UK Economics Weekly

The Labour Market "Miracle"

- The UK labour market continues to outperform expectations: in April-July, the numbers in work rose by 236,000 (0.8%) versus the prior three months, the third biggest 3-month gain of the last 40 years. The number of people in work is within a whisker of the pre-crisis peak, even though real GDP is still 4% below that peak, reflected in unusual weakness in productivity.
- We do not regard the strength in jobs as a sign that economic growth is at or above potential. Labour supply is rising sharply, reflecting increased workforce participation rates (especially among people aged 50+years), and people are pricing themselves into work, with sharp declines in real earnings plus expansion in less secure (and less well-paid) forms of employment. The numbers of full-time employees remains down from a year ago and is at a record low as a share of the workforce. The economy has considerable slack in our view, reflected both in the relatively high jobless rate and under-employment of people in work. We continue to expect that persistent economic weakness will prompt the MPC to expand QE markedly further over time, reaching £500bn in total over the next few quarters.

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Figure 1. Citigroup Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs Bunds	$/£	£/€
End 2012	0.50	£425bn	1.25	25bp	1.55	0.78
End 2013	0.50	£500bn	2.25	25bp	1.57	0.78

Source: Citi Research

Figure 2. UK — Change in Numbers of People in Work, Percentage, 2008-12

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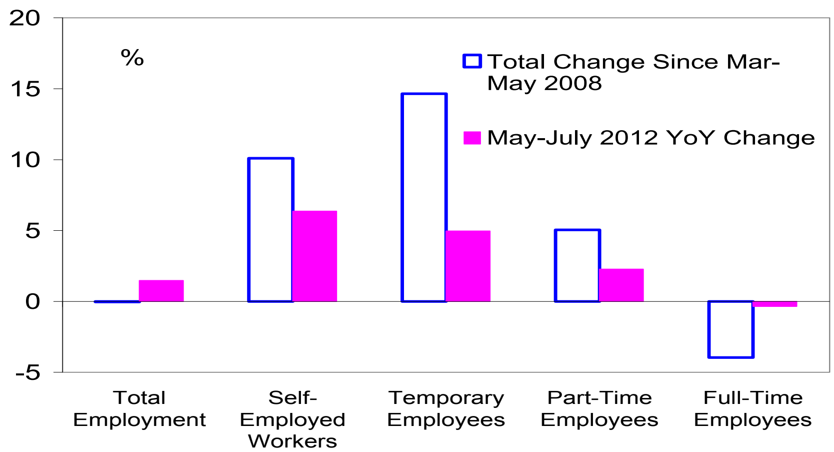


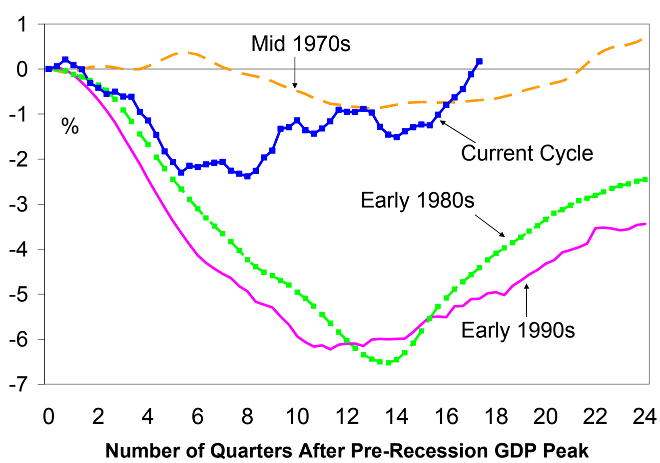
Sources: ONS and Citi Research

The Labour Market "Miracle"

Job growth continues to outperform compared to GDP growth and prior cycles…

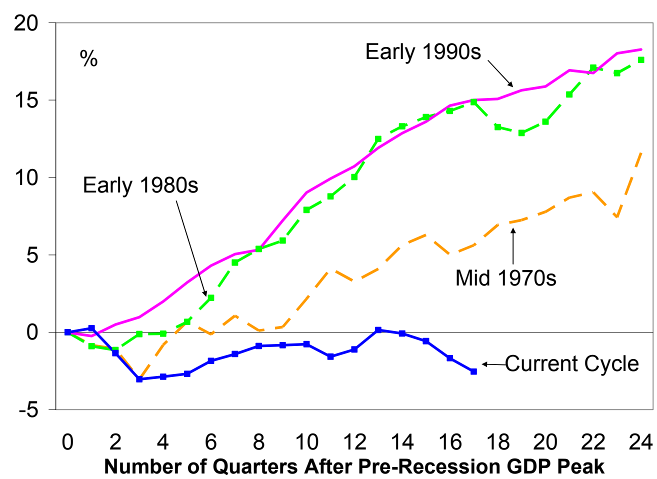
The UK labour market continues to outperform expectations: in April-July; the numbers in work rose by 236,000 (0.8%) versus the prior three months, the third biggest 3-month gain of the last 40 years[1]. The number of people in work is within a whisker (12,000, less than 0.1%) of the peak in May 2008. By contrast, at the equivalent stages of the recession/recovery cycles in the 1980s and 1990s, the numbers in work were 4%-5% below the pre-recession peak. The disparity is all the more striking given that this recession/recession cycle is much worse than the 1980s and 1990s in terms of GDP growth. Of course, the corollary of the divergence between jobs and GDP is that productivity trends are much weaker than in prior recession/recovery cycles. The level of productivity (real GDP per hour) fell about 2.6% YoY in Q2 and was lower than five years earlier, whereas over the period 1987-07, productivity on average rose by 2.4% YoY.

Figure 3. UK — Change in Numbers of People in Work In Recession/Recovery Cycles, 1970-2012



Note: We calculate the change from the quarter with the pre-recession peak in GDP.
Sources: ONS and Citi Research

Figure 4. UK — Change in Productivity (Real GDP Per Hour) In Recession/Recovery Cycles, 1970-2012



Note: We calculate the change from the quarter with the pre-recession peak in GDP.
Sources: ONS and Citi Research

…and this is a major factor in the divergences of views among MPC members

The divergence between GDP and jobs also is a key factor in the disparity between views of MPC members evident in recent speeches:

- Dale argued that given the weakness of productivity, the MPC should not necessarily loosen in response to signs of weak economic growth: "*further demand stimulus may run up against supply capacity relatively quickly and so largely result in higher inflation…the Pavlovian-like response of some commentators to call for more monetary stimulus each time they observe weak growth is not sensible*"[2].

- Broadbent also stressed the deterioration in the supply side and productivity trends, and argued that these reflect the poor state of credit availability. He suggested that in this situation, policymakers should steer by employment growth: "*as monetary policymakers, we should probably pay less attention (than we normally do) to movements in output and relatively more to changes in employment…we're likely to want to ease policy if employment falls (because either demand has weakened or underlying productivity has risen) and to tighten*

[1] The peak gains were 239,000 in June-August 1987 and 276,000 in May-July 2010.
[2] See speech of 7 September 2012.

it if employment growth improves."[3] With employment rising strongly, the "Broadbent" rule would argue against easing and if anything would point to the need to tighten policy soon.

- By contrast, David Miles highlighted the recent weakness in activity: "*growth in the UK has been anaemic — output has stagnated for more than a year.*"[4] So it sounds as if Miles supports further loosening.

Potential growth has worsened, but we still suspect the economy's current growth rate is below potential…

It is fairly clear that the potential growth has worsened from the pre-crisis period. Even though the level of real GDP remains about 4% below its pre-recession peak and about 15% below a simple extrapolation of the pre-recession trend, surveys suggest that capacity use in firms is around its long-run average and the jobless rate remains below the peaks of the early 80s and early 90s. The IMF and OECD both estimate that potential GDP growth is 1%-1½%, versus pre-crisis norms of 2½%-2¾% YoY. However, we strongly doubt that potential growth has worsened so much that the recent gains in real GDP (around zero) and nominal GDP growth (about 2% YoY) are the "new normal".

…and we suspect weakness in productivity is related to other unusual labour market trends

In particular, we do not believe that the gains in employment imply that economic growth is at or above its depressed potential pace (which is what Dale and Broadbent seem to imply). Whereas Dale seems to regard the weakness in productivity as an unexplained exogenous shock, and Broadbent attributes it to frictions related to poor credit availability, we believe weakness in productivity is related to three other unusual labour market trends:

Workforce growth is unusually high, implying rapid growth in labour supply…

- **Rapid workforce growth**. In May-July, the workforce (ie the sum of people in work and unemployed) rose by 1.6% YoY, the fastest pace since 2006 and before that the fastest pace since 1984. By contrast, workforce growth averaged 0.5% YoY over 1972-2011. In turn, with the working age population up by only 0.1% YoY, the surge in the workforce reflects unusually high and rising workforce participation rates. The participation rate usually falls during downturns as people get discouraged from their inability to find a job and opt for labour market inactivity, early retirement or move onto long-term sickness and disability benefits. But, over the last year, the participation rate among the working age population has risen from 76.6% to 77.6%, the highest since 1991 and indeed higher than it was before the recession. The UK's participation rate is a little above the EU15 average (72.6%) but is by no means the highest and participation rates have generally been rising in recent years across other EU15 economies (apart from Greece, Ireland and Portugal, where — with massive job losses — the "discouraged worker" effect seems to be dominating)[5].

…while real and nominal pay growth is unusually weak…

- **Unusual weakness in real and nominal pay**. Average earnings growth remains low at 1-2% YoY, while median weekly earnings (which are less affected by pay trends among high-income earners) have not risen at all since Q4-2010. Separate ONS data show that hourly labour costs, using the common Eurostat measure, which includes non-wage costs, rose by just 0.6% YoY in Q2, down from 1.2% YoY in Q1-2012 (which already was the weakest among the EU15 countries) and compared to 2.0% YoY for the euro area as a whole. By contrast, UK hourly labour cost growth averaged 4.8% YoY over 2000-07 and 2.4% YoY in 2008-11 (versus 2.9% YoY and 2.6% YoY respectively for the euro area). In real terms, average earnings are down by 8% from their peak while real median

[3] See speech of 12 September 2012.

[4] See speech of 11 September 2012.

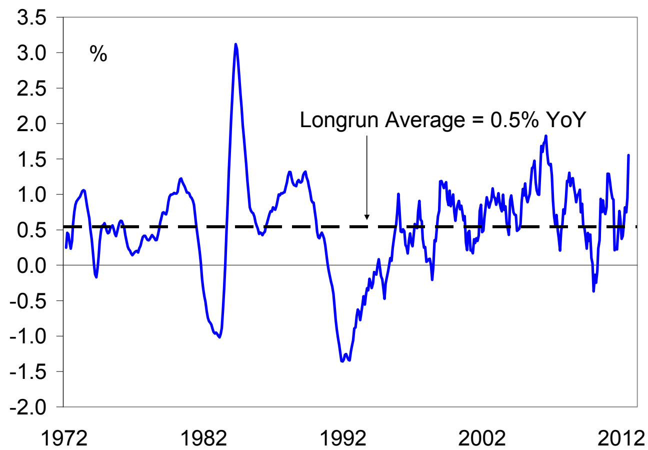
[5] Over the last seven years, the participation rate in Sweden has risen from 75.9% to 79.3%, that in Germany is up from 73.4% to 76.7%, and the rate in the Netherlands is up from 76.6% to 79.1%.

earnings are down by 7%, whereas in the pre-crisis period real wages typically rose by 1%-2% YoY.

…and recent job growth is concentrated in less well-paid and less secure forms of work

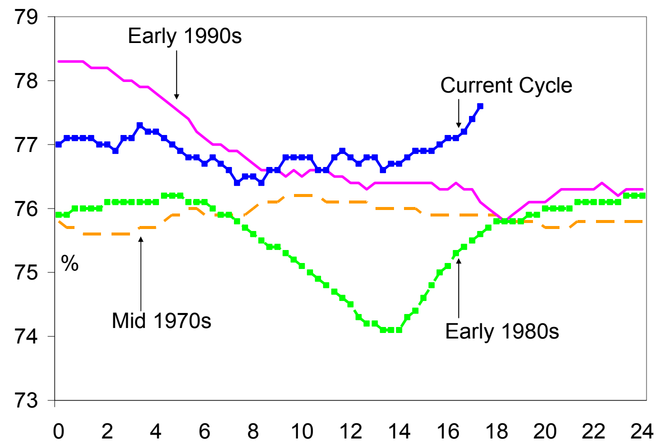
- **Expansion in less secure and lower-paid forms of work**. In May-July, the numbers of self-employed people was up 6.4% YoY (with the numbers of part-time self-employed people up 12.4%), the numbers of temporary employees rose 5.0% YoY, the numbers of part-time employees rose 2.3% YoY and the number of full-time employees fell by 0.4% YoY. The share of the workforce that are full-time employees (ie in work but not self-employed or working part-time) has fallen from 61% four years ago to 57.0% now, a record low. As well as being less secure, typical earnings levels in these less secure jobs also on average are lower than for full-time employees.[6]

Figure 5. UK — Workforce Growth YoY, 1972-2012



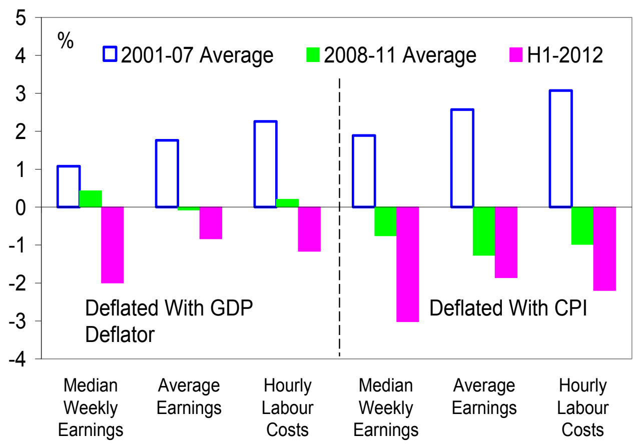
Sources: ONS and Citi Research

Figure 6. UK — Workforce Participation Rates (Working Age Population) in Recession/Recovery Cycles, 1970-2012



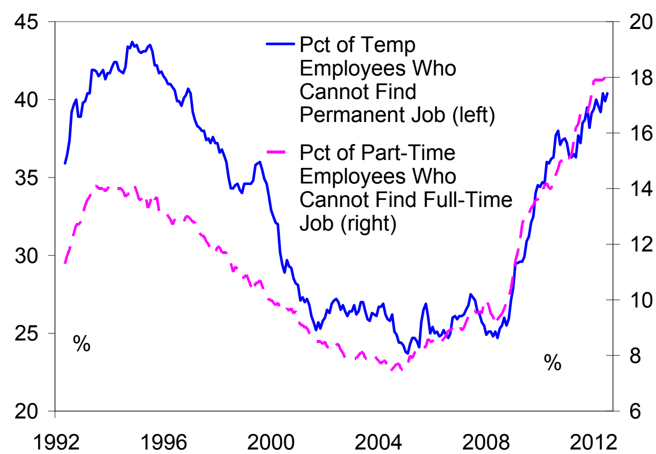
Sources: ONS and Citi Research

Figure 7. UK — Real Pay Growth, YoY, 2001-12



Sources: ONS and Citi Research

Figure 8. UK — Share of Temporary and Part-Time Employees Seeking Permanent/Full-Time Job, 1992-2012



Sources: ONS and Citi Research

[6] For example, in Q2 this year, median hourly earnings were £7.50 for part-time workers (unchanged from two years ago), versus £11.54 for full-time workers (up 2.9% over the last two years).

A range of factors probably are contributing to the rise in labour supply

A range of factors probably are causing the rise in labour supply, for example increased life expectancy, worries over pension provision, the low level of state benefits, reduced availability of long-term sickness benefits, plus greater scope for older workers to remain in work given the long-term trend to a services-oriented economy[7]. In addition, the rapid expansion of secondary and tertiary education in the 1960s, 1970s, 1980s and 1990s means that a far higher share of the older workforce completed secondary and tertiary education than was the case 20 or 30 years ago. For example, among people aged 55-59 years, 32% have some form of tertiary education now compared to 18% in 2000. The age split shows that in the UK (as in many other EU countries), participation rates have been drifting up for many years among people aged 50+years (including people above the usual retirement age), and these age groups also account for a growing share of the overall workforce. In addition, the UK workforce recently has been lifted by higher participation rates among people aged 18-24 years, which may reflect the drop in university applications following the rise in tuition fees.

Core employment is still being hollowed out

At the same time, with weak economic activity, core employment is still being hollowed out, but the people displaced are pricing themselves into jobs — taking any work available, even if at lower pay than before — rather than drift into unemployment and face erosion of workplace skills. Over the last four years, the share of temporary employees who say they cannot find a permanent job but would like one has risen from 25.5% to 40.4%; the share of part-time employees who would like a full-time job but cannot find one has risen from 9.5% to 17.9%.

The combined effect of rising labour supply with the sluggish economy plus labour market flexibility is that real wages are falling sharply

The combined effect of this rise in labour supply with sluggish economic activity is weakness in real pay and expansion of non-core employment, with the side-effect of weak productivity growth (because people take jobs with lower levels of pay and lower value added than their potential). The key point is that, in our view, weakness in productivity does not imply that the economy has no potential growth, but rather reflects the under-utilisation of the available workforce, with scope for productivity to rise if and when demand picks up and people can move into higher paid and more productive work. The labour market and workforce are flexible enough to ensure that the excess supply of labour is reflected in the falling price of labour (ie real wages) rather than purely in high unemployment. In this context of various supply and demand shocks, the “Broadbent” rule (tighten if employment picks up) makes little sense in our view, even if modified to the principle of tightening when unemployment falls. Gains in jobs accompanied by a squeeze on real pay do not pose an inflation threat. In our view, the MPC need to pay at least as much attention to trends in pay as to trends in productivity.

We continue to expect further QE over time, although it may not be a continuous process

We continue to expect that persistent economic weakness will prompt the MPC to expand QE markedly further, reaching £500bn in total over the next few quarters. The next installment may well come at the November meeting, straight after the completion of the current programme (which will take QE up to £375bn). But, the MPC have already done one temporary pause (May) and restart (July) and it is always possible that they will do the same again (pause and restart) if economic data are not too bad, with episodes of QE triggered by soft data or market stress. Either way, the key point is that the economy needs, and will get, more stimulus, with QE alongside credit easing.

[7] People aged over 40 years now account for 53% of employment in the services sector versus 43% in 1988. Among people aged 40-64 years, in 1992, 3.2 million worked in manufacturing or construction, while 1.8 million worked in education and social work. In 2011, 2.8 million people aged 40-64 years worked in manufacturing or construction, but 4.0 million worked in education and social work.

Economic Indicators

Tue 18 Sep	***Consumer Prices (Aug)***	**Forecast: 0.5% MoM, 2.5% YoY**	**Prior: 0.1% MoM, 2.6% YoY**
	CPI Ex Food, Drink, Tobacco, Energy (Aug)	**Forecast: 0.6% MoM, 2.2% YoY**	**Prior: 0.1% MoM, 2.1% YoY**
	Retail Prices (Aug)	**Forecast: 0.5% MoM, 3.1% YoY**	**Prior: 0.1% MoM, 3.2% YoY**
	RPIX – Excludes Mortgages (Aug)	**Forecast: 0.5% MoM, 3.0% YoY**	**Prior: 0.1% MoM, 3.2% YoY**
	Base effects from the relatively strong rise in the CPI a year ago and lower gains in air travel prices probably will bring CPI inflation a little lower this month, despite higher petrol prices. The CPI rose 0.6% MoM in August 2011, matching 1995 and 2008 as the biggest MoM gains in August over the last 20 years and compared to the average August reading of 0.3-0.4% MoM.		
Thu 20 Sep	***Retail Sales Volumes (Aug)***	**Forecast: -0.2% MoM, 3.0% YoY**	**Prior: 0.3% MoM, 2.8% YoY**
	These figures could go either way and we regard our forecast as highly uncertain. The Olympics may have hit sales in the early part of the month, and the CBI retail survey was quite soft, but weekly sales data suggest that spending in the second half of August grew steadily from a year ago. On balance, we go for a small drop in sales, but would not be surprised if the outturn is very different.		
Thu 20 Sep	***CBI Industrial Trends Survey (Sep)***		
	Monthly Output Expectations Net Balance (Sep)	**Forecast: -2%**	**Prior: 0%**
	Monthly Order Books Net Balance (Sep)	**Forecast: -23%**	**Prior: -21%**
	Monthly Selling Prices Net Balance (Sep)	**Forecast: +1%**	**Prior: +1%**
	The August survey showed markedly weaker trends for overall order books and export orders, and we expect to see further deterioration in these series this month. UK domestic demand is slowing, while the drag on the UK from the EMU crisis is expanding as the euro area slips into recession.		
Fri 21 Sep	***Public Sector Net Borrowing (Aug)***	**Forecast: £13.3 bn deficit, £30.2 billion deficit fiscal year to date**	
	(Figures Exclude Costs of Financial Intervention)	**Year Ago: £14.6 bn deficit, £50.2 billion deficit fiscal year to date**	
	The fiscal balance has been worse than a year ago in each of the last three months, with particular weakness in revenues. For the August figures, we expect the fiscal balance to be slightly better than a year ago. The sales of Olympic tickets (which totalled about £500m) will be counted as reduced borrowing by public corporations, while base effects are a bit helpful because borrowing in August last year was relatively high, lifted by unusual strength in central government spending and the current deficit of local authorities and public corporations. Nevertheless, the deficit is likely to rise versus a year ago in subsequent months.		

Sources: BoE, CBI, CML, ONS, national sources and Citi Research.

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Economic Calendar, 10 September — 28 September 2012

10 September	11 September	12 September	13 September	14 September
London 2012 Paralympic Games ended 9 Sep 2012	**RICS House Price Survey (Aug, 00:01)** **Trade Balance – Goods & Services (Jul)** Jun £-4.3bn Jul £-1.5bn	**Claimant Count Unemployment (Aug)** Jul -13,600 MoM, 4.8% Rate Aug -15,000 MoM, 4.8% Rate **LFS Unemployment (May-Jul)** Apr-Jun -46K QoQ, 8.0% Rate May-Jul -7K QoQ, 8.1% Rate **Average Earnings (Jul)** Jun 0.4% MoM, 1.3% YoY Jul 0.0% MoM, 1.4% YoY **Germany:** Constitutional Court Gives Green Light to German Participation in ESM with Two Conditions **Netherlands:** General Election	**Swiss National Bank Monetary Policy Assessment** (08:30) **FOMC Meeting:** QE3 Launched	**Construction Output (Jul)** **Informal EcoFin Meeting Of EU Finance Ministers** (Cyprus, Sep 14-15)
17 September	**18 September**	**19 September**	**20 September**	**21 September**
	Consumer Prices (Aug) Jul 0.1% MoM, 2.6% YoY AugE 0.5% MoM, 2.5% YoY **CPI Ex Food, Drink, Tobacco, Energy (Aug)** Jul 0.1% MoM, 2.1% YoY AugE 0.6% MoM, 2.2% YoY **Retail Prices (Aug)** Jul 0.1% MoM, 3.2% YoY AugE 0.5% MoM, 3.1% YoY **RPIX – Ex Mortgages (Aug)** Jul 0.1% MoM, 3.2% YoY AugE 0.5% MoM, 3.0% YoY	**MPC Minutes (Sep 6)** **BoE Agents' Summary Of Business Conditions (Sep)**	**Retail Sales Volumes (Aug)** Jul 0.3% MoM, 2.8% YoY AugE -0.2% MoM, 3.0% YoY **CBI Industrial Trends Survey (Sep, 11:00)** **Output Expectations (Sep)** Aug 0% SepE -2% **Order Books (Sep)** Aug -21% SepE -23% **Selling Prices (Sep)** Aug +1% SepE +1%	**Public Sector Net Borrowing (Aug)** Aug 11 £14.6bn Deficit Aug 12E £13.3bn Deficit **Fiscal Year To Date** Apr-Aug 11 £50.2bn Deficit Apr-Aug 12E £30.2bn Deficit
24 September	**25 September**	**26 September**	**27 September**	**28 September**
During The Week **Nationwide House Prices** (Sep, 07:00)	**BBA Mortgage Advances (Aug)**	**CBI Retail Survey (Sep, 11:00)**	**Balance of Payments (Q2)** **GDP (Q2, 3rd Release)** Q1 -0.3% QoQ, -0.2% YoY Q2P -0.5% QoQ, -0.5% YoY **Record of Financial Policy Committee Meeting on 14 Sep**	**GfK Consumer Confidence** (Sep, 00:01) **Service Sector Output (Jul)** Jun -1.7% MoM, -0.6% YoY Jul 1.7% MoM, 1.1% YoY **Labour Productivity (Q2)** **Bi-Annual Gov't Deficit & Debt Return to EU Commission**

E Citi estimate. B Billion. P Provisional. R Revised. Note: All data are released at 9.30 a.m., except those marked otherwise.
Sources: BoE, CBI, CML, ONS, national sources and Citi Research.

Notes

Appendix A-1

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