Falling unemployment should not be a worry

It is time there was a change in the way labour market trends are reported and interpreted. Unemployment fell by 24,100 in July to a five year low of 2.1 million. Instead receiving the news well, financial markets reacted with fear. As well as indicating a small rise in average earnings, it prompted the misplaced concern that the labour market may be too tight and that further falls in unemployment could pose inflation problems. This reaction is wrong. The fall in unemployment should not be seen as a worry or as a reason for interest rates to rise.

The unemployment rate is not always the best guide to what is happening in the labour market. Attention should also be paid to changes in employment, as in the USA, and to aggregate hours worked. Total hours worked have been stable over the last year, suggesting the labour market is not tightening.

Unemployment is now 7.6% of the labour force. This is in excess of Japan's 3.5% or America's 5.4%, but it is far less than the average in the European Union, where almost one in eight are unemployed. With British industry remaining competitive and attracting inward investment, there is still room for the unemployment rate to fall further.

Far from showing an overheating economy, the recent fall in UK unemployment overstates the strength of the labour market. Since the economy hit bottom in 1992 the bulk of jobs created have been part-time. Part-time work accounts for 28% of total employment, compared with 20% in 1980. There is nothing wrong with part-time work. This is what many people desire. But with fewer full-time jobs available this has restrained wage growth, and may have contributed to job insecurity.

Looking at actual employment also suggests talk of a tight labour market is misplaced. The Labour Force Survey showed a rise of 118,000 in employment during the winter, but in the three spring months employment actually fell by 34,000. This is hardly a sign of a boom and is another reason not to look at the unemployment rate in isolation.

The Labour Force Survey shows there are 44.5 million people over 16 years of age, and 25.7 million are in employment. In addition to the 2.1 million unemployed, 16.7 million people are considered "inactive". This definition includes 9.2 million pensioners, spouses who stay at home looking after the children and who do not claim benefit, the black economy and people who may be discouraged from looking for work. These "discouraged workers" could re-enter the labour force and decide to look for work when the economy improves and the chance of finding a job is easier. If enough of them re-enter the labour force the unemployment rate can sometimes rise, even though no jobs have been lost!

The best guide is total hours worked. This avoids any distinction between full and part-time jobs and gives a good indication of output. Over the last year, total hours worked has been stable, even though unemployment has fallen. Not only does this suggest talk of a tighter labour market is misplaced, it also fits in with evidence that the economy has grown at only a steady pace.

Disinflationary pressures have meant this recovery is different from previous ones. Firms have cut costs, curbing fringe benefits, not offering such attractive deals to new employees and, wherever possible, replacing older and higher paid employees with younger and lower paid ones.

This has encouraged those who can hold on to their permanent jobs to do so. Wages and conditions in alternative jobs may not be so attractive and permanent jobs may be difficult to find. Indeed, the average redundancy rate rose from 5.5 per 1,000 in winter 1994 to 10.1 per 1,000 last winter. A big increase but still well below the 17.8 per 1,000 seen in spring 1991, during the recession.

There has also been a surge in those in full-time education and this has helped reduce the labour supply and unemployment rate. The number of 16 to 24 years olds in full-time education rose from 17.2% in 1984 to 19.9% in 1988, but has since shot up to its present 33.4%. It is expected to remain around this level.

All these facts suggest it is wrong to conclude that the fall in the unemployment rate implies a tighter labour market. The fact that average earnings has risen to 3.75% this year compared to 3.25% last December has exacerbated this misplaced view. Earnings growth has been remarkably stable for some time, growing between 3% to 4% for over 3 years. Large bonuses, particularly in the City, and higher profit related pay have boosted earnings this year, not a surge in wages. Compared with the recovery in the early 80's, real wages have risen far more slowly in this expansion. Even the Bank of England acknowledges that the natural rate of unemployment, below which wage pressures appear, may have fallen.

A surge in wages could trigger a rise in inflation and prompt higher official rates. Thus, labour market trends need to be monitored closely. But rather than showing a tight labour market, a broad based look at the data shows there is still plenty of scope for the recent favourable trend in unemployment to continue. With inflation remaining low, there is no case for policy to tighten and every reason for interest rates to fall further.

Gerard Lyons is chief economist of Dai-Ichi Kangyo Bank (DKB) International.

ECONOMICS WEEK

The recent fall in unemployment is welcome but there are better ways of assessing labour market trends, says **Gerard Lyons**

Sunday 18th August 1996
Sunday Business