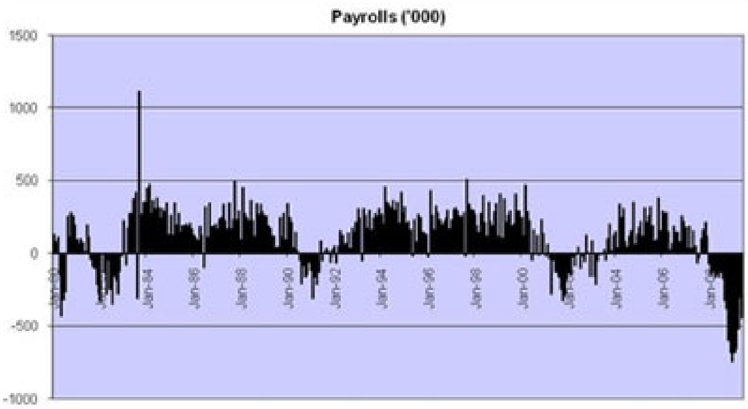
A 'Jobless' And 'Wageless' Recovery?

Nouriel Roubini, 08.13.09, 12:01 AM EDT

Parsing the 247,000 payroll losses.

After severe job losses in early 2009, the pace of job losses slowed starting in April, and the July numbers have brought more respite. Non-farm payroll job losses were 247,000 in July. However, the private sector lost 254,000 jobs. This is considerably better than analysts expected (around 325,000) but not good enough to claim that we are in the middle of a strong and sustainable recovery.

Looking at the recessions of the post-war period, average monthly job losses ranged between 150,000 and 260,000. Average monthly losses in this recession are still at 350,000. For the first four months of the year, the average was at 648,000. The improvement with respect to the first part of the year is clear. The improvement with respect to what we are used to seeing in recessionary periods is much less clear cut. The latest numbers are not exactly what you'd call good news, at least not in absolute terms. In relative terms, however--after skirting a near-depression--markets seem to consider 247,000 payroll losses a breath of fresh air.



Data Source: Bureau of Labor Statistics

The increase in average weekly labor hours in July is certainly a positive sign. But it also shows that, when economic conditions begin improving, companies will increase labor hours and temporary workers and move workers from part time to full time. Only after that do they begin hiring new workers. So hiring is still a long way ahead. The decline in the unemployment rate from 9.5% in June to 9.4% in July was not due to an improvement in the employment situation but is explained by the large decline in the labor force (-422,000). Workers facing hiring freezes, fewer full-time jobs and jobs at lower wages are leaving the labor force.

Implications of Continued Job Losses

The economy has lost over 6.6 million jobs since the recession began, which is way above the job losses that we are used to seeing in recessionary periods when job losses have ranged between 1.5 million and 2.5 million. The large job losses of the past months and longer unemployment duration will continue to weigh on the economy in the coming months. The unemployment duration improved slightly in July from the record high witnessed in June, which is positive news. Unemployed workers are falling behind their debt payments, raising defaults on loans and making government mortgage modification programs ineffective. Default rates on various loans have already surpassed the unemployment rate. According to the Moody's credit card index report, published in May 2009, the credit card charge-off rate crossed 10% in May 2009 and is expected to reach a peak of 12% by the second quarter of 2010.

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I'm sorry, correction. THe job/population growth for the 90's was over 70%. Not 705.

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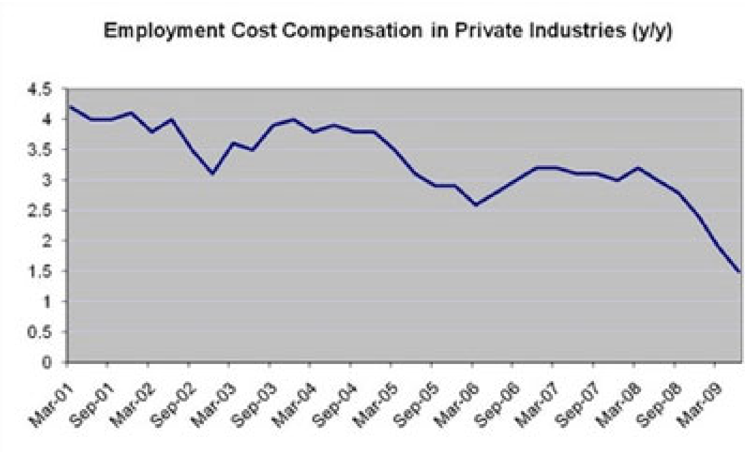
For the labor market to stabilize, job losses need to slow to 100,000 to 150,000 per month, and jobless claims need to fall to around 400,000. Payrolls alone don't reflect the strength of the household sector. Labor compensation and work hours also function as indicators, and both of these have slowed sharply in recent months. Even as borrowing conditions remain tight and home prices continue to fall, the dip in labor compensation will continue to constrain consumer spending, notwithstanding any fiscal stimulus.

In a severe, consumer-led recession like this one, the labor market is a leading (rather than lagging) indicator of economic recovery, and the consumer still drives the U.S. economy (private consumption still makes up over 70% of GDP). A slowdown in the pace of job losses from 650,000 to 250,000 is welcome, but in no way offers comfort about a prompt comeback of the U.S. consumer. This raises concerns about the strength and sustainability of any economic recovery that most people are expecting in the second half of 2009, and beyond.

Besides Cutting Jobs, Businesses Are Reducing Compensation
Companies need a certain head count to run their businesses. After cutting jobs, companies are increasingly reducing compensation and work hours to keep a lid on labor costs. Labor compensation slowed significantly to 0.4% in Q2 2009, after slowing to 0.3% in Q1 2009. The slowdown in wages and salaries (0.4%) and benefits (0.3%) is significant, especially in the private sector (0.2%). Private sector labor compensation slowed to 1.5% in the 12 months ending June 2009, the smallest increase on record. Firms are reducing benefits significantly in the service sector while employers in manufacturing are largely cutting wages.



Data Source: Bureau of Labor Statistics

Average weekly hours in the private sector, despite slightly improving in July 2009, are still hovering at record-low levels, especially in services. The number of part-time workers has risen sharply since late 2008 because many workers cannot find full-time jobs. Employers are also switching to temporary employers to cut spending on worker benefits. However, the bid to maintain profit margins will backfire on companies in the form of subdued sales as labor incomes suffer.

Data Source: Bureau of Labor Statistics

A Jobless Recovery Ahead

Continued pressure on sales, uncertain demand recovery, weakened balance sheets and tight credit access, especially for smaller firms, imply that firms will continue to shed jobs through 2009. The unemployment rate, even after peaking in late 2010 or early 2011, will remain elevated for some time. It may take several quarters or years to recover the jobs lost during this recession. Several jobs in housing and related activities, finance, autos and consumer-oriented services will be lost permanently. Wage-bargaining power will also weaken, implying another "jobless" and "wageless" recovery.

About 53% of the unemployed have been jobless for over three months and around 34% of them for over six months, which is the highest on record. Over 50% of the unemployed have lost their jobs permanently, again the highest on record. Underutilization of workers will lead to an erosion of human capital and a deterioration of labor productivity going forward and will negatively affect the potential growth rate of the economy. Inadequate safety nets, the dearth of labor retraining programs and tight access to student loans suggest that when workers begin looking for work during the recovery, they will face the possibility of skill mismatches. These factors might raise the structural unemployment in the economy from below 5% in 2007 to close to 7% ahead.

Private Demand Will Remain Under Pressure

Apart from job losses and income pressures, several factors will continue to weigh on consumers. Consumer credit has been contracting since Q4 2008, and mortgage equity withdrawal is negative as home prices have about 10% more to fall. Mortgage rates are higher compared to early 2009, and oil prices are up from their February 2009 lows. Thus, there hasn't been any fundamental improvement in the health of the household sector in recent months, except for the potential wealth effects from the ongoing market rally. And these income and wealth constraints are unlikely to ease markedly in the second half of 2009.

Lower home-equity withdrawal, tighter credit conditions, a jobless recovery and higher taxes imply that the ongoing change in consumer spending is structural rather than cyclical. As witnessed since Q2 2009, any stimulus in the form of tax cuts will fail to have a significant impact on consumer spending, as almost 80% of tax cuts are saved. Credit incentives such as the "cash for clunkers" program and tax incentives for first-time home-buyers will have only a small and temporary impact on consumption.

Rather than fiscal incentives, consumer spending going forward will depend on income, net worth and the debt burden of households. The household debt-to-GDP ratio is over 125% (as of Q1 2009), implying that households have a long way to go in terms of de-leveraging. In the coming quarters, a larger share of the growth in household income and wealth will go towards savings and paying off debt, not for consumption. This will reduce the ratio of consumption-to-GDP to below 70%.

Investment recovery will lag the recovery in consumption. With sluggish consumer spending and rampant excess capacity in the economy (capacity utilization is at a record low of 68% compared to the historical average of 81%), firms will be reluctant to start hiring workers and investing in structures and equipment. In fact, it may take several years for capacity utilization to return its pre-recession levels. Some capacity in manufacturing, housing and services will be destroyed permanently as firms adjust to a lower level of consumption.

Temporary Improvement in Growth?

There are hopes that inventory restocking, auto production and residential investment will drive the GDP growth in the second half of 2009 to positive territory. Despite the large inventory drawdown in the first half of 2009, the inventory-to-sales ratio hasn't come down significantly (the ratio is still over 1.40, while the historical average ratio is close to 1.25). This is because sales are plunging faster than inventory drawdown.

Given the bleak outlook for consumer spending, firms need to continue cutting inventories aggressively. This diminishes the hope of inventory restocking making a large positive contribution to GDP growth during the second half of 2009. However, the sharp decline in auto inventories in Q2 2009 and the "cash for clunkers" program may temporarily boost auto production and auto sales in the second half of 2009. Given large home inventories, residential investment is likely to have only a limited affect on GDP growth. Tighter mortgage conditions, low expectations of appreciation in home values and government intervention will also reduce this sector's significance in driving growth going forward. In sum, the boost to growth from these factors, if any, will be small and temporary.

As inventory adjustments and fiscal incentives end and the impact of fiscal stimulus wanes, the economy might fall back into lower growth sometime in 2010 as the drivers of the recent economic boom--the consumer, the housing sector and easy credit--will remain under pressure. By then, there will be little or no room left for further fiscal and monetary stimulus without aggravating investor concerns about long-term fiscal sustainability.

Sluggish Recovery Ahead

It is very difficult to argue that the U.S. economy is not still in a recession while the labor market is still weak. But the interesting question is not whether the U.S. economy is still technically in a recession, or whether the recession will end in Q3 2009 or Q4 2009--or later. What is interesting is understanding the implications of this severe downturn and financial crisis for the recovery.

Any sustained and strong improvement in growth has to come from a revival in private demand, and not from temporary factors like inventory adjustment and policy measures. The U.S. consumer, who, as we've noted, still accounts for close to 70% of GDP, is pulling back. Investment, which still trails consumer spending at home, will be weak. Exports will be a source of growth only in the medium term. In the short term, the rest of the world will remain dependent on the U.S. to drive demand while consumption abroad will be unable to offset the decline in U.S. consumption.

These factors suggest a sluggish economic recovery for the U.S. in the coming years until new sources of growth emerge (such as exports to emerging markets, investment, new energy and technology). Factors such as unsustainable public debt, higher structural unemployment, lower credit growth and higher taxes in the future will also constrain growth.

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