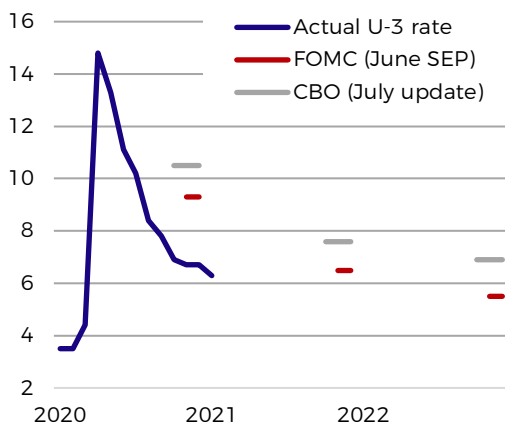


ASSESSING THE STATE OF THE US LABOR MARKET

Suttle Economics Notes #152

- The US is the high-volatility labor market among DM economies
- Rapid healing since mid-2020 has followed on from a catastrophic collapse in 20Q2
- More slack has been created in 2020 than the conventional unemployment rate suggests
- It is possible, however, that there will be a rise in the “natural rate” during this expansion

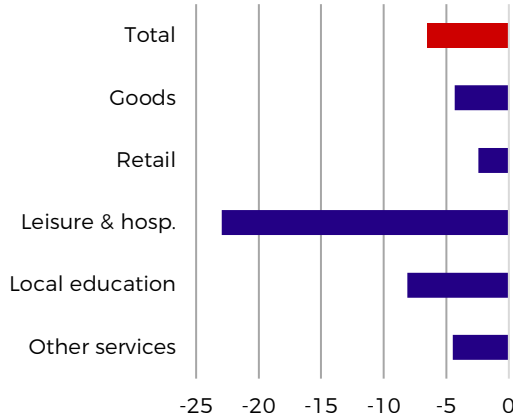
Chart 1
US unemployment rate
% of labor force



The standard measure of the US unemployment rate fell to 6.3% in January, a substantial (0.4%-point) decline on the month. More notably, the unemployment rate has fallen far more quickly through the early phase of the C-19 recovery than key policy agencies (especially the Fed) had projected around mid-year (Chart 1). Aside from raising obvious reminders about the difficulties of macro forecasting in the current environment, the unexpectedly rapid decline in the unemployment rate raises questions about whether the US labor market is, in aggregate, doing much better than perceived.

In its December projections, the FOMC appeared to be targeting an unemployment rate in the range of 3.5%-4% as a necessary condition for a rate lift-off (in 2024). If we head there much faster than expected through 2021, then this could bring forward market expectations for rate hikes into 2023, or even earlier.

Chart 2
US employment by sector through C-19
% change in employment, Feb '20 to Jan '21



All recessions have their unique characteristics. The C-19 recession stands out, however, as largely a supply-side event. The sudden, sharp slump in the demand for labor in some key sectors (most obviously leisure and hospitality; Chart 2) neither reflected that consumers no longer valued the underlying service nor no longer had the means to buy them. Health and safety concerns (and associated behavioral changes) restricted normal demand. Most other DM countries chose to protect the jobs of many affected workers. The US has always revealed a preference for a more “flexible” labor market (hire and fire at will). Many workers laid off in affected sectors were low-wage workers, often working multiple jobs. Their job losses were accompanied by a decline in labor market participation which means that the “true” U-3 unemployment rate is probably about 3%-points higher than the reported January rate (albeit still down very dramatically from its April 2020 peak).

The major policy challenge is how to handle an employment shock that is dominated by these *structural*, rather than *cyclical* forces. The first-best

Chart 3
Leisure and hospitality labor flows

million per month in 2020, sa

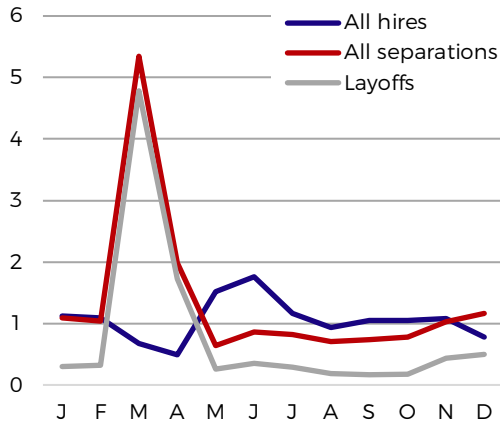


Chart 4
Employment and GDP by country

% change through C-19 crisis

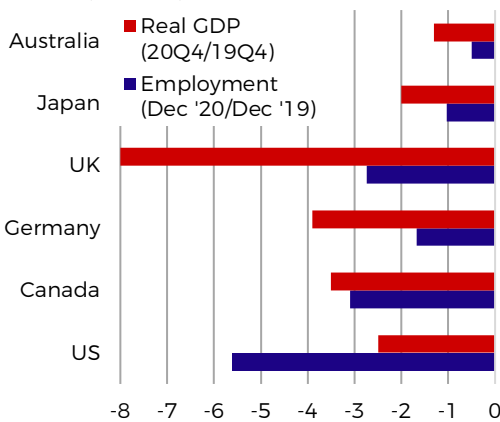
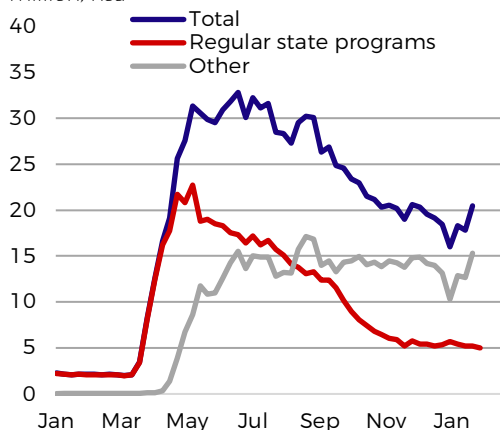


Chart 5
Unemployment insurance claimants

million, nsa



policy solution is to lower the rate of C-19 infections, such that they no longer dominate economic decisions. This will lead to a sharp revival in the demand for labor in affected sectors. Not all jobs in these sectors will return in the short-term. Businesses will have failed and temporary layoffs have increasingly become permanent (Chart 3). Underlying behavior will likely have changed durably (e.g. more work from home, leading to a reduced demand for shops providing office worker lunches). Easy macro policy to promote employment growth in expanding sectors to accommodate resulting slack is helpful but needs to be complemented by (supply-side) retraining measures to encourage structural shifts.

Cross-country labor market differences

The United States was only major DM economy where the decline in household employment through 2020 exceeded the decline in real GDP (Chart 4). This difference reflected two sets of factors.

First, US labor contracts are more flexible than elsewhere, leading to rapid labor shedding and re-employment during phases of cyclical volatility. This greater propensity for turnover has served the US economy well through recent decades of rapid structural change in the global economy, although the income benefits from this flexibility have become increasingly skewed. In 2020, the outcome was much more resilient for profits of larger companies than expected in the early months of the crisis.

Second, new labor market policies developed through the crisis in most DM economies were designed to sustain suddenly unviable jobs through government (and, to a limited extent, employer) subsidies on the hope and belief that these jobs would eventually become viable once again. Although this was an aspect of US PPP loans (which became grants), the main policy focus in the United States has been the provision of Federal support for state-based unemployment insurance claimants. New programs were developed, notably Pandemic Unemployment Assistance, aimed at workers not eligible for normal state benefits. All told, there were 20.5 million claimants for all these benefit programs at the end of January (12.8% of the labor force), up 18.4 million from the end of February 2020 (Chart 5). About 6.4 million were claiming longer-term benefits.

Assessing the amount of new labor slack created

I normally think of the US unemployment rate as one of the most reliable statistics in economics. One reason for this is that it is the key output from the largest regular social science survey in the world (a rotating panel of 60,000 households). There are two reasons to doubt that the latest reading for the unemployment rate (6.3% in January, up 2.8%-points from the low in February 2020) adequately captures

Chart 6
Labor force participation rate
labor force as % of working-age population

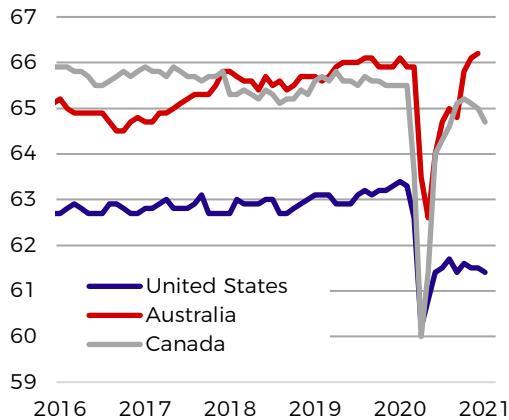


Chart 7
Unemployment rate differential
U-6 versus U-3 differential, %-pt of labor force

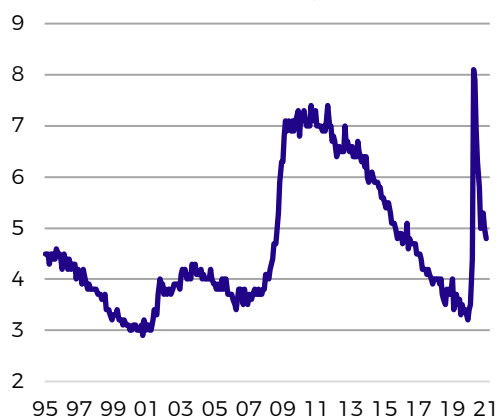
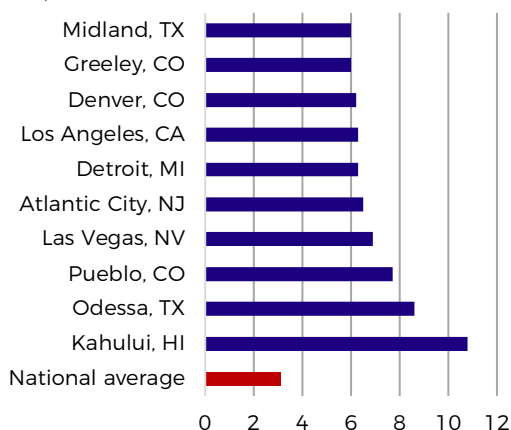


Chart 8
Increases in urban unemployment rates
%-points of labor force; Dec 20 versus Dec 19



the greater degree of labor slack opened up by the C-19 recession. As noted, the rate which would prevail under more “normal” conditions would probably be at least 3%-points higher.

First, there is the problem that the C-19 crisis has caused a decline in the labor force participation rate. This is another difference between the US and some other DM labor markets (Chart 6). One factor possibly accounting for this drop is the need to provide child-care during periods of school closure. In the year to January 2021, the labor force *fell* 2.6%oya. In the two years to December 2019, it had *grown* at an annual average rate of 1.2%.

Second, the BLS has consistently recognized that classification errors have meant that workers who should be classified as unemployed because of C-19 are counted as employed but unable to work. Early on, this bias may have been worth several percentage points, although now it is generally reckoned to be about 0.6%-points. There were more general household survey quality questions through 2020. The response rate dropped, from 82.3% in February to 64.7% in June. It has since recovered to about 80%.

The BLS publishes six measures of the unemployment rate each month. The broadest (U-6)—which includes those marginally attached to the workforce—should correct for *some* of the problems noted above. Its persistently high level relative to U-3 in 2010-12 was often cited as evidence of slow labor market healing. Since April 2020, the differential has narrowed sharply—another example of rapid healing (Chart 7).

Trouble in paradise

The sector-specific employment damage from the C-19 crisis can be illustrated by the geographic pattern of the labor market shake-out to date. Among urban areas (51 metro areas with 2010 population of at least 1 million), the highest increases in unemployment rates through 2020 came in areas dominated by tourism and commodities, including Hawaii, Texas and Colorado (Chart 8). Gambling tourism centers (Las Vegas and Atlantic City) also suffered hard. The unemployment rate in Las Vegas was 3.5% in December 2019. It jumped to 34% in April 2020. By December 2020, it was back down to 10.4%.

Wage inflation through the crisis and beyond

The spike in unemployment in Q2 was accompanied by sharp rise in the benchmark measure of US wage inflation—average hourly earnings (AHE; Chart 9). This jump, which might initially seem counter-intuitive, was a reflection of the way that the AHE data are calculated. The whole economy measure is derived by dividing overall wage earnings by hours worked. When fewer low-paid workers are employed, as occurred between February and April, the whole

Chart 9
Alternative measures of wage growth
%q/q, saar

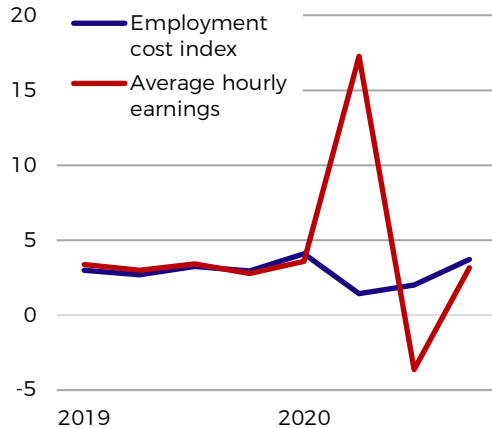


Chart 10
Unemployment rates by ethnicity
% of labor force; changes since Feb '20

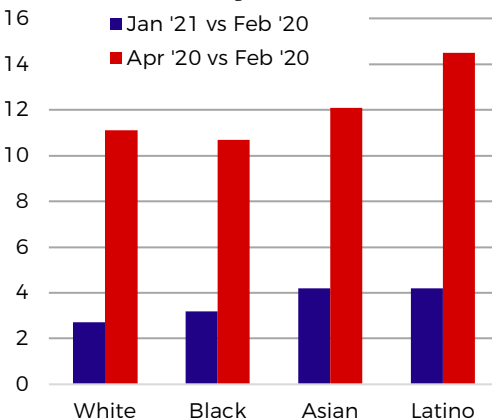
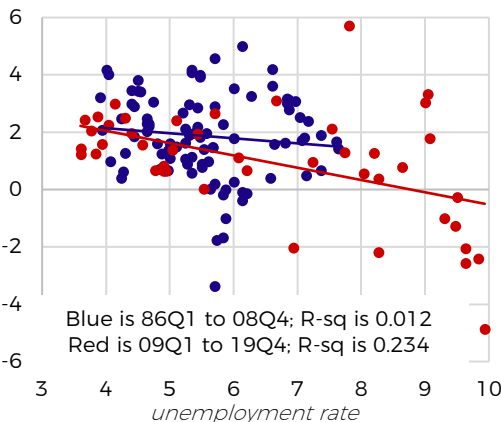


Chart 11
Productivity-adjusted Phillips curve
unit labor cost, %oya



economy average wage goes up. As those workers come back to employment, the average wage paid goes back down (as occurred in Q3). The quarterly wage and salaries measure included in the employment cost index (ECI) corrects (“mix-adjusts”) for these employment composition shifts. Its path through 2020 was more intuitive, with wage growth weakening in Q2 and Q3, and firming in Q4. Q4’s ECI wage inflation rate was the highest since 2018Q1.

The severe impact of the C-19 crisis on lower-wage workers was also reflected in the rise in unemployment rates by ethnic groups through 2020 (Chart 10). Rates for Asian and Latino workers have both risen by 4.2%-points since February 2020.

Thoughts on the post-pandemic labor market

It is highly likely that the dissemination of vaccines will allow for a resumption of much deferred (and employment-intensive) service sector activity during 2021, plausibly through Q2. This could lead to stronger employment growth from the spring onwards. US labor market normalization might well then resume to surprise on the strong side (the current high level of first-time claims is concerning).

The productivity-adjusted Phillips Curve has steepened a little since the global financial crisis and, most importantly, become better-determined. A 5% unemployment rate would be consistent with unit labor cost growth of about 1¾%. Assuming productivity growth of ¾%, this implies (ECI) wage growth of about 2.5%—consistent with policy on hold at its current stance, albeit with an expectation of Fed QE tapering in 2022H1.

One issue is what might happen in an environment where there is a greater reluctance to hire low-wage workers in the next upturn, possibly because of more caution among and about low-wage service-sector businesses. These effects could be compounded by measures (state and Federal) to raise minimum wage rates. Strong demand for relatively skilled labor could then push wage growth higher, supported by capital deepening. The overall effect would be to lift the perceived natural rate through the next expansion.

Philip Suttle
phil@suttleeconomics.com
202-378-6793

Important Information

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