

# What's happening in the US labor market & where will unemployment peak?

July 2009

- The US unemployment rate is already at a 26-year high. Whilst the most severe phase of economic contraction is probably behind us, companies are likely to continue shedding jobs, and the probability of moving out of unemployment into employment is low.
- This suggests the US unemployment rate will continue to rise for some time. We expect it will peak at around 11% in late 2010.
- Household credit quality will therefore continue to deteriorate for some time even after the worst of the recession is over.
- In most previous economic cycles the Federal Reserve has not raised rates until unemployment has peaked. We therefore expect that the first interest rate rise will not occur until early 2011.

## Recent developments – labor market slack at multi-year high

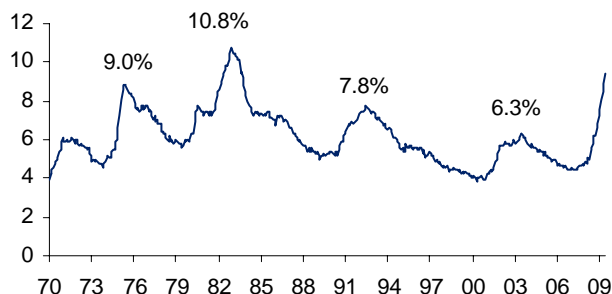
Since the US officially entered recession in December 2007 the number of unemployed has risen by 7.0 million to 14.7 million in June, and the unemployment rate has increased by 4.6 percentage points to 9.5% of the civilian labor force (a 26-year high). Most of the increase has been concentrated in the last 14 months (with the unemployment rate jumping from 5.0% in April 2008 to 9.5% in June this year). US unemployment is already higher than at its peak in three out of the last four US recessions. Only the peak of 10.8% in the 1981-2 recession is still higher (Chart 1).

Other measures of labor market slack are also at multi-year highs with some measures already worse than in the early 1980s. The fraction of the work force that reports working part-time for economic reasons (either because of slack business conditions or because they could only find part-time work) has almost doubled, from 3.0% in December 2007 to 5.8% in June 2009. The unemployment rate plus the number working part-time for economic reasons, together with marginally attached workers (persons not officially classed as unemployed but who are available for work and have searched for work during the past 12 months) amounts to 16.5% of the labor force.

As more people are working part-time or reduced hours, the average working week has also declined substantially to close to its lowest levels since records began in 1964 (Chart 2). This suggests that there is *considerable* slack in the US labor market, even more so than implied by the headline unemployment rate.

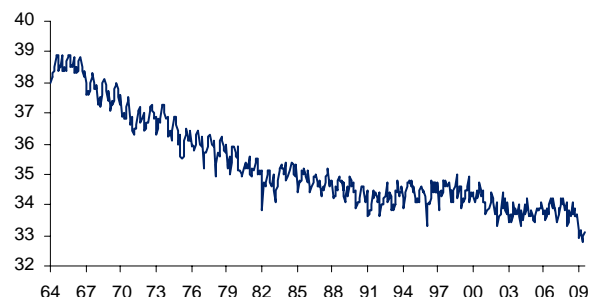
**Chart 1: Previous peaks in the unemployment rate (%)**

Source: Thomson Datastream



**Chart 2: Average weekly hours worked in private sector**

Source: Thomson Datastream



### Contacts:

Julien Seetharamdoo  
 Senior Economic Advisor  
 0131 626 3925  
[julien.seetharamdoo@rbs.co.uk](mailto:julien.seetharamdoo@rbs.co.uk)

[www.rbs.com](http://www.rbs.com)

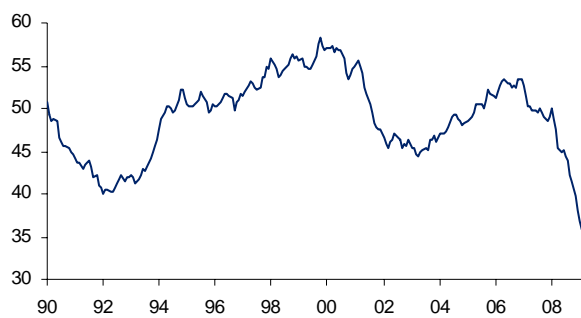
### Understanding unemployment inflows and outflows

Another distinguishing feature of this recession is the movement into and out of unemployment, which is combining the worst aspects of previous recessions. We are currently at an historically low outflow rate, meaning that the unemployed are finding it very difficult to find jobs (see Chart 3). This can also be seen by the fact that the average duration of unemployment at 24.5 weeks is at its highest since this series was first recorded in 1950 (Chart 4).

At the same time as record low probabilities of finding employment, the inflow into unemployment is also close to an all-time high. The combination of high inflow into unemployment and low outflow out of unemployment explains why the unemployment rate has shot up in recent months. The decline in non-farm payrolls in the first quarter of 2009 averaged almost 700k per month, the worst quarter in the post World War Two period. In the second quarter, payrolls fell 436k on average each month, still an enormous fall. And private sector employment intentions, as measured by the employment components of the ISM surveys, remain extremely weak. We calculated a composite employment index as a weighted average of the service and manufacturing sector ISM employment indices. A number above 50 signals firms' intentions to boost hiring and a number below 50 signals firms intentions to reduce their headcount. This composite ISM employment component was at 38.8 in June, still consistent with further substantial declines in payrolls in the months ahead (Chart 5).

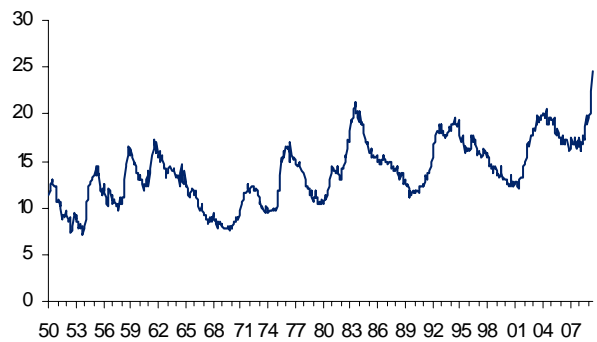
**Chart 3: % of unemployed finding a job each month**

Source: Thomson Datastream



**Chart 4: Average duration in unemployment (weeks)**

Source: Thomson Datastream



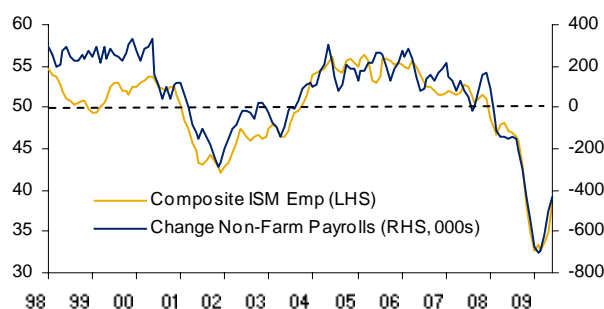
### When will unemployment peak?

Unemployment is known as a "lagging indicator" of economic activity, because it tends to lag or trail overall economic growth rather than lead it (Chart 6). Indeed, in recent recessions, the unemployment rate has tended to peak well after the last quarter of negative GDP growth and well after the National Bureau of Economic Research (NBER) has officially declared the recession to be over (Table 1). (In the US, the NBER is officially tasked with identifying the beginning and end of recessions.)

On average, in the past five recessions, unemployment has peaked two to three quarters after the last quarter of negative GDP growth. We expect Q4 09 or Q1 2010 to be the last quarter of negative growth in this current downturn for the US. Therefore we do not expect the unemployment rate to peak until the end of 2010. There is uncertainty over exactly when the last quarter of negative growth will be. Government stimulus programmes such as tax cuts and increased social security payments may temporarily boost GDP in Q3 2009, but we still anticipate one or two negative quarters of growth at the turn of the year, after these temporary boosts wane. The key point is that, for the reasons outlined above, we expect the peak in the unemployment rate approximately three quarters after the last quarter of negative growth. Our best estimate is that unemployment will therefore peak in the last quarter of 2010.

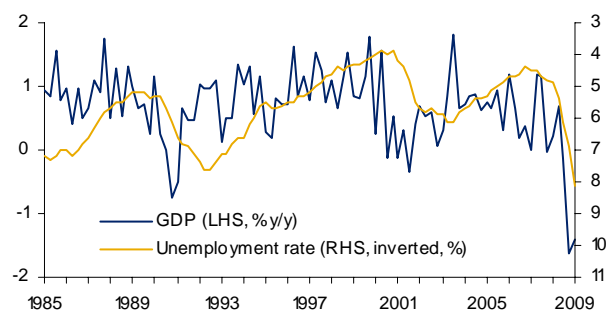
**Chart 5: ISM employment components & payrolls**

Source: Thomson Datastream, (shaded area indicates recession)



**Chart 6: Unemployment rate and GDP growth**

Source: Thomson Datastream



There are a number of reasons why unemployment tends to peak some time after growth has resumed. For a start, positive GDP growth is not enough to increase employment (or decrease unemployment levels). GDP growth must at least be higher than productivity growth (i.e. growth in output per worker) to increase hiring by firms. In addition, because the US population is growing, even an increase in employment levels will not necessarily reduce unemployment levels, because the size of the labour force is constantly expanding.

**Table 1: US unemployment peaks, recessions and rate increases**

Recession period (NBER determined)	Last negative quarter of growth	Date of peak unemployment	Peak rate of unemployment	Date of first Federal Reserve rate increase after recession ends
Dec. 2007 - ?	Expected Q4 09/Q1 10	Expected Q4 10	-	-
March 2001 - Nov. 2001	Q3 2001	June 2003	6.3%	June 2004
July 1990 - March 1991	Q1 1991	June 1992	7.8%	February 1994
July 1981 - Nov. 1982	Q3 1982	December 1982	10.8%	March 1984
Nov. 1973 - March 1975	Q1 1975	May 1975	9.0%	April 1976
Dec. 1969 - Nov. 1970	Q4 1970	August 1971	6.1%	July 1971

Source: NBER, Bureau of Labor Statistics, RBS Group Economics

**At what level will US unemployment peak?**

We calculate that for every percentage point that US growth is below its potential rate of growth, the unemployment rate increases by just over half a percentage point. The Congressional Budget Office estimates potential growth for the US economy is currently around 2.2% (down from 2.8% over the period 2000 to 2008). We expect GDP growth to be minus 3.5% in 2009, and only plus 0.8% in 2010 (Table 2). As a result, we expect the unemployment rate to increase by around 3 percentage points in 2009 and just under 1 percentage point in 2010. With unemployment sitting at 7.2% at the end of 2008, this implies the unemployment rate touching 11% by the end of 2010 (Chart 7).

**Table 2: RBS Group Economics Forecasts (May 09) & Consensus Forecasts (June 09) – US economy**

	Group Economics		Consensus Forecasts	
	GDP (% y/y)	Unemployment (av.)	GDP	Unemployment (av.)
2009	-3.5	9.3	-2.8	9.2
2010	0.8	10.7	1.9	9.8

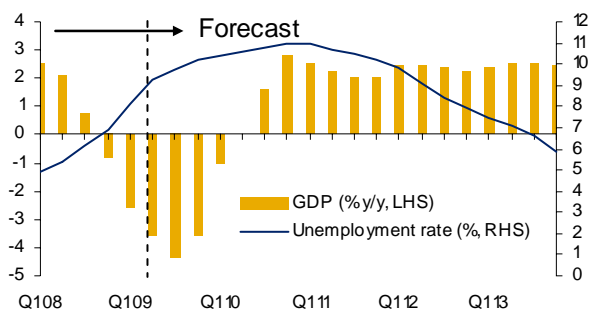
Source: RBS Group Economics, Consensus Forecasts

The consensus forecast (i.e. the average of professional economic forecasters) is more optimistic, and appears to be based on the view that the US recession ended in the second quarter of 2009, with growth expected to resume in the second half of the year. However, we think the recession will last longer, with the last quarter of negative growth in the final quarter of 2009 or first quarter of 2010, and growth will be sluggish even once the recession is over. As a result, we expect that unemployment will rise further than the consensus expects.

This downturn is being driven by a credit contraction and household de-leveraging, rather than a manufacturing inventory cycle, hence it will be longer than 'ordinary' recessions and the recovery weaker. Households have experienced an unprecedented destruction to their wealth (see our recent report "[US household finances – the new reality](#)"). As a result, the household saving rate is likely to continue rising for some time (Chart 8), as households attempt to repair their balance sheets, and consumer spending will remain depressed. (We will explore this subject in more detail in a separate paper).

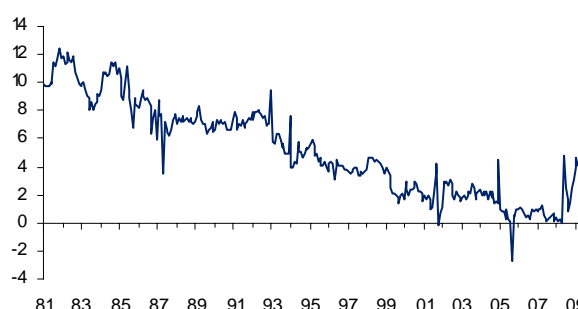
**Chart 7: Unemployment & GDP forecasts**

Source: Thomson Datastream, RBS Group Economics



**Chart 8: Personal savings rate (% disposable income)**

Source: Thomson Datastream



### **'Jobless recovery' likely**

With significant spare capacity in the workplace there will be little need for companies to hire workers aggressively in the early stages of economic recovery. Instead, companies could increase working hours, or move employees back from part-time work to full-time work. The increase in service industries, where flexibility with additional hours worked and moves between part-time and full-time employment are more common, makes this easier. This is another reason why unemployment could continue to rise for a few quarters even after the economy starts growing again, and why a 'jobless recovery' is likely for the US even after growth resumes. Therefore, we expect only a gradual decline in the unemployment rate even after the recession ends.

### **Conclusions and risks to our forecasts**

- We expect the US to be in recession most of this year, with only a sluggish recovery next year. As a result, unemployment will continue to rise, peaking at around 11% late in 2010. Thereafter, the unemployment rate should fall, but the significant amount of spare capacity in the workplace and sluggish growth will lead to only a gradual fall in unemployment.
- Household credit quality will therefore continue to deteriorate for some time even after the worst of the recession is over.
- One other implication of continued increases in unemployment is that the Federal Reserve will be in no rush to raise rates. In most previous economic cycles, the Fed has not raised rates until unemployment has peaked (see Table 1). As a result, we expect that the first rate rise may not occur until early 2011 (possibly late 2010). Unlike some other central banks, the Fed has a dual mandate of ensuring both price stability and maximum employment.
- The principal risk to this forecast is that growth in the US rebounds more quickly than we expect, and as a result that unemployment peaks below 11% and then falls more quickly. This would be an outcome closer to the current consensus forecast. However, so far the consensus has consistently underestimated the severity of this recession.