Quarterly Economics Briefing

The nation's most experienced provider of workers compensation information, tools, and services

June 2015

Review of Current Conditions:

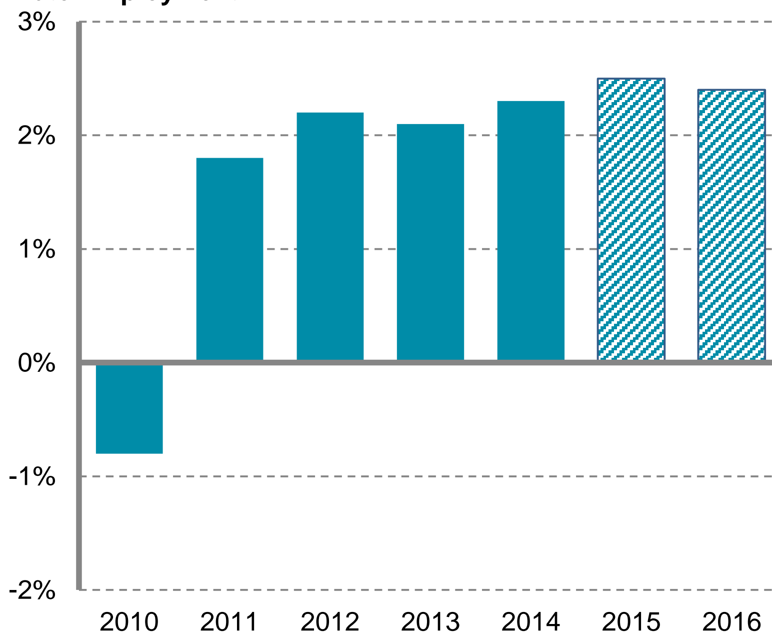
The Economic Outlook and Its Impact on Workers Compensation

The exhibits below are updated to reflect the current economic outlook for factors that typically impact workers compensation. Each exhibit also provides some context for the outlook, relative to the historical data. Consensus forecasts are derived from Blue Chip Economic Indicators and Moody's economy.com.

Employment Growth

The US economy softened in the first quarter of this year for several reasons. Factors that have been resolved include especially bad winter weather and the strike at West Coast ports. Other factors that are continuing to impact the economy are the strong dollar that has hurt exports and the fall in oil prices that led to steep declines in oil-related employment. First quarter real (inflation-adjusted) gross domestic product (GDP) declined at a 0.2% annual rate. Taken together, these factors have caused Moody's Analytics to slightly shave its forecasts for employment from what was reported in last quarter's newsletter. Employment is still forecast to tick up from the 2.3% growth in 2014, but now to 2.5% this year and 2.4% next year instead of the 2.6% shown last quarter. This is still an increase from an average annual 2% employment growth from 2011 to 2013 and a decline in 2010 when the country was just emerging from the Great Recession.

Increases in employment will likely lead to increases in exposure-based premium and create upward pressure on claim frequency.



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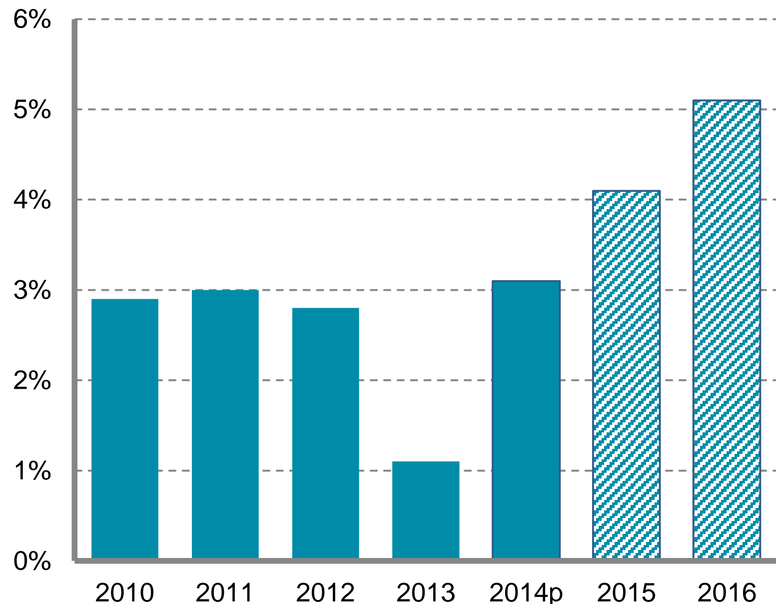
Wage Growth

A key driver of indemnity severity is the average weekly wage. Average weekly wage growth lagged in 2013, increasing by only 1.1%. Wage growth rebounded somewhat in 2014. According to the preliminary estimate, wages increased by 3.1% during 2014, just above the average annual 2.9% rate of growth from 2010 to 2012.

Lagging growth in wages is an indication of continued slack in labor markets despite the recent decline in the unemployment rate. Possible reasons for sluggish wage growth include the large number of discouraged workers who are not counted as part of the labor force, the large number of part-time workers, job insecurity, increased global competition, low minimum wages, and shrinking union jobs. See the discussion below on the unemployment rate and full employment for more information.

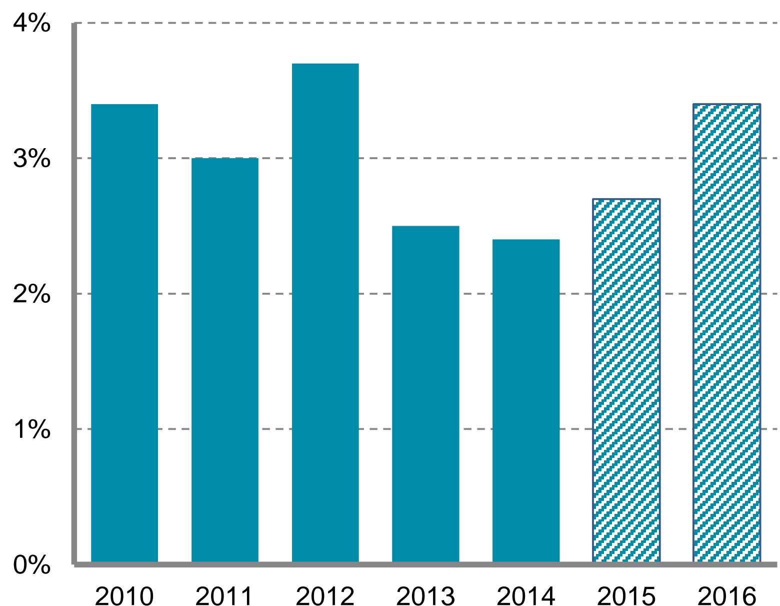


It looks like wages may now be accelerating with a strong gain posted in the employment cost index for the first quarter, but as with the employment outlook, forecasts for wages for this year and next have been reduced from those shown last quarter. Wages are expected to increase 4.1% this year and 5.1% next year, down from 4.4% and 5.3%. The potential for rising wages suggests that there will be upward pressure on indemnity severity. Private-sector payrolls should also grow due to the combined impacts of higher employment and increases in the average weekly wage.

Medical Inflation

Medical price inflation is a major driver of changes in medical severity. Rising medical care inflation suggests that we can expect increased pressure on medical costs per claim.

However, medical care inflation has been muted for the last two years, increasing by only 2.5% in 2013 and 2.4% in 2014. This is considerably below the average annual medical inflation of 3.4% experienced from 2010 to 2012. Moody's forecast is for medical care inflation to accelerate somewhat this year and next—2.7% in 2015 (down from 2.9% last quarter) and 3.4% in 2016—but still remain below 4%.



Rising medical care inflation will put upward pressure on medical costs, and medical severity increases could be higher due to changes in utilization that are not reflected in changes in price. Medical inflation will continue to outpace general inflation in the

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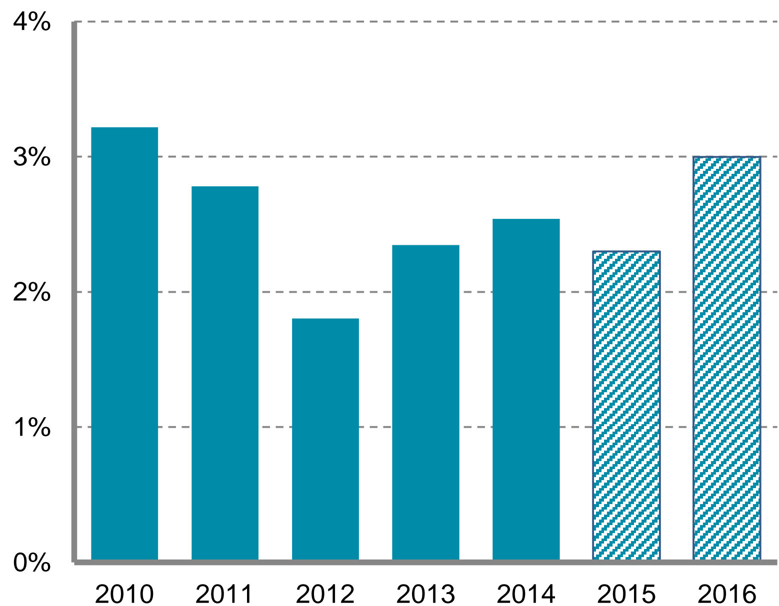
economy in the foreseeable future. Moody's forecast for general inflation is 0.4% this year and 2.6% next year.

Interest Rates

The current low-interest-rate environment continues to restrain investment income in the property/casualty (P/C) industry.

Since December 2008, the Federal Open Market Committee (the Fed) has maintained the target range for the federal funds rate at 0%–0.25%. In her monetary policy report delivered in February 2015, Federal Reserve Chair Janet Yellen said that there has been improvement in labor markets, but that the Fed recognizes that there is still room for more. However, the Fed may soon be raising the target rate. In June, the Fed indicated that it is moving toward increases later this year. The Blue Chip consensus forecast expects the Fed's first rate hike to come in September, although that has shifted from the expectation of June or September last quarter.

Blue Chip Economic Indicators' consensus expects the 10-year Treasury note average annual yield to decline to 2.3% in 2015 (down from 2.5% in 2014), and then to increase to 3.0% in 2016. Both of these forecasts are 0.1% or 0.2% below what they were last quarter.



Source: Federal Reserve Board, Blue Chip Economic Indicators

The P/C industry's investment performance should be positively affected as long-term interest rates begin to rise next year.

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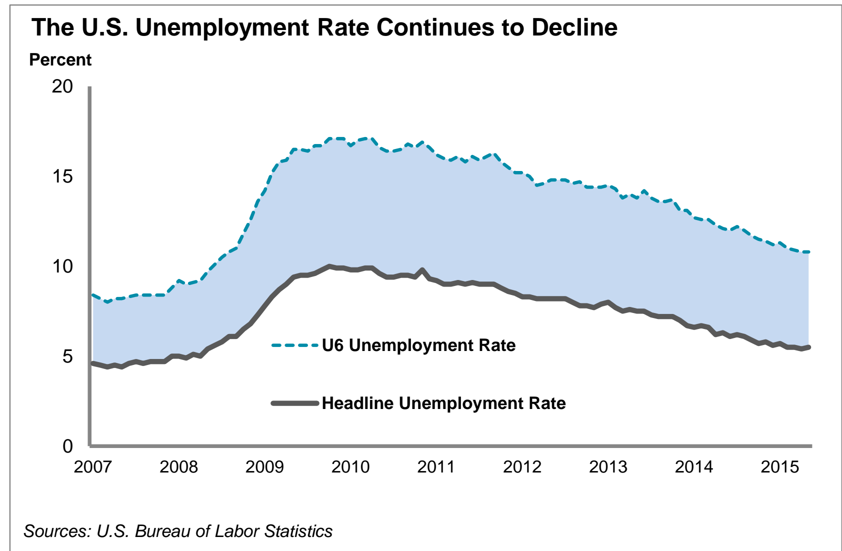
Drilling Down:
The Unemployment Rate and Full Employment

The aggregate employment level is one of the most important drivers of workers compensation premium and losses. The latest reading of the unemployment rate for May was 5.5%, down significantly from 10% in 2009 in the wake of the Great Recession (the Headline Unemployment Rate in the chart). As the US labor market strengthens, two questions naturally arise: What is the new normal for post-recession employment levels, and are we there yet? Far from being simple to answer, these questions relate to one of the most important and subtle issues in modern economics: What should the unemployment rate be when the economy is at "full employment"?



The Full-Employment Level of Unemployment

The idea of a full-employment level of unemployment sounds paradoxical, but actually makes sense in terms of labor market supply and demand at the Econ 101 level. Absent economic shocks such as the financial crisis that precipitated the Great Recession, labor markets can be expected to settle out, or equilibrate, at relatively stable levels of wages and employment that balance the supply and demand for labor. The aggregate unemployment rate in such a putative equilibrium will reflect "ordinary" or *frictional* labor market turnover and volatility, and so can be considered as a *natural*, *structural*, *long-term*, or *full-employment* unemployment rate—these are different adjectives used interchangeably by economists to mean the same thing.

To push the supply-and-demand logic further, if the current unemployment rate is above or below the structural unemployment rate, then the labor market is out of equilibrium and, consequently, both employment levels and wages can be expected to adjust over time until the market equilibrates and the structural unemployment rate is realized. If the current unemployment rate is above the equilibrium rate (a slack labor market), then real wages should fall and employment should rise. Conversely, if the current unemployment rate is below the equilibrium rate (a tight labor market), then real wages should rise and employment should fall. This means that the structural unemployment rate is a destination: it indicates where the current unemployment rate ought to be heading, though not how long it may take to get there.

In sum, economic theory points to two important conclusions: First, full-employment levels of employment (and unemployment) are the result of labor market supply and demand—they cannot be dictated directly or permanently by policymakers. Second, the labor market may be out of equilibrium, even for extended periods of time. All of this implies that an appropriate posture for macroeconomic policy is to ensure, to the extent possible, that labor markets stay at or near a full-employment equilibrium, but not to try to push employment levels above full employment, as this would lead to a self-defeating spiral of wage inflation.

The Fed and Full Employment

The US Federal Reserve System is statutorily tasked with conducting monetary policy with the goal of maintaining a balance between full employment and price stability. According to the Fed's policy statement, "In setting monetary policy, the [Federal Open Market] Committee seeks to mitigate deviations of inflation from its longer run goal and deviations of employment from the Committee's assessments of its maximum level."[1]

From the Fed's perspective, correctly identifying the maximum, or full-employment equilibrium, level of employment is central to its mission of conducting monetary policy. In essence, the Fed is asking the same questions as the rest of us about the new normal for the unemployment rate: How high should it be, and are we there yet?

[1] "Statement on Longer-Run Goals and Monetary Policy Strategy," www.federalreserve.gov, 24 January 2012, as amended 27 January 2015.

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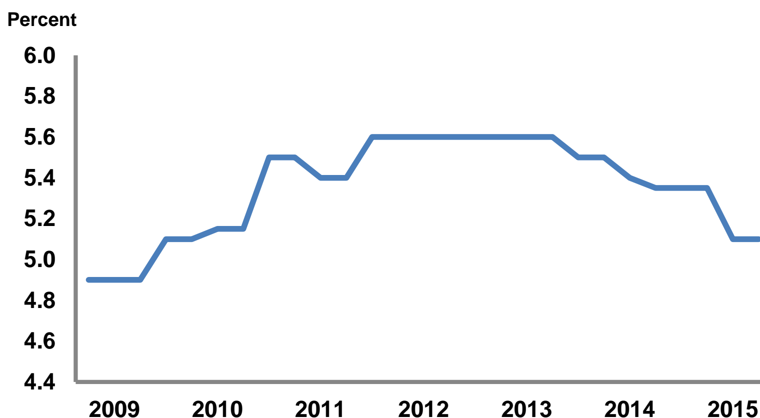
But the Fed's mission statement also incorporates an important subtlety. The desire to maintain full employment is balanced by a desire for price stability. This means that the Fed cares about two targets, not just one: the full-employment rate of unemployment and a target upper bound for the rate of price inflation. The Fed defines its targeted long-run, or full-employment, rate of unemployment as the lowest aggregate unemployment rate that is consistent with its price inflation target. For the past several years, the Fed's target for price inflation has stayed steady at 2%. But the Fed's median estimate of the full-employment unemployment rate has declined from 5.6% in 2011 through 2013 to 5.1% currently. Further, other researchers have suggested that the full-employment rate of unemployment may be as low as about 4.0%. Since the current unemployment rate for May is 5.5%, then either we are almost there if the Fed is right, or not really there if other researchers are right or if the Fed continues to revise its estimates downward.



FOMC Midpoint of Central Tendency, February 2009–June 2015
Source: Federal Reserve Board

How Close Is the US Economy to Full Employment?

How close the economy is to full employment has been the subject of recent research published by the Federal Reserve Banks of Atlanta[2] and Chicago[3]. Even though the unemployment rate has fallen considerably, other statistics point to continued slack in the labor market. These indicators include the large number of workers wanting more hours, low labor force participation rates, sluggish wage growth, and the composition of the labor force.

Involuntary Part-Time Workers

The large number of part-time workers who want a full-time job is one indicator pointing to labor market slack. During the Great Recession, the number of these involuntary part-timers doubled. In 2014, the number declined by 1 million following a decline of only 160,000 in 2013, but it still stood at 6.8 million workers who were working part-time but wanted full-time work. Reasons employers cite for employing more part-time workers are the higher costs of employing full-time workers compared to part-time and weak business conditions. Some employers have chosen to change the structure of working relationships by making more jobs part-time and using temporary staff. The Atlanta Fed believes that, as the economy strengthens further, employers are likely to use fewer part-time workers, but the proportion will probably not return to prerecession levels due to preferences for new temporary work arrangements.

Lower Labor Force Participation Rates

The labor force participation rate is another statistic pointing to slack in labor markets. It has trended down since 2000 when it was 67%. At the end of 2014, it stood at 62.7%, the lowest level since the 1970s. The Fed estimates about half the decline is due to structural changes (the aging population and retirement of baby boomers) and half is due to cyclical changes (weaker economic conditions leading to a large number of marginally attached workers).

In the fourth quarter of 2014, there were estimated to be about 2.2 million of these marginally attached workers, those who wanted a job but had not actively looked for one in the past month. As a result, they were not counted as part of the labor force and were not counted as unemployed in the headline unemployment rate. In contrast to the headline rate of unemployment, the U6 unemployment rate counts these marginally attached workers as part of the unemployed. While the headline rate of unemployment was 5.5% in May, the U6 unemployment rate would almost double to 10.8% if we add this shadow unemployment of an additional 5.3% (see the chart on the previous page).

When conditions improve, marginally attached and discouraged workers will likely rejoin the labor force putting upward pressure on the participation rate, but the downward pressure due to aging workers will continue.

Sluggish Wage Growth

Low wage growth also underscores slack in the labor market, indicating that the economy has not yet reached full employment. Lagging wages may be the result of several factors. First is the large number of discouraged workers who

[2] "Jobs: More Work to Be Done?" *Federal Reserve Bank of Atlanta's 2014 Annual Report*, April 2015, www.frbatlanta.org/.
[3] "Declining Labor Force Participation and Its Implications for Unemployment and Employment Growth," *Economic Perspectives,* 4Q/2014, Federal Reserve Bank of Chicago.

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aren't counted as unemployed as discussed above. Second, job insecurity means workers stay with their current job so employers don't have to raise wages to retain employees. Third, during the recession, employers didn't sharply reduce pay, so they are now reducing increases. Fourth, increased global competition, low minimum wages, and shrinking union jobs are keeping wages down. It is not clear the extent to which each of these is contributing to slower wage growth, but it is clear that the relationship between lower unemployment and higher wages is not as strong as it has been in the past.

The Federal Reserve Bank of Atlanta's Annual Report cites two factors among many that especially contribute to sluggish wage growth. The first is that the large numbers of unemployed and underemployed (involuntary part-time) workers are restraining wage growth, since the demand for hours by workers is greater than the supply of hours offered by employers. Second is the fact that the larger share of part-time workers is depressing wage growth, since increases in part-time wages have been about half as much as increases in full-time wages.

The first quarter reading of the employment cost index showed a strong gain, indicating that the tightening labor market may now be contributing to an acceleration in wage growth.

Composition of the Labor Force

A recent study by the Chicago Fed found that the composition of the labor force is also pointing to additional slack in labor markets. The labor force is now more heavily weighted toward older workers and those with higher education levels. Both of these groups tend to have lower levels of unemployment. The study estimates that these factors have lowered the natural unemployment rate by 0.3 percentage points since 2007 and by 0.6 percentage points since 2000. On average, it is declining by about 0.05 percentage point per year.

The New Normal Labor Market and Workers Compensation

The preceding factors can have various implications for workers compensation. First, the natural rate of unemployment is important because the Fed considers it when deciding when to start raising interest rates. If the Fed continues to believe that the unemployment rate is fast approaching the natural rate of unemployment, it will likely start to raise interest rates later this year. However, it may take a less urgent approach considering the other indicators mentioned above that point to additional slack in the labor market. When the Fed starts raising interest rates will have a direct impact on investment returns for workers compensation insurers.

As employment levels continue to increase and the labor market tightens, wage growth can be expected to accelerate indicating that the economy is getting closer to full employment. However, if the economy is further away from the natural rate of unemployment than currently thought, it could take longer before wage gains are realized. When wages do start to rise, they will cause both workers compensation losses and premiums to increase. Frequency may rise as marginally attached workers reenter the labor market, since newly employed workers with less tenure on the job have higher accident rates.

Analysis and charts prepared June 2015.
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