How tight is the labour market?

There are many reasons why policy makers might be concerned about unemployment. One of these is that it represents the balance of demand and supply in the labour market, and therefore the likely impact of wage growth. If wage changes result in price changes then the level of unemployment can be an important determinant of inflation- a relationship summed up by the short run Phillips curve. A prediction of likely inflationary pressures can thus be formed by examining the tightness of the labour market.

However, it is arguable that unemployment statistics do not give the full story when it comes to measuring the degree of labour market tightness. It is simply defined as the proportion of those who are out of work who are both looking and are available for work, as a proportion of the total workforce. In the UK the claimant count measures just this- as these are the requirements for collecting unemployment benefits.

UK unemployment has fallen considerably since its recent peak in the early 1990s, yet wage growth has remained subdued. As figure 1 shows, this pattern looks odd relative to the historical performance of the labour market which shows an inverse relationship between unemployment and nominal wage inflation.

Figure 1: Source ONS

There are of course a number of structural factors that might account for this. The new monetary policy regime with an independent central bank has been successful in anchoring inflationary expectations, which in turn will anchor wage demands. Globalisation, and particularly the integration of low cost emerging markets countries such as China into the global economy, has increased competition in the goods market. And also, labour market reforms introduced during the 1980s have curbed the bargaining power of organised labour in the wage bargain.

However, an additional hypothesis is that unemployment does not fully measure the tightness of the labour market. There are two additional sources of labour supply. These are the pool of inactive workers and migrants.

In the UK, the flows into employment are just as large from the economically inactive as they are from the unemployed. The economically inactive consists of the student population, those on invalidity or incapacity benefits, and those who care for children or elderly relatives. As a proportion of the total potential workforce, these groups make up a much larger proportion than the official unemployed (see figure 2). In fact, the UK government has acknowledged that the benefits of reducing the numbers of inactive may be much larger than simply trying to reduce the already low numbers of unemployed.

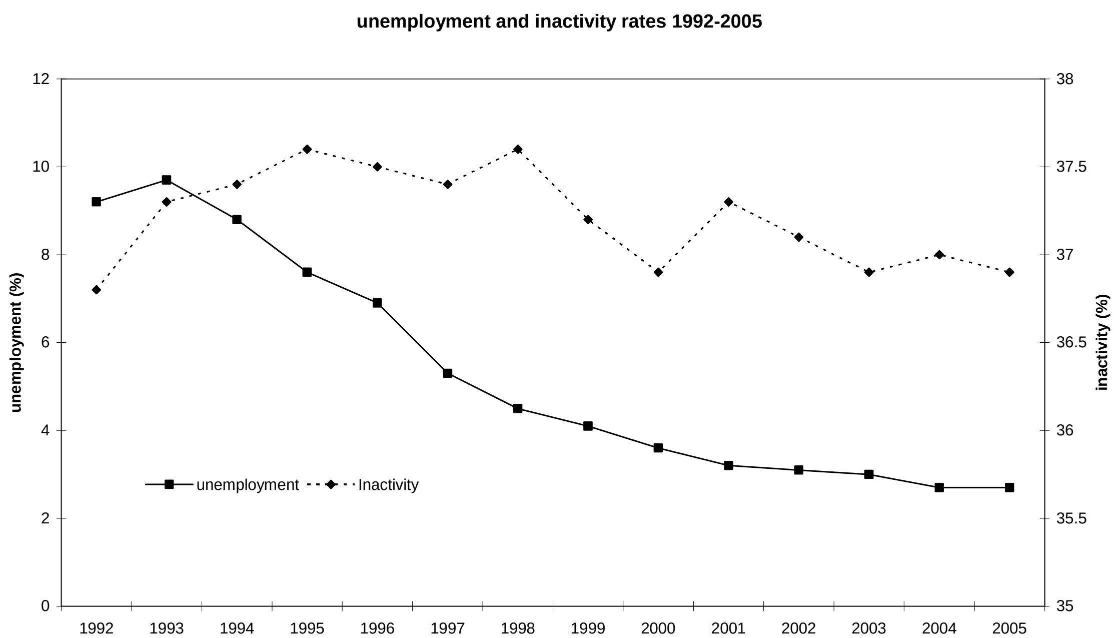
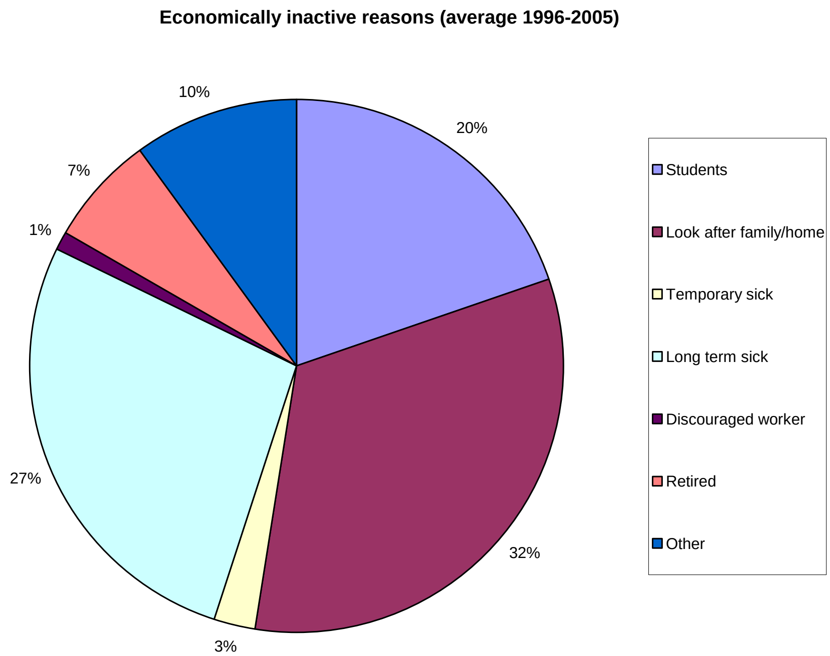


Figure 2: Source ONS

In figure 3 the inactive labour is diagnosed in more detail, where it can be seen that on average 29% of those classified as inactive expressed the desire to get a job.



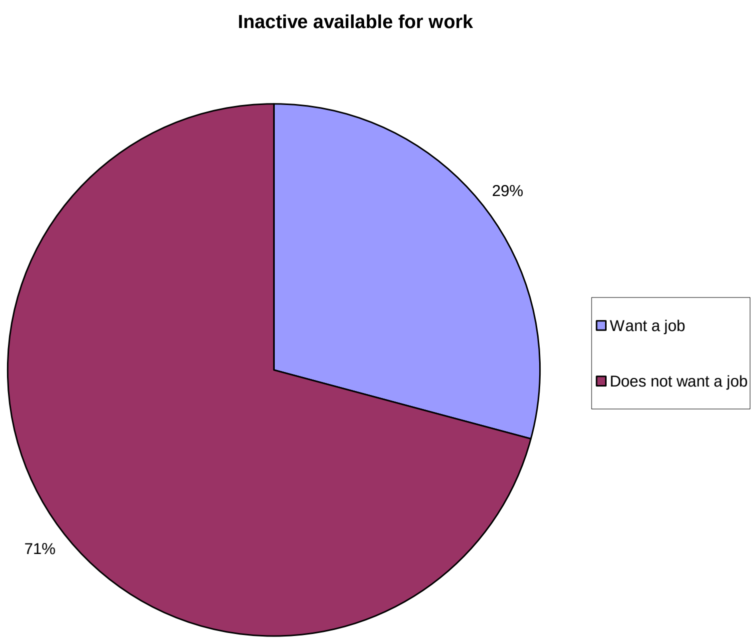


Figure 3: Source ONS

Suppose the availability of domestic labour for work consists of the claimant count unemployed and the inactive who have expressed a desire to gain employment. As figure

4 reports, the overall availability of the labour force may be much higher than just the pool of unemployed workers would suggest.

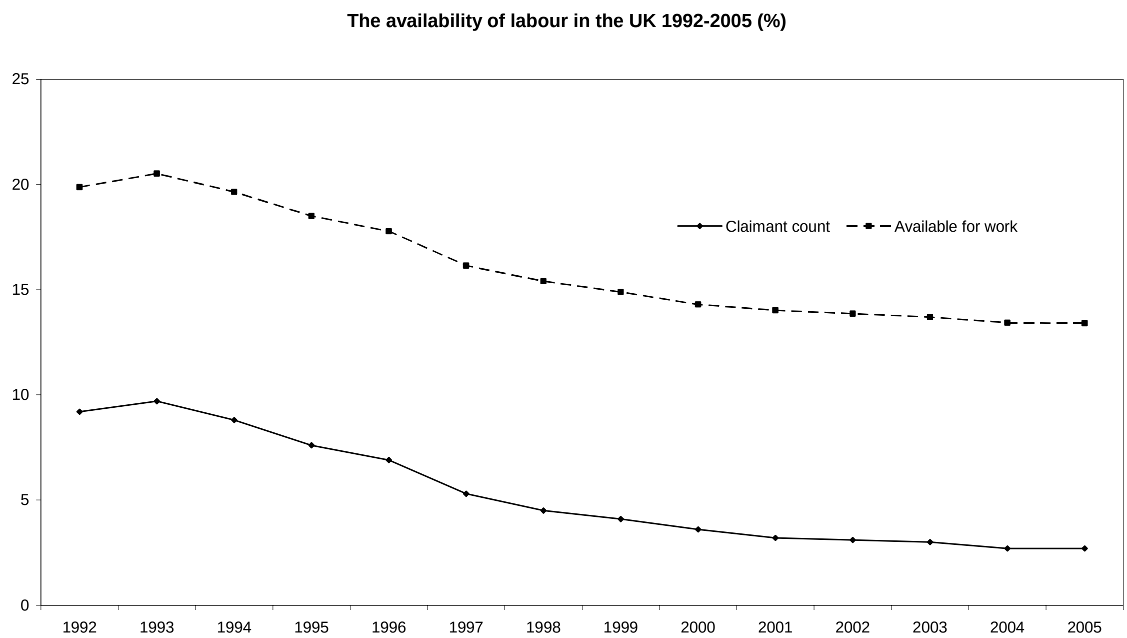


Figure 4: Source ONS

The second source of additional labour supply is migration. The UK labour market is relatively open, especially compared to the rest of the European Union. Language and cultural barriers are less of an impediment to working in the UK than they may be for other European countries, and employment restrictions are arguably looser than in the EU and US. The EU guarantees free movement of labour around the European area, and the UK has traditionally benefited from a flow of skilled immigrants from the continent. Recently, the accession of Eastern European countries has added to this potential source. Many are proficient in the English language, and the relative strength of the UK economy vis-à-vis the other major economies has seen healthy vacancies which has attracted migrant labour. Figure 5 shows the recent trends in migration into the UK.

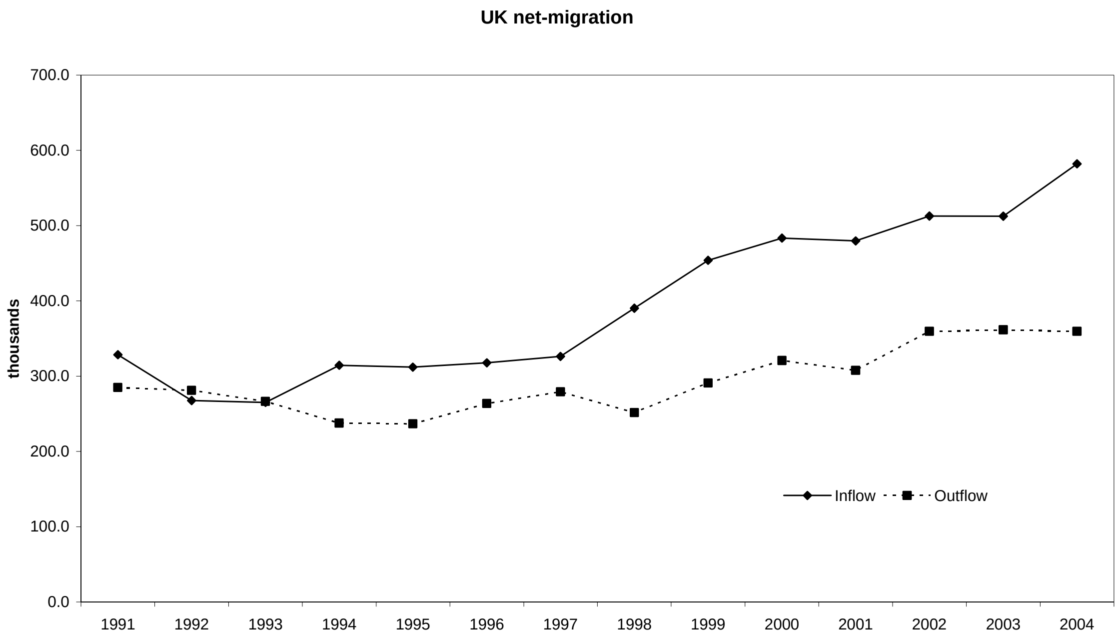


Figure 5: Source ONS

In 2004 there was surge in net-immigration to almost ¼ million. Much of this represented an increase in inflows from the group of A8 accession countries to the EU (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia). At the time of writing the only EU nations not to impose employment restrictions on the citizens of the A8 counties are Ireland, Sweden and the UK. Migration has therefore provided a further source of labour. Official figures imply that this has been strong of late and may be responsible for countering wage growth in certain sectors of economy such as hotels and restaurants.

It is difficult to say what factors might drive migration. One view that has emanated from the Bank of England is that economic factors might play a role. A strong economy creates vacancies which attract migrants into the domestic labour market. When the economy weakens and employment opportunities recede this flow might be stemmed. If this were true it would provide an automatic mechanism to preventing strong wage growth in certain sectors of the economy, as the supply of labour would expand and contract relative to demand.

There are other theories. Some believe that the flow of migrants from accession countries will largely be a one-off change. The permanency of this migrant flow is again unknown, the intentions of new migrants to perhaps return to their country of origin is not obvious. The impact of the indigenous work force is also uncertain. In a slow down it may well be those that are displaced into the pool of unemployment rather than a reduction in the inward flow of migrants.

Overall there appears to be some grounds for arguing that unemployment figures do not give an indication of expected wage and price pressures arising from the labour market. Monetary policy makers might therefore be better informed by looking at employment- which would be expected to indicate the strength of demand in the economy. A further consideration is that the labour market is not always best viewed as an aggregate, or as a single entity. Within it, there are many sectors and industries, which do not necessarily have to move in unison. At the end of the 1980s when unemployment had halved over the decade, wage growth was strongest in the sectors where there was a severe shortage of skilled labour. The argument is that it is skill shortages, rather than the numbers available for work that may drive wage growth.