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Understanding the economy and labour market

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

Introduction

The macro-economic context provides a useful indicator of labour market activity, which in turn shapes the scope of how organisations recruit, retain and develop their people in line with the wider organisational strategy. Being aware of the various interrelated factors within this dynamic, people professionals can monitor likely developments and adapt to changes with greater agility.

This factsheet introduces key economic terms and measures, including economic cycles, economic stability and economic growth and inflation, and how these link to changes in the labour market. It explores the relationship between human resources and the economic context, and highlights the need for HR professionals to understand how the economy works.

Why understanding the economy matters for people professionals

Economic conditions provide the background to the everyday business of HR. What happens in the macro economy, or in individual product and labour markets, ultimately determines how many staff organisations need to recruit, retain and develop in order to meet customer demand.

That's why it's important for organisations and people professionals to monitor the state

of the labour market and likely developments in the economy. In the UK, official statistics, mostly published by the [Office for National Statistics \(ONS\)](#), or evidence drawn from independent surveys can help with this. Most official statistics are backwards-looking and indicate how the economy has been doing. Independent surveys, such as those by the [Confederation of British Industry](#), the [British Chambers of Commerce](#) and the CIPD can provide intelligence on future market conditions. Our quarterly [Labour Market Outlook](#) survey collects data on pay and employment expectations from around 1,000 organisations in the private, public and voluntary sectors. However, the most influential forecasts are contained within the [Bank of England's quarterly inflation report](#), and the [Office for Budget Responsibility's Economic and Fiscal Outlook](#) that accompanies the government's annual Budget.

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 and low unemployment rates.

However, the COVID-19 pandemic has put significant pressure on the economy and labour market, which has led to employers adopting a variety of tactics to stave off redundancies, including recruitment freezes, redeployment and wage flexibility. Employers have received significant government support through the Coronavirus Job Retention Scheme (CJRS), otherwise known as furlough. The scheme has enabled employers to claim support for every employee that is furloughed to help them cope with the impact of coronavirus on the workforce and reduced business demand. Together with the UK's flexible labour market, the furlough scheme has helped limit the rise in unemployment. At the time of writing, the [UK unemployment rate was 5%](#), which is well below the consensus of economic forecasts. For more on what employers should be doing, see our [Responding to the coronavirus hub](#).

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 that people want or need.

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. The most commonly quoted measure is known as **Gross Domestic Product** (GDP). Not all goods, services and activities of economic value are bought and sold in markets. Estimates of the value of some non-marketed activities are included in GDP, such as providing public services, but other activities are not measured at all, such as much caring activity and work within the home.

The percentage rate of change in GDP over a given period, say a year or quarter, is a measure of **economic growth**. This is a key economic indicator since it shows the rate at which national income is expanding or contracting.

The level of output for an economy 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 that are valued by consumers or users of public services – this is known as the **productivity** of the economy. A key measure of labour productivity is GDP per hour worked. Based on this definition, for many years the UK's productivity has lagged behind rival economies - namely the USA, Germany and France.

Economic theory suggests that, to improve productivity, organisations should constantly review their operations to ensure that they can exploit innovative ways of doing things, taking 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 at any given time. This is called **potential GDP** and indicates the capacity of the economy to supply goods and services. 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).

Potential GDP is determined by a number of factors:

- The amount of work people are able and willing to do, which will depend in turn on

human resources (the size of the population, how many people in the population can or want to work, and how many hours they work).

- The amount of physical capital (machines, equipment, computers and so on) that people use in their work.
- The level of skill people use in their work which enables them to produce more in each hour of work.
- The state of technology and knowledge which improves the quality of the physical capital people use in their work.
- The range of techniques, including HR practices and wider people management, which enables individuals to produce more in each hour of work.

Change in any of these factors will affect potential GDP. Because there is usually underlying (positive) change in all or each factor, potential GDP tends to grow over time. This underlying rate of change is called the **trend rate of economic growth** or the **sustainable growth rate**.

The economic cycle

Potential GDP and the trend rate of growth cannot be measured directly, only estimated using data over a fairly long period. Most estimates have suggested that until recently, the UK had a trend rate of economic growth of 2.5 to 2.75% per annum.

The economy can only grow faster than trend without producing higher inflation if there is **spare capacity**. This develops during periods when demand for goods and services is less than the economy can deliver (that is, growth is below trend) and some productive resources, such as labour or capital machinery, are not fully used.

Periods when growth is below trend but still positive are commonly known as **economic slowdowns**. If growth is below trend but negative (that is, GDP falls) for at least two successive calendar quarters, this is known as a **recession**.

A complete period during which an economy moves from a position of full capacity, experiences an economic slowdown (or recession) and a recovery and then returns to full capacity is called an **economic cycle**.

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. Another way of looking at the MPC's role is to say that it aims to maintain **economic stability** – using changes in interest rates to smooth out (but not eliminate) economic cycles.

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 or 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 and salaries (earnings). If demand is high relative to supply, earnings will rise. This will increase the cost of employing people (assuming no change in their productivity) 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**, the resulting slack being closely associated with the output gap (see above).

Structural unemployment and labour market flexibility

In principle the existence of cyclical unemployment should cause the rate of growth of earnings to moderate and thereby create renewed demand for any unused human resources. Because of this the MPC closely monitors labour market indicators such as unemployment, vacancies and the rate of pay increases when making decisions on interest rates.

However, even when unemployment is high, the necessary adjustment of earnings may not always occur and unemployment may persist. This **structural unemployment** is more problematic than cyclical unemployment because it cannot be corrected simply by a cut in interest rates or extra government expenditure. The remedy is to improve the employability of job seekers, match them effectively to the vacancies available and minimise any barriers that stop this process from happening – often called improving **labour market flexibility**.

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. However, while this might have been a reasonable assumption a generation ago, today there is a much higher number (7.9 million) and greater proportion (more than 1 in 5) of people of working age who don't participate in the market, a group classified in official statistics as the 'economically inactive'. In addition, the UK labour market has had a large number of people who are underemployed, meaning they would prefer to work more hours than they do at present - including more than a million part-time workers who say they would like more hours.

Until 2020, the UK's unemployment rate had fallen to a record low. However, despite the gradual tightening of the labour market, this did not lead to wage growth during the same period, due in large part to the UK's lacklustre productivity. It also seemed that employers were not under a great deal of pressure from workers to raise wages, which may be partly

explained by the relatively strong labour supply being driven by welfare claimants, older workers and EU nationals.

Useful contacts and further reading

Contacts

[Office for National Statistics – employment and labour market statistics](#)

[The Economist – British economy](#)

[PwC – UK economic update](#)

[Deloitte COVID-19 Economics Monitor](#)

Books and reports

CLARKE, S. and COMINETTI, N. (2019) *[Setting the record straight: how record employment has changed the UK](#)*. London: Resolution Foundation.

UK COMMISSION FOR EMPLOYMENT AND SKILLS (2015) *[Growth through people: evidence and analysis](#)*. London: UKCES.

Journal articles

DAVIES, G. (2021) *[Employers and the Government are sleep-walking into a labour supply crisis](#)*. *CIPD Voice*. Issue 28, 21 April.

SUFF, R. (2020) *[Time to strengthen UK labour market enforcement](#)*. *CIPD Voice*. Issue 26, 16 November.

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This factsheet was last updated by Gerwyn Davies.