GLOBAL ECONOMICS UPDATE

What explains the resilience of labour markets?

- **The recent resilience of labour markets partly reflects a lag before higher interest rates feed through fully to economic activity. But employment has also been supported by the industry-led nature of the economic slowdown and by the fact that firms are still trying to restore headcounts following pandemic-driven shortages. Both of these props seem more sustainable. Unemployment will probably rise in time, but if tightening cycles are as close to their peaks as we assume, the rise should be modest by past standards.**
- The aggressive monetary policy tightening cycles of the past 18 months have prompted fears of a slump in employment and surge in joblessness. But those fears have yet to materialise, with unemployment across advanced economies still as low as, or even lower than, pre-pandemic rates and employment growth now outpacing that of GDP in the G7. (See Chart 1.) We think there are four main reasons for this.
- **One is that the tightening has yet to take its full toll on general economic activity and hence on labour markets.** While there is ongoing debate and uncertainty over the length and variability of the lags (see here and here), conventional wisdom informed by many models is that interest rate hikes take around 18 to 24 months to take effect, with the impact on output being felt before that on inflation. A simple chart of UK interest rates and GDP growth bears out the 18-month hypothesis to some extent. (See Chart 2.) And as Chart 1 showed, employment usually moves more or less coincidentally with GDP.
- **Interest rates started to rise just under 18 months ago in the US and UK and under a year ago in the euro-zone. What's more, depending on your definition, rates did not rise into restrictive territory (i.e. beyond the neutral rate) until around 6 months ago.** So it is not that surprising that GDP and employment have held up reasonably well so far, particularly when you take into account that economies have been recovering from COVID at the same time.
- However, Chart 1 showed that the resilience of employment growth has been a bit unusual *relative* to the slowdown in GDP, so we need another explanation. **This brings us to the second possibility, which is that the sectoral make-up of activity has been supportive of employment.** In the advanced economies on average, manufacturing output fell by 1% during 2022, but services output *increased* by 2% - and the PMI surveys suggest that the divergence has widened since then. Since the services sector is relatively labour-intensive, this has benefitted aggregate employment. **In the US, service sector employment has been far more resilient than that in the manufacturing sector.** (See Chart 3.) A similar sectoral divergence in employment has been recorded in Germany, albeit not in the UK or Japan.
- **The third plausible reason is that firms are still trying to restore their headcounts to normal after the acute shortages experienced over the past two years.** Survey measures show that labour shortages surged during the pandemic as some people left the labour force and spending patterns shifted. (See Chart 4.) Partly because of that, employment only reached its pre-pandemic level late last year. (See Chart 5.) Ongoing shortages may still be limiting hiring, but they have also made firms wary of layoffs.
- **A fourth possible reason for the resilience of labour markets during the economic slowdown so far is that firms seem to have unusually strong pricing power and hence can afford to maintain their workforces.** We will explain in a forthcoming *Global Economics Focus* that profit margins have been more resilient than they would normally be given the rise in costs that firms have experienced in the past couple of years.
- So how long can this be sustained? There are already signs that labour markets are cooling, with job vacancy rates, quit rates, and hours worked coming down. **But given that we anticipate only fairly mild recessions with peak-to-trough falls in GDP of less than 1% in the US, euro-zone and UK, we are forecasting only small increases in unemployment rates.** (See Chart 6.) Our expectation is that as headline inflation and inflation expectations fall back, wage growth will ease nonetheless. (See here.) **But a key risk is that labour market resilience generates persistent core price pressures and forces central banks to stamp it out by keeping rates higher for longer.**

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Chart 1: G7 GDP & Employment (% y/y)

Chart 2: UK Real GDP & Bank Rate

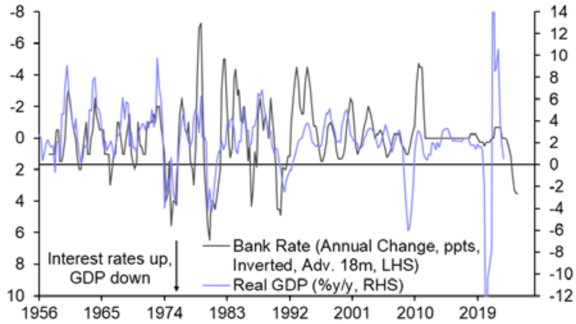


Chart 3: US Employment by Sector (NFP measure, %3m/3m)

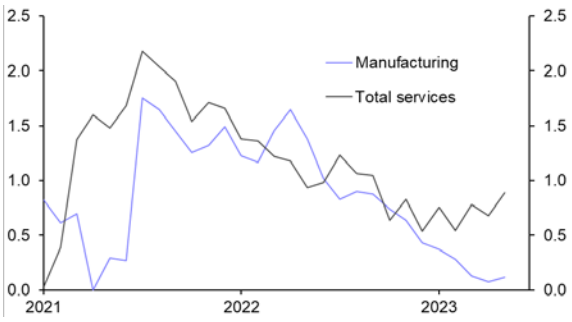


Chart 4: Survey Measures of Labour Shortages

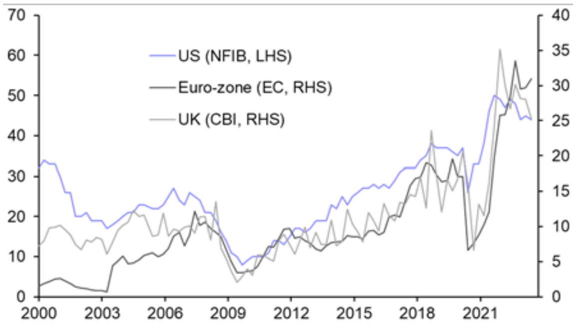


Chart 5: G7 GDP & Employment (Q4 2019 = 100)

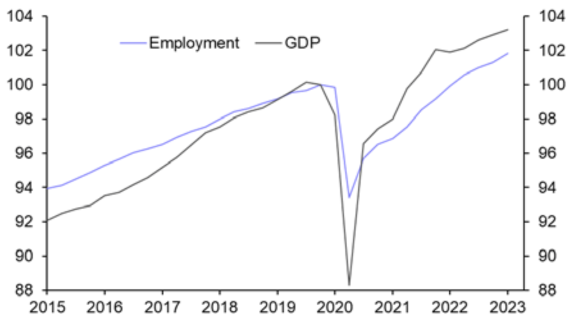
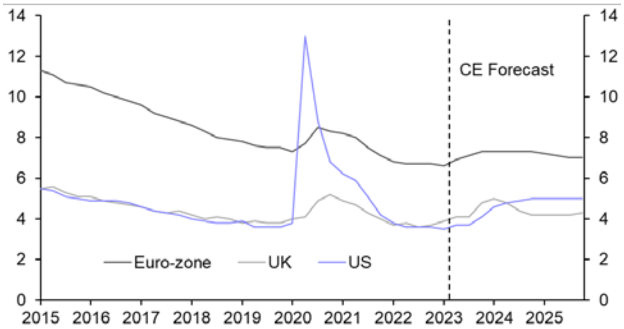


Chart 6: Unemployment Rate (%)



Sources: Refinitiv, Capital Economics

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