JANUARY 2023

Inflation, Wages and the Risk of a Wage-Price Spiral in 2023

Ius Laboris research on global economic trends and wage indexation

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The global economy has been subjected to multiple crises during the last several years. In 2020, the pandemic forced countries to impose restrictive measures. Widespread lockdowns and border closures had a massive impact on economic conditions around the world. The speed of transmission of the Covid-19 virus and the growing number of infected individuals pushed many countries' healthcare systems and other infrastructure into an almost unbearable situation.

Tightened financial conditions and restrictive measures triggered loss and damage in many markets and sectors and the labour market was no exception. In 2020, global employment dropped by 60 million. However, the pandemic's impact on employment was not the same for low-paid as it was for high-paid workers. Low-paid workers were pushed out of the labour market straight after the pandemic began, while their high-paid counterparts largely kept their positions. In other words, the more vulnerable cohort was hit harder than others. To support people in urgent need, governments around the world started applying fiscal and stabilising measures.

In 2021, countries started widespread vaccination campaigns and relaxed their restrictive measures. As a result, economic growth in 2021 bounced back significantly, and in the labour market, the number of salaried workers almost reached pre-pandemic levels. But just at the moment when life seemed to be returning to normal came the shock of war in Ukraine. A new wave of crises, including energy and food shortages hit many countries worldwide. As a result, the inflation rate started growing almost everywhere. Between 2015 and 2019, the five-year average global inflation rate had been 3.16%, whilst in 2022, it soared to 8.8%.

This report aims to explore economic and labour market trends since the pandemic started. How has the situation changed in the last few years, and what do international organisations predict for the near future? We also touch on wage indexation mechanisms. In research conducted by Ius Laboris, data from 27 countries shows only two out of 27 had automatic wage indexation. Finally, we consider whether a wage-price spiral is on the cards for 2023.

2. Global economy and inflation

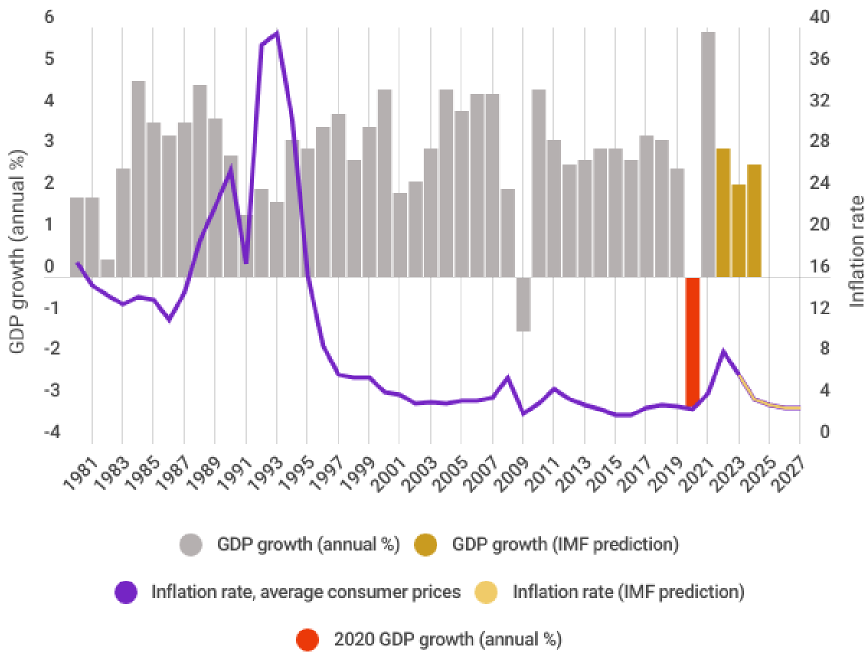
Global growth

COVID-19, with its swift and massive healthcare, social, and financial shocks, jeopardised economies around the world significantly. Annual global Gross Domestic Product (GDP) growth dropped to -3.1% in 2020 compared to 2.6% in 2019, which was a record low since the Second World War.

However, already in 2021, as countries started relaxing their pandemic-related measures, economies began to bounce back, with annual global GDP reaching 5.9%. This extreme economic recovery was the strongest since records began 80 years ago, prompted by a rebound in aggregate demand. Widespread vaccination campaigns and fiscal measures adopted during the outbreaks played a profound role in the recovery, amongst other factors. The rebound was not entirely equal amongst different income-group countries, however, with GDP increasing by 5.2% amongst the advanced economies and 6.6% amongst developing economies (International Labour Organizatoin (ILO), 2022).

In 2022, however, the world was shaken again when Russia began prosecuting a war against Ukraine. Russia's invasion triggered a massive energy shock and raised fears about a global food crisis.

GDP GROWTH (1980 -2021)
INFLATION RATE (1980 - 2027)



Source: The World Bank DATABANK, IMF DATAMAPPER

All this put the fledgling economic recovery seen in 2021 at risk. According to Organisation for Economic Co-operation and Development (OECD) predictions, in 2022, global growth would drop to 3.1% and was expected to decrease further, reaching 2.2% in 2023. In 2024, the growth rate should increase a little to 2.7% (OECD 2022).

Tight financial conditions and increasing food and energy prices have started threatening nations with a massive cost-of-living crisis.

Before the pandemic, between 2015 and 2019, the five-year average global inflation rate was 3.16%. While in 2020, the inflation rate was still as low as 3.2%. In 2021, it increased to 4.7% and in 2022 in almost all countries, the inflation rate jumped to 8.8% (International Monetary Fund (IMF) DATAMAPPER).

Source: ILO, Global Wage Report 2022 - 2023, https://www.ilo.org/digitalguides/en-gb/story/globalwagereport2022-23

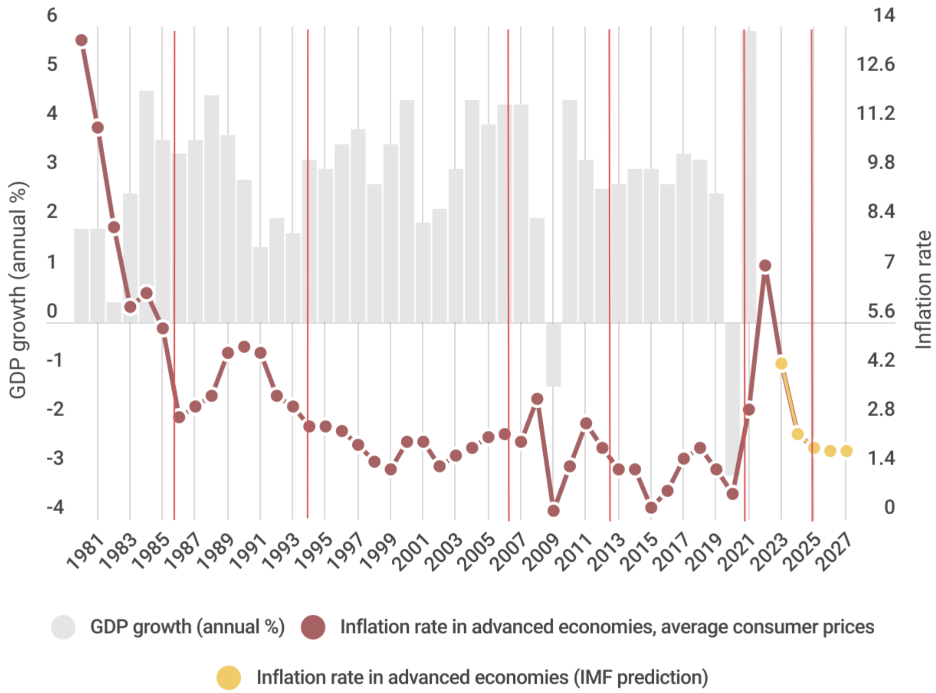
OECD Economic Outlook, Volume 2022 Issue 2

3. A brief history of inflation trends

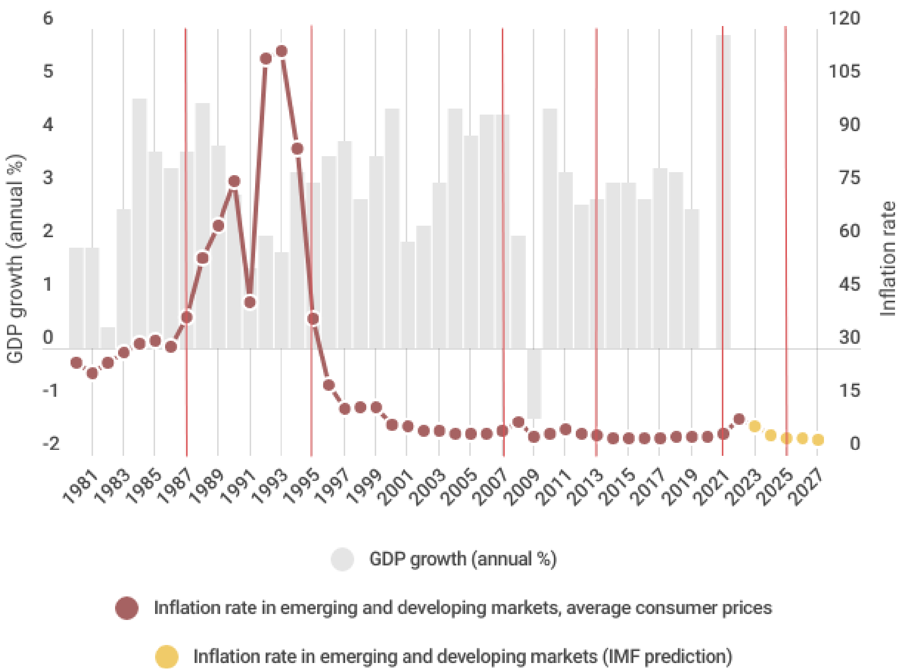
Inflation trends

In 2022, advanced economies registered their highest recorded inflation rate since 1985: 7.2%. Last year, the inflation rate in emerging market and developing countries reached 9.9%, the highest since 2000. Overall, the long tail of inflation since 1985 shows the global inflation rate has soared significantly three times: around the late ’80s and early ’90s, around 2008 following the financial crisis, and in 2021 and 2022, following the pandemic and price crises (IMF DATAMAPPER).

INFLATION RATE IN ADVANCED ECONOMIES



INFLATION RATE IN EMERGING MARKET AND DEVELOPING ECONOMIES,1980-2027



Source: The World Bank DATABANK, IMF DATAMAPPER

Inflation trends

The reason behind the inflation seen in the late '80s and early '90s was the structural reforms and macroeconomic stabilisation programmes adopted by governments. These initiatives were intended to improve economic and state efficiency and often included measurements eliminating or relaxing foreign exchange controls, more assertive monetary and fiscal policies, and trade liberalisation. As a result, inflation started soaring in emerging market and developing countries as economies that used to be centrally-planned collapsed, and the price and exchange rate liberalisation depressed demand.

The next inflation jump occurred between mid-2007 and early 2009, following the global financial crisis, during the extreme stress experienced by the global financial markets and banking systems.

However, the soaring inflation rates more recently recorded in 2021 and 2022 came as a surprise to many economic forecasters. It is not clear exactly why economists failed to predict it, but it may be that they undervalued how the fiscal interventions used to boost the recovery of 2021 would play out. And yet, it is important to note that the soaring inflation of 2021 and 2022 has come at a time of tightening labour markets and strained supply chains.

"Inflation is as violent as a mugger, as frightening as an armed robber, and as deadly as a hit man."
Ronald Reagan

4. Inflation forecast for 2023-27

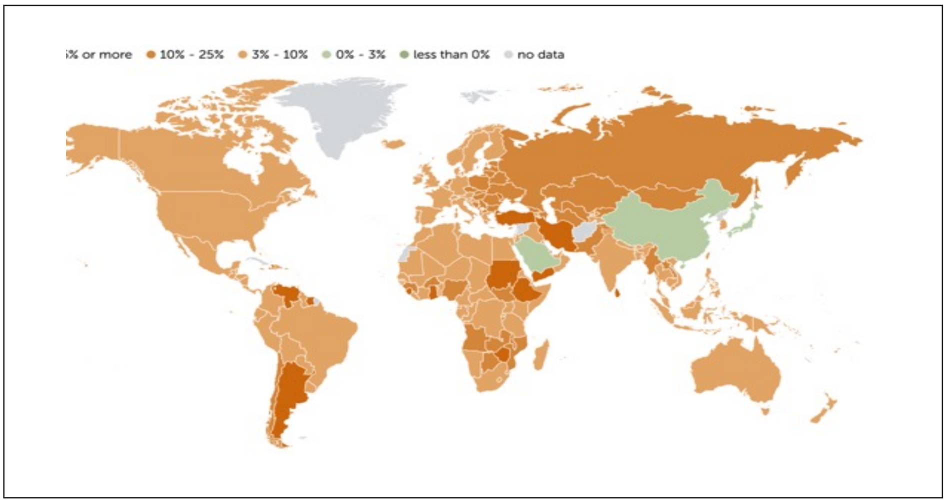
Expectations

According to IMF predictions (IMF DATAMAPPER), the global inflation rate will decrease to 6.5% in 2023 and 4.1% in 2024. This gradual decline will continue until 2027, when the inflation rate will reach 3.3%. Before the pandemic, between 2000 and 2019, the twenty-year average global inflation rate was 3.885%.

The decreases will apply to advanced economies specifically as well. In 2023, inflation is expected to drop to 4.4%, gradually declining to reach 1.9% in 2027. Before the pandemic, the twenty-year average inflation rate in advanced economies was 1.77%, slightly less than it is expected to be in 2027.

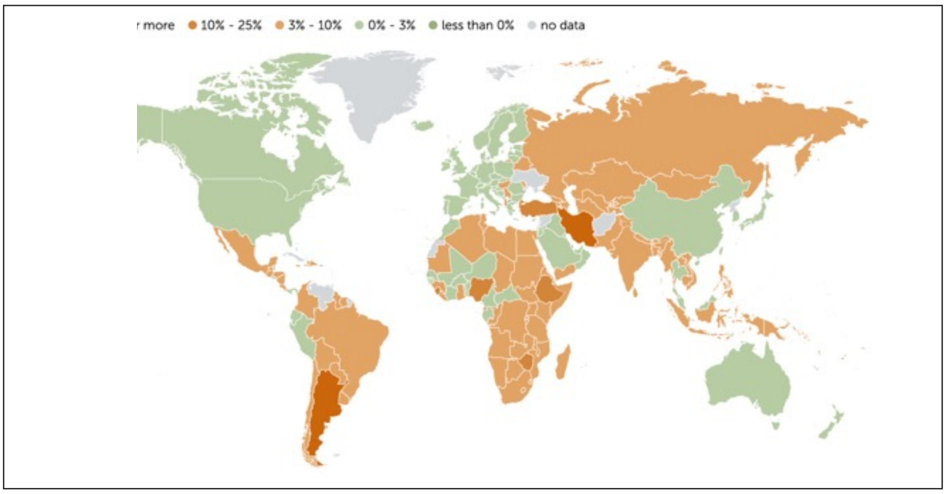
In emerging and developing markets, the inflation rate is expected to drop to 8.1% in 2023, with an expectation that it will reach 4.3% in 2027, far less than the 6.035% pre-pandemic twenty-year average inflation rate.

INFLATION RATES BASED ON AVERAGE CONSUMER PRICES ANNUAL PERCENT CHANGE



2022

2027



Source: IMF DATAMAPPER

5. Global wages amid soaring inflation

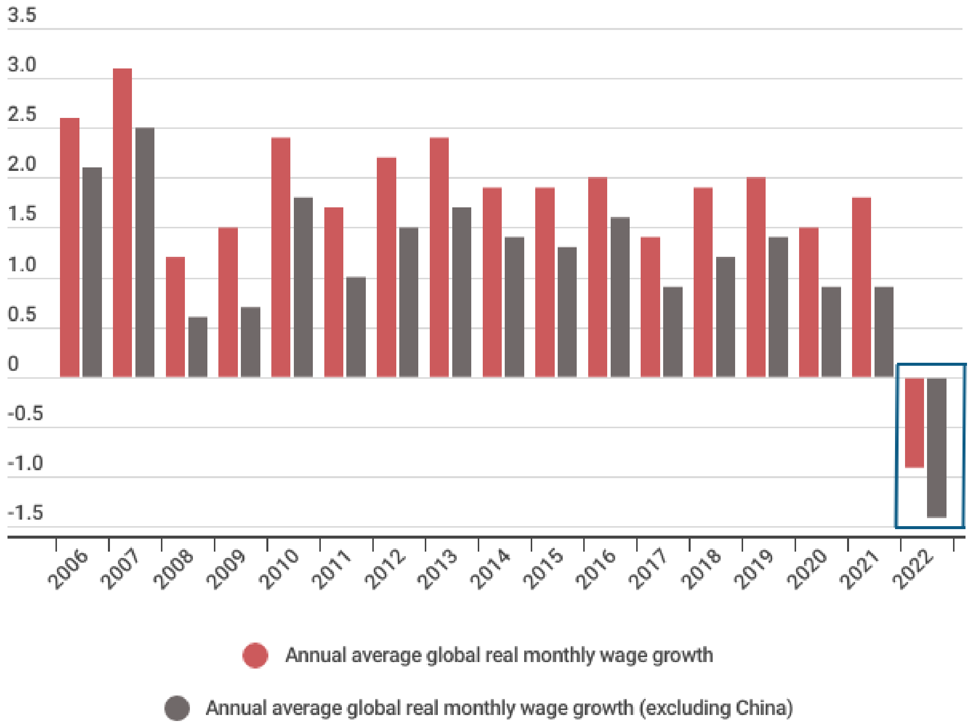
Global wages

Gross economic conditions and financial tightness due to the pandemic have harmed the labour market in 2020 and 2021. Many around the world lost their jobs, while others were compelled to work from home. In 2020, global employment fell to 1.69 billion compared to 1.75 billion in 2019. However, by the end of 2021, the number of salaried workers increased to 1.74 billion, almost reaching the pre-pandemic level. The recovery came when nations started to remove pandemic-related restrictions and, as a result of doing so, they regained their economic activities. From a long-term perspective, the ILO estimates reveal a gradual increase in wage and salaried employment since 2005, increasing by 36% between 2005 and 2021 (ILO 2022).

In average terms, in 2020 and 2021, wages increased globally by 1.5% and 1.8%, respectively. This occurred during the pandemic, and the main driver was a change in the composition of employment, particularly in certain large economies, such as the US. Thus, although many lost their jobs during the pandemic, the shock was unequal as between high-paid and low-paid workers, as those who lost their jobs were mainly low-paid workers. This meant that while low-paid employees were pushed out of the labour market, their high-paid colleagues continued working, and increased the estimated average wage (this is known as the 'composition effect').

In 2022, the world was shaken by energy and food price increases, following Russia's war in Ukraine. As a result, almost every country in the world recorded a rise in inflation and the growing cost-of-living crisis ended up having a significant effect on real wages. According to ILO estimates, global wage growth in real terms dropped to –0.9%, but excluding China, as its wage growth is usually significantly greater than the global average, yields a figure of -1.4% for the first half of 2022. This adverse trend suggests that the high inflation rates forecast for 2023 will probably also impact wage trends until the end of the year.

ANNUAL AVERAGE GLOBAL REAL MONTHLY WAGE GROWTH, 2006 - 2022 (PERCENTAGE)



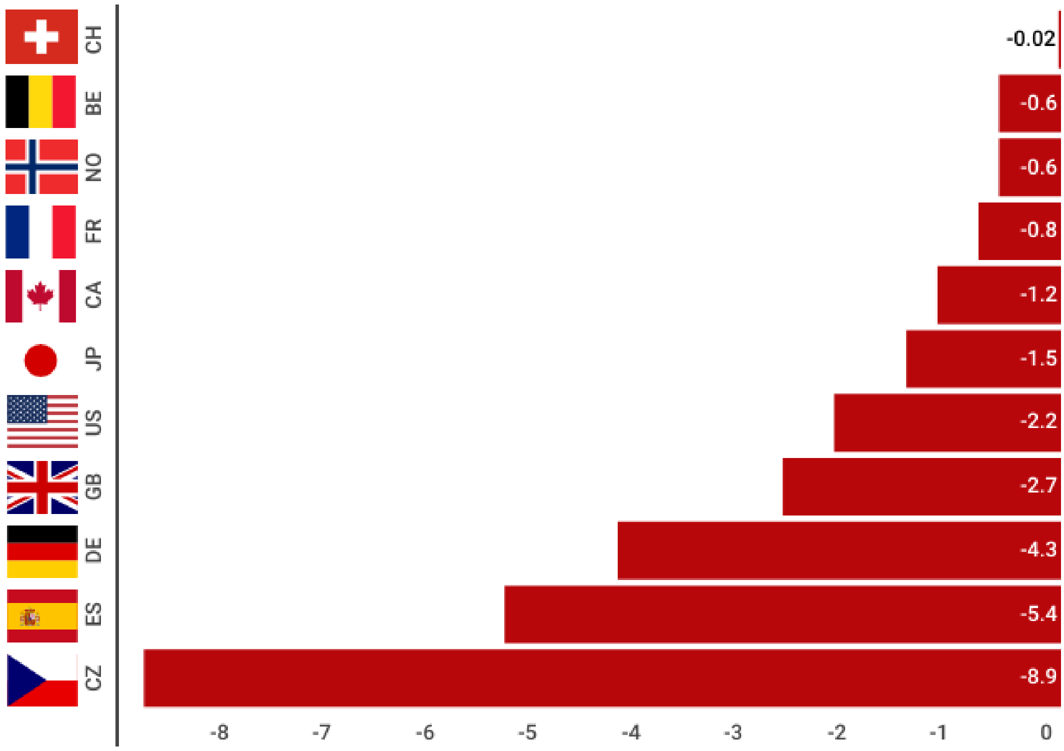
Global wage growth, in real terms, plunged significantly in 2022 due to soaring inflation rates.

Source: ILO, Global Wage Report 2022 - 2023, https://www.ilo.org/digitalguides/en-gb/story/globalwagereport2022-23

Global wages

While pay negotiations in some sectors may have triggered wage increases last year, according to OECD data, in many countries, total wage growth is not expected to catch up with consumer prices. However, OECD country level data shows that real wages fell unevenly across economies. Among OECD countries, the sharpest fall was registered in the Czech Republic, where real incomes plunged by 8.9% in 2022. In Spain and Germany, real wages fell by 5.4% and 4.3%, respectively. The smallest reduction was recorded in Switzerland, where real wages reduced by a mere 0.02%. Different factors, such as inflation levels, can explain some of the differences across countries, but the various social protection measures adopted by governments also play a significant role (WEF, 2022)

ANNUAL AVERAGE GLOBAL REAL MONTHLY WAGE GROWTH, 2006 - 2022



Source: WEF 2022, Which OECD countries are facing the sharpest falls in real wages

6. Potential role of wage indexation in an inflationary environment

Wage indexation

To help people cope with the cost-of-living crisis, governments across the world have adopted measures targeting either specific groups or the whole society. Some of the most common measures are applying a cap on electricity prices or making direct transfers to households.

For instance, in 2022, Germany announced a €200 billion package, aimed at easing the impact of the cost of living on households and companies. Among the measures, it applied a brake on gas prices and a cut in sales tax for fuel. Similarly, France has frozen gas prices and capped electricity prices.

An alternative way of keeping salaries and social benefits in line with inflation is wage indexation. The European Central Bank defines it as "the presence of clauses in laws or contracts whereby wages (either public or private) are to a large degree automatically linked to price developments." The form of wage indexation varies depending on the company or sector.

One type of wage indexation is 'automatic wage indexation.' Here, wages are altered automatically if a previously-defined pivot index exceeds a certain level.

Automatic wage indexation helps maintain the purchasing power of employees and reduce in-work inequalities. It guarantees solidarity between workers and sectors, facilitates wage negotiations and helps to ensure social harmony. On a global level, wage indexation helps stabilise the economy and sustain private consumption, as well as guaranteeing a steady rise in public revenue.

In some cases, governments decide to apply wage indexation to minimum wages only, to reduce the effects of inflation on the lowest paid. Other forms of wage indexation do not trigger an automatic rise in wages in response to inflation but feed into wage negotiations.

In recent research by Ius Laboris law firms across the world, data from 27 countries shows that only two countries, Luxembourg, and Belgium, have automatic wage indexation mechanisms. Five out of the 27 countries have a wage indexation mechanism in place just for minimum wages. In Canada (British Colombia only) and France, the inflation rate is only considered when setting minimum wages in the private sector.

IUS LABORIS RESEARCH ON WAGE INDEXATION, 2023

Countries	Flag	Automatic Wage Indexation	Wage Indexation for only public sector minimum wages	Wage Indexation for only private sector minimum wages
United Kingdom		✗	✗	✗
Mexico		✗	✗	✗
New Zealand		✗	✗	✗
Hungary		✗	✗	✗
Hong Kong		✗	✗	✗
Kazakhstan		✗	✗	✗
Venezuela		✗	✗	✗
Colombia		✗	✗	✗
Portugal		✗	✗	✗
Poland		✗	✓	✓
Serbia		✗	✓	✓
Argentina		✗	✗	✗
Japan		✗	✗	✗
Germany		✗	✗	✗
Greece		✗	✗	✗
Ireland		✗	✗	✗
Luxembourg		✓	✓	✓
Switzerland		✗	✗	✗
Sweden		✗	✗	✗
Finland		✗	✗	✗
Turkey		✗	✓	✓
Slovenia		✗	✓	✓
Brazil		✗	✓	✓
Canada (British Colombia only)		✗	✗	✓
Denmark		✗	✗	✗
France		✗	✗	✓
Belgium		✓	✓	✓

Automatic wage indexation in Belgium

In Belgium, each company belongs to a joint committee that covers a sector of industry, and it is composed of trade unions and employer representatives. Collective bargaining agreements are agreed within these committees, and they provide employment terms and conditions that apply to the sector. Therefore, whether there is a CBA at the sectoral level providing for the indexation of salaries should be checked. The indexation mechanism depends on sectoral regulation. In principle, there are two types of indexation mechanisms:

(1) Exceeding the pivot index:

An increase in salaries is linked to a flattened health index (equal to the average of the health indexes over the past four months). If this index exceeds a certain threshold or "pivot index", (2%), salaries are adjusted by 2%. In 2022, the pivot index was exceeded five times. Depending on sectoral regulations, wages will be indexed in the same month or the month following the excess. There are strict pay scales for civil servants, which are automatically indexed according to the same principle.

(2) Annual indexation:

Increases in salaries are linked to a flattened health index (equal to the average of the health indexes over the past four months). Once a year, salaries are adjusted according to the increase in this index.

In addition, in Belgium, the so-called 'guaranteed average minimum monthly income' applies at a national level to all employees (or if no sectoral pay scales are agreed upon that are higher). The guaranteed average minimum monthly income is also indexed once the pivot index has been exceeded.

Certain sectors only provide for the indexation of pay scales (minimum wages), while effective wages (i.e. the part that exceeds the pay scales) are not indexed. The largest sector for white-collar workers (joint committee n° 200 - +/- 500,000 employees) has an annual indexation of pay scales and effective wages. On 1 January 2023, the employees' salaries in this sector were indexed by 11.08%.

Automatic wage indexation in Luxembourg

In Luxembourg, inflation is measured by the consumer price index (CPI), which is published each month by the central service for statistics and economic studies. If, within a six-month period, the index has varied by more than 2.5 points since the last adjustment, all wage rates must be readjusted by the employer accordingly. In Luxembourg, there is no minimum wage for the public sector. Civil servants are paid according to a basic wage that is fixed by law for each grade.

Luxembourg law provides that the rates of wages and salaries resulting from a law, agreement or individual employment contract must be adapted to variations in the cost of living in accordance with the law of 22 June 1963 establishing the salary system for State employees (Article L.223-1 of the Labour Code). This is mandatory, under penalty of a fine from EUR 251 to EUR 25,000 for individuals and from EUR 500 to EUR 50,000 for legal persons. In the event of a repeated offence within two years, the fine may be increased to twice the maximum.

The minimum wages are as follows:

(1) EUR 2,313.38 (for non-qualified workers) and EUR 2,776.05 (for qualified workers) (index 877.01).

(2) As from 1 of January 2023, the minimum wage will be EUR 2,387.40 (for non-qualified workers) and EUR 2,864.88 (for qualified workers) (index 877.01).

Luxembourg law provides for two types of adjustments to the private sector minimum wage:

(1) Every two years, the Government considers whether to increase the social minimum wage based on the evolution of the economy (Article L. 222-2 of the Labour Code: "(1) The level of the social minimum wage is set by law. (2) To this end, every two years the Government shall submit to the Chamber of Deputies a report on the evolution of the general economic conditions and incomes, accompanied, if necessary, by a bill raising the level of the social minimum wage").

(2) Separately, the social minimum wage is automatically re-adjusted when the cost of living index has altered by more 2.5% since the last adjustment (Article L. 222-3 of the Labour Code: "Without prejudice to the increases provided for in Article L. 222-2, the adaptation of the social minimum wage to the weighted price index to consumption is made in accordance with Article L. 223-1").

7. Is there a risk of a wage-price spiral?

Wage-price spiral

While wage indexation brings the economy multiple benefits, it also comes with risks. For instance, wage indexation binds the social partners when they set wages, and this can trigger an unnecessary compression of wage distribution if the rest of the wage structure does not change. At the same time, it may reduce the margins of judgment that can be used by governments, commissions and social partners in re-setting wages. (OECD 2022)

Most importantly, however, in times of high inflation and uncertainty, automatic wage indexation increases the risk of a wage-price spiral (OECD, 2022). The wage-price spiral is an academic concept defined as a situation in which both consumer prices and nominal wages rise simultaneously for a period of time. In other words, knowing that inflation is growing, employees demand higher wages. Businesses, in response to the demand, increase salaries and pass on the cost of the higher wages to their customers. This, in turn, creates a second round of rising prices, fuelling inflation and causing another round of automatic wage indexation. In this way, the economy can enter a spiral of increasing prices and inflation.

Source: OECD 2022, Minimum wages in times of rising inflation.

That's the theory, but in practice, this hasn't happened very often and when it did, the wage-price spiral lasted only a short time. That said, the risk of a wage-price spiral is higher in countries where automatic price indexation exists for all wages. Countries where only the minimum wage is indexed are less likely to enter into a wage-price spiral, as the role of minimum wages in aggregate wage growth is relatively limited. Even if a country makes a significant increase to the minimum wage, it will still have little impact on inflation, given the comparatively low proportion of minimum wage earners in the total number of workers in the economy.

According to the recent Global Wage Report 2022 – 2023 published by the ILO, nominal wages are not currently catching up with inflation, as measured by the consumer price index. And the gap continues to widen, mainly in high-income countries, as real wages fell in 2022 while productivity increased. Thus, for the moment, we would characterise the risk of a wage-price spiral as being relatively low, meaning that countries should be able to continue increasing wages in line with the cost-of-living without undue fear of generating a wage-price spiral.

8. Take-aways

Multiple crises have caused shockwaves to ripple through the global economy several times during the last few years. Economic progress across countries was significantly impacted in 2020 due to the pandemic, when GDP annual growth dropped to a record -3.1%. In 2021, following the relaxation of pandemic-related restrictions, global growth bounced back, reaching 5.9% compared to a pre-pandemic level of 2.6% in 2019. And yet, in 2022, following the energy and price crisis which rocked world economies, GDP annual growth has fallen back again to 3.1%.

Russia's war in Ukraine, tight financial conditions, and increasing food and energy prices have together triggered a serious cost-of-living crisis in many countries in 2022. In that year, the inflation rate increased to 8.8%, as compared to 3.5% in 2019. According to IMF predictions, the global inflation rate is expected to decrease to 6.5% in 2023 and 4.1% in 2024. The gradual decline should then continue until 2027, when the inflation rate reaches 3.3%.

According to research conducted by Ius Laboris, only two out of 27 countries, Luxembourg, and Belgium, have automatic wage indexation mechanisms. In these countries, all wages are amended automatically if a previously defined 'pivot-index' exceeds a certain level. Five out of the 27 countries analysed have a wage indexation mechanism that only applies to minimum wages. In Canada (British Colombia only) and France, the inflation rate is considered only when setting minimum wages in the private sector.

Amid a growing inflationary environment, nation fear the prospect of entering into wage-price spiral, a situation in which both consumer prices and nominal wages rise simultaneously for a certain period. However, according to research published by the ILO, nominal wages are not currently catching up with inflation as measured by the consumer price index, meaning that, in our view, countries can continue increasing wages in line with the growing cost-of-living crisis without undue fear of generating a wage-price spiral.

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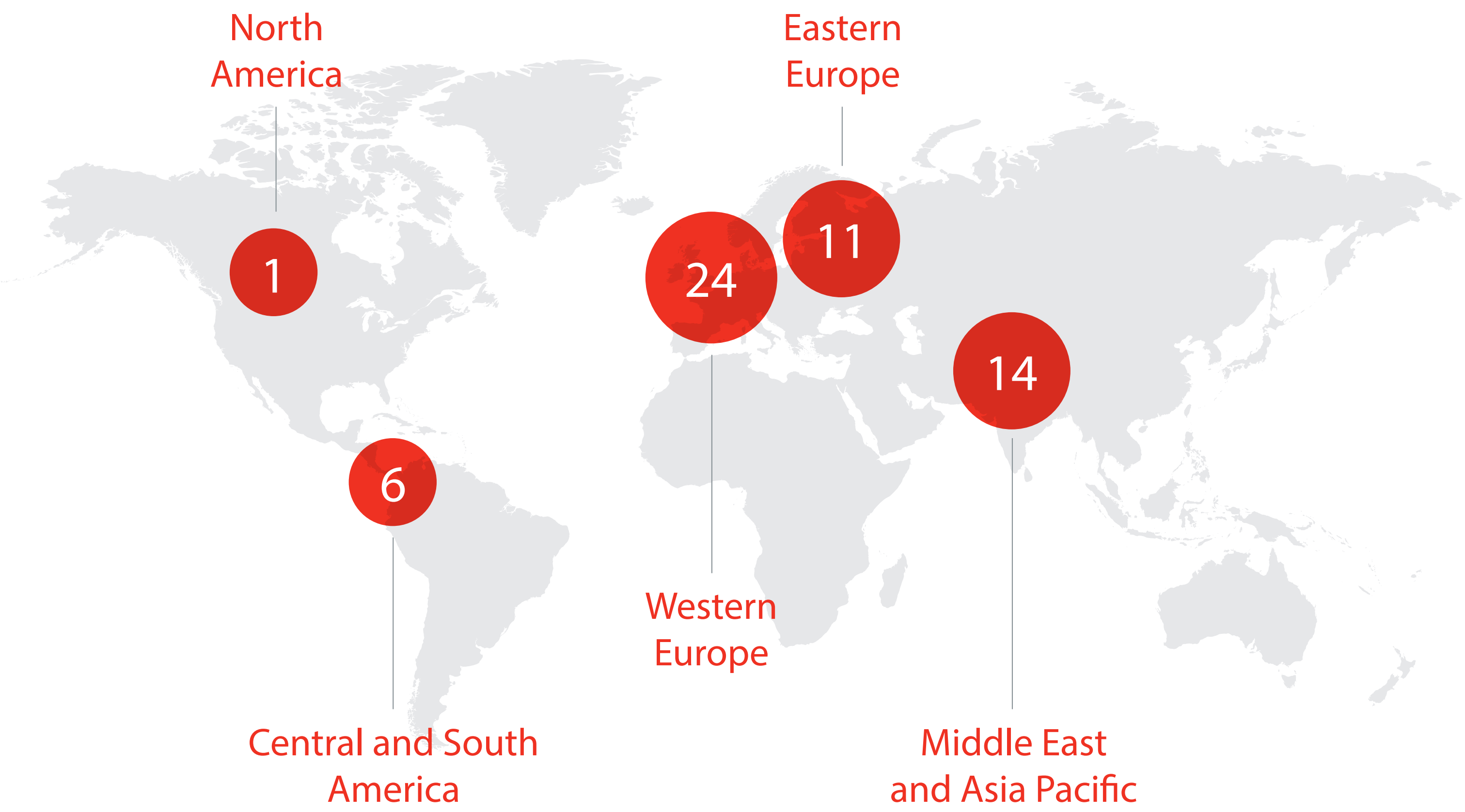

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