UCLA ANDERSON FORECAST: WHITE PAPER SERIES

The Labor Market is Different This Time

You Should Know How and Why

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I. INTRODUCTION

National job growth is a constant topic in the media and in Washington these days, and it is fitting that this should be the case. The state of the labor markets by mid-2004 will be a pivotal issue in the 2004 election, and the availability, location, and cost of productive labor will be crucial issues for businesses in the next few years. Presently, labor markets are taking an even higher profile than normal, as U.S. jobs performing vastly differently from what we are accustomed to, even relative to the early stages of an economic expansion.

Typically by this point in previous expansions, the U.S. would be experiencing robust job growth, with payroll job *levels* far above previous peaks and *growth rates* near 3% or 4%. This time around however, payroll jobs are still 2 million below their March 2001 peak levels, and growth rates have not been sustained above 1%.

A number of unusual developments within the U.S. economy have coalesced to give us these unprecedented labor market conditions. This white paper is intended to identify and integrate these developments and to assess their continued evolution.

The roadmap for this investigation is as follows. The following section, **IT'S DIFFERENT THIS TIME**, will document the difference in current job growth performance from previous norms. The section entitled **WHY THINGS ARE DIFFERENT** will analyze the main factors that we believe have driven this bizarre performance. **SIDESHOWS** will touch briefly on some issues which have attracted attention in the press, but which we feel are at best tangential to current job market realities. Finally, the last section concludes with a brief assessment of labor market prospects through the next few years.

II. IT'S DIFFERENT THIS TIME

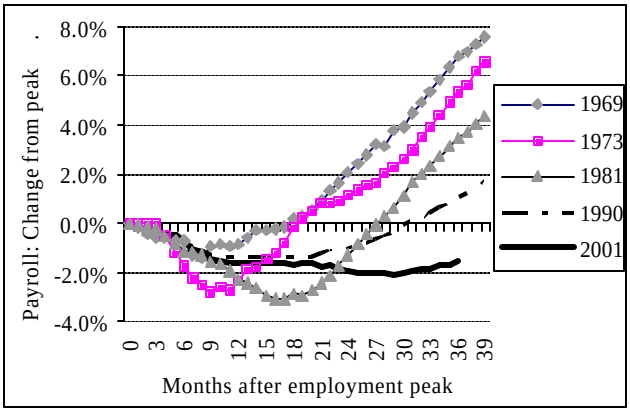
Wall Street's assessments of the economy swing wildly on a single datum. A soft February payroll job report (announced in March) left pundits proclaiming a "jobless recovery," asserting there had been "no improvement" in jobs growth since the onset of expansion in early 2002. Then, a strong March report now has the Street proclaiming that the economy is on a roll.

Beneath these frivolous swings in sentiment, payroll job growth has been improving steadily for the last nine months. Still, these facts remain: 1) those improvements occurred much later in the expansion than has typically been the case, and 2) the rate of acceleration in job growth is slower than what we are accustomed to from past experience.

These points are clear in the chart here, "**Payroll Employment Around Past Recessions**," showing cumulative changes in payroll jobs following peaks over the last five business cycles.[1] While the initial job loss in 2001 was relatively mild compared to past downturns, the cycle trough for employment also occurred much later than in any of the preceding four cycles. Furthermore, the incipient upturn has also proceeded much more slowly than was the case in previous recoveries.

Payroll Employment around Past Recessions

Seasonally Adjusted, Percent from pre-recession peak



As a result of the later trough and milder upturn, payroll employment is still significantly lower than it was at the cycle peak three years ago. This is unprecedented across postwar U.S. recoveries. Even the so-called "jobless recovery" of the early 1990s saw payroll jobs re-attain their previous cycle-peak level within thirty months of the 1990 peak. Over the three preceding cycles, payroll employment was 3% to 7% above previous cycle-peak levels three years after the previous peaks.

Now, March data did feature a robust 308,000 job gain in total payroll jobs. However, this one statistic is no reason to believe that job growth will be sustained at anywhere near that pace. This is because most of the March gains either came within very volatile sectors or else merely offset below-trend job growth in January and February.

Almost half of the March job gains came from two sectors: retail trade and construction. However, these account for only 15% of the total workforce, and they vary considerably from month to month because of the seasonal nature of these sectors. Net of these, payroll jobs grew by 190,000 in March. While this is a strong gain, it followed sub-par growth of approximately 50,000 in January and February, *leaving the average for the first three months of the year at 98,000, about the same as in the previous four months*.

[1] From the U.S. Bureau of Labor Statistics' BLS Payroll Establishment Survey: CES.

The table here, "**Employment Changes December 2003 to March 2004**," breaks down the average monthly job gains over the past three months by sector, showing the share of each sector in total employment and in first quarter job growth. Note that the job market is indeed improving, as is evident in the data for such sectors as Professional Services, Leisure and Hospitality, Transport/Utilities, and Administrative Services. Similarly, even manufacturing (durable and nondurable goods), which lost an *average* of -100,000 jobs per month over 2001-02, has staunched its declines in the last few months. Yet, aside from the volatile construction and retail sectors, underlying job growth was still consistent with a pace far below the 200,000 to 250,000 job-per-month rate that is considered necessary to maintain even stable unemployment, let alone to reduce unemployment.

Employment Changes December 2003 to March 2004

Seasonally Adjusted Data, Thousands

	Total		*Monthly Change*	
Total nonfarm	130,548		171.0	
Construction	6,862	5.3%	29.3	17.1%
Durable goods	8,882	6.8%	4.7	2.7%
Nondurable goods	5,428	4.2%	-9.3	-5.4%
Wholesale trade	5,621	4.3%	7.5	4.4%
Retail trade	15,008	11.5%	44.0	25.7%
Transport / Utilities	4,769	3.7%	11.0	6.4%
Information	3,167	2.4%	-2.7	-1.6%
Financial Services	7,995	6.1%	4.8	2.8%
Professional and technical	8,360	6.4%	6.6	3.9%
Administrative Services	7,867	6.0%	16.0	9.4%
Educational services	2,736	2.1%	2.5	1.5%
Health care and social	14,070	10.8%	22.4	13.1%
Leisure and hospitality	12,249	9.4%	19.0	11.1%
Other services	5,383	4.1%	3.0	1.8%
Federal	2,713	2.1%	-2.3	-1.3%
State and Local	18,860	14.4%	12.0	7.0%

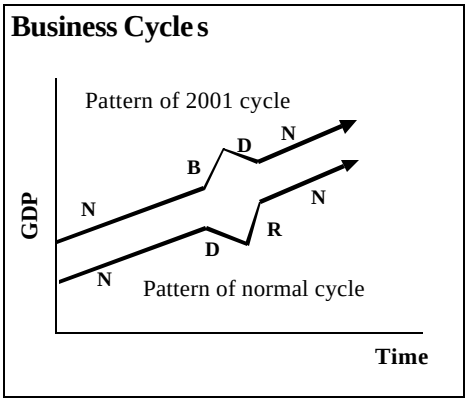
Our forecast looks for manufacturing to start adding jobs sometime in the second quarter, propelling total job growth up to a rate of about 125,000 per month. However, even that pace would be far below the norms of the U.S. economy in recent decades. Such lackluster growth would come on the heels of the especially weak 2001-03 performance documented above. Something is very different here.

III. WHY THINGS ARE DIFFERENT

Long-run economic trends are fairly stable, especially when the drivers are non-economic factors such as birth rates decades earlier, As is the case with labor force formation and jobs. It takes a number of factors to drive U.S. labor market performance as far off "course" as it has gone of late. We believe four major, emerging factors have worked to effect this change: 1) the unusual, truly ***business*** cycle nature of the 2001 recession, 2) the after-effects of "excessive" job growth in the late 1990s, 3) rapidly-rising fixed costs of employment, and 4) the growing importance of outsourcing jobs abroad. The first two factors are

offshoots of the peculiar nature of the late 1990s economic expansion. The last two factors have been part of the landscape for over 20 years, but have become increasingly important of late because of interaction with the technological advances of the 1990s.

A True Business Cycle This Time. One reason the labor markets have not performed to expectations is that the rest of the economy is not "up to speed" either. Most recessions are abnormal periods in which the economy is pushed off its long-run growth path by some shock. This creates a large amount of excess supply in resource markets and causes the economy to contract for a short period of time. In the lower line in the chart here, "**Business Cycles**," this is characterized by movement from path N (Normal) to path D (Depressed). In such cases, after recession has run its course, a period of especially rapid growth ensues — path R (Recovery) — until output and employment conditions have returned again to normal.



The 2001 recession was unusual for a number of reasons. It was led by businesses rather than by consumers. Also, it occurred at the end of a major bubble in stock prices that had driven a surge of excessive business investment. Irrational expectations of the future of productivity and profits drove the boom economy of the late 1990s, and the inevitable return to reality created the downturn. In short, normal growth through the mid-1990s was followed by excessive growth in the late 1990s, or movement from path N to path B (Boom) along the upper line in the chart here. The downturn of 2001 and after, then, was a *return to* normalcy — via path D on the upper line, not a *departure from* it.

Investment fell from excessively high levels in the late 1990s back to only slightly below-normal levels by 2002. Presently, there is little potential for investment to "recover," since there is nothing from which to recover. The same is true for consumer spending and housing. These demand components never weakened during the recession, so there is absolutely no potential for them to "recover," as they did in previous downturns.

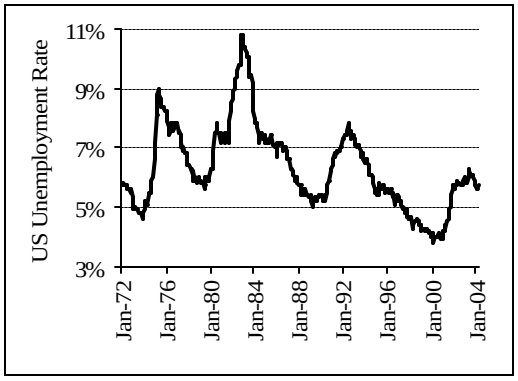
We've documented these points in our Forecast reports over the past four years. With the present cycle being driven truly by *business* spending rather than household spending, there was, and is, less potential for an economic recovery, per se. Thus, it is inevitable that economic growth early in the expansion would be slower than has previously been the case in the U.S. Without a major surge in output, we could not expect to see a major surge in the purchases of labor inputs, i.e. jobs.

After-Effects of Late 1990s' Job Surge. The late 1990s' bubble economy also saw a mad scramble by businesses for employees, driven largely by rapid expansion in high-tech. With IPO and VC money flowing freely and with profitability at best a secondary consideration, start-up companies sought to establish their legitimacy by recruiting ample – often more than ample – staff and in-house expertise. Just as these companies overlooked profitability when investing in physical capital, they also overlooked it in investing in human capital: staffing. Non-tech companies had to compete with technology companies for labor, and they faced similar concerns (unconcerns?), leading to an overheated labor market.

College undergraduates often enjoyed substantial signing bonuses when joining new companies, a perk previously reserved for graduate students from elite universities. Unemployment rates were below 4% nationally, and they were far lower in hot technology markets like San Jose. Hiring levels became clearly exaggerated. The employment surge continued through March 2001, a good nine months *after* the emergence of declines in industrial production and elsewhere, as the excesses wrought by the tech bubble persisted.

U.S. Unemployment

Seasonally Adjusted

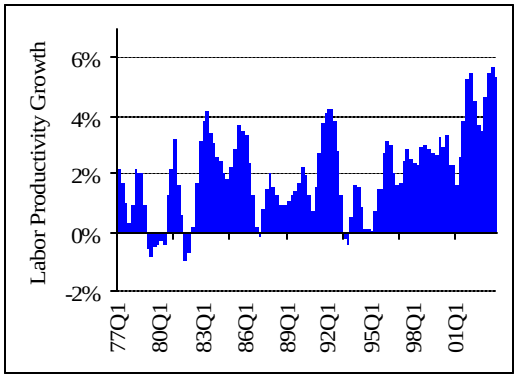


One of the paradoxes of the late 1990s' technology boom was that the promised labor productivity growth did not immediately surface. Productivity growth averaged 3% per year then, a rate that was solid but not spectacular. Keep in mind that *real* physical investment *per worker* rose by 50% between 1995 and 2000. Since 2001, however, the U.S economy has seen truly spectacular productivity growth of 5% per year or more. That growth is even more unusual in that it came during a recession and an especially slow expansion. (Productivity growth traditionally has been pro-cyclical and has risen *directly* with growth in output and investment, not *inversely*.)

What was occurring, of course, was excessive hiring in the 1990s by firms anxious to have staffing in place when the "new economy" finally arrived.

U.S. Labor Productivity Growth

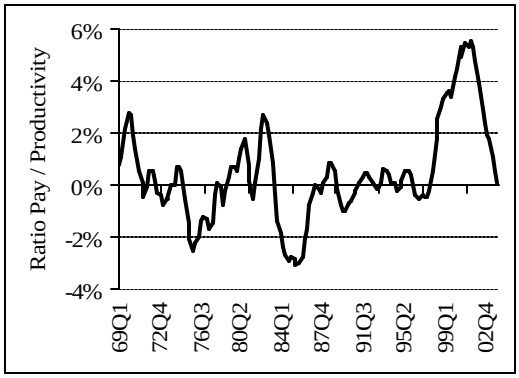
Seasonally Adjusted, Annualized, Smoothed



This offset the productivity gains that should have occurred then thanks to soaring investment per worker. Those gains finally surfaced when staffing was "rationalized" and conditions in general returned to normal in the 2000s.

Worker Pay / Productivity Ratio

Seasonally Adjusted, Detrended



The late 1990s' hiring surge also resulted in excessive growth of employee compensation. In the long-run, employee compensation is inexorably linked to worker productivity. However, in the late 1990s, wages rose sharply despite mild productivity growth. Weaker compensation growth and surging productivity since 2000 have reversed this imbalance.

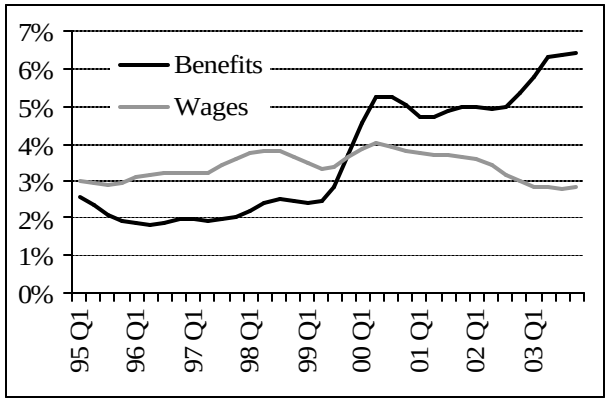
The last three years' experience should best be described as a productivity "echo." The true productivity gains that occurred in the late 1990s are only now being seen, as workforces have been trimmed and reorganized. Unfortunately, with growth in aggregate demand and output so soft, rapid productivity growth has led to downward pressures on employment.

There is No Free Lunch…Workers Pay For Their Own Benefits. The good news presently is that the pay/productivity imbalance of the late 1990s has been worked off, and demand for new workers is on the rise again. However, that demand is being tempered by rising fixed costs of employment.

Healthcare insurance premia have been increasing at double-digit rates for three years, a gain on par with that of the late 1980s. The current cost of healthcare insurance for a family of four is about $9,000 per year. Here in California, businesses face the additional burdens of rising workmen's compensation insurance, state-mandated health insurance provision, paid family-leave benefits, and other regulatory costs. Furthermore, reduced yields on stocks and bonds are increasing the present costs to employers of providing future pension benefits. All in all, costs of employee benefits are rising far faster than those of wages and salaries.

Increases in Worker Compensation by Type

Annualize Rates, Seasonally Adjusted



As stated above, employee compensation is ultimately determined by productivity. What must also be understood is that so far as employers are concerned, benefits are part of workers' compensation just as much as are wages. Both come out of the same "pie." The size of employees' total compensation package is determined by interaction between the supply and demand for labor (including the effects of productivity). Once these forces have interacted to determine the size of the pie going to workers, benefits and wages then compete for shares of that pie: raising benefits inevitably mean reducing the amount left for basic wages. Alternatively, demands for increased benefits not offset by reduced wages mean increases in the total pay package, which leads to reduced demand for workers, thus falling jobs. There is no free lunch, and there are no free benefits.

As mentioned just above, benefit costs rose similarly in the late-1980s. When economic expansion resumed in the early 1990s, businesses were slow to hire permanent workers, instead utilizing existing staff more intensively and also utilizing temporary help. Those avenues allowed firms to avoid increasing "fixed costs" during a period when expansion was rapid but incipient (therefore uncertain). With a similar rise in benefit costs presently, with the pace of expansion even slower (and productivity gains even larger), firms have been even more reliant on raising production via increased workhours for *existing* workers and increased utilization of temporary workers.

The early 1990s' avoidance of permanent hiring (and so of higher fixed labor costs) was finally overcome by sustained expansion and by the emergence of the tech surge. With the pace of expansion presently likely to be slower and with the tech surge "ancient history," firms' reluctance to embrace the higher fixed-costs associated with permanent hiring will be more enduring.

Outsourcing: It's Not Just In Manufacturing Anymore. We hear constantly these days about foreign call-centers, cheap imports, and outsourced jobs. Such trends have actually been part of the U.S. landscape at least since the early 1980s, when U.S. manufacturing employment began its secular decline, perhaps even since the 1970s, when imports' share of GDP started rising sharply. What has changed recently is that new technologies have allowed foreign competition in services as well as manufacturing.

Economists have long held that the forces of foreign competition, international price/cost arbitrage, purchasing power parity, etc. held most clearly and quickly in the markets for traded goods, for manufactured products, and that these forces were less of an issue for services, which could not be internationally traded. The emergence of universally-available digital, satellite communications and high-band-width Internet computing have changed the competitive environment for a variety of services.

It was once impractical to import local customer service operations from abroad. However, low-cost intercontinental telephony now allows these functions to be performed abroad at only a fraction of domestic operating costs. Similarly, the ubiquity of the Internet and the universality of Windows and UNIX platforms now allow computer programming to be performed effectively—and much more cheaply—continents away. Besides the technological advances, it is also surely true that the emergence of China and India as economic powers, with literally hundreds of millions of potential manufacturing and IT/service workers, has raised the prevalence of and potential for outsourcing for both manufacturing and services, compared to what it was when operations were being outsourced to previous Asian tigers, such as Korea and Taiwan, with much smaller populations.

Outsourcing and trade is good for the U.S. economy and for foreign economies. The essence of trade, be it among nations or among people, is specialization. The more specialized an economy becomes, the more it can focus on its comparative advantages, and the better off its people will be. Yet, as with any rapid change to an economy, long-run gain is often preceded by short-run losses, and the losses that are occurring are receiving outsized media and political attention amid the economy's slower growth pace.

As yet, imports of labor services are only a tiny share of GDP. However, that share is growing, and the potential for further increases is currently casting its shadow over labor markets. Meanwhile, similar effects in manufacturing have been accumulating for thirty years.

What Does It All Mean? We have stated that the proliferation of outsourcing in recent years is merely a broadening of trends that have been in place for decades. As is the case with the issues of higher productivity growth and higher fixed-costs of employment in the U.S., if the 2000s' outsourcing trends had occurred within a milieu of "normal" cyclical expansion, they would have reduced the extent of job growth temporarily, but it would have been hardly noticeable.

Instead, an economy falling back to reality, higher productivity growth, rising fixed-costs of labor, and increased outsourcing have all occurred at once and have interacted with each other. (For example, outsourcing allows still-higher *average* productivity levels for remaining domestic workers. Rising benefit costs make employers more likely to seek out foreign outsourcing. And so on.) The end results are sub-par economic growth and two years of a jobless recovery followed by only weak job growth since then. Before making conclusions and projections from these trends, let's first work through some factors which have received a lot of popular attention, but which have little substantive connection to the key developments we have detailed here.

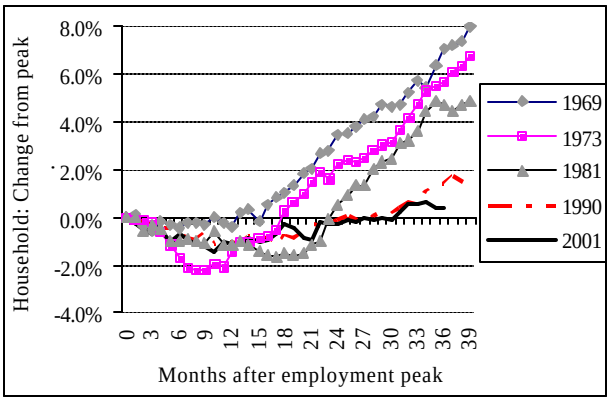
IV. SIDESHOWS

Payroll Jobs vs. Household Jobs. While we have been identifying the reasons for unusually weak job growth, other analysts still insist that the sluggishness is a statistical "blip," supposedly belied by other indicators. Those folks far overstate the condition of those "other" employment indicators.

The BLS publishes two measures of employment: *payroll jobs*, counting jobs at establishments which pay/report payroll taxes and compiled from written surveys and payroll tax returns, and *household employment*, counting employed workers and compiled from telephone surveys. These two indicators cover slightly different aspects of the labor force, and they are tabulated from different sources. It is inevitable that they will provide at least slightly different looks at the labor market, and it is important to put the different signals provided by the two measures into context.

Household Employment around Past Recessions

Seasonally Adjusted, Percent from pre-recession peak



Those contending that U.S. employment growth is proceeding just fine are either ignoring or distorting that context. They decry the weak levels of *payroll jobs* (still below 2001 peak levels) and claim that *household employment* has grown robustly in this expansion. Certainly, household employment is above the previous cycle peak. However, as the chart here shows, the cumulative growth in household jobs to date in this recovery is just as far below the "norms" of previous history as we found payroll jobs to be in Section II.

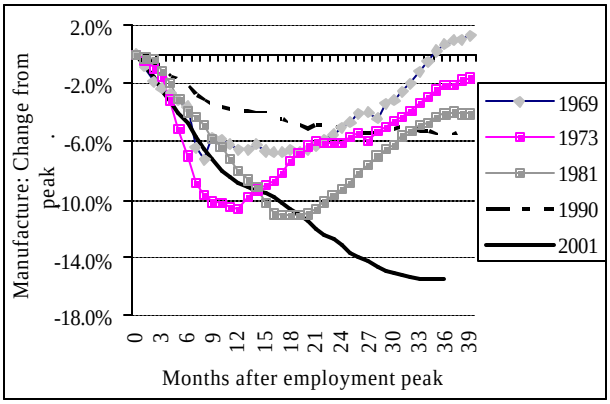
We could expound at length about the technical differences between the two employment measures, but the chart here makes our point much more simply. There is no substantive difference in the performances of the two indicators. By either measure, U.S. underlying job growth is the slowest it has been in forty years.

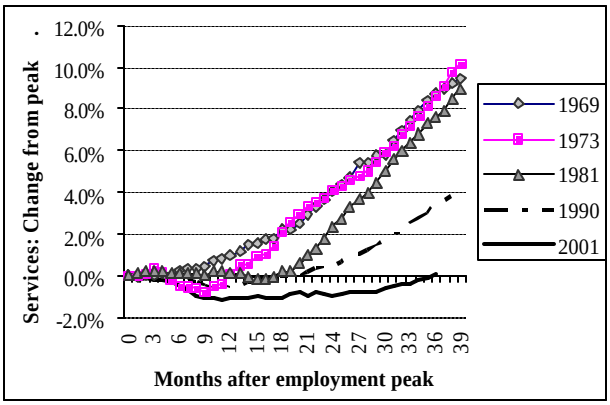
Both Manufacturing and Services Are Hurting. Similarly, media reports tend to focus on the plight of U.S. manufacturing, since the bulk of net job declines during 2001-2002 were experienced there. However, it is always the case that manufacturing loses more jobs during a recession than do service sectors. While it is true that manufacturing has seen sharper job losses over 2001-03 than in previous cycles, service sector performance has also been much weaker than in previous cycles.

The following two charts show the cumulative net change in manufacturing and service jobs from cycle peaks over the last five expansions. As these charts clearly show, both sectors have shown much weaker performances over the last three years than they did in previous business cycles. So, yes, the forces afflicting U.S. labor markets are having a dramatic impact on manufacturing, but they are also having a dramatic effect on services as well.

Employment by Sector around Past Recessions

Manufacturing, Seasonally Adjusted, Percent from previous peak





V. CONCLUSIONS

It is important to remember that weak labor markets are a short-run phenomenon. Workers and employers will eventually adjust to the factors listed in previous sections.

Normal times will eventually elicit normal behavior by employers and job seekers. Expectations overheated by the 1990s' boom will come back to ground. Workers will realize that *they* pay for their health care and figure out how much of it they really want. Asian sellers of labor and factory goods to the U.S. will decide to spend more of their dollar receipts, and American entrepreneurs will find out what they can successfully sell to Asia and create the jobs to do that: comparative advantage will win out.

Unraveling the imbalances of the late 1990s—and the attendant slow rate of growth—won't stop the economy from adjusting to these factors, but it is slowing the adjustment process down. In the meantime, labor market conditions are improving, but the issues/problems detailed above will persist. Employment growth in 2004 is not going to be very strong.