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UK Watch

Wage growth higher for longer

14 July 2023

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The labour market is easing

Rising long-term sickness cutting workforce growth has left the UK labour market extremely tight despite no growth in the economy in around four years. Recent data have been more encouraging, however, with labour supply improving and signs the labour market is easing. This should give the Bank of England a crumb of comfort.

One-off supply increases

The participation rate improved first as students returned to work and then from increasing workforce participation from those previously inactive due to family commitments and retired people. The number of people inactive due to long-term sickness has also thankfully stopped rising. There are limits to how much further labour supply can improve in our view. The rise in student activity seems to have run its course. Given continued healthcare issues we are not at this point prepared to forecast the widespread return to work of those who have been long-term sick.

Demand slowing

Further labour market easing will have to come from weaker demand in our view. Here the signs are encouraging for the BoE. Vacancies continue to fall, particularly for the private sector. If private services vacancies continue falling at their recent rate they will be back to their pre-Covid level before year-end. Short-term unemployment is rising, underemployment seems to have bottomed.

But wage growth surprised on the upside again

Why aren't these signs of easing in the labour market slowing wage growth? Wage growth continues to surprise consensus on the upside, with private sector regular pay growth annnualising at 8.6% over the past three months, far above a rate consistent with inflation at target. We use a set of wage equations to show that wage growth seems to be reacting more to lagged inflation than the past. That suggests wage growth will be more persistent than the BoE expects and the gap between the data and the BoE's most recent forecasts will continue to widen. Wage growth may not slow below 7% yoy until 2Q 2024.

Risks skew up to terminal rate

The BoE will likely have to raise its wage growth forecasts markedly in the next set of forecasts, potentially offsetting much of the impact of higher market interest rates on inflation 1-2 years ahead. More persistent wage growth skews the risks to our terminal rate call up. We expect two more 25bp rate hikes to 5.5% terminal, with risks skewed to another 50bp hike instead in August. We continue to think the BoE will take any opportunity to pause and that opportunity will be afforded by core inflation slowing from late summer. We then expect the BoE to hold rates at terminal through end-2024. Wage growth, however, suggests large upside risks. We see a non-negligible probability that the BoE has to deliver a hard landing to bring wage growth and inflation down to target.

Refer to important disclosures on page 8 to 9.
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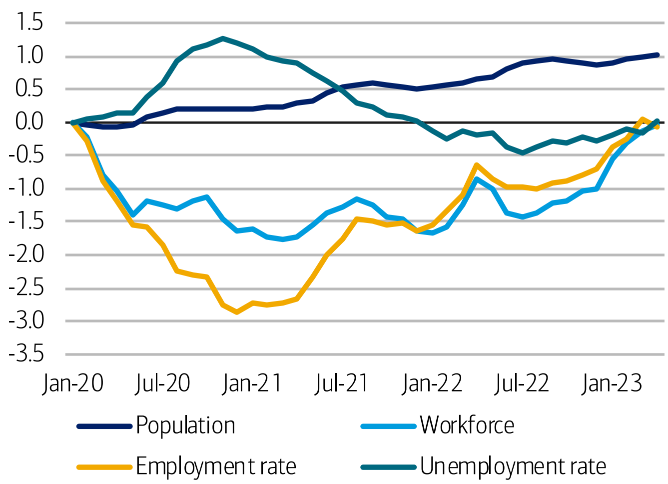
Timestamp: 14 July 2023 01:30AM EDT

Fall in labour supply caused tight labour market

Why does the UK have a very tight labour market while GDP is unchanged since 2Q 2019? The answer lies in the workforce. It is unchanged since 2019, a sharp break from the trend of a rising workforce (Exhibit 1).

Workforce growth has been restricted by a structural change. Since Covid the number of people inactive – neither in work nor seeking work –has risen as people left the labour market due to long-term sickness (Exhibit 2). In our view this is a result of rising healthcare waiting lists, which are not only the result of Covid pressures. So, the structural problems are likely to persist (see UK Viewpoint: Growing too much to fix entrenched inflation 30 May 2023). This is one reason that the potential for the UK economy to grow in recent years has been restricted, and why the UK has been particularly inflation prone. We see the UK as having the most severe persistent inflation problem among developed economies.

Exhibit 1: Workforce unchanged since 2019
Change since 2019, % and ppt



Source: BofA Global Research, ONS

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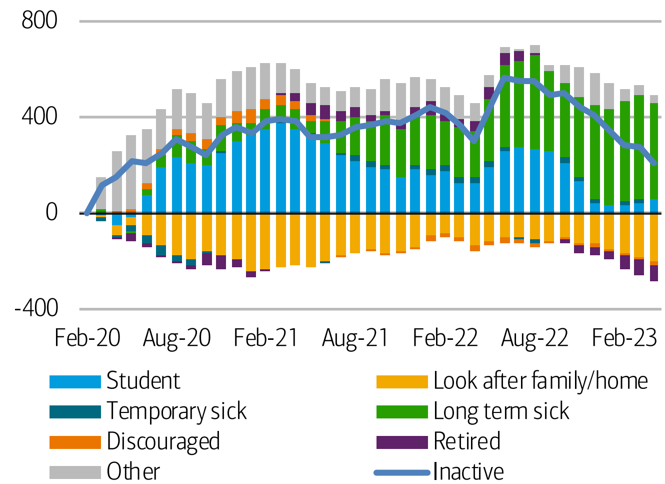
Exhibit 2: Rising long-term sickness restricted workforce growth
Change since January 2020, thousands



Source: BofA Global Research, ONS

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Labour market beginning to ease, first as supply increased

The good news in this week's, and recent month's, labour market data is improving labour supply. That was first as students return to work, and then from increasing workforce participation from those previously inactive due to family commitments and retired people. The number of people inactive due to long-term sickness has also stopped rising. This has allowed employment to rise at the same time as unemployment has increased. Improved supply has eased labour market pressures somewhat.

There are limits to how much further labour supply can improve in our view. The rise in student activity seems to have run its course, for instance. Given the structural healthcare issues, we are not at this point prepared to forecast the widespread return to work of those who have been long-term sick. Continued strong immigration could boost labour supply. But the implications for spare capacity are not clear, as immigrants bring demand as well as supply. Likely the impact on inflation pressure would depend on whether immigration can help reduce any sectoral mismatch in the labour market.

And as labour demand ebbs

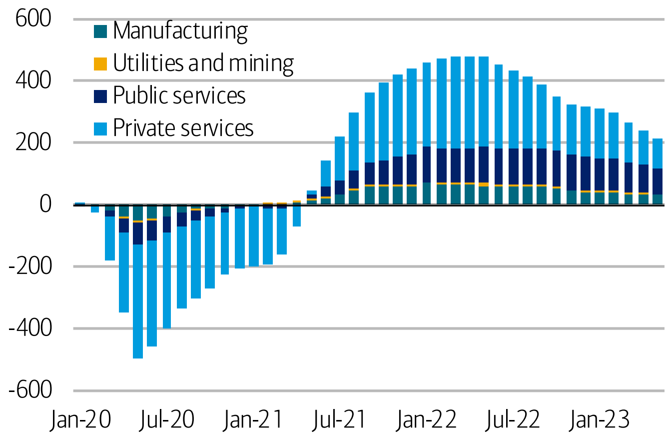
The improvement in supply will have been a welcome surprise to the BoE, but the structural supply problems mean further easing of labour market pressures will require weaker demand. This appears to be happening.

Vacancies continue to fall, especially in the private services sector (Exhibit 3). If private services vacancies continue falling at their recent rate they will be back to their pre-

Covid level in October. Public sector vacancies seem more likely to remain elevated, which may mean private vacancies need to fall below pre-Covid levels to fully ease labour market pressures. To bring wage growth down its likely, in our view, that vacancies will have to fall below 'normal' levels.

As well as vacancies falling, short term unemployment has begun rising. Full time employment stopped rising last September, with most recent growth in part-time employment. The labour market remains extremely tight, but it is easing.

Exhibit 3: Private service vacancies falling rapidly
Change in vacancies since 2019, thousands



Source: BofA Global Research, ONS

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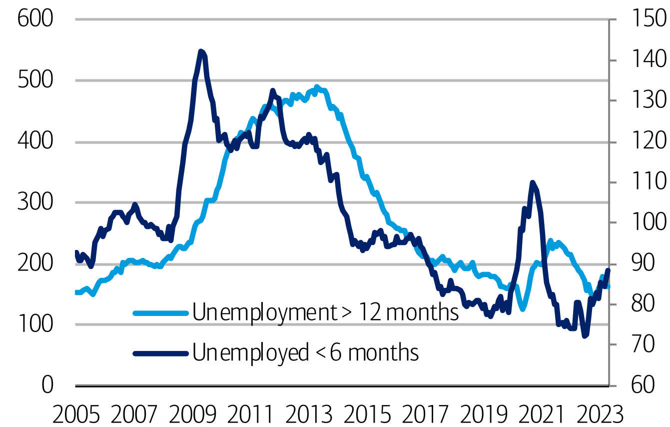
Exhibit 4: Short-term unemployment rising
Unemployment rate by duration of unemployment, %



Source: BofA Global Research, ONS.

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Wage growth surprised again

In contrast to labour market quantities, wage growth surprised consensus expectations again on the upside this month and private sector regular pay growth seems likely to beat BoE forecasts for 2Q by 150bp.

Why does wage growth remain so strong if the labour market is easing? Part of the reason is that wage growth responds with a lag to labour market slack. But to examine what is driving that surprise we update a set of wage equations (see UK Economic Viewpoint: Persistent wage growth 30 June 2022). We estimate four wage equations for private sector pay growth. We use two types of equation. First, an error correction mechanism (ECM) set-up, where wages follow productivity and the GDP deflator in the long run and are affected by slack, inflation expectations and productivity growth in the short-run. Second, a wage equation based on Yellen (2017). We estimate two variants of each, using 5 year and 10-year inflation expectations.

We use government bond breakeven inflation rates for inflation expectations in our estimates. Slack is based on our estimate of the unemployment gap, productivity based on market sector output per head. We measure pay growth with Average Weekly Earnings from 2000 spliced to the Average Earnings Index prior to 2000. We assume productivity grows at its average rate in 2019 over the forecast and inflation expectations stay at their latest observed level. We estimate the equations over the period 1990-2019.

Likely due to lagged inflation

Wage growth has far exceeded what we would have expected given the determinants above. Exhibit 5 shows this by comparing the average forecast from our wage equations to the private pay data (the light blue line compared to dark blue). Those equations would have suggested slowing pay growth.

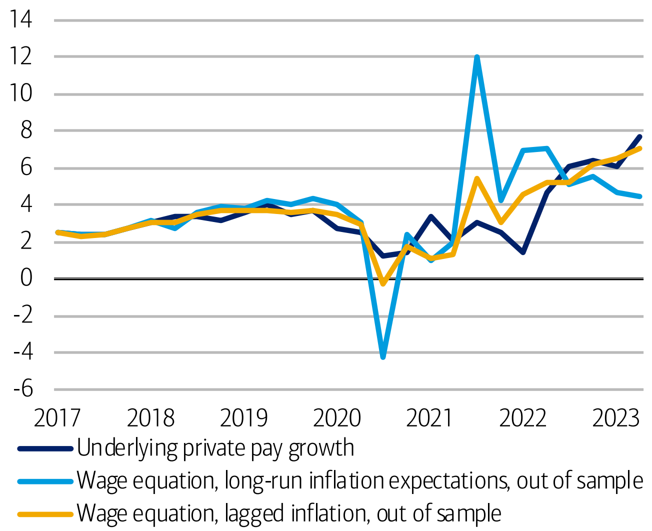
If we substitute lagged CPI inflation for long-run inflation expectations in the equations, wage growth is not surprising (yellow vs dark blue line in Exhibit 5). This suggests pay growth has been strong mainly because pay is responding to recent inflation outturns rather than lower and more stable long-term inflation expectations.

It's hard to say whether that represents a change in behaviour by consumers and firms or not. We cannot easily estimate whether wages respond to recent inflation or long-term expectations until there is a major inflation shock that drives a wedge between the two. And there hasn't been an inflation shock as large as now since the late 1980s. The most recent shock was after the financial crisis, when inflation rose above 5%. Exhibit 6 shows the same exercise as above for that post-2010 experience. There was not a large difference in the performance of the two types of equations.

But the BoE's Decision Maker Panel (DMP) survey shows that firms have responded to high inflation recently by resetting their prices more frequently and in response to events, rather than at set times (say once or twice a year). That might suggest a shortening of horizons, which could have been matched in the labour market. That would also be consistent with evidence we have previously presented showing UK inflation expectations have become unanchored (UK Viewpoint: Anchors aweigh 20 January 2023).

The various shocks hitting the UK economy may also multiply up. High inflation at a time of an extremely tight labour market might mean a different wage response than high inflation at a time of a loose labour market as after the financial crisis. Changes to immigration rules may also have contributed. While there is little evidence that the rate of immigration affects aggregate wage growth much it is possible that a less contestable labour market post Brexit (immigration is subject to greater frictions) steepened the Phillips curve. This could alternatively suggest it is a tight labour market, rather than lagged spot inflation, that is keeping wage growth strong.

Exhibit 5: Past inflation boosting wage growth
Out of sample forecasts of private sector pay growth from a set of wage equations



Private pay growth is ONS data except from 2020-2022 when we use the BoE's estimate of pay growth adjusted for compositional effects from the Furlough scheme. Wage equations used discussed in the text. **Source:** BofA Global Research, ONS.

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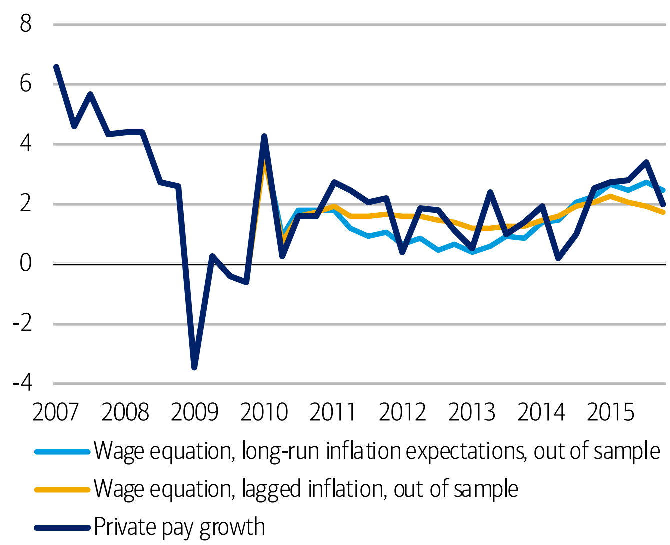
Exhibit 6: Before the post-Covid inflation surge wages seemed more related to longer-term inflation expectations
Out of sample forecasts of private sector pay growth from a set of wage equations



Wage equations used discussed in the text. **Source:** BofA Global Research, ONS.

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Gap compared to BoE forecast keeps growing

Assuming that households are responding to lagged inflation, rather than longer run inflation expectations, we would not expect wage growth to slow below 7% until this time next year (Exhibit 8), at which point it should slow sharply as drops in headline inflation and unemployment increases feed through.

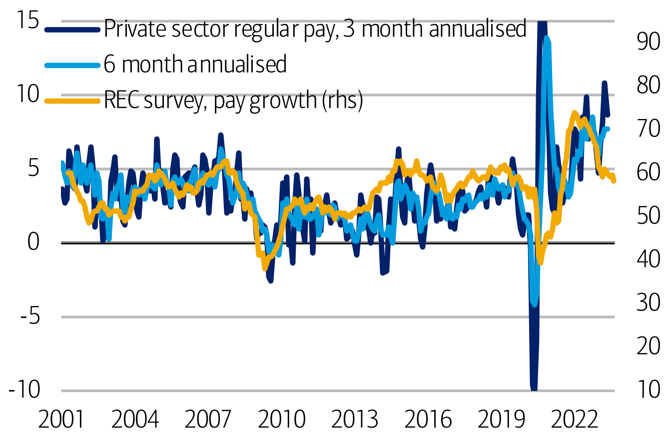
That wage growth trajectory would lie well above the BoE's. They forecast private sector regular pay growth of 5.4% yoy in 4Q 2023. We would estimate that is equivalent to total private sector pay growth of 5.2%. By contrast, we would expect wage growth still at 7.5% at year-end if households are responding to lagged inflation.

High frequency measures of wage growth remain high

The widely watched Recruitment and Employment Confederation Survey (REC) has been suggesting weakening pay growth since mid-2022. While the survey tends to pick up sharp turning points, such as the financial crisis, it has in our view proved a less reliable quantitative indicator of pay growth at other times. That is likely in part because the survey is qualitative. Recruiters are asked if pay is rising or falling, not by how much.

The survey has disconnected from annualised pay growth recently. Continued very high 3- and 6-month annualised pay growth suggest year-on-year pay growth is unlikely to slow sharply soon.

Exhibit 7: REC survey seems to be giving a misleading steer
Annualised private sector pay growth and REC survey



Source: BofA Global Research, ONS, S&P Global/REC/KPMG

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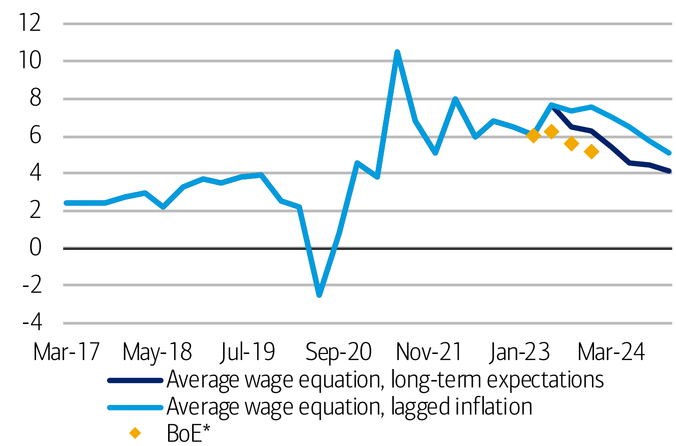
Exhibit 8: Wage growth likely to persistent for longer than BoE expects
Private sector wage growth forecasts from a set of wage equations and our estimate of the BoE's forecast



*BoE provides forecasts for private sector regular pay. We show private sector total pay (including bonuses). We add an estimate of the bonus contribution to wage growth to the BoE's ex-bonus pay forecasts. The precise contribution the BoE assumes is uncertain but is unlikely to change the big picture of the BoE forecasting less persistence than the set of wage equations. **Source:** BofA Global Research, ONS, BoE

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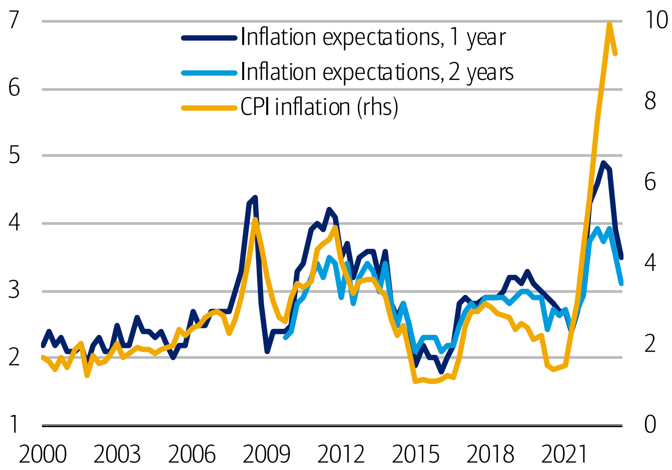
Uncertainty is high

In addition to the caveats above, we should also note that it is hard to differentiate whether consumers are responding to lagged inflation itself or short-term inflation expectations. That is because the two have comoved in the past. The difference is important now. Inflation expectations have slowed more than would have been expected given headline inflation (Exhibit 9). This has been particularly surprising because food inflation has remained very strong, and expectations are usually more sensitive to high visibility products.

Using lagged inflation or survey measures of inflation expectations in wage equations is ultimately an attempt to capture the same thing: the extent to which wages are responding to inflation. But now those two indicators are diverging it matters which series is the 'right' one. The faster fall in inflation expectations poses the risk of a faster fall in wage growth than we describe above.

Exhibit 9: Short-term inflation expectations dropping sooner than would be expected given headline inflation

CPI inflation and 1- and 2-year inflation expectations from BoE survey



Source: BofA Global Research, ONS, BoE

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Some comfort from slowing demand

Wages respond with a lag to labour market tightness and inflation, so we would expect the BoE to take some comfort from signs of labour market easing. This suggests wage growth will slow in time.

But the incoming wage data suggest wage growth likely will prove to be more persistent than the BoE previously expected. The size of the wage surprise is large, and it keeps growing relative to the BoE's May forecasts.

How should we interpret the latest data? The BoE will likely have to raise its wage growth forecasts markedly in the next set of forecasts. That will boost inflation at the 1 year and perhaps 2-year horizons.

Working in the other direction will be higher Bank Rate, raising slack more than in the previous forecasts and bearing down on inflation, meaning wage growth would eventually drop further. This highlights some of the trade-offs for the BoE. There is relatively little it can do now about near-term wage inflation given the lags from rate hikes to growth and the relative importance of inflation expectations and slack in driving up pay growth. By the time policy raises slack, inflation expectations could already have cut pay growth.

On the other hand, the BoE cannot simply rely on inflation expectations dragging down pay growth. Expectations are likely in part a function of what consumers and firms expect the BoE to do. The longer wage growth remains elevated the longer inflation will also remain elevated, feeding back to wages and risking inflation expectations further deanchoring.

How we should think about the BoE's next policy decision depends a lot on how it balances these factors. The BoE gives relatively little information in our view. We need to consider the precise interpretation of the sentence below, and specifically whether the BoE has changed its reaction function or not. Is the BoE describing an accelerationist type Taylor Rule where they keep hiking in, say, 50bp increments until signs of persistence start to improve i.e. wage growth slows. Or are they saying, as had been the consensus before June, that the data have to surprise their forecasts to warrant any further hikes. And if so, which forecast? The wage forecasts from May, which have already been heavily surprised and the BoE argues it has responded to with the 50bp hike last month, or new implicit forecasts that take some account of the data surprise.

> "If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required." (Minutes of BoE policy meeting, June 2023).

This returns to a theme of ours. In our view the BoE's reaction function has been difficult to pin down. This makes it hard to translate data news into policy. What would we suggest the best policy would be? We can't help thinking guidance about the BoE's preferred approach might help, not unlike what other central banks have begun to discuss. This may help shift the wage formation process that appears to have become quite related to short-term inflation. Or at least it may stop the problem getting worse.

For instance, the BoE could talk about holding rates at an elevated level until core inflation has, say, halved and wage growth is falling. An alternative would be to say they continue to plan hiking until wage growth and core inflation slow and then hold until another condition is met. The latter would mean a certainty of overtightening, but it would also minimise risks of inflation expectations deanchoring further. Either may allow the BoE to step down to 25bp rate hikes – by giving a road map and leveraging expectations they may not need such a big hike now, and pain in the form of weaker growth, to shift expectations.

As former-Monetary Policy Committee member David Miles (2004) commented when considering the implications of shift away from variable to fixed rate mortgages:

> "With fixed-rate mortgage lending the impact of a given change in short rates on house values and probably on consumption expenditure will be lower… The impact of a change in short rates will depend to a greater extent than at present upon the induced impact on longer-term bond yields and swap rates." (Miles, 2004)

What are the BoE likely to do? We suspect they will not provide detailed guidance. Instead they will, we think, hike 25bp in August – risks skewed heavily to a 50bp hike – and retain similar guidance to before. We think this leaves the risks to wages, inflation and interest rates skewed up relative to our call that the BoE stops hiking in September with Bank Rate at 5.5%. Ultimately if the BoE is not able to leverage expectations and wage growth remains as persistent as suggested in Exhibit 8 the BoE may have to deliver a hard landing to force down wage growth and inflation.

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