Gauging Current Conditions:
The Economic Outlook and Its Impact on Workers Compensation

The gauges below are updated quarterly to reflect the current economic outlook for factors that typically impact workers compensation. Each gauge also provides some context for the outlook, relative to a historical average of the previous five years.

**Employment Growth**

The “jobless recovery” likely means continued weakness in exposure/premium growth that is offset, in part, by limited upward pressure on frequency.

Given the breadth and depth of the recession, the economy is exhibiting anemic employment growth primarily due to a lack of business confidence. The weak pace of employment growth is not nearly enough to bring down the unemployment rate, which remains very high. Even as corporate profits are expected to rise, the consensus of leading economists anticipates the unemployment rate to remain as high as 9.6% by the year’s end before dropping to a still-high 9.0% by the end of next year. The consensus projection reflects an expected “jobless recovery” in 2010, and continued weak employment growth is anticipated for 2011. A key factor is that recovery from previous recessions typically was led by a rebound in construction. This time, the limited job opportunities in residential construction likely will be accompanied by deteriorating activity in commercial and retail construction. Moreover, there is no other industrial sector—exports, consumption, state and local government, manufacturing, banking/finance—that appears poised to play a strong leadership role. Weak job growth suggests less upward pressure on claim frequency, but it also means that there is a lesser likelihood of strong rebound in workers compensation premium in the near future.
Wage Growth

A weak job market recovery also indicates that there will be little if any growth in weekly wages; this suggests that the growth in indemnity severity also should be limited. It is not surprising that workers’ wages have remained under pressure during the “Great Recession.” This trend is not likely to abate while unemployment remains high and firms remain skittish about adding new workers. The anticipated weakness in the labor market creates great uncertainty in projecting the likely course for wages. In particular, changes in the average weekly wage actually reflect the combined impacts of changes in two other factors: hourly pay rates and hours worked per week per employee. Based on experience in past recessions it seems relatively certain that hourly wages will continue to increase, although the increases will be quite modest during the jobless recovery. In contrast, the outlook for changes in hours worked is far less certain. Changes in hours worked per week are an alternative to hiring or laying off workers. Indeed, preliminary data indicates that although hourly wages were up slightly, the average weekly wage decreased a bit in 2009 due to a decrease in hours worked per week per employee.

In spite of this uncertainty, it is clear that any increases in the average weekly wage over the next year will be well below the five-year average of 2.9%. The uncertainty surrounding the trade-off between employment and hours worked prevents us from offering any projections for changes in the average weekly wage at this early stage of the recovery. Broadly speaking, an expected slower wage increase suggests that the rate of indemnity severity (cost per claim) will remain tepid over the near term because indemnity benefits are generally tied to wage growth in most states.

Medical Inflation

Medical price inflation will continue to exert upward pressure on medical severity.

It is generally well recognized that the prices of medical goods and services as measured by the medical consumer price index (MCPI) typically increase at rates well above the average rate of inflation. There are a myriad of causes for high medical inflation debated by economists, policy makers, and the general public. The solution to the problem remains elusive, but the fact remains that as we consume more and more medical services due to aging of the population or other social and economic factors, reported medical price inflation will likely outpace the general rate of inflation in the economy. According to Moody’s Economy.com, the rate of medical inflation will likely return to prerecession levels. This suggests that there will be continued pressure on medical severity (cost per claim) for the foreseeable future.
Interest Rates

A continued Federal Reserve policy of low interest rates will limit the potential contribution of investment income to total profitability.

Short-term interest rates are largely determined by the Federal Reserve. The outlook for an extended jobless recovery suggests that monetary policy will continue to remain accommodative and will maintain short-term rates at or near current low levels. Long-term interest rates are strongly influenced by inflationary expectations; most observers currently expect, at best, only mild inflationary pressures over the next 12 to 18 months. The term “at best” may seem surprising; however, there is some concern that ongoing weak global economic conditions may result in general price deflation. As illustrated by the struggling Japanese economy over the past decade, deflation makes strong economic recovery very difficult. Many economists have raised concern about deflation in recent months. More recently, the Federal Open Market Committee’s August 10 minutes gave a hint about its concern for the deflationary pressure that the economy may be facing by indicating that “while no member saw an appreciable risk of deflation, some judged that the risk of further near-term disinflation had increased somewhat.”
Behind the Gauges:
Macroeconomic Outlook

Macroeconomic factors affect the workers compensation line; this annual section presents separate charts and commentary focusing on real GDP growth, private investment, consumer spending, production, inflation, and interest rates.

Real Gross Domestic Product (GDP)
The current consensus forecast indicates that most economists are anticipating a steady but modest recovery in economic activity over the next 6 to 8 quarters. Although the projected 2.7% projected rate of growth in real GDP is relatively close to the long-term average, it is disappointingly low for an initial period of recovery, especially when considering the steep decline in 2008 and 2009. Two key sectors will remain sluggish: housing and personal consumption. Historically, a rebound in housing has typically been central to recovery from recessions. The continued uncertainty surrounding the economic outlook and related policy actions likely will hold business investment and hiring in check at this early stage of the recovery. Similarly, the uncertain outlook for employment as well as the desire to reduce debt burdens will continue to restrain consumer spending. Furthermore, government spending and investment are likely to be smaller going forward as effects of the federal fiscal stimulus wane and state and local governments continue to battle a severe shortfall in revenues through austerity measures.

![Real GDP: Forecast for Modest Growth](image)

Source: Bureau of Economic Analysis; forecast GDP from Moody’s Economy.com
Residential Construction

Housing starts will remain well below levels needed to provide a strong boost to economic activity. One can argue that in many regions of the country, the construction industry produced up to six years’ worth of new housing in the last three years of the housing bubble; it likely will take two to three years for this inventory to be absorbed. New construction will also be hampered by competition from low-priced foreclosed properties returning to the market. In many ways, the housing market remains a linchpin in the recovery efforts; what started as a housing-led slowdown and quickly turned into a full-blown Great Recession has still not resolved the issue of the oversupply of homes across the nation. The fact that millions of homeowners remain underwater (owe more on mortgages than their houses are currently worth) along with the already high foreclosure activity suggest a long road to recovery in the housing market.

![Forecast Housing Starts: Continued Weakness](image)

Source: Historical data from the US Census Bureau, forecasts from Blue Chip Economic Indicators
Forecast Capacity Gaps: GDP, Capacity Utilization, Employment

There has been some encouraging news about the capacity utilization rate recently, but it remains to be seen whether the trend can keep up the pace going forward. According to the latest data from the Federal Reserve, the capacity utilization rate for total industry moved up to 74.7% in August—that is 4.7 percentage points above the rate from a year earlier but 5.9 percentage points below its average from 1972 to 2009. The economy will continue to operate well below capacity. This is readily seen in data on manufacturing activity, labor markets, and GDP. Manufacturing activity is increasing but is likely to remain well below full capacity for the foreseeable future. Similarly, employment growth will fall short of full employment. As a consequence, there will be a sizeable gap between actual and potential GDP.

Forecast Capacity Gaps: Slow Rebound
Percent Change From Prior Year

*Annual rate is based on the average of the first 8 months of 2010 versus the same period of 2009.
Capacity Utilization: Board of Governors of the Federal Reserve
Forecast Change in Personal Consumption Spending
The capacity gap in labor markets will result in only modest growth in wage rates. When combined with weak increases in
hours worked and total employment, the growth in personal disposable income and personal consumption spending will
remain weak.

Forecast Inflation
The output gaps described above will also restrain inflationary pressures. Indeed, there are concerns that continuing
capacity gaps in a slow recovery may contribute to deflationary conditions. Inflation remains less of a threat in the short
term. Some economists think that from a policy perspective, the danger lies in the extremes of either high inflation or
deflation. Given how much slack we have in the economy, the risk of excessive inflation remains quite subdued; however,
the risk of deflation remains a concern.
**Interest Rates**

Interest rates are likely to remain at historically low levels. Short-term rates will reflect continued easing of Federal Reserve monetary policy as economic activity remains sluggish. Short-term rates are expected to remain very low before beginning to rise by the middle of the next year. The Federal Reserve is expected to keep the federal fund target rate at its current range of 0.0%–0.25% until the summer of 2011. Long-term rates are strongly influenced by inflationary expectations, which are likely to remain subdued for the next several quarters and are likely to follow the same trajectory as the short-term rates.

![Interest Rates: Up Slightly](image)

**Summary**

Premium—Growth in workers compensation will remain weak because the growth in private sector payrolls will be weak. The lack of growth in construction payrolls is particularly noteworthy.

Frequency—NCCI research indicates that a long-term downward trend is the dominant characteristic of changes in frequency. In addition, over the business cycle, an increased pace of new hires is the primary source of upward pressure on frequency. An increased rate of layoffs also is associated with upward pressure on frequency. Over the emerging recovery, it seems likely that the pace of layoffs will ease, while the rate of new hires will increase only modestly. The outlook is that frequency will continue its long-term downward trend.

Indemnity Severity—Changes in indemnity severity are driven primarily by changes in the average weekly wage and by changes in the duration of temporary total claims. The weak recovery suggests that indemnity severity will, at most, increase modestly. The rate of change will be restrained primarily by slow rates of increase in average weekly wages over the Great Recession. Uncertain changes in duration, which will depend on the strength of the recovery in the job market, add to the uncertain outlook for indemnity severity.

Medical Severity—Inflation in medical prices will continue to be the key driver of changes in medical severity. Utilization, primarily in the shape of an increasing share of more costly injuries (e.g., rotator cuff, knee) related to growing obesity and an aging workforce, will likely add a bit of upward pressure.