



# Research Digest | November 2018

## Summary

*Fed chair Jay Powell considers that financial stability is still the poor relation to monetary policy. An outbreak of financial instability would clearly interrupt the steady upward march of the US funds rate, but a 10 per cent equity market correction does not qualify. Global wage bill acceleration has yet to kill off the corporate profit cycle.*



*“An aging US expansion has just passed its medical”*

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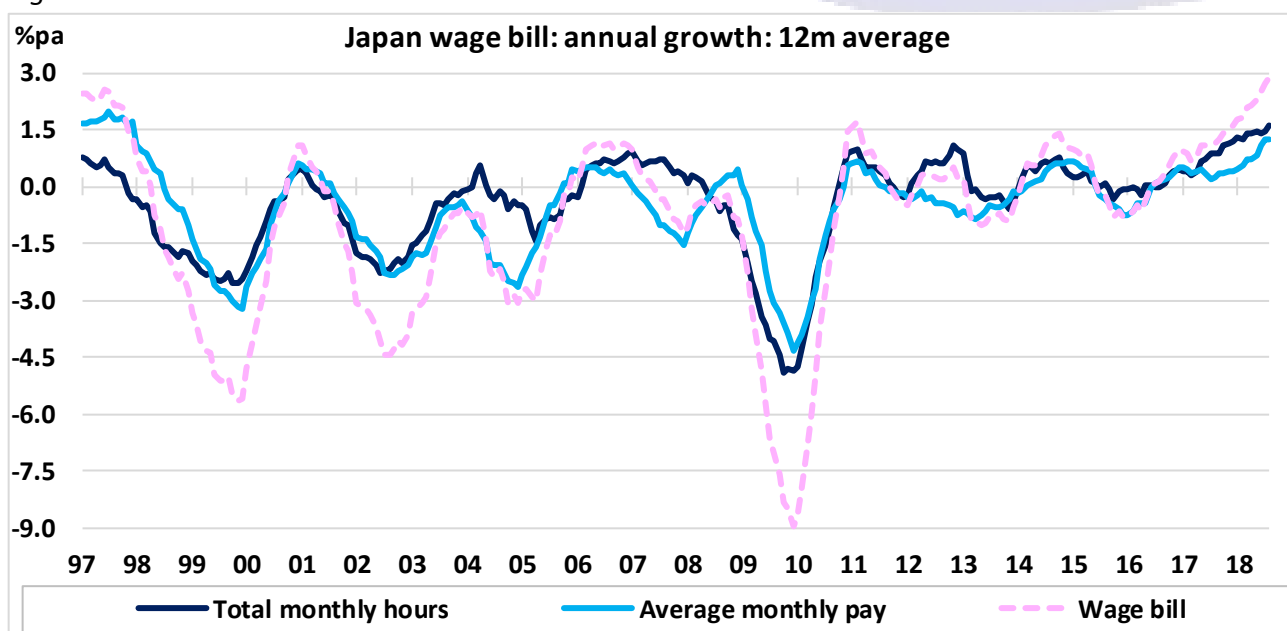
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### Chart of the month

The chart of the month and its predecessors can also be seen on our website: [www.economicperspectives.co.uk](http://www.economicperspectives.co.uk). This month's chart shows that while monthly wage data for Japan is notoriously erratic, it is difficult to dispute the steady acceleration of the wage bill over the past 2 years. With labour shortages widespread, companies are offering more full-time contracts to part-time workers as a retention strategy. There have also been boosts to the overall wage bill as more workers have transitioned from irregular to regular employment, a furtively rising migrant population, higher bonus payments and the response to PM Abe's tax incentives linked to pay growth. Scheduled cash earnings have recorded six consecutive months of stronger readings, averaging above 1 per cent annual growth. Finally, we have lift-off.

Figure 1



Data source: CEIC

## Why the crude oil price won't save US Treasuries

The round trip in crude oil prices back to sub-US\$60/barrel will undoubtedly take the wind out of inflationary sails over the next few months. US Treasury breakeven inflation rates have also reacted in a manner consistent with their new-found correlation to the oil price. However, we doubt whether this news will be enough to reverse the bear trend in US bond prices. The psychology of inflation has shifted over the past three years, reinforced by a buoyant labour market, confident consumers and new leadership at the Federal Reserve. And the transfer of ownership of an expanding stock of US Treasury notes from weakened international hands to domestic holders will require yields to move to a premium.

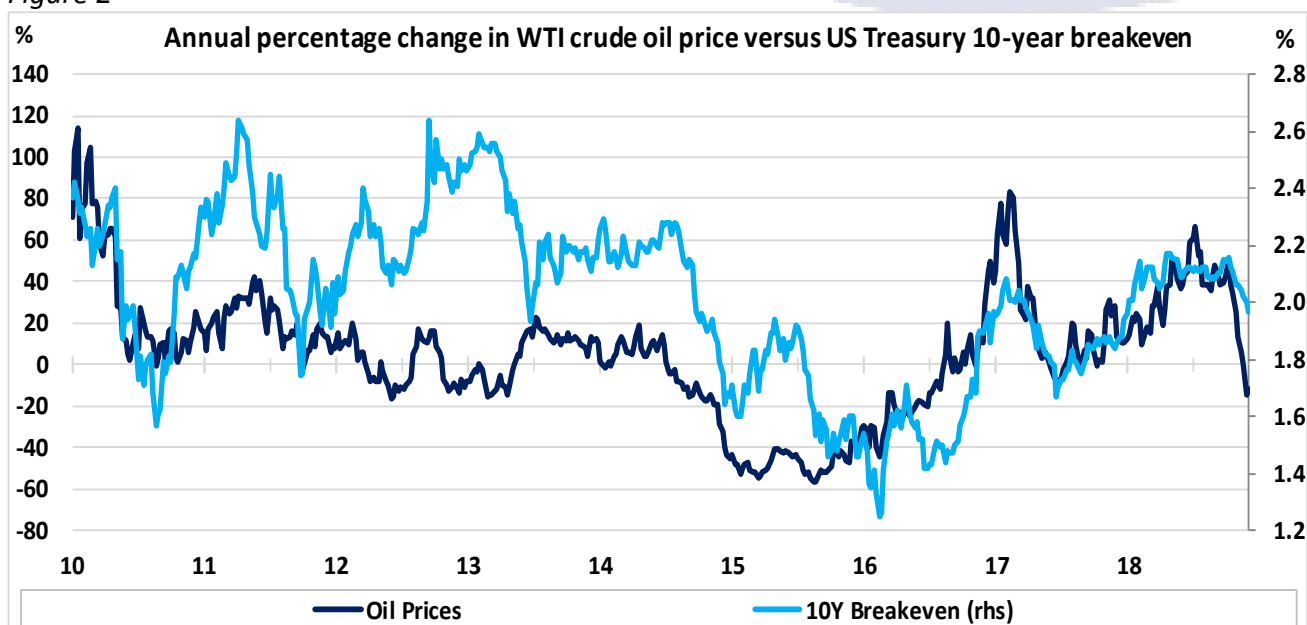
The plunge in the WTI oil price from a peak of US\$76/ barrel to US\$51/barrel is starting to resemble the beginning of the 2014 oil price collapse, but the context is very different. The US president may have exerted his influence over Saudi Arabia, but this is no guarantee that OPEC will not decide to cut production again next month. Global oil inventories were rising uncontrollably in 2014 but have modestly depleted in 2018. Even September's higher fuel prices seemed to have little impact on consumer and business demand as global oil consumption hit almost 100m barrels/day. The threshold of demand destruction looks to be further away.

“The psychology of inflation has shifted over the past three years”

The drop in the WTI price has been associated with less than a 20-basis point reduction in US 10-year inflation breakevens, thus far. The US inflationary narrative is much broader and better established in 2018, as consumer confidence is buoyant, business surveys close in on previous highs and the labour market has finally delivered the much-vaunted wage acceleration. The inflationary psychology has shifted during the past 3 years and with it, the outlook for the Treasury bond market.

Finally, a momentous transfer of ownership of the US treasury note market is underway, even as its supply is projected to rise strongly. Weakening international demand for US Treasury bonds necessitates a rising yield premium to entice new domestic holders to take their place.

Figure 2



Data source: Thomson Reuters Eikon

## Oh no! Oh no! It's off to work I go....

Since 2011, rates of long-term unemployment have fallen very sharply in the UK. Any temptation to attribute this success to the coalition government's flagship Work Programme (WP) should be resisted. Independent evaluations suggest that the conversion rates from the WP into continuous full-time employment were abysmally low. The more plausible explanations are the abundance of job opportunities (albeit gathered at the entry level pay grades) and the progressive squeeze on the entitlement to and the amounts of social security payments paid to adults of working age.

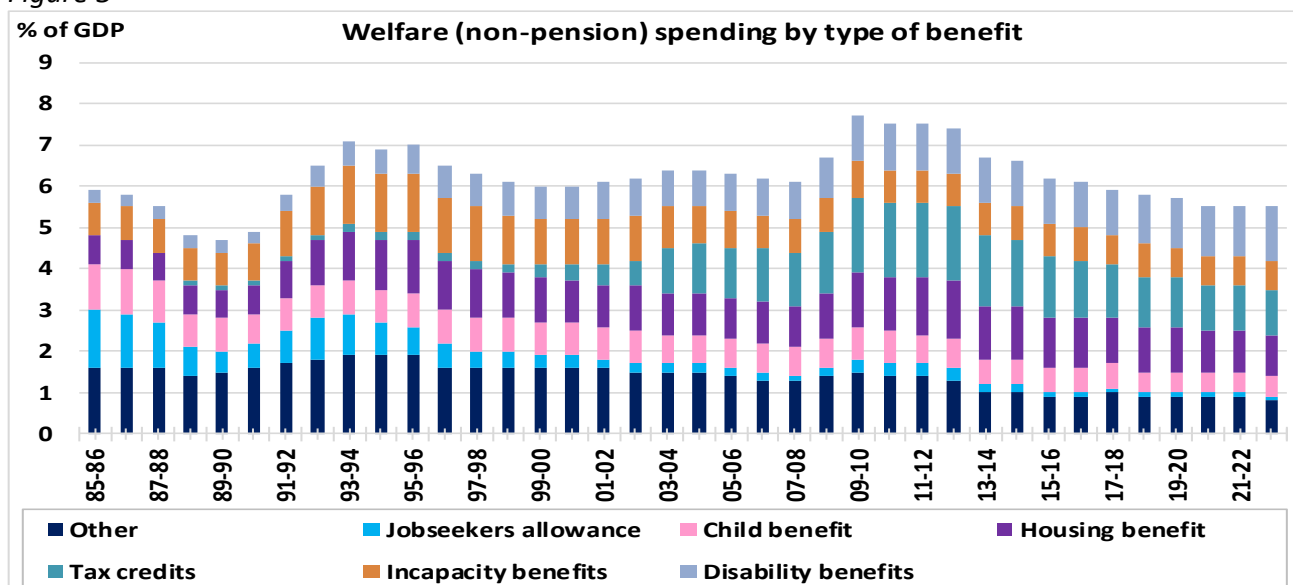
“The pressure on working age adults to find paid work has intensified”

The reduction in the burden of welfare payments (tax credits, benefits and allowances) has been a government policy priority since budget deficit reduction began in earnest in 2010. Figure 3 confirms that the share of non-pension welfare spending peaked at 7.7 per cent of national income in 2009-10. Under current government spending projections (and assuming no recession over the next 5 years), this ratio will level out at 5.5 per cent of GDP from 2019-20. As the criteria for the receipt of benefits have become more restrictive and the benefits themselves have been frozen in real terms since 2014, the pressure on working age adults to find paid work has intensified.

Nevertheless, as of February 2018, there were 6.8m adult welfare recipients of working age, representing a sixth of the 15-64 age group. The most common benefit is Housing Benefit (4.2m), followed by Employment and Support Allowance (2.3m), Disability Living Allowance (2.0m), Personal Independence Payment (1.7m), Attendance Allowance (1.6m), the new Universal Credit (1m), Carer's Allowance (0.84m), Income Support (0.56m) and Jobseeker's Allowance (0.44m). In addition, approximately 5.3m adults receive either Working Tax Credit or Child Tax Credit or both. Universal Credit will ultimately replace Income Support, income-based Jobseeker's Allowance, income-related Employment Support Allowance, Housing Benefit, Working Tax Credit and Child Tax Credit.

Over the past few years, there have been three moderating supply-side influences on UK wage inflation. First, increased transitions from unemployment and inactivity into employment, second, the rising participation rate of the over-65s, seeking to augment pension incomes. Third, the migrant

Figure 3



Data source: OBR



population was also rising strongly, up 26 per cent in the past 5 years. However, migrant employment seems to have peaked in the third quarter of last year. By Q2 2018, a fall of 82,000 had taken place, while employment of UK residents surged by 1.4 per cent a year. Unsurprisingly, the incidence of under-employment has continued its steady decline.

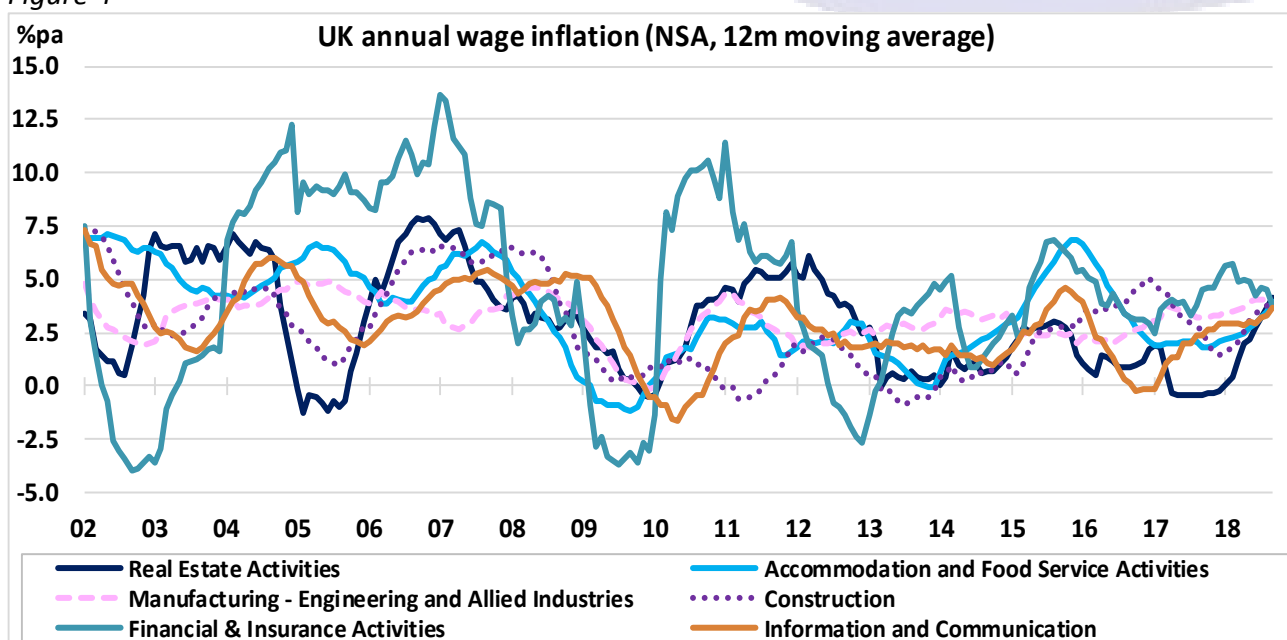
All estimates of aggregate underemployment (including outright unemployment) require judgements to be made about the employability of various categories. We define the numbers of unemployed and underemployed on a full-time equivalent basis as the sum of the Labour Force Survey definition of unemployment, the number of discouraged workers seeking employment, the excess of the incidence of part-time workers wanting full-time work over its lowest ever ratio (scored at 50 per cent of FTE), and 30 per cent of the total numbers of long-term sick or disabled (scored at 33 per cent of FTE). Taking the ratio of underemployed full-time equivalents to the total of employed full-time equivalents provides a basis of time series comparison of the degree of underemployment which is now lower than any point since the series began in 1993.

“Wage inflation pressures have intensified across the private sector”

An alternative calculation of underemployment is where we calculate the total number of weekly hours worked in each quarter that would correspond to the highest observed ratio of total weekly hours worked to the population of working age. On this basis, the UK is now closer to its maximum participation rate (recorded in 1973) than at any time since 1979 – almost 40 years ago. The implication of these results is that the phase of strongest expansion of UK labour supply has passed and that the progressive tightening of the market must trigger faster wage inflation.

The evidence is gathering that wage inflation pressures have intensified across the private sector during the past year, with the notable exception of financial and insurance activities. Figure 4 cautions that we have experienced a couple of false dawns with wage inflation since 2012, but the wage data is supported by numerous recruitment surveys, reporting a rising wage bid. Our message is straightforward: that the tightness of the labour market is not a statistical mirage. It is a tangible reality that will bear down on UK policymaking to an increasing degree over the coming months.

Figure 4



Data source: ONS

## Still waiting for a decisive turn in the global labour share

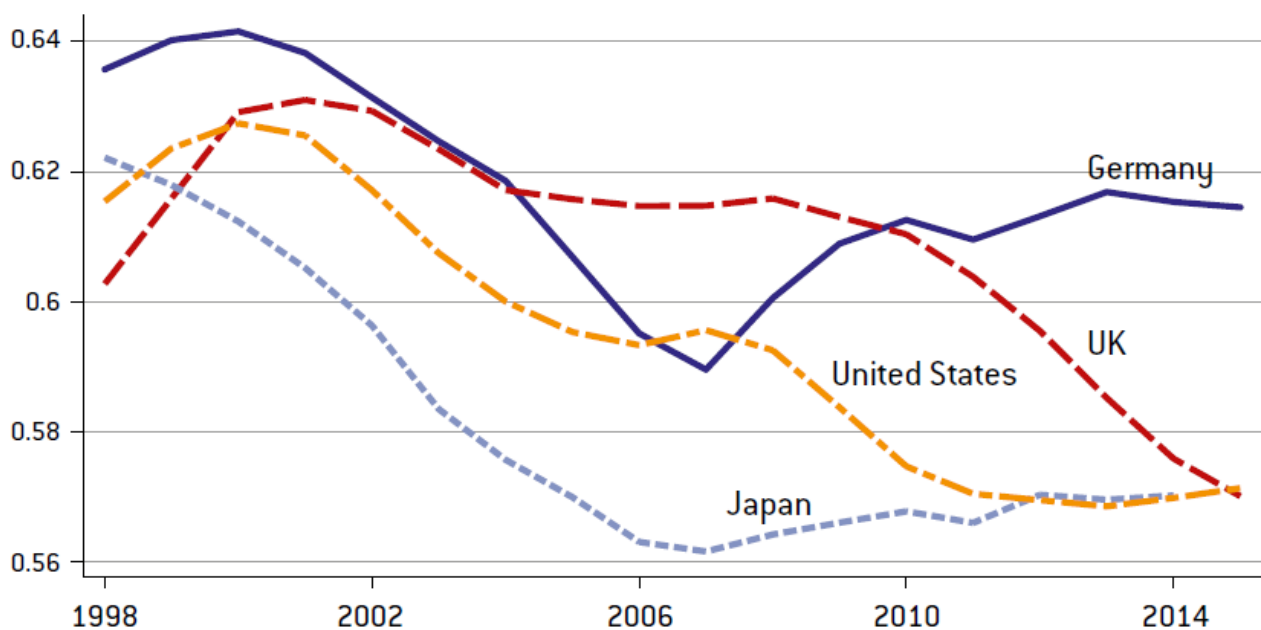
It is a matter of arithmetic, that when average wages increase more rapidly than average labour productivity, the labour share rises. Between 1960 and 1980, there was identifiable cyclicality in the labour share in advanced economies. As an economic expansion was becoming mature, the relative scarcity of labour would prompt an acceleration of wages. At the same time, the full utilisation rate of the capital stock implied a slowing rate of productivity growth. The conjunction of wage acceleration and productivity deceleration warned of an overheated economy. Typically, the labour share of national income would rise during late cycle and continue during the transition to the cyclical low. As the full impact of the downturn, or recession, unfolded, labour would become redundant and the wage share would fall back. As the next upturn took hold, labour productivity would rise faster than average wage growth and the labour share would continue to fall.

“Over the past 35 years, some powerful structural forces have rebalanced the distribution of national income”

These cyclical tendencies have not disappeared altogether but have become variations around a falling trend in the labour share of factor incomes, rather than a stable trend, as before. Over the past 35 years, some powerful structural forces have rebalanced the distribution of national income, including the adoption and diffusion of labour-saving technology, the creation and development of global value chains (GVCs), otherwise known as supply chains, and the slow death of anti-trust policies. The outsourcing and offshoring of goods production to regions and countries where labour costs are considerably lower is the primary motivation for the creation of GVCs, although a second important motivation is to bring production closer to the fastest-growing consumer regions.

The impact of technology on the organisation of industrial economies is immense and promises to be disruptive for many years to come. Beyond the straightforward substitution of capital for labour, technology has redefined the nature of work. Clerical workers perform their duties through repeated interactions with software and communications technology. Technology is also influential in determining the length of work-shifts and the divisibility of tasks, subtly eliminating wage premiums

Figure 5: Labour shares of national income in US, Japan, Germany and UK, business sector



Source: Bennet Berger and Guntram Wolff (Breugel website)

for overtime or unsociable hours working. The evidence suggests that technological change has transferred real resources from employees to entrepreneurs, whether operating at large or small scale. An indication of the size of the cumulative transfers is shown in figure 5.

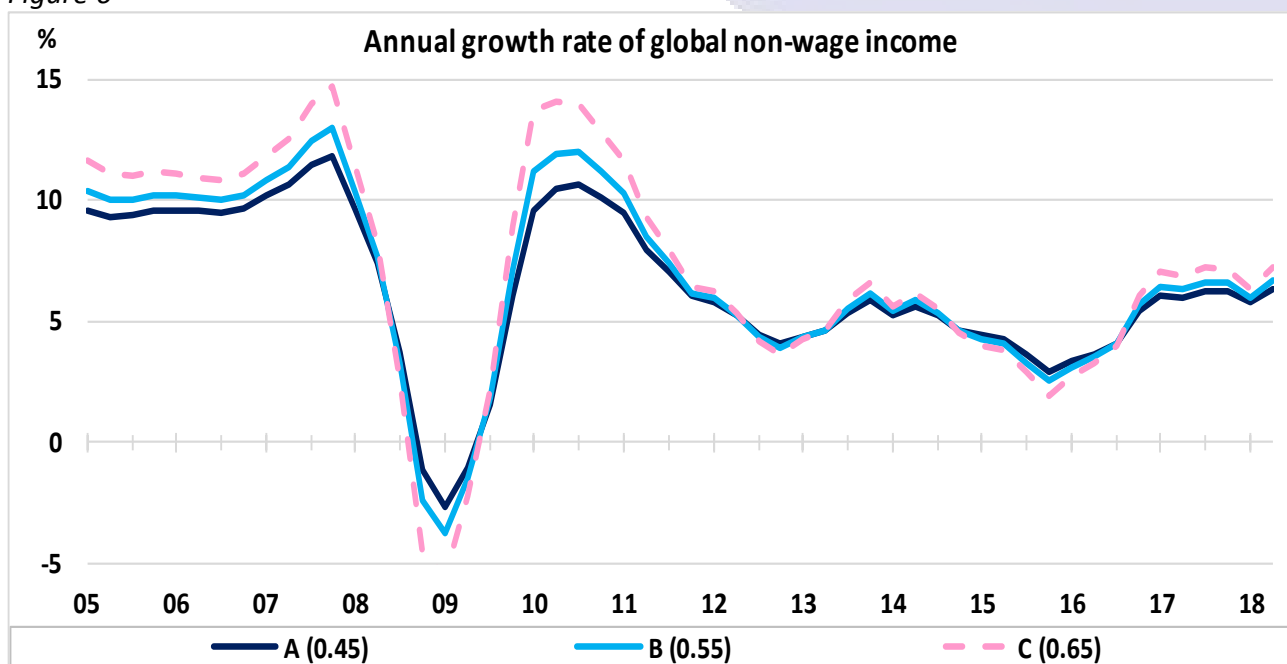
Technological advances have fostered the emergence of dominant firms, both nationally and globally, as rival platforms and protocols have lost ground to the giants. During the 1980s and 1990s, the vision of competitive capitalism has been abandoned in favour of a pseudo-protectionism around national champions. Regulatory interventions – not least in banking and finance – have reinforced the barriers to entry and contributed to a structural increase in industrial concentration. In time, oligopolists show their true colours and restrict production to boost profitability.

“Non-wage incomes continue to grow robustly”

The strength of these collaborative forces has made it much harder to observe cyclical variations in the labour market. When wage accelerations are so weak, it is much more difficult to assert that an economic expansion is mature. Our objective in our most recent Global Inflation Perspective is to discern the relative rates of growth of the wage bill in 10 large countries and of implied non-wage incomes that make up the remainder of nominal GDP. Thankfully, the growth of non-wage incomes is not very sensitive to the assumption that we make for the absolute size of the labour share. In the main document we employ three assumptions for the labour share: variant A (45 per cent), variant B (55 per cent) and variant C (65 per cent).

To illustrate the simplicity of the exercise, the evolution of the implied growth rates of global non-wage costs are shown in figure 6. The simple, but powerful, message of this chart is non-wage incomes, encompassing profits, rents, interest and dividends, continue to grow robustly. On the other hand, the relatively recent acceleration in the wage bill is attributable as much to growth in the quantum of employment as to a quickening pace of wage growth. In the full document, this analysis is replicated for each of the following countries: US, UK, Canada, Japan, Germany, France, Italy, Australia, China and Brazil.

Figure 6



Data source: CEIC and EP calculations

## China’s enthusiastic embrace of fintech

Nowhere has fintech been more enthusiastically received than in China. The BIS report “Fintech credit markets around the world: size, drivers and policy issues” reveals that in 2016, China accounted for 85 per cent of the global stock and remained one of the fastest growing markets despite its size, with an annualized growth rate of 252 per cent for the three years between 2013 and 2016. Chinese fintech has recorded incredible growth and has begun to have a material impact at the aggregate level.

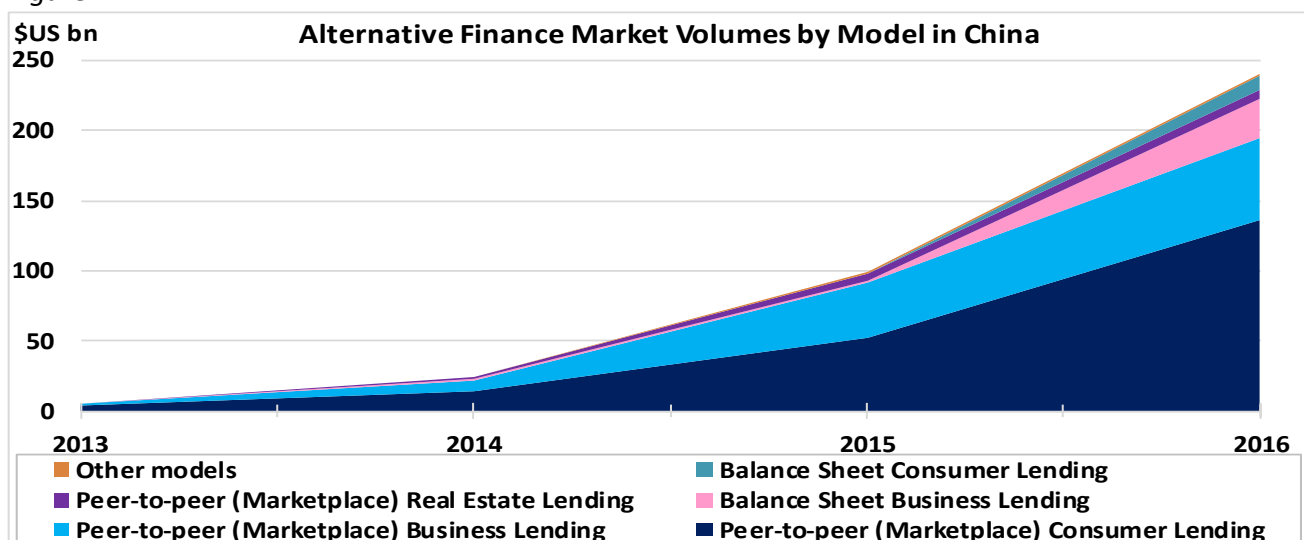
“China accounted for 85 per cent of the global stock of alternative finance”

The BIS provides data for alternative finance stock levels in 2013 and 2016. From a standing start, fintech has achieved observable significance. The annual growth rate of Chinese private debt in 2016 would have been 0.6 percentage points higher if alternative finance had been included. Assuming that the rate of alternative finance grew at the same rate as peer-to-peer lending, around a 50 per cent annual rate, then this is another 0.3 percentage points of private debt growth in 2017. It has reached a level where its mass and pace of growth augment conventional credit growth. However, China has recently seen an abrupt reversal in the fortunes of the peer-to-peer market, which is, thanks to its size, likely to have a material impact on the fintech aggregate.

According to research from Judge Business school at Cambridge University, as of 2016, consumer peer-to-peer lending was the dominant form of alternative finance, with around 56 per cent of the market, business peer-to-peer lending was second with around 24 per cent, balance sheet business lending was third largest at 11 per cent. While consumer lending is the largest part of the alternative lending environment in China, it is perfectly possible that these funds are used for business reasons.

Recently there has been trouble for investors with difficulties withdrawing their money, police investigations into the exchanges and some exchanges owners running away. Clearly there has been some fraud, but there has also been a concerted attempt by the authorities to subdue the sector – with reports that a wave of defaults had been expected in the light of their actions. A further factor highlighted is that some firms might rely on peer-to-peer lending in conjunction with traditional bank lending, hence if the bank begins to tighten conditions, then the company might start to default on all forms of their borrowing.

Figure 7



Data source: The 2nd Asia Pacific Region Alternative Finance Industry Report



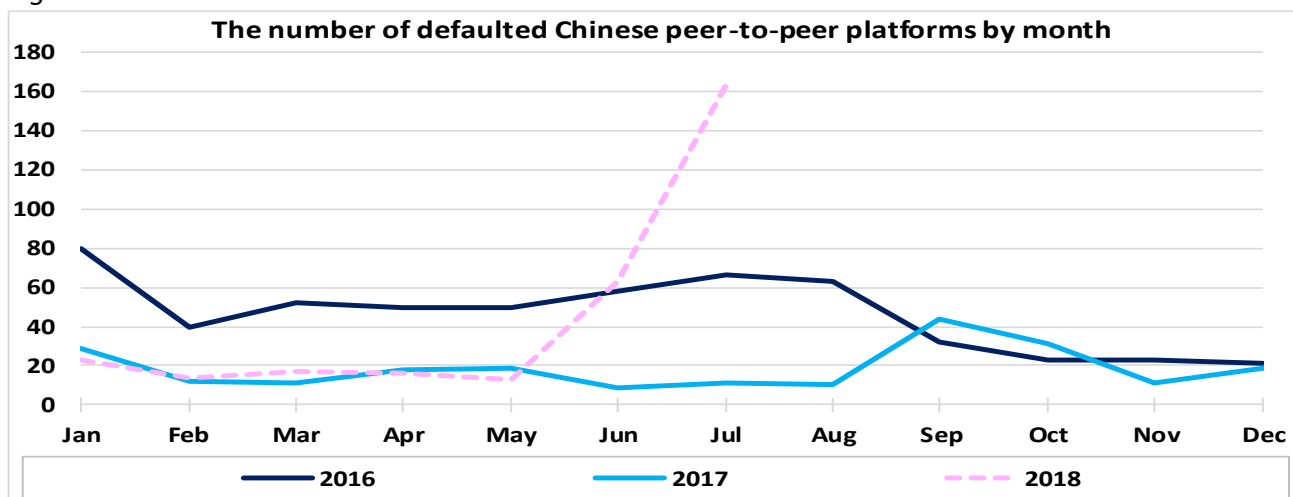
Peer-to-peer default rates in China have risen sharply since June 2018. In May there were ten platforms considered to be in trouble. In June there were 63 and at the end of July this was 163 (figure 8). Reportedly, the trouble has arisen, in part, because a national peer-to-peer rectification campaign has overrun. In late-2017 the platforms were asked to register with local authorities, but the expiry date has passed and many platforms have not met the requirements. One of the main purposes of the regulation is to restrict platforms to a role of intermediaries solely for information – removing their ability to hold funds.

“The alternative lending story could be more significant than first impressions suggest”

Unsurprisingly, the troubles in the Chinese peer-to-peer industry have interrupted the strong growth trajectory. As of October, the number of lenders has halved from the peak in November 2017. The number of borrowers has also fallen by 50 per cent in the last eleven months. It is a similar story for the turnover volume and outstanding balances. The number of platforms peaked in late 2015 and has been falling steadily since. However, the summer of this year saw a noticeable further step down in active platforms. At the same time, the average length of loan has been rising and the interest rate has fallen. The Chinese regulators face a conundrum – they wish to reset as much of the toxic peer-to-peer market as possible, but do not wish to spook the market into implosion, leaving all the investors out of pocket and potentially provoking further civil disorder; jilted investors have already staged public demonstrations.

It might be that the peer-to-peer network finds its footing again and continues to grow, but in the meantime the annual growth rates are going to be weak or negative. The growth of peer-to-peer lending has been responsible for a significant increase in the level of borrowing in China through 2016 and 2017, but this trend is likely to abate through 2018 at least. China’s regulatory framework is much more vulnerable to rapid financial innovation. The regulation is looser and allows new platforms and products to expand rapidly. The Chinese markets are also susceptible to a swift and heavy-handed response from the regulator. While new platforms or products can spring up like weeds, they can also be virtually torn out at the root, without notice. This rapid proliferation of lending, and the recent slowing can have a wider effect on the national economy, particularly at the margins. The alternative lending story could be more significant than first impressions suggest.

Figure 8



Data source: Home of Online Lending via Techcrunch

## Snapshot of monthly inflationary movements

	Euro Area (19)	UK	France	Germany	China	US	Japan
All items	↑	→	↓	↑	↑	→	→
Core	↑	→	↓	→	■	↑	↓
Food	↑	↓	↑	↑	↑	→	↑
Energy	↑	↑	↑	↑	■	↓	↑
Transport	↓	↑	↓	↑	↑	↓	↓
Housing	↑	↑	↑	↑	↑	→	→
Clothing	↑	↑	↑	↑	↑	↑	↑
Alcohol and tobacco	→	↑	→	→	↓	↑	↑

Based on September data

<span style="display:inline-block; width:15px; height:10px; background-color: #e91e63; border: 1px solid black;"></span>	= The annual inflation rate has <b>increased</b> by more than 0.1 points from the previous month's value
<span style="display:inline-block; width:15px; height:10px; background-color: #a9c9e9; border: 1px solid black;"></span>	= The annual inflation rate has <b>decreased</b> by more than 0.1 points from the previous month's value
<span style="display:inline-block; width:15px; height:10px; background-color: #fff; border: 1px solid black;"></span>	= The annual inflation rate has varied by less than 0.1 points in either direction from the previous month's value
<span style="display:inline-block; width:15px; height:10px; background-color: #555; border: 1px solid black;"></span>	= Data unavailable
↑	= The price index has <b>increased</b> by more than 0.1% from the previous month's value
↓	= The price index has <b>decreased</b> by more than 0.1% from the previous month's value
→	= The price index has varied by less than 0.1% in either direction from the previous month's value

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