Global Economic Research

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Labor Force

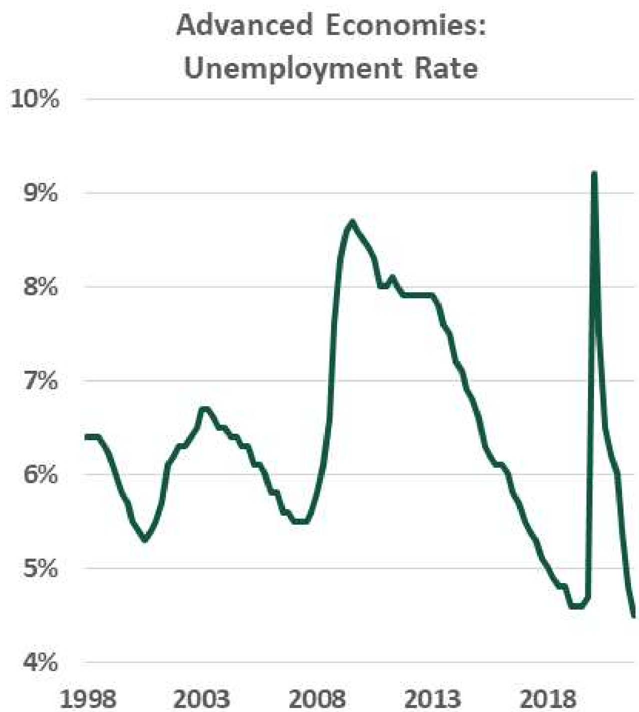
Labor shortages are driving wages higher, but a spiral is not imminent.

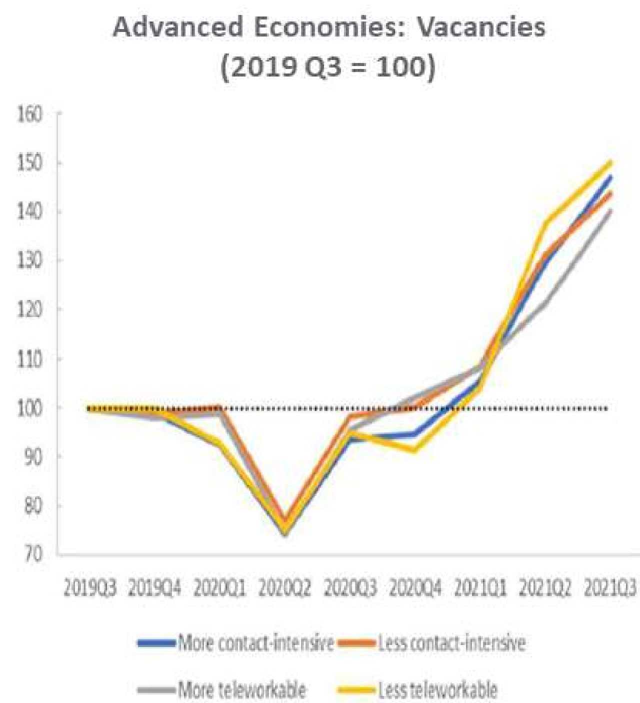
By Vaibhav Tandon

COVID-19 has caused dramatic changes in parts of the global economy which no government or corporate policies could trigger. The labor market is one such area: workers have regained leverage that they did not have prior to the pandemic.

The recovery in the world's labor markets has defied expectations. They are tighter than they were prior to the onset of the pandemic, particularly in the developed world. Across advanced economies, the average unemployment rate has declined from a peak of 9.2% in the spring of 2020 to a historic low of 4.5%. Unfilled job vacancies and vacancies-to-unemployment ratios are rising across sectors. Openings are at a record high in countries like the U.K., Germany, Canada and Australia, causing disruptions in business activities. According to a European Commission survey, the proportion of companies reporting labor shortages rose to a new record of 27.8% in April.

Strong demand for workers is being met with limited supply. Lower labor force participation has reduced the availability of talent, making it harder to fill positions. Generally, participation rates tend to fall during downturns and recover afterwards with economic expansion. Though tight labor markets are bringing workers back, participation rates in many countries have not fully recovered.





Sources: Haver Analytics, IMF

Health and family obligations have prevented some employees from returning to work. A rising share of workers in contact-intensive jobs switched professions or exited the labor force. As high inflation bites into household incomes and savings, more employees may re-enter the job market. However, long COVID could hinder the return.

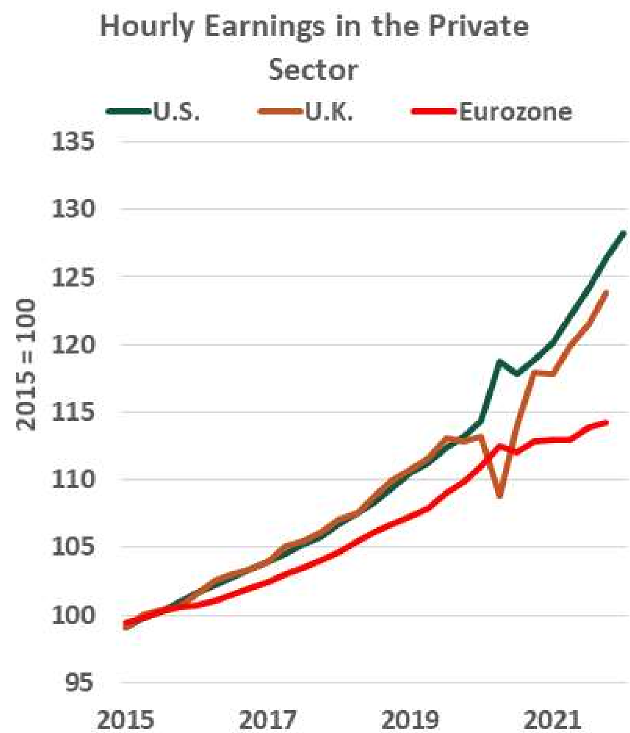
Older employees left the labor force for varying reasons. Apart from health, higher savings boosted by stimulus payments and wealth gains on the back of booming financial markets made retirement achievable for more employees. In Germany, older workers are retiring at a faster rate than younger ones are entering the job market. U.K. retirees' withdrawal accounted for one-third of the overall employment gap compared to pre-COVID levels in 2021. With financial markets having a rough year and stimulus concluded, workers from that age group could return to work.

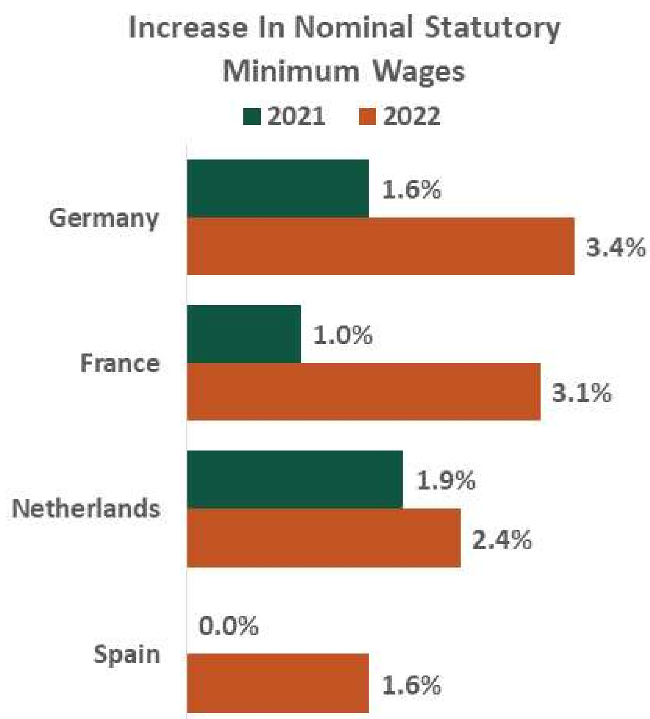
Border controls and limits on immigration have also played their part. Countries like Canada and Australia rely heavily on inflows of foreign workers. After the pandemic forced governments to shut down their borders, the number of admitted immigrants declined notably. In Britain, the shortages have been exacerbated by Brexit, which led to an exodus of European employees. More immigration will be needed to alleviate some pressure.

Labor force participation is still well below pre-pandemic levels.

Among advanced economies, a key factor that separates the tighter U.S. markets from the rest is that its business cycle is more advanced. American real gross domestic product surpassed its pre-COVID level in the second quarter of 2021. By contrast, output only reached 2019 levels late last year in Canada and the eurozone, and in the first quarter of 2022 in the U.K. Also, European job retention schemes helped maintain the relationships between employees and employers, which has limited turnover and kept more of a lid on wage growth.

Labor shortages, coupled with stubbornly high inflation, are driving up compensation. Workers have steered away from low-paying professions, forcing businesses to offer higher pay to fill vacancies. In the U.K., increased tightness in these industries has boosted wage growth by an estimated 6% over the past two years, as compared to 1.3% for other sectors.





Sources: OECD, Eurofound

In the U.K., nominal wages are growing faster than they were before the pandemic. Average weekly earnings grew 7.0% year-over-year in the first three months of 2022.

There are exceptions to the general tightness in global labor markets. Year-over-year wage growth in Australia has been rising for five consecutive quarters, but stands at only 2.4%. Earnings growth has remained muted in the eurozone; however, higher energy and transport costs will almost certainly prompt requests from workers for better terms.

Unions are leading the charge. Minimum wages in a series of countries have moved higher. France's minimum pay has risen three times in the past year. Germany's biggest union is seeking an increase of 8.2%. Given the market power now in labor's hands, firms may have only limited ability to resist. They might then resort to raising their own prices, which has created concern over inflationary loops that would be difficult to dislodge.

Some remuneration indicators are distorted by the effects of the crisis, such as the role of short-time work schemes. In the U.K., furloughed workers received 80% or less of their normal pay, thereby boosting growth rates as employees returned to full paychecks after September 2021.

Restarting immigration will be key to keeping labor markets in balance.

There are silver linings to tight labor markets. Rising wage growth, particularly among low-pay jobs, should help reduce inequality. This cohort has a high propensity to spend, which will add to demand as government support diminishes.

The recent swing in the pendulum toward labor has been encouraging. But as households' savings buffer depletes, health concerns fade and immigration returns to more normal levels, more workers will return to the jobs market, taking some steam off wage pressures. Labor's leverage may not last for long.

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Vaibhav Tandon is an Economist within the Global Risk Management division of Northern Trust. In this role, Vaibhav briefs clients and colleagues on the economy and business conditions, supports internal stress testing and capital allocation processes, and publishes the bank's formal economic viewpoint. He publishes weekly economic commentaries and monthly global outlooks.