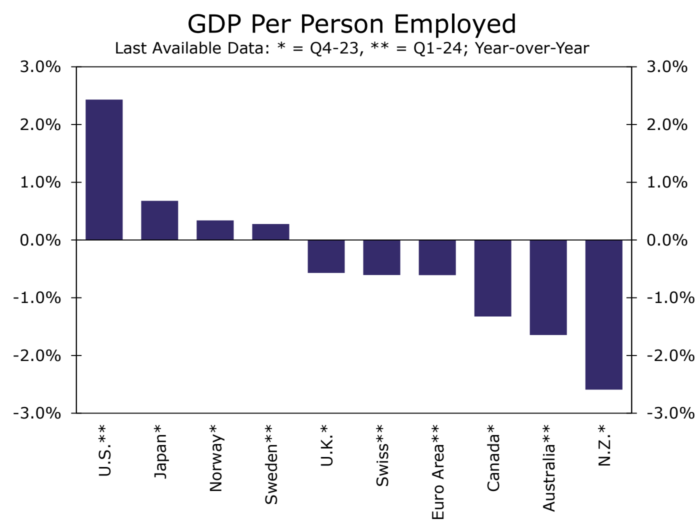
Depending on the exact measure or economy chosen, the latest available data are for either Q1-2024 or Q4-2023. In that sense and because some data will relate to slightly different time periods, the figures are not ***fully*** comparable. That said, we still think they are comparable enough, and recent enough, to provide some insight into the economic environment the respective central banks face, and the approach those central banks may take.

Looking first at ***labor compensation per employee***, it's clear why many central banks continue to express concerns about elevated wage growth. Until very recently, several economies and regions fell into the high wage growth category, which for this analysis we define as gains of 5% year-over-year or higher. These include New Zealand (6.1%), Norway (8.3%), Sweden (5.6%), the United Kingdom (6.4%) and the Eurozone (5.0%). A few fall into a moderate wage growth category of 2.5% to 5.0%, including Australia (3.9%), Canada (3.9%) and the United States (4.4%). Only a couple fall into a low wage growth category, including Japan (0.6%) and Switzerland (2.3%).

Of some note, and with the exception of Japan, recent wage growth is also significantly above the levels that prevailed from 2010-2019. Depending on the country, recent wage growth is anywhere between 1 percentage point to 5 percentage points above the levels that prevailed during that decade. Finally, in terms of the most recent developments, while some economies saw a slight easing in wage growth in late 2023 and early 2024 period, wage growth was steady-to-stronger in recent quarters in Canada, Norway, Sweden, Switzerland, the United States and the Eurozone during that period. With the possible exception of Japan and Switzerland, recent wage developments in our view offer at least some caution against easing monetary policy at an excessively rapid pace.

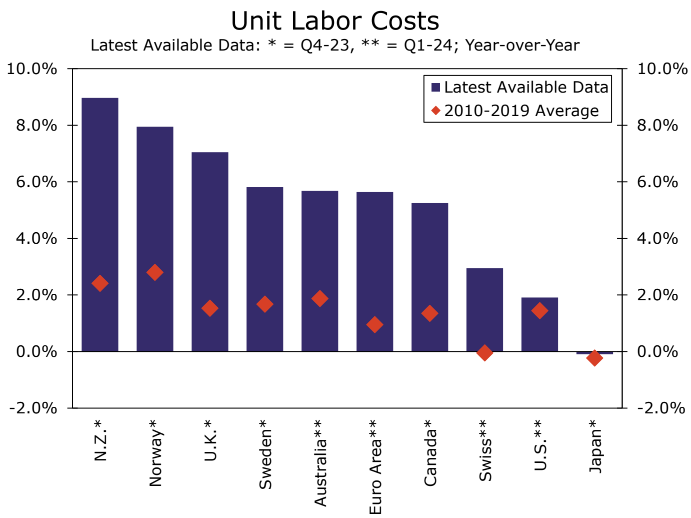


Source: OECD and Wells Fargo Economics



Source: OECD and Wells Fargo Economics

The concerns emanating from elevated wage growth are compounded, we believe, by the recent underwhelming productivity performance of most major economies, as measured by***GDP per employed person***. Among the major economies, only in the United States has there been any significant uptick in productivity, with the latest figures showing GDP per employed person rising 2.4% year-over-year. This in part might reflect an accelerated path toward the utilization of Artificial Intelligence (AI) technology, not necessarily in terms of the adoption of the technology in everyday use, but in terms of the build-out and infrastructure required to support the eventual widespread use of AI across the economy. A few countries have shown rather modest productivity gains, including Japan (0.7%), Norway (0.3%) and Sweden (0.3%). Many countries and regions, however, have shown a cyclical downturn in productivity during the most recent quarters. The most recent figures indicate productivity declines in Australia (-1.6%), Canada (-1.3%). New Zealand (-2.6%), Switzerland (-0.6%), United Kingdom (-0.6%) and the Eurozone (-0.6%).



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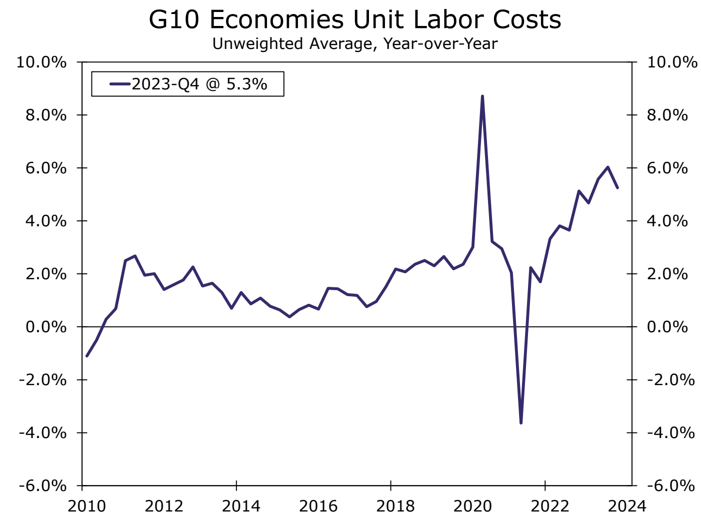

Source: OECD and Wells Fargo Economics

The lack of any perceptible productivity increase for many economies to offset elevated wage trends acts to exacerbate overall cost pressures. In fact, combining the labor compensation and productivity estimates above, the OECD calculates and estimates ***Unit Labor Costs***—as the name suggests, the cost of labor required to produce a unit of output. Here, the contrast in cost pressures across the major economies becomes even more stark. For the most part, growth in unit labor costs are rising well in excess of 5% year-over-year or more, perhaps explaining why services and domestic inflation (areas that are more heavily influenced by wage and labor costs) are proving stubbornly persistent across many economies. Among the economies where the most recent figures are showing accelerated growth in unit labor costs are Australia (5.7%), Canada (5.2%), New Zealand (9.0%), Norway (7.9%), Sweden (5.8%), United Kingdom (7.0%) and the Eurozone (5.6%). Unit labor cost growth is moderate in the United States (1.9%) and Switzerland (2.9%). Only in Japan are cost pressures absent, with unit labor costs dipping 0.1% year-over-year at the most recent reading. Overall, however, considering elevated wage growth and recent disappointing productivity trends, growth in unit labor costs is in many cases running around 4 to 6 percentage points above the averages from the 2010-2019 period, a potential source of costs pressures that could contribute to some persistence in inflation.

While not directly comparable to the OECD figures, data from national statistical agencies for more recent quarters are nonetheless illuminating. For the ***United States***, labor compensation per hour and unit labor costs both slowed slightly further in Q2, reinforcing the trend of reducing costs pressures. In ***Canada***, hourly compensation saw some slowing through Q2, also translating to some moderation in unit labor costs, an encouraging development. In the ***United Kingdom***, a combination of some pickup in productivity in Q1 combined with some deceleration in hourly compensation has contributed to some slowing in unit labor cost growth, though likely still elevated at around a 5%-6% pace. And finally, Q2 data from ***Australia***'s national statistical agency indicated growth in unit labor costs that are still running in excess of 5% year-over-year.

Potential Implications For Inflation, Monetary Policy

Our assessment of productivity trends and labor cost pressures offers, in our view, some potential insights into the outlook for inflation and monetary policy across the major economies. To be sure, mapping labor cost pressures to inflationary trends is not a mechanical or one-for-one exercise. Several inflationary influences, including among others commodity prices, corporate profit margins and exchange rate fluctuations, can also act to influence inflationary trends. Moreover, the trade-off we highlighted above in identifying a data source that is sufficiently comparable as well as sufficiently timely means that key insights will be somewhat generic. With these caveats in mind, we still see some broad takeaways from this snapshot of productivity and cost trends across the major economies.

- **The Federal Reserve could deliver a relatively forceful and somewhat truncated rate cut cycle.** Unit labor pressures are much lower in the United States compared to most other G10 economies, potentially offering the greatest potential for a reduction in underlying inflation trends and thus rapid rate cuts. Moreover, more highly productive economies are likely to be associated with higher neutral or long-run policy interest rates. This combination suggests a relatively aggressive and short-lived monetary easing cycle from the Fed, consistent with our view for Fed rate cuts to come to an end by mid-2025.

- **Slower and steadier policy easing from Australia, Canada, Sweden and the Eurozone.** Unit labor costs for these economies were running between 5%-6% in late 2023 and early 2024, while these regions have also shown cyclical declines in productivity to varying degrees. That suggests that underlying inflation might decelerate only slowly for these economies, while somewhat lower productivity could also equate to a somewhat lower terminal policy interest rate. That backdrop suggests a steady and orderly pace of interest rate reductions. Indeed, some of these central banks that have begun lowering interest rates in a relatively regular manner (Bank of Canada, Riksbank) might still need to pause at times during their monetary easing cycle.
- **Lingering inflation concerns in New Zealand, Norway and the United Kingdom.** Unit labor costs for these countries are still growing in excess of 6%, while the United Kingdom and New Zealand are experiencing cyclical productivity declines. Services and underlying inflation might take longer to abate, or be more subject to upside surprises, than for other major economies. Thus, although the Bank of England and Reserve Bank of New Zealand recently delivered initial rate cuts, we think these central banks are most at risk of needing to pause, and for longer than expected, during their respective monetary easing cycles.
- **In Switzerland and Japan, limited cost pressures means only limited need for policy restriction.** We characterize Switzerland and Japan as relatively low growth economies with limited labor cost pressures. For the Swiss National Bank, that suggests few near-term impediments to further rate cuts. For the Bank of Japan, that suggests a sustainable increase in underlying inflation trends could remain something of a challenge, suggesting some risk of more gradual rather than more rapid monetary tightening.

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