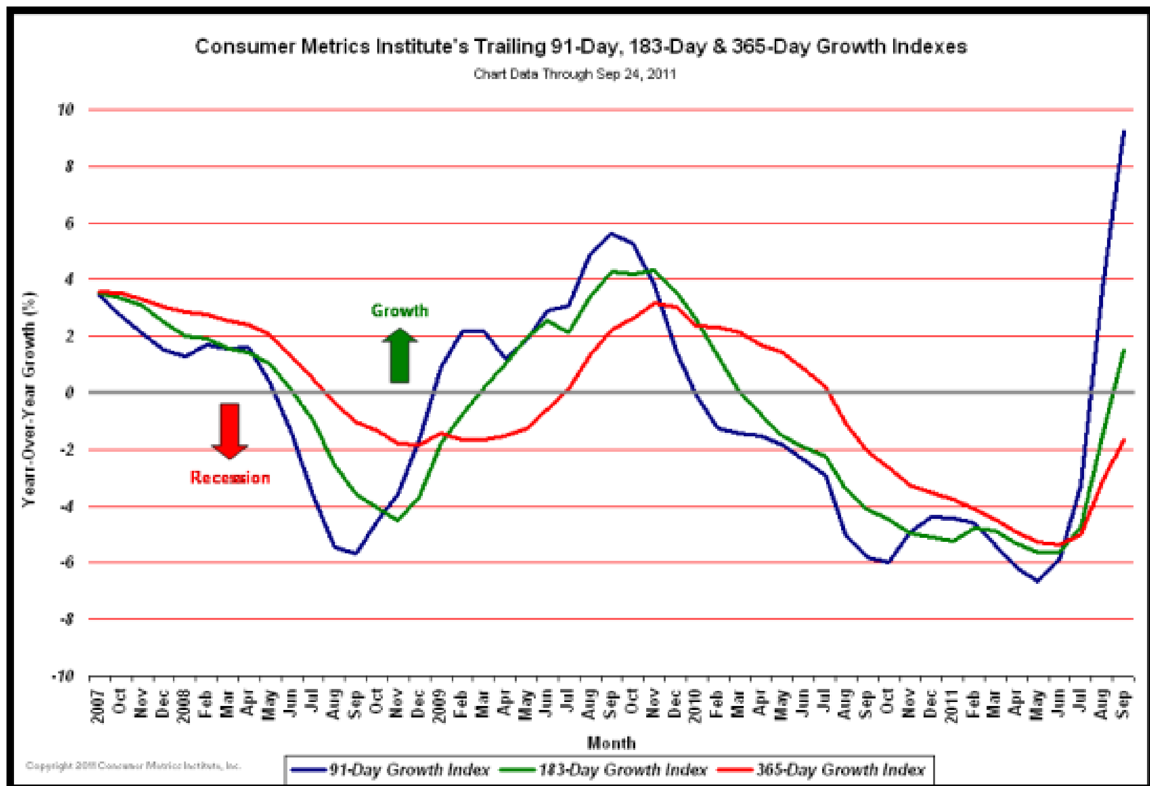
Consumer Metrics Institute Members News

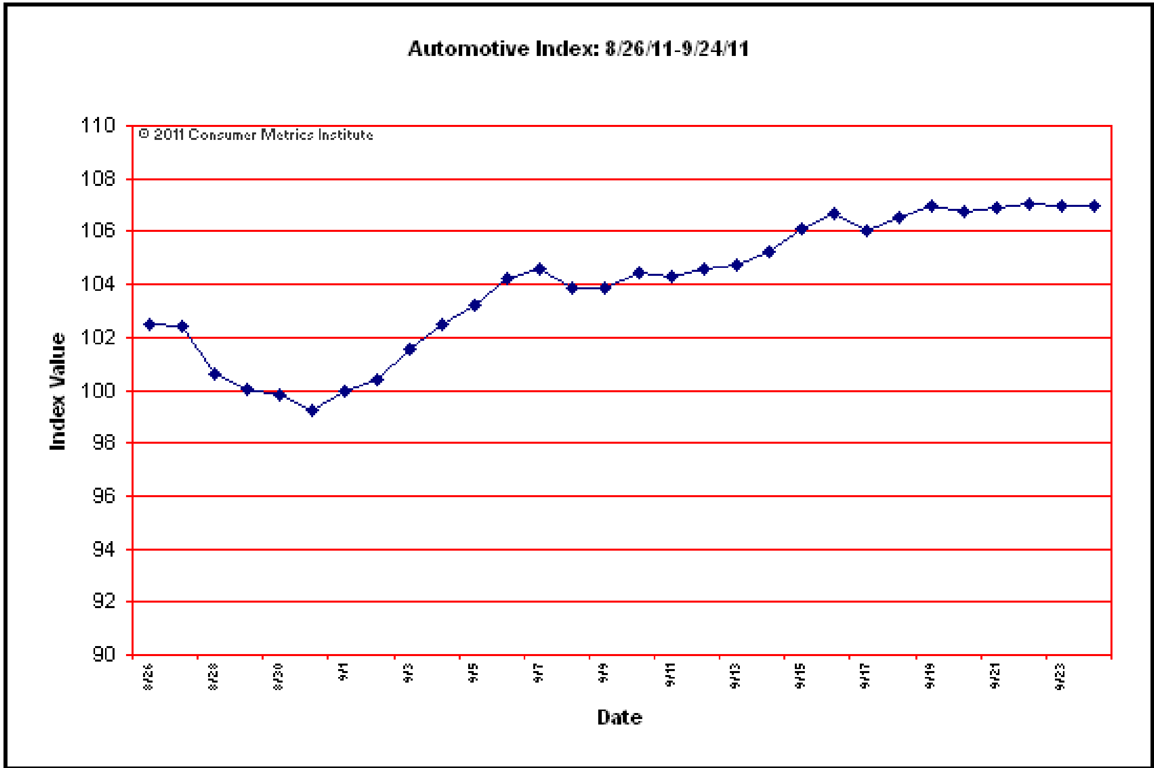
September 16, 2011: Data Update and the Sticky Jobs Situation

Over the past two weeks our Daily Growth Index has been setting new historic highs every day. We have commented previously about the possible causes for this behavior, and we though that today we should look a little deeper into the various components driving the index's unusual behavior.

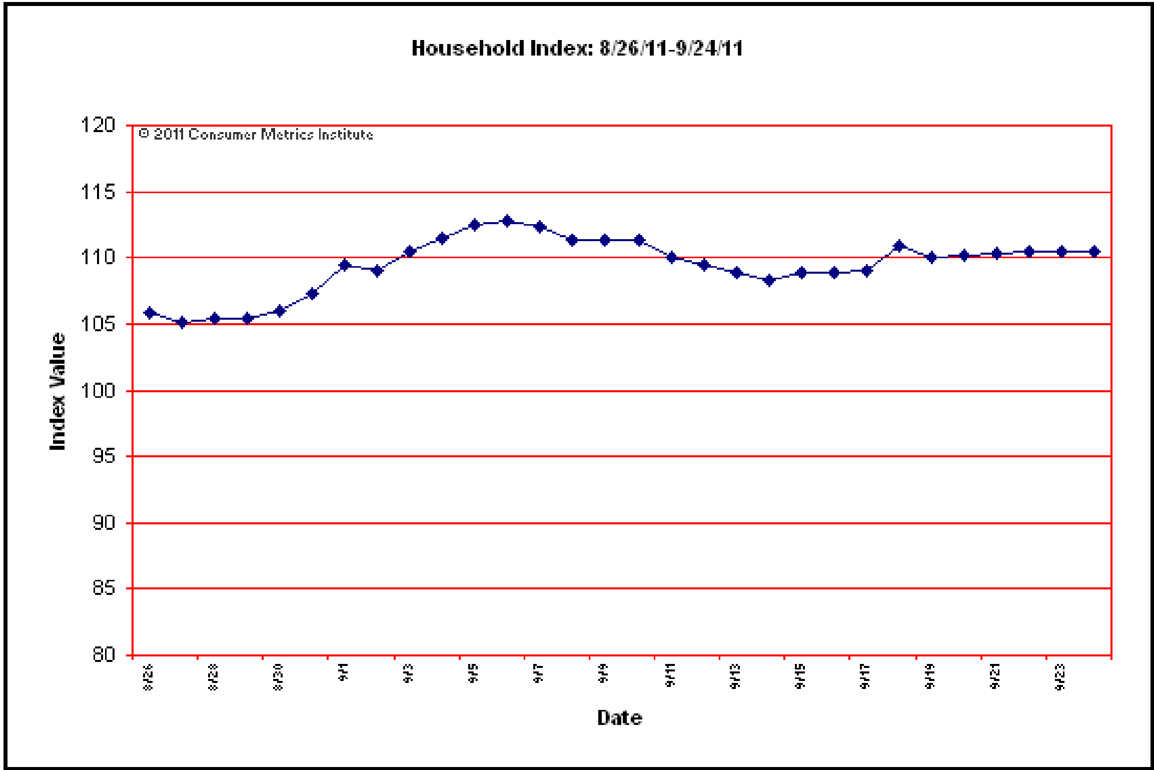
The first thing to note is the extraordinary rate of the rise in the index, which has caused the 91-Day "trailing quarter" index to skyrocket while leaving the longer term averages (the 183-Day 6 month average and the full year average) behind in the dust:



A glance at our current Sector Indexes shows broad based strength, particularly when considering how weak some of the more heavily weighted transactions were during the summer of 2010. Among the improving sectors are the Automotives:

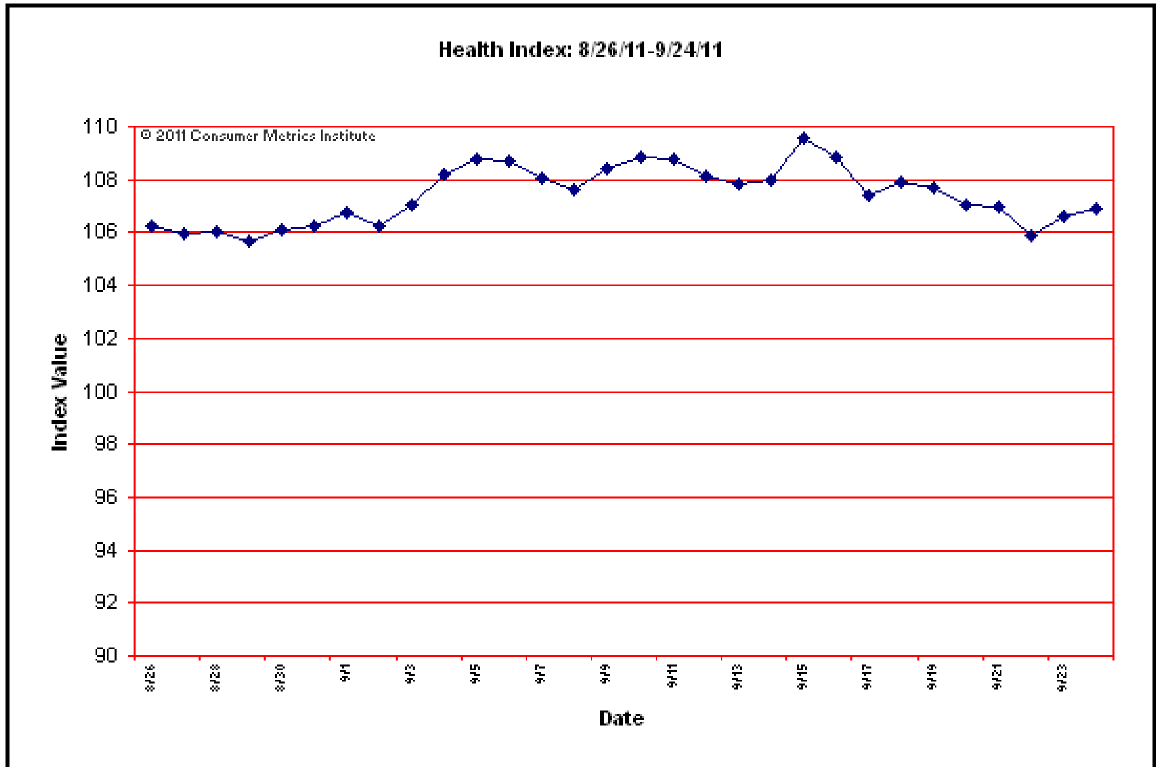


We have previously mentioned that the Household Sector has shown significant recent year-over-year improvement:

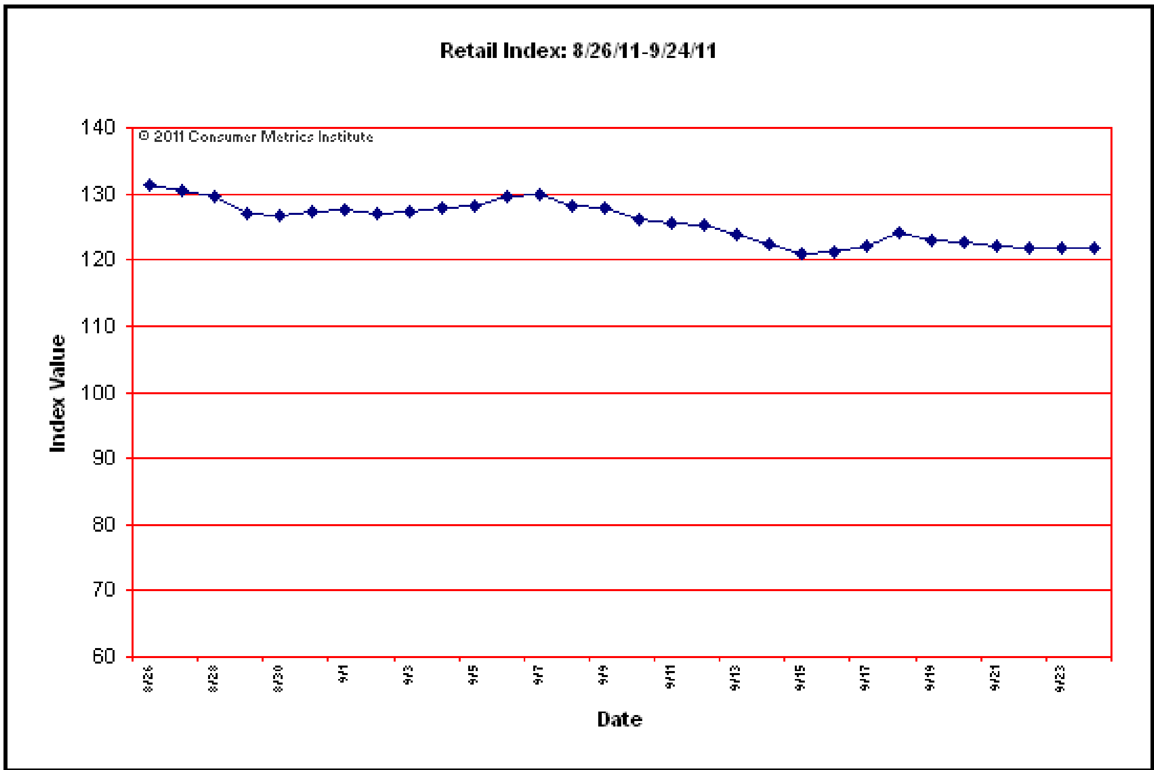


This particular area has major impact on our Weighted Composite Index and the Daily Growth Index as a consequence of the home improvement and major appliances it includes. We had wondered if the surge of activity might be related to spring storms and the subsequent rebuilding that they generated, but our geographical screens have not shown any particular regional aspects to the sector's strength.

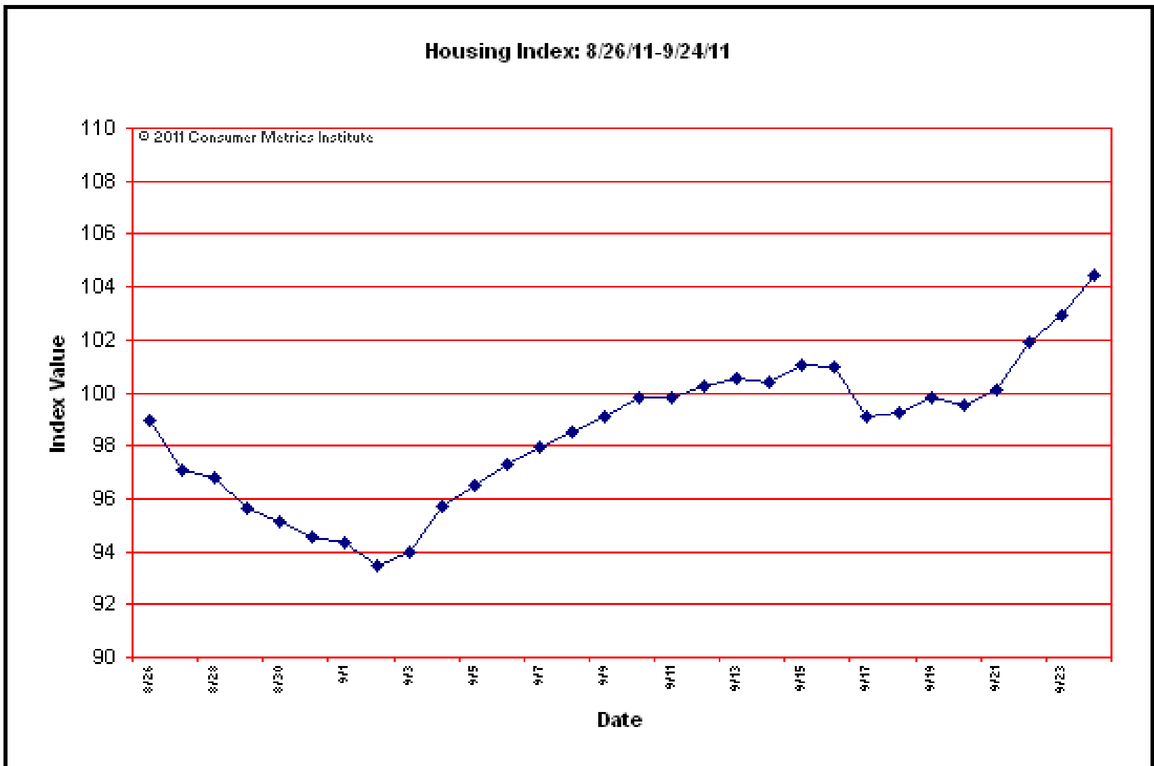
Even non-housing related sectors have shown improvement on a year-over-year basis, including our Health Sector (which captures only the discretionary components of health care):



But by far the strongest of the sectors continues to be our general Retail Sector, which takes the same transactions used for the Weighted Composite but selects exclusively for the major S&P 500 class merchandisers:

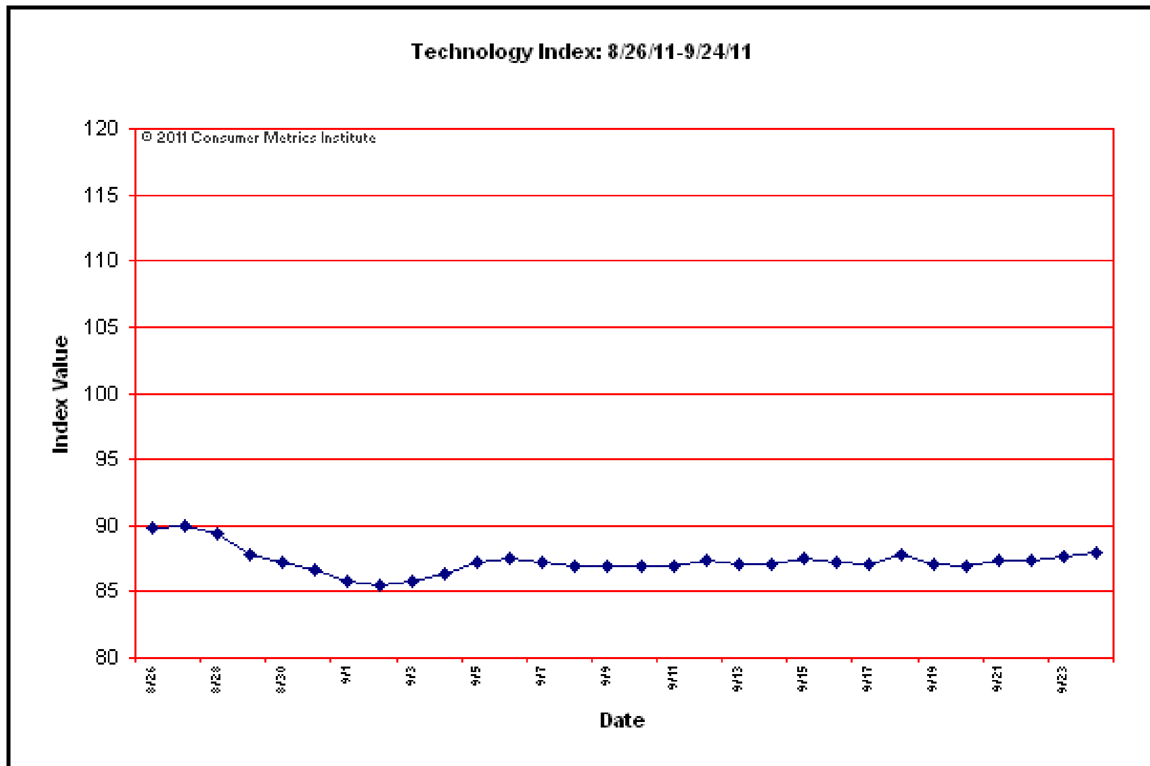


The heaviest weighted sector in our composite is Housing, and it continues to flirt with absolute year-over-year growth. Although this is certainly "bottom bouncing," it is a whole lot better than the free-fall we were seeing from last summer through late spring:



This may only be a sign that things can't get any worse in the Housing arena, but it is at least an indication that, for the moment, the implosion may have stalled.

In fact, only the Technology Sector is substantially in contracting territory:



Our overall read from the indexes is that some interesting things are happening with the consumer beyond what has been reported in the popular press. As our previous comments indicated this is a very complex situation, influenced by continued financial stress on consumers from their negative "real" income growth and a year of soaring commodity prices -- coupled with very recent relief in gasoline prices. We will monitor the data that those consumers are providing us and pass on the results as soon as the cross-currents resolve themselves.

The Sticky Jobs Situation

(In a number of recent articles we have explored potential "unthinkable" solutions to the current economic malaise, the U.S. sovereign debt problem and the fiscal consequences of a suddenly balanced U.S. Federal budget -- given that a truly balanced budget would suck about 14% out of the country's GDP, meeting the clinical definition of a depression. We discussed the historical backdrop to sovereign debt end-games, and solutions possible without major regime change, others requiring modest regime change, yet more that involve radical regime changes, one that uses regime change to de-securitize the mortgage industry, another that would selectively stimulate "Main Street" America, still another that would stimulate the economy through genuine reform to the health care industry, one that addressed the costs within the higher education "industry" and the impact that growing student loan debt and defaults are having on U.S.

economic growth, some ideas that would address excessive regulation, another involving the use of accelerated but highly screened immigration to offset the upcoming demographic drag as the "Baby Boomers" retire, a look at tort reform to lower social-economic overhead, and most recently to a potential slide down the slippery slope to 1930's style "corporatism" as most famously exemplified by Benito Mussolini and his friends in Germany.)

As we consider the paths out of our current unemployment mess, it is useful to look to economic history for an understanding of what works and what doesn't work. We wish that our esteemed leaders in Washington would do the same. If they did, the current President might not be following the same "jobs" path chosen by one of his predecessors, the equally well intentioned Herbert Hoover. That episode did not turn out well, and there is no reason to think that this incarnation of a "jobs" initiative will fare much better.

Oddly enough, Herbert Hoover had been instrumental (as Secretary of Commerce) in an earlier "Depression" that turned out much better. But somewhere between being Secretary of Commerce and becoming President Mr. Hoover also transformed into a politician, and he felt the political compulsion to "do something" -- when, in fact, doing mostly nothing had proven to be a highly effective course of action only nine years earlier.

The "Depression of 1921" is generally remembered as the first time that the Federal Reserve had an opportunity to really screw things up. Their clumsy monetary actions had turned a garden variety recession into what was (at the time) the worst economic catastrophe since 1873. The Department of Commerce (DOC) has estimated that real GDP probably shrank by about 7%, slightly more than the roughly 5% decline during our recent (or perhaps ongoing) "Great Recession." Industrial production decreased by about 30%, and the Dow Jones Industrial Average lost nearly half of its value. Unemployment soared from about 5% to somewhere between 9% and 11%.

But the defining characteristic of the Depression of 1921 was the rapid and severe deflation that accompanied the GDP contraction: nearly 18% in consumer prices (DOC estimate) and an astounding 37% in wholesale prices.

And then, after 18 months, it was all over.

Why was the "Depression" so brief? Having the Federal Reserve reverse the monetary moves that had triggered the "Depression" in the first place certainly helped. But in retrospect another key factor may be that President Warren G. Harding and Congress did very little -- other than to continue to aggressively down-size the Federal bureaucracy and lower tax rates. It was the last pre-Keynesian "Depression," and it has been argued that the economy essentially healed itself through normal market corrections.

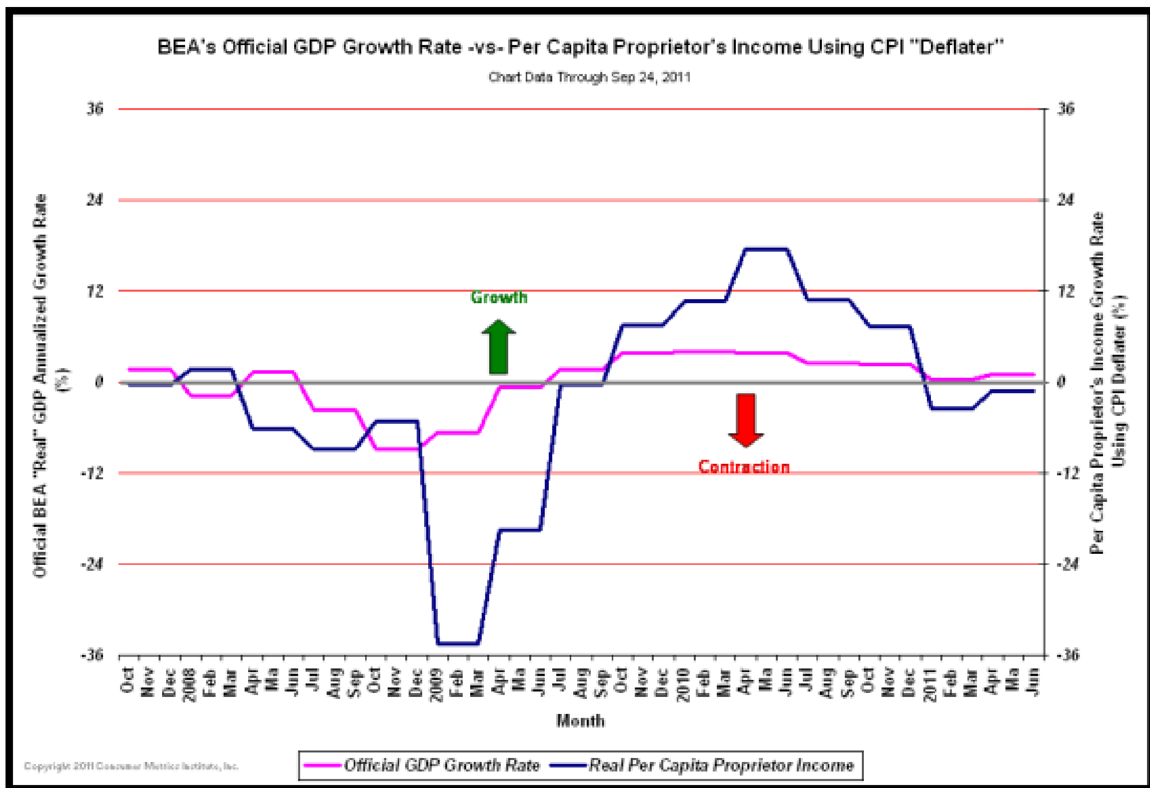
Included in the healing process was the unemployment rate, which had returned to levels consistent with "full employment" by 1923. Contributing to this remarkable drop in the unemployment rate were average hourly wage reductions of about 11%. And in this case the dramatic deflation episode proved to be beneficial to workers: the 11% loss in wages was far lower than the corresponding drop in consumer prices, some 18%. Even in the face of 11% losses in wages, workers found that the purchasing power of their paychecks had increased. Deflation had been labor's friend.

The dynamics of the "Depression of 1921" were complex, as are all economic cycles. And it

would be unfair to characterize the 11% reduction in wage rates as the sole remedy to the unemployment problem. But the ability to wage rates to adjust downward during deflationary times is a critical "necessary" condition for an economy to heal, and the unique labor environment in 1921 may have provided the last opportunity for that condition to be met. Since then wages have become increasingly "sticky" -- they are resistant to change even when drastic economic conditions warrant such changes.

Sputtering Engine

The least "sticky" form of wages are those enjoyed by the proprietors of the small businesses that most people consider the "engine" of job creation in the US. And a look back at the past four years of proprietor's income tells us a great deal about why that "engine" has been sputtering of late:



(The above chart plots the past four years of growth rates reported by the Bureau of Economic Analysis (BEA) for the total GDP and for Proprietor's Income (line 9 of table 2.1, "Personal Income and Its Disposition"). The total GDP numbers are the published "real" rates generally covered in the media, while the Proprietor's Income growth rates have been deflated from nominal data using alternative inflation sources (BLS) and converted to a per-capita basis.)

A glance at the scale of the contraction in small business incomes during the "Great Recession" indicates that the damage done to those businesses has probably been under appreciated by those who are now counting on small businesses for future job growth. Furthermore, the extent of the positive growth from late 2009 through 2010 came in far short of offsetting the damages from the horrific contraction in early 2009. That contraction was six months longer than the BEA recorded

for the economy as a whole, and the contraction has now resumed -- in yet another sign that a "second dip" is already here.

But at least there are no signs of "stickiness" in the wages earned by small business proprietors during the "Great Recession." In that regard their wage records over the past four years have differed significantly from those experienced by most of the bureaucrats in Washington DC.

Un-Shared Sacrifices

The major consequence of "sticky" wages is that employers are forced to lay off employees in order to reduce labor costs when revenues soften. In essence a reverse lottery is run, where the incomes of most employees are unaffected but an unfortunate few lose everything. In "sticky" wage situations sacrifices are not shared -- unless taxpayer costs for the extended unemployment benefits is factored into the equation.

We find it particularly ironic that to some extent the unemployment situation is exacerbated by the "sticky" wage environment created by the labor movement -- and that many self-described progressive labor leaders prefer the reverse lottery environment to one of collective pain sharing. One might think that all labor leadership has a moral (or legal) obligation to protect the interests of all dues-paying members by sharing the sacrifices -- instead of generally acting to protect the incomes of their more senior membership (in apparent self-interest).

From a societal perspective high levels of unemployment can be destabilizing, vastly widening the gap between the "haves" and the "have-nots." And prolonged high levels of unemployment can be dangerously destabilizing for existing political regimes.

And from the perspective of the employer, "sticky" wages have forced the dilemma of down-sizing work forces when prices decline -- even if unit product demand has remained relatively constant. This adversely impacts customer service levels, product quality and employee moral. For this reason, given a 10% decline in revenues most rational employers would prefer to keep an existing and fully trained work force intact at 10% lower wages and benefits, instead of reducing head counts by 10%.

One of the lesson from 1921 is that episodes of deflation need not be catastrophic for labor, particularly if wages adjust downward in a similar (if not slower) manner. In fact, deflationary credit contractions had been a standard fixture in business cycles before the time of John Maynard Keynes (and our more modern Federal Reserve's mandate to moderate the cycles). The "Depression of 1921" was painful, but it was short. There is much to be said for brevity of pain.

Unfortunately most professional politicians are unwilling to accept the need for any sharp pain within the electorate, however brief it may be. Elected officials are far more likely to opt for a couple of decades of anemic and stagnating growth while "kicking the can down the road" (e.g., Japan since 1990). And yet other potential economic solutions are "unthinkable" for a completely different reason: they require shared sacrifice by major constituencies of the current regime.

Lubricating Wages

The current economic situation is complex, in fact too complex for any bureaucratically engineered solution. And if, in fact, we are actually suffering through a deflationary credit contraction, the 1930s taught us that any bureaucratically engineered solution is likely to only

prolong the suffering. We already know that, like during the 1930s, the Federal Reserve is currently powerless to stimulate demand. The risk is that we have learned nothing from either the 1930s or the much briefer pain in 1921.

But we suspect that "sticky" wages are at least one contributing factor to the persistently high unemployment rate. With that in mind we offer several modest proposals to start to un-stick the jobs situation:

-- Legislate the priorities of labor leadership to reflect the rights of all of their dues-paying members to comparable treatment. Collective bargaining should lead to collective gains and collective losses. When faced with unsustainable economics, wages (and contract durations) should un-stick to maintain employment levels as long as possible. The first priority of labor leadership should be to keep all of their membership -- past and present -- employed, with both gains and losses shared.

-- Remove any tax code incentives to the off-shore outsourcing of jobs by eliminating the deductability of any non-domestically sourced services. This, by the way, will tilt the tax code much more materially towards small businesses than anything offered by the Administration's latest programs. Protectionism may not always be a four-letter word.

-- Even John Maynard Keynes agreed that only a highly authoritarian state can mandate wage reductions. However, the Federal Government is (within itself) a highly authoritarian state. Mr. Obama might start paying for some of his new initiatives by progressively un-sticking wages there -- say starting with a 5% scale reduction for GS-10s, a 10% cut for GS-12s, and finally graduated up to 20% for GS-14s and above. The result would be a major cost savings at no increase in unemployment, even if the sacrifices end up getting shared just a little more with the American public.

We don't think that reducing the "stickiness" of wages is any kind of jobs panacea. But it could help, and it could certainly keep things from getting much worse. The problem is that we lack any recent experience in dealing with the deflationary consequences of a credit contraction. And we have collectively forgotten what 1921 should have taught us: that the economy can correct itself more quickly if we simply resist the temptation to tinker with it.

Copyright ©2011 The Consumer Metrics Institute