Economics

# ECONOMIC INSIGHTS

January 11, 2023

## In sickness and in "health": Canada's labour market

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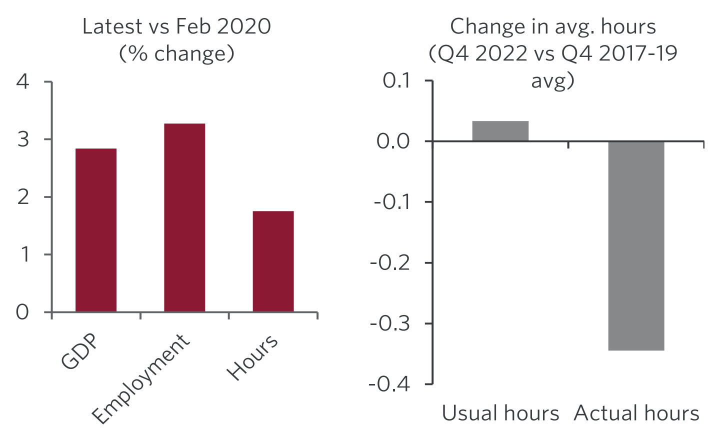
The Bank of Canada has suggested that a rise in the unemployment rate is necessary to cool inflation, with tightness in the labour market a sign of excess demand within the economy. However, the current low jobless rate doesn't just reflect strong demand. It also reflects the fact that a sicker labour force means that a lower, or healthier looking, unemployment rate is needed to achieve the same level of supply that we enjoyed pre-pandemic.

Indeed, the amount of supply the economy is currently getting from a 5.0% unemployment rate would be similar to what we could achieve from a roughly 6% jobless rate in 2019. The absence of this supply would be inflationary in its own right, possibly even more so than having a lower unemployment rate and higher wage growth. The good news is that this should largely represent a one-time lift to labour costs relative to the pre-pandemic normal. As long as the health situation doesn't become an even bigger constraint to supply, we should be able to see an easing of inflationary pressures without a large increase in the unemployment rate.

Chart 1: Hours worked have lagged GDP and employment post-pandemic (L), but not because of more part-time work (R)




Source: Statistics Canada, CIBC

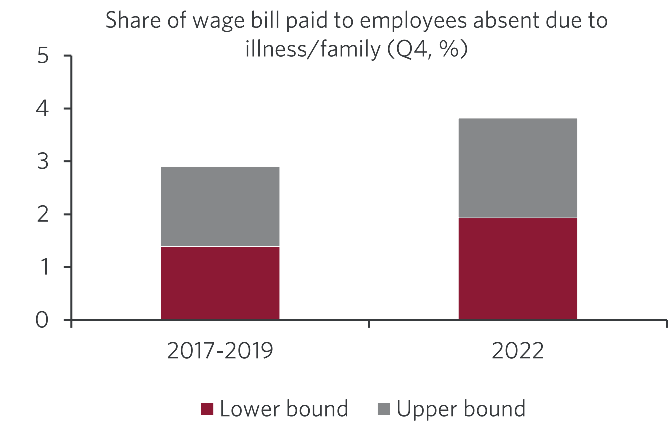
### Less bang for their buck

The difference between employment growth and actual labour supply, which we think is better measured by hours worked, is easy to see. While employment is more than 3% higher than it was at the start of the pandemic, working hours are up by only 1¾% (Chart 1, left).

The divergence isn't because we have suddenly become a nation of part-timers, unwilling to take on a full-time job. Indeed, average usual hours, or the hours you are contractually supposed to work, have not changed relative to where they stood before the pandemic. What has changed is the average hours that people actually work, which is well below its pre-2020 mark due to elevated levels of absenteeism (Chart 1, right). Companies are getting less bang for their buck, or fewer hours actually worked per employee.

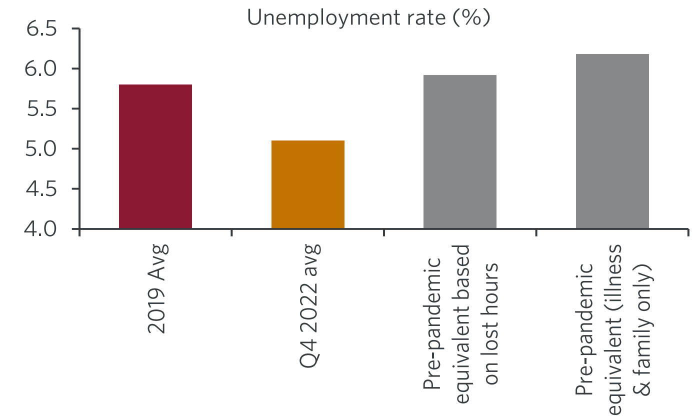
Illness-related absenteeism is inflationary in two ways. First, there is a direct cost for companies in terms of paid sick days. For instance, relative to pre-pandemic years, we estimate that wage costs have increased by between 0.5% and 0.9% solely due to paid time for employees that are absent because of illness or family reasons (Chart 2). These bounds are calculated on different scenarios for the share of employees with paid time away. Second, by forcing employers to recruit additional workers to cover for those who are away, it contributes to tightness in the labour market and increases wage pressures.

Chart 2: Wage costs have increased due to illness-related paid absenteeism




Source: Statistics Canada, CIBC

Chart 4: The actual supply we are getting is equivalent to a 6%+ unemployment rate pre-pandemic



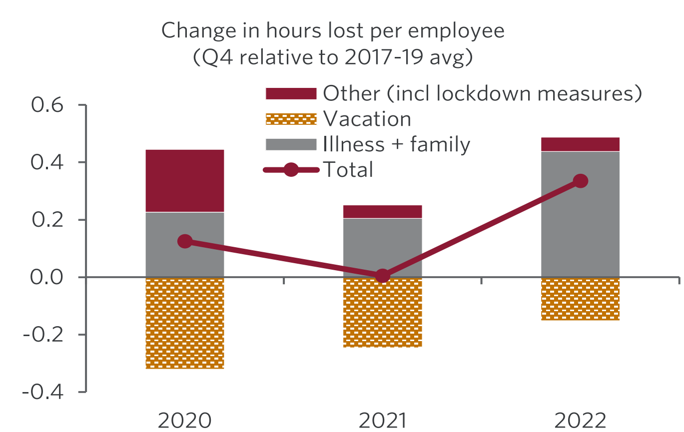

Source: Statistics Canada, CIBC

Unfortunately, the issue appears to have worsened in 2022 due to the continued circulation of COVID in the community and the resurgence of other illnesses. More than 0.4 more hours per employee were lost in Q4 2022 compared to the average seen in 2017-19 (Chart 3). That's an increase from 0.2 extra hours of illness or family-related absenteeism in 2021, relative to the pre-pandemic average.

This is happening at the same time that workers are using vacation time to a greater extent than they were during the first two years of the pandemic, resulting in an even more noticeable increase in overall lost working hours. On aggregate, the additional hours that are being lost compared to pre-pandemic norms is equivalent to requiring around 175K additional staff. If vacation time was not still running below pre-pandemic norms, lost hours due to sickness and family needs alone would be equivalent to requiring around 230K additional employees.

Because of this, the actual supply that the economy is getting from a 5.0% unemployment rate, in terms of working hours, is noticeably less than it would have been prior to 2020. In fact, based on the increase in lost hours, we are currently getting the labour supply equivalent to a roughly 6% unemployment rate pre-pandemic. If employees continue to normalize their use of vacation time, but time lost due to illness or family issues doesn't improve, then labour supply would be equivalent to a 6.2% unemployment rate pre-pandemic (Chart 4).

Chart 3: Excess hours lost due to sickness and family issues higher now than in 2020 or 2021




Source: Statistics Canada, CIBC

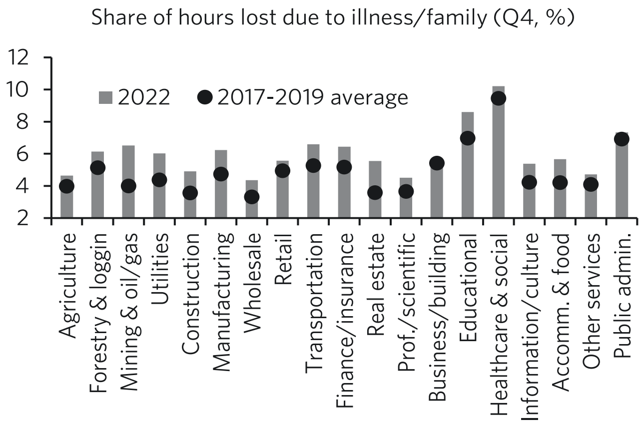
## More staff needed

This shortfall of hours actually being worked can also explain why, even with the level of employment already high in some sectors, vacancy rates are still elevated compared to where they stood before the pandemic. Historically, there is a reasonable correlation between lost working hours and the posting of job vacancies. On average, if working hours lost due to illness or other factors have risen by the equivalent of four employees, then one extra job vacancy has been posted.

Based on that prior relationship, the 230K extra employee-equivalent hours lost due to illness and family matters calculated above would have raised job vacancies by about 60K. That's roughly one quarter of the excess job vacancies currently seen in the economy relative to the pre-pandemic trend. As illness-related absenteeism increased through the fall months, and with that trend likely to continue through the winter, this may limit the decline we would expect to see in job vacancies as the economy cools.

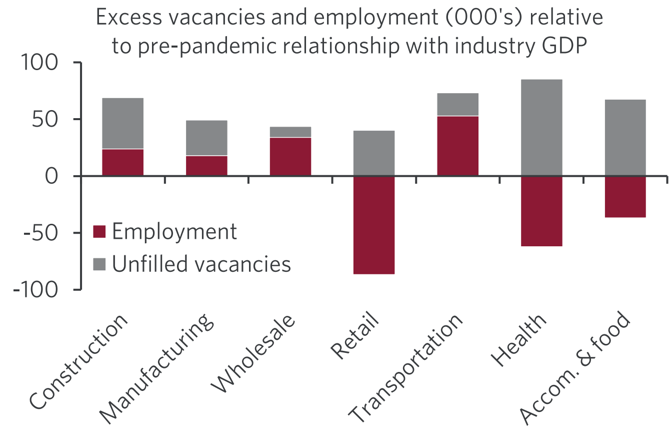
Moreover, there is reason to believe that the hours lost due to employee sickness may account for an even larger proportion of excess job vacancies in the economy at the moment than the historical relationship would imply. Sectors where work cannot be undertaken at home have been disproportionately impacted by the shortfall of actual working hours, including education, manufacturing and construction. While education has always seen elevated levels of sickness-related absenteeism, that was not the case in areas such as manufacturing, construction and

Chart 5: Impact of illness on labour supply has varied widely between sector




Source: Statistics Canada, CIBC

Chart 6: Demand for staff has gone beyond its previous relationship with GDP in many sectors




Source: Statistics Canada, CIBC

mining which have seen the biggest increases relative to pre-pandemic norms (Chart 5). In these sectors, historical relationships suggest that one vacancy is posted per the loss of working hours equivalent to three, rather than four, employees.

This also helps to explain why there is an excess of job vacancies in sectors such as manufacturing, construction and transportation even though employment within these areas has already recovered beyond what would be expected given current demand conditions (measured as real GDP by industry). In health and food/accommodation too, the excess in vacancies is much larger than the current shortfall of actual employment relative to GDP (Chart 6). Labour demand in retail remains lower than its prior relationship with GDP, but that could reflect the fact that more sales are still being conducted online.

For some sectors, the added paid sick leave is putting significant extra pressure on wage costs. This is particularly the case for some in-person industries such as mining, oil and gas, utilities, and education where wage costs are about 1.5% higher due to paid time off for employees absent all week due to illness or family matters. However, it can also impact some industries where telework is prominent, such as public administration, which has seen its wage bill increase by as much as 1% for the same reason.

## In sickness and in “health”

The Bank of Canada should be careful about placing too much emphasis on the unemployment rate as a signpost of excess demand within the economy. The “health” of the Canadian labour market in the coming year will also be influenced by the evolution of COVID and other respiratory illnesses that we are currently facing.

Should the health situation improve dramatically over the spring, the vacancy rate could come down rapidly and the unemployment rate could increase even if demand doesn’t fall. While that would be a bitter pill for some workers, the good news would be that we could get the same output with much less inflationary pressure.

However, while some improvement on the health front is likely in the cards when warmer weather returns, COVID could represent a structural shift within the labour market. Cold and flu seasons have always had a significant impact on the labour market year after year, and with COVID we have added another disease to the list. The good news is that, as long as the health situation doesn’t deteriorate further, this should represent a one-time level shift in labour costs, since in the coming year, we won’t need a further increase in staff to cover a further increase in absenteeism. As a result, this issue’s contribution to year-on-year inflation should be dropping out of the 2023 numbers, helping to achieve part of the necessary deceleration in Canada’s CPI. Along with diminishing inflation impacts from global factors and non-COVID supply-chain issues, that underlies our view that some of the improvement in inflation will come from factors other than the pain of a higher jobless rate.

Table 1: Canada forecast detail (real % change, SAAR, unless otherwise noted)

| Variable | 22Q3A | 22Q4F | 23Q1F | 23Q2F | 23Q3F | 23Q4F | 2022F | 2023F | 2024F |
|---|---|---|---|---|---|---|---|---|---|
| Real GDP Growth (AR) | 2.9 | 1.1 | -0.4 | 0.4 | -0.6 | 0.8 | 3.6 | 0.7 | 0.9 |
| Real Final Domestic Demand (AR) | -0.6 | 1.3 | 0.4 | -0.2 | -0.1 | 1.2 | 2.7 | 0.4 | 1.4 |
| Household Consumption (AR) | -1.0 | 1.7 | -0.4 | -1.3 | -0.3 | 0.8 | 4.8 | 0.4 | 0.7 |
| All Items CPI Inflation (Y/Y) | 7.2 | 6.6 | 5.3 | 2.8 | 2.7 | 2.6 | 6.8 | 3.3 | 2.1 |
| Unemployment Rate (%) | 5.2 | 5.1 | 5.3 | 5.7 | 5.8 | 5.9 | 5.3 | 5.7 | 5.7 |

Table 2: US forecast detail (real % change, SAAR, unless otherwise noted)

| Variable | 22Q3A | 22Q4F | 23Q1F | 23Q2F | 23Q3F | 23Q4F | 2022F | 2023F | 2024F |
|---|---|---|---|---|---|---|---|---|---|
| Real GDP Growth (AR) | 3.2 | 2.9 | -0.7 | 0.4 | -1.0 | 1.1 | 2.1 | 0.7 | 0.8 |
| Real Final Sales (AR) | 4.5 | 2.1 | -0.3 | 0.6 | -0.1 | 0.9 | 1.4 | 1.1 | 0.8 |
| All Items CPI Inflation (Y/Y) | 8.3 | 7.1 | 5.0 | 2.7 | 2.1 | 2.2 | 8.0 | 3.0 | 2.2 |
| Core CPI Inflation (Y/Y) | 6.3 | 5.9 | 4.7 | 3.5 | 2.5 | 2.0 | 6.1 | 3.1 | 2.4 |
| Unemployment Rate (%) | 3.6 | 3.6 | 3.8 | 4.0 | 4.1 | 4.2 | 3.6 | 4.1 | 4.4 |

### Table 3: Canadian interest rates (end of period)

| Variable | 2023 10-Jan | 2023 Mar | 2023 Jun | 2023 Sep | 2023 Dec | 2024 Jun | 2024 Dec |
|---|---|---|---|---|---|---|---|
| Overnight target rate | 4.25 | 4.50 | 4.50 | 4.50 | 4.50 | 3.50 | 3.00 |
| 98-Day Treasury Bills | 4.35 | 4.45 | 4.35 | 4.25 | 4.00 | 3.25 | 2.60 |
| 2-Year Government Bond | 3.96 | 4.25 | 4.25 | 3.75 | 3.30 | 2.75 | 2.30 |
| 10-Year Government Bond | 3.13 | 3.40 | 3.55 | 3.30 | 3.20 | 2.80 | 2.50 |
| 30-Year Government Bond | 3.15 | 3.45 | 3.60 | 3.50 | 3.35 | 2.90 | 2.75 |
| Canada - US T-Bill Spread | -0.28 | -0.50 | -0.55 | -0.60 | -0.80 | -0.45 | -0.70 |
| Canada - US 10-Year Bond Spread | -0.48 | -0.50 | -0.45 | -0.50 | -0.50 | -0.60 | -0.50 |
| Canada Yield Curve (10-year — 2-year) | -0.83 | -0.85 | -0.70 | -0.45 | -0.10 | 0.05 | 0.20 |

### Table 4: US Interest rates (end of period)

| Variable | 2023 10-Jan | 2023 Mar | 2023 Jun | 2023 Sep | 2023 Dec | 2024 Jun | 2024 Dec |
|---|---|---|---|---|---|---|---|
| Federal funds rate | 4.375 | 4.875 | 4.875 | 4.875 | 4.875 | 3.875 | 3.375 |
| 91-Day Treasury Bills | 4.63 | 4.95 | 4.90 | 4.85 | 4.80 | 3.70 | 3.30 |
| 2-Year Government Note | 4.26 | 4.65 | 4.75 | 4.50 | 4.10 | 3.40 | 2.80 |
| 10-Year Government Note | 3.61 | 3.90 | 4.00 | 3.80 | 3.70 | 3.40 | 3.00 |
| 30-Year Government Bond | 3.74 | 4.00 | 4.25 | 4.10 | 3.90 | 3.90 | 3.60 |
| US Yield curve (10-year — 2-year) | -0.65 | -0.75 | -0.75 | -0.70 | -0.40 | 0.00 | 0.20 |

### Table 5: Foreign exchange rates

| Exchange rate | 2023 10-Jan | 2023 Mar | 2023 Jun | 2023 Sep | 2023 Dec | 2024 Jun | 2024 Dec |
|---|---|---|---|---|---|---|---|
| CAD-USD | 0.74 | 0.74 | 0.75 | 0.76 | 0.76 | 0.77 | 0.78 |
| USD-CAD | 1.34 | 1.35 | 1.33 | 1.32 | 1.31 | 1.30 | 1.28 |
| USD-JPY | 132 | 130 | 125 | 123 | 121 | 118 | 115 |
| EUR-USD | 1.07 | 1.04 | 1.05 | 1.07 | 1.10 | 1.13 | 1.14 |
| GBP-USD | 1.22 | 1.16 | 1.17 | 1.19 | 1.22 | 1.26 | 1.27 |
| AUD-USD | 0.69 | 0.68 | 0.69 | 0.70 | 0.71 | 0.74 | 0.76 |
| USD-CNY | 6.78 | 6.85 | 6.85 | 6.81 | 6.79 | 6.73 | 6.69 |
| USD-BRL | 5.22 | 5.26 | 5.05 | 5.20 | 5.40 | 5.20 | 5.00 |
| USD-MXN | 19.1 | 20.0 | 21.0 | 20.5 | 19.8 | 20.5 | 21.0 |

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