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Macro Watch

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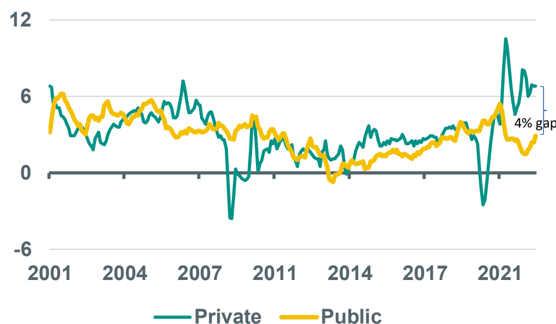
Will public sector strikes in the UK lead to a wage-price spiral?

- **The UK is being gripped by industrial action by public sector workers. In this note we quantify the impact of higher public sector wages on inflation and monetary policy**
- **Major central banks, such as the ECB and the Fed, are monitoring wage dynamics closely, and the UK experience is relevant**
- **We judge public sector take-home pay to be lower than equivalent private sector pay. As a result, the disputing parties are likely to negotiate a settlement that leads to higher pay for public sector workers**
- **Higher public sector wages will feed through to private sector wages and into consumer prices**
- **We consider four scenarios. Depending on the scenario, inflation could be 0.2-0.8 percentage points higher than our baseline with the Bank Rate rising by 25bp-100bp**
- **This, therefore, presents an upside risk to our inflation and Bank Rate forecasts**

Strikes pose upside risks to inflation and interest rates, but a 1970s-style wage-price spiral is unlikely
The UK is gripped by public sector workers taking industrial action. The sequence of events to the endgame is hard to predict but in all likelihood a negotiated settlement will be reached and that settlement will, most likely, involve higher pay. In this note, we quantify the impact of higher public sector wages on inflation and monetary policy.

Public and private sector wage growth

Average weekly earnings (including bonus), % annual change.



Source: ONS, ABN AMRO Group Economics

Wage inflation presents a key upside risk for inflationary pressures across major advanced economies, including the Euro Area and the United States (Schnabel, 2022 and FOMC, 2022). Labour markets remain tight and nominal wages are rising, but not by enough to compensate for higher inflation. That said, wage growth is running at levels well above what might be

considered as consistent with the inflation target. Monetary policymakers, taking this context into account, are vigilant to upside wage pressures. Price and wage developments of the UK are also informative to other advanced economies.

With that said, the UK domestic context has specific features. Many of the striking workers in the UK are engaged in front line foundational sectors that provide important public services such as health, education and transport and most of the workers are employed in the public sector. The workers are demanding higher wages to compensate for the erosion in real pay and in some cases, also demanding changes in working conditions and job protection. The government is resisting these demands on two counts. First, that the higher wage bill is unaffordable and second, that higher public sector wages present a risk to price stability. In our judgement, public sector wages are low compared equivalent private sector wages. As a result, the gap must narrow, as this could create an erosion in the quality or quantity of public services.

The risk to price stability emanates from spillovers of higher public sector wages into the private sector and subsequent passthrough into consumer price inflation. We consider four scenarios to illustrate the impact on inflation and monetary policy. We consider scenarios that allow for low and high spillovers from the public sector to the private sector. Alongside that, we also consider scenarios that assume full convergence of public sector wages to private sector wages and an alternative scenario that assumes partial convergence.

In our judgement, CPI inflation will rise by 0.2-0.8pp and Bank Rate by 25bp-100bp depending on the underlying scenario. The lower estimate represents a scenario with low spillovers into private sector wages and partial convergence and the higher end reflects the scenario with high spillovers and full convergence.

The remainder of this note is structured around the following five questions.

Are public sector wages unsustainably low?

- In our judgement there is a 9% gap in take home pay in favour of the private sector.
- This estimate, however, does not take into consideration pension benefits which are more generous in the public sector. An estimate of the gap that provides for pensions eliminates the advantage enjoyed by the private sector.

Does this imply higher public sector wages or lower private sector wages?

- Research shows that private and public sector take-home pay tend to move together in the long run with the private sector taking a leading role.
- That said, changes in public sector wages also spill over into the private sector in the short run. A 1% increase in public sector wages raises private sector wages by 0.1% to 0.4% in the short run, as shown by research.

By how much will average earnings rise?

- Assuming a starting gap of 9% in 2022, public sector wages will need to rise by 5.0-9.5% in excess of private sector wages depending on the size of the spillovers and the extent of convergence
- Whole economy wages rise by between 0.7% and 4.8% above the Office for Budget Responsibility (OBR) baseline projection over this period.

What does this imply for consumer prices and monetary policy?

- A wage increase of 0.7%-4.8% will result in the level of the consumer price index rising by 0.3-1.9% by 2025. Spreading these wage increases over 2-3 years results in a peak inflation impact of 0.3pp to 1.2pp.
- The MPC will likely tighten policy to anchor expectations. A Bank Rate could rise by 25bp-100bp is conceivable and that would restrict the inflation impact to 0.2-0.8pp

Finally, will the industrial action result in a 1970s type inflation?

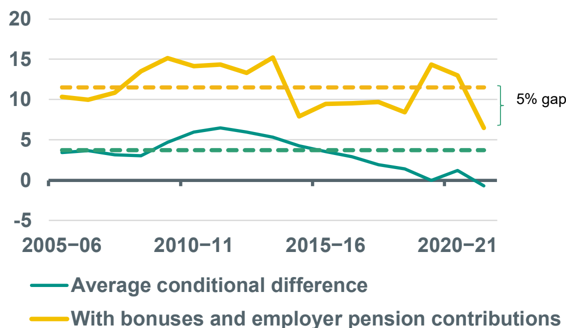
- Unlikely, because trade unions have been marginalised since the 1970s.
- Also, the Bank of England (BoE) has a clear mandate to deliver price stability and the MPC has the tools to deliver on that mandate. This was not the case in the 1970s.

Are public sector wages unsustainably low?

Wages in the private and public sector tend to move together over time, but there are stretches of time when wage growth in one sector outpaces the other. For example, public sector wages outpaced private sector wages in the early 2000s, during the Global Financial Crisis and again during the Covid-19 lockdown period, but for most of the rest of the last 20 years and especially since the government imposed a wage cap on the public sector in 2010, wages in the private sector have outpaced public sector wages.

Pay differentials, public - private

% annual change, series average depicted by dashed lines



Source: Boileau, O'Brien and Zaranko, 2022, ABN AMRO Group Economics
Note : 'Average conditional differences' adjusts for characteristics such as age, education, experience and sex. 'With bonuses and employer pension contribution' additionally adjusts for bonus payments and employer pension contribution.

Comparing wages across the two sectors is not straightforward because of compositional differences of the employees. The public sector, for example, tends to employ a larger proportion of experienced and higher educated workers and as a result, a straight comparison of averages will show that public sector workers are paid better than the private sector. Two recent research papers from the Institute for Fiscal Studies (IFS) and the National Institute of Economic and Social Research (Boileau, O'Brien and Zaranko, 2022 and Dolton, Hantzsche, Kara, 2020) allow for those differences to estimate the relative pay of workers in the two sectors.

The IFS study separately estimates a wage gap that additionally allows for bonuses and employer pension contributions. The private sector pays better bonuses and the public sector makes a more generous pension contribution. The IFS analysis shows that the pension benefit earned by the public sector more than compensates for the shortfall in basic pay and bonus (shown by the top yellow line in the chart above).

Estimates from these two studies clearly show that total compensation, which includes pensions, is more favourable in the public sector compared with the private sector (chart above), but what appears to matter more for workers is take-home pay. History suggests that the gap cannot widen forever. The question then is, which of the two will adjust? Is it wages in the public sector that will rise, or can we see the public sector as the anchor to which private sector wages adjust?

Will public sector wages converge to wages in the private sector?

The dynamics between public and the private sector are nuanced and it varies between the long run and the short run. In the long run, the private sector is the anchor to which public sector wages converge (Dolton et al, 2020). This dynamic is not surprising because the private sector is dominant in the UK, accounting for around 80% of total employment. In very much in line with economic theory, wages in the private sector in a small open economy such as the UK are determined by factors such as productivity, competitiveness and international trade.[1]

[1] Contrast that with resource rich countries such as for instance Oman, Bahrain (fossil fuels) or Botswana (diamonds), where the public sector is dominant. In these countries the public sector is the leader and the private sector the follower.

Consistent with that, Dolton et al. find that the private sector is the leader and that wages in the public sector adjust to that anchor over time. This leadership role of the private sector can also be observed in practice within the framework of the Pay Review Bodies (PRB). The PRB are responsible for recommending to the government the appropriate level of public sector pay. The appropriate level is the level at which 'public sector is able to recruit, retain and motivate suitably able and qualified people'. The PRB consult with a wide range of stakeholders and take into careful consideration developments in the private sector in their calculations.

The short run dynamics are altogether different. We can think of the short run as a few months or quarters, which is the period that matters most for monetary policy. Dolton et al. (2020) show that changes in public sector wages have a small but significant impact on private sector wages. In other words, unlike the long run, where the private sector is dominant, in the short run, changes in public sector wages have an immediate impact on private sector wages

What will happen to inflation and whole economy earnings?

Our starting point is that there is a gap of around 9% between public and private sector take-home pay. This estimate emerges from a 5% gap from the IFS analysis (difference between the current gap and the long-run average as shown in the chart above) plus the further widening that emerged in 2022 (chart on page 1), i.e. 4%.

We consider scenarios that allow for a full and a partial convergence of public sector wages to private sector wages. The full convergence scenario implicitly ignores the pension contribution advantage enjoyed by public sector workers while the partial convergence scenario makes some allowance for the pension advantage. Partial convergence in our analysis is half way convergence (4.5% instead of 9%).

According to Dolton et al. (2020) a 1% increase in public sector wages leads to private sector wages rising by somewhere between 0.1-0.4% depending on the specification of the equation. We take these estimates to craft two scenarios – a low scenario with spillovers of 0.1% and a high scenario with spillovers of 0.4%.

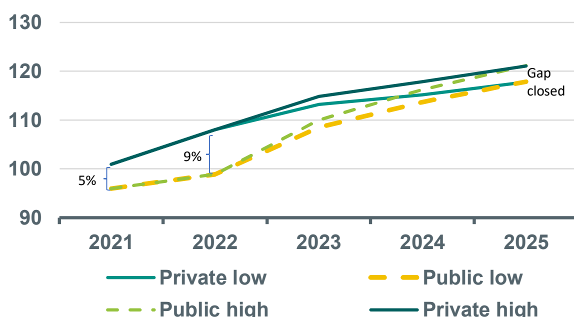
The four scenarios that we consider are as follows:

(i) Low wage spillovers with full convergence
(ii) High wage spillovers with full convergence
(iii) Low wage spillovers with partial convergence
(iv) High wage spillovers with partial convergence

Scenarios (i) and (ii) are illustrated in the chart below and scenarios (iii) and (iv) in the chart below that.

Scenarios where the gap is fully eliminated

Earnings index, 2021 = 100

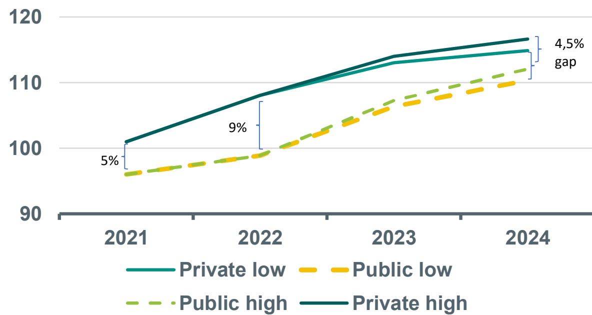


Source: ABN AMRO Group Economics

In order to achieve full convergence, public sector wages need to rise by 9.5% more than private sector wages. We assume that the adjustment is front-loaded and it occurs over three years staring 2023. Under the two alternative scenarios where

only half the gap is eliminated, public sector wages rise by around 5% more than equivalent private sector wages and again, the adjustment is front loaded.

Scenarios where the gap is partially eliminated



Source: ABN AMRO Group Economics

Peak impact on whole economy earnings and consumer price index under four scenarios

Difference from base	Low spillover, full convergence	High spillover, full convergence	Low spillover, partial convergence	High spillover, partial convergence
Average weekly earnings (whole economy, level)	2.0%	4.8%	0.7%	2.2%
Consumer price index	0.6pp	1.2pp	0.3pp	0.7pp

Source: ABN AMRO Group Economics

Our analysis suggests that whole economy wages will rise by 0.7-4.8% above the baseline OBR forecast (see table above). What matters for monetary policy is, of course, the impact that the wage adjustments will have on consumer price inflation. So as a next step, we estimate the impact of higher wages on inflation. To do that, we assume that productivity, profit margins and employment are stable. We additionally assume that wages account for around 40% of a firm's total cost of production in the service sector (Bobeica, Ciccarelli and Vansteenkiste, 2019), that inflation expectations remain anchored and that the BoE holds monetary policy unchanged. Under these conditions, we estimate that consumer price inflation will rise by 0.3-1.2pp (table above).

What does all this imply for monetary policy?

Our estimates for inflation shown in the table above assume that inflation expectations remain anchored and that the MPC keeps monetary policy unchanged. In reality though, the MPC is more likely to respond to ensure that inflation expectations remain anchored, especially under the high spillover and full convergence scenarios. The Bank will not, in our view, fully offset the inflation shock but a Bank Rate rise of 25-100bp is conceivable in our judgement and that will be sufficient to restrict the inflation response by 0.1-0.4pp relative to our base case. Depending on the timing, a tightening of this magnitude could lower peak inflation impact to 0.8pp.

Risk of 1970s type inflation?

There are similarities between today's industrial action and the labour disputes in the 1970s that was accompanied by high inflation outcomes (Phillips, 2022), but there are important differences that will ensure that inflation remains low and stable. In terms of similarities, the trigger this time, as before, is a cost-of-living crisis and job insecurity as well in some cases. Also, the workers that are at the forefront of the dispute today provide essential services such as health and transport which was also the case in the 1970s. Then, the main disputes involved coal miners, council workers, firefighters and transport workers. Another point of comparison is the role of trade unions. It is no surprise that ongoing industrial action is largely restricted to public sector workers. One reason is the unsustainable divergence in public and private sector wages which we discussed in first question. But this is not to say that workers in other sectors are fully shielded from the cost of living shocks. The difference is that public sector workers have the mechanism to protest because of trade union membership.

This is borne out by the data. Union density is significantly higher in the public sector at 50% of the workforce compared with 23% for the whole economy. In fact, union density taking all workers, public and private sector, into consideration, has fallen from 50% in the 1970s to 23% today. Also, where unions exist, the threshold to invoke industrial action is also much higher today compared with the 1970s. These factors impose a heavy restriction on the ability of private sector workers to express similar grievances and as a result, the likelihood of strikes by private sector workers is low.

Another key difference is the monetary policy framework. Unlike in the 1970s, the BoE has a clear and well established mandate to maintain price stability. The central bank also has the tools to deliver on that mandate.
It is against this backdrop that long run inflation expectations remain well anchored in spite of the sharp and persistent increase in inflation. Tinkering with the inflation targeting is a key risk for our view. However, in our view the government is unlikely to make any adjustments to the BoE after a similar experiment with the OBR earlier this year forced the Prime Minister to resign.

Conclusion

We believe that the gap in take-home pay between public and private sector workers is in the region of 9% and that the dispute will result in higher pay for public sector pay, resulting in a narrowing of the pay gap. History suggests that higher public sector pay has a knock on effect on private sector pay and the spillover estimates from Dolton et al. range from 0.1-0.4%. This spillover is a potential risk to inflation and monetary policy especially against a backdrop of a tight labour market is tight and high headline inflation. Consequently, there is a greater possibility of spillover at the higher end of that spectrum. That said, it is possible that the convergence in take-home pay between public and private pay is partial because public sector workers enjoy more generous pension contributions. In our view, inflation could rise by up to 0.8pp and the Bank Rate could be 25-100bp higher depending on the scenario.

We have also implicitly assumed that the higher public sector wage bill will be funded by tax increases or spending cuts which will have minimum impact on aggregate demand and inflation. The inflationary impact could be higher if the government funds the additional spending through borrowing, although that could result in higher sovereign yields which can crowd out private demand.

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