UK Economics update
Economics

UK labour market: your flexible friend

- **Plenty of jobs but soft wages:** In days gone by, rip-roaring inflation would have accompanied the employment surge the UK has seen recently. Not this time. A greater proportion of the population are in work than at any point since records began in 1971, but inflation is nearly zero. What is going on? For markets and the BoE, the answer to this puzzle is key.

- **Flexible labour markets:** Margaret Thatcher kicked off three decades of reform by kneecapping unions, freeing employment to rise without causing destructive wage price spirals. Rooting out discrimination and increasing availability of part-time work helped female employment, which reached 68.5% this January, up from 52.8% in 1971, offsetting the fall in the male employment rate from 92.1% to 78.1%. Smaller reforms sometimes go under the radar, but recent efforts may also have helped. The UK has been diligently implementing changes endorsed by the OECD recently, with childcare featuring highly.

- **Older workers join the party:** Employment among over 50s has been on a continual upward trend since the painful shake-out of the 1990s recession. Reforms, from outlawing fixed retirement ages to raising the overall, and especially the female, state pension age have paid dividends. Growing private pension provision probably helped too, by revealing the true cost of early retirement. The employment rate of over 65s has doubled in 15 years.

- **No rest for the government,** which needs to keep reforming to offset the depressing effect an aging population would normally have on the employment rate. Female participation remains the biggest area ripe for improvement. If the UK could match world leaders like Sweden, employment could see another big boost. The Chancellor seems obsessed by the totemic issue of a budget surplus. But these types of labour market reforms are what can really transform government finances.

- **Non-existent problems from EU regulation:** The UK employment rate is close to the pre-crisis US position, which can hardly be described as a bastion of socialist intervention. Moreover, freedom of movement is another reason for the seeming weak worker bargaining power in the UK.

- **How much higher can the employment rate go before wage pressures emerge?** Looked at from the perspective of the employment rate, the UK labour market is red hot. But wages remain cold. All the reforms described above combine to help explain that: the supply of labour has risen, which in part explains why productivity has been so weak (German productivity growth was also weak during the Hartz reforms). At some point though the UK will hit the limits and wage growth will pick up. That point may be nearing. Surging numbers of vacancies suggest firms are struggling to find enough employees at current wages, and wage growth surveys have also improved. In our view, wage growth will gradually pick-up to 3.0% by end-2015. But the risks to that call are to the downside.

Chart 1: Reforms deliver record employment and little inflation

Berenberg UK forecasts

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<th>2015</th>
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<tbody>
<tr>
<td>GDP</td>
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<tr>
<td>Inflation</td>
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<tr>
<td>U/e</td>
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<tr>
<td>Fiscal deficit</td>
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Next week’s key data
(See p5 for more details)

Inflation, February
Published 09:30, 24 March

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<th>Previous</th>
<th>Berenberg</th>
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<tr>
<td>0.3%</td>
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</table>

Another drop in petrol prices, cuts to utility bills and the continuing drag from sterling’s appreciation through last year should drive inflation down further in February. If the renewed falls in oil prices stick, then inflation should turn negative in June (-0.1%), before gradually picking up again.

Retail sales, %mom, February
Published 09:30, 26 March

<table>
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<th>Previous</th>
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<tr>
<td>-0.3%</td>
<td>0.6%</td>
<td>0.4%</td>
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Low inflation boosting real wages, strong jobs gains and consumer confidence riding high should ensure retail sales post another month of strong growth.

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UK employment rates on the left-hand side, RPI inflation on the right-hand side. Source: ONS.

20 March 2015
Flexible, flexible UK

The UK’s big advantage over most other rich economies is the inheritance bequeathed by Margaret Thatcher. She was divisive, but rescued the UK from the misery of post-war decline that resulted in the lunacies of 1970s statism to leave the economy much more flexible, competitive and dynamic. Her reinventing of the UK became so ingrained that the Labour government in power from 1997–2010 declined to unwind most of the free-wheeling capitalist ideals instilled before it.

Subsequent governments built on the Thatcher reforms

Thatcher’s labour market reforms remain the most high profile all. Their enduring impact was evident this week when the UK employment rate reached a new record high of 73.3%. In combination with persistent weak wage growth, this shows that subsequent reforms have continued to push the UK in a more flexible direction.

Back in Thatcher’s time as Prime Minister, the employment rate peaked at 72.8% in 1990. That was a touch lower than today, but the labour market was overheating badly at the time, with rapid wage gains and consequent high inflation. The contrast to today could not be more stark. Inflation may turn negative in the next few months and wage growth is quiescent. We described on the front page the various stages of reform that have put the UK in this enviable position of employing nearly three-quarters of its working-age population. But here we break it down more precisely.

The first set of actions was on union bargaining power. Thatcher pruned back unions, reducing labour’s bargaining power and cutting the so-called non-accelerating inflation rate of unemployment: the jobless total that neither pushes up nor pulls down on inflation. The unemployment rate averaged 4.7% in the 1970s and 9.9% in the 1980s, versus 5.1% in the five years before the financial crisis, yet the former two periods saw high and volatile inflation, and the latter low inflation. Of course, central bank credibility has a central role to play in that story, but labour market reforms matter too.

The second aspect of reforms has focused on participation in the labour force. This continued after Thatcher’s time. Throughout the past thirty years, reducing discrimination in the workplace as well as modernisation, such as the increasing availability of part-time work, have supported rising female participation (Chart 3). Improving child-care could also have had a vital role to play. The latter is particularly worth remembering given that the current government has been quietly but diligently implementing a large proportion of structural reforms recommended by the OECD, some of which relate to helping female participation in part via child-care improvements.

Some of the key participation reforms have been focused on older workers. As Chart 4 shows, employment rates among those aged over 50 have been rising strongly in recent years. Compulsory retirement ages were outlawed in 2011, which neatly matches the timing of a reacceleration in the uptrend of older workers employment.
Other changes will have had an effect on older workers too though. The Pensions Act 1995 began the process of increasing the state pension age for women from 60 to 65, while the current government has set in train earlier, further, increases to the pension age for both men and women. They will reach 67 by April 2028.

The rising importance of private pensions could also have encouraged older workers to stay in their jobs for longer. First, because it can be harder to retire early with a private defined contribution pension scheme. Second, because the collapse in real interest rates may have meant potential pension payments disappointed some workers, encouraging them to continue toil in jobs. The end result is that the participation rate of those aged 65+ has risen about twice as much in the UK as the G7 average since 2000. That rise in the number of older workers also helps to explain the UK’s surging self-employment in recent years. Those over 50 are more likely to work for themselves.

The third key event was the EU enlargement in 2004. At a stroke that gave millions of workers from countries much poorer than the UK the right to work in Britain. The savage unemployment increases in some Eurozone countries since the financial crisis increases yet further the pool of workers looking to swap their current position for a job in the (now growing) UK. By cutting British workers’ bargaining power, freedom of movement means any given unemployment or employment rate could place less upward pressure on wages. This effect is hard to measure (in part because it is so recent), but it seems real for many people.

There have been other, smaller-scale, changes over the years. Active labour market policies have been tried and revised, while the current government is attempting to overhaul welfare payments to raise the incentives for work, and has removed some workers from the need to pay any income tax at all. There may have been better ways of achieving that effect than the one the government took (raising the tax-free personal allowance) but it should be congratulated for trying to sharpen incentives.

All that reform has resulted in a world-leading, flexible labour market. Indeed, Germany jumped on the labour market reform bandwagon from 2003-2005 to end its own period of being the sick man of Europe. The results have been just as spectacular as in Britain (Chart 5). The Eurozone as a whole, however, continues to languish miles behind even the low point to which the UK sank in the dark days of the early 1980s. Much more than discussions of austerity, it is labour market reforms that could truly transform the fiscal outlook across some of the Eurozone’s most indebted nations.

How much further can the employment rate rise?

The UK may be hitting the buffers of previous reforms. Wage growth remains subdued to be sure, but vacancies are surging (Chart 6). For firms with 10-49 employees, vacancies are up 37.4% in the past year. Almost all industries have rapidly raised vacancies over the past 12 months, with the exception of the oil industry and estate agents. Among those seeing vacancies rise, water utilities’ unfilled positions have increased 53%, transport by 51%, construction by 43%, admin by 32.8%, and human health and social work by 30.9%.
UK Economics update
Economics

This suggests firms are increasingly struggling to find as many employees as they want at current wage rates, which tallies with increasing pay growth signalled by surveys (Chart 7). Still soft official average earnings are the outlier among labour market series, and it is hard to know precisely why that series has not picked up.

Perhaps risk-averse behaviour prompted by the financial crisis is stopping workers from pushing for much higher pay – that would be consistent with job-to-job moves still running below pre-crisis rates. And it stacks up with still low levels of business investment (even though they have risen sharply from the trough reached after the recession). Or, alternatively, perhaps the labour market is tight but workers’ bargaining power is so low – the Phillips curve so flat – that it is not as readily expressed in higher pay. Though that could not also explain overall weak wage growth if the labour market has returned to normal – one would also need to believe inflation expectations have slipped materially, which there is only weak evidence for.

Our judgement is that the labour market has tightened materially and will continue to do so. So wage growth will gradually pick-up to about 3.0% yoy by the end of 2015. We would not be surprised to see that process take longer, given the still raw memories of the financial crisis. But aside from the vacancies evidence, more signals come from labour force participation. It seems that the surge in older workers participation rates has slowed. Indeed, 50-64 year olds’ labour force participation rates have not changed for 12 months. By focusing on weak wages today, we could, therefore, miss an underlying change, which is a positive supply shock ending.

For the BoE, policymakers seem to be watching events like doves. Ultimately our call for a February 2016 rate hike comes down to a judgement that they will have to hike rates if the unemployment rate falls below 5%, as it will plausibly do later this year. But surging sterling and weak wage growth, along with cooing noises from some BoE policymakers means the risks are increasingly moving to the side of that hike being delayed.

Chart 6: Running out of workers? Vacancies surging

Chart 7: Surveys point to better wage gains

Index, 2007=100. Small firms defined as having less than 50 employees. Medium 50-2499 employees and large firms more than 2500. Source: ONS.

All series shown as standard deviations from their average since 1998. REC lagged by three quarters, BCC unlagged. All other wage indicators lagged by one quarter. Unemployment rate on the right-hand axis and inverted. Pay series excludes bonuses. Source: BoE, ONS.
**UK Economics update**

Economics

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**Economic calendar**

*CPI inflation, February published 24 March*

Another drop in petrol prices along with cuts to utility bills should drive inflation down a bit further. Sterling’s appreciation through 2014 should add to the disinflationary pressure, keeping imported price pressure very weak. Cheaper oil prices and higher sterling, along with falling food prices, explain most of the UK’s below target inflation but domestic inflationary pressures are weak too, which is one reason why we expect inflation to recover to only 1.5% next year, even after the oil price dissipates.

*Retail sales, February, published 26 March*

Low inflation boosting real wages, strong jobs gains and consumer confidence riding high should ensure retail sales post another month of strong growth in February. January saw a small correction in sales after a bumper Christmas period as a whole, but there are no signs that the small fall at the turn of the year is a harbinger of a period of weakness to come. The British Retail Consortium survey reported 1.7% yoy sales growth in February, above the 1.5% average for the previous twelve months. The Confederation of British Industry (CBI) retail survey gave a more downbeat story, which poses a risk to our above-consensus calls. But that survey can be volatile, and often gives a poor steer of sales growth.

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