Economist Insights
All work and no pay

Central banks talk a lot about inflation, but what they are really keeping an eye on is wages. In the UK, the BOE may be downplaying the improvement in employment because so much of it has come from a rise in self-employment. Yet the growth in the number of employees has been recovering. And although wage growth may look like it is slowing, this may be down to a temporary composition effect. Within most sectors, wage growth is weak but rising.

Joshua McCallum
Senior Fixed Income Economist
UBS Global Asset Management
joshua.mccallum@ubs.com

Gianluca Moretti
Fixed Income Economist
UBS Global Asset Management
gianluca.moretti@ubs.com

Central banks talk a lot about inflation, but what they are really keeping an eye on is wages. Inflation can be pushed around by oil prices, taxes, exchange rate movements and such-like, but these will all be transitory effects unless wages go up as well. If oil prices go up but wages do not, people will have less money to spend on other goods and services, pushing inflation back down again. To get sustained inflation, you need to have wage growth.

In principle, wage (or earnings) growth should come when the unemployment rate falls low enough, so that there are more employers chasing scarce employees. Employers have to compete and bid up earnings to fill job vacancies. You could be forgiven for thinking that, following higher economic growth in the UK and a falling unemployment rate, earnings growth should start to become an issue. In fact, the Bank of England (BOE) remains quite dovish, and still thinks that there is substantial slack in the labour market.

The BOE may be downplaying the improvement in employment because so much of it has come from a rise in self-employment (see *Economist Insights*, 10 February 2014). If this represented lots of successful new start up-businesses that were making these entrepreneurs very rich then the BOE would need to be more worried about inflation. Unfortunately, many of these businesses are likely to represent less profitable, second-best alternatives for people who would rather be employed. If this is the case, it is likely that the growth in self-employment could put downward pressures on earnings dynamics. Measuring the effect of self-employment on earnings is difficult because the surveys only cover employees.

But even stripping out the self-employed, growth in the number of employees has been recovering. This growth in employees has traditionally been well-correlated with earnings growth (chart 1). That is, at least, until the last few years. The slow pace of growth in total weekly average earnings (excluding bonuses) is puzzling.

Chart 1: More jobs, cheaper labour

Growth of number of employees and average weekly regular earnings (excludes bonuses) (% year-on-year)

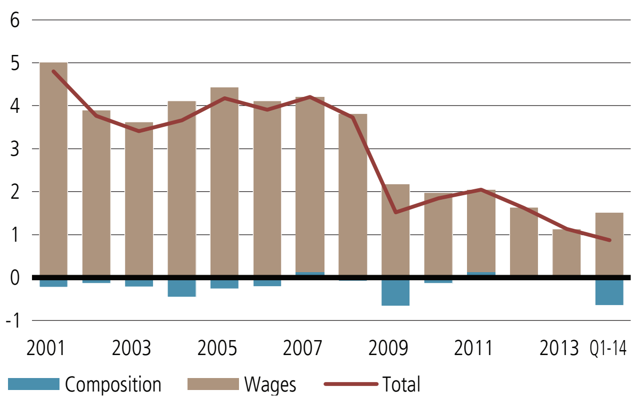
Source: ONS

It could be that job growth has shifted from higher-productivity (higher-paying) sectors to lower-productivity (lower-paying) sectors. Even if earnings are rising within each sector, average earnings can fall thanks to this composition effect.

Interestingly, over the last decade or so, the composition effect has generally been negative (chart 2). In 2009, the composition effect was notably negative because so many jobs were lost from higher-paying sectors (such as the financial sector). In the first quarter of this year, the composition effect was also markedly negative as more jobs were added in lower-paying sectors. Nevertheless, with these exceptions, the composition effect has generally been small so another explanation is needed for low earnings growth.

Chart 2: Trading down

Contribution to average yearly earnings growth (% year-on-year)



Source: ONS, UBS Global Asset Management

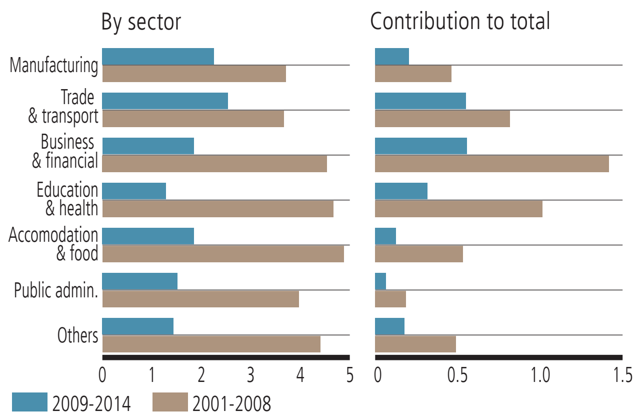
Aside from the composition effect, total average weekly regular earnings growth can be explained by the earnings growth in each industry sector. The composition effect was only really significant in 2009 and the first quarter of this year; lower earnings really have been caused by slower earnings growth within sectors.

Looking across the major industry sectors, the weakness in earnings has been broad-based (chart 3). In line with the common view, the business and financial services sector contributed the most to average earnings growth before the financial crisis (and, interestingly, is still one of the largest contributors). But education and health was also a very large contributor, thanks both to its larger size (25% of total employees) and the largesse of public spending at the time. Since then, austerity has taken its toll and this sector contributes little to overall Earnings growth. In general, the message is clear: every sector is exhibiting much weaker earnings dynamics after the crisis than before.

The BOE thinks that very few companies are reporting spare capacity in terms of having too many employees. Instead the BOE thinks that there is greater spare capacity in the labour market overall - there are many people who would be willing to take over the jobs of those who are currently working.

Chart 3: Earning your contributions

Earnings growth (% year-on-year), by sector and contribution to total earnings (ex-bonuses) growth in the economy



Source: ONS, UBS Global Asset Management

Many of the newly self-employed may be part of that group. For example, a laid-off chef who sets herself up as self-employed to take occasional work may prefer to have stable employment. These self-employed may not be unemployed but they are under-employed. The unemployment rate may therefore underestimate the slack in the labour market and the potential downward pressure on earnings.

Such is the thinking of the BOE, which finds itself in the unusual position of talking down the UK economy. Yet if, as the most recent data suggests, it is only the composition effect that is making earnings growth look like it is slowing, the BOE might want to temper its pessimism. The composition effect is likely to be temporary, and earnings growth within sectors is accelerating from weak levels. All that work may eventually lead to more pay.