

## Novus Capital Markets Research

### A difficult narrative

13 October 2011

**What is going on in the labour market?** This week's labour market data were poor – the largest drop in employment since the depths of the recession and a 15-year high in the rate of unemployment. I have struggled to explain the labour market since the onset of recession in 2008. Why did a huge fall in GDP (7.1% we are now told) not result in an equivalent surge in job losses and a big rise in unemployment? The answer – pay freezes, more short-time or part-time working – never seemed entirely adequate. And, if labour market flexibility was the explanation, why did the early stages of the recovery produce an immediate increase in employment? Was there no spare capacity in the labour market? Now, even though GDP is still just about on a rising trend, the labour market is deteriorating. What has happened to our much-vaunted flexible working practices? Why are hours worked and productivity rising again at the expense of employment? The explanation may lie in the structure of the labour market though what we are currently seeing appears to be consistent with the slowdown and a weaker outlook for GDP. So why – and I know I keep coming back to it – was it all apparently so different in 2008 and 2009?

**Q3 GDP update:** I wrote at the start of September that, for all the pervading doom and gloom, Q3 GDP (the release has been postponed to 1 November) should notch up a decent increase, possibly even as much as the 0.8% that the MPC forecast in August. The argument was simple: Q2 was depressed by the Royal Wedding; May and June had bounced back so the entry point into Q3 more or less guaranteed a decent outturn. IP fell back in July but recovered in August; in Jul-Aug combined it was 0.2% above the Q2 average. The quantitatively far more important service sector rose 0.2% in July and was 0.5% above the Q2 average. Construction appears to have fallen back in July. Together these point to a Q3 GDP increase of 0.4-0.5%, below the MPC's estimate but in the circumstances a reasonable increase.

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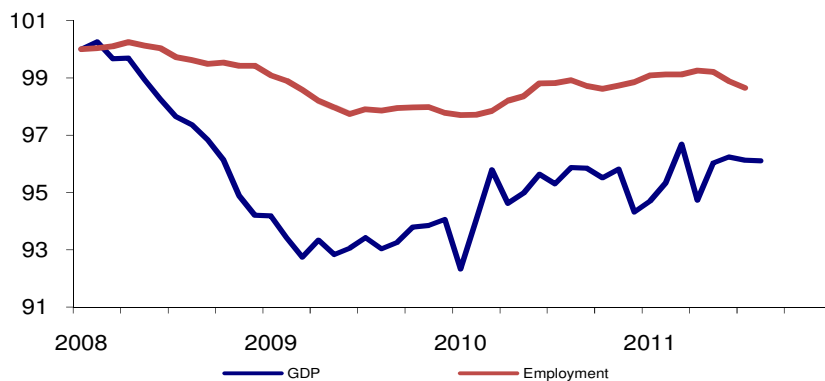
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### A difficult narrative

This week's labour market data are not encouraging. Employment fell 178k in the most recent (Jun-Aug) period, the largest 3-month decline in over two years. Unemployment rose 114k to 2,566, a 17-year high, and the rate rose 0.4pp to 8.1%, the highest in 15 years.

Since the onset of the recession in 2008 it has been difficult to explain trends in the labour market given what was happening to GDP. I noted last week that a 7.1% peak-trough fall in GDP and a 2.3% peak-trough decline in employment (Chart 1) are difficult to reconcile. The explanation that was offered at the time, the only one that made any sense of the data, was that employees accepted low wage increases or even pay freezes and cuts in hours as a way of preserving their jobs.

**Chart 1: GDP and employment (monthly, Jan08 = 100)**



Source: ONS, Novus

Employment started falling in May 2008, three months after GDP (which on my monthly estimates peaked in February). At the very low point in the recession (May 2009) employment was falling by around 90k (0.3%) a month. At its low point, some 3-6 months earlier GDP was falling at a monthly rate of 0.7-0.8%, more than twice as rapidly as employment.

The recovery in GDP started in the summer of 2009 and appeared to be gathering momentum by the middle of 2010. Employment, which had stopped falling in the second half of 2009, also picked up quite sharply and for a brief period in the summer of 2010 the labour market was creating new jobs (283k in the May-Jul period) at a faster rate than it had shed them in the recession. From a low of 28.8m in January 2010 employment rose 460k (1.6%) over the next 15 months. At this point employment was less than 1% down on the pre-recession peak while GDP is still nearly 4½% lower.

The lesson appeared to be that, in a flexible labour market, employment would fall less rapidly than GDP and that once GDP started recovering, notwithstanding the spare capacity that a recession generated, jobs would start being created again (Table 1).

**Table 1: GDP & employment**

% change (quarterly data)	Peak-trough	Trough- 11q2
GDP	-7.1	2.8
Employment	-2.3	1.4

Source: ONS, Novus

After a promising start the recovery faded badly around the turn of the year as the output lost in December's severe winter was not fully recovered until about the middle of this year. Over the last nine months there has been no growth in GDP – though as I note below growth appears to have been resumed at a reasonable pace in Q3.

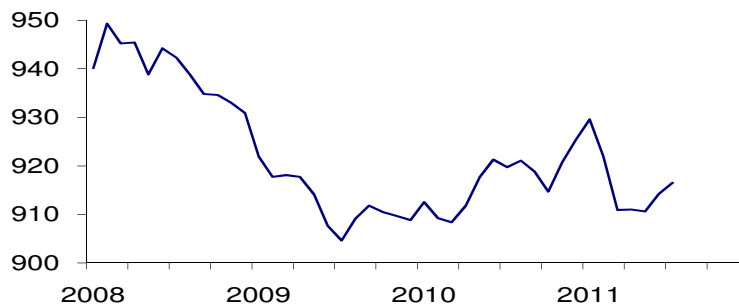
Over the last three months the labour market has deteriorated sharply. The 178k fall in employment is the sort of decline we saw when GDP was contracting at a rate of about 1% in the recession. So what has happened to our much-vaunted labour market flexibility? Have workers stopped pricing themselves into employment?

The answer might lie in the structure of the labour market. Of the 178k job losses in the last three months, only 2k were for full-time workers; the vast majority was concentrated on part-time workers (175k) most of whom were young (employment fell 79k in the 16-24 age group) or old (-74k in the 65+ age group). On top of that job losses are probably accelerating in the public sector. The data are only available to 11q2 but in that quarter there were 111k job losses in the public sector (and for the first

time since public sector payrolls started falling at the start of last year public sector job losses outnumbered private sector job gains). This trend is likely to have continued into Q3.

Another part of the explanation might come from hours worked and productivity. Hours worked rose 0.5% in July on the Q2 average (Chart 2). Where at the height of the recession cuts in hours helped to preserve jobs, that no longer appears to be the case. Fewer people are working longer hours (and part-time jobs are being shed).

**Chart 2: Hours worked (total weekly hours, m)**



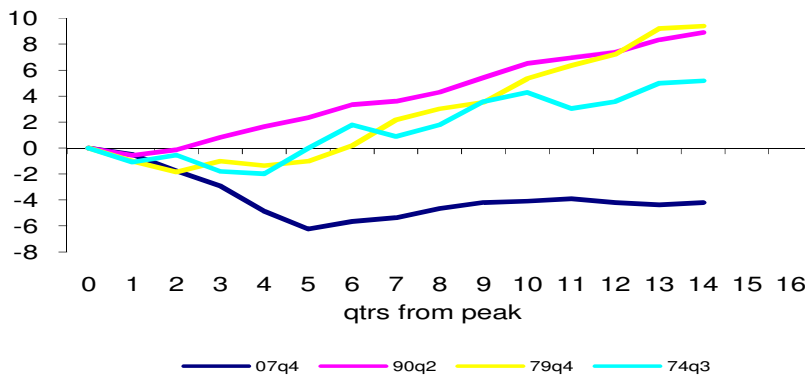
Source: ONS

Last week I described the combination of a relatively large drop in GDP and a far more modest decline in employment as having ‘totally implausible implications for productivity’. The revised data show whole economy productivity peaking in 07q4 and falling rapidly in 2008-09. The peak-trough fall was 6.2% measured by output per job and a little bit less at 4.7% measured by output per hour (hours fell more rapidly than employment).

From about the middle of 2009 productivity has been improving though on the latest (11q2) data output per job is still 4.2% below the 07q4 peak while output per hour is 1.7% down. The contrast with previous recessions where productivity typically falls 1-2% initially but by this stage in the recovery is anywhere between 5 and 10% higher is stark (Chart 3 – nb the 07q4 data are as per the revised 2008 national

accounts; the earlier data are still on a 2006 basis as I haven't managed to get an updated series from the ONS website – does that surprise anyone?).

**Chart 3: Productivity (output per job) – recessions compared**



Source: ONS, Novus

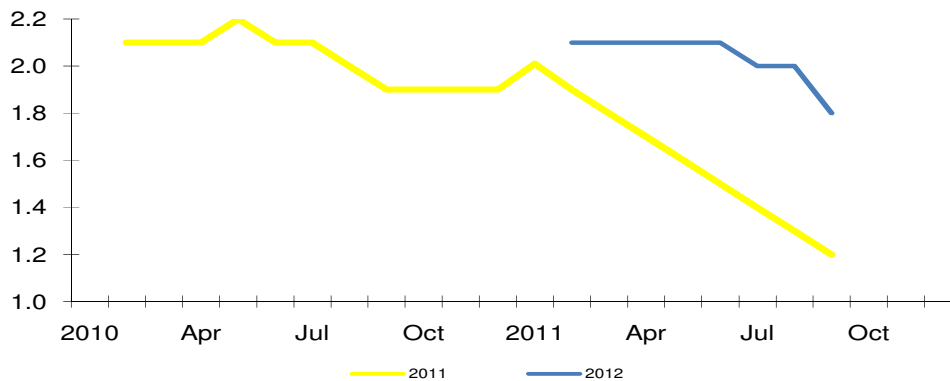
Where output per job has been flat over the last year, output per hour rose nearly 1½% over the year to 11q2 (a period in which hours worked were falling). Together, it appears that hours worked and productivity per hour are slowly recovering and preventing a fading recovery from translating into further job gains. That seems more 'normal' labour market behaviour compared with what we saw in 2008-09 (unless – and I know I keep coming back to it – the official statistics are still exaggerating the decline in GDP that occurred in the recession).

**Q3 GDP update**

Last week's downward revisions to GDP show that there has been no growth in the economy over the last nine months, that the level of output in 11q2 (98.0 on the revised 2008 basis) was the same as in 10q3. The revised data show GDP falling 0.5% in 10q4 (mainly because of December's severe weather), then rising 0.4% in Q1 and 0.1% in Q2. Since then the outlook has deteriorated as the European debt crisis has intensified and global forecasts have been revised down. For the UK the consensus according

to the Treasury compendium is for GDP to rise 1.2% this year (a full 1pp below what was expected a year ago) and 1.8% next (Chart 4).

**Chart 4: GDP forecasts (% y/y)**



Source: HMT

Yet, as I wrote six weeks ago, the headline number for Q3 (the release of which has been pushed back to 1 November from 25 October) will be ok:

All the doom and gloom notwithstanding, the monthly profile of output tells us that GDP should notch up a decent increase in Q3 ... The MPC's August forecast was for Q3 GDP to rise 0.8%, which requires as little as 0.1% a month in Jul-Sep. Output could easily slip back in manufacturing though stronger oil output should boost industrial production as a whole. Maybe for once the MPC won't have to downgrade its growth outlook come the November forecast'.

That assessment was based on the profile of GDP in Q2 which was reduced by a very large drop in output in April brought about by the Royal Wedding and the associated extra bank holidays. I estimate that GDP fell as much as 2% in April and that most (though not quite all) of this loss was recovered in May and June. As a result output exited Q2 at a level that was around 0.6% above the quarterly average.

At the time of my previous estimate (1 September) there were no official data for Q3, only the survey data. Since then, in addition to the Blue Book revisions, we have had IP for July and August and services for July. We also have the July construction data (seasonally unadjusted from the ONS and an adjusted version from eurostat).

IP fell 0.4% in July on a large drop in the (new) electricity & gas (EG) sub-sector and rose 0.2% in August as EG rebounded. As I suggested six weeks back, manufacturing has fallen in each of the last three months while oil & gas extraction has risen each month. The level of IP was 0.1% above the Q2 average in July and 0.2% above Q2 in Jul-Aug combined. For services, which recovered strongly in May-Jun a rise of 0.2% took July to 0.5% above the Q2 average. On the eurostat data construction rebounded strongly in May-Jun but then slipped back in July to a level that was 0.6% below the Q2 average. Adding these together I estimate that GDP fell back in July but was still 0.4% above the Q2 average (Table 2).

**Table 2: GDP estimates**

2006 = 100	11q2	Apr	May	Jun	Jul	Jul/Q2
Industrial production	92.1	91.4	92.3	92.6	92.2	0.1
Construction	94.0	<i>90.8</i>	<i>93.5</i>	<i>97.6</i>	<i>93.4</i>	<i>-0.6</i>
Services	99.5	98.5	100.1	99.8	100.0	0.5
GDP	<i>97.8</i>	<i>96.7</i>	<i>98.3</i>	<i>98.4</i>	<i>98.2</i>	<i>0.4</i>
GDP (% 3m/3m)	0.1	<i>0.6</i>	<i>1.1</i>	<i>0.1</i>	<i>0.6</i>	<i>0.4</i>
GDP (% m/m)		<i>-2.1</i>	<i>1.6</i>	<i>0.1</i>	<i>-0.2</i>	

Source: ONS, Novus estimates (*italics*)

For Q3 as a whole IP looks set to make a positive contribution – it would have to fall 0.8% in September for this not to be the case. This looks unlikely with the manufacturing PMI back in expansionary territory and oil & gas on a rising trend (though hot weather at the end of the month may have held back EG). On this basis IP (15.4% of GDP) should manage a 0.2-0.3% rise in Q3 overall.

What happens in the service sector (76.3% of GDP) is far more important. We do not get the August data until 1 November (along with Q3 preliminary GDP) so it is all guesswork at this stage. We know that retail sales volumes fell in August, which will depress activity in the retail trades. We also know that the service sector PMI was unexpectedly strong in July, fell sharply in August (though it was still comfortably

above the 50% expansion line) and staged a partial recovery in September. With 0.5% under the belt for July alone, I would guess that services will rise 0.5-0.7% in Q3 as a whole.

We know even less about construction which is unhelpful since its weight has been raised from 6.3% to 7.6% of GDP. According to eurostat it got off to a poor start in July and needs to bounce back in Aug-Sep if it is to make a positive contribution to Q3 GDP.

Overall it looks at this stage as if GDP will rise 0.4-0.5% in Q3 (NIESR estimates 0.5%; the RBS tracker shows 0.4%). That is less than seemed likely six weeks ago when I suggested that the Bank's 0.8% might not prove too high. But, unless the economy shows strength in Aug-Sep which at this stage seems unlikely, the Bank will yet again have been too optimistic in its near-term growth outlook – though if I was right last week it will not be because it underestimated inflation.

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