December 2014

Labour market predictions for 2015

WORK WORKFORCE WORKPLACE

LABOUR MARKET PREDICTIONS FOR 2015

Key points

- Economic growth of around 2.4% is expected in 2015, slightly lower than in 2014.
- Employment might grow by half a million or so in 2015, slightly more than the OBR forecast.
- Wage growth is likely to remain in the 1–2% range for most or all of 2015, although low inflation means that average earnings might increase slightly in real terms.
- No significant increase in wage growth can be expected until 2016, and even then it is not guaranteed.
- Employers need to raise their productivity – and that includes developing their workforce – before skill shortages mount.
- Productivity again needs to be the focus of economic policy.

This report provides a commentary on what might be expected to happen in the UK labour market in 2015.

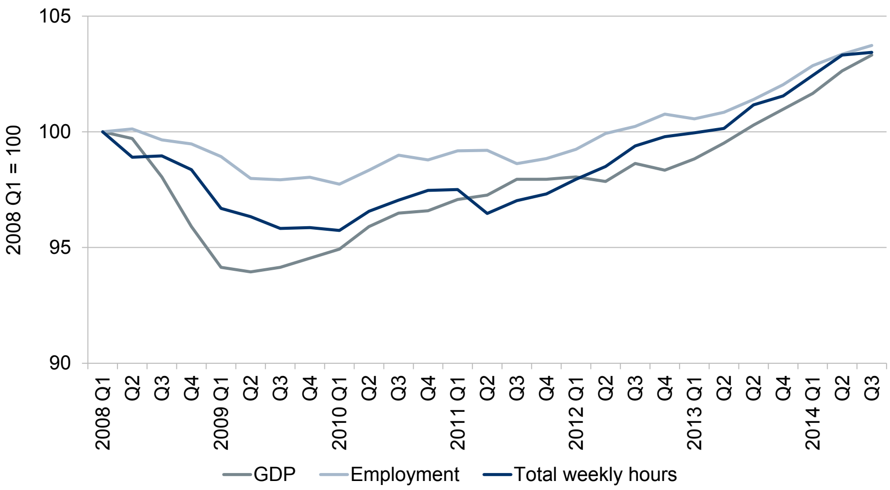
The CIPD does not use an economic forecasting model, so the report does not contain specific numerical predictions, recognising of course that *any* forecast has margins of error attached to it. Instead, this commentary refers to economic forecasts already in the public domain, principally the economic forecast published by the independent Office for Budget Responsibility (OBR) alongside the Autumn Statement on 3 December 2014 (referred to as 'the OBR forecast').

Putting 2015 in context

The year 2014 ends with the UK economy experiencing, by historic standards, a year of reasonably strong economic growth. The OBR expects output (GDP) to grow by 3% over the calendar year.

The changes made by the Office for National Statistics (ONS) this year to the methodology and coverage of GDP – to bring the UK in line with European standards – change slightly our interpretation of the past few years (see Figure 1).

Figure 1: Output, employment and hours worked since 2008



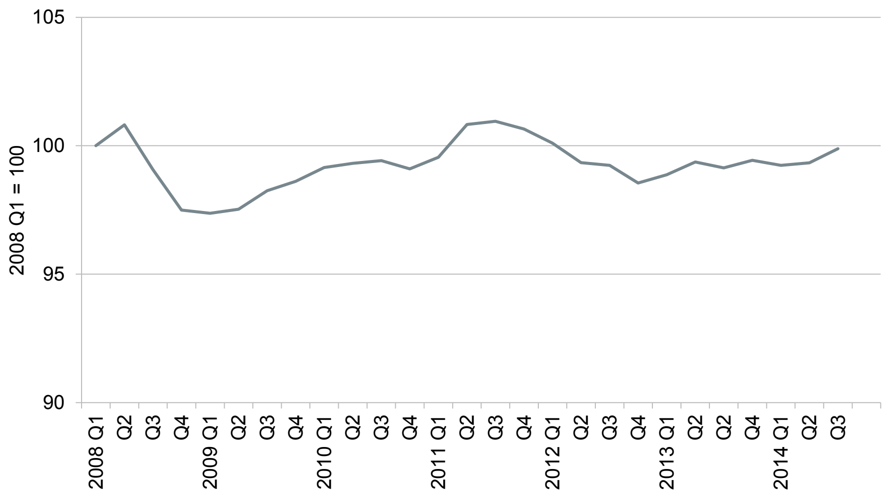
Source: Office for National Statistics.

Figure 1 shows output, the number of people in employment and the total number of hours worked as indices, all set to 100 in the first quarter of 2008, which was the peak quarter for GDP and hence the starting point for the last recession. From that point, output fell by about 6% during 2008 and 2009 before beginning to recover. There was a period of weaker growth during 2011 and 2012 – although no 'double-dip recession' – preceding the stronger growth we have seen since early 2013.

Employment fell by much less in the early stages of the recession – surprising most forecasters – in part because of reduced average hours worked. However, average hours started catching up again during 2011 and 2012 and are now back to pre-recession levels.

The result of these trends has been flat labour productivity, defined as the value of output produced for each hour worked (see Figure 2).

Figure 2: Output per hour worked since 2008

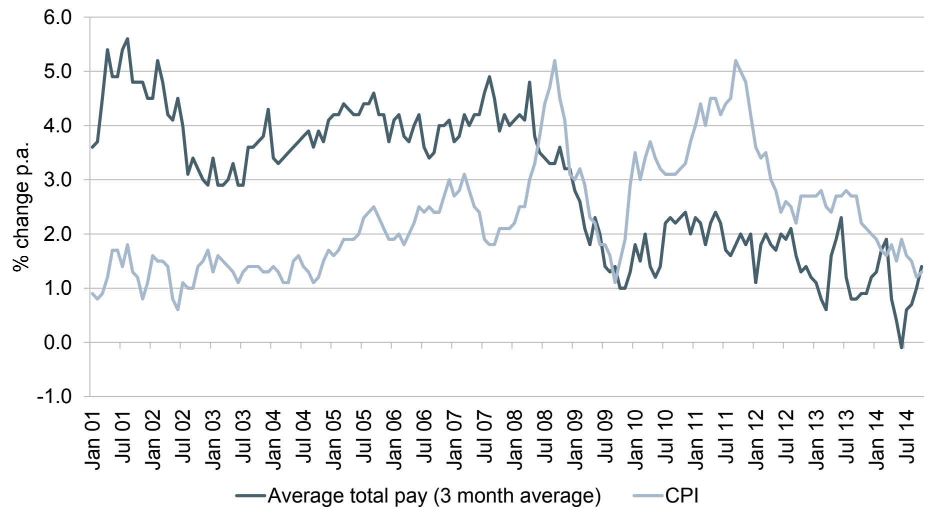


Source: Office for National Statistics.

It is not unusual for productivity to fall in the early stages of a recession; for example, Germany saw a similar productivity fall during 2009. What has been unusual is the weak response since output started growing again. Average productivity fell during 2011 and 2012 and growth since then has been modest, meaning that output per hour worked is still slightly below its pre-recession level. This is why economists talk of a ‘productivity puzzle’.

It is also critical to understanding what has happened to pay. Average earnings typically grow faster than prices to reward increased labour productivity and this was the case in the UK for most of the post-War period, except when the Government attempted to restrain earnings through incomes policies. We also see this for the 2000–08 period, when the ONS measure of average weekly earnings (measured using a three-month moving average) consistently grew faster than the headline measure of inflation, the Consumer Price Index (CPI) (see Figure 3).

Figure 3: Average earnings growth and CPI inflation



Source: Office for National Statistics.

Since the second half of 2009, however, average earnings growth has rarely exceeded 2% a year and has failed to keep pace with inflation. The extent of the fall in average real earnings depends upon which measures of earnings and prices are used, but most estimates of the average loss since 2009 are in the 8–10% range.[1]

The economy in 2015

The OBR forecast expects output growth in the UK to be lower in 2015 than in 2014, with a central estimate for the year of 2.4%. This is slightly below most of the forecasts produced by the major international institutions and by independent UK forecasters, although the OBR forecast would have been produced using slightly more up-to-date information (see Table 1).[2]

Table 1: Forecasts of economic growth for the UK in 2015

	OBR	IMF	OECD	European Commission	Average of independent UK forecasters
UK economic growth, 2015	2.4%	2.7%	2.7%	2.7%	2.6%

Sources: OBR, IMF *World Economic Outlook* (October), OECD, European Commission autumn forecast, HM Treasury compilation of independent forecasts for the UK economy (December).

There are many 'known unknowns' that could affect economic growth in 2015 but three are highlighted here.

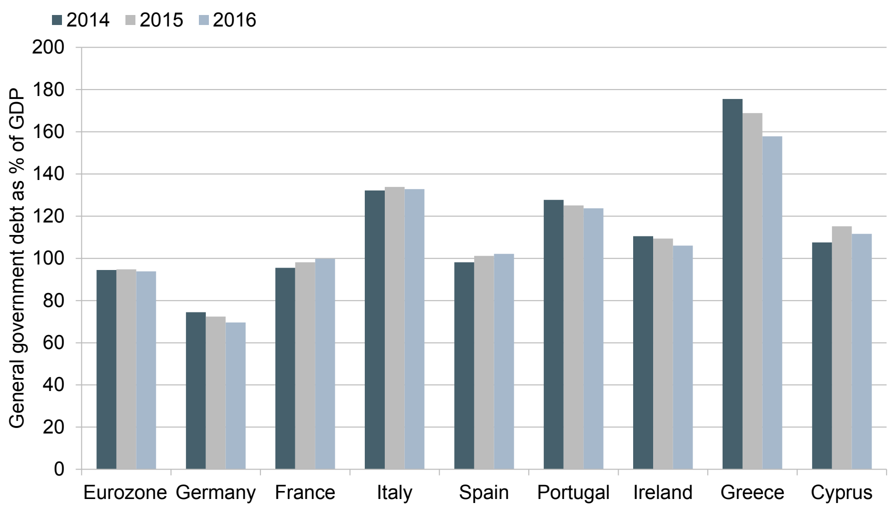
First, May 2015 will see a general election. The OBR forecast contains projections for future government spending – set by the Treasury and consistent with the Autumn Statement – as well as forecasts for revenue collected. These imply further reductions in government spending. An incoming government could make different choices about how quickly the government deficit is reduced, how much of that is taken up by spending cuts and how much is due to tax increases, and how the available government expenditure is allocated (for example, between departments or between current and capital investment). If different choices were to be made, there could be some impact on growth in 2015, although this may be more of a factor in the years following.

Second, after a long period of interest rate stability (with a base rate of 0.5%), forecasters expect the Bank of England to start increasing interest rates in 2015, although precisely when, and by how much, will be the subject of intense discussion, debate and 'Bank-watching'. As inflation is currently below the 2% target, and inflationary pressures remain subdued, any rate rises are likely to be small. This ought to mean that the impact on savers, lenders, consumers and investors should also be small. However, there is a risk of a stronger (negative) effect on growth if a rate rise prompts borrowers – consumers, in particular – to reassess their financial position. Did some consumers take out loans on the assumption that interest rates would remain low, and could a rate rise trigger a rethink?

Third, there is the economic situation in Europe. The European Commission's latest forecast is slightly more optimistic than its previous versions. Underpinning this is a view that financial conditions and risks within the EU have diminished and that member states have made progress in reducing fiscal deficits and improving their competitiveness. Nevertheless, the scale of the challenge remaining in many of the Eurozone economies means that the Eurozone as a whole is still expected to grow by just 1.1% in 2015. Furthermore, risks remain. The possibility of a Greek general election is a reminder of the country-specific risks that could throw the markets and the Eurozone into turmoil. In addition, inflation in Europe is very low. The official Harmonised Consumer Price Inflation measure for the EU as a whole was 0.5% in October 2014, with six member states experiencing negative inflation (including Bulgaria at –1.5% per year and Greece at –1.8% per year). Falling prices sound like good news but can have some very unwelcome macroeconomic effects, especially when economies are already in a slump. Consumers prefer to spend money tomorrow (when they expect prices to be even lower) rather than today. Debtors find it becomes (even) more difficult to repay debts, including Eurozone governments who cannot pay off their debts by printing money.

There is little scope for governments in the Eurozone to use public spending to raise economic growth. Most of the large Eurozone economies have debt-to-GDP ratios that are uncomfortably high (see Figure 4). Only Germany has the fiscal headroom to expand.

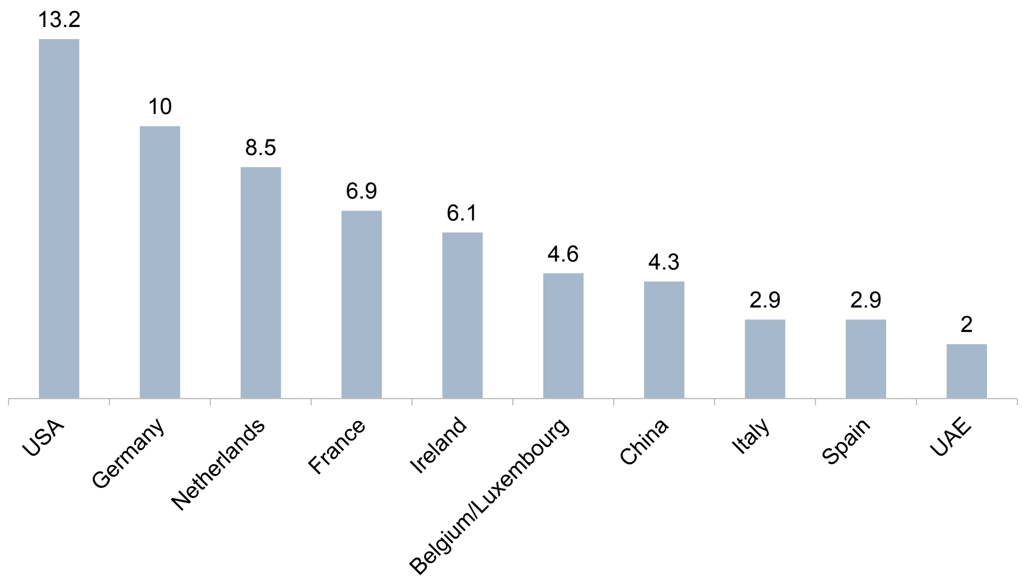
Figure 4: Government debt in the Eurozone



Source: European Commission, autumn 2014 forecast.

The most likely outlook is a continued period of slow growth for the Eurozone as a whole, possibly with the odd crisis or near crisis along the way. This will act as a drag on the UK economy because of our close trading links with Europe. Seven of the UK's top ten export markets are in Europe (see Figure 5).

Figure 5: Top ten goods export markets in 2013 (% of total exports)



Source: Office for National Statistics.

This combination of risks probably explains why growth in 2015 is expected to be slightly lower than in 2014. There are some indications that businesses are thinking the same, although as yet this is a cooling of positive sentiment, rather than expectations of a downturn.[3]

The labour market in 2015

The OBR forecast expects economic growth in 2015 to translate into more people in employment and less unemployment. So, comparing their forecast for Q4 2015 with Q4 2014 (which is itself a forecast as we do not yet have the data), employment increases by 400,000 from 30.9 million to 31.3 million and unemployment falls by 200,000 from 1.9 million to 1.7 million (and the unemployment rate falls from 5.7% of the labour force to 5.2%).

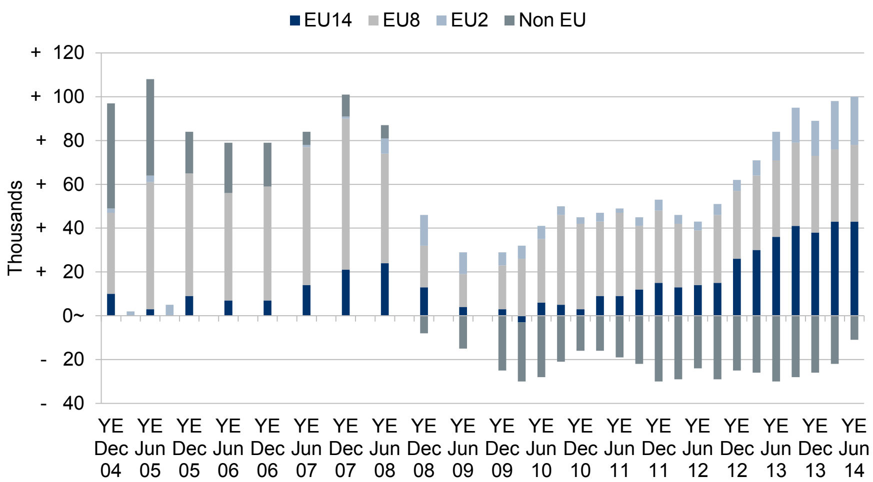
OBR forecasts have consistently underestimated employment growth and falls in unemployment, even when they have been proved to be correct (or too optimistic) on economic growth. This seems to be for two reasons. First, OBR forecasts have had productivity growth built into them that has failed to materialise, meaning that growth has been more 'employment-rich' than expected. Second, the forecasts probably under-estimated growth in the effective labour supply – the number of people looking for work and available for work, and thus competing for jobs. As a result, employers have found it easier to recruit than expected and have not had to adjust to labour shortages by investing in more capital equipment or by raising pay.

Sources of additional labour supply

The UK population is increasing, which means that the UK economy needs to create additional jobs each year to stand still, but in addition there are three identifiable sources of additional labour supply.

Migrants are one source, especially those from other EU countries, who are not subject to restrictions on their ability to work in the UK (see Figure 6).

Figure 6: Work-related migration



EU14 are countries that were EU members prior to 2004. EU8 are the eight East European countries that joined the EU in 2004. EU2 are Romania and Bulgaria. Figures refer to net in-migration in the preceding 12 month period.
Source: Office for National Statistics.

During the period from 2004 to 2008, migration for work-related reasons had a positive impact on the UK's labour supply, largely the result of migration from EU8 countries (the East European countries that joined the EU in 2004).[4] The in-flow eased off during the recession but, since 2012, has begun to increase again. In addition, the UK is seeing more migrants for work-related reasons from the EU14 (countries such as France, Germany, Spain, Portugal and Italy), no doubt because of the very high rates of unemployment in many Eurozone countries. Compared with migrants from EU8 countries, these migrants are much more likely to find highly skilled work.[5]

Another source of labour supply is older workers. Workers aged over 50 are now, on average, healthier than previous generations and many want to continue working past the 'retirement age' set by the state or by their occupational pension scheme. Sometimes the driving motivator will be the desire to remain active, maintain friendships and networks and continue to make a contribution; in other cases, it will be financial, in order to supplement whatever pension income is available. The removal of a default retirement age has also made it easier for people to work for longer. The inactivity rate for 50–64-year-olds has been falling for almost 20 years and the employment rate for 50–64-year-olds hardly fell during the recession. Since 2011, employment rates have been increasing for both 50–64-year-olds and for those aged 65 and over.

The labour supply may also have been boosted by changes in benefit eligibility, benefit rates and how benefits are administered. Those claiming Jobseeker's Allowance (JSA) are required to be available for work and actively seeking work, and there has been an active regime to ensure they do so for a long time. Numbers claiming JSA have fallen by half a million in the past two years. According to ONS data, there have also been modest falls in numbers claiming lone parent and other income-related benefits, although these have been partially offset by a small increase in numbers claiming Employment and Support Allowance and other incapacity-related benefits. Numbers claiming benefits, however, may not be the full story. The number of adverse benefit decisions against

JSA claimants increased from 531,000 in the year ending June 2010 to 832,000 in the year ending June 2014. The (much smaller) number of adverse sanctions against ESA claimants started to increase noticeably in 2014. Government statistics also suggest that the benefit cap might have increased employment among those affected. The net effect of various benefit changes on the labour supply is difficult to calculate, but it could have been significant.

We asked employers in our most recent *Labour Market Outlook* survey whether they had seen an increase in applicants from these sources in the previous year and, in each case, more had seen an increase than a decrease (see Table 2). In addition, 21% of employers said they had received more requests from employees to stay on in their jobs past the state pension age.

Table 2: Sources of additional labour supply

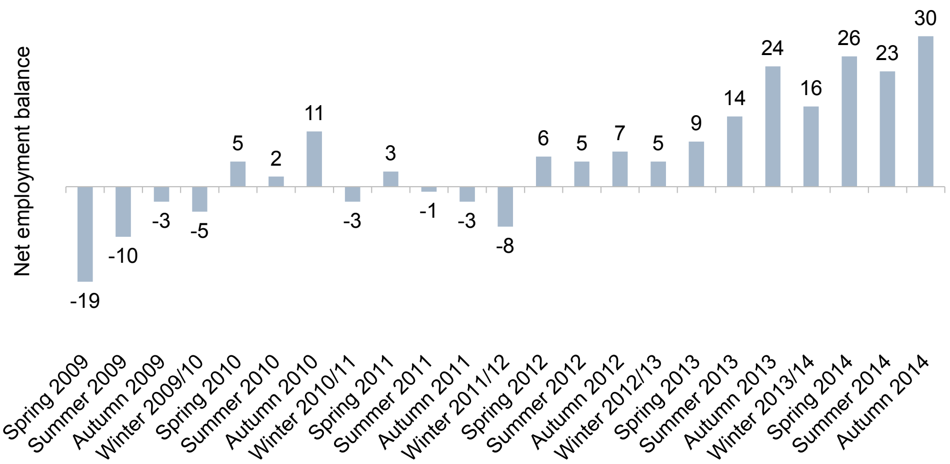
Source of applications	Received more applications in last 12 months (%)	Received fewer applications in last 12 months (%):	Net balance (%)
EU migrants	26	7	+19
Workers aged 55–64	23	9	+14
Workers aged 65+	8	5	+3
Benefit claimants	17	6	+11

Sources: OBR, IMF *World Economic Outlook* (October), OECD, European Commission autumn forecast, HM Treasury compilation of independent forecasts for the UK economy (December).

Employment growth

A healthy level of applications for most vacancies advertised, combined with general optimism about business prospects, explain why employers expect to continue increasing staffing levels (see Figure 7).

Figure 7: Three month ahead employment expectations



The net employment balance is the difference between the % of firms expecting to recruit over the next three months and the % expecting to make redundancies.
Source: CIPD *Labour Market Outlook*.

The net employment balance in autumn 2014 – the proportion of employers expecting to recruit in the next three months minus those expecting to make redundancies – was at its highest level since before the recession. This indicator has tended to correlate reasonably well with employment out-turns, and suggests that the UK should continue to see strong employment growth in the short term.

In addition, the OBR forecasts incorporate assumptions about the 'underlying' or 'equilibrium' rates of employment and unemployment rates that the economy can sustain without generating inflationary pressures.[6] These assumptions appear not to have changed over the past few years and may be conservative; in other words, there may now be more slack in the labour market than previously thought and more scope for employment to increase without triggering inflationary pressures than is built into the OBR model.

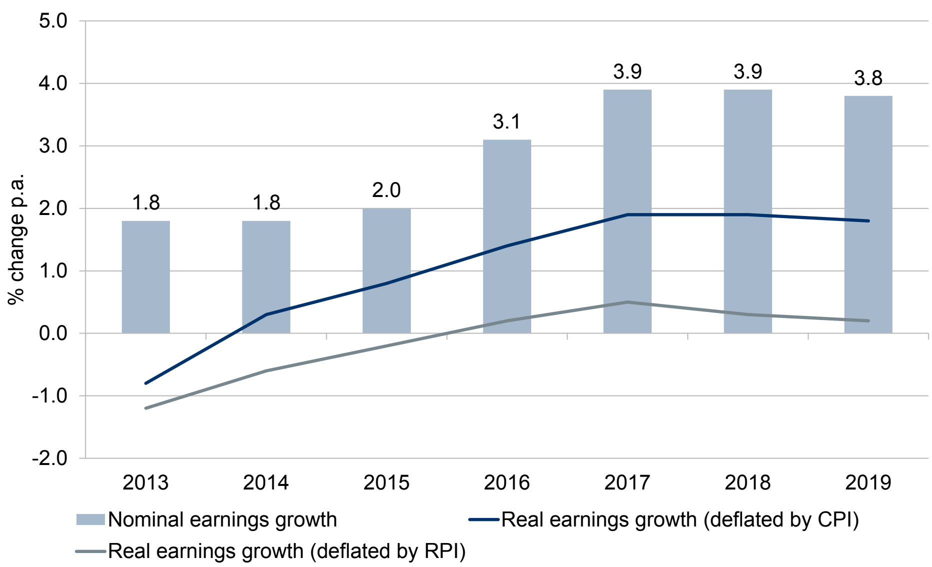
For this reason, it seems possible that employment will once again out-perform the OBR forecast, which is for growth of 400,000 between Q4 2014 and Q4 2015. The rate of employment growth seen earlier in 2014 is unlikely to be sustained, but this might still give room for jobs growth of half a million or more.

The effect on unemployment will not be one-for-one because the labour supply is increasing. Unemployment could fall faster than the OBR forecast of 200,000 and the unemployment rate may well end the year at just above 5%, in line with the OBR forecast.[7]

Wage growth

The OBR forecast is for average earnings to grow by 2% in 2015, compared with 1.8% in 2014 (see Figure 8).

Figure 8: OBR forecast of average earnings growth



Source: Office for Budget Responsibility, Autumn Statement 2014 forecast.

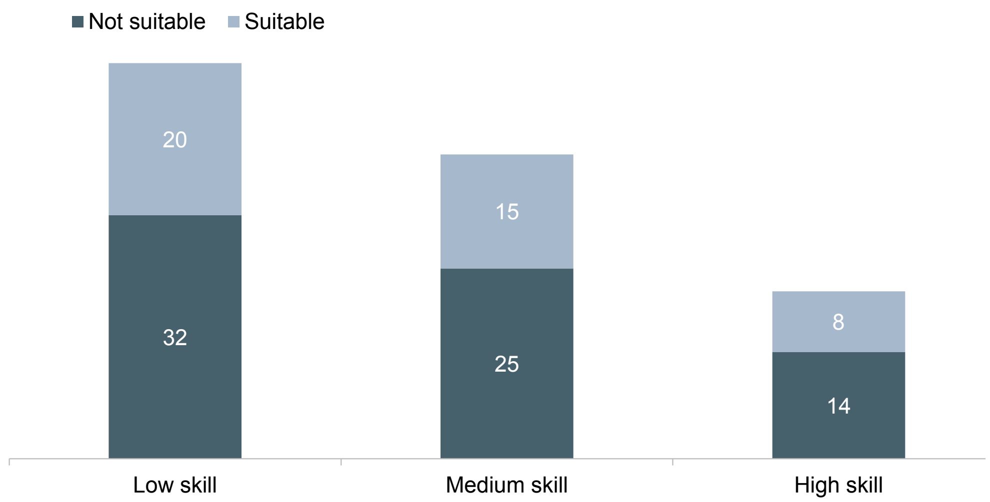
We should note that the OBR measure of average earnings is not the same as the ONS measure of Average Weekly Earnings presented in Figure 3, so there is not a direct read-across, and we should remember that other measures of earnings growth (such as the Annual Survey of Hours and Earnings) have produced slightly higher estimates of earnings growth in recent years. Hence we should focus on the pattern over time rather than the precise numbers – and this suggests that any increase in the growth of average earnings during 2015 will be very modest.

Current measures of wages settlements tend to cluster in the 2–2.5% a year range. The autumn 2014 CIPD *Labour Market Outlook* asked employers about their pay expectations for the year ahead (in other words, September 2014 to September 2015). For those employers who expected to conduct a pay review in the coming year and who felt able to make a prediction about the likely outcome, the median pay increase was 2% a year, the same as it has been since the winter 2013/14 survey.

An important feature of our survey is that it highlights the degree of uncertainty that many employers feel in making forward predictions about pay. While 42% of employers expected to increase pay in the year ahead and 10% expected to reduce pay, 47% did not know if they would have a pay review in the coming year or what the outcome would be (and lack of a pay review often turns out to be a de facto pay freeze).

One reason why employers are not expecting higher pay rises in 2015 – if they feel the need to raise pay at all – is because many vacancies still attract plenty of suitable applicants. Employers in the autumn 2014 CIPD *Employment Outlook* survey were asked how many applicants each vacancy they had advertised had attracted, and how many of those had been suitable for the post (see Figure 9).

Figure 9: Mean number of applications for each vacancy advertised



Source: CIPD *Labour Market Outlook* survey, Autumn 2014.

On average, low-skilled jobs attracted over 50 applicants and high-skilled jobs attracted over 20 applicants. Across all three categories of vacancy, employers thought about 40% of applicants were suitable for the role. These data suggest that most employers could find suitable people at existing wage rates. Importantly, these estimates are very similar to those collected using the same questions in 2013.

Job turnover also remains low. So if few employees are leaving, and most employers can find suitable applicants for vacancies, the conditions required for higher across-the-board pay rises – recruitment and retention – are not being met. Labour market pressures are insufficient to push wage increases up from their current range and falling inflation may remove any temptation employers may have had to offer an extra 0.5% or 1% in the next pay review as compensation – a 2% pay increase will be a real terms increase, if the CPI is used as the relevant measure of inflation.

Hence we expect pay increases to remain around their current level for most or all of 2015 (which would appear consistent with the ONS measure of Average Weekly Earnings remaining in the 1–2% corridor). If pay rises do begin to increase later in 2015, this could be because of interest rate rises (which push up the Retail Prices Index measure of inflation, still more commonly used as a benchmark in pay-setting than the CPI). Otherwise, there seems little reason for higher earnings growth until at least 2016. Of course, falling CPI inflation means this could translate into slightly higher real earnings.

Pay and productivity

Productivity is also a factor underpinning pay and the lack of productivity growth helps explain why average earnings have fallen in real terms since 2009. The OBR forecast is for productivity growth of 0.5% a year in 2014, rising to 1.3% in 2015 and then increasing to 2%, something closer to its 'normal' long-term growth rate, in 2016.

However, there is no clear and complete understanding of why productivity stagnated between 2008 and 2014 and, if the very recent past cannot be explained satisfactorily, that makes it very difficult to be confident about even the near future. Business investment has started to pick up again, but public sector investment remains low.

As a result, there is no guarantee that productivity will grow in line with the OBR forecast and hence there is no certainty that wage growth – fuelled by higher productivity – will accelerate in 2016. Employers may still not need to increase wages even then or there may not be enough productivity growth to enable higher wages in any case.

Implications

In many respects, the implications for employers and policy-makers in 2015 are very similar to those we highlighted in 2014. We said 2014 needed to be a 'year of productivity [growth]'. Well, 2015 needs to be the year when we see UK employers secure a productivity rollover.

For employers, this appears in many respects a very benign environment. Compared with most recent periods when the economy has been growing, average turnover is low, most vacancies are attracting suitable recruits and there is hence little upwards pressure on pay, which is important because the profitability of UK businesses is still below pre-recession levels.

Nevertheless, all good times must come to an end. At some stage, labour shortages will start to become more acute and it may be more difficult to secure new hires even by paying more. Employers competing in international markets also need to keep an eye on their broader competitiveness: taking advantage of relatively cheap and available labour may work very well in the short term but may take the business away from the market position it might need to be competitive in the long term.

In both cases, employers can manage the risks and position their organisation advantageously by investing in productivity. This might include investments in capital equipment (plant, machinery, and so on), as well as investments in intangible assets, including people. Upskilling the existing workforce is an insurance policy against future skill shortages. But returns on investment will not be maximised without broader changes, which could include strategic positioning (how and where to compete), management practices and job design, all areas where there is ample room for improvement.[8]

We need to see a similar focus from policy makers. Higher productivity is a necessity if living standards are to improve and economic policy in the next Parliament should be focused on achieving it. Government policies are critical in creating an environment that encourages and supports productivity growth through investment in education, training, research and public infrastructure as well as through tackling some of the barriers that firms face in raising their game.

But we think more could be done. In particular, policy makers need to overcome their reluctance to consider what is happening within the workplace. There is scope for Government to work more closely with employers, employee representatives and other stakeholders to determine what the most pressing problems are and build partnerships that are able to deliver innovative solutions to them, often working at a sector or at a local level.

Endnotes

1 CHARTERED INSTITUTE OF PERSONNEL AND DEVELOPMENT. (2014) *Have we seen the end of the pay rise?* London: CIPD.

2 The OBR forecast would have been produced with knowledge of the GDP estimate for Q3 2014, which the international forecasters would not have had. Note also that the average for the *most recent* independent forecasts in the Treasury comparison was 2.5%.

3 The latest British Chambers of Commerce quarterly economic survey found – compared with the previous survey covering Q2 2014 – that less manufacturing firms were expecting to expand sales or exports and less service firms were expecting to export more.

4 Although not presented in this chart, we should also remember that there is a consistent net out-migration of UK citizens for work-related reasons: 29,000 for the year ending June 2014.

5 CHARTERED INSTITUTE OF PERSONNEL AND DEVELOPMENT. (2014) *The growth of EU labour: assessing the impact on the UK labour market*. London: CIPD.

6 These appear to be an employment rate of 60% for all aged 16+ and an ILO unemployment rate of about 5.3% (see Table 1.6 of the OBR's supplementary economic tables).

7 If employment growth exceeds the OBR forecast because of additional labour supply, we need to remember this features in the denominator as well as the numerator of the unemployment rate.

8 CHARTERED INSTITUTE OF PERSONNEL AND DEVELOPMENT. (2014) *Are UK organisations managing their people better?* London: CIPD.