TSB Economic Briefing

PAY 1990: the spectre of stagflation

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As the economy moves into 1990, the outlook is precariously balanced between the risks of recession and inflation, with trends in pay settlements the key to future developments. There is a clear worry that if pay increases are not contained, as demand and and productivity fall off during 1990, pressures on prices will not moderate rapidly. Companies, already faced with a burgeoning financial deficit and a squeeze on profits and liquidity, may then be forced into a period of intense labour shedding, thus tipping the economy towards recession. The intensity of pressures in the labour market have once again raised the spectre of stagflation, albeit of a milder form than previously experienced and in the context of a far more benign international environment; slugflation may be a more appropriate term.

However, many commentators have pointed to the relatively "innocuous" trend in underlying average earnings in the face of a series of headline pay settlements which have pointed to more inflationary developments. Despite persistent warnings of a pick-up in the growth of underlying average earnings, the Department of Employment's (DOE) monthly series fell back slightly in mid-1989 before finally regaining its January level of 9% in September, the latest month available at the time of writing. There is, therefore, a clear need for an understanding of the relationship between pay and average earnings, which has apparently confounded so many city analysts throughout 1988.

The TSB Pay Settlement Index, shown in Chart 1, is based on raw company data covering 10 million workers per annum, provided by Income Data Services. The estimate produced for each month or quarter is an average of all settlements recorded in that period, weighted by the number of workers covered by the individual settlements. There are, of course, difficulties in this approach, related to the complexity of many deals often involving, for example, the consolidation of bonus earnings into the basic rate of pay. However, the Index does provide a useful view of the broad trend in pay settlements in the economy. The chart clearly illustrates the rise in pay settlements over the course of the first three quarters of 1989 - driven by rising inflationary expectations, the buoyancy of company profits, falling unemployment and skill shortages. The rise is, in fact, starker if the series is adjusted for the 15.3% awarded to the nurses in early 1988.

It is equally clear from the chart that the trend in average earnings has been slower to pick up. However, it should have been expected that the underlying trend in average earnings would lag behind the increase in the level of pay settlements. Only a portion of workers, perhaps as low as 4% of the workforce in any one month, immediately benefits from the new level of pay settlements since pay reviews are unevenly spread throughout the year. However, the underlying rate of earnings growth looks at the year on year increase in earnings for all civilian workers. An increase in the level of pay settlements must then work its way through the workforce before its full effect on average earnings is felt. Consequently, the average earnings figures are driven by the pay settlements received by the average worker over the preceding twelve months.

Chart 2 illustrates the gradual impact that the increase in the level of monthly pay settlements during 1989 has had on the 12-month weighted average settlement. The weighted average exhibits a similarly sluggish response to pay pressures as average earnings; the mid-year drop is due to the effect of the nurses' award in 1988. Indeed, it provides an excellent leading guide to monthly movements in underlying average earnings once

consideration is given to two factors:

- statistical adjustments made by the Department of Employment's statisticians in creating the underlying series.

- short-term movements in wage drift, the difference between basic pay settlements and total earnings.

The methodology behind the creation of the underlying average earnings series has been laid out by DOE, but can in practice be somewhat elusive and necessitates the use of a large degree of subjective judgement by the DOE's statisticians. Most importantly, the underlying series attempts to strip out distortions caused by changes made to the timing of settlements and one-off bonus payments in consecutive years. For example, where a settlement normally paid in July is, due to protracted negotiations, still not settled in August the DOE's statisticians will enter an "estimate" in order to minimise distortion to the year-on-year comparison. This "estimate" will be "upgraded" in each month until the dispute is settled. However, neither each new estimate, nor the final settlement is backdated. Therefore, a jump in the weighted average settlement, related to the final settlement of a number of outstanding disputes, will only have a similar impact on the underlying rate of average earnings where the statistician's estimates are wildly wrong. This clearly tends to produce a smoother series.

Nevertheless, a pick-up in the 12-month weighted average pay settlement will certainly feed through into the underlying rate of average earnings. This relationship, however, tends to be dampened by movements in wage drift, which covers all payments which are not directly related to basic settlements. It is therefore affected by both compositional drift -due to the changing composition of the workforce - and incremental drift, due to the general movement of employees within individual company pay scales. However, short-term fluctuations mainly result from movements in overtime and bonus payments as well as locational allowances. These payments can have and important impact on earnings; the 1989 New Earnings Survey indicates that 13.4% of all workers' pay and 25.3% of manual workers pay is related to payments which contribute to wage drift.

As the economy slows, overtime and bonus payments tend to have a reduced impact on earnings, although skill and general labour shortages may ensure that locational allowances hold up better. During the course of 1989, this partially dampened the impact of increasing pay settlements on average earnings. Our Index suggests that by September wage drift had fallen to just over 2% from its peak of 3% in May, as the year-on-year growth in overtime became negative.

The worrying feature of this analysis is that, even if pay settlements merely stabilise at the 8.5% recorded in September 1989 and fall to 8% in early 1990, a growing number of workers will continue to benefit from the new level of settlements, and the 12-month average will continue its relentless rise upwards, from the 6.5% recorded at the end of 1988, to above 8% by the middle of 1990. Consequently, wage drift would have to fall to below 1% for the rate of growth of underlying average earnings to resist a further rise above 9%.

It has been suggested that wage drift could fall quite rapidly and, in fact, as a result of the high level of bonus and overtime payments built up in 1988, could have a negative impact on average earnings in 1990. Clearly, the rate of growth of these payments only has to fall in order for wage drift to be reduced. Intuitively, it may seem that if bonus, overtime and other payments were to fall rapidly from the actual levels seen in the year-on-year comparison, wage drift could well be negative. However, what facts are available do not tend to suggest that this is likely.

A measure of twelve months average settlements since mid-1981, based on the CBI Pay Databank series for manufacturing, is shown in Chart 3, along with the official manufacturing average earnings series. The difference between the two lines represents movements in wage drift. Despite the fact that the CBI series is a straight arithmetic average of recorded pay settlements, it provides both a worthwhile basis for analysis and interesting results. The most discouraging feature of the analysis is that, since its inception, the CBI Pay Databank Survey has never pointed towards a period of negative wage drift - and at its lowest, in the second quarter of 1986, wage drift only fell to 1.5%. If pay settlements were to fall to 8% in early 1990 and wage drift fell to this historically low level in mid-1990, growth in underlying average earnings would still

be forced up to around 9.5%, depending on the speed of the easing in pay settlements.

There remains, of course, the possibility that the strength of the economy in 1988 produced such unprecedented levels of payments associated with wage drift that a sharp slowdown in output growth would produce an equally unprecedented shift in wage drift. This is a very difficult area to tie down statistically. However, an interesting analysis can be produced by examining trends in the DOE's manufacturing overtime series, if the series is adjusted to produce an estimate of average hours of overtime worked per employee in manufacturing. It would be expected that the year-on-year percentage change in this series would indirectly influence wage drift; an increasing rate of growth in overtime per worker should increase the contribution of wage drift to the annual growth in average earnings. However, it should be noted that a fall in the growth of overtime to below the going rate of pay settlements is not enough to produce negative wage drift, irrespective of the other components of drift, since overtime payments will be influenced both by the growth in hours of overtime worked and increases in the basic rate of pay, which determine the overtime rate. Therefore, if overtime rates generally increase with basic rates of pay, positive growth in overtime, even at a declining rate, will always produce positive wage drift.

By the beginning of 1989 overtime had reached 3.8 hours per worker; much higher than previous peaks of 3.2 hours per workers. This provides some hope that a slowdown in activity in 1990 would produce a rapid fall in overtime payments. However, previous experience, based on this data compared with the wage drift series created from the CBI pay databank, does not point to an encouraging effect on wage drift.

In broad terms, manufacturing wage drift has tended to follow movements in overtime reasonably well, as Chart 4 illustrates. However, the trough in wage drift in the second quarter of 1986 was associated with an actual fall in overtime of nearly 7%, from its peak of 3.2 hours/worker, hardly encouraging for those looking for a more positive effect on wage drift.

Interestingly, both wage drift and the rate of increase in overtime appear to be very buoyant in the second half of the 1981 recession year, the earliest period covered by the CBI survey. A look at a longer run of the overtime series suggests that this was due to a recovery following eight consecutive quarters of falling overtime, in the period from mid-1979. In the final quarter of 1980 and the first quarter of 1981 this produced falls in overtime worked of 37% and 30% respectively on a year-on-year comparison. Despite the fact that 1990 would not be expected to produce such a fall as in these recession years, it would certainly be interesting to estimate the effect of these developments on wage drift. Although the full CBI pay databank series does not date back this far, the CBI has provided us with rough annual estimates of pay settlements from an earlier survey. It should be stressed that this series is certainly not as reliable as the full CBI databank, which is based on a sounder sample. Perhaps disappointingly, this data produces a bottom estimate of wage drift of 1.7% in 1979, when overtime fell by 5% over 1978, and nearly 3% in 1980 when overtime actually fell by 19.5%.

Clearly, there are many serious problems with the interpretation of the data in this area, many of which have not been discussed here. However, it is extremely difficult, in the light of this analysis, to be overly optimistic about the benign impact of falling wage drift on labour costs.

The outlook for 1990, therefore, is certainly clouded by stagflationary pressures. As companies act to deal with falling profit margins and the slowdown in the economy begins to affect both sides in the wage bargaining process, pay pressures may well moderate. Although it is too early to make a meaningful judgement, there are signs of this in our latest estimates of average settlements. However, a degree of wage-wage emulation, driven by competition between groups of workers, already seems to be embedded in this year's pay round. Importantly, the rise in interest rates to 15% (at the time of writing) has ensured, through a rise in mortgage rates, that the headline RPI will not fully benefit as the rises in the mortgage rate in 1988 and early 1989 fall out of the year-on-year comparison. Consequently, inflationary expectations are likely to remain stubbornly high.

In this environment, a realistic estimate of both the extent of the easing of pay pressures over 1990 and the likely fall in wage drift would still see average earnings growing at a rate of just

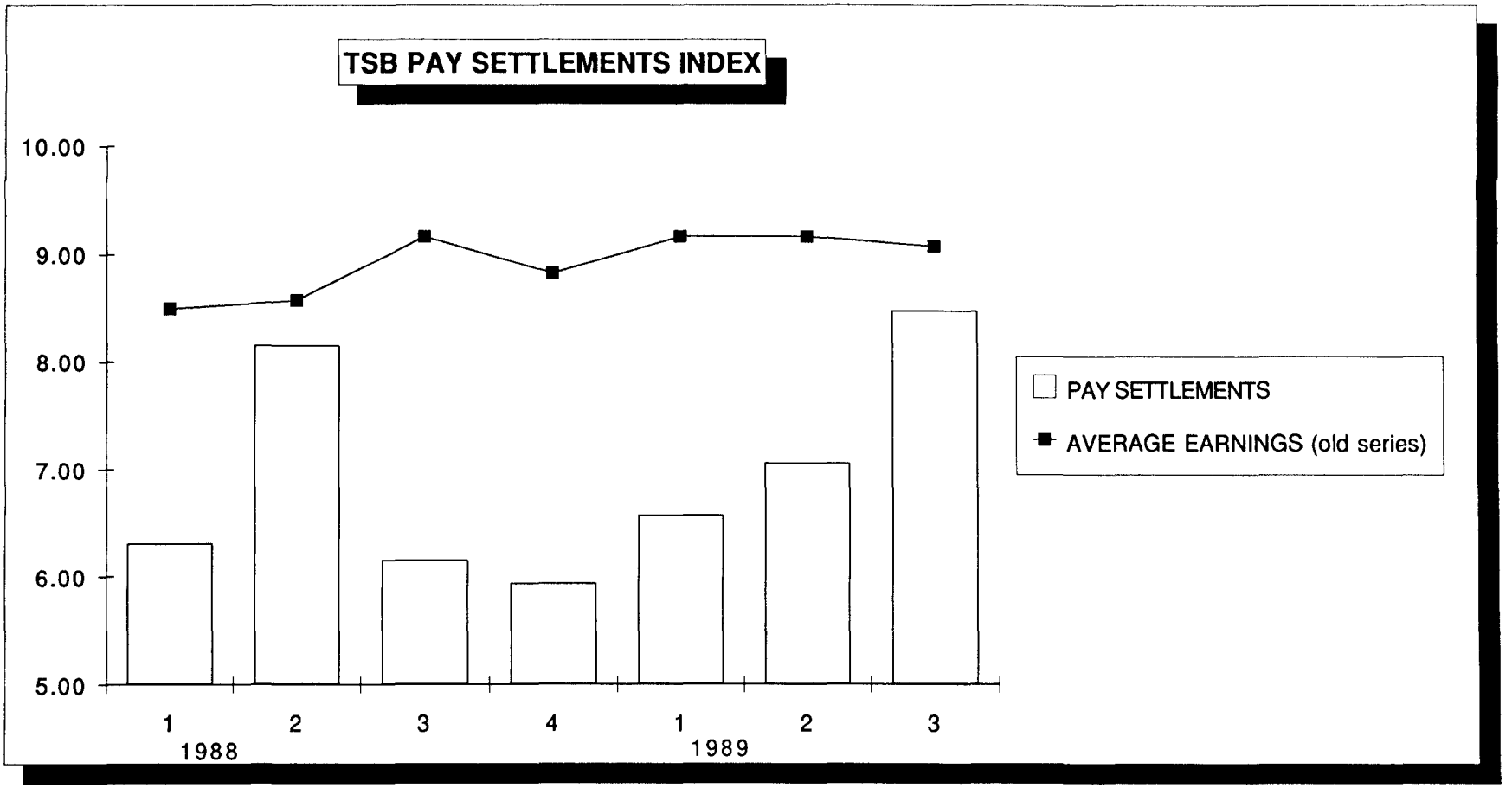
above 9% over the year as a whole, leaving unit labour costs extremely vulnerable to slowing productivity growth: a development normally associated with a slowdown in output growth.

The international environment is likely to provide a more favourable background to developments in the economy than in the early 1980s; world growth should remain respectable and international inflation and commodity prices should ease off. However, the government is almost certainly faced with a period of mild stagflation over 1990. There is also the worry that settlements may fail to respond as the economy slows, leading to the entrenchment of a vicious wage-price spiral. In this event the respite offered by falling wage drift will certainly not be enough to contain labour costs.

Footnote

1. For a discussion of the methodology see "The Average Earnings Index", Employment Gazette, November 1989.

Chart 1


TSB PAY SETTLEMENTS INDEX
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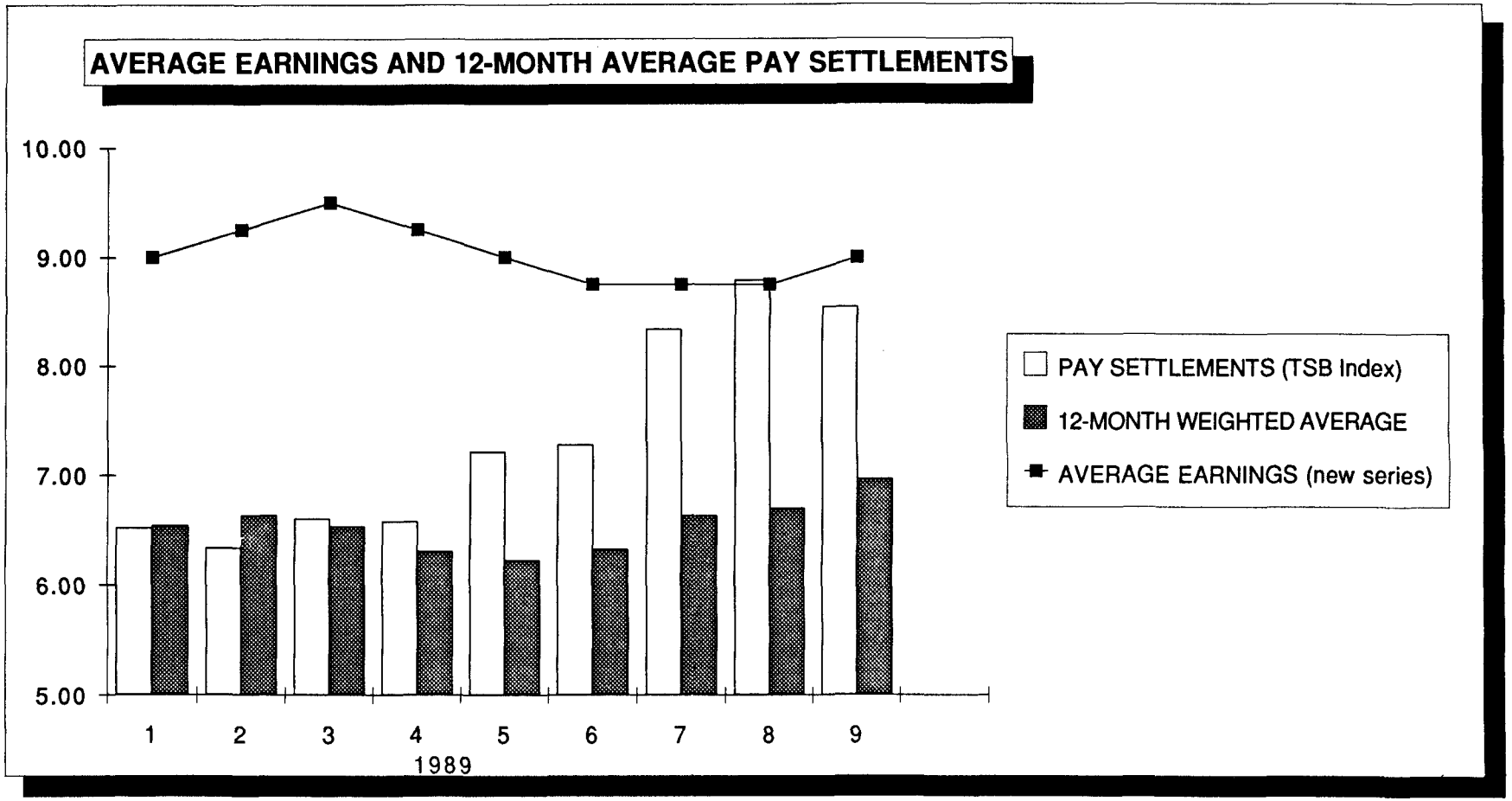
1988
1989
PAY SETTLEMENTS
AVERAGE EARNINGS (old series)

Chart 2


AVERAGE EARNINGS AND 12-MONTH AVERAGE PAY SETTLEMENTS
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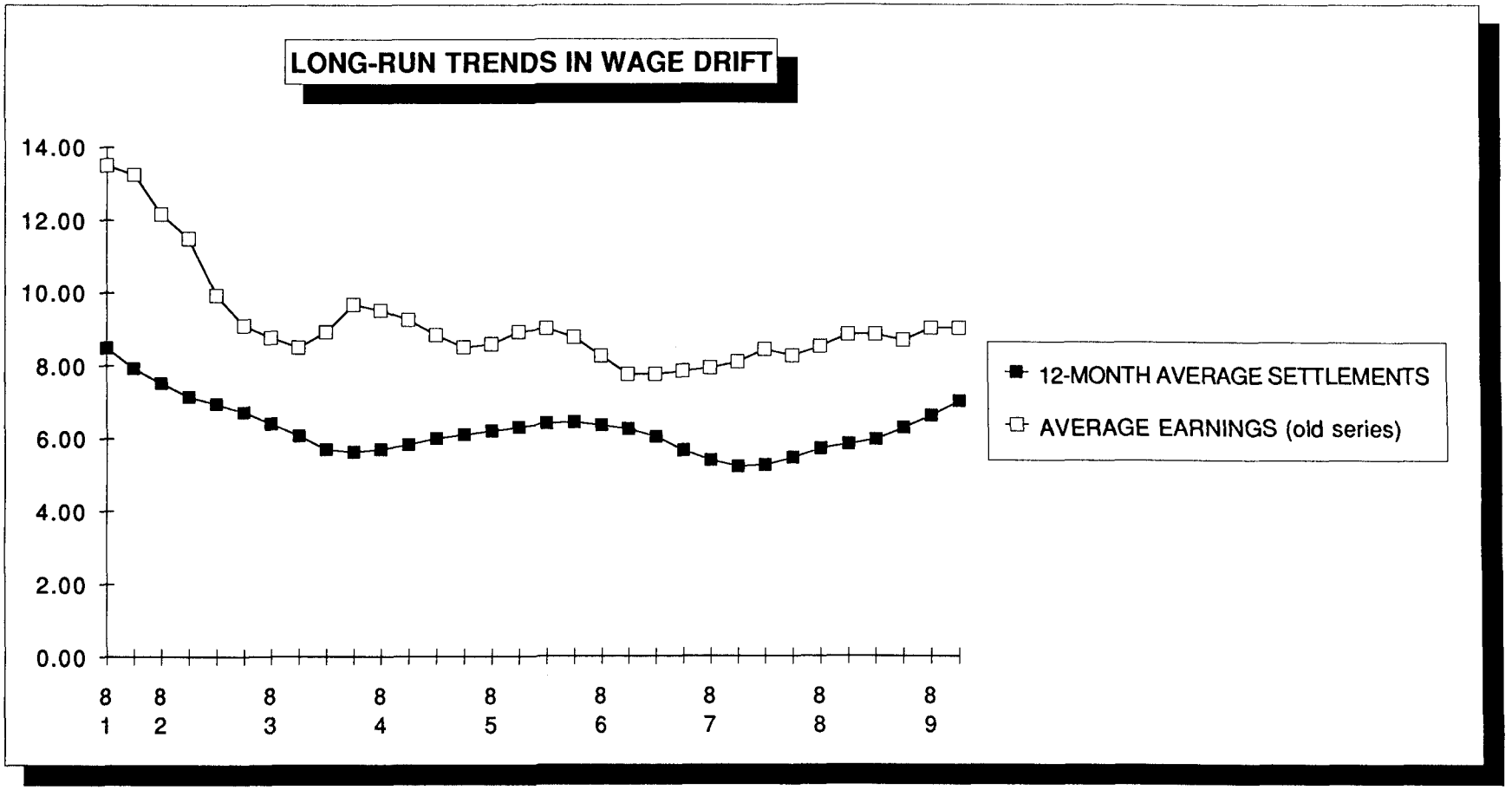
1989
PAY SETTLEMENTS (TSB Index)
12-MONTH WEIGHTED AVERAGE
AVERAGE EARNINGS (new series)

Chart 3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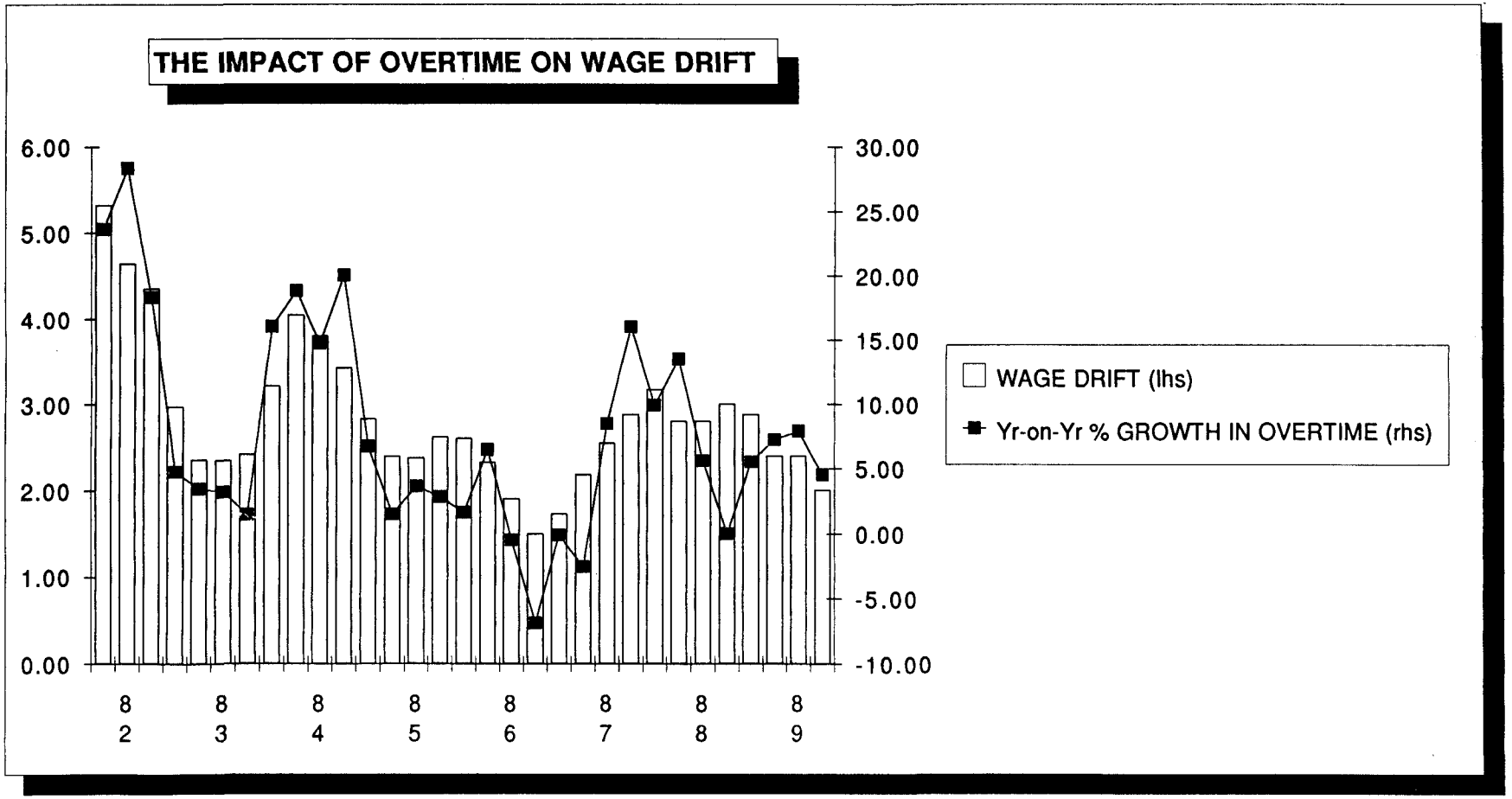
12-MONTH AVERAGE SETTLEMENTS
AVERAGE EARNINGS (old series)

Chart 4


THE IMPACT OF OVERTIME ON WAGE DRIFT
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WAGE DRIFT (lhs)
Yr-on-Yr % GROWTH IN OVERTIME (rhs)