

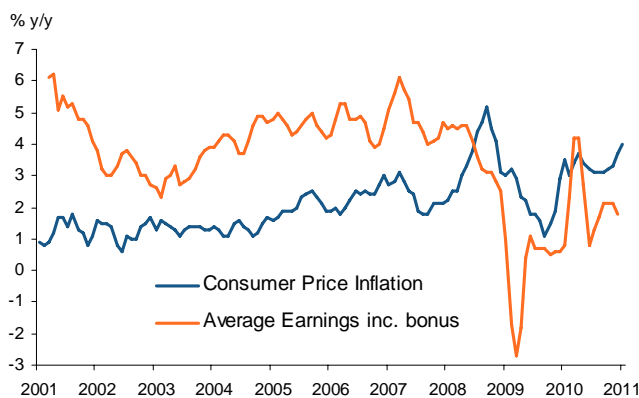
UK labour market

Slowdown in employee earnings growth signals absence of 'second round' inflation effects

- **Pay growth weakens despite accelerating headline inflation.**
- **Rise in unemployment highlights fragility of recovery.**

Official data today show a drop in the rate of growth of average employee earnings. This is arguably more important than yesterday's rise in headline inflation as far as the Bank of England's policy making is concerned. Crucially, the rise in consumer price inflation to 4.0% in January was expected, and can be explained by factors which are to a large extent temporary in nature, while the fact that average earnings growth is slowing was a surprise, and suggests that the longer-term inflation outlook is even more benign than previously expected.

Average earnings and consumer price inflation



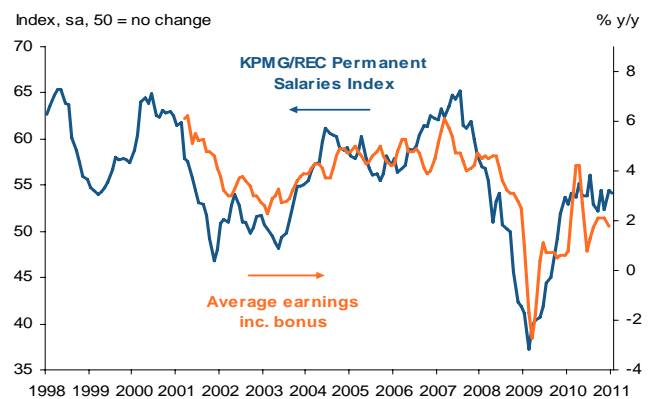
Sources: Markit, ONS.

Clearly, inflation is not feeding through to higher wages, which should help to subdue inflation once the effects of higher VAT, the recent surge in commodity prices and sterling's depreciation wane in medium-term. The weakness of the labour market meanwhile continues to result in widespread job insecurity, meaning employees are wary of pushing for higher pay. According to official data, average earnings rose just 1.8% in the year to December, down from 2.1% in November.

Survey data indicate that subdued wage trends persisted in January. The KPMG/REC Report on Jobs, compiled by Markit, signalled an easing in permanent salary inflation in January.

Furthermore, given the pressure on public sector headcounts that we are likely to see in the coming year, it is likely that this will create an additional downward force on pay growth in 2011. Note that the latest official data showed that the government sector was still creating the largest upward pressure on pay rates. Private sector pay rose 1.7%, compared to 2.4% in the public sector.

Permanent salaries and average earnings



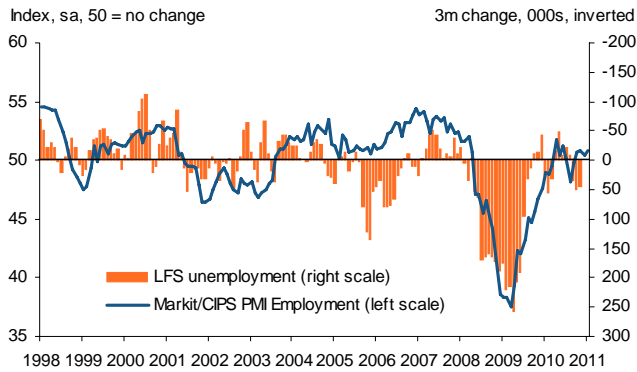
Sources: Markit, ONS.

Weak private sector employment trends drive unemployment higher

Subdued pay pressures reflect the ongoing weakness of the labour market, which in turn highlights the fragility of UK economy. Claimant unemployment increased by 2,400 in January (confounding analysts' expectations of a 3,000 decline), the first increase in jobless claims since last September. The claimant count now stands at 1.46m. The wider Labour Force Survey measure of unemployment rose by 44,000 in the three months to December 2010, taking the rate of unemployment to 7.9%. Unemployment among 16-24

year olds approached 1m, its highest since records began in 1992.

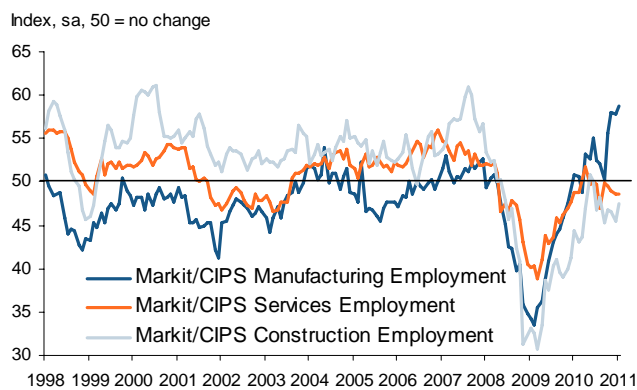
PMI employment and LFS unemployment



Sources: Markit, ONS.

The rise in joblessness highlights how the private sector is struggling to create enough jobs to offset the squeeze on government spending. PMI data – available four months ahead of comparable official data on employment by sector – indicate that growth of employment across the whole of the private sector remained only marginal in January, weighed down by weakness in the services and construction sectors.

PMI employment by sector



Source: Markit.

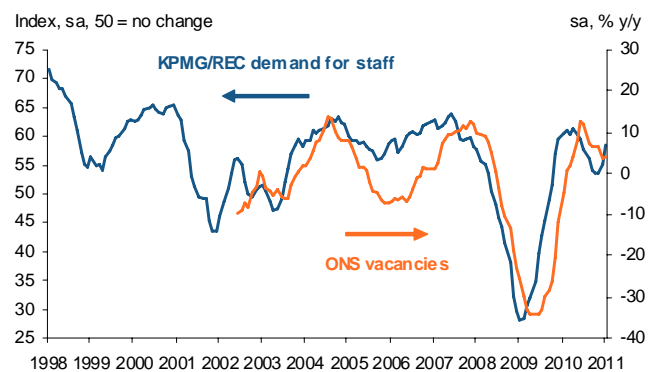
Productivity

A bright spot from the latest labour market data was that output per worker rose 1.7% annually in Q3 of last year and unit wage costs fell 0.5%. This bodes well for the competitiveness of UK business.

Vacancies/Demand for staff

A further glimmer of hope was a 40,000 increase in job vacancies over the final quarter of last year, taking the total 20,000 higher than a year ago to 500,000. The increase in hiring tallies with the KPMG/REC recruitment industry survey, which showed the demand for staff at employers rising at the fastest rate for seven months in January, having slowed late last year.

Demand for staff



Sources: Markit, ONS.

Implications for policy

The February *Inflation Report* from the Bank of England, also published today, highlighted the short term nature of the current inflation, noting that the chances of inflation being above or below the 2.0% target in the medium term were finely balanced. The *Report* stresses the importance of pay growth in determining the longer-term outlook for inflation. It therefore seems likely that the downbeat labour market statistics published today will further bolster the case of the doves on the Bank of England's Monetary Policy Committee, who believe that an early hike in interest rates would threaten the recovery and increase the risk of pushing the economy back into recession.

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