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Understanding the economy and labour market

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

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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. By becoming more aware of the various interrelated factors that exist within this dynamic, HR professionals can proactively monitor likely developments and adapt to changes with greater agility. In the UK, Brexit is now a major factor in any economic and labour market developments.

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.

CIPD viewpoint

HR professionals should keep up to date with changes in the labour market, so that they can ensure that the organisation in which they work is reacting appropriately to market conditions. HR professionals should use a number of the sources identified in this factsheet to keep in touch with developments to review their talent planning, resourcing and training strategies.

The jobs boom in recent years has put increased recruitment pressures on employers. And these pressures look set to increase from 2021 when migration restrictions are introduced for EU nationals. Government policy therefore needs to reflect rising skill and labour shortages by ensuring that the new immigration policy framework is streamlined, low-cost and not too restrictive, especially in terms of the planned skill and salary threshold. In addition, employer

investment in skills and adoption of flexible working policies will be key to determining the scale of skill shortages in the UK.

Why understanding the economy matters for HR

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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 HR practitioners to monitor the state of the labour market and keep an eye on likely developments in the economy. In the UK, official statistics, mostly published by the [Office for National Statistics](http://www.statistics.gov.uk/hub/labour-market/index.html) (<http://www.statistics.gov.uk/hub/labour-market/index.html>) (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](http://www.cbi.org.uk/business-issues/the-economy/) (<http://www.cbi.org.uk/business-issues/the-economy/>), the [British Chambers of Commerce](http://www.britishchambers.org.uk/qes) (<http://www.britishchambers.org.uk/qes>) and the CIPD can provide intelligence on future market conditions. Our quarterly [Labour Market Outlook](http://www.cipd.co.uk/knowledge/work/trends/labour-market-outlook/) (<http://www.cipd.co.uk/knowledge/work/trends/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](http://www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx) (<http://www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx>), and the [Office for Budget Responsibility's Economic and Fiscal Outlook](http://budgetresponsibility.org.uk/forecasts-in-depth/the-economy-forecast/) (<http://budgetresponsibility.org.uk/forecasts-in-depth/the-economy-forecast/>) that accompanies the government's annual Budget.

In the June 2016 referendum, the UK voted to leave the EU. Our [Brexit hub](http://www.cipd.co.uk/news-views/brexit-hub/) (<http://www.cipd.co.uk/news-views/brexit-hub/>) has more on what the implications might be.

Measuring the economy

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'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 the provision of 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 of time, 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 (more often the former).

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](http://www.cipd.co.uk/knowledge/work/productivity/motivating-people-report/) (<http://www.cipd.co.uk/knowledge/work/productivity/motivating-people-report/>) 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 that the rate of **inflation** will increase. Inflation can also 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 put in, 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 the wider management of [human capital](https://www.cipd.co.uk/443/knowledge/strategy/analytics/human-capital-factsheet/) (<https://www.cipd.co.uk/443/knowledge/strategy/analytics/human-capital-factsheet/>), which enables people 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

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Potential GDP and the trend rate of growth cannot be measured directly – they can only be estimated using data for a fairly long time period. Most estimates have suggested that the UK has a trend rate of economic growth of 2.5 to 2.75% per annum but this may have been reduced due to the after-effects of the financial crisis.

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 (as was the case in 2005) 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

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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 is 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 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.

The [UK's unemployment rate](https://www.ons.gov.uk/employmentandlabourmarket/peoplenotinwork/unemployment) (<https://www.ons.gov.uk/employmentandlabourmarket/peoplenotinwork/unemployment>) has fallen to a record low. However, despite the gradual tightening of the labour market, this has not led to wage growth during the same period, due in large part to the UK's lacklustre productivity. It also seems that employers are still not under a great deal of pressure from

workers to raise wages, which may be partly explained by a relatively strong labour supply which has been driven by welfare claimants, older workers and EU nationals.

Useful contacts and further reading

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Contacts

Office for National Statistics – labour market statistics
(<http://www.statistics.gov.uk/hub/labour-market/index.html>)

British Chambers of Commerce – economic data (<http://www.britishchambers.org.uk/policy-maker/economic-data>)

CBI (Confederation of British Industry) – the economy (<http://www.cbi.org.uk/business-issues/the-economy/>)

The Economist – British economy (<https://www.economist.com/topics/british-economy>)

PwC – UK economic outlook (<https://www.pwc.co.uk/services/economics-policy/insights/uk-economic-outlook.html>)

Books and reports

CLARKE, S. and COMINETTI, N. (2019) *Setting the record straight: how record employment has changed the UK* (<https://www.resolutionfoundation.org/publications/setting-the-record-straight-how-record-employment-has-changed-the-uk/>). London: Resolution Foundation.

CONFEDERATION OF BRITISH INDUSTRY and PERTEMPS NETWORK (2018) *Working together: CBI/Pertemps employment trends survey 2017* (<http://www.cbi.org.uk/news/employment-trends-survey-finds-businesses-set-to-create-jobs-in-2018-despite-uncertainty/>). London: CBI.

UK COMMISSION FOR EMPLOYMENT AND SKILLS (2015) *Growth through people: evidence and analysis* (<https://www.gov.uk/government/publications/growth-through-people-evidence-and-analysis>). London: UKCES.

Journal articles

BOYS, J. (2019) *Is the [UK] labour market a good news story?* (<http://www.cipd.co.uk/news-views/cipd-voice/issue-17/labour-market-good-news-story/>). *CIPD Voice*. Issue 17, 7 March.

BRINKLEY, I. (2017) *Enablers and inhibitors for future growth of the gig economy*. (<http://www.cipd.co.uk/news-views/cipd-voice/issue-11/>). *CIPD Voice*. Issue 11, 21 August.

PARTINGTON, R. (2017) *UK economy in 2018: steady growth tempered by Brexit politics* (<https://www.theguardian.com/business/2017/dec/31/uk-economy-in-2018-steady-growth-tempered-by-brexit-politics>). *The Guardian*. 21 December.

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This factsheet was last updated by Gerwyn Davies.



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Gerwyn is the CIPD's Public Policy Adviser for a wide range of labour market issues. With lead responsibility for welfare reform, migration and zero-hour contracts at the CIPD, Gerwyn has led and shaped the policy debate and achieved substantial national media coverage through various publications. These include *Zero-hours contracts: myth and reality* (2013) and *The growth of EU labour: assessing the impact on the UK labour market* (2014).

In addition Gerwyn authors the CIPD's high profile and influential quarterly *Labour Market Outlook*. Gerwyn is an experienced labour market commentator, making regular appearances in the national media and on other public platforms, including several appearances before the House of Commons Work and Pensions select committee.

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While employers seem to be shaking off any Brexit related uncertainty, this hasn't extended to pay despite a tightening labour market.

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