Vicious circle of higher pay deals

Pay is one key to inflation, argue **John Hall** and **Gerard Lyons**, but understanding the effects of wage settlements needs careful interpretation

THE rise in real earnings is becoming as threatening as the record trade deficit to the prospect of lower interest rates. As Chancellor John Major discusses pre-Budget policy with his advisers this weekend, his options are limited by both factors, the more so after Ford workers last week rejected a pay offer which burst the 10% barrier.

Ford settlements tend to be at the top end of the range, but it is almost certain that earnings growth will put upward pressure on inflation by accelerating to 10% by the summer. So policy may have to remain tight or become tighter.

Pay is the key to domestic inflation but needs careful interpretation. As headline settlements have risen since late 1988, many commentators have been confused by the lack of response from the government's underlying average earnings figures.

Average earnings include basic pay settlements and other increases, such as bonus and overtime payments, known as wage drift. Increases in drift generally ensure average earnings rise more rapidly than pay settlements.

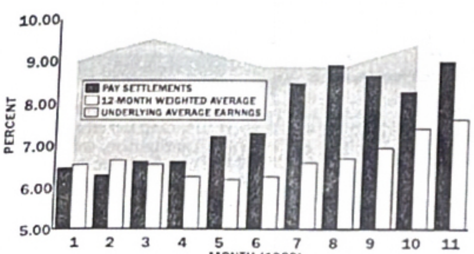
Average earnings also show a delayed response to increasing pay awards because settlements are spread throughout the year so it takes time for an increase in the going rate for settlements to have its full effect on average earnings. Consequently, the average earnings figures are driven by the pay settlements received by all workers over the preceding 12 months.

Since the going rate is now so far above that in the first half of 1989, it would take an unprecedented fall in average settlements to prevent further upward pressure on the 12-monthly average over the first half of 1990. The outlook for the pay round is unlikely to provide such a fall.

In the coming months, workers expecting higher inflation because of the economic outlook will demand even higher wage increases. Also, those workers who settled early in last year's pay-round will be seeking compensation this time for the rise in inflation since their last settlement. And comparability between groups of workers will add to these pressures now that a higher going rate has been established. Despite the high level of corporate profits, the deteriorating financial outlook could make companies less willing to grant large wage awards.

Analysis of settlements in the 1980s suggests — even taking account of substantial pressures on companies and of a fall in retail price inflation by the end of the year — that average awards are unlikely to fall by more than 1.5% over the course of one pay round. So even on a fairly optimistic scenario, settlements would fall to around 8% by mid-year and towards 7% by year end. Given this outlook, only a sharp deceleration in overtime and bonus payments would prevent average earnings growth increasing to at least 10% cent by the summer.

Historical evidence suggests this is unlikely. Wage drift estimates produced from the CBI's manufacturing pay data bank indicate that the contribution of wage drift to earnings is unlikely to fall below 1.0 to 1.5%. At its lowest level over the 1980s, drift still added 1.4% to growth in average earnings, pointing to their continued rise.



This rise poses the threat of higher direct inflation, a rise in underlying inflationary pressures, and loss of competitiveness. As the economy slows, productivity growth will slow and, coupled with higher earnings growth, will force a rise in unit labour cost.

Firms could pass on higher costs to the consumer, causing a cost-push inflation cycle. But weak domestic demand could reduce the ability to pass on costs and, in this scenario, profit margins would be squeezed. Although positive for the inflation outlook, lower retained profits would hit investment and force unemployment higher.

The main concern must be that the government's anti-inflationary credibility has been severely dented and is creating an unfavourable background for wage bargaining.

With incomes policy and credit controls remaining anathema to the government, this pick-up in average earnings growth will mean policy remains tight with either tax increases or no indexation of allowances in the Budget, and no early respite in the form of lower interest rates.

□ For a discussion of the technical aspects of pay, earnings and wage drift see John Hall's article in the *Fraser of Allander Commentary*, December, 1989.

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John Major: the man who cannot turn his back on inflation