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Economic Bulletin

WHY THE BANK OF ENGLAND WILL BE WRONG AGAIN ON WAGES

- Average inflation has been double average wage growth over the last six years.
- There is more labour market slack than suggested by the unemployment rate.
- Productivity has consistently disappointed throughout 2014.
- BoE forecasts for a return to real wage growth by next summer seem too optimistic.

1. FALLING REAL WAGES

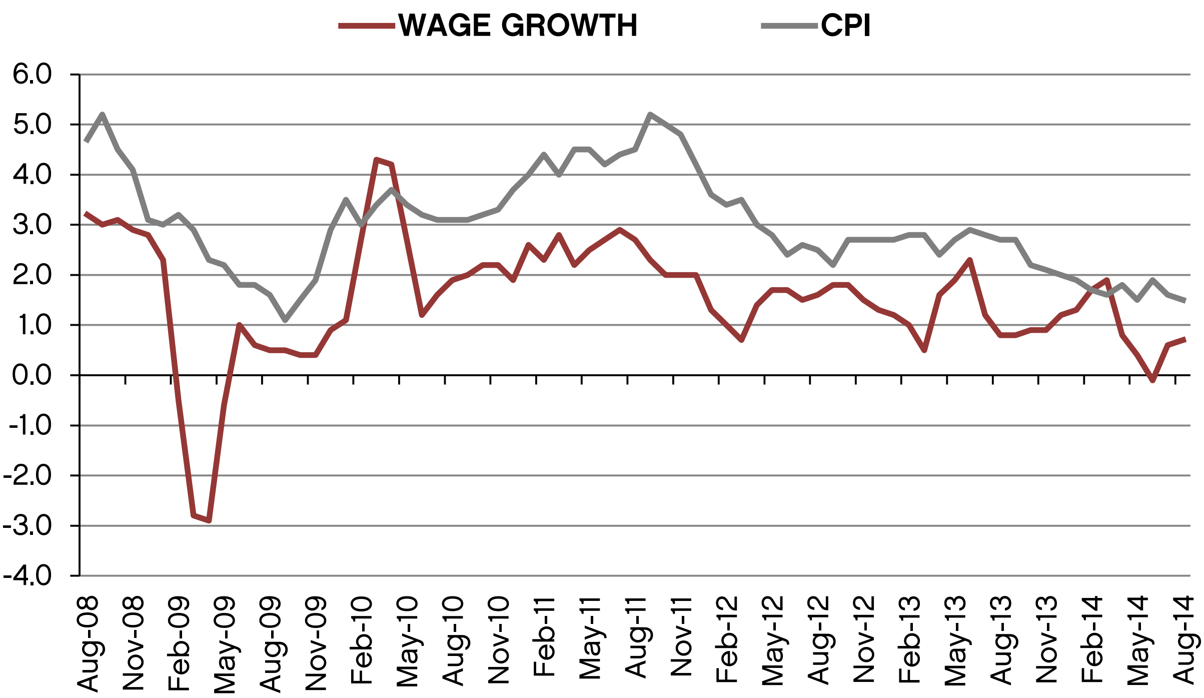
Out of all the major measures of economic performance, real wages have been one of the most important measures to have failed to improve over the last few years. The inability of wages to grow in line with prices has meant that despite a strong recovery in output and employment growth, the UK has indeed been faced with a Cost of Living Crisis. This contraction in real wages means that the economic recovery has not led to higher living standards for many families.

Furthermore, the recent overshooting of borrowing targets is incongruous with robust output growth. However, this slowing of deficit reduction can in large part be explained by lower than expected income tax receipts which are themselves a function of negative real wage growth.

Whilst the Bank of England at the beginning of the year expected a return to real wage growth, the Governor of the Bank of England now forecasts that wages will grow in real terms by mid-2015. To examine whether this forecast is reasonable, it is worth examining the average weekly earnings (AWE) data provided by the ONS. The three month average of earnings is used so that single-month distortions can be largely discounted.

AWE over the last year has been particularly poor despite strong economic growth. In July 2014, AWE reached £478, an increase of just 0.6% over the year and well below the 1.6% consumer price inflation in the year to July. This means that AWE are virtually unchanged since May 2013, when they reached £477.

Inflation has been higher than nominal wage growth for every month over the last six years apart from on three occasions (March and April 2010; and March 2014). Over this period, the monthly CPI figure was an average of 3% compared to an average nominal wage growth of just 1.5%.



The Bank of England forecasts that CPI will be 1.86% by the end of Q2 2015 based on market interest rate expectations and no change to the stock of asset purchases. Assuming that the CPI rate in July 2015 is similar, then in order to achieve growth in real terms, AWE therefore need to grow by 1.9% in nominal terms in the year to July 2015.

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AWE in May, June and July 2014 were £479, £477 and £478 respectively. This gives an average of £478. If earnings are to have grown in real terms, then the three month average of weekly earnings will need to be £487 by July 2015.1

Whilst an increase of £9 in AWE over a year may not seem large, it would still need to be much bigger than earnings growth over previous years. In the year to July 2014, AWE grew by just £3 and over the previous two years, earnings grew by just £7. The question is therefore: how likely is it that AWE will grow from £478 to £487 over the next year?

2. SURVEY DATA

Other survey data on wages is mixed. For example:

- the monthly survey carried out by KPMG and the Recruitment and Employment Confederation shows that whilst permanent staff salaries grew in September, the growth has slowed down. Furthermore, candidate availability was falling which would imply upward pressure on wages including for temporary workers who have seen nominal wages rise. However, it would appear that these skills shortages are being filled by temporary workers rather than permanent staff; this places constraints on total economy wage growth.

- 65% of company directors surveyed by the IoD in June said they expect to increase pay levels at least in line with inflation over the next year.

- research carried out for the Complete University Guide estimates that graduate starting salaries in professional posts fell by 11% in real terms between 2007 and 2012. This suggests that the decline in starting salaries is continuing and perhaps worsening.

- according to the VocaLink Take Home Pay Index which uses information from actual wages rather than survey responses, real earnings are still £38 a month lower than in 2009. For workers at FTSE 350 companies, the average monthly wage has increased by just 8 pence over the three months to September when compared to last year.

- Finally, the CIPD projects that median wage settlements in the year to June 2015 will reach 2% nominal growth which suggests very weak real wage growth over the coming year. In addition, the CIPD also reports that fewer employers than would be expected have actually carried out pay reviews with only 26% of SME's doing so in the first half of 2014. Only 30% of employees received pay rises in the first half of the year and the median increase has fallen from 2.5% in 2013 to 2% in 2014.

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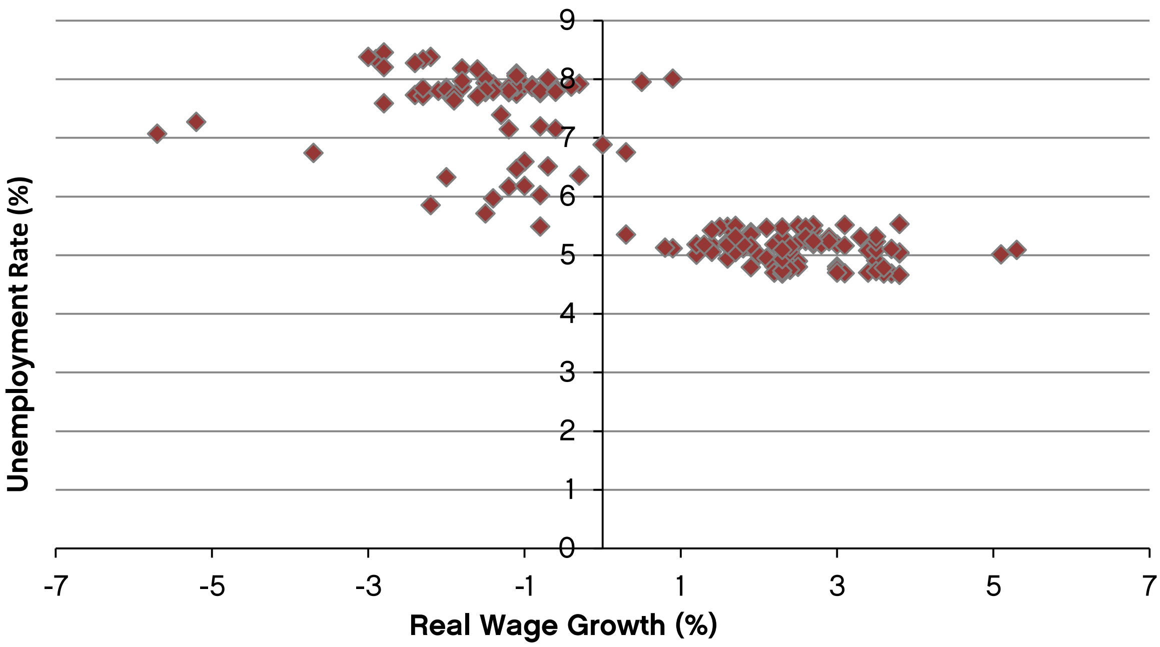
[1] The ONS data for AWE does not include decimal points. Whilst this means that rounding effects may lead to some small differences the actual figures are unlikely to be much different.

3. LABOUR MARKET SLACK

The amount of slack in the labour market is fundamental to when real wages will grow at least in the short term and the most important measure of slack is the unemployment rate. The theory is that, as the number of unemployed workers falls, employers find it increasingly difficult to find workers with the right skills and experiences and so are forced to raise wages. Also, current employees see their wage bargaining power rise and are thus better placed to demand higher salary growth.

Bank of England data from 1855 to 2009 shows a clear negative correlation between the annual unemployment rate and annual real wage growth. Extracting data from the ONS shows in the graph below that since 1992, this negative correlation between real terms growth in average weekly earnings (using CPI) and the unemployment rate has held quite well.

However, the graph divides roughly into two periods. The first is a pre-recession period with unemployment at approximately 5% and real wage growth largely between 1% and 3%. The second period is the recession and its aftermath with unemployment at approximately 8% and real wage growth largely between -1% and -3%.



If this relationship holds, then if the unemployment rate continues to fall and reaches 5.5% and below, then real wage growth should begin to rise purely as a function of reduced labour market slack.

The unemployment rate is currently at 6% compared to 7.7% one year ago. This rapid fall is also matched by big rises in the employment rate which for 16-64 year olds is at 73%; this is a 1.5 percentage point increase over the year and is close to the record highs. Vacancies have increased by 24% over the last year and the number of unemployed people per vacancy has fallen from 4.7 to 2.9 over the same period. This does seem to fit well with a lot of survey evidence including from the Bank of England's Agents' summary of business conditions which highlights rising hiring intentions.

4. DOWNSIDE PRESSURES

Nevertheless, despite these improving signs it is clear that that there is more labour market slack than would be suggested by the unemployment rate alone. It is clearly always better for people to have jobs than be unemployed but even so, the rise in self-employment and part time employment place constraints on the capacity for real wages to recover.

Self-employment as a percentage of total employment has increased sharply from the approximately 13% in the pre-recession period to a peak of 15%. Many of these may become successful entrepreneurs whereas others have become self-employed more out of necessity. There is some evidence that self-employment income remains at depressed levels.

Moreover, if as seem likely, some of these self-employed workers would prefer to be employed then the pool of available workers is actually larger than just the unemployment rate might imply. The number of self-employed workers has actually fallen by 85,000 over the last two months and as a percentage of total employment it has fallen from 15% to 14.7%. It seems reasonable to assume that this trend of falling self-employment will continue, as happened after the early 1990s recession. This in turn will lead to an elevated ratio of available workers per vacancy which places downward pressure on real wages.

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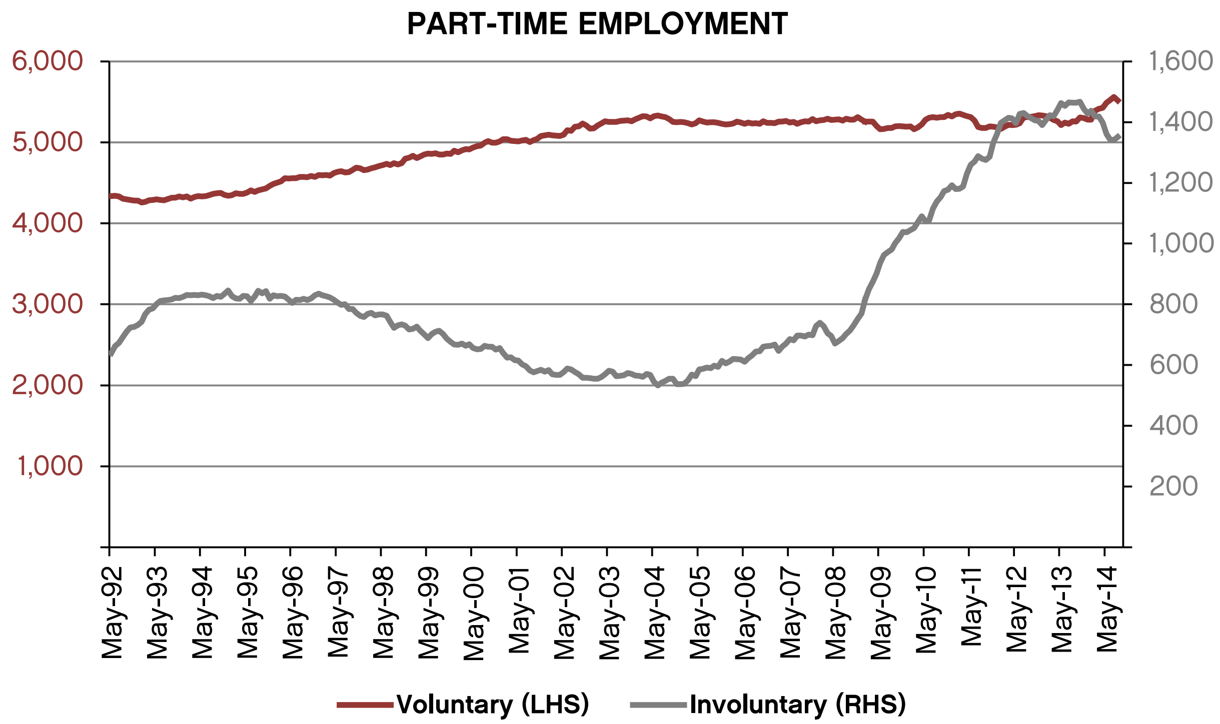
Part-Time employment as a share of total employment also remains at an elevated rate at 26.9%, although it has fallen from its peak of 27.6% in July 2012. This compares to 25.5% in January 2007. This suggests greater labour market slack because demand for labour can to some extent be filled by increased hours from part-time workers as well as part-time workers moving completely into full time work. This would fill labour demand without needing to take on new staff. The average part time employment as a percentage of total employment between January 1995 and December 2006 was 25.3%.

However, it may also be that there has been a structural increase in part time employment. In May 1992 when the ONS data series begins, it was 23.4% and this rose gradually to reach 25% by December 1995. This may be reflective of the lagged effects on the labour market of the early 1990s recession. However, rather than falling during the period of robust output growth, part time employment as percentage of total employment stayed quite flat at just above 25% until the financial crisis in 2008. Some of the current increase in part-time employment may therefore be permanent.

The ONS surveys the main reasons for part time employment. Those who could not find full time jobs, those who did not want full time jobs, those who were ill or disabled and those who are students or at school. By classifying those who could not find full time jobs as involuntary and those who did not want full time jobs as voluntary, it is clear that a large proportion of the increase in part-time employment is involuntary. This means that the number of workers available to start full time work is again larger than the reflected by the unemployment rate.



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5. PRODUCTIVITY REMAINS WEAK

In the medium and long term, employers simply will not be able to afford to give real terms wage rises without improvements in productivity. Labour productivity has seen an unprecedented stagnation and has shown no sign of improvements in 2014. In Q2, productivity was flat relative to Q1 and was 0.3% lower than a year before. New ONS data confirms that UK productivity has consistently underperformed other G7 countries since 2007.

The fundamental relationship between productivity and real wages is confirmed by historical Bank of England data. This implies a protracted period of real wage stagnation given the sustained weakness in productivity. This is a point that we have made consistently despite what have proven to be the Bank of England's and the OBR's far too optimistic forecasts on productivity and real wages. Even if productivity does eventually begin to rise in next few quarters, then it is quite possible that the proceeds will go to pension contributions rather than immediate real wage rises.

Overall, it seems unlikely that wages will by next summer have achieved the underlying growth necessary to see real terms rises. There remains significant labour market slack despite the falling unemployment rate and productivity shows no sign of improvement. The Bank of England will probably be wrong again on real wages. Are we feeling better off than we were five years ago? For much of Britain the answer next summer will still be no.

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6. MUST BE READ:

Allister Heath: Three reasons why wages are falling
Ed Conway: The UK is paying the price of its jobs miracle
Tony Dolphin: Relentless slide to a low pay Britain

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