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Western Europe

UK Economics Weekly

The Squeeze on Living Standards

- Even though the UK economy is picking up, the unprecedented squeeze on living standards continues. Real wages are down 1-2% YoY and have now been falling for 5-6 years. The decline in real wages is partly a side-effect of the long period of economic weakness, but has been exacerbated by gains in import prices and higher prices for energy and utilities (driven mainly by global costs, taxes and government surcharges). In addition, with buoyant labour supply and the flexible labour market, the inevitable squeeze on labour costs has come through more via a decline in real wages than via persistent declines in employment.

- We suspect that real wages will continue to fall in YoY terms in H2 this year, and probably also in 2014. Investment is at a record low as a share of GDP, capping future productivity gains. Labour supply remains ample, with high unemployment and, attracted by the UK's relatively high wage levels, sizeable inflows of foreign workers. The government may act later this year to cap some regulatory or tax-driven price hikes, but has limited fiscal space to do much. We expect that the decline in real wages will not prevent the economy picking up, with recovery driven more by housebuilding, exports and lower savings than by real wage gains. But, to some people, it may not feel like much of a recovery for a while.

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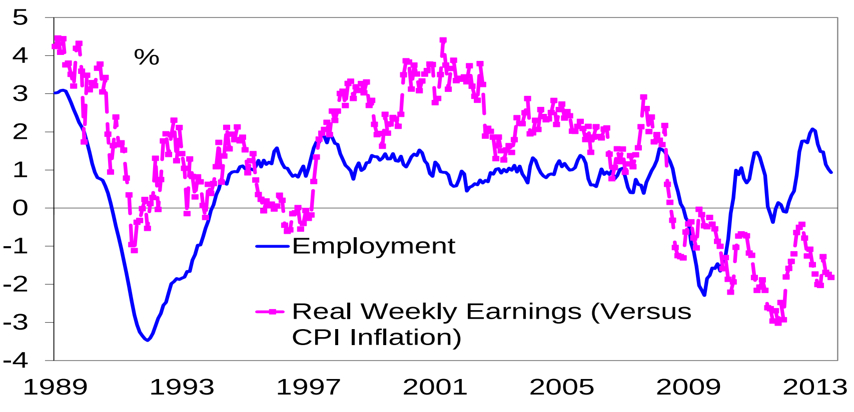
Figure 1. Citi Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs. Bunds	$/£	£/€
End-2013	0.50	£375bn	2.80	102bp	1.65	0.83
Mid-2014	0.50	£375bn	3.05	127bp	1.66	0.82

Source: Citi Research

Figure 2. UK — Real Average Earnings and Employment Growth, YoY, 1989-2013



Note: Average earnings measured excluding bonuses since 1997. Sources: ONS and Citi Research

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The Squeeze on Living Standards

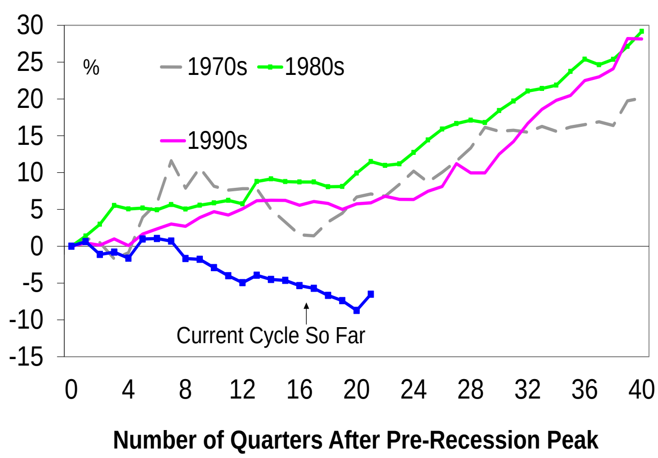
Real wages continue to fall…

Even though the UK economy is picking up, the unprecedented squeeze on living standards continues. Underlying average earnings growth, at 1.0% YoY in May-July, remains well below CPI inflation (2.8% YoY over the same period), leaving underlying earnings down by 1.8% YoY. Real earnings growth has been consistently negative since mid-08, with a total decline of 6.6% over the last six years (ie average decline of 1.1% YoY). By contrast, over the prior 10 years (ie the 10 years ended July-07), real earnings grew by 28%, an average gain of 2.5% YoY. Other measures tell a similar dismal story.

…and the extended decline in real wages in recent years is without precedent over recent decades

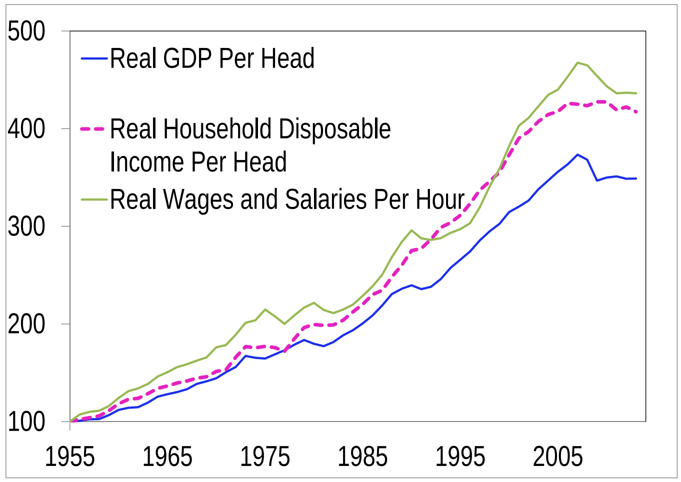
- Real wages and salaries per hour[1] have fallen by 0.9% over the last year (even with the erratic tax-driven Q2 jump in bonus payments), and are down by a total of 7.9% since Q4-07 (with declines in 2008, 2010, 2011 and 2012). By contrast, real wages per hour rose by an average of 2.6% YoY over the prior 30 years. Such a long period of persistent declines in real wages is without precedent over recent decades. Indeed, before the recent period, the only full years with falling real wages since data began in 1971 were 1976 and 1977, along with minor declines of 0.1% YoY in both 1984 and 1995.
- Real personal disposable income per head in Q2 was 2.0% below the mid-07 level, whereas over the prior 10 years, real incomes rose by an average of 2.4% YoY. Again, this is the first time since data began in 1955 that real income per head has fallen over a 5-year period.
- Average household income fell 3.0% YoY in nominal terms in 2011/12, the first YoY decline since data began in 1977.

Figure 3. UK – Change in Real Wages and Salaries Per Hour Worked From Pre-Recession Peak in GDP, 1970-2013



Note: Real wages measured by total wage and salary income, divided by hours worked, deflated using the consumer spending deflator.
Sources: ONS and Citi Research

Figure 4. UK – Real GDP, Per Head, Real Income Per Head and Real Wages Per Hour, Indexed to 1955= 100, 1955-2013



Note: Figure for 2013 is H1 only. Real income and real wages deflated by the consumer spending deflator.
Sources: ONS and Citi Research

The erosion of real wages is largely an inevitable by-product of the long period of economic weakness…

The unprecedented and sustained decline in real wages is partly an inevitable reflection of the unprecedented and sustained weakness in the economy over recent years. This has been the weakest recession/recovery cycle in terms of GDP in recent decades, with real GDP per head still 7.1% below the 2007 peak. Indeed, the decline in real household disposable income (RHDI) actually has been quite modest relative to the decline in GDP. Real wages have fallen sharply but

[1] Measured by aggregate wage and salary income, divided by total hours worked and deflated by the consumer spending deflator.

disposable incomes have been cushioned to an extent by the rise in the fiscal deficit, although this may be of only limited comfort to many consumers.

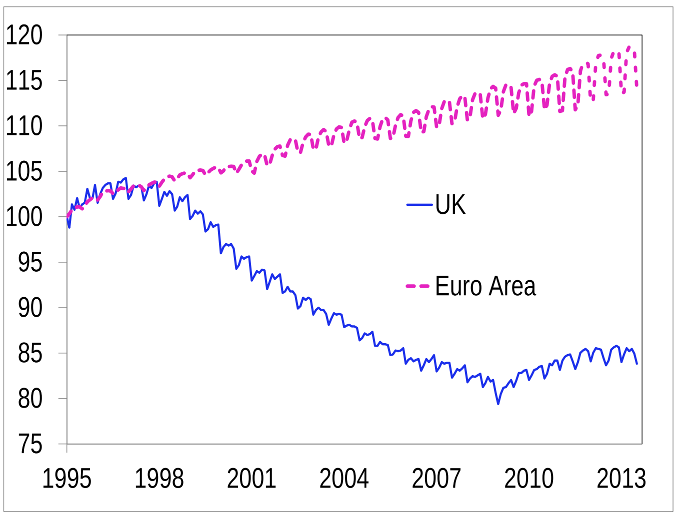
…but has been exacerbated by other factors

However, these cyclical effects do not tell the whole story. Real wage growth already began to slow sharply in 2005-06, before the financial crisis hit, and cyclical effects have been reinforced by three other trends.

The pre-crisis growth in real wages benefited from an extraordinary decline in prices of imported consumer goods

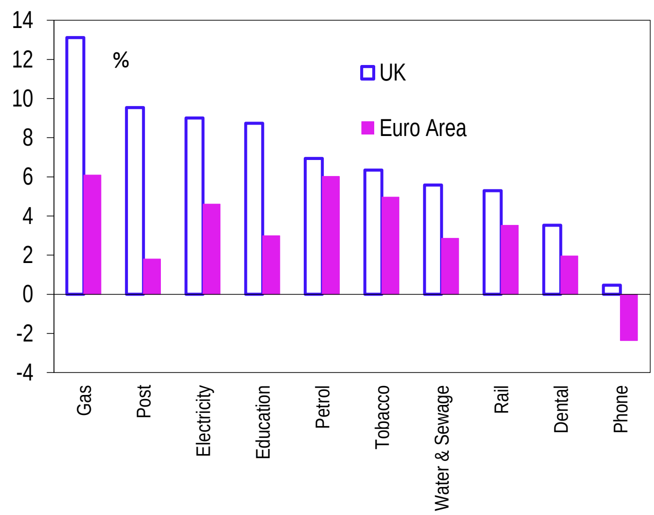
First, the pre-crisis growth in real wages was in part a symptom of the economy's unsustainable imbalances (worsening current account, high pound and credit-driven boom. From Jan-97 to Jan-08, the high pound and shift to importing from low-cost countries caused core consumer goods prices (ex food, drink, tobacco and energy) to fall by a total of 20%, whereas prices rose by 8% in the euro area over that period. This decline reflected a windfall gain for UK real incomes. In recent years, with the weak pound and rising global costs, this consumer windfall has ended. UK core consumer goods prices have risen by an average of 3% over the last five years, matching the trend in the euro area.

Figure 5. UK and Euro Area – Core Consumer Goods Prices, Indexed to Jan 1995 = 100, 1995-2013



Note: Core consumer goods exclude food, drink, tobacco and energy.
Sources: Eurostat and Citi Research

Figure 6. UK and Euro Area – Average YoY Change in Prices of Selected CPI Items, 2005-13



Note: Data for 2013 is H12 only.
Sources: Eurostat and Citi Research

The UK has relatively rapid rises in prices of utilities and other regulated items

Second, inflation in recent years has been further lifted by large gains in indirect taxes, energy prices, utility prices and other semi-regulated prices (eg electricity, gas, water, rail fares, university tuition fees). These items have persistently added about 1% to YoY CPI since mid-2006, with a similar effect at present, hence eroding real incomes by a similar amount. By contrast, price rises for these items were typically far more modest in the pre-crisis period, with these items adding only 0.4% per year to the CPI over 2001-05. The faster gains in recent years reflect a mix of higher global costs (eg for fuel), indirect tax hikes and regulatory-driven price hikes designed to finance extra investment and reduced subsidies. This effect has been more pronounced in the UK than most EU countries.

Compared to prior cycles, the squeeze on labour costs has come more through lower real wages than through a drop in hours worked

Third, while the above factors have caused an inevitable decline in aggregate real incomes, this has been reflected in an unusually large drop in real wages per hour (and real average earnings) rather than a sharp decline in employment and hours worked. Real pay has been unusually flexible, reflecting the combination of high unemployment and strong labour supply growth, driven by inflows of foreign workers, rising participation rates in the UK (particularly among the over-50s,

mothers with young children) and people previously on long-term sickness and disability benefits. These groups have been unusually keen to seek work even if it means taking a squeeze on pay or less secure forms of employment. In aggregate, a large number of people have priced themselves into work. Hence, compared with previous cycles, real wages per hour have been relatively weak, while employment and total hours worked have held up quite well. Of course, the corollary of all this has been unusual weakness in productivity.

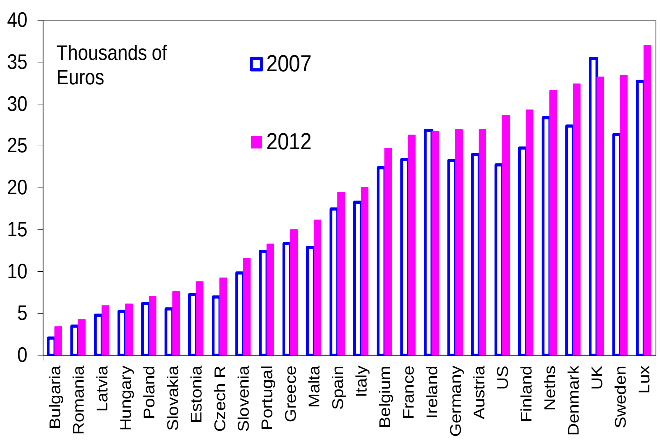
The squeeze on living standards has been compounded by worse credit availability and weaker house price gains

In the pre-crisis period, some people may have tapped home equity wealth and easy credit availability to support spending despite constraints from weakness in real wages. That lifeline has been less available in recent years, with lower LTV ratios on mortgages and high interest rates on overdrafts and unsecured loans, hence compounding the erosion of living standards.

We expect that real wages will continue to fall in H2 this year and perhaps again fall slightly in 2014

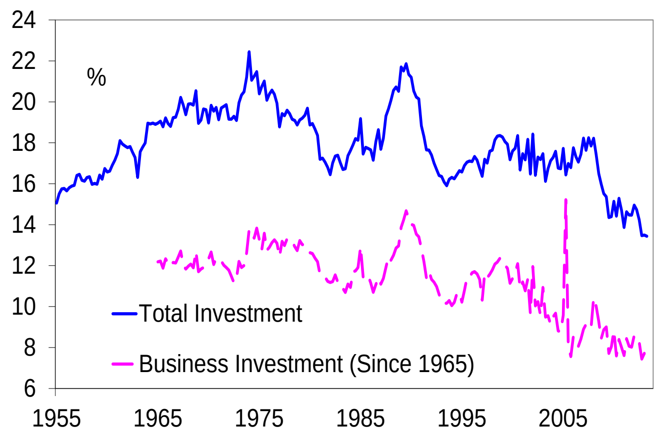
We expect that real wages for those in work (measured by average earnings ex bonuses less CPI inflation, or real wages and salaries per hour) will continue to fall in H2 this year and perhaps also fall slightly in 2014. The labour market still has plenty of slack, with the relatively high jobless rate, uptrend in the participation rate and inflows of foreign workers. The level of pay in the UK is among the highest in the EU, and the UK remains very open to foreign workers, with full labour mobility within the EU and sizeable inflows of non-EU workers as well. Further fiscal restraint lies ahead over time, capping incomes via public sector job cuts, wage restraint and benefit curbs. The previous windfall to real incomes from falling consumer goods prices is unlikely to repeat, given the lower pound and (with gains in Asian labour costs) reduced global deflationary impulses. The Chancellor recently hinted that he will address the rises in regulated prices later this year (most likely in the Autumn Statement), but — given that many regulated price hikes are used to finance investment or cut subsidies — we suspect that he will seek merely to slow price increases rather than to reverse them.

Figure 7. EU and US – Average Net Pay After Tax and Benefits, (Single Person With No Children), Thousands of Euros Per Year, 2007-12



Sources: Eurostat and Citi Research

Figure 8. UK – Investment as Pct Nominal GDP, 1955-2013



Sources: ONS and Citi Research

Weakness in real wages is unlikely to prevent the economy continuing to recover

We expect that weakness in real wages will limit, but probably not prevent, the economic recovery, which initially is likely to be driven by housebuilding, exports, plus gains in consumer spending financed from lower household savings and growth in employment rather than expansion in real wages. This mix is very different from the recoveries of the early 1980s and early 1990s, when real wages for those in work generally continued to grow even while unemployment was very

high. Compared with those cycles, the current mix in effect trades off declines in real wages for higher employment and a lower jobless rate.

Even when real wages start to rise, we suspect that progress will be modest compared to the pre-crisis norm

We do expect that real wages will pick up further ahead, as the jobless rate falls, investment recovers and productivity picks up. But, with the factors discussed above, the UK probably faces a long period during which real wage growth remains low compared with the pre-crisis norm of about 2½% YoY. Investment fell to just 13.4% of GDP in Q2, down from 18.2% of GDP in Q1-08 and the lowest since data began in 1955. Business investment accounts for just 7.2% of GDP, also a record low (data go back to 1965). Such low investment implies meagre capital stock growth and, over time, weak growth in labour productivity and hence reduced scope for rapid real wage gains. It also is possible that the UK will replay the US experience of recent decades in which real income gains are concentrated towards the top end of the income distribution, so that the growth of median (ie middle) incomes lags the economy for an extended period[2].

There are no lasting short-cuts to producing higher real wage gains, but we would emphasise measures to lift investment and innovation

One can imagine policies that superficially appear aimed at lifting real wages near term, but in practice would probably have large adverse side-effects. For example, restrictions on labour supply (eg higher minimum wage, limits on employment of foreign workers, earlier retirement ages, more generous benefits for long-term sickness and disability) might well reduce labour market slack and lift real wages for those in work. But they would do so by reducing the numbers in work. A sharp appreciation in sterling would probably cut prices of imported consumer goods, but would also hit exports. Similarly, cuts to regulated prices would, unless replaced by alternative subsidies, probably reduce the investment that regulated price hikes are meant to finance. Better solutions, on our view, would be measures to lift productivity through higher business investment — for example, better SME credit availability plus a strong focus on encouraging globally mobile firms to invest in the UK (eg low corporate tax rate, more generous capital allowances, reduced discussion about possible EU exit).

[2] This does not seem to have been in a major way the case so far. The ONS report that over the last five years, both mean and median hourly earnings of all employees rose by 11%. The ONS also report that over the last ten years, incomes of the bottom 20% of the income distribution have risen by 20% in nominal terms, whereas incomes have fallen slightly for the top quintile. See "*The Effects of Taxes and Benefits on Household Income*", 2011/12, ONS, July 2013.

Economic Calendar, 23 September — 11 October 2013

23 September	24 September	25 September	26 September	27 September
Labour Party Conference (Brighton, Sep 22-25)	BBA Mortgage Advances (Aug) Jul 37,428 MoM, 31.1% YoY Aug 38,228 MoM, 25.6% YoY	CBI Retail Survey (Sep, 11:00) Aug Sales +27% YoY Sep Sales +34% YoY	Balance of Payments (Q2) Q1 £-14.6bn Q2 £-13.0bn GDP (Q2, 3rd Release) Q1 0.4% QoQ, 0.2% YoY Q2 0.7% QoQ, 1.3% YoY	GfK Consumer Confidence (Sep, 00:01) Nationwide House Prices (Sep, 07:00) Aug 0.7% MoM, 3.5% YoY Sep 0.9% MoM, 5.0% YoY Service Sector Output (Jul) Jun 0.0% MoM, 2.8% YoY Jul 0.2% MoM, 1.8% YoY *During The Weekend:* Austria: General Election (Sep 29)
30 September	**1 October**	**2 October**	**3 October**	**4 October**
	Manufacturing PMI (Sep)	Government Debt & Deficit (Sep 2013) ECB Meeting (Paris) 12:45 Outcome 13:30 Press Conference	Services PMI (Sep)	*Around Now* Halifax House Prices (Sep, 08:00)
7 October	**8 October**	**9 October**	**10 October**	**11 October**
	British Chambers of Commerce Quarterly Economic Survey (Sep) IMF Releases *World Economic Outlook*	Industrial Production (Aug) Manufacturing Output (Aug) Trade Balance – Goods & Services (Aug) MPC Meeting Starts IMF's *Global Stability Report* and *Fiscal Monitor*	MPC Meeting Ends: Outcome At Noon G-20 Finance Ministers & Central Bank Governors Meeting (Oct 10-11, Washington, DC)	Construction Output (Aug) IMF/World Bank Annual Meetings (Oct 11-13, Washington, DC)

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, ONS, national sources and Citi Research.

Notes

Notes

Appendix A-1

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