THE FULL-SPEED ECONOMY

DOES RUNNING A HOTTER ECONOMY BENEFIT WORKERS?

Joseph Evans and **Carsten Jung**

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SUMMARY

Managing the macroeconomy to achieve strong growth and low inflation is a careful balancing act. Overly restrictive macroeconomic policy – such as too-high central bank interest rates – stifles growth, but policy that is too loose risks 'overheating' the economy and triggering high inflation. However, over the last two decades an interesting phenomenon occurred: countries that ran their economies slightly 'hotter' than was previously thought possible registered surprisingly positive effects.

Before the Covid-19 pandemic, several economies – including the US, Japan and nations in the Euro area – were effectively 'running hot'. These cases showed that 'tight' labour markets did not necessarily translate into rising inflation, which led macroeconomic institutions to raise their estimates of an economy's potential. Crucially, economists also found that disadvantaged groups benefited from these episodes, suggesting that macroeconomic policymakers should pay more attention to the potential economic and distributional benefits of running a slightly hotter economy.

The experience of the US economy after pandemic reinforces this. Although inflation and cost-of-living pressures contributed to the Democrats' election defeat in 2024, the economy actually delivered strong growth and remarkable gains for workers. US wage inequality fell significantly, labour force participation among some of the most disadvantaged groups rose to record highs, and real wages rose fast for lower-income workers. Dube (2026) found that, even though pay growth slowed for lower earners last year, this wage compression largely persisted into 2025. Economists concluded that 'running the economy hot' led workers to switch to more productive jobs, and that the strong labour market was not the main driver of high inflation.

The US economy was not alone in experiencing wage compression after the pandemic. The UK labour market was 'tight' – with high vacancies and significant wage compression – as businesses rapidly raised pay to attract workers. Real hourly wages rose fastest for low-paid workers in sectors where labour shortages were high (partly aided by minimum wage increases). This is a striking finding – especially given that the dominant narrative of the post-pandemic recovery period has been, understandably, the impact of high inflation on household budgets, driven by global energy and supply-chain shocks.

These experiences prompt questions for macroeconomic policymakers.

- Is it possible to hit existing inflation targets with a more accommodative monetary or fiscal policy?
- Could running a 'slightly hotter' economy have benefits for low-paid workers, in particular by reducing wage inequality?
- Should macroeconomic policymakers adjust their approaches in light of this evidence?
- How should policymakers balance the potential benefits for workers against the risks of triggering inflation?

Our review suggests that policymakers might be able to run the economy slightly hotter than previously thought – if the starting point is close-to-target inflation. A slightly hot economy could also boost future growth. In other words, running the economy at 'full speed' could generate momentum that subsequently helps to

sustain future growth. It could also bring benefits for lower earners without causing above-target inflation.

In practice, macroeconomic policymakers will need to weigh the benefits of running the economy at full speed, against the risk of triggering high inflation. Running an economy hot can lead to:

- higher growth
- wage gains for low-paid workers
- better labour market participation
- more productive job switching
- higher rates of business creation.

Our central recommendation is that macroeconomic institutions, such as the Bank of England and the Office for Budget Responsibility (OBR), should better reflect the potential benefits of running the economy hot in their models and forecast scenarios. One way to think about this is in relation to 'positive scarring effects'. This is the flipside of 'negative scarring', a term widely accepted in the macroeconomic literature – the idea that a prolonged period of below-potential growth, negatively affects potential growth itself. That is, running the economy too cold hurts future growth. Even if they do not end up capturing this in their central scenarios, macroeconomic institutions should be much clearer about the uncertainties around potential output estimates than they currently are.

We also recommend that the UK should run a less restrictive macroeconomic policy going forward, when inflation is close to target and inflation expectations are at pre-pandemic averages. Both the Bank of England (2025) and the OBR (2025) forecast significant negative output gaps over the coming years – meaning a relatively 'cold economy'. As a result, we risk leaving the economy 'too cold for too long'. If our argument is correct, then this could hurt not just present but also future growth and lead to worse outcomes for workers. As we go into 2026, the Bank of England should thus loosen monetary policy aggressively to boost growth and wages.

Importantly, we are not suggesting that economies that are experiencing above-target inflation, as the UK is at the moment, should be run 'hotter'. But when inflation is at target and inflation expectations are anchored, there might be a case for stimulating the economy more than current standard approaches seem to suggest. At the very least, macroeconomic policymakers should be more explicit about the trade-offs, the uncertainties and how they decide whether or not to run the economy hot.

1. INTRODUCTION

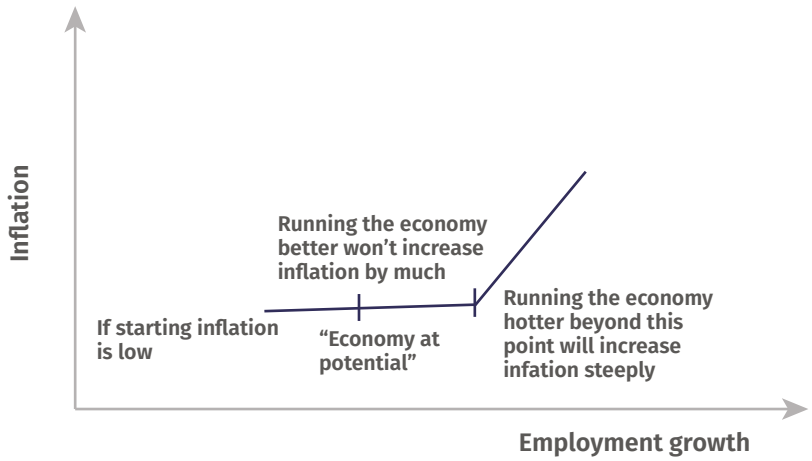
Before the Covid-19 pandemic, several economies were effectively 'running hot'. In some cases, this was a deliberate policy decision and in other cases it was caused by other factors. But it led to unemployment falling to levels that had previously been expected to lead to above-target inflation.

In the US, in 2018–19, unemployment fell well below the estimated 'natural rate', but core inflation stayed near 2 per cent. Japan saw a sustained positive output gap and record-low joblessness from 2016, yet core inflation lingered at 0.5 per cent to 1 per cent. In the euro area, the gap closed by 2018 with little price pressure. These cases showed that 'tight' labour markets did not necessarily translate into rising inflation, leading institutions to raise their estimates of an economy's potential. Meanwhile, rigorous studies of some of these episodes found that running the economy slightly hotter can benefit disadvantaged groups (Aronson et al 2019). These outcomes suggest that macroeconomic policymakers should pay more attention to the potential economic and distributional benefits of 'running the economy hot'.

The pre-pandemic experience, where tight labour markets went hand in hand with on-target inflation, had prompted organisations such as the IMF to say that the 'Phillips curve' – the trade-off between lowering unemployment and higher inflation – was flat *up to a point* (Ari et al 2023). A flat Phillips curve means that economies are able to run 'slightly hot' without higher inflation. But after this point, the risk of spiking inflation could increase significantly (see figure 1.1). Bunn et al (2025) present evidence that this is safer to do when inflation is already low and expectations are anchored. The 'bite point' is more likely to be breached when inflation is elevated or the labour market is already relatively tight.

FIGURE 1.1: POLICYMAKERS MIGHT BE ABLE TO RUN THE ECONOMY HOTTER THAN WHAT IS CONSIDERED 'AT POTENTIAL'

Stylised model of the 'flattening' and 'steepening' of the Phillips curve



Source: IPPR analysis

But against the risk of potential above-target inflation are potential benefits. Therefore, to untangle the question of whether and when macroeconomic policymakers should seek to run a hot economy, in this report we seek to answer the following questions:

- Is it possible to hit existing inflation targets with a more accommodative monetary policy?
- Could running a 'slightly hotter' economy have benefits for low-paid workers, in particular by reducing wage inequality?
- Should macroeconomic policymakers adjust their approaches in light of this evidence?
- How should policymakers balance the potential benefits for workers against the risks of triggering inflation?

We review theory and evidence from the past four decades, as well as early evidence from the past four years of differing macro policies and their impact on wages.

2. ‘RUNNING THE ECONOMY HOT’ IN THEORY AND PRACTICE

RUNNING THE ECONOMY HOT IN MACROECONOMIC THEORY

The mainstream macroeconomic view on ‘running the economy hot’ has evolved since the post-war period. The classical view is that there is a hard, inverse relationship between unemployment and inflation – also known as a stable Phillips curve. In this model, running a hot economy, with tightening labour markets and unemployment falling below a ‘natural’ level, will lead to higher inflation.

Economists have since argued that the Phillips curve has become flatter – meaning that the relationship between unemployment and inflation has weakened. This implies that there could be more space for macroeconomic policymakers to lower unemployment further than previously thought, without triggering inflation. This new evidence led central bankers to tolerate historically low levels of unemployment in the UK and the US in the 2010s.

There is, however, some evidence that the Phillips curve may have steepened during the post-pandemic recovery period, including in the UK, Spain, Italy and the euro area. But labour market tightness likely was not responsible for the surge in inflation (Ari et al 2023, Bernanke and Blanchard 2023). Instead, the recovery period was skewed towards goods consumption and ran up against significant supply constraints, and this led to the steepening of the curve (Gudmundsson et al 2024). In line with this, the IMF (2024) has concluded that when supply bottlenecks interact with demand pressures, this can steepen the relationship between prices and inflation. An important caveat is that, given the highly unusual conditions that national economies experienced during and after Covid-19 lockdowns, this evidence does not necessarily imply a permanent shift in the Phillips curve.

BOX 1: THE CHARACTERISTICS OF A ‘HIGH-PRESSURE’ OR ‘HOT’ ECONOMY

We define a ‘high-pressure’ or ‘hot’ economy as one that is expanding at the limits of sustainable macroeconomic capacity. Breaching the threshold of sustainable capacity is likely to trigger high inflation, as demand outpaces supply, the prices of goods and services rise rapidly, and inflation expectations become unanchored. This means that there are risks of running the economy hot. In economies that are operating below sustainable capacity, policymakers have more scope to raise output.

The main characteristics of an economy that is being run hot are as follows:

- **National economic output is growing faster than estimates of ‘potential output’.** The economy is growing beyond the theoretical limits of potential output, often estimated on past trends and based

on theoretical modelling. This measure is constructed to imply that the economy is expanding beyond what should be in line with low inflation.

- **Labour markets are 'tight'.** This means unemployment falls below its 'natural level', estimated to be where lower unemployment causes inflation. Alternative measures are historically high levels of vacancies, implying firms are struggling to find employees. Tight labour markets mean workers' bargaining power is higher and wages rise due to higher competition for labour.

DOES RUNNING THE ECONOMY HOT TRIGGER HIGH INFLATION?

Our analysis finds a weak correlation between an economy's 'output gap' and inflation (see figure 2.1). We draw on evidence from G7 countries during the 'great moderation' – the period of low inflation and solid growth between the mid-1980s and the financial crisis in 2007/08 – and before the pandemic. The output gap is a metric to show if an economy is above or below potential (see Box 2). A positive gap means it is above potential. It is thus a crucial indicator for macroeconomic policymaking.

BOX 2: MEASURING OUTPUT GAPS

The 'output gap' is the difference between what an economy is actually producing and what it *could* produce without stoking inflation. If an economy is running below that sustainable speed, there is slack; if it is running above it, it is 'overheating'.

The following structural factors drive the Bank of England's estimate of the UK economy's potential:

- technology
- labour supply and skills
- capital stock
- openness/trade.

The Bank of England uses a suite of measures to estimate the economy's output gap. Statistical filtering models split Gross Domestic Product (GDP) into a trend (potential) and a cyclical component (slack). Macro relationships between GDP, unemployment and measures of domestic inflation constrain these filters (Bank of England 2020). The Phillips curve relationship and an estimate of what the 'equilibrium rate of unemployment' is are other ways of deciding whether growth is 'hot' or 'cold'. The Bank of England started the 2010s with a relatively high assumed equilibrium unemployment rate, then watched unemployment fall far below it with limited inflation increase. In response, it decreased the equilibrium and explored why the Phillips curve seemed lower and flatter. It found a range of reasons, ranging from the role of 'hidden unemployment' (underemployment) and improved labour market matching, to more anchored inflation expectations (Cunliffe 2019)

But there are various criticisms of using the output-gap approach. For instance, it can misread one-off shocks as being permanent, as might arguably be the case at the moment. Conversely, financial booms can be dangerously misread as genuine productivity improvements, such as in the run-up to the 2007/08 financial crisis.

As a result, real-time output-gap estimates are famously error-prone and frequently revised away – and often the revisions are as large as the gaps themselves. For instance, the OBR's forecast for the UK's output gap in

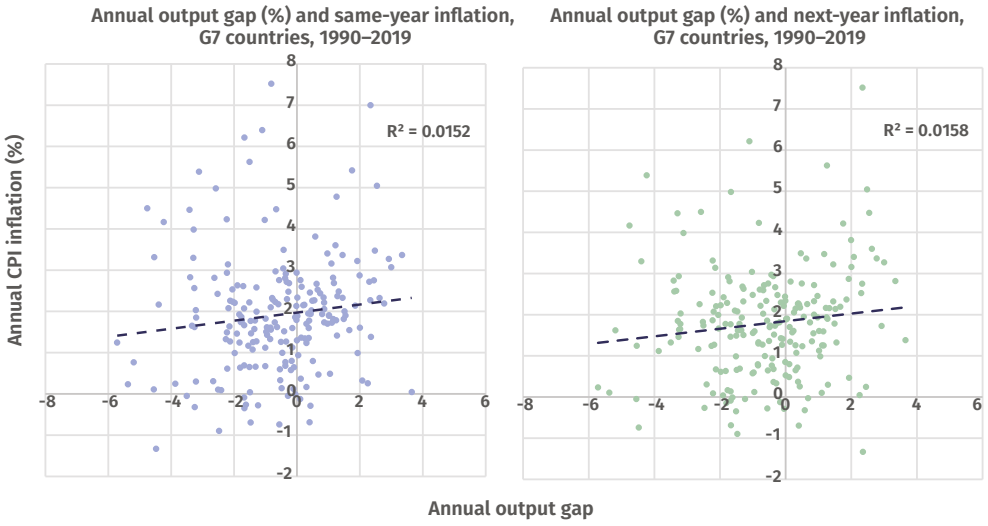
2024 changed from -0.7 per cent to -0.2 per cent of GDP between March and October 2024 (OBR 2024a, OBR 2024b). This was a huge change even though no major macroeconomic change had occurred. The OBR has also documented wide uncertainty across the methods deployed. The Bank of England now often leans into ranges and uses explicit uncertainty language.

This report adds to the debate around output gaps and their use in macroeconomic policymaking.

Figure 2.1 presents two scatterplots. One shows annual output gaps and same-year inflation rates for G7 economies during the 'great moderation' – a period, from around the mid-1980s to the financial crisis of 2007/08, of historically unprecedented stable macroeconomic conditions for many advanced economies – and before the pandemic. The other shows output gaps and next-year inflation rates, to take account of the lag in the inflationary impacts of high-pressure economic conditions. It shows a relatively flat relationship: above-potential growth was only weakly associated with higher inflation. This suggests that other factors were more important in this period when explaining high inflation.[1]

FIGURE 2.1: ABOVE-POTENTIAL GROWTH WAS NOT A MEANINGFUL CAUSAL FACTOR FOR HIGH INFLATION IN G7 COUNTRIES DURING THE 'GREAT MODERATION' AND BEFORE THE PANDEMIC

Annual output gaps compared to same- and next-year inflation rates for G7 economies, 1990–2019 (%)



Source: IPPR analysis of International Monetary Fund, *World Economic Outlook Database – April 2025* (IMF 2025a)

Note: CPI = Consumer Price Index.

Figure 2.2 maps out a timeline of when advanced economies have been growing significantly above potential, and when this has coincided with a **period of high inflation (red squares)** and when it was **not associated with higher inflation in**

1 This analysis reveals a different relationship between output gaps and inflation from that presented in Bunn et al (2025). The main difference is the sample: we focus on G7 economies during the 'great moderation' and before the pandemic, whereas Bunn et al looked at 38 countries (including emerging market economies) and included data from the post-pandemic inflationary spike.

the subsequent year (yellow squares). It shows that there have been a number of cases since the 1990s when there was high inflation but it did not trigger subsequent inflation.

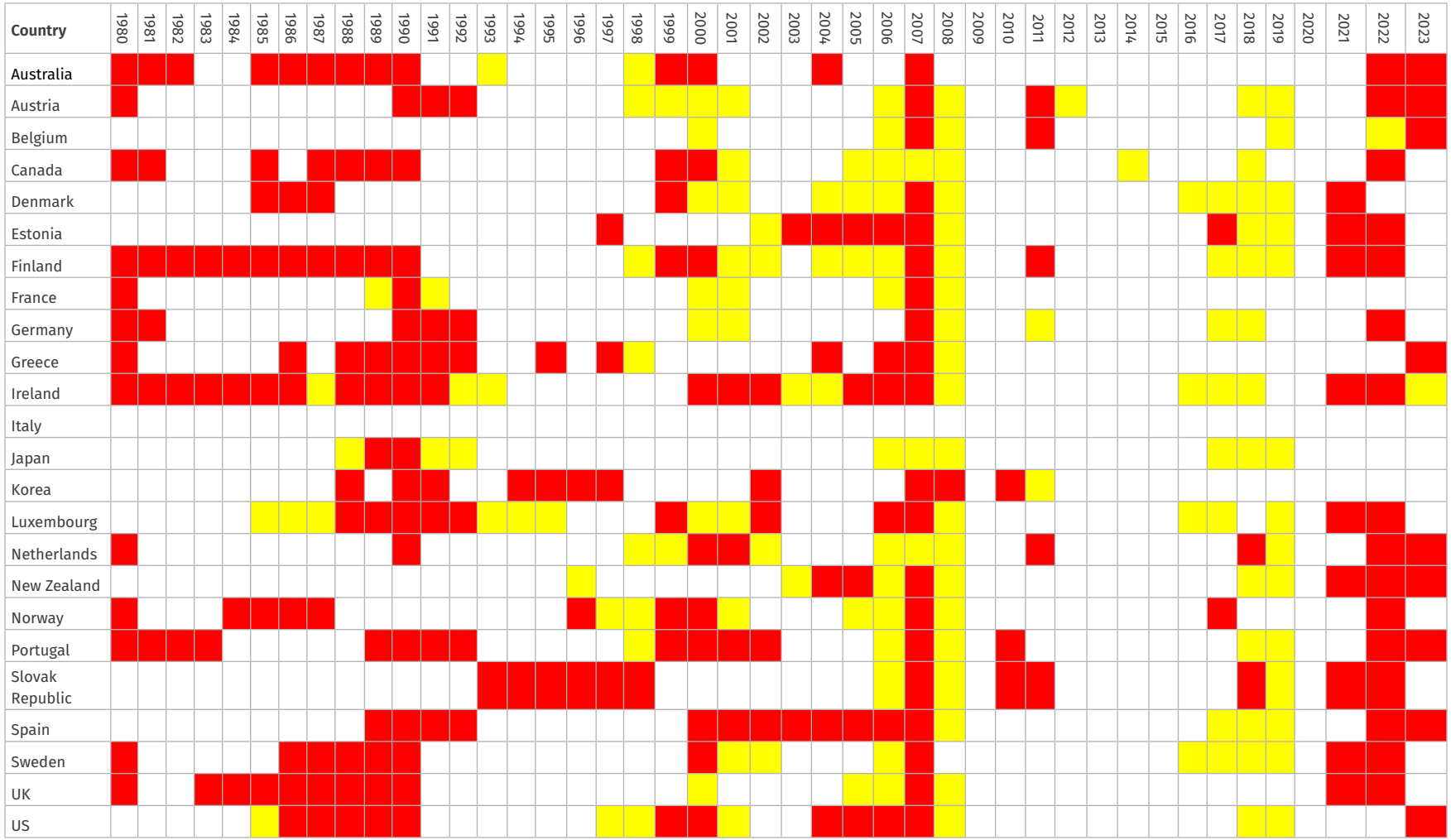
Figure 2.2 provides a perspective on economic history, as advanced economies moved from more volatile, inflationary economic conditions in the 1980s into the 'great moderation' – followed by years of relative stagnation after the financial crash in 2007/08. In the 1980s, running the economy hot and higher inflation were more commonplace, whereas from the 1990s onwards inflation was more under control and running the economy hot could go hand in hand with low inflation. For instance, in the US, president Trump's 2017 tax cuts ran the economy hot but this did not lead to higher inflation.

Figure 2.2 also shows that there are many instances of above-potential growth coinciding with high inflation in the following year. Yet given that these instances have become less frequent over time – particularly in the 2010s – this suggests that the link between output gaps and inflation has changed in some way.

It is important to note that running the economy hot was different in the 1980s, compared to more recent years. Output gaps (that is, growth above potential) were more than 5 per cent in many cases in the 1980s, whereas more recent episodes – such as before the Covid-19 pandemic – were much smaller. This supports the claim that the Phillips curve might be nonlinear, that is, running the economy hot 'a bit' might have positive effects, while running it 'too hot' could cause inflationary pressures.

FIGURE 2.2: IT HAS BECOME MORE COMMON FOR ADVANCED ECONOMIES TO GROW SIGNIFICANTLY ABOVE POTENTIAL WITHOUT TRIGGERING HIGH INFLATION

A timeline comparing significantly above-potential growth (output gap > 0.5 per cent) and next-year high inflation (> 2.5 per cent) in 24 OECD countries from 1980 to 2024



Key

Growing significantly above potential and high inflation (red)
Growing significantly above potential and low inflation (yellow)
Not growing significantly above inflation (no colour)

Source: IPPR analysis of International Monetary Fund, *World Economic Outlook Database – April 2025* (IMF 2025a)

THEORY AND EVIDENCE FROM THE 'HOT' US ECONOMY AFTER COVID-19

The US economy under president Biden ran hot after the Covid-19 pandemic, with fast growth and significant wage gains. This was partly the result of lockdowns being lifted, but the Biden administration also made a deliberate choice to run a hotter macroeconomic environment. The federal government stimulated the economy through the Infrastructure Investment and Jobs Act 2021 and aimed to increase demand and supply capacity in the medium term through the Inflation Reduction Act 2022 and the CHIPS and Science Act 2022.

Biden's treasury secretary, Janet Yellen, outlined the theory behind running a hotter economy. In her previous role as chair of the Federal Reserve, Yellen proposed that it might be possible to reverse the adverse supply-side effects of deep recessions "by temporarily running a 'high-pressure economy,' with robust aggregate demand and a tight labour market" (Yellen 2016).

The data from Biden's time in office suggests that Yellen's theory was largely accurate, and that the hot US economy did reverse the scarring effects of the financial crash for low-wage and disadvantaged workers (see table 2.1).

TABLE 2.1: BIDEN'S TREASURY SECRETARY, JANET YELLEN, WAS BROADLY RIGHT THAT THERE COULD BE BENEFITS FROM RUNNING A HOTTER ECONOMY

Treasury secretary Janet Yellen's theory of potential benefits from running a hotter economy (Yellen 2016)	Real economy trends during Biden's administration (2021–25)
Raising the productive capacity of the economy. Increased business sales would raise the productive capacity of the economy by encouraging additional capital spending.	Real GDP growth in the US was the highest among G7 countries in 2023. Productivity growth defied expectations of the business cycle. Both GDP and productivity growth exceeded public and private forecasts (Unkenholz and Shepherd 2025).
Improving labour market participation. A tight labour market might draw in potential workers who would otherwise sit on the sidelines, encourage job-to-job transitions and lead to more-efficient and productive job matching.	Unemployment decreased from 6.7 per cent to 4.1 per cent (Saul 2025). Labour market participation improved among mothers with young children (White House 2024b) and Black Americans (White House 2024a). There was three times more sectoral reallocation of workers in the US than in the euro area (Soyres et al 2024).
Reversing the scarring effects of recessions. Running the economy hot could reverse the labour market hysteresis of economic downturns.	Fast growth led to significant wage gains for US workers, especially those who had lost out in the period after the financial crash. Dube (2024) found that real wages exceeded pre-Covid-19 trends, while they stagnated or declined in other G7 countries besides Canada. Low-wage workers experienced particularly fast real-wage growth between 2019 and 2023 (Gould and deCourcy 2024). In the US, this reversed one-third of the rise in wage inequality since the 1980s (Autor et al 2024).
Incentivising business innovation. Strong demand could lead to significant productivity gains by prompting higher levels of research and development spending and increasing the incentives to start new, innovative businesses.	Under Biden, the rate of new business applications was 90 per cent faster than pre-pandemic averages (White House 2025).

Source: Authors' analysis

Some argue that the scale of the US 'fiscal stimulus' – that is, government action to boost economic activity, usually through tax cuts or more spending – may have pushed demand beyond sustainable limits, thereby inducing inflation, with

economic commentators such as Larry Summers (2021) warning at the time that this may happen. However, others have traced the source of inflation in the US to goods market shocks, rather than higher aggregate demand from the additional fiscal stimulus (Stiglitz and Regmi 2022). Bernanke and Blanchard (2023) argue that the main early driver were supply shocks, but that labour market tightness played some role in the latter part of the inflation episode. Even economies that deliberately ran their economies 'cold' in response to spiking inflation did not do materially lower in their inflation outcomes, pointing to the primary importance of supply shocks.

BOX 3: LOW-PRESSURE ECONOMIES DID NOT HAVE LOWER INFLATION AFTER THE PANDEMIC

There were also examples of countries that did not run their economies hot after the pandemic. Eight countries – Brazil, Chile, Hungary, New Zealand, Norway, Peru, Poland and South Korea – raised interest rates much earlier and more aggressively than the Federal Reserve and the European Central Bank. But despite this tighter monetary policy, inflation climbed to levels comparable to 'high-pressure' economies (*Economist* 2024).

3. LABOUR MARKET IMPACTS FROM RUNNING THE ECONOMY 'HOT' AFTER THE COVID-19 PANDEMIC

After the Covid-19 pandemic, many advanced economies experienced tight goods markets and labour markets. A global energy shock, a series of further supply shocks and supply mismatch in sectors that reopened after lockdowns induced high inflation. Post-pandemic inflation can be seen as similar to post-war inflation – the result of a rapid opening up of economies that were previously shut, where the supply side could not cope. Bernanke and Blanchard (2023) make this point clearly for the US case, highlighting, as noted earlier, that it was supply-chain disruptions that drove up inflation via goods markets in the US.

However, at the same time, high-pressure economic conditions translated into higher real-wage gains for workers in some countries. In this chapter, we present evidence since the pandemic on the potential effects of running the economy 'hot' for workers' wages. We present three core findings.

1. The US and Canada saw higher real-wage changes than other economies.
2. Low earners benefitted disproportionately from the post-pandemic economy in the US and the UK.
3. Switching jobs was a driver of real-wage increases.

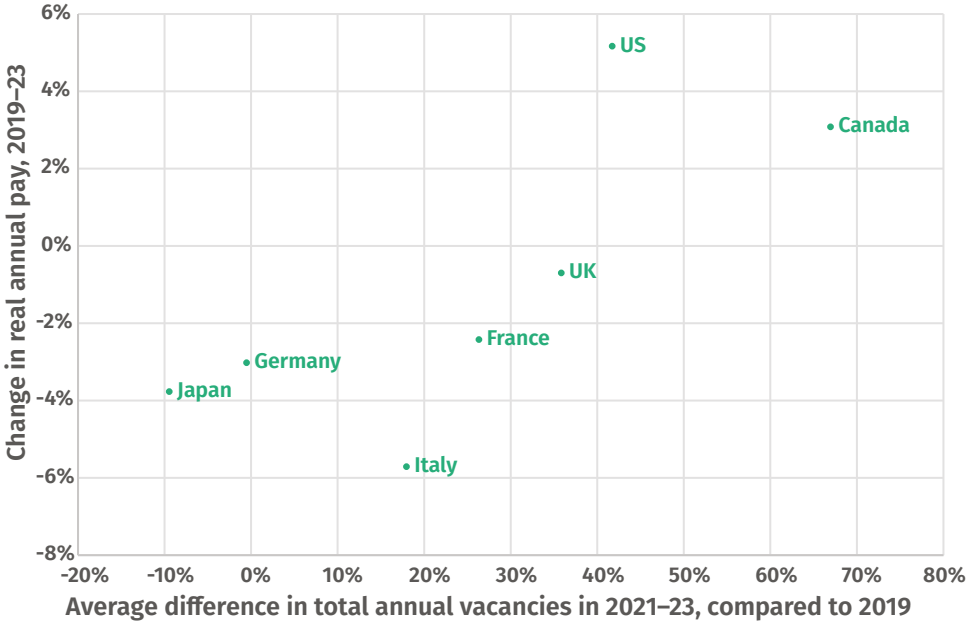
THE US AND CANADA SAW HIGHER REAL-WAGE CHANGES THAN OTHER ECONOMIES

One of the defining features of a hot economy is a tightening labour market, indicated for example by a rise in the number of job vacancies (demonstrating rising demand for labour). The US and Canada stand out as having larger increases in vacancies than other economies in 2021–23 compared to 2019, along with significantly larger real-wage increases (see figure 4). Across 2021, 2022 and 2023, they had vacancy rates that were, on average, 42 per cent and 67 per cent higher than the rate in 2019, respectively, while their real wages increased by 5.2 per cent and 3.6 per cent, respectively, between 2019 and 2023.

France, Germany, Italy and Japan did not see a similar degree of wage increase or run their economies that hot. Accordingly, real wages did not fully keep up with inflation. The UK is somewhere in between these countries and the US experience. The implication is that if, say, the UK and France had provided more macroeconomic support to their economies, wages could have kept up by more.

FIGURE 3.1: THE US AND CANADA SAW LARGER REAL-WAGE INCREASES FOR WORKERS

Percentage change in real annual earnings, 2019–23, vs the average difference in total annual vacancies in 2021–23 compared to 2019, for G7 countries



Source: IPPR analysis of France Travail, 'Les offres collectées et satisfaites par France Travail' (France Travail 2025), Istituto nazionale di statistica, 'Job vacancies – enterprises with employees' (ISTAT 2025), Office for National Statistics, 'VACS02: vacancies by industry' (ONS 2025c), Organisation for Economic Co-operation and Development, 'Average annual wages' (OECD 2025), Statistics Canada, 'Job vacancies, payroll employees, and job vacancy rate by provinces and territories, monthly, unadjusted for seasonality' (Statistics Canada 2025) and Trading Economics (2025) 'Japan new job offers' (Trading Economics 2025)

BOX 4: THE FACTORS LEADING TO THE STRONG POST-PANDEMIC RECOVERY IN THE US

It was not fiscal policy alone that led to the strong recovery from the Covid-19 pandemic in the US. Soyres et al (2024) and Pittaway (2025) found that the US labour market exhibited greater flexibility after the pandemic, with higher unemployment but also more sectoral reallocation of workers, potentially leading to improved productivity. The US also experienced higher business dynamism, with a surge in new business formation and lower bankruptcy rates, which likely supported the strong rebound in aggregate economic activity.[2] Gas prices in the US were also a quarter of those in Europe.

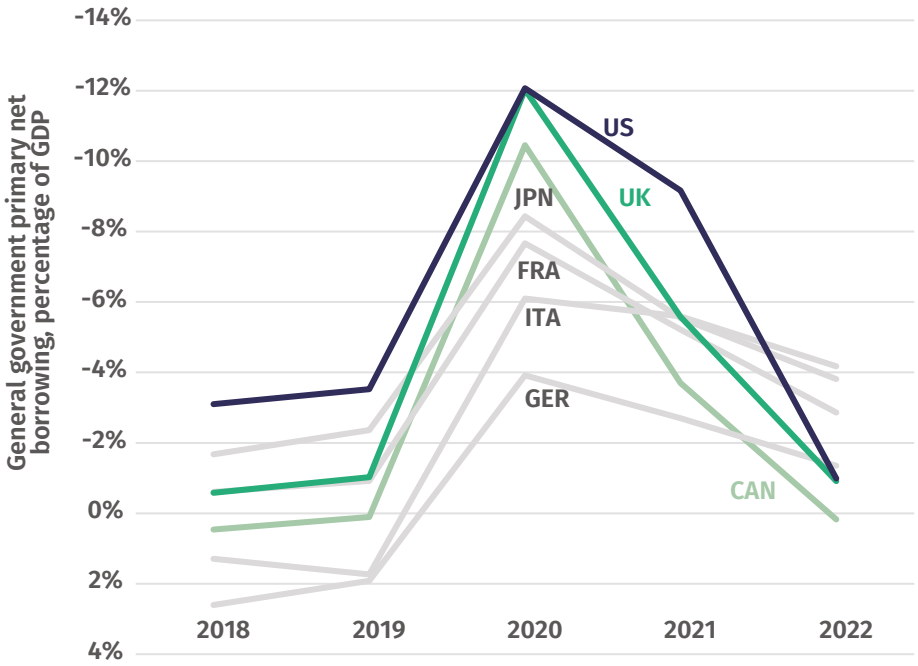
While the Biden fiscal stimulus was a key contributor to running the economy hot in the US, factors other than macro policy can be drivers too (box 4). The Canadian government did not run its economy hot through fiscal policy in a way that was comparable to the US: after having the third largest stimulus in the G7 in 2020, Canadian fiscal policy was rapidly tightened so that government borrowing as a proportion of Canada's economy fell to the lowest in the G7 by 2022 (see figure 3.2).

2 This was not just a post-pandemic trend. Pittaway (2025) found that the business investment gap between the US and the UK widened after 2016.

The Bank of Canada also raised interest rates in line with other central banks from March 2022 onwards. The Canadian government judged that reduced immigration inflows during the pandemic and structural changes in the labour market caused by lockdowns, not higher demand induced by fiscal policy, drove the rise in vacancies in the country (Government of Canada 2022).

FIGURE 3.2: CANADA'S FISCAL INVESTMENT DURING THE PANDEMIC YEAR OF 2020 WAS SIGNIFICANT, BUT BY 2022 WAS THE LOWEST IN THE G7

General government primary net lending/borrowing as a percentage of GDP for G7 countries, 2018–22, US 2022 projected



Source: IPPR analysis of International Monetary Fund, *World Economic Outlook Database – October 2025* **(IMF 2025b)**

LOW EARNERS BENEFITTED DISPROPORTIONATELY FROM THE POST-PANDEMIC ECONOMY IN THE UK AND THE US

We found that lower earners benefitted disproportionately from the high-pressure economy in both the UK and the US. Both economies experienced wage compression from 2019 to 2024, with lower-paid workers receiving greater hourly pay increases than higher-income workers (see figure 3.3).

This is a striking finding. The dominant narrative of the post-pandemic recovery period has been, understandably, the impact of high inflation on household budgets. But under the hood of this trend, there was a remarkable period of wage compression, which reduced earnings inequality. During the pandemic, low-paid workers in the UK made early gains relative to middle- and higher-income workers, which were sustained through this period.

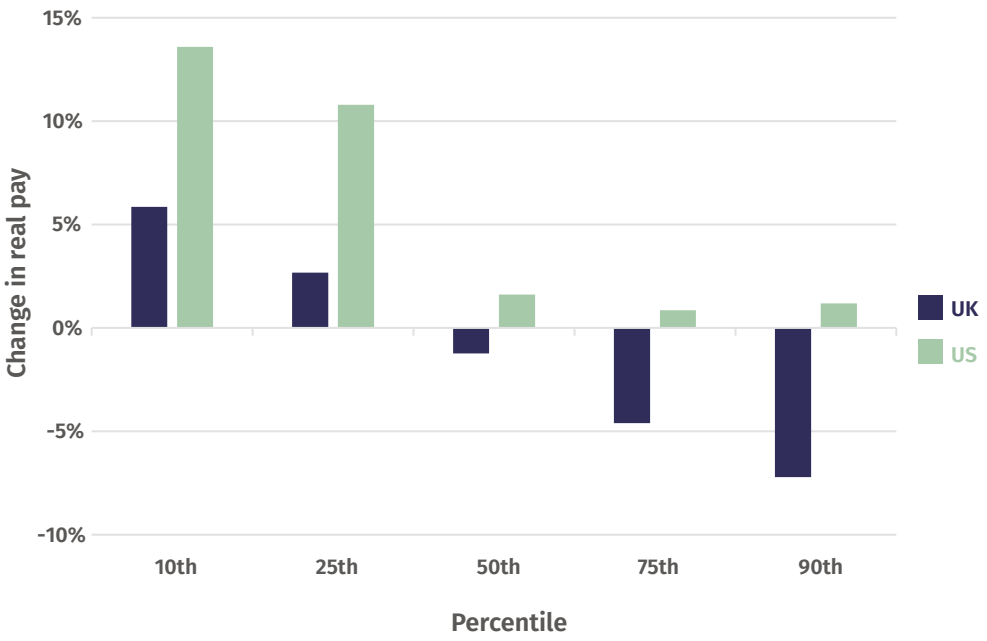
Workers across the income distribution received real-terms pay increases in the US, reflecting the strong performance of the US economy despite the inflationary pressures of the post-pandemic period. This was most pronounced for the bottom quarter of earners (see the annex). Dube (2025) found that strong wage gains for lower-paid workers have persisted into November 2025.

This means that the US economy is now, structurally, delivering higher wage gains for workers at the lower end of the labour market.

By contrast, during the same period, middle- and higher-income workers in the UK experienced a hit to their real-terms incomes.[3] So, there has been a compression in both countries – it was just more pronounced in the US. There are various factors that might explain the difference (including different labour market structures), but the slightly hotter economy in the US might be one factor.

FIGURE 3.3: BOTH THE UK AND THE US HAVE EXPERIENCED WAGE COMPRESSION SINCE THE COVID-19 PANDEMIC, BUT WORKERS' GAINS HAVE BEEN STRONGER IN THE US

Real hourly wage changes (%) in the UK and the US between 2019 and 2023 by wage percentile



Source: IPPR analysis of Office for National Statistics, 'CPI ANNUAL RATE 00: ALL ITEMS 2015=100' (ONS 2025a), Office for National Statistics, 'Earnings and hours worked, all employees: ASHE table 1' (ONS 2025b), US Bureau of Labor Statistics, 'CPI seasonal adjustment tables' (US Bureau of Labor Statistics 2025a) and US Bureau of Labor Statistics (2025b) 'Occupational employment and wage statistics (OEWS) tables' (US Bureau of Labor Statistics 2025b)

SWITCHING JOBS WAS A DRIVER OF REAL-WAGE INCREASES

In the US as well as in the UK, low earners shifted jobs at higher rates after the pandemic, achieving real-wage increases. Autor et al (2024) found that increasing labour market power for non-college-educated workers rose and led to them switching to more productive higher-paying jobs. They argue that the high-pressure economy had this beneficial effect, because it created the conditions for workers to leave their existing jobs, with more confidence that they might find more productive and higher-paying ones, often in other sectors. **This is a crucial new angle of looking at high-pressure economies: they increase**

3 These findings provide a different perspective to Corlett (2025), which found that living standards fell for the tenth percentile of households in 2023. The key difference is that Corlett's analysis focusses on real household disposable income, which includes people who are not in work. Figure 3.3 of this report focusses on real pay, so only captures those who are in work.

dynamism, which breaks up suboptimal equilibria. Autor et al (2024) found that job switching to higher-paying jobs was a key explanatory factor of pay growth, rather than in-job wage increases.

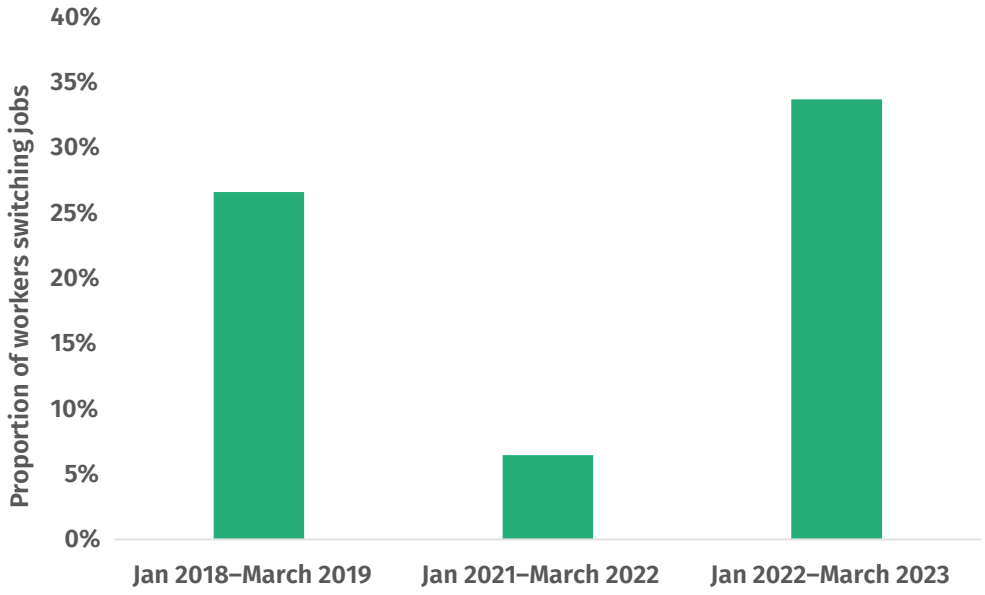
During the height of the pandemic, sectoral reallocation surged in the US to well above previous peaks. This reflected both the lack of support for existing jobs during the pandemic and the subsequent 'great resignation', whereby many workers gained from leaving their existing jobs and moving into higher-paying roles in more productive firms (Pittaway 2025).

In the UK, the Bank of England found that the number of workers moving between jobs increased sharply from the end of 2022 (Bank of England 2022). It is likely that low-paid workers were moving between jobs at particularly high rates. Low-paid workers were more likely to work in sectors that the pandemic had affected the most, particularly hospitality and non-essential retail. As coronavirus restrictions were lifted, vacancies in low-paying sectors recovered quickly (Francis-Devine 2022). The Institute for Fiscal Studies has found that job opportunities in the lowest-paid third of occupations were almost 20 per cent higher in June 2021 than two years earlier (Blundell et al 2021).

Our analysis confirms this story. Figure 3.4 shows that job switching increased by about 20 per cent between pre-pandemic and post-pandemic years (with a dip during the pandemic). This could explain part of the wage compression observed in the data presented above, in line with the mechanism that Autor et al (2024) proposed.

FIGURE 3.4: JOB SWITCHING INCREASED SUBSTANTIALLY FROM PRE TO POST PANDEMIC
PROPORTION OF WORKERS SWITCHING BETWEEN JOBS IN THE FIVE QUARTERS PRE AND THE FIVE QUARTERS POST PANDEMIC

Percentage of employees changing their four-digit occupation in a five-quarter period

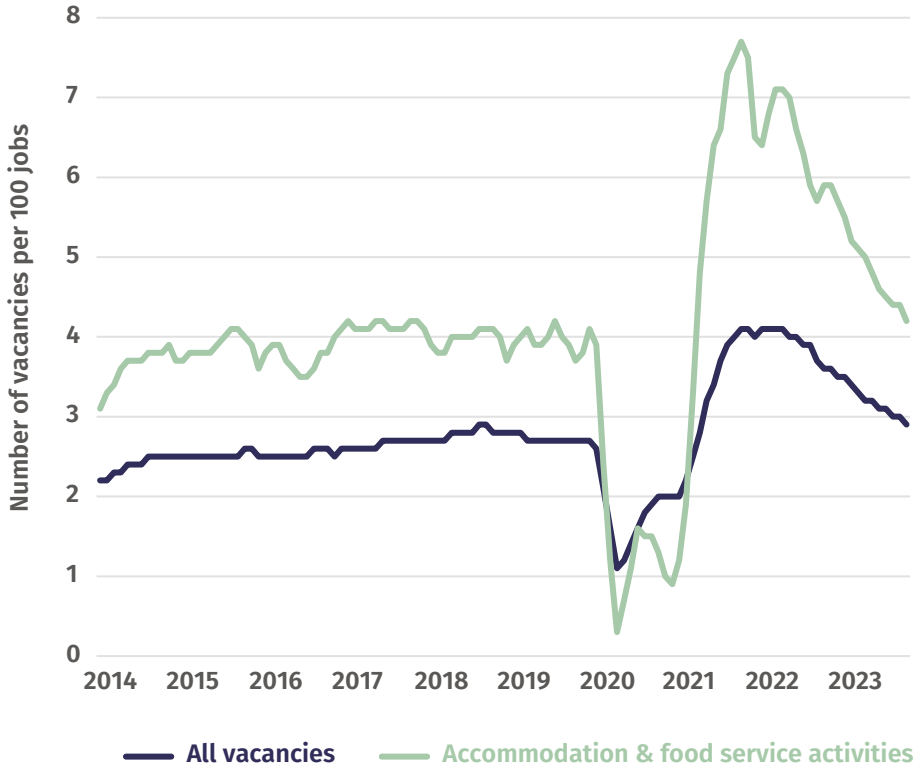


Source: IPPR analysis of the Office for National Statistics' five-quarter longitudinal Labour Force Survey (January 2018 – March 2019, January 2021– March 2022, January 2022 – March 2023)
Note: The Standard Occupational Classification system classifies jobs according to skill level and job role, producing a four-digit code.

This dynamic clearly played out in hospitality, one of the lowest-paying sectors in the economy. There was a sharp and sustained increase in vacancies in the sector as lockdown restrictions were lifted in 2021 and businesses that were previously forced to stay closed – such as pubs, restaurants, clubs and bars – began trading again (see figure 3.5). As a result of labour shortages, hospitality businesses were under pressure to increase wages and improve working conditions (Hutton 2022). UK Hospitality reported that many employers increased basic rates of pay in response to the tight labour market (BEIS Select Committee 2022). Average pay for a weekend and weekday shift reportedly rose by 9 per cent and 5 per cent respectively between 2019 and 2021 (Perrett 2021).

FIGURE 3.5: HOSPITALITY EMPLOYERS RAPIDLY INCREASED RECRUITMENT FOLLOWING THE PANDEMIC

Number of vacancies per 100 jobs, in the whole economy and in hospitality



Source: IPPR analysis of Office for National Statistics, 'VACS02: vacancies by industry' (ONS 2025c)

4. SHOULD POLICYMAKERS RUN THE ECONOMY 'HOT'?

The evidence presented in this report sheds new light on an old macroeconomic strategy. We have described cases that show that running the economy 'hot' does not necessarily cause inflation, thanks to a flattening of the Phillips curve during the 'great moderation' and up until the Covid-19 pandemic. While fiscal policy is not the sole cause of high-pressure economic conditions, increasing demand by loosening fiscal policy certainly contributes to a hot economy. After the pandemic, the scale of the US fiscal stimulus, and the propensity of US workers to switch jobs in the 'great resignation', drove huge wage gains for lower-paid workers. Wage compression also occurred in the UK, but real-wage increases were lower than in the US.

Arguably, in the US, the real wages of low-paid workers are higher than they would have been in the absence of a high-pressure economy. But at the same time, inflation and higher prices mean that people do not necessarily *feel* better off (Stantcheva 2024).

What can this tell us about whether macroeconomic policymakers should seek to run a hot economy? Should this be pursued to aid low-income workers? And can policymakers run the economy hot without causing inflation? In this chapter, we assess the evidence and present recommendations for government, central banks, independent forecasters and economists.

ASSESSING THE EVIDENCE ON RUNNING THE ECONOMY HOT

The evidence presented in this report suggests that macroeconomic policymakers might be able to run the UK economy hotter than previously thought, with potentially significant labour market benefits for lower earners and without causing excess inflation. It would also boost and help to sustain the equilibrium economic growth rate.

Our central recommendation is that macroeconomic institutions, such as the Bank of England and the Office for Budget Responsibility (OBR), should better reflect the potential benefits of running the economy hot in their models and forecast scenarios.

One way to model this is as a hot economy causing 'positive scarring effects'. As noted earlier, this is the flipside of 'negative scarring' – the idea that a prolonged period of below-potential growth negatively affects potential itself. In other words, running the economy 'too cold' hurts future growth. Positive scarring or 'economic momentum' means that running the economy hot now could boost growth in the future.

Some of the recent episodes of running the economy hot provide insights into how this could be better modelled. Autor et al (2024) concluded, in a detailed state-by-state analysis of the post-pandemic US economy, that running the economy hot caused job switching towards more productive jobs, and did not go hand in hand with higher inflation. Many macro models and their forecasts lack this insight.

More broadly, flatter Phillips curves and external supply-chain shocks mean inflation contains less information about whether or not the economy is at potential. Supply-chain shocks become increasingly relevant in a world of larger supply-chain volatility. Not confusing high inflation with a hot economy is thus crucial for developing the right policy stance. Standard tools used thus become less useful and should be complemented with additional tools that can account for recent outliers.

POTENTIAL CONDITIONAL FACTORS IMPACTING THE OUTCOMES IN POST-PANDEMIC YEARS

There are several factors that may undermine our 'run the economy slightly hot' argument. The unique conditions that lockdowns to stem the Covid-19 pandemic created, as well as the exceptional dynamism that US businesses and workers exhibited, must be considered before we draw any broad lessons from the evidence.

First, the pandemic may have created unique conditions that make it hard to draw generalisable lessons that can be applied in different macroeconomic conditions. As countries emerged from lockdowns, demand for labour increased sharply and the labour market tightened rapidly, even without policy stimulus. As figure A1 in the annex demonstrates, this led to wage compression in both the US – where policymakers deliberately ran the economy hot – and the UK – where they did not. The sharp contraction of labour demand when lockdowns were introduced, following by the rapid expansion of demand when they were lifted, was without much precedent in modern history.

Second, the US economy may be particularly well placed to reap the benefits of high-pressure economic conditions. The US has performed significantly better than the UK across a range of indicators (Pittaway 2025).

- **Dynamism.** The US saw an increase in business formation after the pandemic, particularly in services, while UK firm creation and the movement of workers to more productive firms remained subdued.
- **Investment.** The UK's private-sector capital stock (excluding real estate) has grown by less than that of the US in 22 of the last 26 years.
- **Tech adoption.** Between 2019 and 2023, professional, scientific and technical services –sectors that use rather than produce tech – accounted for a sixth (17 per cent) of the post-pandemic gap in productivity growth between the US and the UK.

This suggests that having these indicators in place is a condition for reaping the benefits of running the economy hot. Rather than an argument against a high-pressure economy, governments could seek to emulate these US conditions and combine them with more fiscal or monetary stimulus. And, finally, as our analysis in this report has shown, there are many historical episodes when countries ran their economies above potential but did not face excess inflation. Economists should study these episodes and establish whether they are anomalies, or whether we need a better theory of labour markets and aggregate demand.

LESSONS FOR THE UK

If our arguments set out above are right, then the UK should consider running a less restrictive macroeconomic policy now, all else being equal. But the current above-target inflation is a complication.

We recommend, therefore, that the UK should run a less restrictive macroeconomic policy in the future, when inflation expectations are at pre-pandemic averages. Both the Bank of England and the OBR have forecast negative output gaps over

the coming years – meaning a relatively 'cold economy' (Bank of England 2025, OBR 2025). **As a result, we risk leaving the economy 'too cold for too long'.** This could hurt future growth and lead to worse outcomes for workers. As we go into 2026, the Bank of England should thus loosen monetary policy significantly to boost growth and wages.

Ultimately, politicians will need to weigh the benefits of running an economy hot against the potential downsides. Running an economy hot can lead to higher growth, wage gains for low-paid workers, better labour market participation, more productive job switching and higher rates of business creation. However, the risks include higher inflation, scarring effects of job switching and the public's preference for low inflation and low wage increases.[4] More research is needed to work out the challenges and enabling conditions.

4 YouGov polling conducted for IPPR found that the UK public would prefer costs to fall and wages to remain flat, rather than wage growth and accompanying inflation, which may mean – as far as the public are concerned – that the economy should not be 'run hot' (Alvis et al 2025).

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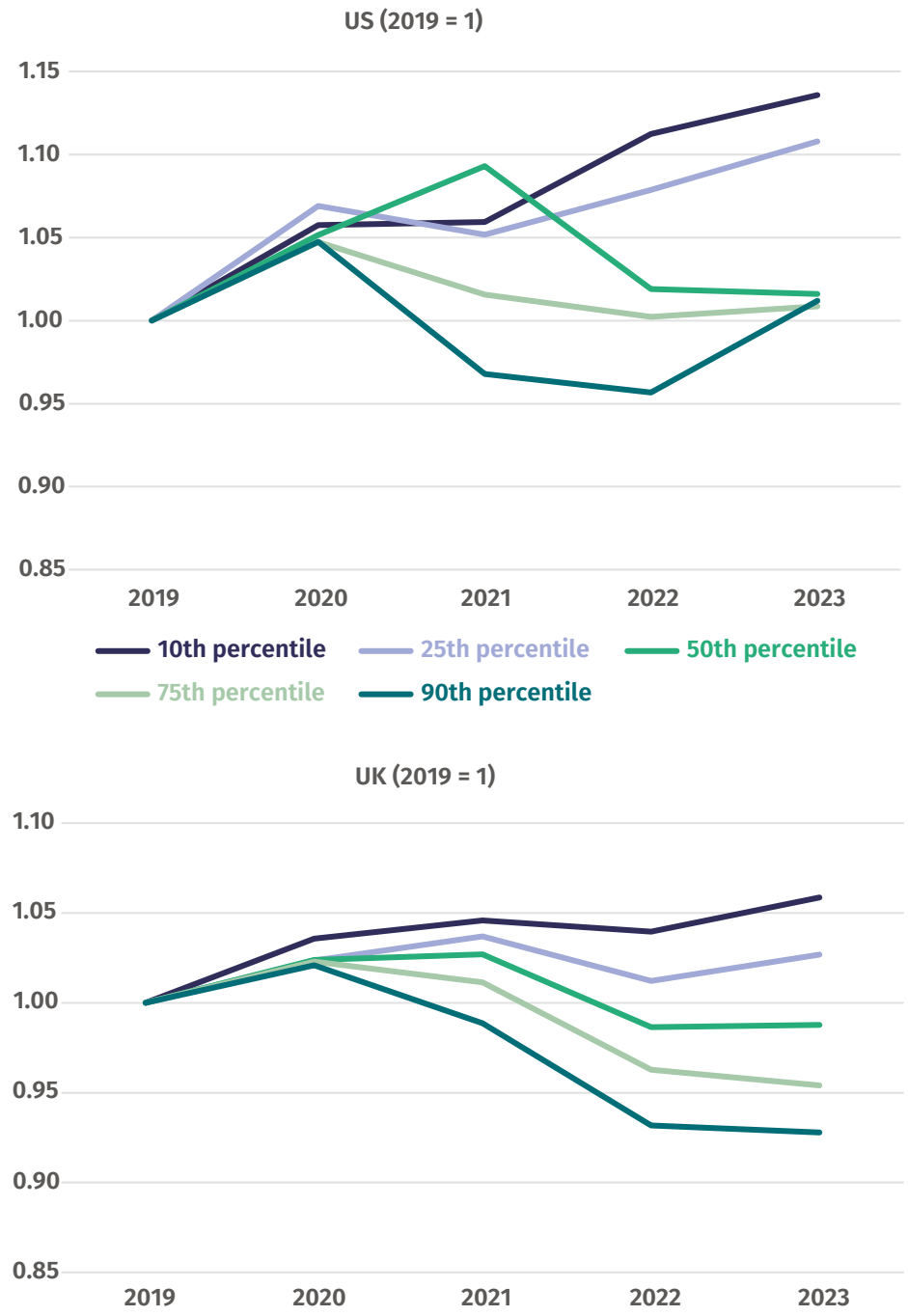
ANNEX

FIGURE A1: BOTH THE UK AND THE US ECONOMIES SAW WAGE COMPRESSION AFTER THE PANDEMIC

Nominal annual wage changes in the UK and the US by wage percentile, 2019–23



Source: IPPR analysis of Office for National Statistics, 'CPI ANNUAL RATE 00: ALL ITEMS 2015=100' (ONS 2025a), Office for National Statistics, 'Earnings and hours worked, all employees: ASHE table 1' (ONS 2025b), US Bureau of Labor Statistics, 'CPI seasonal adjustment tables' (US Bureau of Labor Statistics 2025a) and US Bureau of Labor Statistics, 'Occupational employment and wage statistics (OEWS) tables' (US Bureau of Labor Statistics 2025b)

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