Flash

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What effects from the different way in which labour markets function in comparison with the past?

In all regions (United States; euro zone and Japan), the way the labour markets operate is different from the past even when there is a return towards full employment. Income sharing continues to be distorted at the expense of wage earners, a fact we can undoubtedly account for by competition from emerging countries.

If this new modus operandi *of the labour markets persists and is confirmed, very different cyclical developments from the past will also have to be expected:*

- *monetary policies will not become restrictive, and yield curves will remain flat, the consequence will be a support factor for asset prices and indebtedness, an increased and more durable role played by debt and wealth effects in bolstering activity, and expansion will likely last longer;*

- *the end of the cycle will not result from the return of inflation or the deterioration in profitability and the rise in interest rates, but from the excess indebtedness, or the corrections of bubbles in asset prices, i.e. an end of the cycle linked to private agents' behaviour and not from the action of central banks aimed at keeping matters under control and the determinants of inflation, i.e. in all likelihood greater financial fragility at the end of the cycle.*

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A new way of operating of labour markets

In all likelihood, competition from low wage cost emerging countries has **durably reduced labour's bargaining power in job markets**, due to the risk of offshoring, outsourcing into emerging countries, job losses in industry, and so forth.

This loss in labour's bargaining power is well illustrated by the fact that since 2001 **profit rates have risen everywhere (Chart 1),** whereas prices of commodities have soared, and this shows that **companies have been able to reduce wage costs to a greater extent than was needed to cover the rise in input prices**.

This can be seen in the **significant divergence between productivity gains and real pay rises (Charts 2A, 2B** and **2C)**.

Chart 1
Profits after tax and interest (as % of GDP)

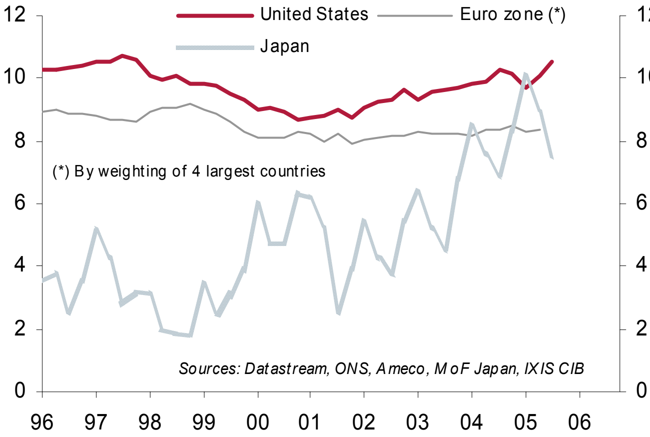


Chart 2A
United States: Real wage and productivity (Y/Y as %)

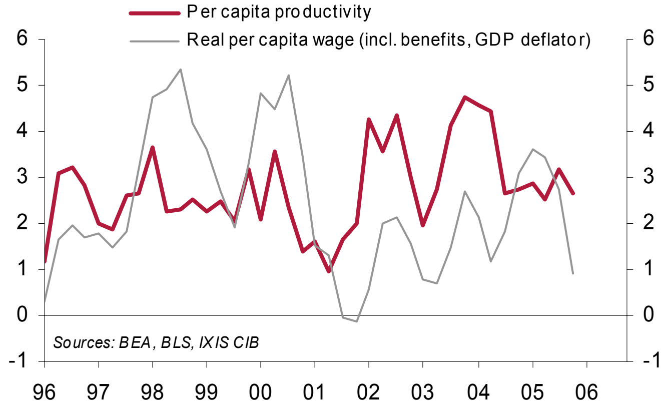


Chart 2B
Euro zone: Per capita productivity and real wage (Y/Y as %)

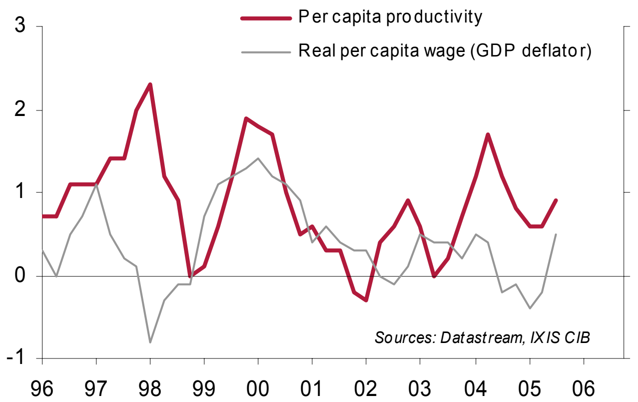
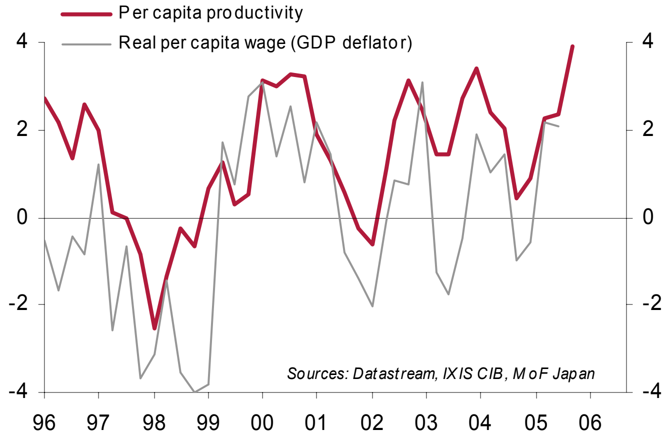


Chart 2C
Japan: Productivity and real wage (Y/Y as %)



The important point in terms of what follows is that **this loss in labour's bargaining power leads to the disappearance of the link between real wages and unemployment (Charts 3A, 3B** and **3C)**.

Chart 3A
United States: Unemployment rate and real per capita wage (Y/Y as %)

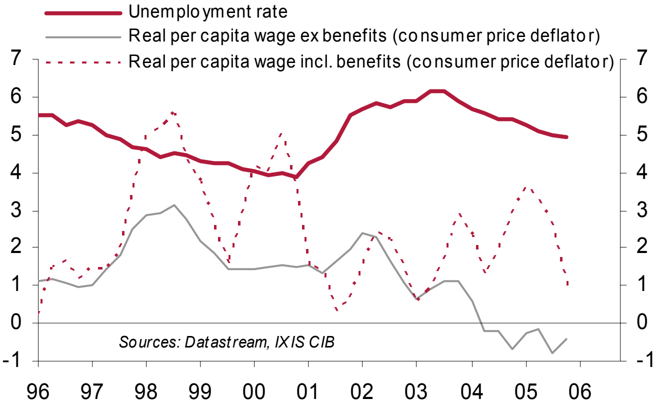


Chart 3B
Euro zone: Unemployment rate and real per capita wage (Y/Y as %)

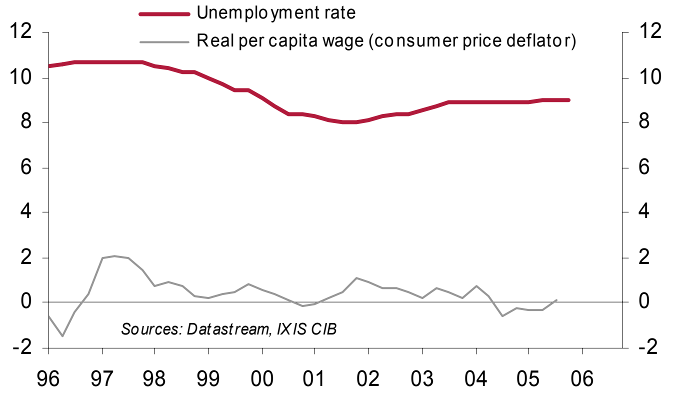


Chart 3C
Japan: Unemployment rate and real per capita wage (Y/Y as %)

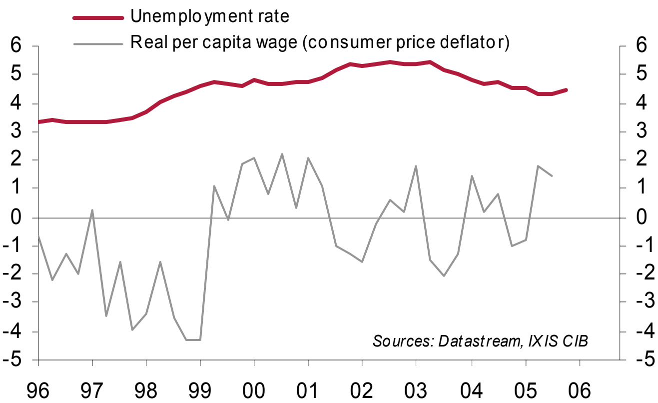
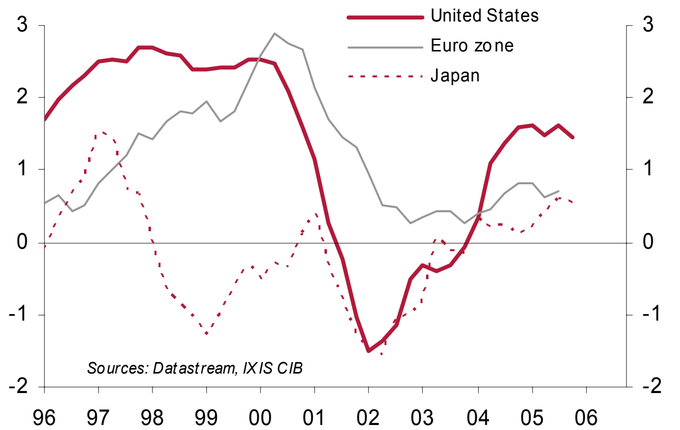


Chart 4
Total employment (Y/Y as %)



Even when unemployment declines and there is job creation (United States, Japan recently, **Chart 4**), the fact that wage earners no longer have bargaining power implies **that they can no longer benefit from the fall in unemployment to obtain higher pay rises**. The recent situation in the United States **(Chart 3A)** perfectly illustrates this change.

We accordingly can see **very low rises (declines in Japan) in unit wage costs and, therefore, in underlying inflation, despite the improvement in the labour market (Charts 5** and **6)**.

Chart 5
Unit wage costs (Y/Y as %)

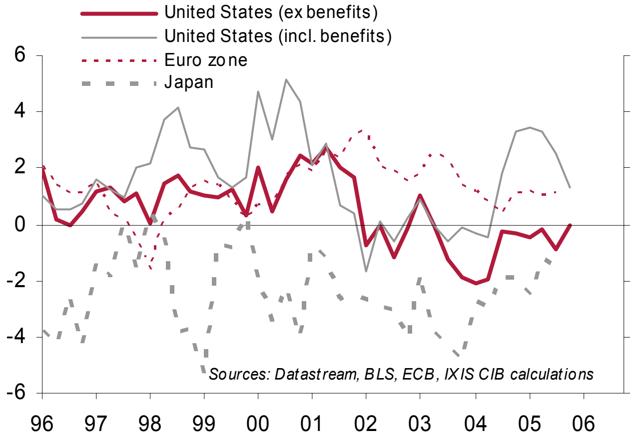
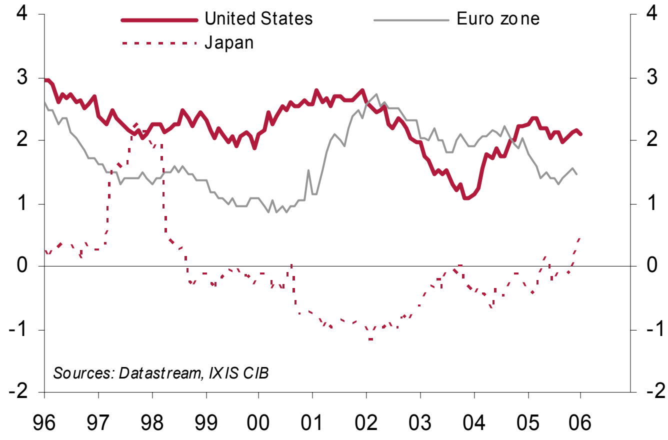


Chart 6
Underlying inflation (Y/Y as %)



We suppose that this mechanism will persist due to durable competition from emerging countries.

What changes during the cycle?

We first look at the effects, during the growth cycle, of the weakening in labour's bargaining power.

If unit producer costs and underlying inflation do not increase despite the improvements in the labour market, one has to expect:

- **monetary policies to head back towards neutrality but not become restrictive**, as is currently the case in the United States and the euro zone **(Charts 7A** and **7B)**, with low real short-term interest rates;

- **a further rise in asset prices linked to interest rates**, i.e. in equities and real estate **(Charts 8A, 8B** and **8C)**. In the current cycle, such a rise began very early for property, but more belatedly (2003 and especially 2005) for equities.

Chart 7A
Key intervention rate

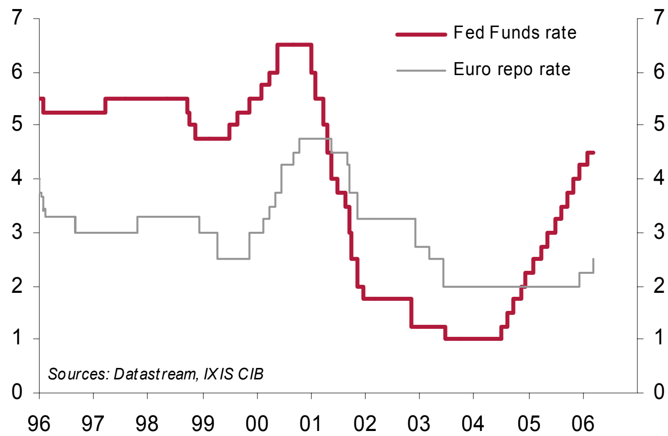


Chart 7B
Real key intervention rates (deflated by CPI)

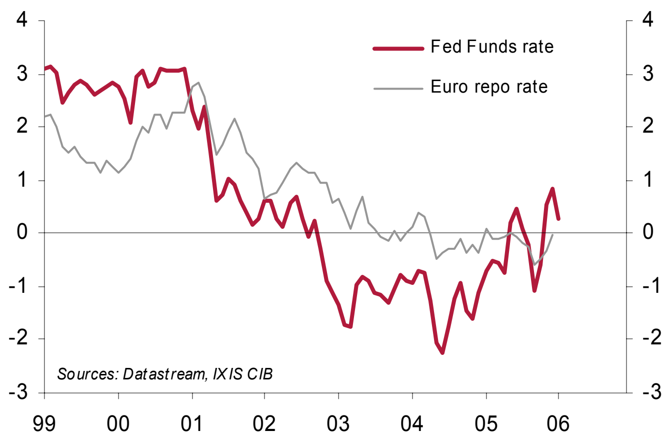


Chart 8A
Stock-market indices (1996 = 100)

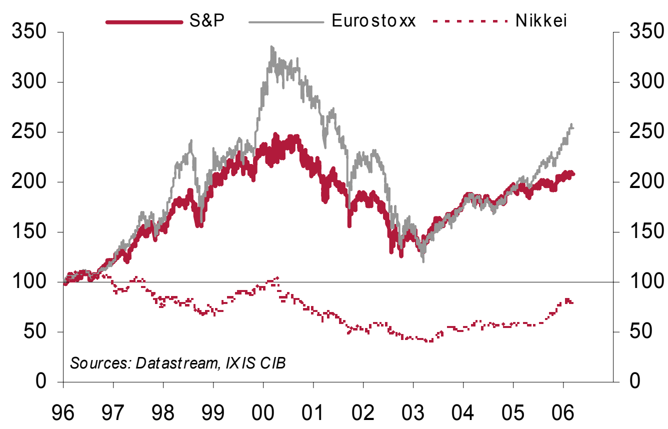


Chart 8B
Stock-market indices (2004 = 100)

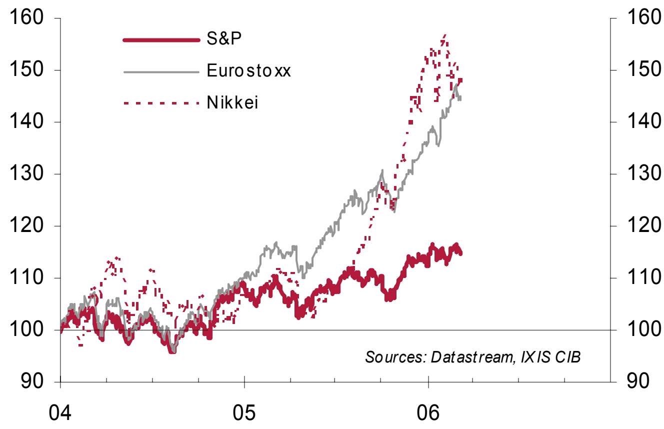
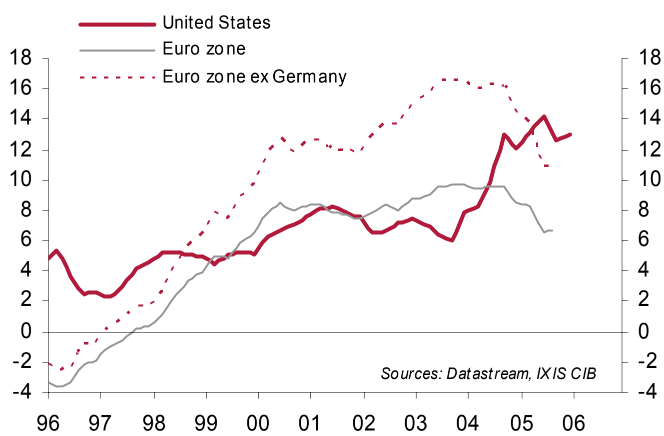


Chart 8C
Real estate prices (Y/Y as %)



If monetary policies do not become restrictive, and if asset prices continue to rise, by consequence, **this growth cycle should be characterised, in comparison with previous ones** (e.g. 1993-2000) by:

- **real interest rates remaining at a lower level (Chart 9)**; the real long-term interest rate is now close to 1%, against 4% in the growth cycle of the late 1990s;

- **debt ratios rising further**, for companies as well as households **(Charts 10A, 10B, 11A** and **11B)**; the corporate debt ratio was still very low in 2005 in comparison with its peak in 2001 in the United States; it is already slightly higher in the euro zone; while household debt ratios in 2005 were already far higher than in 2000;

- **asset prices increasing to a greater extent and more durably (Charts 12A** and **12B)**.

Chart 9
Real 10-year interest rate (deflated by CPI)

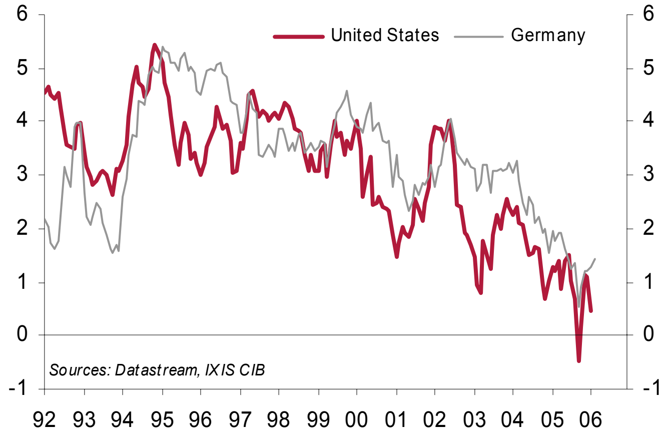


Chart 10A
United States: Business loans and corporate debt load

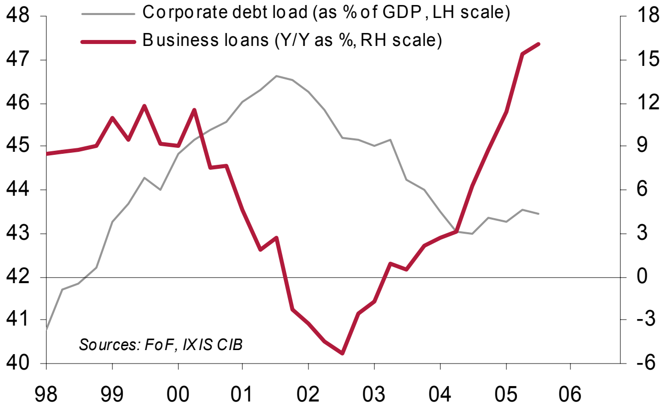


Chart 10B
United States: Loans to households and household debt load

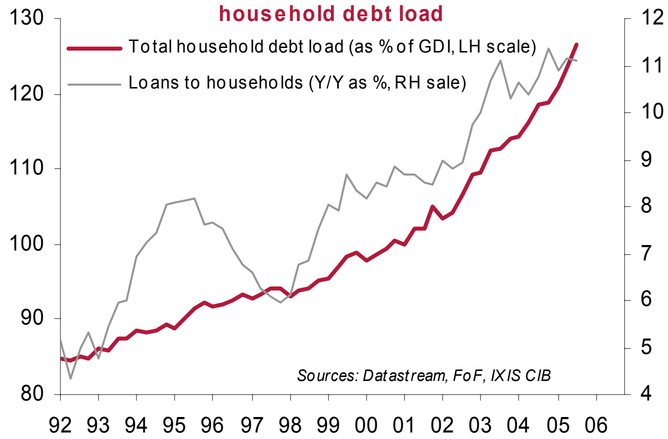


Chart 11A
Euro zone: Business loans and corporate debt load

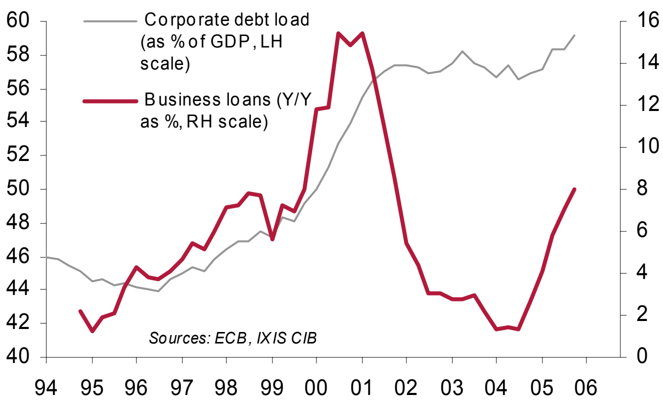


Chart 11B
Euro zone: Loans to households and household debt load

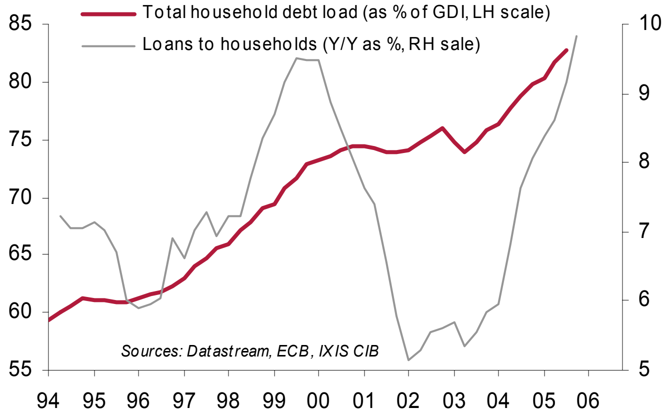


Chart 12A
United States: Stock-market capitalisation and real estate prices

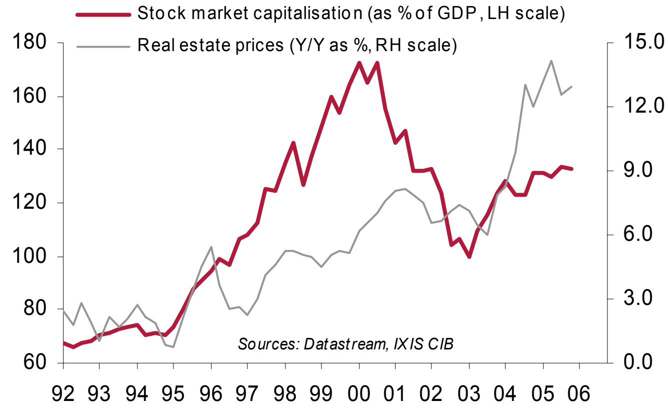
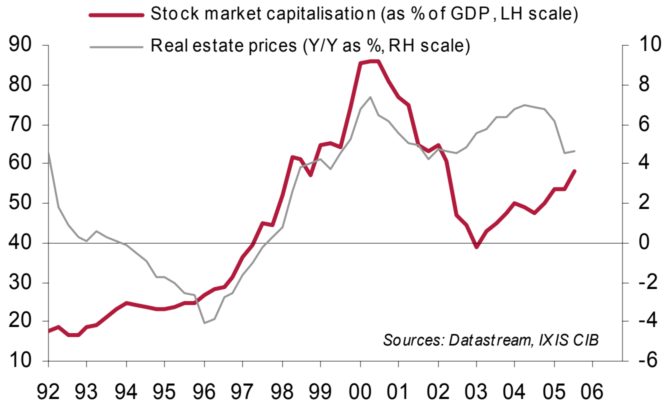


Chart 12B
Euro zone: Stock-market capitalisation and real estate prices



Clearly, property prices have surged in the United States and the euro zone since 2003, while there has been a noteworthy recovery in the European stock market since 2005, but not yet in the US stock market. The difference is undoubtedly due to the problems encountered by companies' pension funds, which imply that US institutional investors are not switching back into equities.

All in all, the current growth period could:

- **last** if inflation does not reappear;
- **be dominated by growth in indebtedness and by wealth effects,** taking over from income growth in terms of sustaining demand.

What changes are to be expected at the end of the growth cycle?

The above suggests there will **normally be significant changes in the way in which a growth cycle ends**:

- **the return of inflation and, by consequence, a rise in real interest rates, would no longer lead to the end of expansion**, since wage costs are no longer increasing, if the new *operandus modi* of the labour market persists, even though the unemployment rate is low. The foregoing means that the mechanism, repeatedly seen in the past, which interrupts growth — i.e. the tightening in monetary policy, for example in the late 1980s and late 1990s in the United States **(Chart 13)** — would not operate;
- **nor would there be a contribution to the end of growth from the deterioration in profitability any more,** as in the late 1990s in the United States, owing to a sharp rise in real wages **(Chart 14)**, if the improvement in the situation of the labour market no longer drives real wages upwards. We saw, in late 2005, a subdued rise in real wages and a further improvement in the profit rate.

Chart 13
United States: Inflation, key intervention rate and real GDP

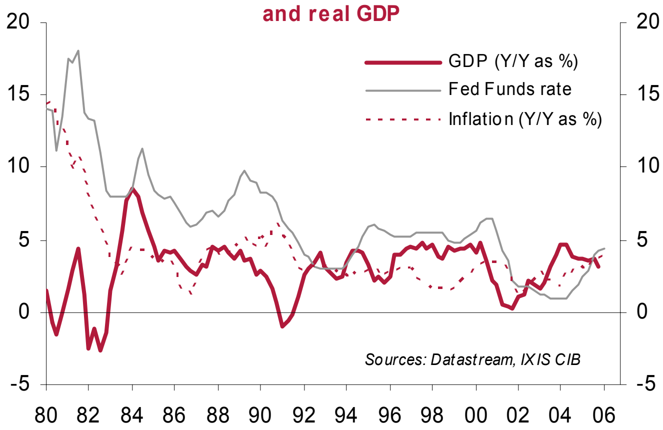
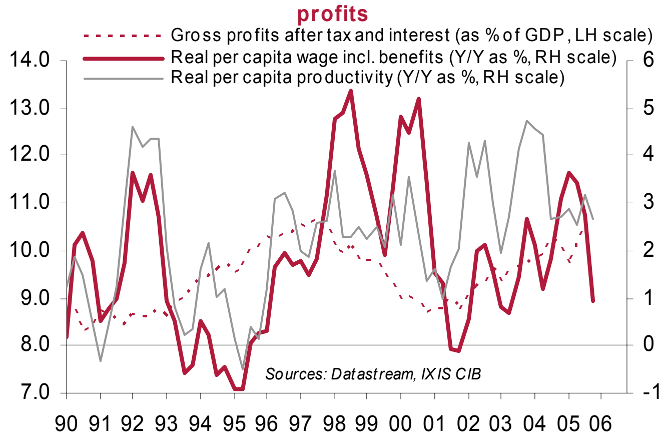


Chart 14
United States: Real wage, productivity and profits



A decline in profitability can bring a growth cycle to its end either directly by reducing business investment and stock market prices, or indirectly by contributing to price rises.

The above means, in particular, that the **end of the growth cycle would no longer result, in the future, from the keeping in check of inflation (thus activity) by central banks. The end of the growth cycle would therefore result in the future from a reaction of private economic agents** (companies or households) **due to excess indebtedness, or a rise in asset prices.**

Already, in 2000-2002, the downturn in stock market prices (of IT companies) and the induced need for corporate degearing played a significant role in the contraction in activity, in the United States and Europe **(Charts 15A** and **15B)**.

Chart 15A
United States: Nasdaq, business loans and real GDP

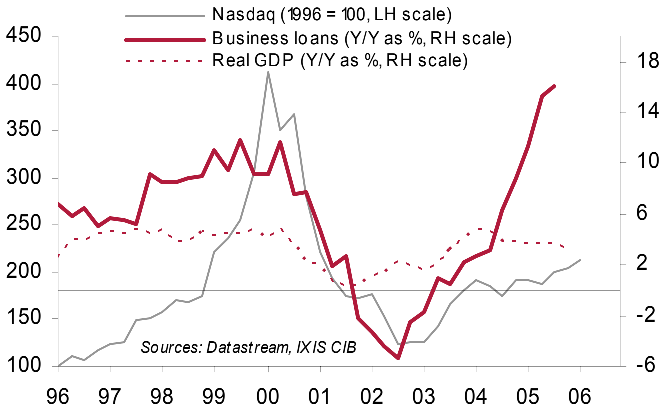
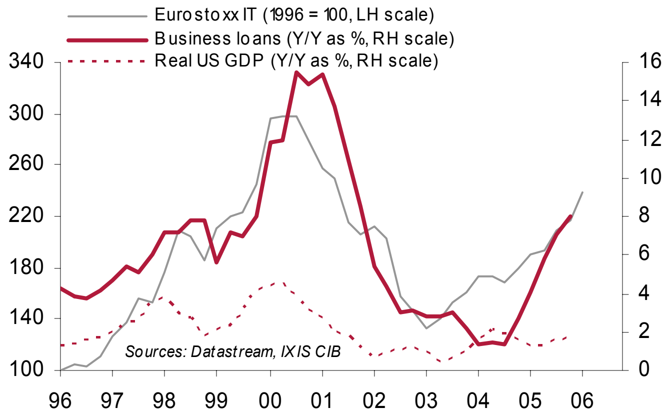


Chart 15B
Euro zone: Eurostoxx IT, business loans and real GDP



The effects of excess indebtedness and excessive rises in asset prices on the end of growth cycles could therefore be expected to be even more pronounced in the future, and would appear without being triggered by a tightening in monetary policies.

Conclusion: Increased financial fragility, and a "private" end of expansion cycles

We start off from the hypothesis, which we believe likely, according to which **the *operandus modi* of labour markets has deeply and durably changed**, due to competition from emerging countries, offshoring, and so forth.

Labour's bargaining power has markedly weakened, and even in the countries where unemployment is low, the share of wage earners in added value has shrunk while real wages do not accelerate.

This can have **very important implications**:

- **during expansion phases**: the lack of underlying inflation, enabling accommodating monetary policies to be maintained and, therefore, greater use of indebtedness, a larger rise in asset prices; an **increased role played by debt and the wealth, and a smaller role played by income**, since real wages hardly rise, **in terms of explaining growth;**

- **at the end of expansion phases: the downward cyclical reversal is no longer due to a tightening in monetary policy or the inflation risk; it thus no longer results from economic policy, but from the financial fragility of private economic agents**: excess debt, hence degearing; and over-valued asset prices, leading to a choking-off of demand for these assets and a fall in their prices.