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**July 17, 2024**

# ECB's Labor Market Nerves on Show

## ECB set to maintain Sintra tone

- "Exceptionally benign" labor market limits ECB space
- ECB will seek to keep easing on agenda
- Upside risk to wage growth from further fiscal expansion

## ECB policy space continues to face wage constraints

Compared with the June meeting, tomorrow's ECB decision is not expected to be eventful. Much of the necessary communication on the upcoming policy path was provided at the Sintra Forum, and ECB President Lagarde will probably repeat her speeches from the event in the post-decision press conference. Yet, for once the focus of interrogation for the Governing Council will probably not be on monetary policy per se, but the potential impact of the next French government, whose leadership is yet to be determined.

As the second round of French legislative elections was being held after Sintra, per the norm most of the ECB commentary at the event was scrubbed of political commentary. The election itself was a surprise – the ECB would almost certainly have considered changing dates for the forum if there was a vote in a core Eurozone country scheduled well in advance. As we recently highlighted, Lagarde omitted her commentary from the 2023 speech when she cited public-sector expansion as one of the key drivers of inflation, as the sector itself suffered from weak productivity – not the kind of language a central bank would like to use during a hard-fought election campaign. As Mme. Lagarde served in a previous French government, she would be particularly attuned to political sensitivities surrounding the ECB. President Macron himself called for "bolder monetary policy" only weeks before.

Ultimately, she chose to characterize the labor market as “exceptionally benign,” but in a policy context this is much more relevant to wage growth, which remains stubborn. In the paragraph where she uttered the phrase, she noted that growth was “near the bottom of that range [of previous soft-landing episodes],” which was an acknowledgement that the Eurozone economy was not performing particularly strongly. On an outright basis we can see that both the French and German (Exhibit #1, top and bottom, respectively) labor markets are decelerating sharply. Even considering the seasonal summer recovery in service-sector openings, the drop has been quite pronounced. Based on the current Purchasing Manager Indices (PMIs) in the Eurozone, manufacturing or non-services job openings in general are likely falling at an even faster pace. The bottom line is that the post-pandemic labor demand surge has come to an end and total job openings will continue to decline as the economy continues to moderate. Even in a soft-landing scenario this should normally translate into materially lower wage growth, which hitherto has been elusive.

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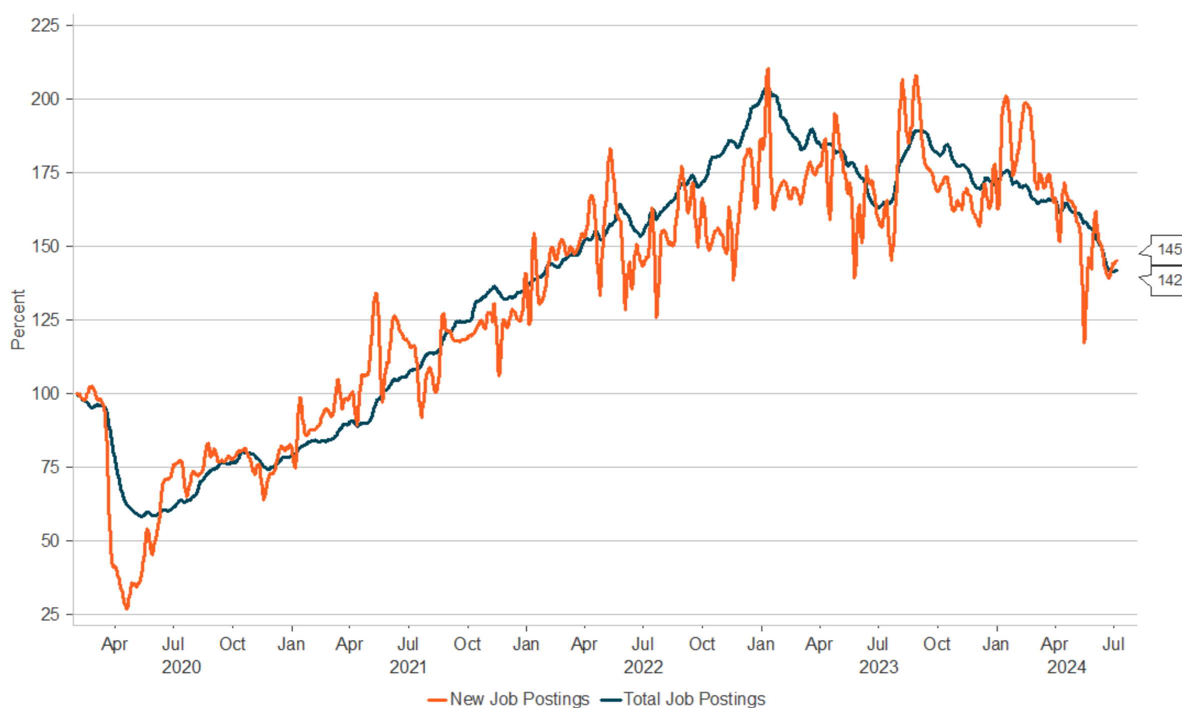
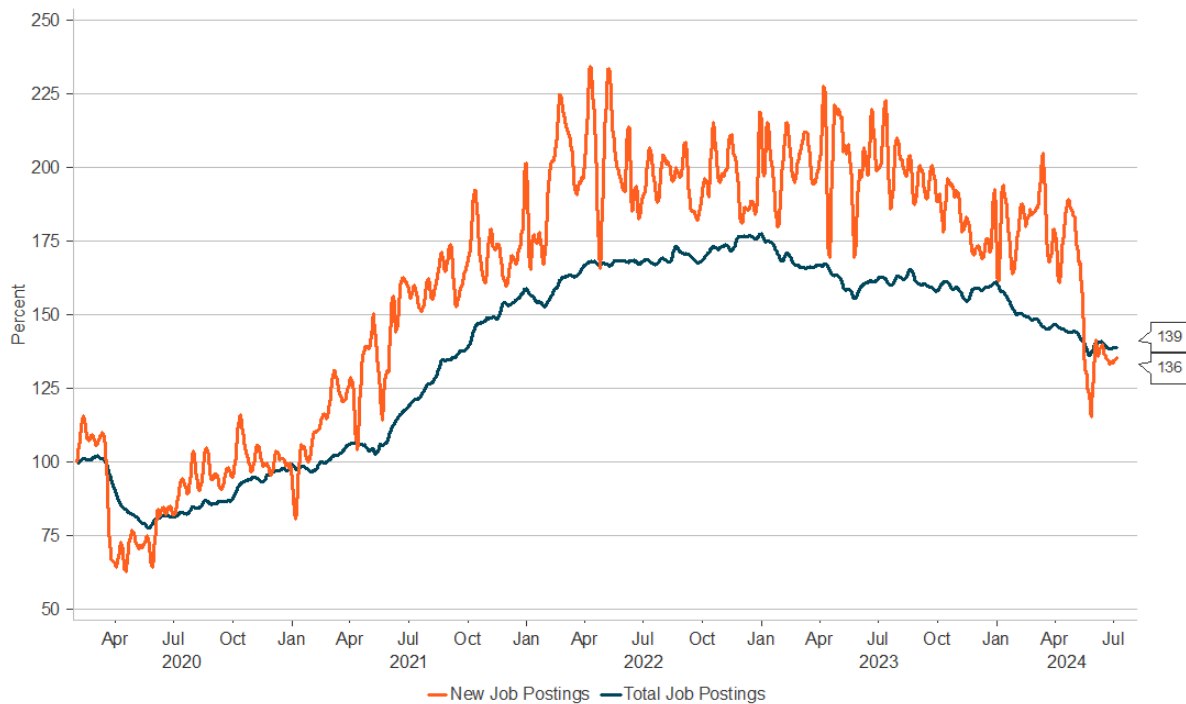
## Exhibit #1: French and German labor markets






Source: Macrobond, BNY

Based on these trends, the ECB normally should be comfortable in signaling multiple cuts through a forecast horizon, but the conditionality placed on future steps is quite telling. This harks back to the notion that the June move itself was a "hawkish cut," which we still see as an oxymoron. If the Governing Council was already concerned about upside risks to wage/labor-based inflation, then the June cut wasn't necessary. What may change their calculation up ahead is the prospect of a renewed fiscal push in France and Germany, especially given the surprise result in France. As things stand, it is unlikely that some of the more radical proposals on government spending will come through, but there will be an expansionary shift in France's fiscal outlook. Considering that France's state auditor this week has already said that the plan under the previous government to repair public finances wasn't "credible or very realistic," even a moderate rise in spending would further damage the country's credibility. This already stands in sharp contrast to the UK's expected path, where a left-leaning government made fiscal credibility a cornerstone of its electoral platform. Although the share of public sector workers in France's total employment has fallen in recent years (Exhibit #2), it remains well above peers in Europe, and bond markets will take notice in time.

Meanwhile, although the ECB doesn't have an employment mandate, Lagarde's 2023 Sintra assessment surrounding public-sector productivity has not changed. This means that inflation risk – especially in services, as this is where the bulk of the public sector generates its output – in France will only be to the upside if there is large-scale public-sector expansion.

Meanwhile, the recent budget settlement in Germany – while adhering to fiscal rules – also risks a marginal price push from public-sector wage growth: the base may be low, but Germany's public sector has expanded the most as a share of workers out of the core Eurozone countries over the past three years.

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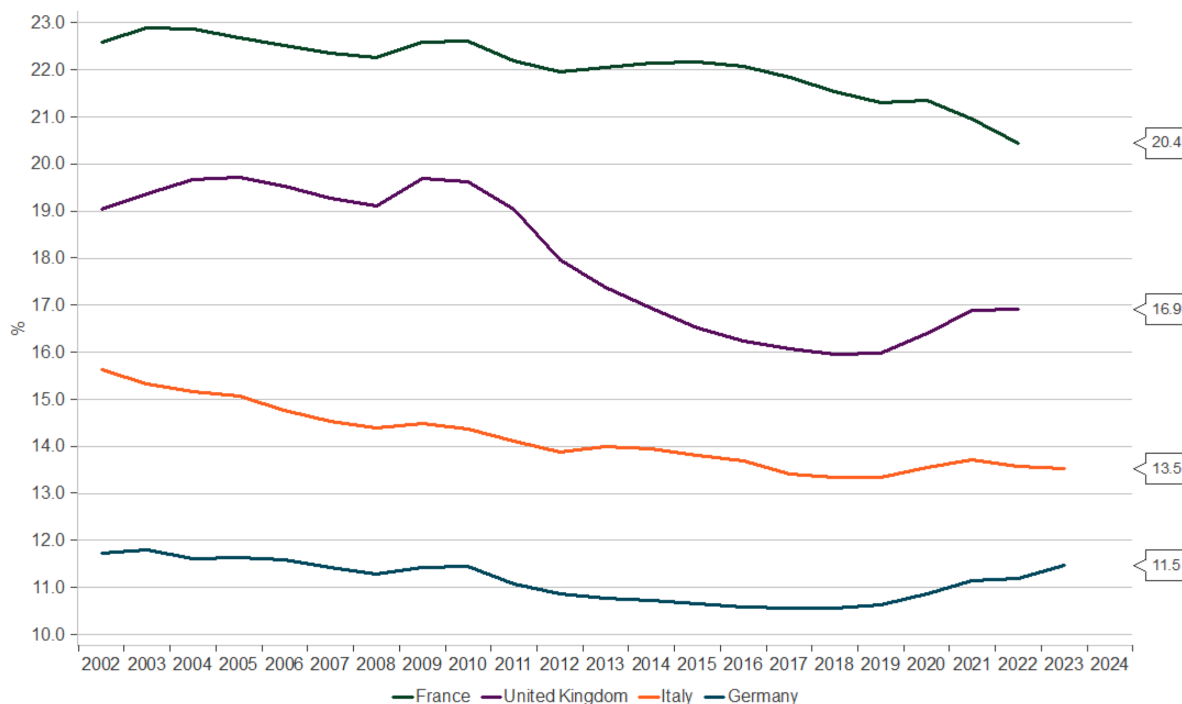
**Exhibit #2: Public sector employment shares**




Source: Macrobond, OECD, BNY

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Since Lagarde warned about the stubbornness of services inflation a year ago, data has continued to soften, but progress has been limited in driving inflation expectations lower. On a forward-looking basis, inflation expectations remain well-anchored at the three-year point, but since the peak last summer, 12-month forward inflation has only fallen by just over 1pp. On a more favorable note, in absolute terms 12-month forward inflation has fallen back to pre-pandemic levels, when the Eurozone economy wasn't exactly growing at potential either, indicating that the household outlook continues to moderate and tight financial conditions are having an effect. However, this would probably give more credence to the view that further declines in inflation expectations and subsequent data confirmation is needed before the ECB can pick up the pace of easing.

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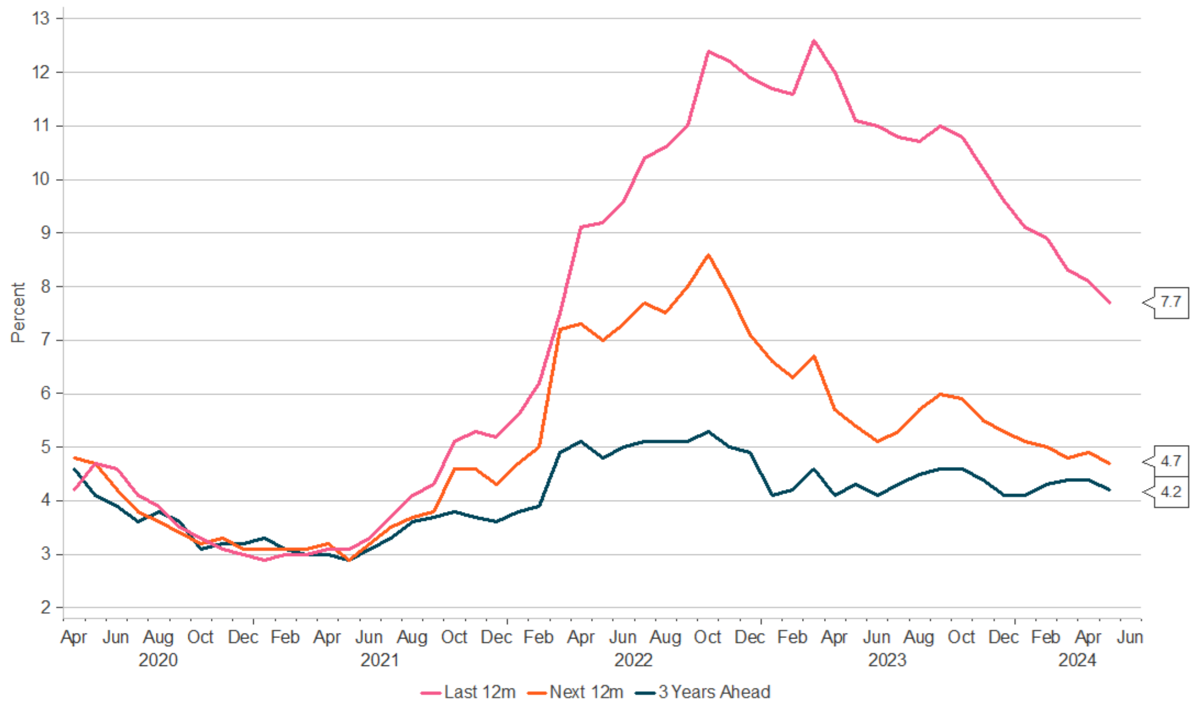
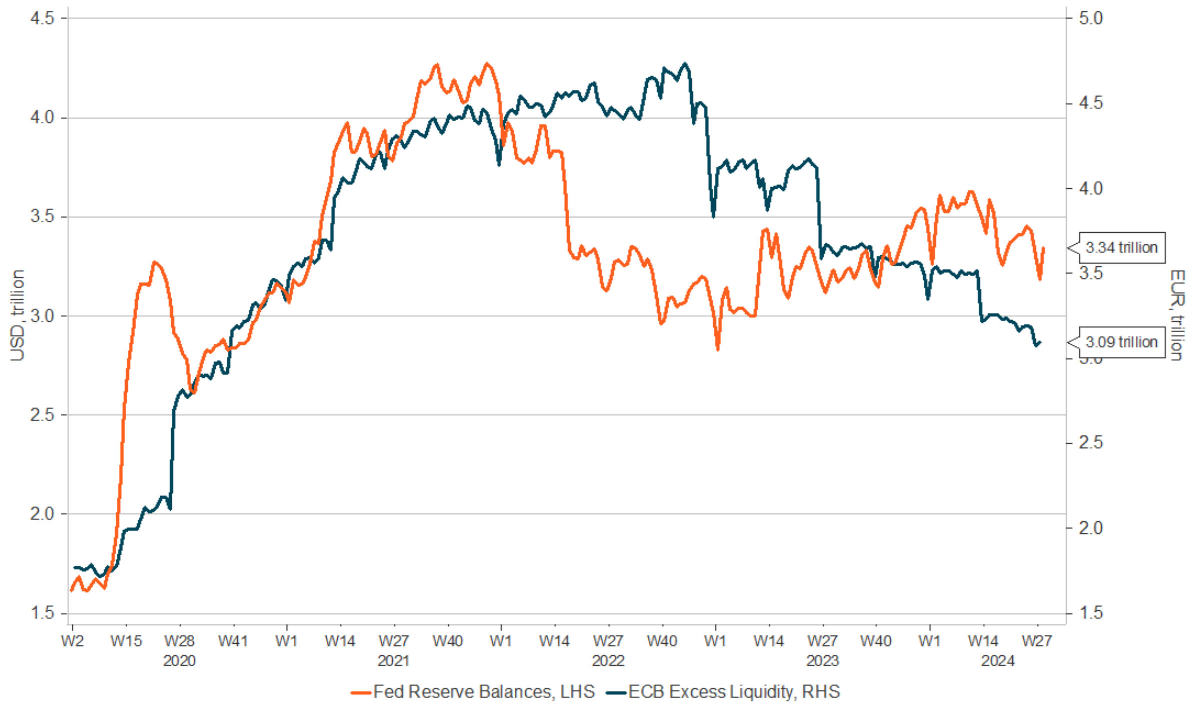
**Exhibit #3: Eurozone inflation expectations**




Source: Macrobond, ECB, BNY

Combined with the recent shift in pricing for the Fed toward a cut in September and the possibility of a further move thereafter, rate differentials have moved in EURUSD's favor, or at least mitigated any potential downside which could have arisen from political gyrations and associated fixed income outflows. Furthermore, we expect President Lagarde to provide some initial observations on its own quantitative tightening process, as the ECB's PEPP reinvestment levels began to slow in July. As Eurozone excess liquidity is clearly falling on an absolute and relative basis compared to the Fed equivalent, liquidity differentials will also favor the euro. FX markets are cognizant of the need to factor political and fiscal risk into the euro itself, but this is largely being done on the crosses rather than EURUSD.

**Exhibit #4: Excess liquidity balances**




Source: Macrobond, BNY

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