

# Focus on Economics

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## More hype than substance? Not all is rosy on the US job market

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Labour market conditions are generally an important object in the analysis of an economy, especially in the USA where full employment is not only an economic policy objective but also (and above all) a monetary policy mandate.

Since the recovery after the 2009–2010 recession, the trend on the US labour market has been characterised by solid job growth and declining unemployment. Today, the situation is stable enough to justify taking the long-awaited first step to raising key interest rates. Yet the US Federal Reserve Board is still hesitant.

The Fed's hesitation may be somewhat excessive but if we take a closer look we can indeed recognise pitfalls on the US labour market. The most obvious of them is inadequate wage and salary growth, which should be much higher given the job market figures. Below we explore two factors that may provide an explanation for this: weak productivity development and continuing high long-term unemployment.

All observers of the US economy and monetary policy are eagerly awaiting the US Federal Reserve's imminent key interest rate rise, the first since June 2006. An important determinant for the move is the job market situation because, in addition to ensuring price stability, the Fed is also committed to achieving as high a level of overall employment as possible. From the 2009/2010 recession up to the end of 2013, it even issued 'forward guidance' that was coupled with the labour market. This meant the Fed would not raise interest rates until the unemployment rate dropped to at least 6.5%. Even though it

abandoned this commitment in early 2014, trends and developments on the US labour market are and will remain of great interest to US monetary policy-makers.

The labour market is generally of great significance to an economy, not just in the USA. Labour is an important economic input factor and, thus, a measure for the overall production capacity. Besides, the provision of labour means a source of income for people. This makes the labour market situation, for example the number of job vacancies, unemployment rate and salary levels, indispensable for analysing an economy and its development prospects.

### Some figures: the labour market is in good shape ...

At first glance, the current US job market figures are very positive (Figure 1). The unemployment rate of currently 5.3% is at the mid-2008 level, when the international financial crisis had begun but not

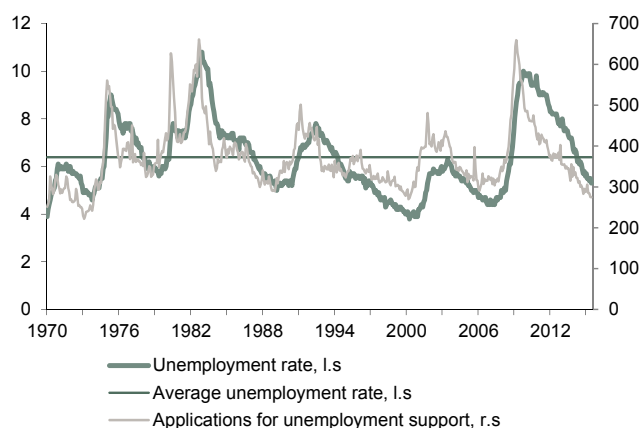
yet reached its peak (Lehman insolvency) and thus significantly below the long-term average of around 6½%. Applications for unemployment support (both initial and follow-up applications) are at very low levels in a historical comparison. Only at the beginning of statistical record keeping in the late 1960s and mid-1970s were levels significantly lower.

Moreover, job growth is continuing on a very sound basis. With an average of around 210,000 new jobs each month in the year 2015, job growth is roughly following the long-term average trend.<sup>1</sup> In 2014 it was even significantly higher, with 260,000 jobs created. Job growth should ideally continue at a minimum monthly rate of just under 100,000, as this is the number of people entering the US job market additionally every month in purely arithmetic terms through population growth. If job growth were systematically lower than this demographically driven workforce growth, the unemployment rate would rise despite growing employment.

These figures would have long justified raising the key interest rates of the Federal Reserve System. The reason this increase has not yet taken place is that the Fed is very cautious, perhaps too

**Figure 1: Labour market indicators**

Unemployment rate: share of unemployed persons in the workforce (in per cent); applications for unemployment support: number of initial applications per week, moving four-week average (thousand)



Source: Bloomberg, own calculations

cautious. Its concern is that the capital market may react strongly should it start raising interest rates too early, thus crippling economic momentum. But the longer it waits, the more difficult it may eventually be to actually make the move.

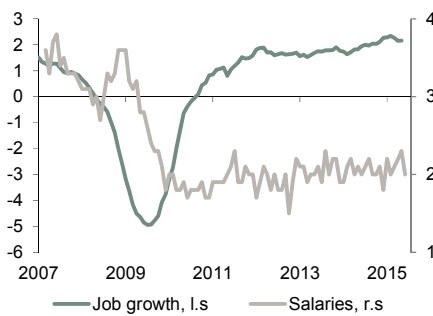
The Fed's caution is not completely unfounded either because there is in fact some unpleasant 'background noise' on the job market that deserves to be taken into account.

**... but there is water in the wine**

The loudest background noise is the wage increase process, which has not got off the ground. While wage dynamics weakened during the 2008/2009 economic and financial crisis, wage levels have not recovered since, although job growth has been positive again since mid-2010 and has now returned to a pre-crisis rate (Figure 2). If companies are hiring more workers and unemployment is falling, why is this not translating into rising wage growth?

**Figure 2: Job and wage dynamics**

Job growth: Increase on previous year in number of persons employed (per cent); salaries: increase on previous year in overall average hourly remuneration (per cent)



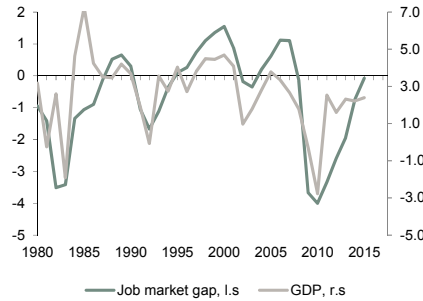
Source: Bloomberg, own calculations

One relatively obvious answer to this could be the degree of capacity utilisation in the labour market. If companies hire more workers and therefore reduce the number of unemployed persons, but at the same time the level of unemployment continues to be sufficiently high, there is no reason for employers to increase wages (more substantially).

One indicator of capacity utilisation in the job market is the job market gap. This is the difference between the non-accelerating inflation rate (NAIRU) (and thus the non-accelerating wage rate) of

**Figure 3: Labour market and GDP**

Job market gap: NAIRU less unemployment rate (percentage points); GDP: variation on previous year, moved forward by one year (per cent)



Source: Bloomberg, OECD, own calculations

unemployment and the current unemployment rate.<sup>2</sup> According to OECD estimates, this currently lies at around 0 percentage points (Figure 3). The Fed is still using a negative job market gap because it estimates the NAIRU lower, at approximately 5.1%. The Labor Market Conditions Index (LMCI) of the Kansas City Fed, which also still shows a minor capacity underutilisation rate, arrives at a similar result.<sup>3</sup>

This continuing (minor) underutilisation in the US labour market is one reason why there have not been any higher wage increases yet. From the point of view of capacity utilisation, however, the threshold from which wage and salary dynamics should accelerate noticeably will soon be reached, provided the unemployment rate continues to fall.

**What is happening to productivity?**

As mentioned at the outset, the workforce is a significant input factor for the creation of national income (= gross domestic product). If, however, the labour market is nearly balanced (as is currently the case), this should be coupled with high overall capacity utilisation (in simple terms: with high production activity). That was the case in the 1980s and 1990s, when labour market gaps of around zero percentage points were associated with capacity utilisation rates of significantly more than 80%. The corresponding real GDP growth rates were 3½ to 4% (Figure 3). That has changed since the turn of the millennium: a balanced labour market has since combined with capacity utilisation rates of sometimes noticeably less than 80%

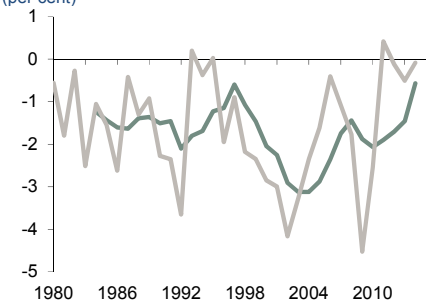
and growth rates of 1 to 2%. What is behind this?

Industrialised countries, including the USA, normally have a declining labour coefficient, which means that increasingly less labour input (in workers or working hours) is required to produce one US dollar of gross domestic product (GDP).<sup>4</sup> This reflects growing labour productivity. This continues to be the case in the USA but to a diminishing extent, as the labour coefficient is now falling only relatively slowly (Figure 4). Should it actually begin to rise, that is (consistently) exceed the zero line in Figure 4, that would mean more labour input would be required than before to generate one dollar of GDP. It would be a sign that the economy was becoming less productive, that is, losing efficiency.

From the perspective of the labour market, this is not so bad at first because this trend causes the demand for labour to rise significantly and with it the likelihood of wage and salary increases. But this is where a pitfall lurks. If wage dynamics do in fact pick up and, as described, productivity growth remains weak, this will very quickly result in price increases and, thus, higher inflation rates. In the case of the USA, this would still be desirable in the short term because, from a monetary policy perspective, the current inflation rates are still slightly too low. However, wage growth rates that consistently lie above the productivity growth rate cannot be desirable because that would reduce competitiveness in the long term. Conversely, if wage dynamics fail to pick up precisely because the productivity growth rate

**Figure 4: Labour coefficient**

Variation on previous year and five-year moving average (per cent)



Source: BLS, Bloomberg, own calculations

prevents this, the situation is not better because wage and salary earners fail to benefit from the improving labour market

situation.

Thus, increasing overall economic productivity is ultimately a key to boost-

ing wage and salary growth in the long term. Scientific and technological progress plays a significant role in this (see box).

**Long-term unemployment dampens wage growth**

One topic that is often neglected in the debate on the US labour market is long-term unemployment. It destroys human capital because (long-term) unemployed persons maintain their knowledge and skills more poorly than employed persons and may lose them completely at some stage. That, in turn, affects earnings prospects because unemployed persons are offered jobs at below-average pay rates when they re-enter the workforce and their outlook on pay rises is then lower.<sup>6</sup> It is obvious that this is especially true for people who have been unemployed for a long time. They agree to accept lower entry salaries and lower pay rises to be able to compete on the labour market.

In the USA, the long-term unemployment rate skyrocketed to unprecedented levels in the course of the 2009/2010 recession (Figure 7). After 2011 it began to fall noticeably and the trend is continuing. However, this also means that the proportion of long-term unemployed persons who have not permanently given up looking for work in frustration are returning to paid employment. As long as this continues, overall upward pressure on wages will remain dampened. Measured against the pre-crisis average (1970 to 2006), there are currently still around one million long-term unemployed persons too many. Once they are reintegrated into the labour market (or drop out of the workforce altogether), there will be a higher chance of wage growth returning to pre-crisis levels, when the number of long-term unemployed workers was within the long-term average (Figure 8).

**Conclusion**

The strong job growth of the past months in the USA and the associated significant drop in unemployment indicate a tangible improvement in the job market situation on the pathway towards full employment. This generally justifies a rise in key interest rates by the Fed in the near future because full employment is, after all, one of the two objectives of the Fed's dual

**Box: Total factor productivity (TFP)**

The productivity development of the input factor labour is 'only' one indicator (the same applies to the productivity of capital, another important input factor). Although it provides an answer to the question how efficiently labour (or capital) is used in an economy (or in a particular sector or even enterprise), it does not explain the causes of a weak or strong development of labour (or capital) productivity.

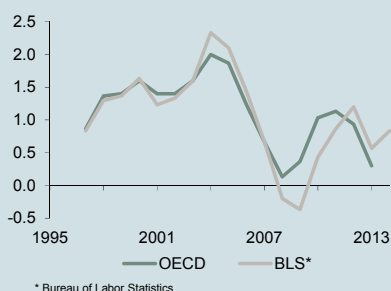
One parameter for measuring the factors influencing total economic output that are not due to changes in the factors labour and capital is the variation of total factor productivity (TFP). A major influence affecting TFP is technological progress. In simple terms: the higher it is, the more effectively production processes run and the less labour and capital is required to generate one dollar of GDP – resulting in rising productivity.

In the USA, there was a noticeable trend of accelerating TFP from 1995 to 2004 – a consequence of the Internet and IT revolution of those years (Figure 5). After that, momentum declined again, with a brief interim high in 2010/2011 which was due to the investment rally following the 2008/2009 recession. Overall, the trend of the past years has been declining and TFP growth in the USA is currently below average, even if the variation rate increased moderately again in 2014. The impact of technological progress on economic activity in the USA may have been trending downward in the past years, thus dampening productivity growth as well.

The U.S. Bureau of Labor Statistics also confirms the finding of weak TFP development. While TFP still accounted for roughly half of productivity growth from the mid-1990s until roughly the mid-2000s, it has since dropped to only a good third.<sup>5</sup> Among the G7 countries, TFP growth in the USA ranks in the middle (Figure 6). According to the OECD, from 2009 to 2013 average TFP growth was 0.8 %, less than that of Japan (1.6%) and Germany (1.3%) but above the average of the other G7 countries (0.4%). Detailing the causes of the country's TFP weakness would go beyond the scope of this paper, partly because of the great difficulty of proving what impact technological progress has on productivity and growth. The USA continues to dominate the rankings in areas such as research and development expenditure as a proportion of GDP and number of per-capita patent applications.

**Figure 5: Total factor productivity**

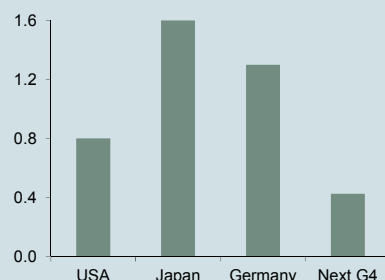
Variation on previous year (per cent, three-year moving average)



Source: OECD, BLS, own calculations

**Figure 6: Comparison of TFP**

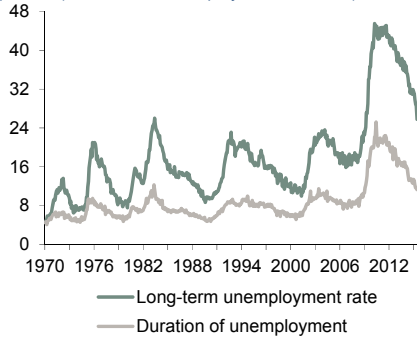
Average variation on previous year from 2009 to 2013 (per cent)



Source: OECD, own calculations

**Figure 7: Long-term unemployment (1)**

Long-term unemployment rate: long-term unemployed workers (more than 26 weeks) in relation to all unemployed (per cent); duration of unemployment: median (in weeks)



Source: Bloomberg

**Figure 8: Long-term unemployment (2)**

Long-term unemployed persons: deviation from the average 1970-2006 (in millions); salaries: increase in overall average hourly remuneration compared with previous year (per cent)



Source: Bloomberg, own calculations

tivity growth and continuing high long-term unemployment.

Even if the US economy and its job market are well able to cope with initial key interest rate rises, which would not least give monetary policy scope back to the Federal Reserve Board for the future, the above explanations at least make the Fed's cautious approach somewhat easier to comprehend. ■

mandate.

But where there is light, there is dark. In the case of the US labour market, the dark side is the sluggish wage and salary

growth. Given the development of the job market, that growth should actually be much higher. In our assessment, the reasons for this lie in insufficient produc-

<sup>1</sup> This average includes only the phases of job growth.

<sup>2</sup> The *non-accelerating inflation rate of unemployment* (NAIRU) is the (estimated) rate of unemployment that is compatible with a steady rate of inflation (and thus ultimately also with stable wages and salaries). If the actual rate of unemployment falls below the NAIRU, wage increases are likely to be enforced. If the rate of unemployment exceeds the NAIRU, this tends to have a dampening effect on wages. Accordingly, the difference between the NAIRU and the actual rate of unemployment is a measure for the tension existing on the labour market.

<sup>3</sup> The LMCI is calculated from a total of 24 sub-indicators and published in two variants: as a 'level of activity' index and as a momentum indicator that shows the rate of improvement or deterioration of labour market conditions. Here we refer to the first variant. The high number of sub-indexes, however, does not make the indicator easy to interpret either because a great amount of information is condensed into a single indicator. Nevertheless, it does play a role for the Federal Open Market Committee (FOMC), which determines the direction of monetary policy.

<sup>4</sup> In mathematical terms, the labour coefficient is the quotient between macroeconomic labour input (number of workers or working hours) and GDP. Labour productivity is the inverse of the labour coefficient.

<sup>5</sup> Cf. Bureau of Labor Statistics, Preliminary Multifactor Productivity Trends – 2014, News Release 23 June 2015.

<sup>6</sup> On the effects of unemployment and long-term unemployment in general, cf. eg. Hagedorn, M. and A. Kaul, Langzeitarbeitslosigkeit in Deutschland: Fakten, Ursachen und Bekämpfung, IZA Working Paper No. 680, December 2002 (in German) or Arulampalam, W., Is Unemployment Really Scarring? Effects of Unemployment Experiences on Wages, IZA Working Paper No. 189, August 2000.