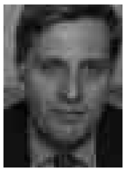


THE LABOUR MARKET IS KEY FOR THE UK'S ECONOMIC OUTLOOK, SAYS **DAVID OWEN**.

Labouring for growth

Although it is encouraging that activity in the UK housing market has picked up again, the resurgence does not imply that UK growth is set to remain at trend in the coming quarters.

Housing may be a key driver of retail sales, but its correlation with the other two-thirds of consumption is, in general, lower than was the case in the past. Instead, since 2000 there has been an increased correlation between house prices and the net acquisition of financial assets in the UK. In part, this could be because older people have been making increasing use of their principal asset, their home, to fund their retirement years by purchasing annuities on the back of mortgage equity withdrawal.

Outside retail sales, only education spending now seems to be more highly correlated to house prices than was the case 10 years ago, as parents perhaps make use of mortgage equity withdraw as a way to fund their children's schooling and university fees.

As has always been the case, the main determinant of consumption is disposable household income. The fact that real household disposable income slowed sharply in the second half of last year and has been very weak ever since has received surprisingly little attention. But this is the key reason why UK economic growth is likely to prove disappointing in 2006.

DECLINING EMPLOYMENT In recent years employment has been growing by around 1% year on year. Of course, a major boost to employment has been the public sector. In fact, since 1999 more than 600,000 additional full-time jobs have been created in the public sector. At its peak in 2003, public sector employment was growing by almost 3% year on year.

The situation today is very different, putting far more of the onus on private sector companies to take up the running. Unfortunately, this has not happened. Ominously, overall employment has recently been declining.

The Netherlands in recent years provides the model of a housing bubble that did not burst, but only deflated. Even so, consumer recession followed in the Netherlands in 2003 and 2004 after employment started to fall.

True, the Netherlands is an economy significantly influenced by global developments, but an improvement in the labour market was at that time a major factor underpinning the recovery in

Executive summary

- In the UK overall employment has been declining while unemployment and economic inactivity has been rising.
- The inactive and migrants can add to the labour supply.
- If unemployment continues to rise, so will the saving ratio, further hitting consumption.

Chart 1. Unemployment rate and savings ratio

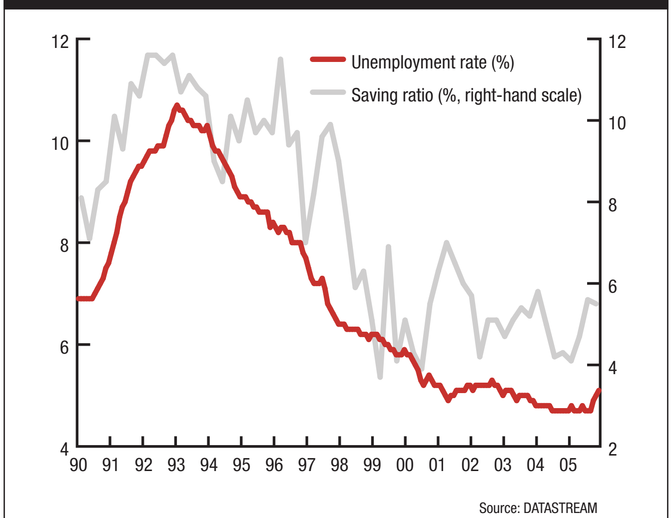
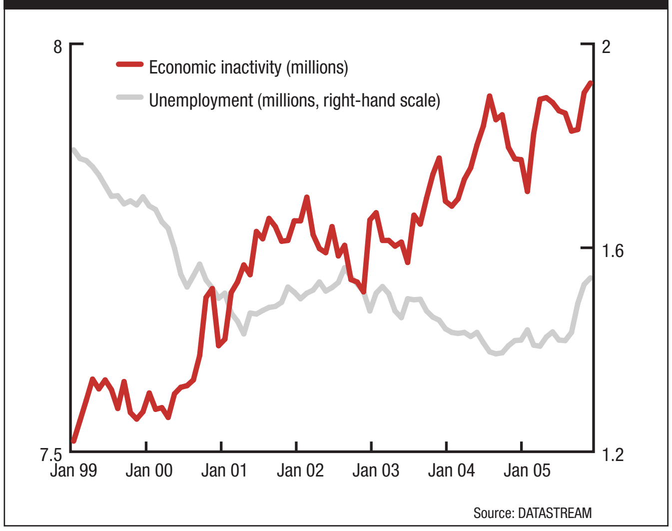


Chart 2. Economic inactivity and unemployment



consumption experienced by the economy in 2005.

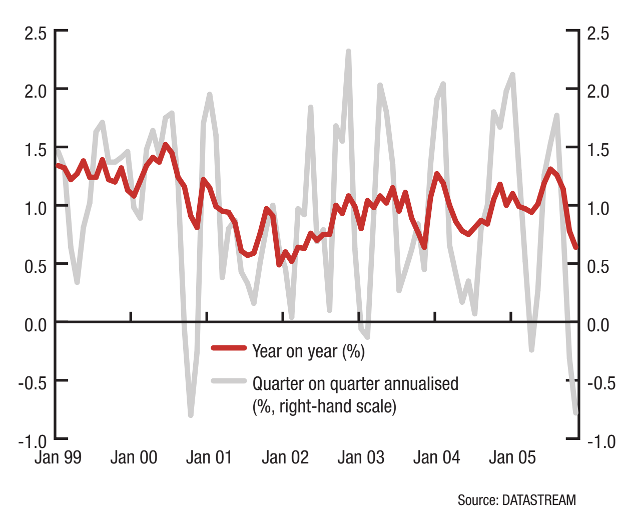
Not only has overall employment been falling in the UK, but unemployment and so-called economic inactivity are both on the rise. There are almost eight million inactive people of working age in the UK compared with just over 1.5 million who are unemployed. Inactive individuals are defined as those who are neither in employment nor unemployed. Inactivity includes those who want a job but have not been seeking work in the last four weeks, those who want a job and are seeking work but are not available to start work, and those who do not want a job. Inactive individuals typically fall into four main categories: full-time students, those looking after a family, the sick/disabled, and the early retired.

There are now around twice as many inactive prime-age males (those aged between 25 and 54) in the UK as unemployed prime-age males. Around 70% say they are inactive because they are sick or disabled. This contrasts with the 1970s, when prime-age males who were unemployed outnumbered those who were inactive by a factor of two to one.

The substantial rise in inactivity since the 1970s in the UK has been skewed towards the unskilled. By the late 1990s the inactivity rate of prime-aged unskilled males was almost four times the equivalent figure for more skilled males of the same age cohort. In fact, there has been no increase in prime-age inactivity among those outside the bottom skill quartile. This in large part reflects the fact that the low skilled have faced growing competition from developing economies, reducing the odds of them finding work or remaining in employment, and pushing them onto benefits. Arguably, the UK has been more affected by these global developments than other northern European economies because the unskilled represented a relatively large proportion of the workforce to start with.

MARKET FLUIDITY But the UK jobs market is more fluid than a few years ago. This has certainly improved the unemployment-inflation trade-off. In particular, the inactive have become an important source of additional labour supply. In recent years an average of 17% of those declared as inactive have found themselves in work within 12 months. Given the large number of inactive people in the UK, this represents an annual figure almost as great as the total number of unemployed people in the economy. The majority of those employed work in services. Examples of people switching from inactivity to employment include many former nurses and teachers tempted back into work after their children have grown up.

Chart 3. Employment



Net migration has been another powerful force for change in the labour market. In 2004, net migration totalled over 0.5% of the UK working age population – up from 0.1% of the working age population in 1997. This was despite the fact that more than 200,000 British people decided to leave the UK in 2004.

Most of the EU 15, including France, Germany, Italy and Spain, chose to impose some kind of restriction on the movement of labour from the 10 countries that joined the EU in May 2004. The UK, Ireland and Sweden were the exceptions (although from 1 May, Spain and Finland will also abolish their restrictions).

Between May 2004 and September 2005 almost 300,000 people took advantage of the UK's more open policy towards migration from the new members of the EU. This figure is equivalent to 1% of total employment. The vast majority of migrants were young and single: 44% were aged between 18 and 24, and a further 39% between 25 and 34. A large proportion have found work in distribution, hotels and restaurants (almost 30%), manufacturing (around 28%) and agriculture and fishing (around 10%). Over 80% are earning between £4.50 and £6.00 an hour, compared with medium hourly earnings of £9.56 in 2005 and the minimum wage of £5.05 for those aged over 22.

INCREASING OUTPUT It has been suggested that the surge in migration from the new members of the EU has been a contributory factor to the increase in claimant unemployment seen during the period. But the evidence to date is that this migration has had the effect of increasing output and employment, rather than being the reason unemployment has risen. In other words, if it were not for the significant rise in migration from the expanded EU, economic growth would have been even weaker.

But the point remains that total employment fell by almost 60,000 in the fourth quarter of last year and 40,000 more workers moved from being registered as employees to registering as self-employed. This is all consistent with a softening in labour demand.

And where the labour market goes, the saving ratio often follows. To date, a significant rally in equity prices may have masked the effect that the sharp slowdown in the housing market would otherwise have had on the saving ratio. But the risk is that if unemployment continues to increase so will the saving ratio, further hitting consumption.

Moreover, investment intentions in the UK continue to be very weak, in contrast to what has been seen in other countries. Despite the rally in equity markets, falling bond yields and changing mortality assumptions (with actuaries owning up to the fact that everybody is living longer) have meant that pension fund deficits remain a major competing drag on corporate cashflows. There is little sign of this changing. It all suggests that 2006 will be another year of below-trend growth and, eventually, interest rate cuts.

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