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HERMES ECONOMIC OUTLOOK: THE MISSING JIGSAW PIECE...

In his latest Economic Outlook, Neil Williams, Group Chief Economist at Hermes Investment Management, looks at the final missing jigsaw piece in economic recovery: that is, wage growth.

Seven years after the first traces of crisis, and we still have only a three-speed recovery. In the fast lane are the US, whose real GDP is 8% higher than pre-crisis, Canada and NZ's 11-12%, and Australia's 20%. In the middle, the UK's is now 2½% higher after up-revisions. But, in the slow lane, Japan and the euro-zone are barely back to 'square one'.

The wages conundrum...

Yet, over the same period, wages have not outpaced inflation, marking a real-terms hit to consumers' incomes. US GDP may be 8% up, but its CPI has risen 16%, and wages 16%. Worse still, the UK's RPI is 27% higher, but average wages up just 5%. Not even in the GDP fast-lane have real incomes fully recovered, despite falling unemployment.

This absence of wage growth, even as US and UK unemployment rates slide, is a conundrum for central banks. On the one hand, it may be that the traditional lags between the two have simply become extended, in which case the fillip to wages will at some stage feed through. On the other, it may more be the case that the supply of labour has increased, reducing wage pressure. Most likely, it's a mix of both.

Surprisingly, there's a disconnect this time between the US and UK labour markets. In the US, wage pressure may soon build. The lower unemployment rate since 2009 reflects not so much job gains, but a drop in the 'participation rate', which gauges the labour force as a share of the working-age population. The US's has plummeted to a 36-year low, which is the lowest in five recessions.

For the Federal Open Market Committee (FOMC), three quarters of the US's fall reflects retirees, and an 'easier' take-up of disability payments after a relaxation of the rules. On the premise these participants are in general unlikely to re-enter the workforce, it offers hope for wage growth.

But the US's drop is the mirror image of the UK's rise since 2012 - the UK's reflecting *inter alia* deferred retirement, possibly net migration, and a more favourable tax system relative to benefit payments. This suggests the chances of wage inflation into 2015 are better in the US than the UK.

In the UK, wage growth will be the key to sustaining the 'sugar rush' recovery, which, according to our Phillips Curve analysis, needs even faster unemployment cuts. Aggressive rate hikes make little sense while real wages are deflating.

Hopefully for financial markets, the uncertainty attached to 'Scotland' will now start to ebb away, though, of course, the detail and extent of any new devolved powers need to be thrashed out. The tensions arising from a monetary union bereft of sufficient fiscal union are still being suffered in the euro-zone. These need to be avoided in the UK.

In Japan too, real-wage growth is a missing link. Japan's higher CPI needs to be matched to avoid a repeat of 2008, when an oil-inspired CPI-rise hurt consumption. If it isn't amid major tax rises, Prime Minister Shinzo Abe's progress will be another false dawn. But, the spring wage round (*shunto*) was uninspiring, and, unintentionally, Abe's encouragement of more women and seniors into the workforce could cap wage growth.

In the euro-zone, unemployment needs to plummet for demand-inflation to pick up. This needs a weaker euro. The euro's 14% trade-weighted rise between mid 2012 and mid 2014 sliced about 0.4%

points from CPI inflation. It also threatened the competitiveness-gains made by Spain, Portugal and Italy at a time when geopolitical risk in eastern Europe makes Germany look less 'bullet proof' economically.

Dr Draghi's proposed private asset purchases may help. But, the amounts look small (circa 2% of all euro-zone issuance), with any benefit from ABS purchases falling more to the 'core' than the periphery. More potent would be the 'bazooka' of unlimited sovereign QE (government bonds accounting for half of all issuance), which has yet to be fired. This comes in 2015, when yields are rising.

In Australia, meantime, labour participation is climbing and wages only now matching inflation. And China's collapse in productivity questions the urgency in making the renminbi fully convertible.

So, the labour market will be critical to completing the recovery 'jigsaw'. The issue for central banks is whether to be proactive on rate hikes, or wait till the last jigsaw piece of recovery (wage growth) has fully slotted in. We suspect they'll do the latter.

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