Is Canada’s labour market too robust?

Employment growth has remained strong in the past few months. With the slowdown in economic growth, more modest job creation could be expected. Otherwise, labour productivity and, ultimately, corporate earnings, could suffer. Several factors are reining in adjustments in the labour market, however, meaning that employment could continue to grow at a fairly sustained pace in the quarters ahead. That said, despite the current uptrend, we are not immune to more disappointing results by this spring.

JOB CREATION IS QUITE STRONG

In a previous Economic Viewpoint, we showed how employment data can be highly volatile. To analyze the results of the Labour Force Survey, using a 6-month moving average was recommended.

The data gathered these past few months were very positive in terms of employment. Among other good news, December ended with 31,200 new jobs while 56,300 new jobs were reported in November. Since August, Canada’s labour market has been boosted by 183,900 new jobs, meaning that, on average, 26,800 new jobs have been created each month for the past six months. Thus, the deceleration in the 6-month moving average recorded last summer has been reversed, with an upswing at the end of 2012 (graph 1).

EMPLOYMENT GROWTH CONTRASTS SHARPLY WITH WEAK ECONOMIC GROWTH

Fairly strong employment advances stand alone against other economic variables, which instead highlight the many difficulties currently hindering Canada’s economy. For example, real GDP increased by just 0.6% (quarterly annualized) in the third quarter of 2012 and the preliminary data point to about a 1% gain for Q4. This is fairly weak growth from a historical standpoint and clearly below the growth potential of Canada’s economy which the Bank of Canada (BoC) estimated would be 2% in 2012.

As graph 2 on page 2 shows, employment growth is usually in tune with economic growth. However, there can be a significant difference at times between the annual change in employment and annual change in GDP, resulting in major jolts in labour productivity. Generally speaking, when production growth outpaces employment growth, it usually leads to improved labour productivity. Conversely, when employment outshines production, it usually signals that labour productivity has deteriorated.

Graph 1 – The labour market is still robust

| Source: Statistics Canada and Desjardins, Economic Studies |

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Yet, annual employment growth has just eclipsed annual output growth. In these conditions, one should expect productivity gains made since 2010 to start eroding and make way for deteriorating labour productivity. This is clearly bad news for Canada’s economy as Canadian companies’ competitiveness has been spiralling downwards for the past few years due to increased unit labour costs and, to a greater degree, the increase in the loonie’s value.

This loss of productivity could have major repercussions on corporate earnings. It bears reminding that several factors influence corporate earnings—price levels, the health of the economy, advances in input costs and salaries, and capital and labour productivity. As a result, any significant deterioration in labour productivity usually translates into a slowdown in corporate earnings. Corporations could respond by investing more to modernize their installations in an effort to reduce labour intensity in their production processes. This adjustment would be facilitated by the high level of corporate liquidities, weak interest rates and a soaring loonie, which would reduce the cost of imported machinery and materials. This of course would also translate into much lower demand for workers.

Employment Growth Poised to Slow Down
Most forecasters agree that the current weakness in Canada’s economy will continue for a few more quarters. On one hand, support from domestic demand is on the wane, the real estate market is starting to trend downwards and government spending is going head to head with budget deficit battles. On the other, the recession in Europe and weak demand in the United States—with fiscal issues and the public debt ceiling casting shadows—will continue to hinder international trade.

Under these circumstances, the gap recently noted between employment growth and production growth could remains in the coming quarters if the labour market maintains the same pace of growth as that posted in the past few months. The negative impact this could have on labour productivity and corporate earnings could be substantial.

Since businesses usually strive to maximize earnings, we could conclude that employment advances will slow down in the next few months. For example, annual employment growth similar to annual production growth for the coming quarters, i.e. close to 1.5%, means that about 22,000 jobs would be created each month—a level that is slightly lower than the 6-month moving average of 26,800 jobs. In reality, monthly job creation could be even weaker if corporations were not willing to accept almost no productivity gains.

Several factors suggest however, that businesses might show more tolerance. For one, corporate earnings are at a fairly high level historically speaking (graph 3) and profit margins in several sectors are hovering above their historical averages. This provides businesses with some leeway, allowing them to keep hiring and preparing themselves for the anticipated rise in demand later on in 2013 and in 2014.

Another issue is the labour scarcity plaguing some businesses, especially when it comes to specialized workers. According to the BoC survey, 25% of businesses reported suffering from a labour shortage that limited their capacity to meet demand. The lack of workers appears to be even greater in smaller businesses. A survey by the Canadian Federation of Independent Business showed that 34% of SMEs (small to medium-sized enterprises) were facing a shortage of skilled labour. The apparent scarcity of certain types of workers is hampering the labour market’s flexibility and balance between production and labour in the short and medium term.

Lastly, the issue of an aging population further encumbers the labour market. Amid concerns of a labour shortage in the next few years as baby boomers start to retire, some
businesses will be compelled to hang on to their workers to fulfill their future needs.

We therefore expect Canadian businesses to maintain a hiring pace of 20,000 to 25,000 jobs per month on average, making for a fairly positive outlook. In doing so, not only will the unemployment rate continue to decline gradually in the months ahead, but consumer spending will also continue to enjoy strong support.

Tomorrow, Statistics Canada will publish its January labour force data. Given the highly volatile change in employment, anything can happen, from strong job creation to substantial losses. However, it would take a loss of at least 23,500 jobs for the 6-month moving average to decline compared to the level posted in December. To bring this average back under the 25,000-job mark by March, job creation would have to be limited to only 10,000 jobs per month. Compared to the exceptional gains recorded lately, employment results could very well be more limited in the months ahead.

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