

UK: Unemployment rate to fall to 7.0% in mid-2017?

Executive summary

- UK witnessed its first-ever “Growthless Jobs Boom” in 2012, in which more than 600,000 jobs - highest annual addition since late 1980s - were added, while the economy grew only 0.3%. Nevertheless, other major labour market indicators – such as productivity, wages, full-time/part-time employment, long-term unemployed etc – which are relevant for the future growth prospects fail to show such an impressive performance. Consequently, it seems difficult that UK labour market would be able to repeat the 2012 performance and UK’s unemployment rate is expected to fall only gradually.
- A major share of employment gains happened in the part-time jobs - which are up by ~7.5% from its pre-crisis level, while full-time jobs are still lower than their early 2008 levels.
- Besides, although active population rate has not changed much in the UK during the crisis, the participation rate for youth population (aged 16-24 years) has declined to its lowest level at least since 1992, which is likely to have adverse impacts by delaying their ability to gain on-the-job training and experience.
- Although the jobs boom helped the unemployment rate to fall from 8.4% in 2011 to 7.8% last year, we expect it to stay at 7.8% till the end of this year. Besides, our unemployment model shows that in case the nation adds 300,000 jobs per annum (or 25,000 jobs per month) for the next four years till 2017, UK unemployment rate could fall to 7.0% in mid-2017 (Please note that the economy increased its employment by an annual average of 266,000 between 2003 and 2007). It points to a rate movement by the Bank of England (BoE) only in late 2017 or in 2018.

The Objective

BoE's monetary policy committee (MPC) intends not to raise bank rate at least until the unemployment rate has fallen to 7.0%, as against the current level of 7.8%

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Just a few weeks ago, Bank of England (BoE) provided a "forward guidance" on monetary policy, following its US counterpart. Just like Mr. Bernanke, Mr. Carney linked UK's monetary policy with the unemployment rate target. In particular, BoE's monetary policy committee (MPC) intends not to raise bank rate at least until the unemployment rate has fallen to 7.0%, as against the current level of 7.8%. The corresponding threshold in the US is 6.5%, as against the recent number of 7.4%.

In addition with the unemployment rate threshold, the forward guidance mentioned three 'knockouts' - 2.5% or higher inflation in 18-24 months in the MPC's view, unanchored medium-term inflation expectations and a threat to financial stability - which would cease the threshold. Firstly, it appears equivalent to UK increasing its current 2% level of inflation-target, at least for the next few years. Secondly, although macro-economic data has been extremely good in the past few weeks, it would still be premature to consider it as sustainable. Recently, business surveys show that UK capacity utilisation has fallen to 77.8% in Q3 2013, the lowest in the past three years. British home prices, according to Rightmove Inc., appear to have posted their first decline in August in 2013. Overall, while the bottom might have reached, the future growth may not be as strong as indicated by the past few weeks.

Nevertheless, with BoE choosing the unemployment rate as its threshold, the importance of understanding the labour market has increased further. Accordingly, we have assessed UK's labour market in this paper. For comparison purpose, we have compared it with the US labour market. It is interesting to note that UK witnessed its first-ever "Growthless Jobs Boom" in 2012, in which more than 600,000 jobs were added, while the economy grew only 0.3%. This was the highest annual addition since late 1980s. Nevertheless, like in the US, a major share of employment gains has happened in the part-time jobs, while full-time jobs are still lower than their early 2008 levels.

Although the 2012 jobs boom helped the unemployment rate to fall from 8.4% in 2011 to 7.8% in 2012, a higher (and recently rising) youth unemployment rate and above 4% long-term (>6 months) unemployment rate don't indicate as strong recovery in the UK labour market as suggested by the employment numbers.

Besides, declining productivity partly explains the extremely subdued growth in the UK, which is in stark contrast to sharp rise in productivity in the US. Along with rising unit labour costs in the UK, the combination does not bode well for the UK corporate sector, which has found it hard to grow profitability as rapidly as in the US.

Our unemployment model shows that in case the economy adds 300,000 jobs per annum (or 25,000 jobs per month) for the next four years till 2017, UK unemployment rate could fall to 7.0% in mid-2017 (Please note that the economy increased its employment by an annual average of 266,000 between 2003 and 2007). It points to a rate movement by the Bank of England only in late 2017 or in 2018.

Note: Although UK Labour Force Survey (LFS) data is released on rolling-quarter basis, we have used it monthly, considering the last month of the quarter. For instance, the latest data available is for the quarter 'April to June'. In this paper, we have used it as 'June' data.

Despite the fact that real UK GDP in Q2 2013 was 3.3% lower than its pre-crisis peak, the employment in UK economy is almost 1.3% higher than its pre-crisis level

Other major labour market indicators – such as productivity, wages, full-time/part-time, long-term unemployed etc – which are relevant for the future growth prospects fail to show such an impressive performance

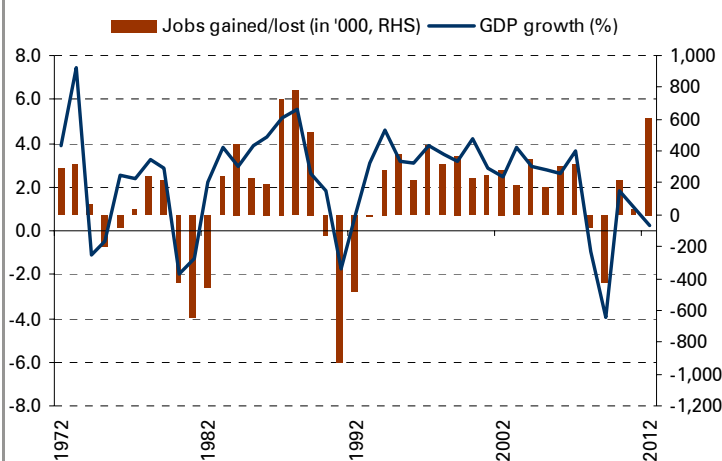
UK witnessed its first-ever 'Growthless Jobs Boom' in 2012

UK economy added 605,000 jobs in 2012, the highest increment in more than the past two decades. This, of course, helped the unemployment rate to fall from 8.4% to 7.8% last year. The only other time the economy has witnessed more than 600,000 annual jobs growth in the past four decades was in 1987 and 1988 - just before the 1990s crisis. An important point to note is that UK grew more than 5% in each of those years, as against a growth of merely 0.3% last year (Please see chart 1). In fact, UK's per capita GDP grew only 0.8% in 2012, marking the lowest growth (barring a decline in 2009) in at least the past six decades.

Despite the fact that real UK GDP in Q2 2013 was 3.3% lower than its pre-crisis peak, the employment in UK economy is almost 1.3% higher than its pre-crisis level. In stark contrast, while US real GDP was 4.4% higher than its pre-crisis peak, the employment in the US is still 1.5% lower than in the US (please see chart 2). This is what makes the year 2012 one of its kind in the UK, as the nations witnessed its first-ever 'Growthless Jobs Boom'.

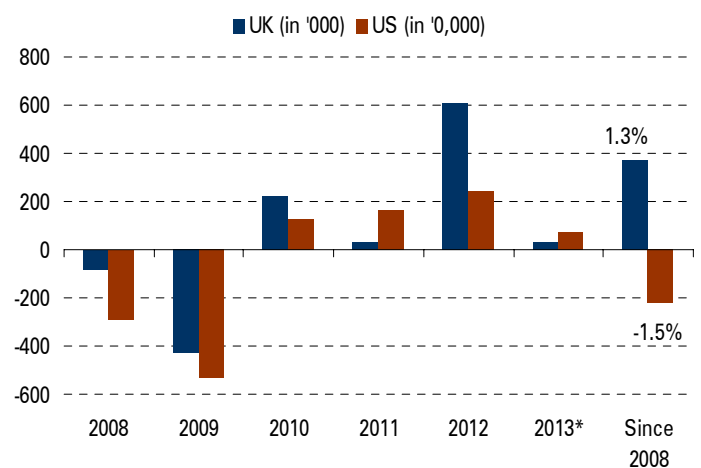
As we will see in the following sections, other major labour market indicators – such as productivity, wages, full-time/part-time, long-term unemployed etc – which are relevant for the future growth prospects fail to show such an impressive performance.

Chart 1: Growthless Jobs Boom in the UK



Source: Office For National Statistics (ONS), ICICI Bank Research

Chart 2: Comparison of change in Employment



Source: Bureau of Labor Statistics (BLS), ICICI Bank Research

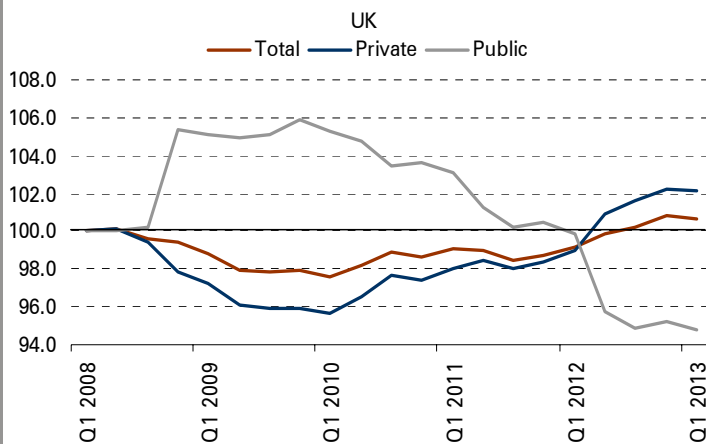
The private sector employment has risen sharply in the past few quarters, completely offsetting the falling public employment. Nevertheless, the pace of declining public sector employment in the UK is notable

Private sector leads the growth in employment...

The positive from the trends in the labour market is that the private sector leads the growth in employment. This is encouraging, especially at a time when the public (or government) sector is reducing its employment sharply.

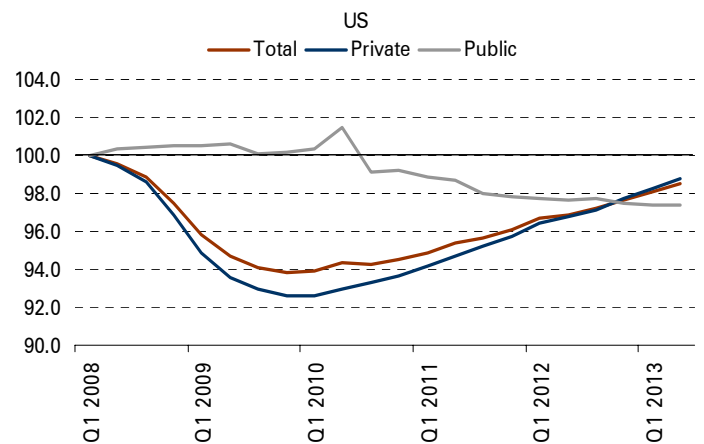
Chart 3 and 4 show the trends in the private and public sector employment in the UK and US respectively. The trends are similar in the sense that the private sector employment has risen sharply in the past few quarters, completely offsetting the falling public employment. Nevertheless, the pace of declining public sector employment in the UK is notable. Since the end of 2011, public sector employment has fallen 5.7% (as of Q1 2013) in the UK, as against a marginal fall of 0.4%. Since the beginning of 2008, public sector employment in the UK is down by ~5.0%, as against a fall of ~2.5% in the US.

Chart 3: Private-public employment in the UK



Source: ONS, ICICI Bank Research

Chart 4: Private-public employment in the US



Source: BLS, ICICI Bank Research

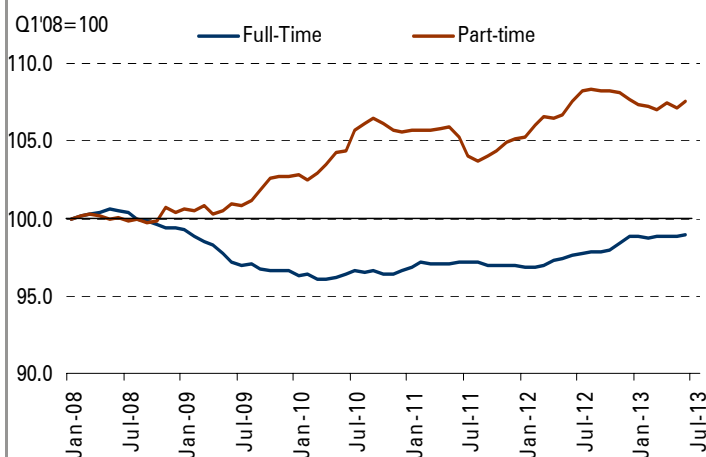
Although total employment in the UK was 1.3% higher than pre-crisis level, full-time workers are still almost a percent lower than their pre-crisis level

...although part-time employment is preferred

Despite a rise in employment in the UK, employers appear to prefer part-time workers, keeping full-time workers waiting. Chart 5 shows that although total employment in the UK was 1.3% higher than pre-crisis level, full-time workers are still almost a percent lower than their pre-crisis level, implying that part-time employment – which is up by ~7.5% from its pre-crisis level - accounts for the higher total employment.

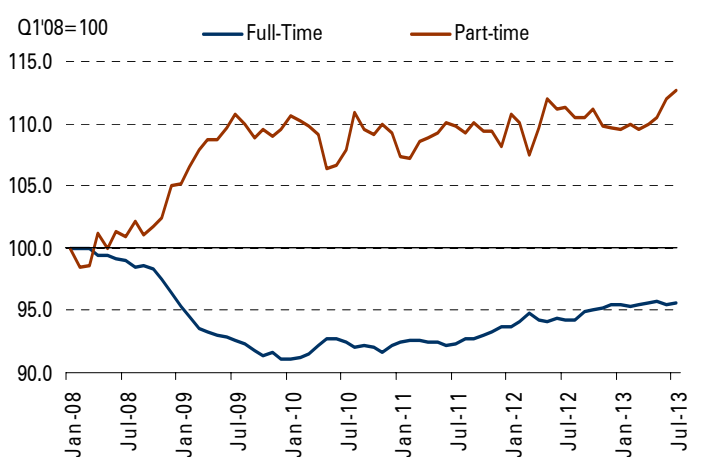
This feature is even more prominent in the US (please see chart 6). Although the employment has not reached its pre-crisis level, part-time employment is 12.6% higher than in January 2008, while full-time employment is still ~4.5% down from its pre-crisis level.

Chart 5: Full-Time and Part-Time employment in the UK



Source: ONS, ICICI Bank Research

Chart 6: Full-Time and Part-Time employment in the US



Source: BLS, ICICI Bank Research

Although active population rate has not changed much in the UK, the participation rate for youth population (aged 16-24 years) has declined consistently from ~75% in early 1992 to 63% in June 2013, marking the lowest level at least since 1992

Falling active population rate has numerous implications, mostly reflecting over a period of time. Fewer workers supporting the population base adversely for some economic prosperity measures such as per capita income

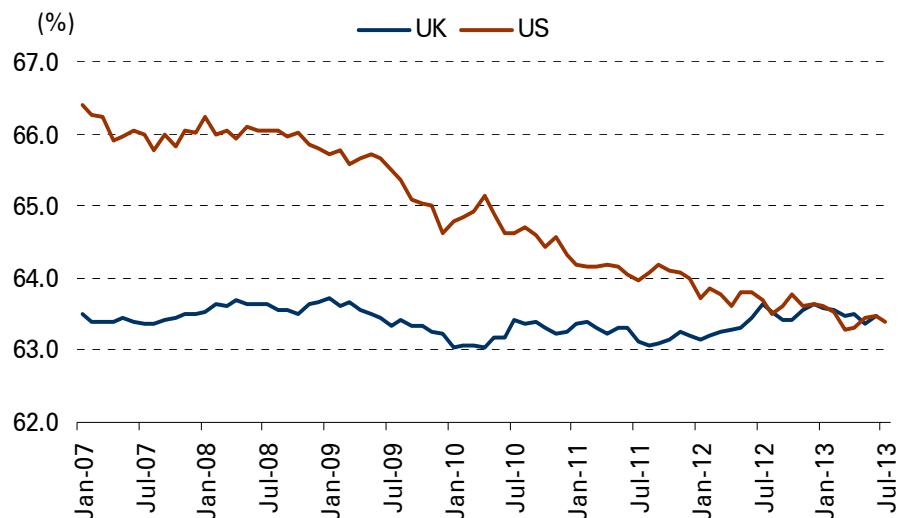
Economically active population more-or-less unchanged during the crisis in the UK

Another interesting thing to note in the UK labour market is an almost unchanged economically active population ratio (equivalent to 'Labour Force Participation ratio' used in the US). A number of economic and demographic factors impact economically active population. Aging population, young workers' participation and economic environment could play a role in determining active population rate.

Although active population rate has not changed much in the UK, the participation rate for youth population (aged 16-24 years) has declined consistently from ~75% in early 1992 to 63% in June 2013, marking the lowest level at least since 1992. This trend is likely to have adverse impacts by delaying their ability to gain on-the-job training and experience. This lack of experience could be a hindrance as young people move into what should be ages of increased participation.

Besides, worsening (improving) economic environment could also impact active population rate by increasing (reducing) discouraged workers. From 170,000 in mid-1993, the better macro picture helped discouraged workers to fall to 40,000 in early 2001. After remaining at around that level till 2008, the number of discouraged workers has more than doubled to 90,000 before easing to 57,000 in June 2013. Going forward, assuming no deterioration in the economic activities, we could see this number falling further.

Chart 7: Economically active Population rate (%)



Source: ONS, BLS, ICICI Bank Research

Employed plus unemployed population make economically active population

UK's economically active population is equivalent to labour force participation ratio in the US

Apart from these factors, a number of other factors such as productivity growth, wage rate, technological advances etc. could impact active population rate.

Falling active population rate has numerous implications, mostly reflecting over a period of time. Fewer workers supporting the population base adversely for some economic prosperity measures such as per capita income.

In the first half of 2013, UK economy has added only 26,000 jobs, as against 330,000 additions in the corresponding period last year

Another reason for stubbornly high unemployment rate in the UK is extremely high youth unemployment rate, which has increased recently to 21.4% in June 2013, marking the highest rate since July 2012 and as against pre-crisis rate of 14%

A Look At The UK Unemployment Rate

UK headline unemployment rate at 7.8% for almost a year...

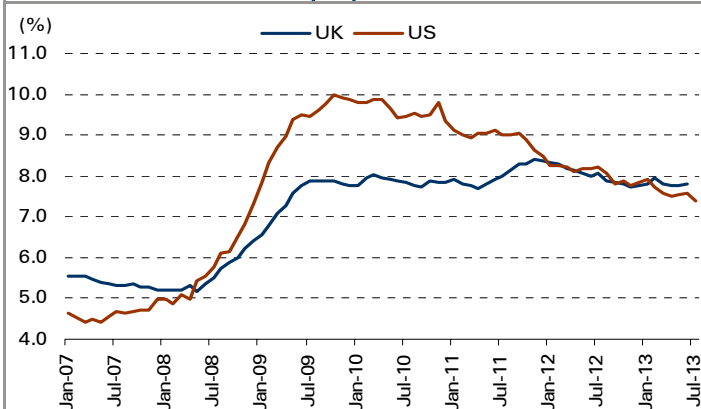
The headline unemployment rate (for people above 16 years) has hovered around 7.8% in the UK for the past 11 months. After the jobs boom witnessed in 2012, which helped the unemployment rate to fall from 8.4% in 2011 to 7.8% last year, employment has remained extremely muted this year. In the first half of 2013, UK economy has added only 26,000 jobs, as against 330,000 additions in the corresponding period last year. On the other hand, the number of unemployed people in the UK increased slightly by 11,000 in H1 2013, as against a reduction of 93,000 in H1 2012. Consequently, the active population ratio has fallen from 63.63% at 2012-end to 63.48% in June 2013.

Just like the UK, US participation rate has fallen in 2013. The unemployment rate has fallen from 7.8% at the end of last year to 7.6% in June 2013. (Please note that US participation rate fell further to 63.40% in July 2013, while the nation added 227,000 payrolls. Accordingly, its unemployment rate has fallen to 7.4% last month). Although US unemployment rate is lower than that in the UK, it is important to note that it might have been primarily because of a fall in economically active population rate (discussed in the previous section). This is because if a worker is unemployed for a long time, his willingness to keep looking for a new job diminishes, which might make him fall out of the active population. Accordingly, unemployment rate could fall.

Another reason for stubbornly high unemployment rate in the UK is extremely high youth unemployment rate, which has increased recently to 21.4% in June 2013, marking the highest rate since July 2012 and as against pre-crisis rate of 14% (shown in Chart 9). Notably, while the number of youth unemployment has been little change in the first half of 2013, as against a fall of 58,000 in 2012; the youth employment has fallen sharply by 138,000 in H1 2013. Consequently, economically active youth population has fallen drastically this year, with active population rate falling to 63.1% in June 2013, marking the lowest level ever at least in the past two decades.

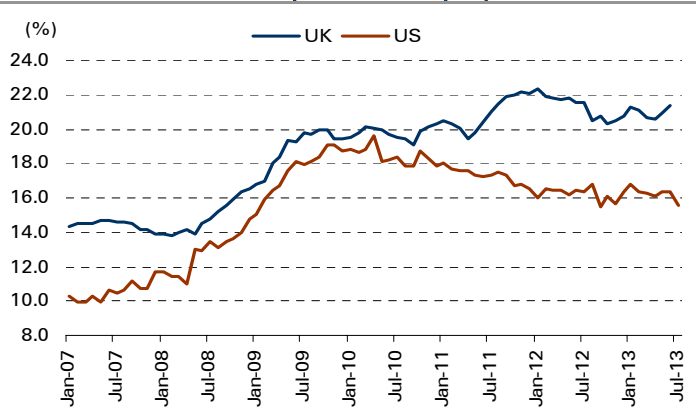
In contrast, US youth unemployment rate has hovered around 16% in the recent months (falling to 15.6% in July 2013), lower than its peak of 19% reached in late 2009, but higher than ~11% before the crisis.

Chart 8: Headline unemployment rate (%)



Source: ONS, BLS, ICICI Bank Research

Chart 9: Youth (16-24 years) unemployment rate (%)



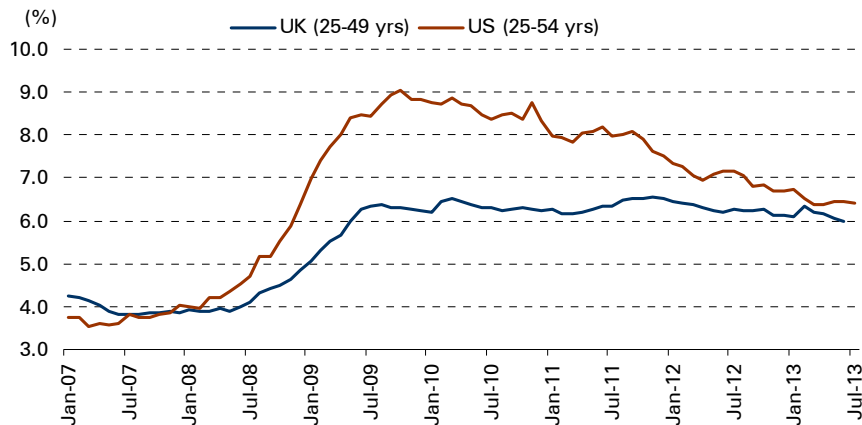
Source: ONS, BLS, ICICI Bank Research

However, a silver lining for the UK is that the unemployment rate among the prime working section (aged 25-49 years) has fallen to 6.0% in June 2013, marking the lowest rate in the past four years

...but 'prime working' unemployment rate is lower than that in the US

However, a silver lining for the UK is that the unemployment rate among the prime working section (aged 25-49 years) has fallen to 6.0% in June 2013, marking the lowest rate in the past four years. In fact, this is even lower than the comparable unemployment rate in the US (for people aged 25-54 years). As shown in chart 10 below, US unemployment rate for the prime working section has been stuck at 6.4% for the past few months. Although this is also the lowest since 2009, it is higher than that in the UK.

Chart 10: Prime working unemployment rate (%)



Source: ONS, BLS, ICICI Bank Research

However, skills of Britons could have deteriorated more than Americans

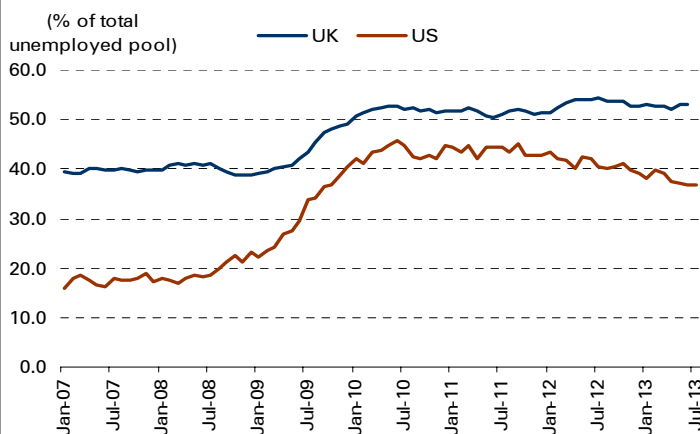
Although UK employment has risen higher in comparison to its pre-crisis levels and its active population rate has stayed intact during the recession (primarily due to steadily rising participation rate of the prime working-age segment), the share of long-term unemployed in the UK has been more than 50% since 2010. Even recently, it has not shown any sustainable improvement. In comparison, the share of long-term unemployed in the US has fallen consistently in the past few months from ~45% in 2011 to ~37% recently.

**The share of long-term unemployed in the UK has been more than 50% since 2010...
... In terms of long-term unemployed as a ratio of economically active population, UK long-term unemployment rate has been above 4% since 2010**

In terms of long-term unemployed as a ratio of economically active population, UK long-term unemployment rate has been above 4% since 2010 (4.1% in June 2013), while US long-term unemployment rate has fallen from 4.0% in early 2011 to 2.8% in June 2013 (fell further to 2.7% in July 2013).

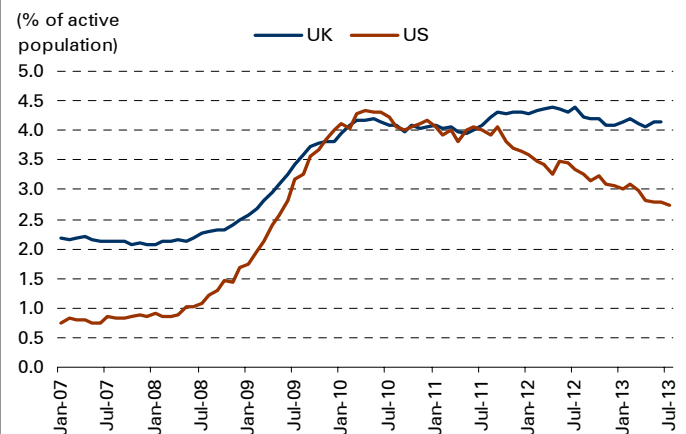
As an implication of high and consistent long-term unemployment, Britons are at the risk of losing their skills, which is likely to have an adverse impact over a longer term.

Chart 11: Long-term (>6 months) unemployed



Source: ONS, BLS, ICICI Bank Research

Chart 12: Long-term (>6 months) unemployed



Source: ONS, BLS, ICICI Bank Research

An unfavourable combination for UK corporate profit

Declining productivity...

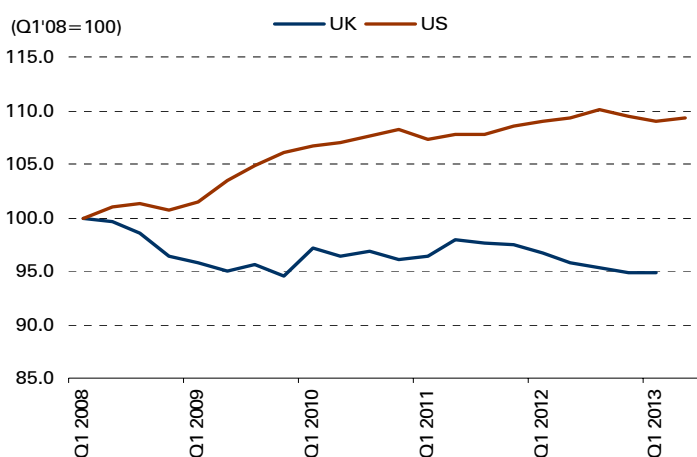
One of the reasons for subdued growth in the UK, as against stronger recovery in the US, has been a decline in UK productivity, as against a sharp increase in the US productivity. Chart 13 and 14 show movements in the UK and US productivity (measured as output per hour) since the beginning of 2008.

As of Q1 2013, while UK productivity was 5% lower than that in Q1 2008, it was ~9.3% higher in the US

As of Q1 2013, while UK productivity was 5% lower than that in Q1 2008, it was ~9.3% higher in the US (please see chart 13). In fact, while US productivity has rarely witnessed a decline since 2008 (though it has been flat in H1 2013), UK productivity has been extremely volatile. Not only has UK productivity declined much faster and sharper immediately after the crisis, it has also declined in the past four quarters (up to Q1 2013).

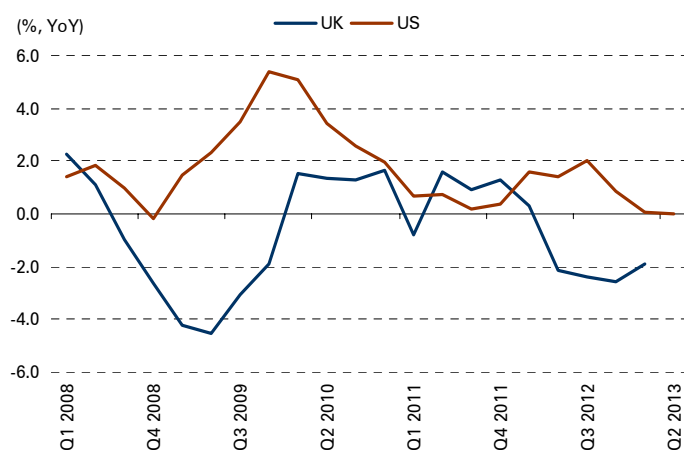
Although higher productivity is desired, it has an adverse side-effect of keeping employment level subdued. This implication might partly explain the combination of high productivity and low employment gains in the US. With productivity rising, the incentive for producers to keep hiring more workers might have reduced.

Chart 13: Output per hour (Q1 2008 = 100)



Source: Office For National Statistics (ONS), ICICI Bank Research

Chart 14: Output per hour (% YoY)



Source: ONS, BLS, ICICI Bank Research

In line with declining worker's productivity and rising employment (as discussed above), unit labour cost (or labour costs per unit of output) has increased sharply in the UK

UK corporate sector's profitability has failed to show such an impressive performance due to an unfavourable combination of lower productivity and rising labour costs

...and higher unit labour costs...

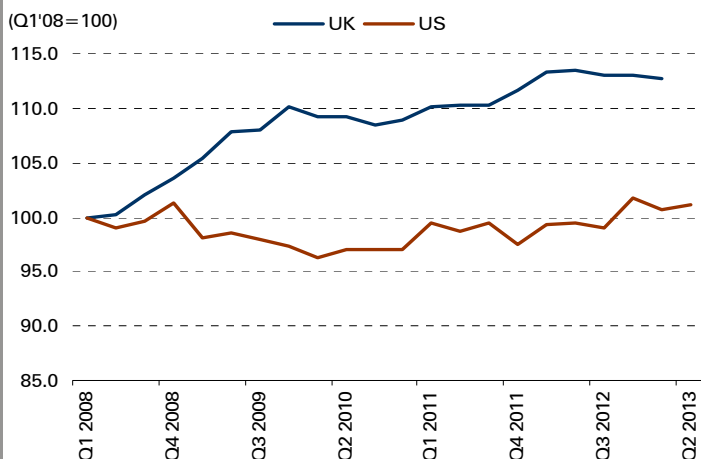
In line with declining worker's productivity and rising employment (as discussed above), unit labour cost (or labour costs per unit of output) has increased sharply in the UK. On the contrary, the combination of higher productivity and slower growth in employment has helped unit labour costs (ULC) to be much lower in the US.

Charts 15 and 16 show that while unit labour cost in the UK has risen by ~13% since 2008, they are up only 1% in the US. These pressures also partly explain a comparatively higher inflation in the UK, as against the US. Recently though, UK ULC declined 0.5% YoY in Q1 2013, marking its first decline since 2011. On the contrary, ULC in the US has increased 1.6% in the past year (up to Q2 2013).

...don't suit well for UK corporate profits

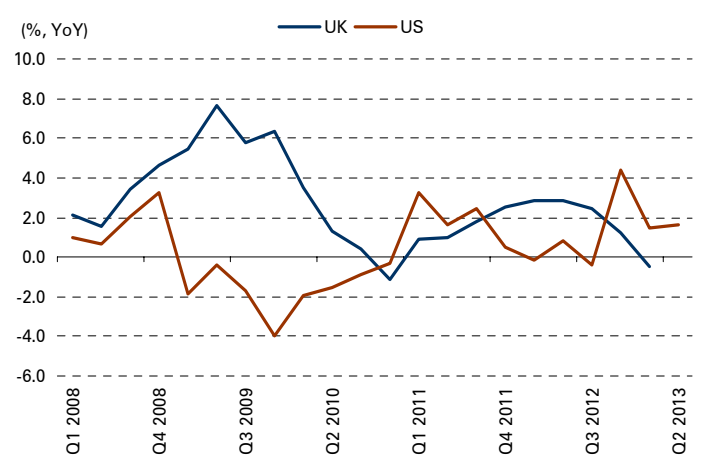
Overall, the combination of higher productivity and declining ULC in the US has worked superbly for the corporate sector, whose profitability has benefitted significantly, which crossed an all-time high of \$2 trillion last year. On the contrary, UK corporate sector's profitability has failed to show such an impressive performance due to an unfavourable combination of lower productivity and rising labour costs.

Chart 15: Unit Labour Costs (%)



Source: Office For National Statistics (ONS), ICICI Bank Research

Chart 16: Unit Labour Costs (%)



Source: ONS, BLS, ICICI Bank Research

UK Unemployment rate to fall gradually

We expect unemployment rate to fall to 7% in mid-2017...

So when could the unemployment rate fall to 7%? Not that the Bank of England (BoE) will raise its interest rate the next day, but it would allow BoE to probably put the unemployment rate on the back-seat while considering monetary policy stance.

To find the answer, we have projected UK unemployment rate till 2017. We have assumed a growth of almost 350,000 people in UK's (above 16 years) population. This is line with the population projections provided by Office for National Statistics (ONS). In total, it implies an addition of 1.764 mn people in UK above 16 years in the five years to 2017, as against an additional 1.843 mn people in the previous five years.

To arrive at active population, we have projected inactive population, which is the trickiest part. Our conventional wisdom tells us that if bad economic environment remains in place for a long time, it tends to increase the inactive population initially, as people are forced to enter the labour force to earn a living. Overtime, as recession takes hold, it becomes a challenging task to find a job, which discourages people to fall out of the labour force, eventually leading to a fall in the inactive population. Nevertheless, as discussed above, UK active population rate has not changed much during the crisis. Therefore, we don't expect it to change drastically in the coming years also.

The table below summarizes our forecasts of UK unemployment rate. We assume the unemployment rate to remain at 7.8% this year. In the pre-crisis semi-decade (2003-07), UK labour market added an average of 266,000 jobs every year. Assuming an addition of 300,000 jobs per year (as we mentioned, these estimates should be considered optimistic) and a marginal decline in inactive population each year, the unemployment rate could reach 7% in mid 2017. The best scenario, which assumes an addition of 350,000 jobs per annum for the next four years, would bring the unemployment level down to 7.0% in January 2016.

Does this mean that the Bank of England (BoE) would not raise rates till late 2017? Well, as we all know there is no one-to-one relation between the unemployment rate and monetary policy. Nevertheless, given the current circumstances, our assessment makes us believe that the Bank could keep policy rates unchanged at least till 2017, moving probably in late 2017 or early 2018.

Assuming an addition of 300,000 jobs per year (as we mentioned, these estimates should be considered optimistic) and a marginal decline in inactive population each year, the unemployment rate could reach 7% in mid 2017. The best scenario, which assumes an addition of 350,000 jobs per annum for the next four years, would bring the unemployment level down to 7.0% in January 2016

Table: UK Unemployment rate forecasts

	Worse scenario	Intermediate scenario	Best scenario	Active-Pop rate
2014				
Annual Jobs addition (in '000)	250	300	350	63.5
Unemployment rate at year-end	7.7%	7.6%	7.4%	
2015				
Annual Jobs addition (in '000)	250	300	350	63.5
Unemployment rate at year-end	7.7%	7.4%	7.1%	
2016				
Annual Jobs addition (in '000)	250	300	350	63.6
Unemployment rate at year-end	7.6%	7.2%	6.7%	
2017				
Annual Jobs addition (in '000)	250	300	350	63.6
Unemployment rate at year-end	7.6%	6.9%	6.3%	
Unemployment rate reaches 7% in	After 2017	Jun 2017	Jan 2016	

Source: ONS, ICICI Bank Research

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