Labor Market Report – Sustained Employment Growth and the Nonlinear Phillips Curve

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AUTHORS AND/OR EDITORS Grupo de Análisis del Mercado Laboral (Gamla) Office for Monetary Policy and Economic Information Morales-Zurita, Leonardo Fabio
This series intend to broaden the discussion and understanding of the current situation of the Colombian labor market by providing relevant information to the public. Additionally, it aims to foster closer engagement with diverse audiences by presenting valuable findings from recent research on this topic that are relevant to the work of *Banco de la República* (the Central Bank of Colombia). These include issues related to labor market fluidity, the structural unemployment rate, the impact of payroll taxes, unemployment rate forecasts, and leading labor market indicators, among others.

Publication Date: Thursday, 9 of November 2023
As of August 2023, employment continued to grow in both urban and rural areas. According to data from the Official Colombian Household Survey (GEIH, by its acronym in Spanish), national aggregate employment grew by 4.8% annually, driven mainly by the strong performance of employment in urban areas, which grew by 5.8%, followed by the dynamics of employment in other municipalities and rural areas, which grew by 3.7%. This has led to a sustained increase in the national aggregate employment-to-population ratio (EPR), bringing it to 58.6%. Consistent with this, a rebound has been observed in salaried employment, which grew at an annual rate of 6.2%, while non-salaried employment increased at a more moderate rate of 3.6%. Other administrative information sources, such as the Social Security Administrative Records (PILA, by its acronym in Spanish), family compensation funds, and the insurance sector, confirm the strong dynamism of formal employment. The sectors that contributed most to annual employment dynamics are services including trade, accommodation, public administration, health, education, and entertainment. Additionally, recent indicators of formal labor demand, such as vacancy indices, remain at relatively high levels, in line with hiring expectation surveys, which suggest a positive and relatively stable balance in the near future, though at levels lower than those observed during 2021–2022.

In line with the strong labor demand dynamics, as of August, an increase was also observed in the labor force participation rate (TGP in Spanish), particularly in urban areas. However, this has not prevented the unemployment rate (UR) from continuing to decline, standing at 9.5% for the national aggregate and 9.7% for the urban aggregate. Accordingly, the urban UR is expected to stand at 10.6% by the end of 2023, while the national UR is projected to reach 10.0%. For 2024, the average urban UR is expected to range from 9.1% to 12.7%, with 10.9% as the most likely value. In turn, for the national aggregate, the UR for the next year is expected to average between 8.5% and 12.1%, with 10.3% as the most likely value. This implies a moderate increase in the unemployment rate by the end of 2024. These forecasts suggest a still tight labor market, which is expected to move toward a neutral zone during 2024, with lower inflationary pressures stemming from the labor market. Forecasts of the UR and estimates of the Nairu (non-accelerating inflation unemployment rate) suggest that the average unemployment gap for 2023 would be -1.9 percentage points (pp), but it is expected to continue narrowing next year.

As usual, this report is divided into two sections. The first section provides a detailed analysis of the current labor market situation. The second section estimates various Phillips curves (PCs) for Colombia, with particular emphasis on nonlinearities during the post-pandemic recovery. The analysis starts with hybrid PCs that account for both inflation persistence and expectations, as well as various exogenous shocks. Results suggest that the slope of the PCs has been considerably steeper since 2022. Based on these estimates, simulations were conducted to determine the level of the unemployment gap that is consistent with the core inflation path projected by *Banco de la República*'s technical staff. The exercises assume three scenarios for inflation expectations, reflecting different degrees of credibility in monetary policy. The results suggest that the sacrifice required to achieve the inflation target may be lower under a nonlinear PC. However, the difference compared to the linear model disappears once the period of nonlinearity ends. On the other hand, the sacrifice increases considerably as inflation expectations rise, reflecting the fundamental role of credibility in the magnitude of the adjustment.