12 May 2022

Understanding the economy and labour market

Learn how an understanding of the macro-economic context can inform HR practice

Introduction

The economic context affects how organisations recruit, retain and develop their people. There is a wealth of data out there, but making sense of where to look can be a challenge. This factsheet will help.

See the **full A-Z list of all CIPD factsheets**.

Why understanding the economy matters for people professionals

Economic conditions provide the background to the everyday business of HR. It determines how many people organisations need to recruit, retain and develop in order to meet customer demand.

In the UK, official statistics published by the Office for National Statistics (ONS) can help with this. Most statistics are backwards looking, however the pandemic has emphasised the need for faster indicators. Some commercial services scrape data from job websites (including adverts and candidate data) to give real-time insights into the jobs market.

Some statistics look forward. Our quarterly Labour Market Outlook survey collects data on pay and employment expectations from around 1,000 organisations. However, the most influential forecasts are contained within the Bank of England's monetary policy report, and the Office for Budget Responsibility's Economic and Fiscal Outlook that accompanies the government's annual Budget.

Within these reports you can find forecasts for key economic indicators such as unemployment, GDP, inflation, and wage growth. In recent years these institutions have invested heavily in user experience making their outputs much more accessible.

The impact of coronavirus and Brexit

The UK labour market has seen a remarkable jobs boom in recent years, reflected in record high employment rates. Under these conditions the labour market is said to be 'tight'. HR professionals will experience this as finding it more difficult to recruit and retain staff.

During the pandemic, the furlough scheme ensured that job losses were minimal. The labour market in the recovery looks much like it did in the pre-pandemic era. In addition to a tight labour market, inflation is higher than it has been seen for 30 years.

Brexit is also a major factor in any economic and labour market developments, including the introduction of new migration restrictions for EEA workers in January 2021. Our Brexit hub has more on the impact on employers and what the implications of leaving the EU might be for UK employment law.

Measuring the economy

'The economy' is shorthand for a myriad of relationships that help allocate human and other resources to the production, distribution and consumption of the various goods and services.

A combination of the relative demand for these goods and services and the relative supply of the resources required to produce them, determines their price (or market value).

Adding up the market values of all the things produced gives a total measure of the size of the economy, also known as total output or Gross Domestic Product (GDP). If GDP is bigger this year than last year, then the economy has grown.

The economy's output is constrained by consumer demand and inputs such as land, capital, energy and labour. Levels of output also depend on how well these inputs are used to produce goods and services – this is known as the productivity. A key measure of labour productivity is GDP per hour worked.

To improve productivity, organisations should constantly review their operations to take advantage of new ideas, machinery and software, new sources of labour and new ways of organising the business. Employee engagement is also key to improving productivity. As our report Productivity: getting the best out of people shows, companies that invest in skills and intelligently adapt modern management practices to the needs of the business tend to have superior productivity.

Economic growth and inflation

There's a limit to the level of GDP a country can achieve, also known as capacity or potential GDP. If the demand for goods and services exceeds potential GDP, there will be upward pressure on costs and prices, which means the rate of inflation will increase.

Inflation can go up or go down irrespective of the balance of demand and supply in the UK if there are big changes in commodities that the UK imports (such as oil). This is particularly relevant to the high inflation experienced in 2022.

The economic cycle

The term ‘economic cycle’ or ‘business cycle’ is a bit of a misnomer as it implies that the pattern of boom and bust are regular. They are not.

If economic growth is negative (that is, GDP falls) for at least two successive calendar quarters, this is known as a recession. At such a time, unemployment will rise and real wages will fall.

Economic stability

The amount of spare capacity in the economy is the gap between potential GDP and actual GDP at any given time.

The Monetary Policy Committee (MPC) of the Bank of England takes the estimated size of this output gap into account when deciding the appropriate level of interest rates, along with several other factors.

The MPC makes its decision independently of the government but is required to aim to ensure that the rate of inflation, as measured by the Consumer Price Index (CPI), stays close to 2% per annum.

Human resources in the labour market

The human resources that contribute to GDP are bought and sold in the labour market. The greater the amount and quality of human resources supplied to the market the higher the potential level of GDP. But this potential will only be realised if there's sufficient demand for these resources, which is itself derived from the demand for goods and services.

The market demand for labour is measured by the number of people in work (employment), how much they work (hours) plus the number of unfilled job vacancies. Supply is measured by employment plus the number of people who are looking for work (unemployment).

The balance of demand and supply in the labour market is reflected in the level (or rate of change) of wages. If demand is high relative to supply, earnings will rise. This will increase the cost of employing people which in turn will cause demand for human resources to drop, easing the upward pressure on wages. If, by contrast, supply is high relative to demand, we would expect employment costs to fall and hence increase the demand for labour.

In periods of relatively high demand, the labour market is ‘tight’. Unemployment will be low and there will be many unfilled job vacancies. When the supply of labour is relatively high, the market is ‘slack’ with few vacancies and lots of jobseekers.

Frictional and cyclical unemployment

There will always be some unemployment because jobs cannot be advertised and filled instantaneously, and it takes time for people to move from one job to another. This minimum level of unemployment is called frictional unemployment (commonly estimated at around 3-4% of the workforce). A higher rate of unemployment than this suggests that some human resources are going unused.

Unemployment tends to rise and fall over the course of the economic cycle and is referred to as a lagging indicator of the economy because it takes a while (normally about six to nine months) for a slowdown in demand for goods and services to translate into a fall in demand for labour. The unemployment that emerges in this way is called cyclical unemployment.

Full employment

An economy operating at full capacity with no cyclical or structural unemployment is said to be at full employment. This situation was close to the norm in the UK and most other developed countries in the 1950s and 1960s and some of the 1970s.

Full employment defined in this way implicitly assumes that everybody who can work or wants to work is participating in the labour market.

Useful contacts and further reading

For the latest national statistics:

Office for National Statistics – labour market statistics, updated monthly

For a local picture of the labour market:

Nomis - local area labour market statistics

For forward looking indicators:

Bank of England – Monetary policy reports

Office for Budget Responsibility – publications

CIPD – labour market outlook

Journal articles

CIPD members can use our online journals to find articles from over 300 journal titles relevant to HR.

Members and *People Management* subscribers can see articles on the *People Management* website.