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Commentary

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Tightening labour markets fuel inflationary pressures

Philip Cross

Overview

The labour market continued to tighten in November and employers found it increasingly difficult to find qualified workers. As a result, wages for newly-hired employees are accelerating even as employers are accepting less qualified workers. Hiring workers at higher pay may seem positive for the economy, but can often translate into lower productivity which raises unit labour costs. This reinforces the upward pressure on inflation while eroding our ability to compete with firms in the United States.

Introduction

Canada's labour market was on fire in November. Employment soared by 154,000, four times faster than the consensus forecast. This lowered the unemployment rate from 6.7 percent to 6.0 percent – close to its pre-pandemic level of 5.7 percent in February 2020 and fast approaching its all-time low of 5.4 percent (Figure 1). The employment rate reached a record high of 84.6 percent for women aged 25 to 54, who show no signs of being unable to find employment because they have to take care of young children, while also remaining near historic highs for men. The employment rate for young people returned to pre-pandemic highs. Older people were the only group whose employment rate lags, mostly because a significant number of them

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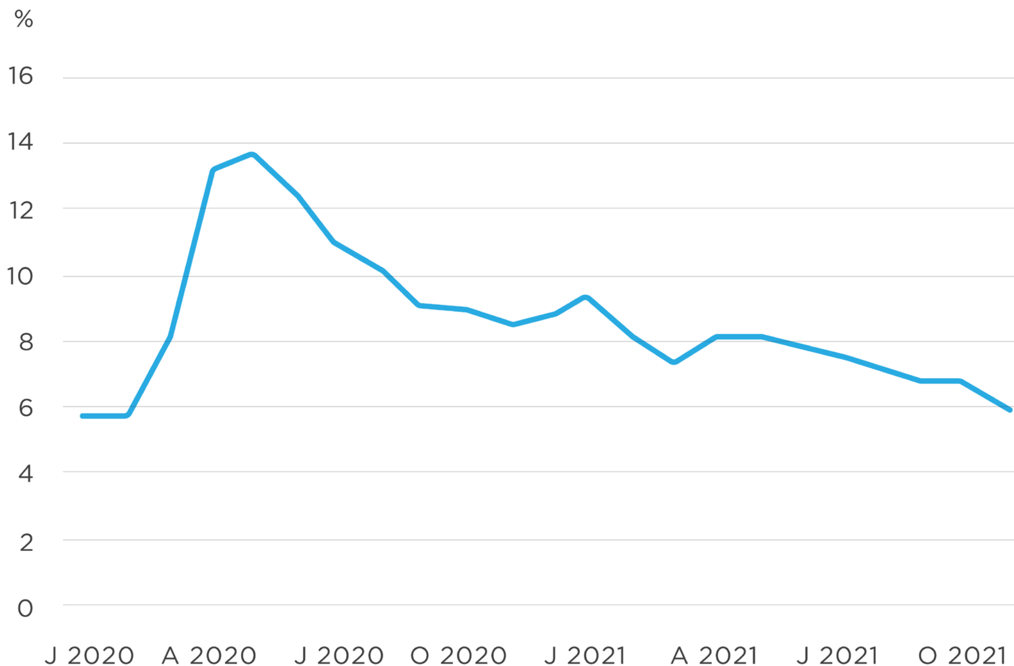
chose to retire during the pandemic. It is noteworthy the November surge of employment followed the end of the government's Canada Relief Benefit (CRB, the successor to the Canada Emergency Relief Benefit introduced at the start of the pandemic) in October.

Figure 1: Unemployment rate (January 2020 to November 2021, adjusted for seasonality)



Source: Statistics Canada 2021d

Employers offer higher wages to new hires

Beyond the headlines about jobs and unemployment, many of the details in the monthly labour force survey reveal labour shortages are worsening. Statistics Canada's analysis took the unusual step of breaking out wages for newly-hired and established employees.[1] This revealed hourly wages for new employees were 10 percent higher in November than two years ago, versus only 6.4 percent higher for established employees (the comparison extends to 2019 to avoid the distortions introduced during the pandemic in 2020).

The increase in wages for new hires shows the upward pressure on wages exceeds the weak 2.7 percent annual rate cited by some analysts.[2] Employers are in the difficult position of having to pay more for new employees while trying to hold the line on wages paid to their existing labour force. Firms also use incentives such as hiring bonuses to attract new hires as well as higher wage rates. Bonuses are captured by Statistics Canada's data on total labour compensation but not in narrow measures such as average hourly earnings.

The broader measures of compensation were rising at a 5 percent annual rate in the third quarter, nearly twice the rate of increase for hourly earnings. Eventually, established employees are likely to react to the higher wages being paid to new hires and demand similar increases, especially as they see their own purchasing power being eroded by higher prices. The Consumer Price Index rose 4.7 percent in the past year, and there are several reasons to believe this understates inflation in the current environment of shortages and stock-outs (Cross 2021, 5).

It is revealing that the gap in wage hikes between new and established employees is wider in industries with high rates of unfilled jobs (the vacancy rate). This reflects how industries with high vacancies are having to pay more to attract new hires. For example, the accommodation and food industry has the highest vacancy rate of any industry at 14.4 percent, and wage rates for new hires in this industry rose 8.5 percent versus 2.3 percent for established workers since November 2019. The gap between wage hikes for new versus existing workers was even higher for nurses in the health care industry, with wages for new hires soaring 20.5 percent while established workers posted a gain of only 2.3 percent. The increase in wages for newly-hired nurses lifted their hourly pay to $35.40, close to the $40.47 for established nurses.

The narrowing gap between pay levels for new hires and established workers poses a major challenge for employers who were trying to fill a record 1 million vacant positions as recently as September (Statistics Canada 2021a). Employers must balance the need to attract new people to fill the record number of vacant positions with adequately compensating long-time employees for their loyalty and experience, all while keeping a watchful eye on the competitiveness of their business. The problem for firms is that once the wage rate for established workers is raised, their total wage bill increases substantially and will be hard to reverse given the near impossibility of implementing wage cuts without devastating employee morale. The reluctance of employers to extend sharply higher wages to established employees means that higher labour costs are not yet embedded in the economy, giving the Bank of Canada the opportunity to dampen inflation by tightening monetary policy early in 2022.

Job qualification standards are falling

A shortage of qualified candidates is also leading employers to lower the educational requirements for some jobs. Employment in occupations usually requiring a university degree expanded by 12.3 percent (or 490,000 people in absolute terms) over the past two years (Statistics Canada 2021b). However, people with only a high school education or less filled 73,000 of these jobs, an increase of 43.4 percent. Overall, 19.1 percent of unemployed people with at most high school education in October suddenly found a job in November. This testifies both to the growing need of employers to fill vacant positions as well as how the end of the government CRB program is restoring the incen-

tive to find a job. Meanwhile, employment in occupations usually requiring at most a high school degree fell by 2.2 percent (or 151,000 people), implying employers were finding it increasingly difficult to fill low-skill jobs as some of their potential labour force shifted to more lucrative occupations.

One of the more puzzling developments during the pandemic has been a steady decline in the number of self-employed people. The number of self-employed remained depressed after little change in November and down 8.7 percent since February 2020. The weakness in self-employment mostly reflects that they are choosing to become employees. In November, 14.2 percent of self-employed workers shifted to become employees. This remains close to its peak rate of 16 percent in the middle of 2020 and well above its pre-pandemic average of 11.0 percent. The increased job security and higher average wages offered by larger employers may be more prized than ever due to the uncertainty associated with the pandemic. The downside is that less self-employment means fewer start-ups of new firms and represents a further retreat from risk-taking in Canada's economy, which needs more risk-taking, more competition from new firms, and more innovation.

Labour productivity suffers, unit labour costs soar

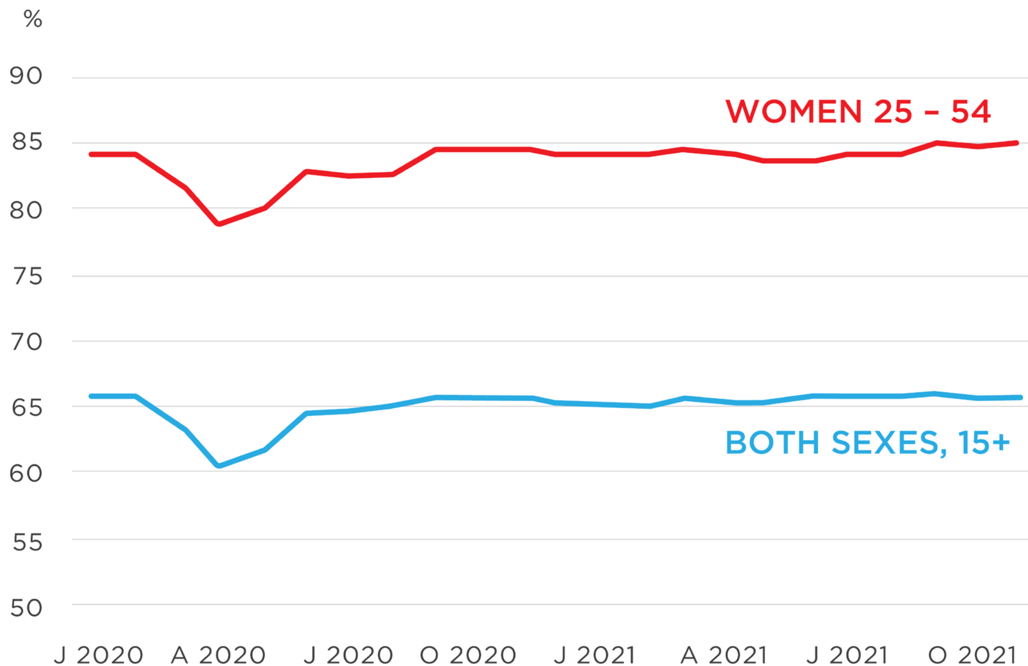
In a separate report released on the same day as the labour force survey (Statistics Canada 2021c), Statistics Canada reported labour productivity in the third quarter was 5.4 percent below its level a year earlier. This is consistent with employers having to settle for new workers with fewer qualifications. A similar phenomenon of low productivity associated with labour shortages was evident in 2007-2008 and again in 2014, especially in Alberta. Meanwhile, labour productivity in the United States fell by just 0.6 percent over the past year. Productivity in both countries was weighed down by a shift in the composition of jobs to low productivity industries (such as accommodation and food, and arts and recreation), where many businesses re-opened over the summer as the pandemic receded.

With productivity falling and wages rising in Canada, unit labour costs rose 6.2 percent in the past year. For employers, this is the key measure of the increase in their labour costs. The pressure on exporters is even greater, as unit labour costs measured in US dollars jumped by 12.3 percent in the past year, compared with a 5.0 percent rise in unit labour costs in the US.

Labour force participation has fallen during the pandemic

Despite the proliferation of job vacancies, falling unemployment, and rising wages for new hires, the number of people in the labour force is not expanding quickly enough to prevent labour shortages. One reason the unemployment rate fell so sharply in November was the participation rate was unchanged, despite strong demand for workers and the end of CRB support from government. Since the pandemic began in February 2020, the labour force participation rate has fallen from 65.5 percent to 65.3 percent.

Figure 2: Participation rate (January 2020 to November 2021, adjusted for seasonality)



Source: Statistics Canada 2021d

The drop in the labour force is concentrated in older workers. The participation rates for core-aged workers (25-54) have risen above its pre-pandemic level while younger workers recouped all their losses during the pandemic. The participation rate for core-aged people 25 to 54 years old was 88.2 percent in November, up from 87.3 percent before the pandemic. As noted earlier, this includes a record 84.6 percent of women in this age group (Figure 2). For youth 15 to 24 years participation was 64.9 percent, equalling its rate just before the pandemic. By comparison, the participation rate for people 55 years and older has fallen from 37.9 percent before the pandemic to 32.1 percent in November (Statistics Canada 2021d).

About the author

Philip Cross is a Munk Senior Fellow at the Macdonald-Laurier Institute. Prior to joining MLI, Mr. Cross spent 36 years at Statistics Canada specializing in macroeconomics. He was appointed Chief Economic Analyst in 2008 and was responsible for ensuring quality and coherency of all major economic statistics. During his career, he also wrote the "Current Economic Conditions" section of the Canadian Economic Observer, which provides Statistics Canada's view of the economy. He is a frequent commentator on the economy and interpreter of Statistics Canada reports for the media and general public. He is also a member of the CD Howe Business Cycle Dating Committee.

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Endnotes

1 Newly-hired are defined as on the job for three months or less; established employees have job tenure of three months or more. Wages are measured by average hourly earnings. See Statistics Canada (2021b).

2 For example, BMO said "Wage growth accelerated from 2% y/y to 2.7% y/y, not worrisome yet, but clearly trending higher." See Reitzes (2021).

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