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Economic Bulletin

WHY THE 11TH OF JUNE WILL BE A DIFFICULT DAY FOR THE COALITION

- Strong rise in the employment rate to 72.7% and vacancies to 628,000.
- Inactivity amongst 18-24 year olds has become entrenched and increased to 28.8%.
- Hours worked have surged but productivity has fallen again in Q1 2014.
- Next month's labour market figures will very likely show falls in real wages.

1. INTRODUCTION

Whilst this week's labour market figures contained good news for employment, there are clear signs that the data to be released on the 11th June could be disappointing. As a result of base effects, it is quite likely wages will show a contraction in real terms compared to a year before. The fragility of real wage growth and continued bad news on productivity show the need for more ambitious pro-growth reforms and the dangers of an anti-business agenda.

The total number of employed people has increased by 283,000 over Q1 2014 and by 722,000 over the year to reach 30.43 million. Even more encouragingly, the employment rate has matched this substantial growth in numbers. 72.7% of people aged 16 to 64 are now in employment, an increase of 0.6 percentage points over the quarter and an increase of 2.3 percentage points since the last election.

The unemployment rate has fallen to 6.8%, a 1 percentage point fall on a year ago, and the number of unemployed people has fallen to 2.21 million, a fall of 15.4% over the last two years. There was an increase in part time employment from 7.9 million to 8.02 million over the last quarter but that appears to have been driven entirely by a rise in the numbers of people who did not want full time jobs from 5.22 million to 5.36 million. The number of part time workers who could not find a full time job actually fell by 7,000.

The inactivity rate continued to fall with 21.9% of 16-64 year olds being inactive in Q1 2014 compared to 22.4% last year. This means the inactivity rate is now the lowest it has been since Q4 1990. Nevertheless, there are still 8.85 million economically inactive people across the UK which remains too high. The progress over the last few years shows that a specific aim of reducing inactivity combined with effective tax and welfare policies can yield improvements and release the economic potential of the country.

It seems likely this strength in employment will continue given the very positive data on vacancies and hiring intentions. The total number of vacancies continued its march upwards reaching 628,000 in the three months to April. This is an increase of 22.6% over the year. Moreover, survey data from the Chartered Institute of Personnel and Development shows substantial rises in employer hiring intentions.

2. ENTRENCHED YOUTH INACTIVITY

However, the labour market is not in universally positive health; this is especially the case with younger workers. The number of unemployed 16 to 24 year olds fell by 48,000 to reach 868,000 in Q1 2014. In January to March 2014, the number of 16-24 year olds in work actually fell by 11,000 compared to December to February 2014. Over the same period, the number of economically inactive 16 to 24 year olds increased by 21,000.

Whilst the fall in youth unemployment is to be welcomed, it has masked the problem of entrenched inactivity. Inactivity amongst the young was clearly rising before the financial crisis but it has remained at an elevated rate unlike across the economy as a whole. The inactivity rate for 18 to 24 year olds is 28.8%, higher than a year ago, and the employment rate has fallen from 71.5% to 71.2%.

3. REVENGE OF THE BASE EFFECTS

Productivity seems once again to have fallen in Q1 2014. Total weekly hours worked grew by 0.9% in Q1 2014 from 966.8 million to 975.9 million. The initial estimate for output growth in Q1 2014 was 0.8% which suggests that output per hour actually fell in the first 3 months of the year. This persistent weakness in productivity is very concerning, as we have mentioned previously.

Hours worked in December 2013 to February 2014 grew only 0.4%, largely due to a dip in hours worked in December 2013. This meant fewer hours were worked in Q4 2013 compared to Q3 2014 which has given the impression of rising productivity in Q4 2013. Now hours worked have continued to surge ahead, the productivity growth of Q4 2013 could well be a false dawn.

These base effects are quite important because given the fall in hours at the end of 2013, there were only 967.5 million hours worked between November 2013 and January 2014. This means that if hours grow as normal in April, then growth in output per hour will appear very weak or even negative when next month's data is released.

The outlook for wages is far less rosy than for employment. Across the whole economy, average weekly total pay in March 2014 was £474: a combination of the average weekly bonus pay of £25 and the average weekly regular pay of £449.

If we look at the latest 3 month average of regular pay, it is 1.3% higher than last year. The latest 3 month average of bonuses is 3% higher than last year. This means the 3 month average of total pay is 1.7% higher than last year. Inflation as measured by CPI was 1.6% in the year to March 2014 which shows that total pay has risen in real terms.

Next month's data will have pay levels for April 2013 as its base comparison. In April 2013, average weekly bonus pay across the economy was an unusually high £47 which meant total pay was £484. This is the result of bonus deferrals but as John Redwood MP has pointed out, the cut in the uncompetitive 50% income tax rate is likely to have led to higher revenue.

Average weekly bonus pay across the economy has fallen from £30 in September 2013 to £25 in March 2014. Even if we assume bonus pay increases by £1 to reach £26 in April 2014, then it is still far below the £47 of April 2013.

Average weekly regular pay has dipped slightly since it reached £450 in December 2013. If we also assume that regular pay increases by £1 in April 2014 to go back to £450, then total pay will be approximately £476.

In this scenario, total pay in April 2014 would therefore be approximately 1.7% less than it was in April 2013. A simple mean of the average weekly total pay in February to April 2013 is £473.7, and the simple mean of the total pay in February to April 2014 (including the assumed £476 for April) is £476.

Under these assumptions, the 3 month average of total weekly pay in April 2014 would be approximately only 0.5% higher in nominal terms than in the same period last year. Given the recent relative stability in inflation, it is unlikely to have deviated far from its current position in the year to April.

Therefore, when the next labour market figures are released on the 11th June, they might actually show real wage contraction of 1% in average total weekly pay. Even if total pay returns to £478 - its level in February 2014 - then pay will still have fallen by 1.2% in nominal terms on a 12 month basis. The 3 month average nominal growth would only be around 0.6% and so there would still be a big fall in real wages.

There is evidence of tightening in the labour market which would normally suggest a boost to nominal wages in the short run. Even without the distortions of April 2013, the underlying growth in nominal wages has been weak thus far.

The danger is this expected real wage contraction adds pressure on the Government to carry out short term, anti-business and anti-market measures. State-imposed price freezes, nationalisation of industries and more regulation might have a superficial appeal but will damage growth capacity and harm our ability to create high paying jobs. The Government should reject siren calls of short term statist fixes which are likely to be heard on the 11th June.

Whilst the strong labour market is still likely to deliver some nominal wage growth in the short term, the current weakness highlights the importance of a renewed focus on pro-growth reforms to boost productivity. Without more robust productivity growth, real wages cannot grow strongly in the long-term.

The CPS will soon be publishing a paper setting out our ideas on how to boost innovation and productivity through far-reaching patent reforms.

4. MUST BE READ

Jeremy Warner: Why Europe threatens Britain's Recovery
Bank of England: Money and Asset Prices
ONS: An Examination of Falling Real Wages

Adam Memon and Tim Knox
Centre for Policy Studies