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CLIMBING OUT OF A DEEP ECONOMIC HOLE

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The 9.4 percent unemployment rate for May 2009, which is 0.5 percentage points higher than the preceding month, comes as no great surprise to U.S. labor market observers. The American economy has been in deep trouble for more than a year.

As has been reported widely, the jobless rate last reached 9.4 percent in the summer of 1983. What has not been noticed is that, whereas the rate of unemployment several times in the past has jumped by 0.5 percentage points from one month to the next, it has never before jumped by that amount at the high end of the jobless range (8.0 percent or higher) even in 1982-83 when the rate reached double digits.

The recessionary hole has gotten deeper which means that recovery when it begins will take time to reach what is considered an acceptable rate of unemployment (arguably 4.0 – 5.0 percent). Many commentators regard the unemployment rate as a lagging indicator which is another way of saying that something else – GDP – is more important. Mayo Research Institute disagrees. What could be more important to the American people than a measure of how many are struggling to find work?

The manufacturing sector has been particularly hard hit having shed 1.8 million jobs since the recession began.

What is especially troubling is the latest revised data regarding productivity and costs in first quarter 2009. Projected over the year, productivity based on first-quarter data stands at 1.8 percent for the entire business sector. A 3.0 percent annual increase is regarded as a healthy sign. Unpacking the data reveals some additional weaknesses in the manufacturing sector where historically hourly wages have been much higher than in the service sector.

Productivity in durable goods manufacturing *dropped* at an annual rate of 10.4 percent from the fourth quarter 2008 to the first quarter 2009 at the same time output fell by 31.0 percent. Even so, real hourly compensation jumped by 18.6 percent on an annual basis. The result was an annualized increase in unit labor costs of 29.3 percent. Across the entire manufacturing sector over the last four quarters, unit labor costs are up by 12.0 percent – the largest one-year increase since this data series was launched in 1987.

The numbers are similar though of a smaller magnitude for nonfinancial corporations where the first-quarter output *dropped* 12.3 percent – the largest annualized quarter-to-

quarter decline on record since the 1958 when these data first were collected. Unit profits at nonfinancial corporations fell by an annual rate of 20.5 percent from fourth quarter 2008 to first quarter 2009.

Profits are being squeezed from two sides – higher unit labor costs and declining sales and revenues as represented by falling output. U.S. employers are hurting and with them U.S. workers.

In following economic trends for more than 50 years, Mayo Research Institute has seen nothing quite like the current economic crisis. We have falling output, below normal improvements in productivity, rising unemployment and unit labor costs, and a squeeze on profits in a global environment where the low-cost producer has the clear advantage. With 305 banks currently identified by the FDIC as “problem banks,” the financial system remains on life-support. Further, Federal Reserve chairman Bernanke very recently warned that deficit spending and the public debt must be brought under control now not later.

These data and Bernanke’s warning point to a discernible build-up of inflationary pressures which attend a fiscal policy aimed at stimulating aggregate demand aggressively but which many economic observers see as a problem to be addressed sometime in the future. What may be emerging right now is the devilish problem of stagflation – higher unemployment and rising prices.

Perhaps Milton Friedman’s monetary rule should be tried. Back off fiscal stimulus and charge the Federal Reserve with a small but steady and therefore predictable increase in the money supply year in and year out. Friedman didn’t promise an economic rose garden. He did say that “steady as you go” is the best we can do in a very large, mature, economic system where economic decision-making still is decentralized.

Even during the monetarist period of the late 1970s and early 1980s, Friedman’s monetary rule never was implemented. The one desirable thing about trying the rule today is that it would not add to the public debt.

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