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Randall W. Eberts
W.E. Upjohn Institute for Employment Research, eberts@upjohn.org

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Authors

Randall W. Eberts, *W.E. Upjohn Institute for Employment Research*

Upjohn Author(s) ORCID Identifier

https://orcid.org/0000-0002-9711-5466

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Randall W. Eberts, Ph.D.
W.E. Upjohn Institute for Employment Research

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The primary challenge facing the U.S. economy is that it simply is not creating enough new jobs to get people back to work after the recession and to place the economy on a firm road to recovery. Despite the effort of a major stimulus package enacted near the end of the recession and aggressive monetary policy, the unemployment rate remains stubbornly high by U.S. standards, at 7.8 percent going into 2013. The unemployment rate has been 7.8 percent or higher for four years, the longest duration of persistently high unemployment since 1947. While the length of time people are unemployed has fallen slightly, 12.5 million people are still looking for work—4.5 million more than were looking immediately before the recession began when the unemployment rate was at 5 percent. All population groups have been adversely affected by the high rate of joblessness, but as in past recessions, youth, minorities and the less educated are most vulnerable.

The economy is improving, but still not at the pace that will reduce unemployment to a more acceptable level. Since October 2010, the U.S. economy has generated employment gains for 27 consecutive months at an average monthly rate of 153,000. Yet the gains are barely sufficient to provide jobs for those entering the working age (16 years or older), and not enough to begin to bring down the number of unemployed. The inability to reduce the large overhang of unemployed is evident in the stubbornly low employment-to-population ratio. In the two-year period from December 2007 to December 2009, the ratio fell from 62.7 percent to 58.5 percent, the largest decline during any recession since WWII. Since then, it has barely budged, and in December 2012 it stands at 58.6 percent. Obviously, less educated and otherwise vulnerable population groups find it even more difficult to find jobs. The employment-to-population ratio of African Americans is 52.6 percent and their unemployment rate is 14 percent. Youth have even greater difficulty, with only 29.1 percent of the population of 16-to-19 year olds employed, leading to an unemployment rate of 21.6. The employment-to-population ratio and unemployment rate of black youth are 14.9 percent and 40.5 percent, respectively.

Averting the Fiscal Cliff

Looming over the U.S. economy for the past year and a half has been the possibility of draconian cuts in federal spending and large tax increases. For now, however, it appears as if the U.S. has averted the so-called "fiscal cliff," at least for now. At the eleventh hour, Congress came to an agreement and President Obama signed into law legislation that staved off $110 billion in domestic and military spending in 2013 alone and prevented tax increases for 98 percent of taxpayers. If Congress had not reached an agreement, the net result, according to the Congressional Budget Office (CBO), would have been a reduction of $607 billion in the federal deficit between 2012 and the end of 2013, which is about 4 percent of GDP. Put in perspective, this reduction in the deficit is a greater percentage of GDP than was the stimulus package within a similar time period.

The proposed fiscal tightening would have slowed the economy significantly. The CBO estimates that if the automatic spending cuts and tax increases would have gone into effect, nearly 3 million jobs would have been lost, raising the unemployment rate from 7.8 percent to 9.1 percent by the fourth quarter of 2013.[1] Furthermore, these spending cuts and tax increases would have come shortly

[1] Congressional Budget Office, "Economic Effects of Policies Contributing to Fiscal Tightening in 2013," November 2012.

after the federal fiscal stimulus program ended. The American Recovery and Reinvestment Act (ARRA), signed into law in February 2009, authorized $840 billion dollars over two years. Even though stimulus spending ended in September 2011, the Congressional Budget Office estimates that the stimulus program accounted for up to 1.2 million jobs in 2012 and 500,000 in 2013.

President Obama, recognizing the importance of maintaining momentum in job creation and the fragility of the recovery, introduced an additional stimulus package—the American Jobs Act (AJA)—in September of 2011. The purpose of the $447 billion bill was to provide incentives for businesses to create new jobs, offer innovative programs to put the unemployed back to work, stimulate the economy by providing tax relief to the middle class, and extend unemployment benefits. The U.S. Senate chose not to consider the AJA for debate or a vote, so the bill died.

Whatever Congress finally decides to do about the federal budget deficit will definitely entail fiscal tightening. The question is how much. Some economists look back to the Great Depression era of the 1930s and recall what happened in 1938 when Congress tightened its belt and the economy relapsed into another severe downturn. It is clear going forward that Congress has no appetite for another fiscal stimulus package. The recent bill to avert the fiscal cliff was only a temporary patch in fixing the problem of the large federal budget deficit and unsustainable public debt. Another congressional confrontation is expected in late February or early March when the federal debt ceiling needs to be raised in order for the government to continue to issue debt to operate the federal government. At that time, Congress may focus more on spending cuts than on additional tax increases, since some members of Congress consider the issue of tax increases already taken care of in the January agreement.

Expansive Federal Reserve Policy

The only economic stimulus still being actively implemented is monetary policy.[2] After its September Open Market Committee (FOMC) Meeting, the Federal Reserve Board announced that it will continue to pursue measures intended to stimulate the economy through its unconventional practice of quantitative easing. In its statement, the Fed set forth the following plan: "If the outlook for the labor market does not improve substantially, the committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability." The bond-buying plan, according to the official Fed statement, "should put downward pressure on longer-term interest rates, support mortgage markets, and help make broader financial conditions more accommodative." The September announcement heralded the third round of quantitative easing, or QE3 as dubbed by Fed watchers.

Quantitative easing is a way in which the Fed pumps more money into the economy by buying bonds or other financial assets from banks. In the case of QE3, the Fed is buying mortgage-backed securities. The Fed action increases the amount of cash banks have to make loans as well as lowers the interest rate, making it less costly to borrow money. The Fed first instituted quantitative easing in November 2008, after its conventional policy of buying short-term government bonds became ineffective when the Fed effectively lowered fed funds rates to zero. Since that time, the Fed has implemented three rounds of quantitative easing, with the third round announced in September. During the first two rounds, which spanned nearly four years, the Fed injected nearly $1.9 trillion into the economy. For the third round, the Fed proposes to purchase $40 billion in mortgage-backed securities each month. The Fed also intends to leave the Fed Funds rate at its current nearly zero rate and to continue to purchase longer term Treasury securities in order to keep longer-term rates relatively low as well.

[2] One could argue that the lingering fiscal deficit continues to act as an economic stimulus.

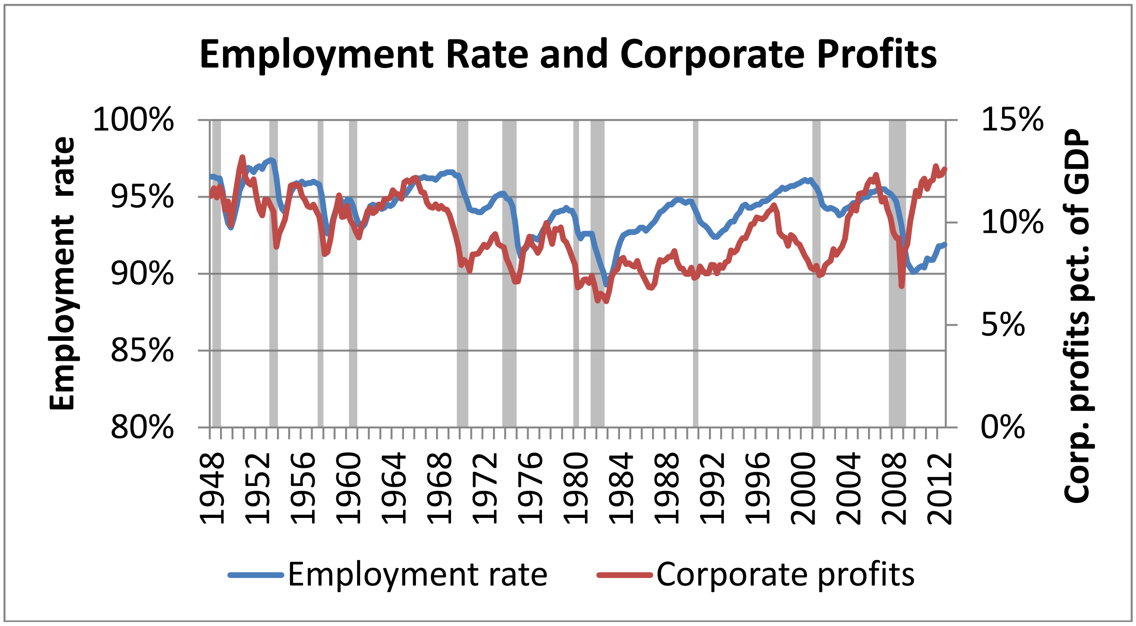
In addition to quantitative easing and keeping the fed funds rate near zero, the Fed has been buying longer-term securities and selling shorter-term securities, as a way to stimulate the economy. Dubbed "Operation Twist," this policy of lowering longer-term yields makes loans less expensive for those looking to buy homes, purchase cars, and finance projects. Operation Twist was the third in a series of major policy responses by the Fed in response to the financial crisis of 2008. The first was cutting short-term interest rates to an effective rate of zero. That rendered the central bank unable to use further rate cuts to spur growth, so its next step was quantitative easing. The Fed then conducted two rounds of quantitative easing, which market-watchers dubbed "QE" and "QE2." Shortly after QE2 concluded in the summer of 2011, the economy began to show signs of renewed weakness. Rather than immediately opting for a QE3, the Fed responded by announcing Operation Twist. The Fed has since launched QE3.

The December FOMC meeting marks the first time the Fed has offered specific targets for the quantitative easing policy. Instead of picking a date the program would likely be terminated, the FOMC stipulated that they would continue the policy until the unemployment fell below 6.5 percent, as long as projected inflation did not exceed 2.5 percent. According to calculations presented by the Atlanta Federal Reserve Bank, the Fed may be pursuing quantitative easing for some time to come. If monthly net job creation continues at 153,000, as it has averaged for the past 27 months, it could take upwards of 40 months for the unemployment rate to fall from 7.8 percent to the target of 6.5 percent. If quantitative easing, along with a more self-sustaining economy, can increase monthly net new job creation to 180,000, the length of time to reach an unemployment rate of 6.5 percent is reduced to 24 months. Average monthly job growth of 180,000 or more is not out of the question; it happened consistently from 1994 to 2001, for example, and several times before then. However, achieving more than 180,000 per month has been rare since then, occurring only within the 24-month period before and during 2006. The Federal Reserve Board projections of the unemployment rate for upcoming years, provided at the December 2012 FOMC meeting, are consistent with a 24- to 30-month time frame to reduce unemployment to a range than includes a 6.5 rate. This calls for at least 170,000 jobs created each month, on average.

Quantitative easing can stimulate the economy only if banks are willing to loan the excess cash. Unlike convention monetary policy in which short-term interest rates are the instrument used to stimulate the economy, quantitative easing impacts the money supply directly, through increasing the amount of excess cash banks have to loan. However, banks are not required to loan excess cash. If banks lack confidence that they will be repaid or they see bank regulations impeding their ability to loan, they may not release the stimulus money into the economy. So far, banks have been reluctant to lend, holding $1.5 trillion in reserves, even though they are required to hold reserves of only $250 billion. Before the financial crisis, bank reserve holdings were no more than required. Therefore, much of the money created from the Fed's quantitative easing is still sitting in bank vaults. Nonetheless, quantitative easing has done some good. Even without loaning out all of this excess cash, the Fed's purchase of securities lowers interest rates, particularly the longer-term rates, which helps to stimulate the economy, albeit not to the extent it would have if more money were loaned to businesses and consumers. Yet, some prominent economists have credited QE with preventing another recession within the U.S. and elsewhere in the world.

Record Corporate Profits, but Relatively Little Hiring

To exacerbate the problem, large corporations are retaining their record profits instead of using the money to reinvest in plants and equipment or to hire additional workers. Corporate profits are nearly 13 percent of GDP, the highest since the 1950s. Typically, profits and employment trend together, but during the current recovery profits have bounced back dramatically right when the recovery began whereas employment languished and only more recently has it begun to slowly trend upward. Employment by firm size shows that firms with more than 1000 workers have had the lowest jobs growth during the recession than any other size group but the very smallest (less than 20 workers). Firms within the 100-500 worker range generated the largest employment gains.



Lingering Uncertainties

Some of the reluctance to hire additional workers may be related to a relatively somber outlook by businesses. The Institute for Supply Management Business Confidence Index is teetering at around 50, after reaching a 10-year high of 61 in 2011. A reading greater than 50 indicates that businesses are generally expanding and a reading below 50 suggests a general business contraction. The last time the index approached 50 was in August of 2011 when the economy was flirting with the possibility of a federal government default because Congress was reluctant to raise the debt ceiling. The time before that when the index skirted 50 was at the end of 2007 when the economy plunged into recession. Clearly, an index reading around 50 indicates business apprehension related to uncertainties around fiscal policy.

A stubbornly low consumer confidence index adds to a tepid business outlook. Consumer confidence fell in January 2013 to 58.6 from 66.7 the month before and 71.3 two months before then. Averaging 110 before the recession and reaching nearly 150 at the beginning of 2000, the index has been stuck at levels that have not been observed since the early 1990s. While considered a lagging indicator, it still expresses the general mood of consumers, which affects their spending decisions. For consumers, the housing market is still weighing heavily on the finances of many households. Many households still owe more on their mortgages than their home is worth, but home prices have moved up lately and banks are working through the large inventory of foreclosed homes. The inability of the U.S. Congress to come to a decision on how to address the federal deficit also creates uncertainty for both consumers and businesses going into 2013, as they face the prospect of higher taxes and reduced government services at some point, but so far Congress continues to postpone any definitive decisions until a later date.

Employment Outlook

The consensus forecast for employment in 2013 falls slightly shy of the average monthly net job creation necessary to bring the unemployment rate down to 6.5 percent by 2015. Thirty-nine forecasters surveyed by the Federal Reserve Bank of Philadelphia expect to see 143,300 average monthly job gains in 2013, down from 155,600 in 2012. Monthly job gains are projected to increase to 178,000 by the fourth quarter of 2013. If that pace can be sustained through 2014, the target of 6.5 percent unemployment rate may be achievable by 2015. In fact, the forecasters project the unemployment rate to be 6.9 percent in 2015. The higher anticipated unemployment rate may be attributed to additional unemployed entering the labor market looking for jobs as employment prospects improve.

Of course, employment growth depends upon GDP growth. The projected average monthly gains of 143,300 jobs in 2013 is driven by an anticipated GDP growth rate of 2.0 percent. This pace may have seemed achievable as the economy has been chugging along at an average annual rate 2.3 percent during the recovery. The third quarter was even more robust, with an annualized quarter-to-quarter increase of 3.1 percent. However, fourth quarter GDP numbers were a complete surprise—showing that the economy contracted by 0.1 percent from the previous quarter. This is the first of three estimates of fourth quarter growth, so later estimates could be revised upward. The downturn was largely attributed to a large cut in federal spending and reduction in inventory.

Job Creation

Even so, the ability of the economy to create jobs has diminished over the past several business cycles. The ratio of average annual household employment growth to the average annual GDP growth over a business cycle has declined by roughly half since the 1970s. That is, a one percentage point increase in real GDP growth in the decade of the 2000s resulted in a lower employment growth rate than in previous decades. From March 2001 to December 2007, employment grew at an average annual rate of 0.9 percent, while GDP grew at an annual average rate of 2.6 percent per year, yielding a ratio of 0.34. In contrast, during the November 1973 to January 1980 business cycle, total employment grew by an annual average rate of 3.4 percent and GDP growth averaged 4.5 percent during the same period, resulting in a ratio of 0.75.

The decline in the economy's ability to create jobs is apparent in the trends in the rate of gross job creation. Gross job gains are the actual jobs created from the expansion of existing businesses and the creation of new businesses. Each month more than 2.3 million jobs are created. Also, each month roughly that many jobs are lost from the closing or contraction of existing firms. The difference between the two gross job flows is net employment change. The ratio of gross job gains to total employment has steadily declined during the past decade. The rate has fallen from 8 percent during the 1990s to 6 percent at the depth of the recent recession and then back up to 6.5 percent during the recovery.[3]

Skill Mismatch

One of several possible reasons for the decline in job creation is skill mismatch. Businesses increasingly complain that they cannot find qualified workers to fill their open positions. A third of the respondents of the most recent survey of small businesses reported that they found "few or no qualified workers" to fill their job openings.[4] The percentage of respondents unable to find qualified workers is approaching pre-recession levels. A ManpowerGroup survey found similar results, with 49 percent of respondents having difficulty filling jobs. They actually found the rate higher now than before the recession. However, digging a little deeper into the survey reveals some contradictions regarding the skill shortage. About 10 percent of the employers admit that the problem is that job candidates are not willing

[3] The Bureau of Labor Statistics compiles job gains and losses for the private sector only, whereas the net employment gain numbers include both the private and government sectors.

[4] NFIB Small Business Economic Trends, Monthly Report, January 2013.

to accept the position at the wage level offered. Furthermore, 15 percent of the employers surveyed revealed that their reluctance to hire is due not to the lack of skills but the lack of experience in the specific job they want to fill.[5] Further confusion surrounding the existence of skill gaps is the simple fact that wages have not increased over the past few years, and have actually fallen, even for the occupations that employers claim to have difficulty filling.

The existence and consequence of a possible mismatch is just beginning to be explored more rigorously. A recent study by the Federal Reserve Bank of New York concluded that unemployment mismatch in general accounted for up to a third of the 5.4 percentage point increase in the unemployment rate during the recession.[6] The study found that persons looking for jobs in sectors and occupations where jobs are relatively scarce due to the recession resulted in a decline in hiring and thus a rise in unemployment. With construction and manufacturing accounting for half of the 7.5 million jobs lost during the recession, one can begin to understand the magnitude of the effect of mismatch on the economy. Displaced construction and manufacturing workers are less likely to have the skills necessary to qualify for jobs in sectors that were not severely affected by the recession, such as health care. Somewhat surprisingly given the role of the housing bubble in the recession, the study did not find any signs of geographic mismatch. However, the study does find that the contribution of the mismatch to the rise in unemployment rate is almost twice as large for college graduates than for high school drop outs.

A study by the Brookings Institution explicitly measured the education gap between job vacancies and the existing workforce and found that areas, as measured by metropolitan areas, with a higher education gap had higher unemployment rates and lower rates of job creation.[7] The study does not establish a causal relationship, but the correlations are consistent with the effects of mismatch.

However, mismatch and other structural problems are not the only set of factors that contributed to the rise in the unemployment rate. Rothstein weighs the evidence on both the supply side and demand side of this current business cycle and finds evidence that structural, supply side factors are only part of the answer.[8] He concludes that labor demand shortfalls, more than skill mismatches, are a primary determinant of the current labor market performance.

Summary

The U.S. economy continued to gain jobs during 2012 and the consensus forecast is for continued improvement throughout 2013. However, the economy appears encumbered with lingering uncertainties, which do not seem to get resolved. The economy entered 2013 averting the so-called "fiscal cliff," which should have eliminated the concern of draconian spending cuts and tax hikes, but the U.S. Congress has yet to decide how it intends to deal with the large fiscal deficit and the unsustainable government debt. Business and consumer confidence indexes reflect these uncertainties and hover at pre-recession lows. To counter these uncertainties and maintain momentum for the recovery, the Federal Reserve still stands committed to stimulating the economy by providing unprecedented amounts of excess cash to banks. Yet, banks are reluctant to loan this cash, leaving much of it in their vaults. Corporate

[5] Federal Reserve Bank of Atlanta, Macroblog: "The Skills Gap: Still Trying to Separate Myth from Fact, June , 2012

[6] Aysegul Sahin, Joseph Song, Giorgio Topa, and Giovanni L. Violante, "Mismatch Unemployment." Working Paper (Federal Reserve Bank of New York, 2012).

[7] Jonathan Rothwell, "Education, Job Openings, and Unemployment in Metropolitan America," Metropolitan Policy Program at Brookings, Brookings Institution, August 2012.

[8] Jesse Rothstein, "The Labor Market Four Years into the Crisis: Assessing Structural Explanations," NBER Working Paper 17966, March 2012.

profits are at historical highs, but businesses are not hiring additional works. Perhaps 2013 will see a resolution of at least the fiscal uncertainties, which will allow consumers and businesses to gain more confidence and add strength to the recovery.