2023: The ECB Changes Camps and 2024: The Labor Market Litmus Test

EMEA Chief Economist Sylvain Broyer's Year-End Reflections

December 14, 2023

This report does not constitute a rating action

For the final 2023 edition of our Essential Economics Newsletter, we asked each S&P Global Ratings chief economist to share insights on following questions:

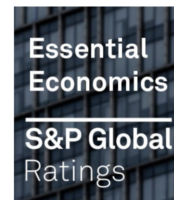
- What was the biggest surprise for you in 2023 and what are the takeaways?
- What will you be watching most closely in 2024, and why?

Contacts

Sylvain Broyer
Frankfurt
+49 69 3399 9156
Sylvain.broyer@spglobal.com

2023: The ECB Moves Camps On Inflation

In 2023, the surprise is neither growth nor inflation--the surprise is the European Central Bank's (ECB's) policy stance. The gap in our forecasts tells the story. Twelve months ago, we thought the ECB would stop raising rates before spring was out, and that its deposit facility rate (DFR) would not exceed 2.75%. In the event, the ECB raised rates right up to the end of summer and as high as 4%. Markets were just as surprised as we were; they had expected the ECB to raise the DFR to 3% and to keep it unchanged from spring (see chart 1).



Follow us on LinkedIn and subscribe

How has the ECB taken everyone by surprise? Because it moved to the opposing camp on inflation. Until the very end of 2022, the ECB was firmly in "camp transitory", assuming that rising inflation would be short-lived; notably, this was after Federal Reserve head Jerome Powell had abandoned this stance. In December 2022, supply-side bottlenecks and commodity prices were still the ECB's main explanations for rising inflation. Most agreed that there was little the central bank could do and that rates did not have to go much higher. Then things started to change. Before spring 2023, the ECB recognized that soaring energy costs were spreading with unusual force throughout the economy. In the early summer, the ECB said that higher wages and profit margins were driving up inflation. Within less than six months, the ECB had moved into "camp permanent", assuming that inflation was here to stay, and it raised rates by another 200 basis points (bps) in 2023, after 250 bps in 2022.

Takeaways: Although starting from a different situation, the ECB followed the same line of thought as the Fed on inflation and came to the same conclusion on rates. Today, it faces a similar problem to that of the Fed: how to restore price stability when the labor market is tight without crashing it. It's a question of bringing down job openings without pushing up the unemployment rate--which is no easy task! Clearly, the resilience of the European labor market will serve as a litmus test for ECB monetary policy calibration next year.

2024: The Labor Market Will Test The Policy Shift's Success

Core inflation is undoubtedly the reason behind the ECB's U-turn on rates. The ECB changed course just as core inflation outpaced headline inflation, in a repeat of the Fed's inflation experience (see chart 2).

Labor costs are the main driver of core inflation and they have soared. The eurozone economy has added 4 million jobs in 2023, breaking its previous record of 163 million in 2022. The labor market remains tight, with only two job seekers left per job opening. Meanwhile, wage growth has accelerated significantly, above 5%.

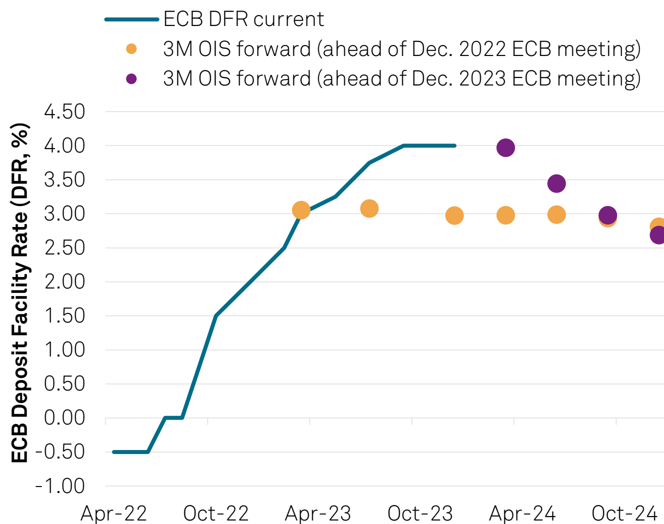
That said, some cracks are showing in the eurozone labor market. As the economy stagnated this year, the higher number of hours worked translates into lower productivity (see "Economic Outlook Eurozone Q1 2024: Headed For A Soft Landing," published Nov. 27, 2023). A fall in productivity at a time when wages are rising sharply is rather unusual. This could come at a cost to employers, which have already seen their financing costs rise. A trade-off between a further increase in selling prices (that is, inflation) and a reduction in the workforce to maintain profit margins could be on the cards in 2024. If companies choose to retain their workforce, inflation could remain stiffer than markets currently expect, particularly since inflation eased to 2.4% in November and the ECB may hesitate to cut rates anytime soon. Either way, the direction of the labor market will be a key factor in 2024 in terms of growth, inflation, and monetary policy.

What to watch: Employment is traditionally a lagging indicator of the cycle. Relying on changes in the unemployment rate may prove too late. We prefer to look at trends in unit labor costs to see how quickly the labor market is turning around. New indicators have also become popular since the pandemic. We can now monitor wage-setting and job openings in real time.

Chart 1

The ECB's shift in policy stance came as a surprise

Main policy rate and three-months OIS forward curve

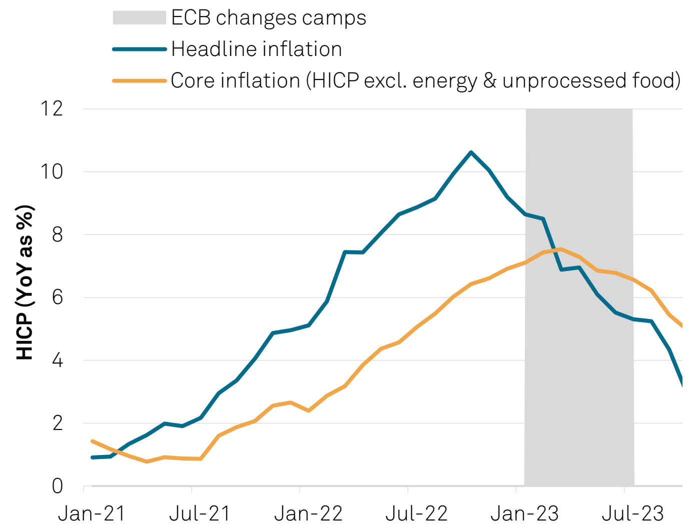


OIS--Overnight Index Swap. Source: ECB, Refinitiv, S&P Global Ratings.

Chart 2

Core inflation was the trigger for the ECB's about-face

Eurozone inflation



HICP--Harmonized Index of Consumer Prices. YoY--year over year.
Source: S&P Global Ratings.

Copyright © 2023 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

Australia: S&P Global Ratings Australia Pty Ltd holds Australian financial services license number 337565 under the Corporations Act 2001. S&P Global Ratings' credit ratings and related research are not intended for and must not be distributed to any person in Australia other than a wholesale client (as defined in Chapter 7 of the Corporations Act).

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.