EURONOMICS: ECB's Fear Of Rising Labor Costs Could Be Real
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MILAN (Dow Jones)--The cost of labor in Europe is rising fast as wage-earners try to keep up with inflation, a trend the European Central Bank says it will combat with higher interest rates.

Spain reported Tuesday that labor costs rose 5.1% on the year in the first quarter, compared with 4.0% in the same period of 2007. A day earlier, Italy reported that labor costs rose 4.0% on the year, twice the pace of a year before.

Since productivity growth in those two economies is the weakest in Europe, such rapid wage gains represent significant inflationary threats.

In the euro area as a whole, hourly wages grew at a 3.7% rate in the first quarter, up from 2.4% in the first three months of 2007.

If workers demand compensation for higher food and fuel costs, which pushed euro-zone headline inflation to 3.7% in May, then companies will have to sacrifice profit margins or pass higher prices along to consumers. This would embed the second-round effect of which the ECB has warned.

Early signs of labor costs passing through into inflation were seen in April, when producer prices in the euro zone rose 6.1% on the year. Stripped of energy prices, the "core" rate was 3.7%, suggesting there's not a lot of pressure beyond labor costs themselves.

The ECB has alerted markets that it intends to raise its main interest rate by 25 basis points next month, to 4.25%.

"Cost-push inflation risks are likely to remain on the ECB's radar screen for longer," said Dresdner Kleinwort economist Rainer Guntermann in Frankfurt.

The euro-zone country in which labor costs grew the slowest was Germany, where nominal wages increased 1.6% from early 2007, contributing to strong gains in productivity in Europe's largest economy.

While the German workers' gains pale when compared with those of their peers in weaker southern European economies, they still show a fivefold leap from their pace a year earlier.

That means unit labor costs in the euro zone's largest economy are now pushing up the aggregate figure the ECB examines. And there's more to come: The Bundesbank forecasts that compensation per employee in Germany will grow by 2.8% in 2009, nearly three times the 2007 pace.

Euro-zone wages are now growing at nearly the rate of those in the U.K. and the U.S., where liberal labor-market laws have allowed faster productivity and stronger compensation gains. Hourly compensation rose 4.4% in the U.S. in the first quarter, and 3.8% in the U.K.

Euro-zone productivity rose at an 0.8% rate last year but will slow to 0.5% this year and 0.3% in 2009, according to Lehman Brothers economist Michael Hume.

"Trichet is doing his job," said Nicola Salerno, an economist at Rome-based think tank CERM. "The blame has to go to the countries that are AWOL on the front of necessary reforms."

Textbook economics tells that inflationary shocks are mitigated as slowing economies put the brakes on wage claims. But rigid labor and product markets often defeat the formula in the euro zone. Over the past two decades, consumer-price inflation has tended to be matched one-for-one by ensuing wage claims, according to U.K. consultancy Fathom Financial.

If wages don't adjust to face new conditions, then the number of jobs will.

Italy had net job losses in the first three months of the year, and a Manpower survey suggests Spain will do the same in the third quarter.

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