KPMG Economics

A tale of two economies: A deep dive on the labor market

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Layoff announcements mounted at the turn of the year even as employment continued to surge. The payroll data showed that we generated more than half a million new paychecks in January, despite a bursting of the pandemic-induced hiring bubble in tech and finance.

Much of the apparent strength we saw in employment was because layoffs, which typically surge in January, were not as large as in the past. Employment dropped by 2.5 million before seasonal adjustment in January. That is 300,000 to 500,000 less than usual.

Why were so few workers laid off? The Federal Reserve's Beige Book for January provided some insight. Firms reported holding onto more workers, even as demand waned. Some wanted to retain talent they fought hard to get, while others struggled with ongoing staffing shortages.

This phenomenon is known as labor hoarding. The Fed and many labor economists speculated it might occur, given the growing gulf between labor demand and supply as the economy reopened. Now, we are living it.

This edition of the *Structural Change Watchlist* examines the imbalances in the labor market, what are causing them and why they are squarely in the sights of the Federal Reserve. A tale of two economies is emerging. Hiring in the service sector, where inflation is stickier, is strong even as pandemic winners are shedding workers.

That resilience suggests the economy is now more responsive to rate cuts, or prone to rebound, than hikes. A half percent hike is back in play for the March Federal Open Market Committee (FOMC) meeting. The Fed looks poised to mark up its trajectory for rate hikes for 2023, again.

Top ten list

The following provides a top ten list of trends in labor demand and supply. Demand is cooling but not enough to meet a more chronic, structural shortage of labor.

1. Demand for workers soared. Job openings after the economy reopened skyrocketed and remained elevated at the end of 2022. There were 11 million new job openings in December, four million more than we had in February 2020.

The ratio of job openings to job seekers, an index the Fed watches for signs of labor market cooling, rose to 1.9 in December. That is close to the record hit in March 2022 and the wrong direction for the Fed; it would like to see that ratio closer to one-to-one.

Why do we care? Because if labor demand and supply do not become more aligned, we could see another acceleration in both hiring and wages.

Don't we want wages to accelerate? Yes, but only if those gains can be sustained without triggering more inflation. Another step up in wages in labor intensive services could add to an already high inflation floor. Service sector inflation, excluding shelter costs, accounts for more than half of the PCE index, the Fed's preferred measure of inflation.

2. Pandemic induced surge in hiring. Payroll employment exceeded the peak of February 2020 in early 2022 and was 2.7 million above that level by January 2023. That is a short transition from an economy in recovery to an economy in expansion. That same transition took more than six years to accomplish in the 2010s.

Professional business services drove those gains, with 1.5 million more jobs than it had in February 2020. The demand for everything from accountants to valuation, legal and technology services increased in response to the surge in stock prices triggered by ultralow rates and the boom in profits triggered by reopening.

It is no surprise that the demand for those services is cooling now that interest rates have spiked. Valuations depend on the cash flow firms generate at the rate at which future flows are discounted; both are reversing.

Next up is trucking and warehousing, which is still growing despite some slowdown. That sector generated nearly a million jobs since February 2020.

Layoffs are not a surprise given rate hikes. What is stunning is how quickly those losses were absorbed with gains elsewhere and whether it can remain that way. Labor hoarding is one reason. Another is revenge travel and the desire to congregate. Convention business is filling the gap left by weddings.

3. New business formation skyrocketed. Young, smaller firms are another source of strength. The rise in job openings in December was driven by firms with less than 250 employees; firms with more than 5,000 employees reduced job postings.

High-propensity business applications – firms that intend to hire, not the self-employed – surged as the economy reopened. The first wave was in July 2020; the second was in the first half of 2021. (See Chart 1.)

Lower barriers to entry created from work from home, ultra easy credit conditions, venture capital funding and the opportunities for new business created by the pandemic fueled those gains. Recent research suggests that those gains increased the birth of new establishments and hiring significantly; more than a million jobs per quarter were added by new business births between the second quarter of 2021 and the first quarter of 2022 alone.

Our own analysis suggests that high-propensity business applications explained more than half of the excess rise in job openings. The correlation between applications and job openings nine months later was particularly strong post-pandemic. (See Chart 2.)

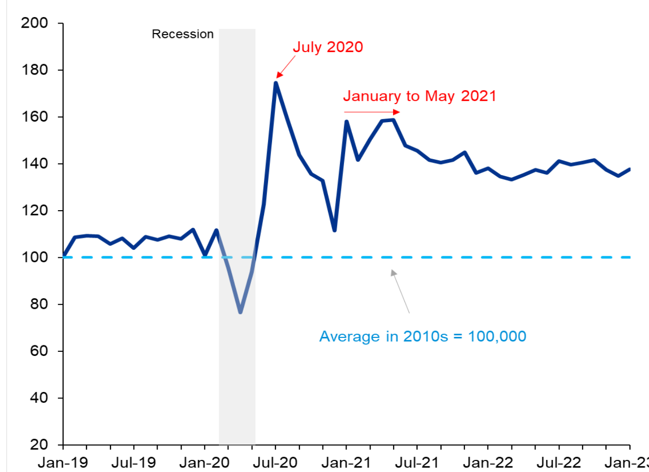
Half of the start-ups we saw were in five sectors:

- online retail
- trucking and warehousing
- professional, scientific and technology services
- administrative support

Chart 1

High quality business formation surged

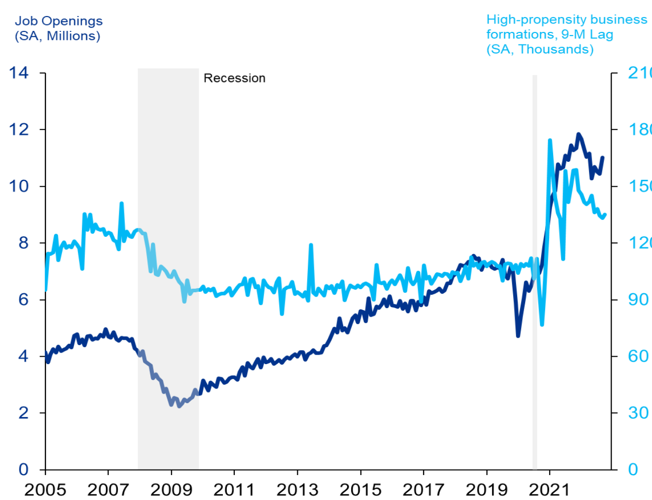
High-propensity business applications (SA, Thousands)



Source: KPMG Economics, Census Bureau, Haver Analytics

Chart 2

Business Applications and Job Openings

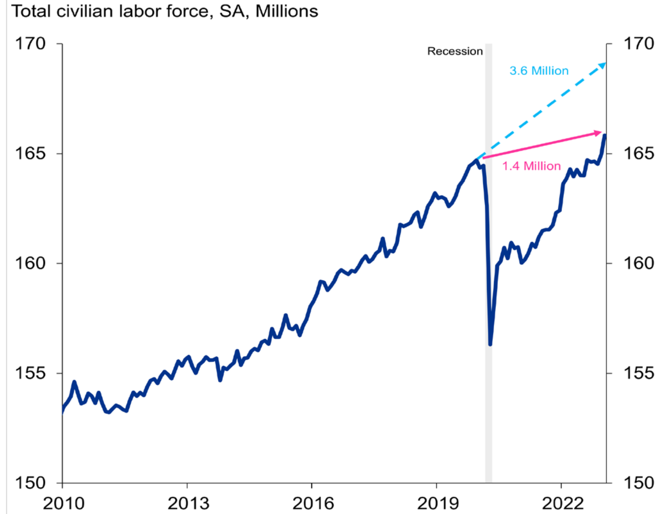


Source: KPMG Economics, Bureau of Labor Statistics, Census Bureau, Haver Analytics

Chart 3

Labor Force Growth Stalls

Total civilian labor force, SA, Millions



Source: KPMG Economics, Bureau of Labor Statistics, Haver Analytics

- personal services

Services include pet and sadly, death services.

What we do not know is how rapidly those businesses will eventually pull back. Start-ups are more sensitive to rate hikes and likely to fail. The pipeline for start-ups was still strong at the start of 2022. That does not explain the resilience in applications since then; they were nearly 40% above their 2010 average in January.

4. Labor force growth stalled. The demand for workers collided with anemic supply. The labor force grew by 0.8% or 1.4 million workers over the last three years. That is less than a third of the pace of the 2010s and 3.6 million workers short of the pre-pandemic trajectory. (See Chart 3.)

That shortfall is not expected to soon reverse. The Bureau of Labor Statistics (BLS) expects the labor force to slow to a 0.5% pace between 2021 and 2031, half the pace of the 2010s. That underscores the structural nature of the slowdown.

Where have all the workers gone?

5. Retirements ballooned. Aging demographics and a surge in pandemic-induced retirements explain more than two million of the 3.6 million shortfall. The participation rate of the over-65 crowd rose steadily for more than two decades, then fell off a cliff after February 2020; those workers show no signs of coming back. (See Chart 4.)

Everything from fear of contagion to long COVID and the surge in wealth created by the pandemic-induced boom in housing encouraged older workers to move to the sidelines. Women who retired report family responsibilities at twice the pace of men, which points to the crises in child and elder care as drivers.

6. COVID fatalities were consequential. Pandemics have a long history of triggering labor shortages. COVID-19 was no different. More than one million people died since the onset of the pandemic in the U.S.; 270,000 of those fatalities were aged 18-64. A good portion of those souls would still be with us and working absent the pandemic.

Those losses are before accounting for the effects of long COVID. The CDC estimates that nearly one in five adults who had COVID were still suffering long-term symptoms of the disease in June 2022. Some are working but not to their full potential; many can no longer work as they once could.

Chart 4

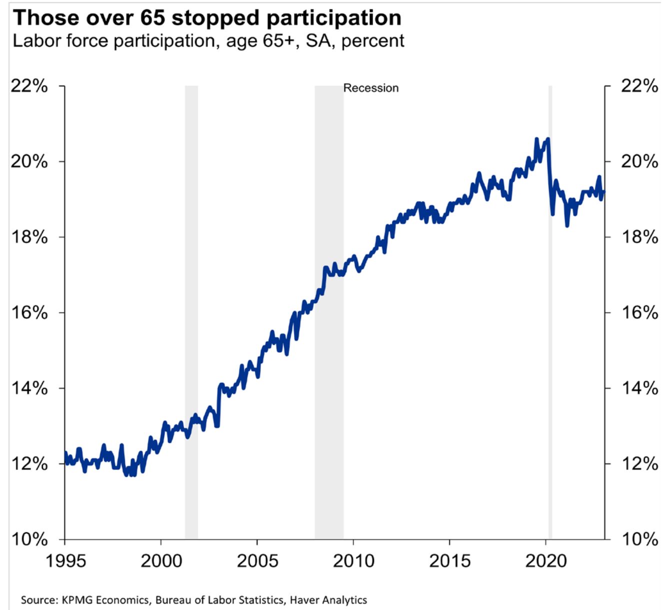


Chart 5

7. Legal immigration slowed. Policies to limit immigration starting in 2017 curbed the inflow of legal immigrants. Border closings triggered by the pandemic exacerbated those losses.

More recently, legal immigration has begun to catch up. The administration is attempting to fast-track the backlogs. The benchmark revisions to employment in January 2023 revealed nearly one million more largely legal and highly educated immigrants in the labor force than previously reported.

The participation rate of those immigrants was more than 90%, well above that of native-born workers. Hence, the jump in participation rates we saw in January when those revisions were implemented.

8. Participation by prime-age workers lags. Among prime-age (25-54) workers, women are participating at the pace we saw in February 2020, but have yet to exceed the peak of 2000. The U.S. is now dead last among the Group of 20 (G-20) nations – the largest developed and developing economies – in female participation. Lack of maternity leave and affordable child care options are the main reasons.

The situation among prime-age men is even worse. Their participation in the labor market peaked in 1954 and has lost ground after every recession since. This is even though the pandemic recession was the first to hit women harder than men with layoffs.

The drop in prime-age male participation is a global phenomenon but it is worse in the U.S. than elsewhere. We ranked last in participation rates among the G-20 for both men and women,despite fewer safety nets.

9. The educational gender gap worsened. Women were outachieving men in high school and college prior to the pandemic. The pandemic accelerated those trends; more men than women dropped out of school at all levels with the pivot to online education.

This is in addition to the education system's failure to boost outcomes for students and the labor force. That is not only a moral imperative, but an economic imperative given the demands for complex problem solving in a more knowledge-based economy.

The private sector has taken note. The KPMG Insights on Inflation Survey consistently shows that labor saving technology tops the list of how firms plan to alleviate the costs associated with chronic labor shortages. The problem is that most firms focus on replacing labor with capital when the greatest productivity growth occurs when capital is leveraged to bridge the skills gap.

The tendency by firms to replace labor with capital and the promise and threat posed by generative AI illustrates the pitfalls. Fear of machines replacing humans is as old as time. Managing that transition will be one of the greatest labor market challenges for firms and governments over the next five-to-ten years.

10. Opportunities for job hoppers diminish. Chart 5 shows the gap between advertised wages and other measures of wage growth. Advertised wages have cooled from the frenzied pace earlier at the height of the reopening boom.

"The wage growth for job hoppers was twice that of those who stayed put."

That doesn't mean those who change jobs do not get higher wages. The ADP data for January revealed the wage growth for job hoppers was twice that of those who stayed put; there were just fewer opportunities.

Tech workers were the outlier. Their quit rate surged late last year, as many jumped ship before layoffs were implemented; they had plenty of opportunities.

Quit rates have cooled from the red-hot pace earlier in the recovery but remain elevated. Recent research reveals that a persistently high level of churn is undermining productivity growth, which is needed to sustain wage gains without triggering inflation.

This is not surprising, given how costly a high rate of churn is both for employers and employees. It takes a lot of work to learn new jobs and cultures.

The question is, where do we go from here? Recent announcements by the largest employer in the country to boost entry-level wages from $12 to $14 per hour could trigger another acceleration in wages for low-paid jobs. Managers want to keep the differential between their wages and those they oversee intact, which means those shifts could ripple up the wage strata.

Why do we care? Because tight labor marker conditions are stunting the Fed's progress on reducing inflation, especially in the service sector, which dominates the overall economy.

Reaching the Fed's 2% target for inflation could be a particularly heavy lift, given the current pace of wage gains. Wages are rising at a pace, absent a major step up in productivity growth, that is more consistent with 4% than 2% inflation.

What is so magical about 2% inflation?

Not much. New Zealand invented the 2% inflation target in the late 1980s. Other major central banks followed suit in the 1990s. The Fed adopted an implicit 2% inflation target under Chairman Alan Greenspan in 1996; Chairman Ben Bernanke instituted an explicit 2% target in 2012.

Initially, inflation targets helped improve central bank credibility in fighting inflation. Later, they became a way for central banks to avert a destabilizing deflation.

The target themselves are somewhat arbitrary and could conceivably shift. The Fed will be reviewing its monetary policy setting framework in 2024. A reassessment of what is "optimal" on inflation will include a trade off between how high the Fed thinks unemployment will need to go to achieve that goal.

Why not abandon the 2% target sooner? You cannot move the goal posts while still fighting inflation without losing credibility. A blow to the Fed's credibility now risks committing the very mistake it is seeking to avert: triggering a more entrenched inflation.

In the interim, the Fed will keep moving the timing of when it believes it will achieve the 2% goal further out. The Fed is scheduled to reassess the optimal inflation and neutral fed funds rate in 2024; we are not returning to ultra-low rates anytime soon. Financial markets have yet to internalize those potential shifts.

Bottom Line

Two economies are emerging. Firms which hired up in response to the initial surge in demand overshot. Firms that are benefiting from the pivot to services are still ramping up and absorbing losses elsewhere. Which firms dominate the outlook on employment depends on the extent to which the Fed raises rates.

Fed officials are willing to accept a rise in unemployment to cool the demand for and boost the supply of workers. Structural labor shortages have likely raised the non-inflationary rate of unemployment. How high an increase in unemployment it will tolerate is less clear.

Next year is an election year. That will ratchet up the political backlash to the Fed's efforts to cool the economy and raise unemployment. The pain of returning inflation to 2% may be too great to bear. Something a little warmer may be more appropriate in a world that has become much hotter than the one we left behind; step into the sun.