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Labor, Capital, Confusion

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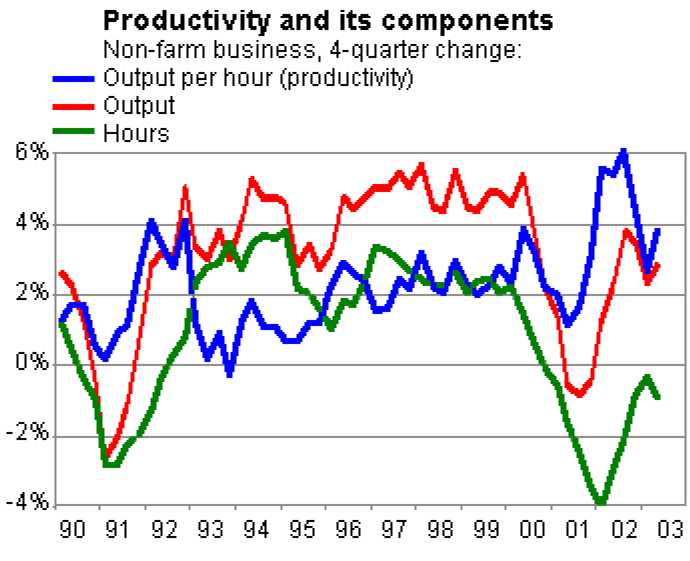
Productivity is not the enemy of job creation -- it is indispensable to it.

As it becomes increasingly clear that the economy has finally entered an appreciably more robust growth phase, a still-stagnant job market stands as one of the few remaining props for those doubting the strength and staying power of this expansion. With the passage of Labor Day marking a new phase of the political season heading toward November 2004, **President Bush's** perceived vulnerability on the jobs issue is sure to be exploited by **Democratic** hopefuls and party leaders. Bush as much as confirmed that liability yesterday when he went before a union audience in Ohio to announce creation of a sub-cabinet office that will seek to stem the tide of the "thousands of jobs" lost in manufacturing.

But if the issue is inevitably going to be overtaken by trite sound-bite politics, the generally accepted consensus about factors currently acting on the labor market is no aid to clarity either. Conventional economic wisdom has latched onto the idea that one of the primary reasons for the labor market's stubborn sluggishness is the acceleration of productivity growth. The thinking goes that because productivity is allowing businesses to get more output from the current workforce, economic growth will have to exceed productivity before much new hiring occurs. The concept has been widely reduced to a fairly straightforward formula: job creation won't resume until annualized output growth exceeds the sum of non-farm productivity and labor force growth.



In assessing this proposition, it's worthwhile first to recognize the extent to which it reflects nothing more than a sterile statistical truism rather than analysis of a real cause-and-effect relationship. Since the end of 2000, non-farm productivity has been growing at a four-quarter average of about 3.5%, while labor force expansion has been running at a long-term rate of about 1%. Does that mean that output growth would have to run at a rate of 4.5% or thereabouts to see appreciable job growth? Well no, not quite. Productivity, which is a measure of output per hour worked, is a statistical residual of two independent variables -- output and hours worked. It's a virtual certainty that once job growth resumes, measured productivity will fall relative to output because periods of labor market recovery are generally marked by a relatively more rapid acceleration of hours than output. The parameters of the consensus explanation will then be met, without explaining anything about cause and effect.

In the accompanying chart, the phenomenon can clearly be observed in the "jobless recovery" of the early 1990s. From the end of the previous recession in the first quarter of 1991 through the second quarter of 1992, productivity growth exceeded output because hours worked continued to decline even as output began to recover. Beginning in late 1992, measured productivity growth abruptly fell when hours went positive against relatively stable output growth. Thus, output exceeded productivity growth at the same time labor market conditions showed significant improvement. But that coincidence says nothing about the causes of the labor market recovery.

In the real world, productivity growth is the result of capital deepening -- the increase in capital relative to labor, which has the effect of making labor scarcer relative to capital. Yes, the accompanying technological innovation is commonly associated with sector-specific, labor-saving restructuring, with the inevitable images of people being thrown out of work due to automation. But times of secular productivity acceleration --as output expands relative to labor input over extended periods -- emerge out of a capital-rich environment customarily marked by heightened entrepreneurship, new business formation and -- inevitably -- job creation. That was certainly the US experience in the second half of the 1990s, when payrolls surged along with productivity. Indeed, the "productivity revolution" of the late '90s, far from being a period of stagnant job creation, coincided with development of the tightest labor market in more than a generation. As is so often the case with public discourse about economic statistics, the facts of historical experience don't have a chance to be heard above the din of seemingly clever pronouncements.

The labor market's laggard response thus far can be seen as a hangover of the '90s employment boom. After scooping up marginal workers to an extent unseen in recent economic history, employers were forced to retrench after the economy broke sharply starting in late 2000. Even now, though it appears the economy is embarking on a fairly brisk expansion phase, employers remain cautious lest the marginal return fail to justify the marginal cost of the additional hire. The fact is, the loss of nearly 3 million jobs has only shrunk payrolls back to levels of mid-1999, which represented a payroll expansion of nearly 15% -- more than 14 million jobs -- during the previous five years. In the current environment of intense sensitivity to job losses it might seem extremely politically incorrect to say so, but it's difficult to argue against the proposition that the economy is currently operating at close to full employment.

That's not to say that job growth will be unattainable going forward. As businesses become more confident about the economic and profit outlook, the workforce will again expand. Positive forward-looking indicators in that regard include the return of risk tolerance (reflected in high-yield bond issuance and technology stock valuations) and encouraging signs of recovery in business fixed investment, especially in high-tech capital goods. Capital investment is the lifeblood of productivity growth, which serves to underscore the point: any suggestion that employment growth can be had at the expense of productivity growth is a short-sighted canard. TM