THE RF EARNINGS OUTLOOK

A look beyond the headline data on the forces behind current developments in pay, how the fruits are shared, and the short- and longer-term drivers of earnings growth

Analysis from Stephen Clarke:

In Q1 2018 the pay squeeze that had affected the UK economy since the beginning of 2017 ended.

Unfortunately this was the result of inflation subsiding rather than any meaningful uptick in nominal pay growth, which seems stuck below 3 per cent.

Those on the MPC will need to decide if this is the new normal. Interest rate hawks may take the view that, bad as it is, this is still as good as it gets. Those holding off on a rate rise may take the view however that small upticks in pay pressure recently mean that things can only get better.

In Samuel Beckett's Waiting for Godot the two protagonists wait in vain for the arrival of the titular character. At the moment the UK labour market bears a certain resemblance to the play, with the Bank of England playing the protagonists waiting (perhaps in vain) for more robust wage growth. As this Thursday's MPC vote approaches the Old Lady of Threadneedle Street must decide if it's worth waiting, or whether the current pace is as good as it gets.

There are some signs that nominal wage growth is picking up. In Q1 2018 annual growth in weekly wages averaged just 2.7 per cent. This is almost 1.5 percentage points lower than the pre-crisis average, yet growth has been between 2 and 3 per cent for 33 of the past 36 months. Our pay projection shows that in the coming months nominal pay growth is set to remain around, or slightly below, its current level, suggesting that this could be the economy's new speed limit. Furthermore some indicators suggest significantly reduced slack. Unemployment has continued to fall, long-term unemployment remains just 0.2 percentage points above its previous nadir, and underemployment is almost back at the levels of the early 2000s. The share of new vacancies filled by migrants has started to decline for the first time in years suggesting additional sources of labour supply may be drying up.

However, just as the protagonists in Beckett's play are befuddled by the people they meet, there are also signs that spare capacity remains. Alongside ongoing employment growth, underemployment remains elevated for women and younger workers. Job-to-job moves (a key feature of a healthy labour market) are still a fifth below their pre-crisis average. Pay rises for those in continuous employment are also subdued. However, whether you think rates should rise can't be determined by looking at these things alone – instead it depends on which Godot you're waiting for: if you believe that, post-crisis, current wage growth is the new top-speed of the UK economy then it's time for a rate rise. On the other hand if MPC members believe that pay growth has plenty of scope to strengthen further towards historic norms, then now is the time to sit tight.

Our **earnings breakdown** shows that the squeeze on real pay ended in Q1 2018. However with inflation remaining above 2 per cent, there is little growth in real wages. More positively the NLW means that in April we can expect another relatively strong boost to pay at the bottom of the distribution.

Our analysis of **pay pressures and slack** shows that the labour market continues to tighten; unemployment remains at a 40 year low, underemployment is below pre-crisis levels and the share of job entries accounted for by migrants is shrinking. Only job-to-job moves buck this trend, remaining significantly below pre-crisis levels.

Our review of **longer-term labour market health** is less rosy, Productivity growth was disappointing in Q1 2018, off-the-job training continues to fall and the share of graduates in non-grad jobs continues to rise. The one bright spot is that labour force participation, rises in which overwhelmingly benefit those on low incomes, continues to rise.

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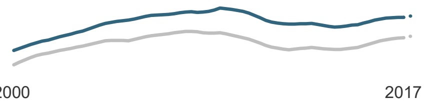
The Scorecard: Q1 2018

What's happened: The earnings breakdown

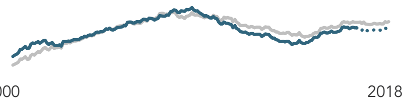
MEDIAN EMPLOYEE EARNINGS



↑ 0.6% on yr (all)
↑ 0.8% on yr (private sector)

Although real pay turned positive again in Q1 2018, growth remains relatively subdued by historical standards. Inflation also began to tick-up at the end of the quarter.

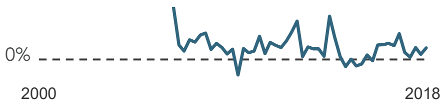
ALL WORKER EARNINGS



Employee earnings and all worker earnings gap →

Self-employed earnings fell by more than employee earnings in 2016-17 but the gap (at 1.8 per cent) has been constant since then.

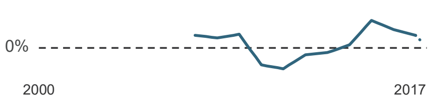
EARNINGS DECOMPOSITION



↓ 0.2 ppts on yr

The compositional boost to pay associated with a changing workforce remains low by historical levels but rose this quarter.

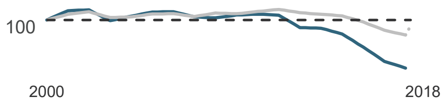
PAY RISES



↓ 0.6 ppts on yr

Median year-on-year real hourly pay growth for employees in work over a year (both job stayers and changers) may have ticked down recently, below pre-crisis levels.

EARNINGS INEQUALITY

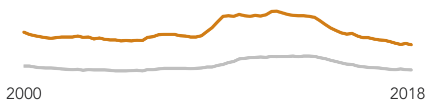


r75:25 ↑ 1% on yr
r90:10 ↑ 1.4% on yr

Some signs that hourly pay inequality between the upper- and lower-middle (r75:25) may be on the rise but too soon to tell if this is just a brief halt in declining inequality.

What's round the corner: Pay pressures and slack

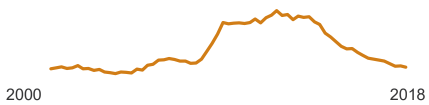
UNEMPLOYMENT BY DURATION



↓ 0.4 ppts on yr (all)
↓ 0.1 ppts on yr (long term)

The unemployment rate continued to fall in Q1 2018. Long-term unemployment also continues to fall, but with signs that levels are plateauing.

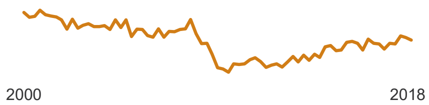
UNDER-EMPLOYMENT



↓ 15% on y

There have been further falls in underemployment (net hours desired by those in work as well as the unemployed) so that it is now almost at the levels of the early 2000s.

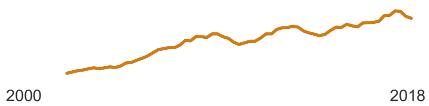
JOB-TO-JOB MOVES



↑ 15% on y

Voluntary job-to-job moves continue to rise, although with some signs that the post-crisis increase could be coming to an end.

MIGRANT JOB ENTRY



↓ 3% on yr

After the post-referendum fall, net migration appears to be holding steady, yet Q1 2018 brought the first significant decline in the rate at which migrants fill vacancies.

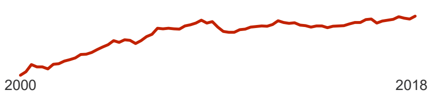
What's in the pipeline: Longer-term labour market health and efficiency

WORKFORCE PARTICIPATION

↑ 0.6% on yr

Labour force participation continues to rise, although the rate of growth has slowed since last quarter.

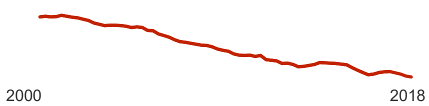
LABOUR PRODUCTIVITY



↑ 0.9% on yr

Labour productivity is higher than a year ago, but fell in Q1 2018 compared to Q4 2017, suggesting that the recent uptick may have just been a blip.

TRAINING INTENSITY



↓ 4% on yr

'Off-the-job' training continues to decline, albeit at a slower rate than in the mid-2000s.

GRADUATES IN NON-GRADUATE OCCUPATIONS

↑ 2% on y

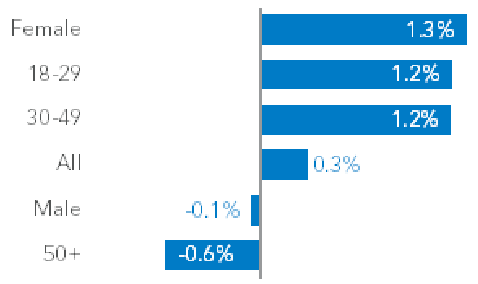
Grads in non-grad roles reflect mismatches between qualifications and jobs, and may constrain productivity. It has risen over time and ticked up again over the past year.

 Source: RF analysis of ONS/DWP datasets. Notes: all real-terms series are CPI-adjusted; for further details of data sources and methods go to www.resolutionfoundation.org/data/sources-and-methods. A full breakdown of each indicator is available at www.resolutionfoundation.org/earningsoutlook. This project was funded by the Nuffield Foundation, but the views expressed are those of the authors and not necessarily those of the Foundation.

Lifting the lid: The picture across different groups and areas

Here we explore a few of the most interesting developments for different groups of workers and different parts of the country. But there's plenty more: a comprehensive breakdown of each indicator is available on the RF Earnings Outlook website: www.resolutionfoundation.org/earningsoutlook

Figure 1: Underemployment: percentage point difference from early 2000s low



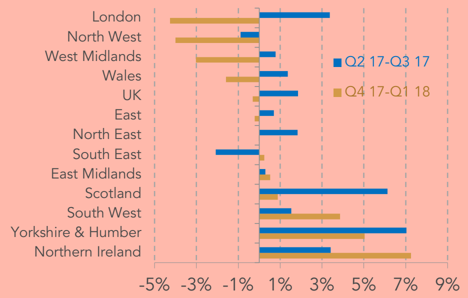
Notes and sources: See notes on Indicator 7: Underemployment: http://www.resolutionfoundation.org/earningsoutlook/

Underemployment is back at 2000s levels, but slack remains for some groups

Although underemployment is just 0.3 percentage points above the lows recorded in the early 2000s, there is some evidence of remaining slack: women, and workers under 50, still have elevated underemployment levels, while older workers and men are back at, or even below, record lows. The groups that have the furthest to go to get back to the levels of the early 2000s (women and younger workers) are more likely to work part-time and find it harder to participate in the labour market. Where there is remaining slack, it is concentrated amongst these groups. On the other hand underemployment is at a record low for people over 50 because the employment rate for this group has risen significantly over the last few years due to improvements in health and increases in the state pension age.

A slowdown in migrant job entry

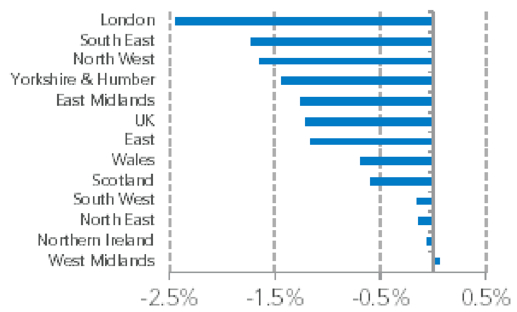
Figure 2: Annual percentage point change in share of new vacancies filled by migrants



Notes and sources: See notes Indicator 9: Migrant job entry at http://www.resolutionfoundation.org/earningsoutlook

In a tightening labour market that is open to migrant labour we would expect an increasing share of vacancies to be filled by migrants. Between 2013 and 2017 the share of vacancies filled by migrants rose from 13 per cent to 21 per cent. This was a period in which migration to the UK increased significantly, from both new EU countries in Eastern Europe and older member states still recoiling from the impacts of the euro crisis. There are now signs that this source of labour may be slowing. On average the share of new jobs filled by migrants was lower in Q1 2018 than a year ago, particularly so in London and the North West. Furthermore although many parts of the country are still experiencing growth in the share of jobs filled by migrants, in all but Northern Ireland and the South West, the growth is slower in the past six months than it was in Q2 and Q3 2017.

Figure 3: Percentage point change in annual labour productivity growth (2001-07 - 2014-16)



Notes and sources: See notes on Indicator 7: Underemployment: http://www.resolutionfoundation.org/earningsoutlook/

The grim 'new normal' is being caused by the old engines of productivity growth faltering

The Bank of England currently estimates that potential output growth is 1.5 per cent, down from around 2.5 per cent in the two decades before the financial crisis. There has been a lot of work done to explain this 'productivity puzzle' and most evidence now suggests that it is the most productive sectors and firms that are responsible for the slowdown. We can also add to this that it is the most productive parts of the country. Figure 3 shows how much lower annual productivity growth was between 2014 and 2016 compared to the rates before the crisis. The most productive regions – London and the South East – have experienced the largest falls. Currently labour productivity is rising at an annualised rate of around 1 per cent, if this is going to rise to 1.5 per cent, let alone a rate close to the pre-crisis trend, then it is the most productive parts of the UK that will need to do better.

 Source: RF analysis of ONS/DWP datasets. Notes: all real-terms series are CPI-adjusted; for further details of data sources and methods go to www.resolutionfoundation.org/data/sources-and-methods. A full breakdown of each indicator is available at www.resolutionfoundation.org/earningsoutlook. This project was funded by the Nuffield Foundation, but the views expressed are those of the authors and not necessarily those of the Foundation.

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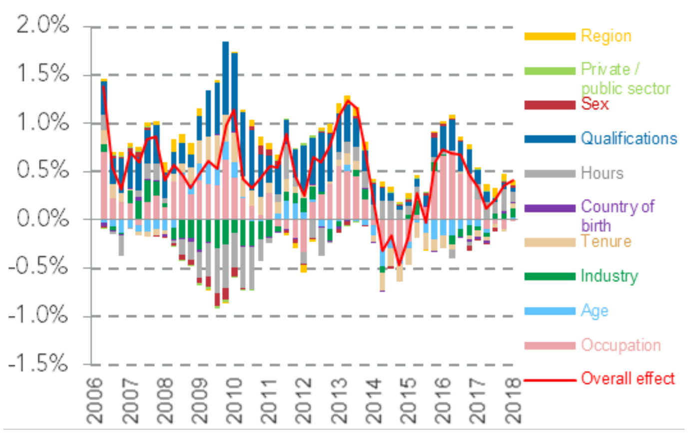
Spotlight: The composition of wage growth

Stephen Clarke, Resolution Foundation

Working out whether it's worth waiting for Godot relies on a clear reading of what's happening to wage growth. One factor that influences this is the changing composition of the workforce. In the short-run one of the big changes is that since 2012 the number of people employed in the UK has risen by 2.5 million and the employment rate has climbed from 71.4 to 75.7 per cent. Significant numbers of people that tend to be out of work (such as single parents, people with lower qualifications, and health problems) have moved into employment. Because these people tend to be paid less (on average) than those already in work we would expect this to lower average pay and repress measured pay growth. In the long-run however, changes in the workforce have tended to boost pay. Over time the share of people with degrees or working in higher-skilled occupations have tended to push up measured pay growth.

Figure 4 shows how these two forces have combined to affect the growth rate of average weekly pay over time. The red line shows that the overall compositional effect tends to be positive, occupational upgrading (pink bars) and improvements in qualification levels (dark blue bars) have provided the biggest compositional boosts. Yet more recently wage growth has been dragged down by falls in hours and shifts into lower-paid industries in the aftermath of the crisis (2008 – 2011). Figure 4 also shows that when the employment rate began to rise after 2012 the compositional effect briefly turned negative.

Figure 4: Compositional effect on annual changes in average weekly pay (nominal)

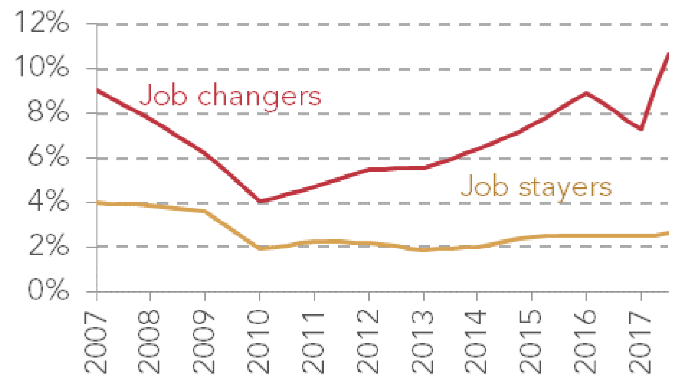


Source: RF analysis of ONS, LFS

Since 2016 the compositional effect has been positive, but, as the Bank of England has argued, the fact that it is below the long-run average means that the changing nature of the workforce is having less of a positive impact than we've been used to. How much is pay growth being reduced by this historically-low compositional boost? Annual pay growth would have been an average of 0.3 percentage points higher since 2013 if the compositional effect had been in-line with the historical average. This is significant but fails to fully explain the currently low levels of pay growth, which are around 1.5 percentage points lower than they were before the crisis. It does however give credence to those that argue that nominal wage growth may be rising faster than the headline average figures suggest.

If the changing composition of the workforce can only explain a small amount of the post-crisis slowdown in wage growth what is responsible? We can strip away the composition effect by analysing pay growth for those in continuous employment. Figure 5 does this by showing the median pay rise for those remaining in the same job from year-to-year and those remaining in employment but switching jobs.

Figure 5: Typical pay change for people remaining in work over a year



Source: RF analysis of ONS, ASHE (post April 2017 figures based on ONS, LFS)

The typical pay rise for someone switching jobs is, on average, around 2.5 times higher than for someone remaining in the same job. Furthermore, pay growth for those switching jobs is back at pre-crisis levels, whereas the typical pay rise for those staying in the same job is still around a third lower than it was in 2007 and 2008.

There has also been a shift in the relative size of these two groups. In the decade before the crisis those moving jobs accounted for around 12 per cent of those in employment, in the decade since this has fallen to 9 per cent. There has been a corresponding increase in the share of people remaining with their employer. The subdued rate of job-to-job moves and the fall in the returns to those remaining in the same job are therefore two indicators that would appear to go some way to explaining the subdued level of wage growth. They are also connected: because job-switching has fallen there may be less pressure on firms to pay their staff more to prevent them leaving. Likewise a lack of job-to-job moves may be dampening productivity growth as firms struggle to attract the most suitable workers. A general lack of pay pressure may also discourage firms from investing in labour-saving, productivity enhancing, technologies.

For those minded to wait for a higher wage growth Godot to turn up the lack of job-to-job moves may be reason to believe that the productive potential of the economy has still not been reached. On the other hand a lack of dynamism may represent the new economic paradigm we find ourselves in – Godot may already have arrived, and just not be much good.

 This project was funded by the Nuffield Foundation, but the views expressed are those of the authors and not necessarily those of the Foundation.