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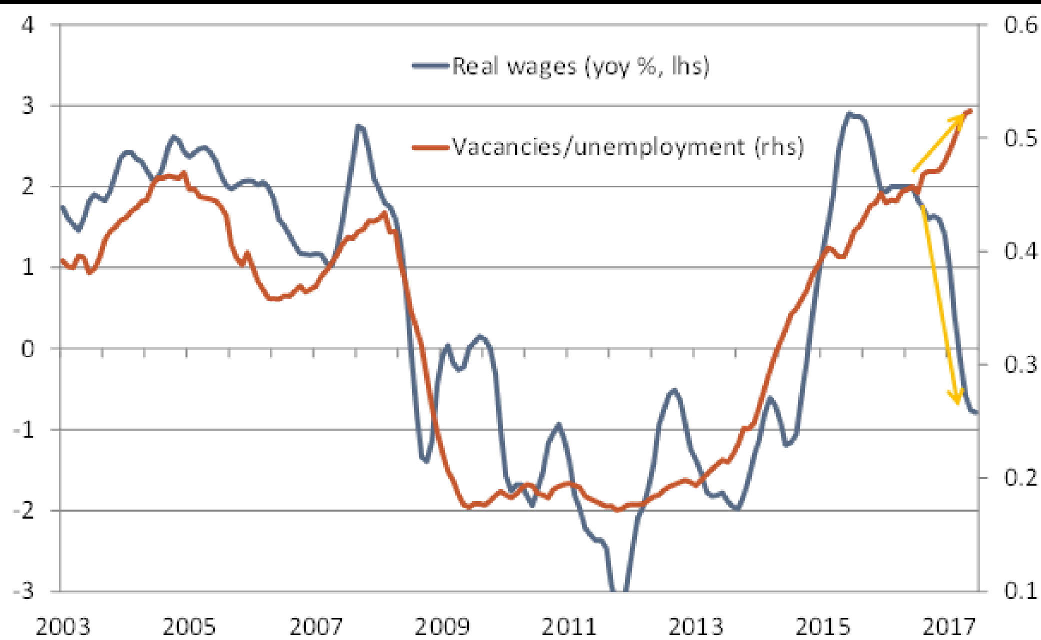
UK: ONE CHART SHOWS WHY THE REAL WAGE SQUEEZE WON'T LAST

Berenberg Macro Flash

Chart 1: Real wages are out of sync with underlying labour market fundamentals



Monthly data. Real wages = average weekly earnings adjusted by headline CPI. Source: Source: ONS, Berenberg calculations. Wage data shows 3 month moving average vs. 1 year ago.

One chart says it all: Real wage growth typically reflects supply and demand conditions in the labour market. As our favourite UK labour market chart shows, in the long-run, real wage growth tends to track the degree of tightness in the labour market. But the shock Brexit vote has temporarily forced a gap in this relationship. The sharp fall in sterling - down c14% on trade-weighted basis - since the Brexit vote is the consequence of markets cutting their expectations of the UK's long-run growth prospects. We anticipate that Brexit will reduce the UK's long-run growth rate to 1.8% from 2.2% pre-Brexit vote. But as the initial concerns of a collapse in short term demand after the UK voted to leave the EU have not materialised in a serious way, labour demand has continued to rise relative to supply – increasing vacancies relative to unemployment. Over time we can expect real wages to recover from the current fall.

The worst for households is nearly over: The major sources of upward pressure to the headline inflation rate, (1) the exchange rate and (2) energy prices, seem to have peaked. It will take a few more months for these cost pressures to fully pass through. We expect headline inflation to peak at 2.9% in Q3 2017 before easing a little thereafter, but remain above the BoE's 2% target through 2018 as the underlying balance of domestic demand and supply keeps inflation above the BoE's 2% target. Meanwhile, recent labour market data suggests that the acceleration in nominal wages from tightening labour market conditions is finally happening. Unemployment fell to 4.4% in June (4.5% exp.) while weekly earnings ex. bonus accelerated to 2.1%, improving for the third month in a row. We expect that by the end of the year, and certainly by the beginning of 2018, providing sterling doesn't take another major leg down, real wages will be rising again.

But will firms really pay higher wages amid Brexit uncertainty? Yes. That is why the vacancy data is key for the wage outlook. The argument touted by some pundits that firms will be reluctant to raises wage amid Brexit uncertainty simply is not backed by the data which signals labour demand is at a record high. Vacancies signal firms' demand for labour. When vacancies rise, it signals that firms want to increase their workforces. And implicitly, that firms are willing to raise their wage bills. That means that when labour is in scares supply, firms will begin to offer higher pay to the candidates that are most suited to the firms preference of skills, pushing up total wage growth.

Nonetheless, wage growth will remain sluggish in the long run compared to historical experience: Weak wage growth in the post-Lehman period can be explained by both transitory and (semi-)permanent factors. The key transitory factors are: 1) persisting weak wage bargaining after a prolonged period of labour market slack and high competition between workers for jobs; and 2) backward looking inflation expectations following the oil-price-driven period of low inflation between 2014 and 2016. But not all factors weighing on wages are temporary. The secular slowdown in real GDP growth – due to a slowdown in productivity growth – will likely have lasting negative effects on long-run wage growth unless other pro-growth policies are used to raise growth. Over time, the temporary effects will fade and nominal wage growth should accelerate to a little north of 3%, in line with the BoE's medium-term forecast. While such a growth rate in wages is lower than in the past, it remains consistent with the slower post-Lehman trend rate of GDP growth and decline in expected trend growth since the Brexit vote.

UK housing market – the risk to watch: So far, the impact of higher inflation on households is mainly showing up in lower confidence rather than a fall in real consumption. As we have argued before, the markets' worries about the impact on consumers from rising inflation are exaggerated and distract from the real threat coming from the housing market – see 'UK housing – the risk to watch'. Household spending exhibits strong wealth effects as house prices fluctuate. Historically, national house prices and aggregate household consumption have tracked closely at a ratio of around 4 to 1 - a 10% yoy rise in house prices would normally imply around 2.5% yoy growth in consumption. Given the strong links between household balance sheets and the housing market, it is hard to imagine a scenario where a nationwide fall in house prices did not trigger a sharp contraction in aggregate household spending. While a nationwide decline in house prices is not our base case, recent softness in the London market serves as a warning that this is the key risk to watch.

For our latest report on the Bank of England and UK monetary policy outlook please see, 'The BoE's job is done: it is time for rate hikes', from 1 September 2017.

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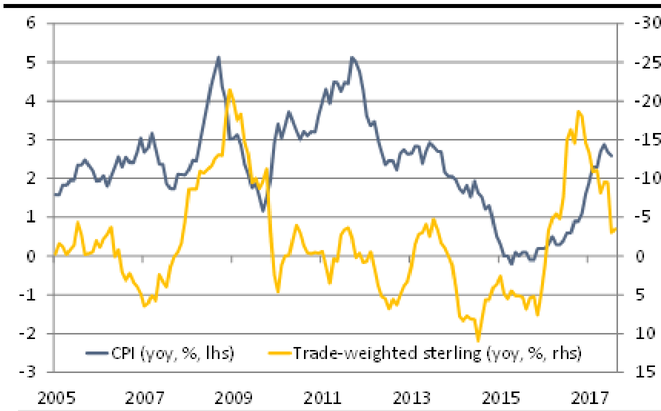
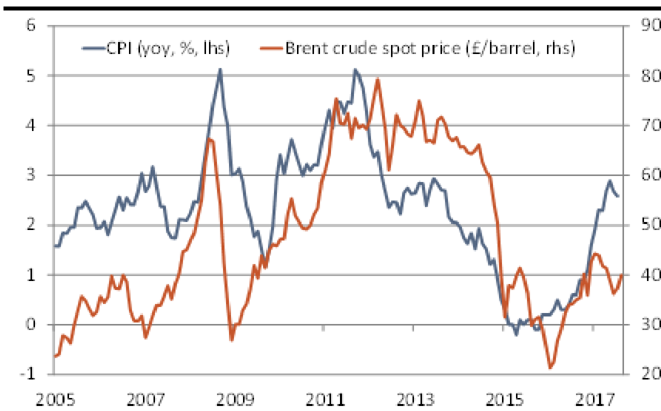
Chart 2: Inflation versus trade-weighted sterling



Source: ONS, Bank of England, Berenberg calculations

Chart 3: Inflation versus £ oil price



Source: ONS, Energy Information Administration, Berenberg calculations

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