

Recent developments in pay settlements

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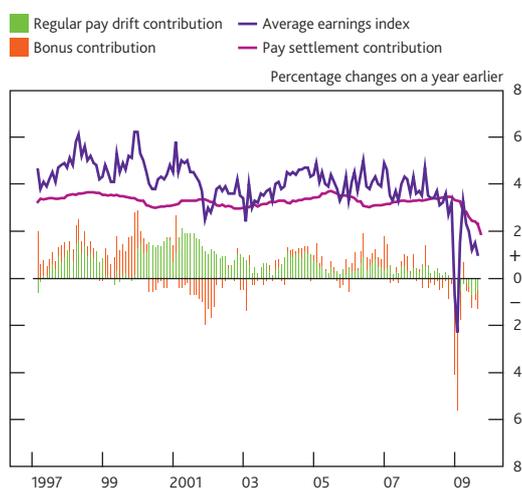
Pay settlements negotiated between employers and their employees have fallen sharply during 2009. Pay settlements have averaged below 2%, with many companies freezing pay. The recession, and the associated drop in employers' demand for labour, has been a key influence on settlements. Inflation measures frequently cited in pay negotiations have also moderated, further reducing upward pressures on pay. This short article examines the recent movements in settlements.

Introduction

Aggregate earnings growth per employee has weakened substantially over the past year as the recession in the UK economy intensified. In the three months to September 2008, whole-economy annual earnings growth was 3.4% according to the average earnings index (AEI).⁽²⁾ In the three months to September 2009, growth was 1.2%.

Aggregate earnings growth can be decomposed into the contribution from pay settlements, regular pay drift, and bonuses. Pay settlements are changes in basic pay which are applied to groups of employees within a business. Firms tend to associate these with general changes in demand, or cost of living changes. Pay settlements do not capture performance-related bonuses or changes related to an individual's performance which will be reflected in regular pay drift along with other factors such as hours worked (Chart 1).⁽³⁾

Chart 1 Earnings growth



Sources: Bank of England, Incomes Data Services, Industrial Relations Services, the Labour Research Department and ONS.

Typically, settlements have made the largest contribution to aggregate earnings growth. Over the past ten years, the annual growth of the AEI averaged 3.8%, with settlements accounting for over four fifths of this.

The figures on pay settlements in this article bring together information from a number of external sources, as well as from the Bank's regional Agents since 1993.⁽⁴⁾ However, the information comes from a sample of businesses, and businesses may use differing definitions of settlements. In 2008, figures are based on over 3,000 settlements, covering slightly fewer than 16 million employees. This is just under 60% of employees, as measured by the ONS' Employee Jobs measure.

The Bank of England often publishes analysis of pay settlements in the *Inflation Report*: this article considers movements in settlements and important influencing factors in more depth. This article first reviews the recent movements in aggregate earnings and settlements. It then considers how settlements may have been affected by the weakness in demand, as well as the role of current inflation and households' expectations of future inflation.

- (1) The author would like to thank Rachana Shanbhogue for her help in producing this article.
- (2) The UK Statistics Authority has recently approved the average weekly earnings series as a National Statistic. It also shows a substantial weakening in earnings growth over this period. This series will in due course replace the AEI as the ONS monthly measure of wages and salaries. See www.statisticsauthority.gov.uk/assessment/assessment-reports/assessment-report-19---average-weekly-earnings.pdf.
- (3) The weakness in the bonus contribution and aggregate earnings in early 2009 reflected sharp falls in financial sector bonuses. These are paid disproportionately in the first quarter of the year.
- (4) The Bank of England's calculations are based on information from the Bank's regional Agents, Incomes Data Services, Industrial Relations Services and the Labour Research Department. We are grateful to these providers for their data and analysis, which are an invaluable input to the Bank's work.

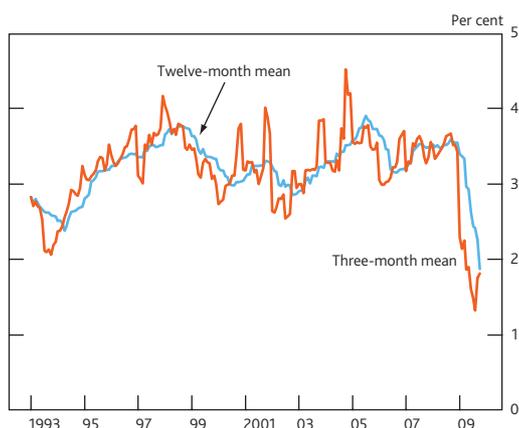
Recent movements in private sector earnings

As discussed, earnings growth per employee has weakened substantially. This is also the case in the private sector, which accounts for around 80% of employment. In the three months to September 2009, earnings grew by 0.8% according to the AEI, compared with growth of 3.2% in the three months to September 2008.

The fall in private sector earnings growth reflects a fall in the contribution from all the components of pay. Businesses have implemented short-time working initiatives, reducing the wage per employee through lower regular pay drift. Bonuses have also fallen, with especially large impacts from the financial sector. Around half of the decline in private sector average earnings growth since late 2008 can be accounted for by these factors. The other half can be accounted for by weaker settlements.

The weighted private sector twelve-month mean settlement has fallen from 3.5% at the end of 2008 to 1.9% in October (Chart 2). This is the measure of settlements which is comparable with the twelve-month change in private sector AEI. The twelve-month mean is calculated because settlement negotiations tend to occur annually, and hence any one pay settlement will influence the annual growth rate for twelve months. So that the estimate is representative of employment in the private sector each settlement is weighted by the number of employees it represents, and also by the employment weight of that sector.

Chart 2 Private sector weighted pay settlements



Sources: Bank of England, Incomes Data Services, Industrial Relations Services and the Labour Research Department.

The twelve-month mean measure of pay settlements is a backward-looking estimate and relatively slow moving. Movements in the three-month mean measure of settlements can give us a more up-to-date picture of pay pressures. This more volatile measure has fallen to under 2% in recent months (Chart 2).

The two factors most often cited in business surveys as being very important in negotiations between businesses and employees are the ability to pay, associated with demand for businesses' outputs, and changes in the cost of living. The remainder of the article discusses these two factors in more detail, and considers the extent to which weakness in settlements reflects them.

How have settlements changed with weakening demand?

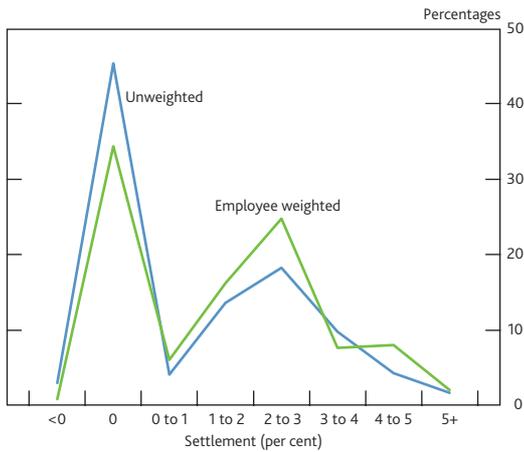
During the recession, demand for the goods and services businesses produce has fallen, and to the extent businesses' profits cannot be squeezed further, this will have necessitated a reduction in the pay bill. The fall in demand for goods and services will also have put downward pressure on the prices businesses can charge for them. This pushes up on real wages — nominal wages relative to the output prices of those goods and services. To achieve the required adjustment in real wages, nominal wage growth — and hence pay settlements — is therefore likely to need to moderate substantially.

There has been a sharp increase in the number of people having their pay frozen, but there have been few instances of pay cuts. Just under 35% of employees received a basic pay freeze (green line in Chart 3), and only 1% received a negative settlement. There is also evidence that the number of businesses deferring pay agreements has increased: in the short term, these act as pay freezes, as businesses postpone negotiations with employees for a specified period. Estimates from the EEF suggest slightly under 30% of businesses in the manufacturing sector deferred pay deals in the three months to October, the highest number during this recession.

It is possible to disaggregate the data by size of business: businesses have been more likely to freeze pay if they have relatively few employees. Weighting each private sector settlement by the number of people it covers shows fewer pay freezes (comparing the blue (unweighted) and green (employee weighted) lines in Chart 3).

The relatively high prevalence of pay freezes among smaller businesses could reflect the nature of the operations of a small firm. Owners of smaller businesses may be more able to discuss the businesses' prospects with employees than owners of larger businesses. Therefore employees may be more willing to accept a pay freeze in smaller businesses than larger businesses. These results chime with a British Chambers of Commerce survey conducted during early 2009, which suggested a larger proportion of smaller businesses were intending to freeze pay during 2009 than were larger businesses.

Chart 3 Distribution of 2009 pay settlements^{(a)(b)}



Sources: Bank of England, Incomes Data Services, Industrial Relations Services and the Labour Research Department.

- (a) Based on settlements effective between 1 January and 25 November 2009.
- (b) A settlement that is a round number is classified within the bucket where that round number is the upper bound. So a 2% settlement is included in the 1% to 2% bucket.

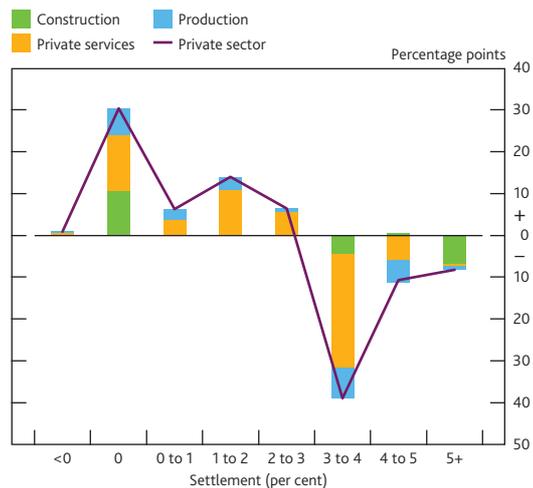
Pay settlements can also be disaggregated by the sector in which people work. **Chart 4** shows the change in distribution of private sector settlements between 2008 and 2009. The private sector line shows the percentage point difference between the number of settlements in each range between January and November 2009, compared with the same period in 2008. The bars show the sectoral make-up of these changes. The bars illustrate the broad-based decline in settlements across sectors over the past year. The largest contribution to the change in the distribution is from private services. The sharp fall in the proportion of people receiving settlements between 3% and 4% can be mostly accounted for by settlements among private services, such as transport and hotels. The fall in the proportion of people receiving over 5% can be almost entirely accounted for by the construction sector. The pay settlement in 2008 was the final year of a three-year pay deal for the vast majority of these employees, so the fall between 2008 and 2009 may have been larger than if the settlement had been renegotiated in 2008. The small numbers of negative settlements have been concentrated in the production and service sectors.

As pay settlements started falling in 2008, pay freezes were initially concentrated among a small number of firms. As discussed in the November 2008 *Inflation Report*, pay freezes became apparent first in housing-related industries, which include private service businesses such as estate agents and property lawyers. As the recession intensified, pay freezes became more common across the economy.

This is the first recession in the data set. Before the recession, the most substantial slowdown in economic growth in the data set was that seen at the start of this decade. The response of businesses as the economy slowed, while not on the same scale, was similar in nature (**Chart 5**). As the

slowdown in growth started influencing businesses' wage negotiations, the number of pay freezes picked up during 2002, and the number of higher settlements dropped back (green line). Pay freezes were, however, relatively short-lived. In 2003, there were very few pay freezes, with an increase in the number of settlements between 3% and 4% (orange line).

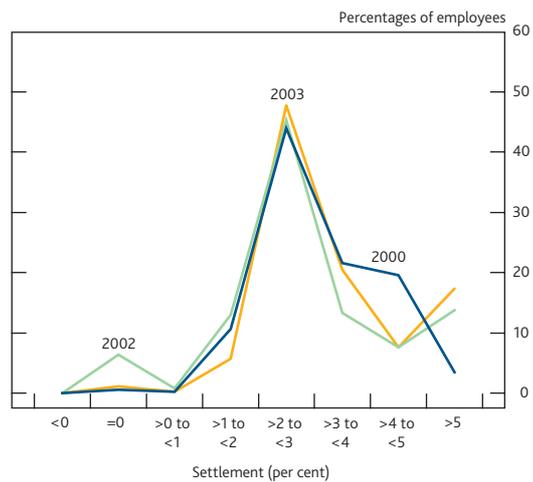
Chart 4 Change in private sector pay settlements between 2008 and 2009^{(a)(b)}



Sources: Bank of England, Incomes Data Services, Industrial Relations Services and the Labour Research Department.

- (a) Applies 2008 sectoral weights to 2009 data for comparability. The sum of all changes, in each sector and at an aggregate level, is zero.
- (b) A settlement that is a round number is classified within the bucket where that round number is the upper bound. So a 2% settlement is included in the 1% to 2% bucket.

Chart 5 Distribution of pay settlements in the private sector^{(a)(b)}



Sources: Bank of England, Incomes Data Services, Industrial Relations Services and the Labour Research Department.

- (a) Settlements weighted by employees.
- (b) A settlement that is a round number is classified within the bucket where that round number is the upper bound. So a 2% settlement is included in the 1% to 2% bucket.

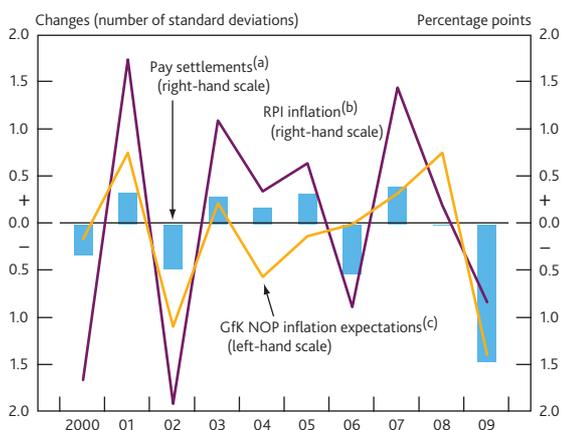
How has the inflation outlook influenced settlements?

The second most frequently cited factor influencing pay negotiations is increases in the cost of living. According to the 2009 *Industrial Relations Services Pay Prospects Survey*, just over two thirds of businesses use a measure of inflation during negotiations. The majority of these businesses use inflation only as a guide to inform pay awards. Only around 15% of the businesses questioned who use inflation had an explicit link between inflation and settlements.

Both current and expected inflation are important to pay settlements. Of those businesses who consider inflation, over half of businesses consider the current inflation rate, and around a quarter use a forecast of inflation, according to recent *Industrial Relations Services Pay Prospects Surveys*. The official measure of inflation which is most often referenced for those pay settlements with an explicit link to inflation is the retail prices index (RPI). The consumer prices index (CPI) has been increasingly referenced, although when used, this has tended to be in conjunction with other measures.

The majority of private sector businesses, and a significant proportion of private sector employees, settle their pay renegotiations in the first four months of the year. Inflation, and expected future inflation, towards the end of the previous year is likely to be very important for the next year's outturn for pay settlements. **Chart 6** presents some evidence for a correlation between the changes in the mean settlement in the early months of the year, and changes in both inflation and inflation expectations at the end of the previous year.

Chart 6 Factors influencing changes in pay settlements



Sources: Bank of England, GfK NOP, research carried out by GfK NOP on behalf of the European Commission, Incomes Data Services, Industrial Relations Services, the Labour Research Department and ONS.

- (a) Change on previous year, based on one-month private sector settlements in the first four months of the year.
 (b) Change on previous year, based on average annual inflation rate in the final four months of the preceding year.
 (c) Inflation expectations over the next twelve months. Change on previous year, based on number of standard deviations difference from its 1997–2009 average in the final four months of the preceding year.

Official measures of inflation have fallen during 2009. RPI inflation fell from 5% in 2008 Q3 to -1.4% in 2009 Q3. CPI fell from 4.8% to 1.5% over the same period. The larger fall in RPI, in part, reflects the impact of cuts in Bank Rate: this reduces RPI inflation through lower mortgage interest payments.

Households' expectations of inflation also moderated sharply during 2009 (Barnett, Oomen and Bell (2009)),⁽¹⁾ in part because measures of actual inflation had fallen, but also because households viewed that there was less upward pressure on inflation going forward.

The upwards impetus on pay settlements from inflation outturns and households' expectations of future inflation, moderated between 2008 and 2009. This moderation in inflation and expected future inflation reflects both the effects of the recession on businesses' ability to increase prices, or pressure to cut prices, and temporary factors such as VAT, some of which may unwind.

Conclusion

Pay settlements in the private sector have fallen sharply in 2009, and many companies have imposed freezes in basic pay. The decline has been broad-based across sectors, and the businesses which have frozen basic pay have tended to be smaller than average.

The decline in settlements during 2009 likely reflects the influence of two important factors in negotiations between businesses and their employees. First, sharp falls in demand for businesses' goods and services will have reduced those businesses' ability to increase basic pay. Second, sharp falls in official inflation measures and households' expectations of future inflation are likely to have acted to reduce settlements.

(1) See Barnett, A, Oomen, O and Bell, V (2009), 'Public attitudes to inflation and monetary policy', *Bank of England Quarterly Bulletin*, Vol. 49, No. 2, pages 101–09.