Technomic on the... ECONOMY

July 2009

Special Foodservice Economic Viewpoint

Unemployment, Underemployment and the Outlook for the Restaurant Consumer

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In recent months, several market indicators suggest some signs of stability after the financial crises that plagued the world in 2008 and early 2009. Investors appear to be more confident in the U.S. government's intention to financially back the banking system while at the same time using techniques such as "stress tests" to reveal crucial information to the market.

While these activities have undoubtedly helped the U.S. economy avoid a depression scenario, expectations for growth need to be tempered by a sluggish labor market, which will lag financial indicators by several quarters. In this update, we will focus on the central role that labor market factors will have on consumer sentiment and the persistence of the current recession.

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The Employment-Recession Connection

The length and depth of recessions are based largely on the efficiency of the labor market. To understand why, it's important to remember that firms try to utilize the optimal amount of labor and capital to meet the demands of the market. Let's say that there exists an ideal world in which firms and workers have found a "real" wage (wages divided by average prices in the economy) that allows the firm to produce the amount and quality of products demanded by the market. If consumer demand for products drops from this level, firms must accommodate the market by adjusting prices downward.

As prices for products decrease, prevailing real wages become too high for firms to produce sustainably in the market. To bring the market back into balance, firms must accommodate lower prices by reducing real wages. While this may have a negative effect on some workers in the short-run, a fast wage adjustment also coincides with a decrease in the cost of money (interest rates). If our faith in the economy and our institutions has not changed somewhere along the way, falling interest rates restores growth by giving firms an incentive to invest.

[1] *Real wages are simply a measure of the spending power of our nominal wage (Nominal wages / prices in the economy)*

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In the real world we often face long recessions because firms that attempt to implement wage cuts or impose furloughs face significant social and political costs (e.g., poor worker morale, government pressure). To compensate, they instead lay off some workers while maintaining wages of those who remain. The market then adjusts in three ways:

- Erosion of real wages. Nominal wages remain the same, but raises are frozen until inflation eventually eats away at the real value of salaries. Health and retirement benefits can also be cut in the process
- Effective hourly wage reductions. Workers who remain usually commit more time to work because of poor alternatives and the looming risk of losing their jobs. They effectively lower their wages in the process and lessens the incentive for firms to re-hire when the economy starts to recover.
- The unemployed and new graduates bear most of the burden. Those who are laid off or are just entering the workforce typically have a hard time finding employment in their traditional industry, producing skill mismatch in the market. Skill mismatch increases the length of unemployment spells and usually results in workers having to accept jobs at significantly lower wages.

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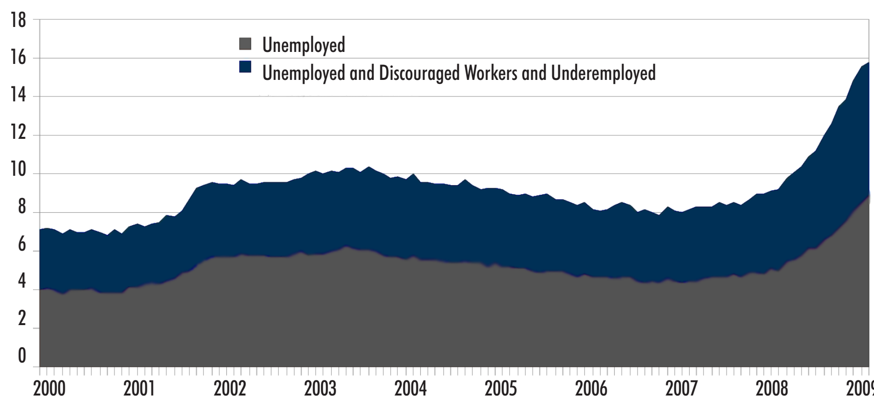
Outlook for Unemployment and Underemployment

The benchmark unemployment rate used by public and news sources to illustrate the relative health of the economy now exceeds 9 percent. However, the spread between this rate and a "broad unemployment" rate that also includes "underemployed" and "discouraged workers" continues to rise. Including these groups, the "broad" unemployment rate has reached a startling 15.8 percent--a number that many say, and we agree, could approach 17 percent by the end of 2009.

EMPLOYMENT AND UNDEREMPLOYMENT



[2] See also "Ranks of Discouraged Workers and Others Marginally Attached to the Labor Force Rise During Recession" Bureau of Labor Statistics, http://www.bls.gov/opub/ils/pdf/opbils74.pdfse

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Broad unemployment rates illustrate how **this recession is impacting the full employment strata**. Core foodservice consumers in finance and professional services have also faced job loss and asset declines and are more likely to trade down to jobs that are not fully commensurate with their skills. Although we can take some solace in knowing that the majority of these high-wage workers are relatively young, well-educated, and better able to adapt to market demands, retraining does take time. Further, these individuals will not place into new, well-paying jobs until we address the financial and psychological uncertainties of those who remain employed. Ultimately, consumption by the employed must increase in order to drive a robust economic recovery.

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How the Downturn Affects the Employed

The employed members of the economy have been affected in two crucial ways during this downturn: first, poor outside employment opportunities and reduced job mobility (due in part to housing constraints) **have given firms the flexibility to implement both layoffs and cut wages in the form of health care and retirement benefits**.[2] Although this wage reduction can help realign and restart the economy, benefit loss can have the effect of negatively impacting the long-term outlook and risk postures of consumers if adequate insurance and secondary savings vehicles are not readily available in the private market. Public policy outcomes, most notably those in the health care and social security arena, will undoubtedly determine which of these effects will win out in the long run.

Next, job uncertainty is taking its toll. Layoffs have also affected the spending habits of the employed by spreading psychological uncertainty across all workers in the economy. This occurs because recessions hit some sectors unpredictably harder than others, even though "only" 5 to 7 percent of jobs are actually lost in the worst modern recessions. These collective threats will delay an economic recovery by inhibiting consumer spending, increasing precautionary savings, and delaying retirement dates across all levels of the economy.

Concluding Remarks

Several economists have recently argued that recessions find an end only after a peak in unemployment claims.[3] If this is indeed the case, there are at least some small glimmers of hope that the free-fall in the labor market has abated. Although manufacturing continues to experience very steep declines, the pace

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[2] *Center for American Progress (CAP), Wall Street Journal Survey (May 26, 2009)*

[3] *See "Green shoot or dead twig: Can unemployment claims predict the end of the American recession?" http://www.voxeu.org/index.php?q=node/3524*

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of layoffs based on first-time unemployment claims has leveled off from all-time highs in recent months. The deceleration reflects slowing rates of job loss in construction, professional services, and retail trade. Consistent with other leading indicators (equity markets in particular), this may signal positive growth in GDP in the latter half of the year. Nevertheless, because employers will remain particularly cautious as the economy expands, the pace of hiring is unlikely to exceed layoffs until mid-2010.

Despite a number of bright spots in recent economic reports, the U.S. labor force will remain under-utilized along a number of key dimensions for some time. Consumer anxiety will remain connected to their prospects in the labor force, and the likelihood of layoffs, unanticipated part-time work, and slashed benefits will promote a continued culture of restraint for what consumers deem non-essential spending. Food service firms will undoubtedly benefit from reduced labor costs but must focus their efforts on developing efficient operations, input management, product mix and price promotion. This is especially true if the current downturn is followed by an economic upswing that also corresponds with higher energy prices.