Are rate rises inevitable?

Employing the right data

Trevor Williams explains the importance of labour market statistics when considering monetary policy

AUTHOR

Trevor Williams is a Visiting Professor at Derby University and Chairman of the IEA Shadow Monetary Policy Committee

A slew of UK economic data is released every month, but it is probably the labour market statistics that are the most important. They are the nearest to real-time we can get for informing us what is happening in the economy, and hence what may happen to monetary policy.

Quarterly gross domestic product (GDP) data is subject to substantial revisions over time. Monthly industrial production and retail sales figures are very volatile.

Surveys tell us what firms and people say they are doing, which may not be the same as what they are actually doing. Inflation data is good at detailing what the current position is, but not so good at predicting what happens next. Contained in the labour market data is timely information on all of these things.

What employment data tells us

Unemployment will only fall consistently if economic growth is fast enough to absorb the number of people joining the labour force. A high level of vacancies will signal that firms are busy and profitable; enough to want to hire more people. Employment data will tell us the number, and share, of those that can work and are doing so. A high number will tell us that the economy is very efficient at creating jobs. Earnings data will tell us how many people are being paid in those jobs, and the amount of total spending power there is in the economy from this source.

Any ‘slack’ can be measured by looking at inactivity – the proportion of the labour force that are not working. By implication, the less slack (or the lower the number of people who are inactive) and the higher the number who are employed, the upward pressure on pay would be more significant.

Both the growth in pay, and its level, are released in the labour market data.

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Measuring the pressure

Faster increases in wages may herald greater price inflation pressure, as higher demand for goods and services encourages firms to charge more for their products. Conversely, slow growth in pay suggests diminishing price inflation pressure. A low level of compensation implies that the jobs created are low-skilled ones; a high level of compensation implies that they are high-skill jobs. Hours worked are also released, telling us whether people are working longer or shorter hours, and about productivity and living standards. Rising living standards occur if people are paid more per hour worked, adjusted for price inflation. Productivity is measured by seeing how many hours it takes to produce goods and services (output per hour).

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The latest data tells us that the economy is still growing, albeit at a slower pace. Layoffs are rising – the number of unemployed rose by 24,000 in the three months to February – but the stock of vacancies remains high. Unemployment is falling, with the rate inching down from 4.4% of the labour force to 4.3% in the three months to January. Inactivity continued its decline, reaching a 1971 low of 21.2% of the working-age population.

Earnings growth, meanwhile, accelerated from 2.6% to 2.8% (excluding bonuses) in the three months to January, compared with the same period in 2017. This combination has meant that the Bank of England is widely expected to raise interest by 0.25% at its May meeting to 0.75%, and possibly another one or two by the end of the year.

Creating employment

But it is not as simple as following decades of reform to make its labour market more flexible; the UK has become extraordinarily good at creating employment. Roughly seven million jobs have been created in the last 20 years, as real wages adjust to allow full employment. Over the decade since the financial crisis, this has meant a fall in real pay growth. So long as real pay is falling, there is little likelihood of price inflation becoming a problem for the economy.

Price inflation fell to 2.7% in the year to February; so inflation-adjusted pay is only a smidgen above zero, and still 3% below its pre-crisis peak. Moreover, the UK economy could slow further as the year wears on. It is already growing much less quickly than either the Euro area or the global economy. Pay growth may therefore not stay positive for longer.

After all, we have been here before. In March 2010, annual pay growth hit 2.9% and another peak of 3.2% in May 2015. Both times, pay growth fell back. In this, as a currently popular phrase says, it is not over until it is over.

Chart 1: UK unemployment continues to fall

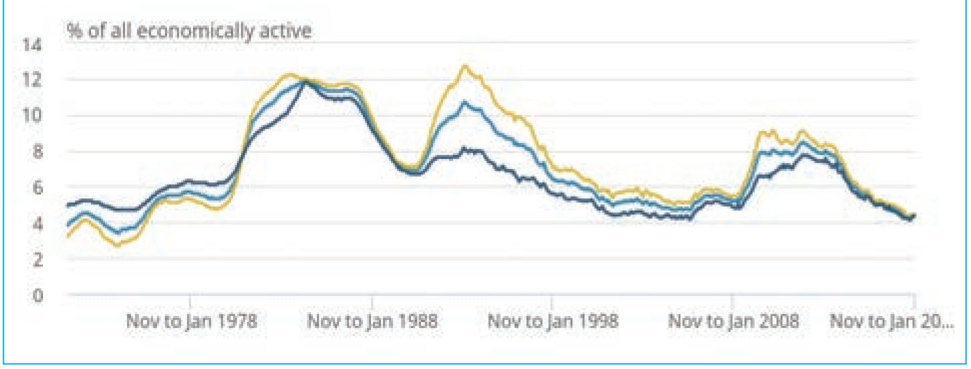

Chart 2: UK real pay remains lower than a decade go