Flexible labour markets, real wages and economic recoveries

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In its 2016 Employment Outlook, the OECD documents that real hourly wage growth has behaved quite differently across countries over the past ten years.

This is true even among the large European economies. Comparing the level of real hourly wages in the fourth quarter of 2015 with a counterfactual value based on the assumption that wages had grown according to the pre-crisis growth rates after the fourth quarter of 2007 reveals stark differences. This 'cumulative wage gap' is plus 14.6 per cent for Germany, minus 1.6 per cent for France, minus 3.9 per cent for Italy, plus 1.0 per cent for Spain and minus 26.3 per cent for the UK.

Some of these differences are due to composition effects, but they are clearly not the whole story. Dustmann et al (2014) document that since 2007 the UK has also experienced a massive decrease in competition-weighted relative unit labour cost, whereas this measure remained roughly constant for France, Germany, and Italy. Spain also displayed a decrease, but smaller than the one observed for the UK.

Real wages and employment levels during recoveries

The first question of this survey focuses on the role that wage setting has played in overall economic activity and specifically employment levels during and after the Great Recession. It could be argued that reductions in real wages are helpful for recovery in that they increase profits and enhance incentives for firms to invest and create jobs. In a range of macroeconomic models, lower wage growth would indeed stimulate employment.

But there are other arguments pointing to possible negative consequences of low wage growth. Low wages could mean low demand, and concerns about demand may have been more important than concerns about wage costs during the Great Recession.

The Institute for Fiscal Studies (IFS) documents that younger workers faced especially sharp reductions in earnings in the UK. These workers are likely to have high marginal propensities to consume. Moreover, low wage growth does not necessarily mean higher profits. Difficulties in finding financing for investment and efficiency improvements may have lowered workers' productivity levels.

The panel

<u>Question 1</u>: Do you agree that lower real wage growth was beneficial for employment levels during the Great Recession?

Sixty-two panel members answered this question. A majority agree: 65 per cent either strongly agree or agree, 24 per cent neither agree nor disagree, 10 per cent disagree (nobody strongly disagrees), and one panel member does not express an opinion. The majority of panel members that agree increases to 70 per cent when the answers are weighted with self-reported confidence levels.

Even though only a small number of panel members disagree with the proposition, many panel members emphasise that this is a difficult question. One aspect that makes it difficult to understand the role of wages for employment is that both variables are endogenous. For example, Roel Beetsma (University of Amsterdam) points out that 'Wage growth being endogenous, one cannot a priori say that it is beneficial for employment.'

A related aspect is that it matters what factors are behind the different behaviour of real wages in different countries. Fabien Postel-Vinay (University College London) writes 'I agree that, holding productivity constant, some degree of wage moderation will encourage hiring. However, I also think that cross-country differences in post-recession wage growth – the dire performance of the UK in particular – reflect in part differences in the types of jobs that were created. Indeed, I am very sympathetic to the observations that 'low wage growth does not necessarily mean higher profits' and that 'difficulties in finding financing for investment and efficiency improvements may have lowered workers' productivity levels.'

The particular situation of a given country and its government's policies are also deemed to be important. Jordi Gali (Universitat Pompeu Fabra) argues that 'The role of wage moderation/wage cuts in promoting recovery cannot be independent of the monetary regime in place. It will be highly effective if the associated drop in inflation is accompanied by a sufficiently expansionary monetary policy. At the zero lower bound or within a currency union, this may not happen.'

The answers make clear that there are many aspects to this question. Nevertheless, there is strong support for the view that low wage growth had a positive impact on employment rates during the recovery phase of the Great Recession. Sir Charles Bean (London School of Economics) argues that 'the [UK] wage moderation during 2009-10 was absolutely central to limiting the rise in unemployment during the period after the collapse Lehman Brothers. Continued wage moderation also helps to explain the subsequent strength of employment growth and the return of unemployment to historically low levels.'

Similarly, John Van Reenen (MIT) writes 'The UK did relatively well compared to other countries in terms of employment rates during the Great Recession. It is highly likely that this was related to greater real wage flexibility, which helped 'price workers into jobs'.'

Panicos Demetriades (University of Leicester), who disagrees, writes 'A low wage economy is likely to be a stagnating economy with low productivity, low effort, insufficient incentives for education and training, low aggregate demand, little investment and high unemployment.' There are other panel members, even among those who agree, who likewise indicate that moderate wage growth may also have negative consequences for employment.

Sylvester Eijffinger (Tilburg University), who strongly agrees, argues that 'Lower real wage growth might be beneficial for economic growth and employment in the short to medium term but can be detrimental for economic growth and employment in the (very) long term because it hampers innovation that is necessary for increasing efficiency and productivity growth.'

Several respondents point out that the positive impact of lower wage growth on employment does not necessarily mean that it is a good thing or that it does not also have negative consequences. David Miles (Imperial College) argues that 'Welfare might have been higher with somewhat higher real wages even if that meant somewhat lower employment – that depends on by how much labour productivity would have been boosted by greater incentives to improve output per worker hour.'

Jonathan Portes (King's College London) writes 'to the extent low real wage growth was driven by increases in the insecurity and precariousness of employment, this may have resulted in an overall reduction in the quality of employment for many.' But, he continues, 'to the extent that low real wage growth was the result of persistently weak productivity (driven by other factors), it is arguably preferable that the inevitable pain that resulted should be shared rather than concentrated on the unemployed.'

Are government policies important for low uk wage growth?

During the period from 2007 to 2015, the UK has been unique in being the only advanced economy that experienced economic growth and a reduction in real wages. Whereas in 2014 real wages were still almost 10 per cent lower than seven years earlier, GDP had already reached pre-crisis levels in 2013. During this period, real wages increased by an average of 1 per cent per year in France and Germany.

The first question focuses on possible consequences of different wage behaviour. The second question focuses on possible reasons behind the quite different behaviour of wages in the UK relative to other European economies.

One possible reason is that the UK labour market is more flexible and increases in unemployment rates have a larger dampening effect of wage growth. In other words, policy choices may have shaped labour markets and these policies are important for the behaviour of wages.

Another possibility is that the different behaviour in the UK is simply due to different experiences of inflation. In the UK, the inflation rate was above the Bank of England's 2 per cent target for a large part of the Great Recession and peaked above 4 per cent in several quarters. In France and Germany, inflation averaged around 1 per cent over this period.

Another possibility is that the UK is simply a different type of economy or that the financial crisis affected the UK economy in a different way than it did the other large European economies.

<u>Question 2</u>: Do you agree that the different behaviour of UK real wages relative to Eurozone wages during the Great Recession is in large part due to the UK having different labour market policies?

Sixty-three panel members answered this question. Again a strong majority agrees with the question: 60 per cent either strongly agree or agree, 22 per cent neither agree nor disagree, 14 per cent either strongly disagree or disagree, and 3 per cent express no opinion. When answers are weighted with self-reported confidence levels, then the majority increases to 62 per cent.

Wouter den Haan (London School of Economics), who agrees with the proposition, argues that the 'UK labour market differs in key dimensions from Eurozone labour markets. In particular, it is quite harsh and offers less worker protection. These are due to policy choices and are very likely to impact wage setting, for example, by affecting workers' bargaining position.'

Government policies are not necessarily the only reason for more (wage) flexibility in the labour market. David Cobham (Heriot-Watt University) says 'the difference in behaviour needs to be related to the substantial shift in the balance of power in the labour market, which in turn is related not just to policies – the removal of workers' and unions' rights – but also to the wider social changes embodied in the demise of an autonomous working class culture.'

Jonathan Portes argues that 'changes in technology and work practices' have contributed to structural changes in the UK labour market, in particular the growth of forms of insecure and precarious work', which in turn have been important for wage setting.

None of the panel members indicate that different labour market policies have played no role at all. Panel members that disagree or neither agree/disagree argue that other factors matter as well and/or matter more. Michael McMahon (University of Warwick), who disagrees, writes 'I'm sure the flexibility of the [UK] labour market has contributed. As have differences in inflation – you can easily imagine firms reluctant to increase prices even further in tough demand conditions facing pressures to cut costs across the board and wage restraint was part of this. Weak productivity growth has further limited the scope for pay increases (another difference with the countries mentioned like Germany).'

Similarly, Stefan Gerlach (BSI Ltd) maintains that 'While the UK does have more flexible labour markets than most of the euro area, the different behaviour of inflation is also important.'

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Notes:

- *This post is based on the survey Wages and economic recoveries, by the Centre for Macroeconomics (CFM) and the Centre for Economic Policy Research (CEPR).*
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