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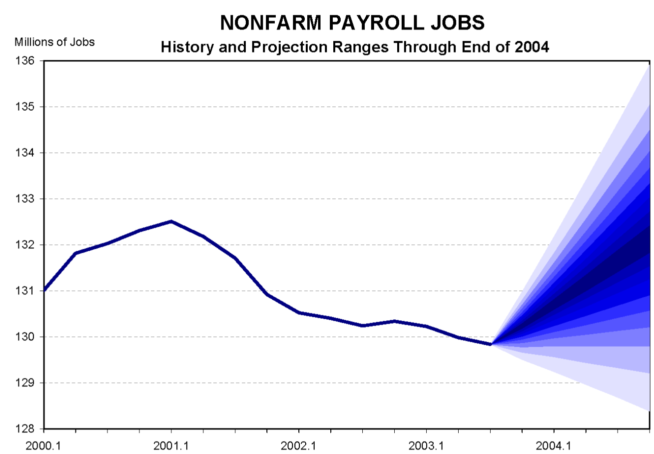
STRONGER ECONOMY – AND PAYROLL JOBS GROWTH – EXPECTED THROUGH 2004

SUMMARY

Most private economists generally agree that the U.S. economy is growing at a strong pace in the second half of this year – and that strong growth will continue through 2004. A big question, though, is how payroll jobs will respond. Thus far, despite growth in the economy over the past 2 years, the labor market performance has been mixed, at best. Only recently has the jobs market shown nascent signs of improvement.

One reason for the sluggish labor market is the strong productivity growth of recent years. This has allowed firms to expand total output without net increases in payroll workers. Going forward, however, history suggests the recent productivity growth surge will settle back somewhat, leading to significant gains in payroll jobs accompanying the stronger growth in real gross domestic product [GDP]. This *Budget & Economic Monitor* provides a further description of the prospects for economic expansion and job growth. Some key points:

- *Economic Growth*: Private economists expect growth in real GDP of about 4½ percent or more during the second half of this year, and about 3½ percent to 3¾ percent during 2004
- *Unemployment Rate*: They also expect the unemployment rate to decline from 6.1 percent now to about 5.8 percent by the end of 2004.
- *Potential Jobs Growth*: Current projections and estimates point to an expected increase in payroll jobs of about 2.3 million to 2.6 million through the end of 2004 – or roughly 150,000 to 175,000 per month on average.
- *Accounting for Risks*: Even accounting for various risks and uncertainties, the bulk of the projections still point to substantial increases in payroll jobs, more likely than not occurring in the broader range of 100,000 to 250,000 per month range through the end of 2004.

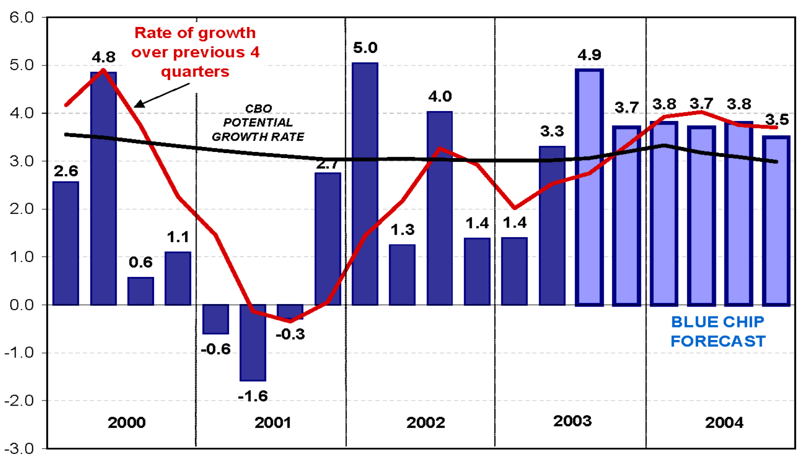


STRONGER ECONOMY AND JOBS GROWTH EXPECTED

STRONGER ECONOMIC GROWTH AND CURRENT LABOR MARKET UNCERTAINTY

The first estimate of gross domestic product [GDP] in the third quarter is to be released this week. Most analysts estimate that real GDP growth in the quarter exceeded 5 percent at an annual rate. Private economists, as indicated by the Blue Chip survey, expect growth in real GDP of about 4½ percent or more during the second half of this year, and about 3½ percent to 3¾ percent during 2004 (see Figure 1).

FIGURE 1 -- REAL GDP GROWTH



Coinciding with the pickup in growth, the unemployment rate appears to have begun trending down – although quite gradually – declining to 6.1 percent in August and September from the recent high of 6.4 percent in June. With continued stronger economic growth, private economists expect the unemployment rate to gradually decline through the end of next year.

In contrast to the initial improvement in the unemployment rate, however, government estimates of payroll jobs at business establishments generally have shown continued declines, although the report from the most recent month (September) showed a gain of 57,000 jobs (see Figure 2 on the next page).

The apparent contradiction in the two sets of employment figures results, in part, from the different methods of measurement. Payroll jobs are tallied in what is called the Current Employment Statistics survey (commonly known as the "establishment" survey), which is based on reports from a sample of business establishments. The unemployment rate, and its associated measure of employment, are determined from the Current Population Survey (the "household" survey), based on samples from households. As a result, the household survey picks up employment not covered in the establishment survey – self-employment and household workers, for example.

The differences in the outcomes of the two surveys may also result from other measurement differences, such as the increase in unpaid work absences associated with reservists being called to active duty, and a tendency of the estimates to understate payroll jobs growth in early economic expansions.

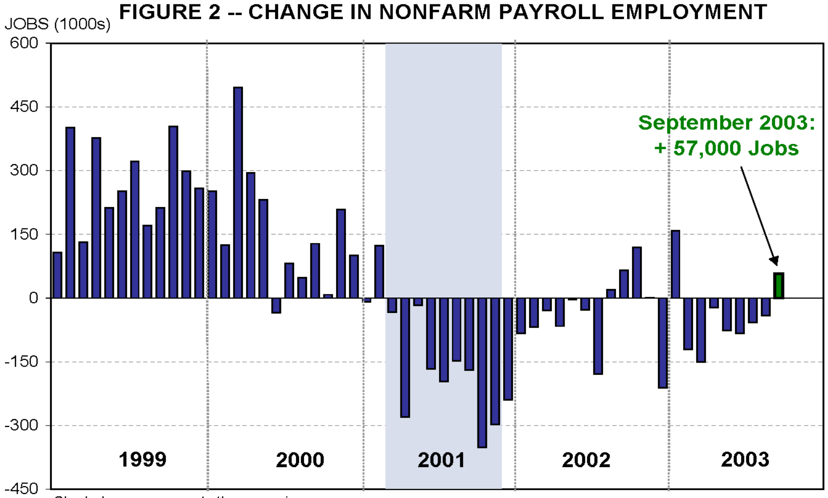
THE ROLE OF HIGHER PRODUCTIVITY GROWTH

High trend and cyclical productivity growth has been a major factor contributing to the sluggish payroll jobs performance of the past year and a half, even as real economic growth initially picked up following the slowdown and recession of 2000 and 2001. (The "trend" rate is an ongoing, underlying rate of growth over an extended period; the "cyclical" portion varies with the stage of the business cycle.) To put it simply, in seeking the most efficient and least costly methods of production, companies boosted productivity and increased their output without taking on permanent new employees.

Figure 3 on the next page shows labor productivity growth – and its trend growth rates – since 1960. Trend productivity growth has been elevated in the years after 1995, and a temporary surge in productivity growth relative to that elevated trend also has occurred in the early expansion following the 2001 recession. The recent rise in productivity growth has been especially pronounced in manufacturing.

Although many analysts view recent productivity growth as abnormally strong, its current cyclical surge relative to trend is very similar to what occurred in other early expansion periods after recessions (e.g., the periods immediately following the shaded areas in Figure 3). The cyclical surge typically lasts about 1½ years to 2 years after the recession. The apparent difference this time, relative to the business cycle experiences of the prior 30 years, is that the underlying "trend" rate of productivity growth is higher. If historical patterns hold, productivity growth will settle back to its trend rate from the recent cyclical surge. Effectively, this means that businesses will need to hire additional workers to increase production and meet the increased growth that occurs with the economy in expansion.

FIGURE 2 -- CHANGE IN NONFARM PAYROLL EMPLOYMENT



Shaded area represents the recession.

THE OUTLOOK FOR PAYROLL JOBS GROWTH

Private forecasters generally expect improving labor markets during the coming year. Specifically:

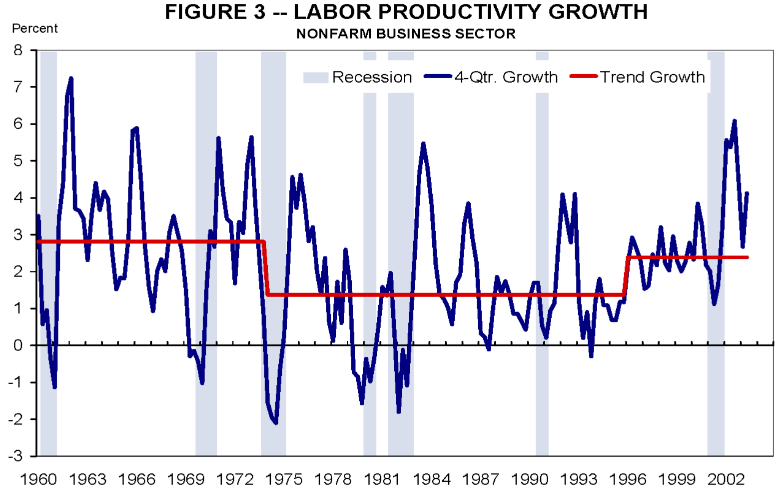
- The Blue Chip average forecast (from the survey of 53 private forecasters) shows an employment increase of about 2.6 million by the end of 2004, with the unemployment rate declining to 5.8 percent (*Blue Chip Econometric Detail*, September 2003).

- Another recent survey of 35 private business economists by the National Association for Business Economics shows a projected increase of about 2.6 million payroll jobs through the fourth quarter of next year – an average monthly pace of about 175,000 per month. The central 60 percent of the projections covers the range from 1.9 to 3.7 million jobs – a pace of roughly 125,000 to 250,000 per month. (A majority of the respondents expect the first monthly increases of 100,000 or more to occur some time in the September-to-November 2003 period.)

These projections represent a collection of estimates from individual forecasters that form a distribution of possible outcomes for employment growth over the next year. To help provide additional understanding of the relationships involved, Figure 4 on the next page shows an alternative method for examining the likely growth in payroll jobs through the end of next year – and the likely uncertainty associated with that outlook.

The chart is based on the estimated historical relationship between real GDP growth and payroll jobs, including accounting for productivity trends and accelerated cyclical productivity growth during early expansion periods. The darker bands in the middle represent the more likely outcomes; the lighter bands on the outside represent the less likely outcomes. (Each shaded band represents 5 percent of the likely outcomes.) The chart was derived from estimates based on the Blue Chip projection for real GDP growth, and allowing for the possible errors for real GDP forecasts and the relationship between real GDP growth and payroll jobs. As described above, the estimates assume a gradual return to trend

FIGURE 3 -- LABOR PRODUCTIVITY GROWTH
NONFARM BUSINESS SECTOR



Shaded areas represent recessions periods.

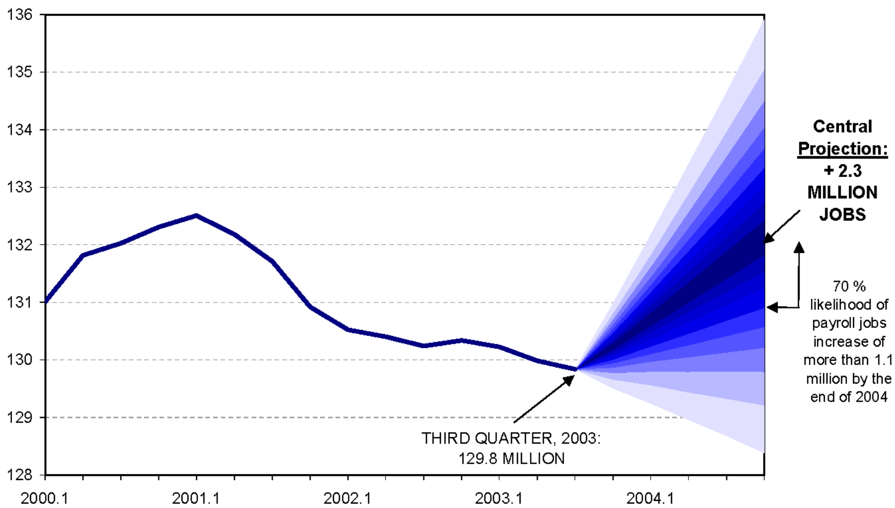
productivity growth from the elevated cyclical growth of the past year and a half.

Figure 4 shows that this method generates a central expectation for payroll jobs gains of around 2.3 million by the end of 2004, with a 70-percent probability that more than 1.1 million jobs will be created. The expectation of 2.3 million jobs is very similar to that of the Blue Chip and the NABE forecasts described above – and points to payroll job increases of roughly 150,000 per month.

The broad distribution shown in the chart illustrates the extent of the upside and downside "risks" that exist in making the payroll jobs forecast. Factors that could lead to an outcome in the lower part of the projection fan include: continued abnormally high, above-trend, productivity growth; lower real GDP growth than in the Blue Chip forecast; or some other unanticipated shock that negatively affects the typical relationship between real GDP growth and payroll jobs. On the "positive risk" side, similar effects could happen in the opposite direction, resulting in higher-than-expected jobs growth. A further factor that could adversely affect the measured change in jobs through the end of next year is the historically observed tendency for the government estimates of payroll jobs to understate payroll jobs growth during early expansions. This last factor is not accounted for in the distribution shown in the chart.

FIGURE 4 -- NONFARM PAYROLL JOBS

History and Projection Ranges Through End of 2004



Projection ranges based on Blue Chip real GDP projection, historical relationships between real GDP growth and jobs growth, historical real GDP forecast errors, and variation in the relationship between GDP growth and jobs growth.

CONCLUSION

Even with all the risks and uncertainties, private forecasts and the approach used here show that it is more likely than not that significant payroll jobs growth will occur through the end of next year, with a high likelihood of jobs gains of 100,000 or more per month and the general expectation of around 150,000 to 175,000 per month.

It is a testimony to the U.S. economy's dynamic resilience, and the monetary and fiscal policies of the past several years, that the economy is in such a position to recover from the various substantial shocks it has experienced over the past several years, including: the bursting of the stock market bubble of the late 1990s, the slowdown and recession of 2000-01, the shock and aftermath of September 11, and the military conflicts in Afghanistan and Iraq and their associated uncertainties. Despite these challenges, the U.S. economy is poised to return to sustained expansion, with improving labor markets and jobs growth.

Prepared by

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