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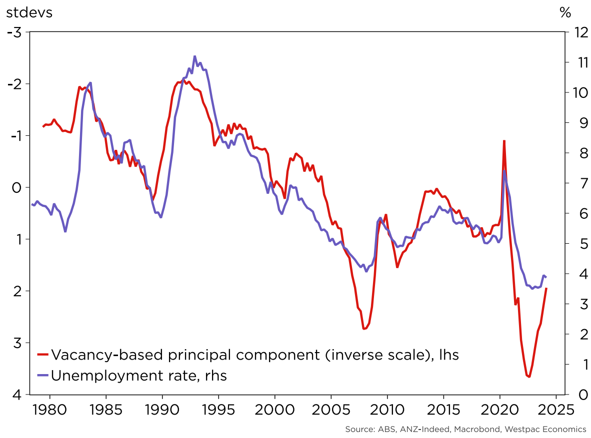
AUSTRALIAN LABOUR MARKET BULLETIN

How tight is the labour market still?

Key points

- Ongoing low unemployment rates have led some people to think that the labour market remains as tight as it was a year ago.
- Job vacancies and ads data suggest that labour market tightness has in fact unwound considerably.
- For some countries, the decline in vacancies occurred without much of an increase in unemployment. This lines up with predictions from earlier Fed research.
- US, UK and possibly Australian job vacancies rose even higher than their usual relationship with unemployment. This might suggest a supply shock as well as the usual curved relationship.
- For Australia, at least, the supply shock – closed international borders – has largely faded.

Unemployment and Tightness Measure



'... it matters whether events have been driven by demand shocks or supply shocks.'

How tight is the labour market still?

Luci Ellis
Chief Economist, Westpac Group

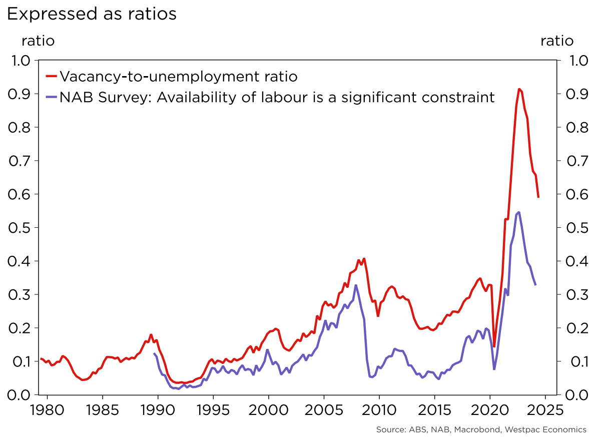
Labour markets tightened significantly as advanced economies opened up after the pandemic. It took time for the networks of workers and firms to stitch themselves back together. Since then, unemployment rates have remained low, leading some observers to conclude that labour markets remain as tight as in the immediate aftermath of the pandemic. Another lens on the labour market, though, uses measures of open positions such as job ads or surveyed job vacancies. One way of visualising this view of labour market tightness is the ratio of vacancies to unemployment. This ratio spiked to historical highs but has since declined rapidly. We can conclude that this ratio is capturing something meaningful because its short-term movements correlate so closely – almost unreasonably so – with other survey measures of labour availability.

Within that ratio, vacancy and unemployment rates tend to move in opposite directions, in a relationship known as the 'Beveridge Curve', named after the economist who first identified it. Normally this relationship is fairly stable, although it is a curve as shown here, not a straight line. (This is because, as the pool of unemployed shrinks, it becomes proportionately harder to find someone for a particular vacancy.) In the aftermath of the pandemic, though, vacancies increased well beyond what even the low unemployment rates of the period would have suggested. The shift in both the position and slope of the curve is exactly what one would expect if 'matching efficiency' – the ability of firms to find suitable workers amongst all applicants – had declined.

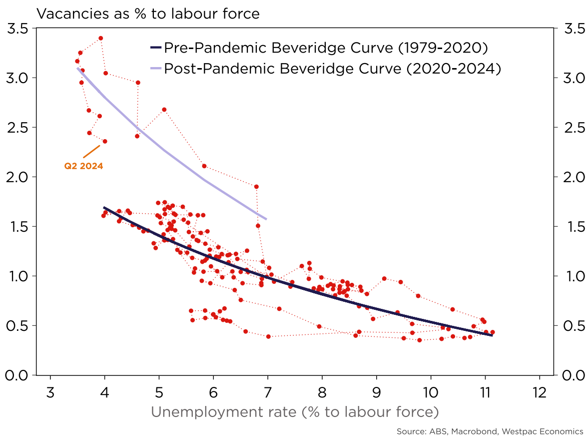
One way to reconcile this gap is to see the additional vacancies as representing labour market tightness that the remaining unemployed cannot meet, for example because there are always some people who have just started searching for a new job. These extra vacancies can be thought of as representing a 'shadow' decline in the unemployment rate in such periods.

Another explanation for the gap might stem from some data issues. ABS suspended publishing the vacancies data during the last period of tightness in the labour market in 2007–08. Fortunately, job advertisement data capture this period and move closely with vacancies at other times. These do, however, suggest that the ABS measure might be overstating labour market tightness recently relative to that earlier episode.

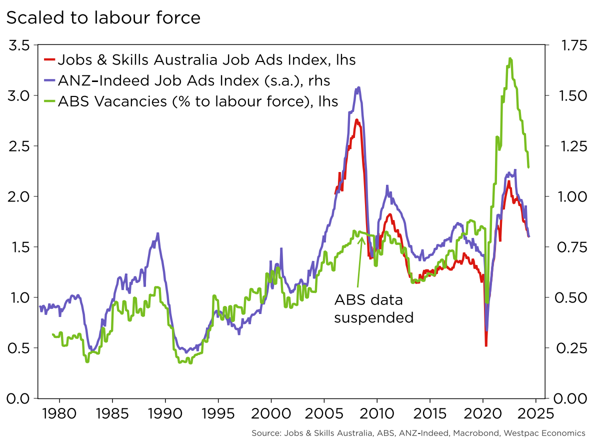
Measures of Labour Market Tightness



Australia's Beveridge Curve



Job Vacancies and Advertisements



We can avoid the issues with the ABS data over that period by condensing this information into a single vacancy-based measure of labour market tightness. One way to do this is with standard statistical techniques for extracting common factors such as principal components analysis. It turns out that most of the time, this measure moves closely with the unemployment rate – though of course with the opposite sign. During the two periods of labour market tightness in 2007–08 and following the pandemic, it spiked well below unemployment rate before returning quickly. This is mostly because the Beveridge Curve is a curve not a straight line. Using this measure of vacancies or the NAB survey measure rather than the ABS measure alone, we see *no* significant shift in the Beveridge Curve.

While the 2007–08 episode did involve an increase in unemployment, the excess vacancies had mostly resolved before unemployment increased. That increase in unemployment might not have been 'needed' to reduce vacancies; it was the result of the Global Financial Crisis occurring when it did.

Look beyond your borders

Both periods suggest that an episode of unusually high vacancies can resolve without requiring much of an increase in unemployment. This lines up with the 2022 prediction by Federal Reserve Governor Chris Waller in a paper written with Fed economist Andrew Figura. At the time, his argument was hotly contested by leading academic economists including Olivier Blanchard and Larry Summers. But the data for a number of countries have seemingly vindicated Waller's thesis.

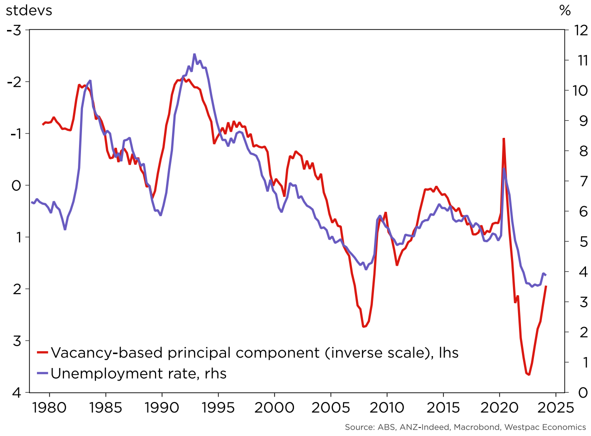
In the United States and (to a lesser extent) Canada, vacancy rates and related composite measures are, like Australia, broadly back in line with the level implied by the unemployment rate without seeing much of an increase in unemployment. For the United Kingdom, there is a way to go before pre-pandemic levels are reached, but again, the gap has largely closed without a material increase in unemployment.

The Dutch labour market is tight, but the Beveridge Curve looks stable and vacancies have declined without unemployment rising much, just as Waller and Figura predicted. Germany never got to the same extremes on vacancies, and so has seen unemployment increase by more as vacancies declined. Likewise, the French and Swiss Beveridge Curves have been stable recently, and never reached the steep part of the curve.

Curves versus shifts

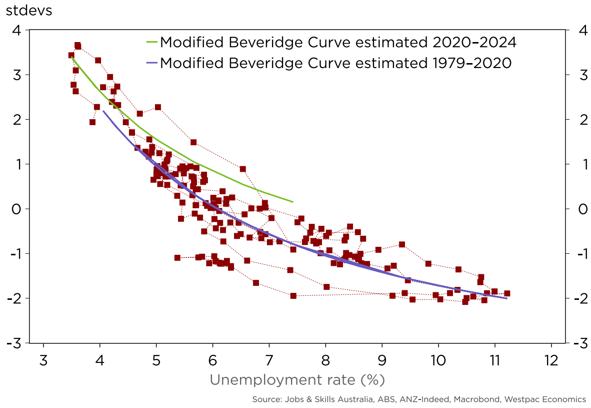
It turns out that the two camps were arguing about different things. Waller was making a statement about the shape of the Beveridge Curve; Blanchard and

Unemployment and Tightness Measure



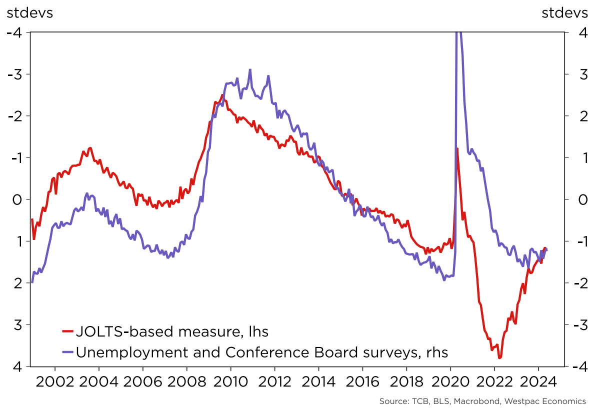
Modified Beveridge Curve

Using principal component analysis for vacancies and job ads



United States: Labour Market Tightness

Using principal components analysis



Summers were claiming that matching efficiency had deteriorated and thus the Beveridge Curve had shifted out. Both could be correct about these points. But then the question needs to be: what caused the decline in matching efficiency and will it last?

With this in mind, I couldn't help noticing that the estimated matching efficiency in the Blanchard, Domas and Summers paper looks a lot like the US participation rate over the same period. What we are in fact seeing is a labour supply shock, borne in the US case out of health concerns and the extended school and childcare closures in parts of the country, which has healed only slowly. Similarly, the UK participation rate has lagged because of Brexit and lingering long-term illness since the pandemic. That might imply that lower matching efficiency – and higher vacancies and wages growth – will persist in the United Kingdom even if it does not elsewhere. And it helps explain why the curves have remained stable in some European countries where participation did not fall in the same way.

If part of your workforce withdraws for non-financial reasons, that is a negative supply shock. Matching efficiency will necessarily deteriorate in that situation. The key question is, will that shock reverse, and what will it take to make that happen?

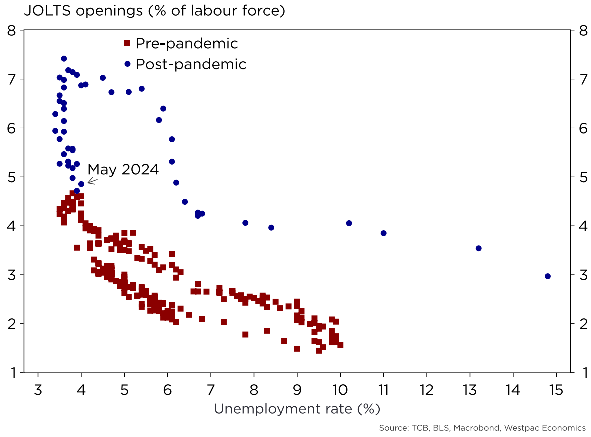
In Australia, the story is a little different. Participation has risen considerably since the pandemic, reaching a 114-year high late last year. Here, the labour supply shock was the international border closure. That shock is resolving itself now. We should therefore expect vacancies and job ads to decline, as indeed they have done. We should also expect estimates of 'matching efficiency' to improve along with business survey measures of labour market tightness. We should also not be surprised that wages growth is already past its peak even though unemployment has not risen much. It turns out that unemployment is not the only margin of adjustment.

Lessons from this debate

The debate and its aftermath highlight some lessons about interpreting economic data in unprecedented times. Firstly, it is perhaps unwise to conclude that, if something has not happened in 70 years in one country, it could never happen. One should check whether other countries' data point to the same conclusion.

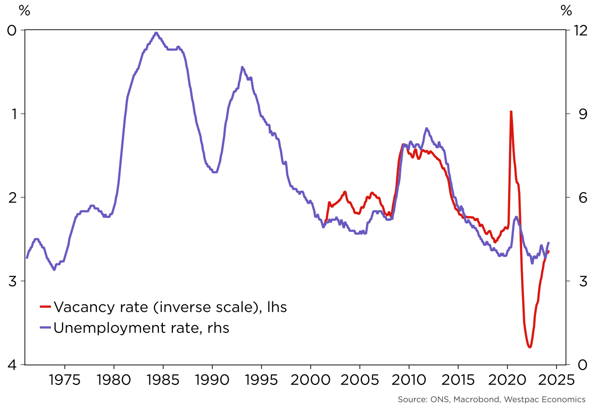
Secondly and more importantly, it matters whether events have been driven by demand shocks or supply shocks. If demand shocks dominated in the past but we now face a supply shock, the past might not be a good guide to the near future. It is essential to understand the nature of the shock and how long it might last.

United States: Beveridge Curve



United Kingdom: Labour Market Tightness

Per cent to labour force



A technical note

Thanks to Ryan Wells for the Beveridge Curve graphs for Australia and helpful discussions.

The principal component for vacancies in Australia uses ANZ–Indeed data, seasonally adjusted by Westpac Economics and scaled to the labour force as published by the ABS, together with the ratio of ABS vacancies to the labour force.

In the time series graph for the United States, we have used principal components, using the JOLTS openings and voluntary quits series scaled to the labour force for the vacancy-based measure, and the unemployment rate and the Conference Board household survey's index of whether jobs are seen as hard to get for the unemployment-based measure. The simpler measures of openings and the unemployment rate work just as well but make for a messier graph. Beveridge Curve graphs for the other countries mentioned are available on request.

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