ECONOMIC VIEWPOINT

Can the US Weather a Recession without a Spike in Unemployment?

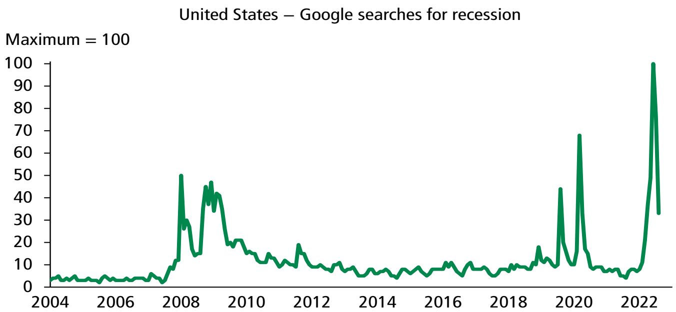
By Francis Généreux, Principal Economist

The job market always takes a hit when there's an economic downturn. During the 1990–1991, 2001 and 2008–2009 recessions in the United States, the unemployment rate jumped 2.8%, 2.5% and 5.6% respectively. And that's not counting the first two months of the pandemic in 2020, when the jobless rate shot up from 3.5% to 14.7%. Recession fears have been mounting in the United States. If the economy dips into recession, will unemployment spike from its current lows? Probably. But it's also possible that the next economic contraction will be less painful for workers. Because of ongoing labour shortages, businesses may be more inclined to eliminate open positions and pull job postings than to let staff go. But it remains to be seen whether that will be enough to slow wage growth, which is helping to fuel soaring inflation and prompting the Federal Reserve (Fed) to pursue restrictive monetary policy.

US Recession Fears Are Running High

We've been hearing about a possible US recession for several months now (graph 1), as GDP fell an annualized 1.6% and 0.6% in the first two quarters of the year. Yet despite two consecutive declines in real GDP, it isn't being called a recession. That's because other economic indicators are pointing to continued growth. The labour market is a prime example. It's doing well, adding 3,504,000 jobs so far this year.

GRAPH 1
Recession speculation is back in the news this year



Sources: Google and Desjardins, Economic Studies

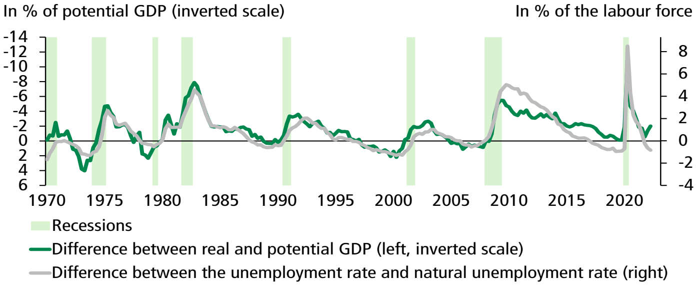
But inflation has eaten into household incomes, consumer confidence declined for several months, and interest rates are on the rise. The US economy may therefore have trouble keeping its head above water over the next few quarters. Forecasters surveyed by Bloomberg in September put the probability of a recession in the next 12 months at 50%. That number was just 15% at the start of the year.

Recessions are typically tough on the US labour market. In the United States, an independent body called the National Bureau of Economic Research is the arbiter of official recessions, and every official recession in the past has resulted in job losses. When the economy is weak and real GDP is well below potential, unemployment almost always goes up (graph 2 on page 2).

The Job Market Is Very Tight

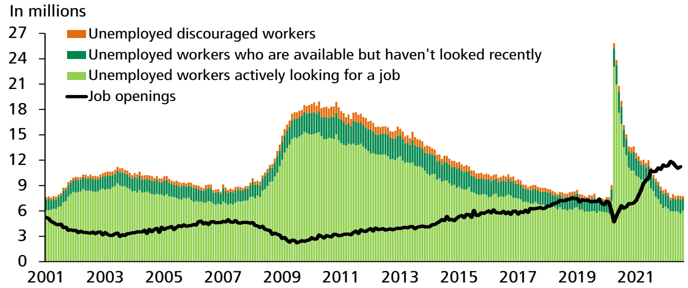
Despite anemic real GDP growth of late, the labour market still seems to be doing very well. In August, the unemployment rate was a near-record-low 3.7%. That's less than the Congressional Budget Office's estimated natural rate of unemployment (4.4%) and the Fed's forecast for the long-term unemployment rate (4.0%). This reflects the maximum employment and labour shortage situation that's been making headlines for a while now.

GRAPH 2
Economic downturns and especially recessions mean higher unemployment



Sources: Bureau of Economic Analysis, Congressional Budget Office, Bureau of Labor Statistics and Desjardins, Economic Studies

GRAPH 3
There's a huge gap between the number of unemployed and the number of job openings



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

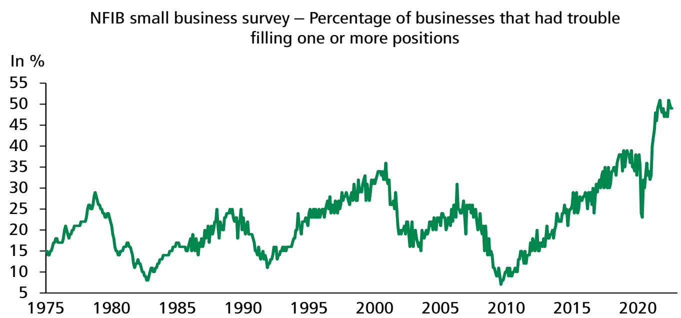
Several factors are at play in today's job market. The pandemic has disrupted employment in the United States. It has accelerated some trends we were seeing before, especially those related to the aging population. Chief among them is the decline in the labour force participation rate. In August of this year, the labour force (employees plus job seekers) was 113,000 workers shy of its pre-pandemic peak. However, the civilian population 16 and older has grown by 3,831,000 since the start the pandemic. That means more American workers are sitting on the sidelines.

But there's no shortage of jobs. In fact, help wanted signs are everywhere. In July, there were 11,239,000 job openings in the US. That's a job openings rate of 6.9%.[1] Both the number and rate of job openings have recently hit all-time highs.

The imbalance between job openings and unemployed workers (active job seekers plus discouraged workers) is unlike anything we've seen in the US over the past twenty years (graph 3). Since summer 2021, there have been far more job openings than job seekers, an unusual situation emblematic of the current labour shortage. The shortage is also reflected in the large number of businesses struggling to fill positions (graph 4). This acute shortage is making life difficult for businesses and increasing competition for the few workers available. This imbalance is putting pressure on wages, driving up inflation and complicating the work of the Fed. In a recent speech, Fed Chair Jerome Powell underscored the importance of balancing the labour market to slow inflation: "What we hope to achieve is a period of growth below trend which will cause the labour market to get back into better balance and that will bring wages back down to levels that are more consistent with 2% inflation over time."

[1] The job openings rate is the ratio (expressed as a percentage) of job openings to the sum of occupied positions and job openings. Job openings are available positions that can be filled within 30 days and for which the employer is actively seeking candidates outside their organization. Bureau of Labor Statistics job openings data beginning December 2000.

GRAPH 4
Many US small businesses are struggling to fill open positions



NFIB: National Federation of Independent Business
Sources: NFIB and Desjardins, Economic Studies

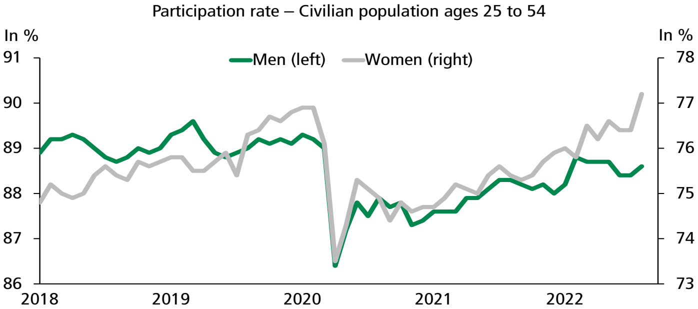
But how much pain must the US economy and workers endure to ease inflationary pressures enough to satisfy the Fed?

Using the Beveridge Curve to Understand the Relationship between Job Openings and Unemployment

Are a recession and a spike in unemployment unavoidable when balancing the labour market? It may seem so at first glance. As you can see in graph 2, unemployment usually rises when the economy weakens.

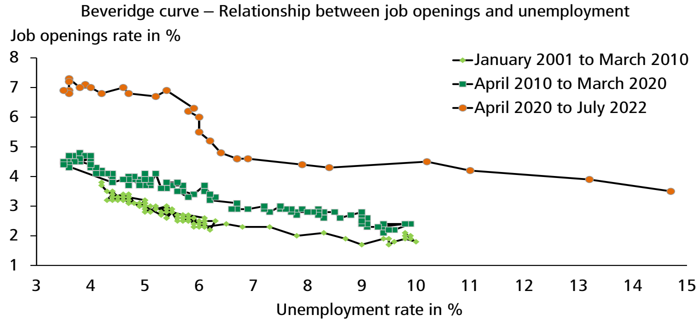
But this can be avoided if the labour force participation rate goes up. The August data was encouraging in this respect, with the participation rate increasing in the age categories most likely to participate in the labour market and rising especially sharply among women (graph 5 on page 3). If this continues, the sheer number of people entering the labour market could bring down the high job vacancy rate. Yes, this could cause unemployment to spike temporarily. But it would be more a function of the increased labour supply than deteriorating economic conditions. A mismatch between the skills of new job seekers and the needs of employers could limit the reduction in job vacancies, however.

GRAPH 5
The labour force participation rate has improved recently, especially among women



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

GRAPH 7
The pandemic has disrupted the relationship between job openings and the unemployment rate

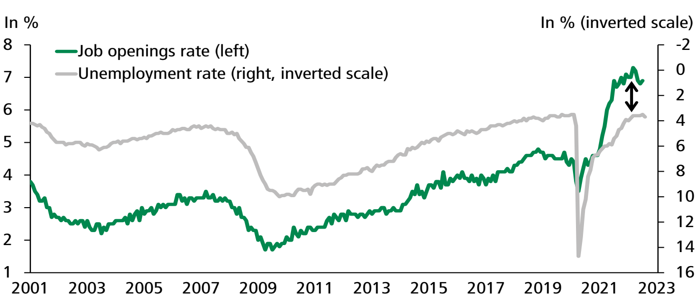


Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

So unless the labour force participation rate rises dramatically, we'll have to find another way to balance the job market. But is a spike in unemployment unavoidable?

There's a clear link between job openings and unemployment. More job openings usually mean lower unemployment. But as you can see in graph 6, there's a bigger gap than normal between these two indicators.

GRAPH 6
Rising job openings and falling unemployment go hand in hand, but the current situation is not normal



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Another way to express this relationship is the Beveridge curve[2] in graph 7. It shows the inverse relationship between the job openings rate and the unemployment rate. In theory, when deteriorating economic conditions push the unemployment rate higher (towards the right in the graph), the job openings rate goes down. But economic upheavals cause the Beveridge curve and the position on the curve to shift. So even though the unemployment rate was roughly the same in both the 2000s and 2010s, there were more job openings in the 2010s. And there have been even more since the pandemic began.

But is this pandemic-induced shift permanent? The answer has huge implications for the future health of the US economy and for the Fed's monetary policy.

What If the US Economy Worsens?

The US economy is already showing signs of slowing. But is a spike in unemployment an inescapable feature of an economic downturn or recession?

When the economy contracts, there's usually a drop in labour demand from businesses. To remain profitable, businesses pull job postings and shed workers. This shifts the current position on the Beveridge curve to the right.

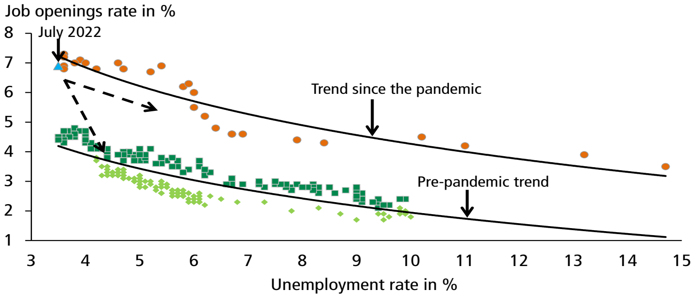
But the situation is extremely skewed right now, with the most recent position (July 2022) far to the left, but also very high up. In many spheres of life, the pandemic seems to be fading into the rear view mirror. If the economy starts to slow down, we could therefore see a reversion toward the pre-pandemic trend (a big downward shift in the job openings rate) rather than a continuation of the trend we've seen since 2020 (a shift to the right indicating a much higher unemployment rate) (graph 8 on page 4).

Could we see a return to a more typical situation, with a sharp decline in job openings without a spike in unemployment? There are arguments for and against. On the one hand, businesses seem increasingly aware of the problems that worker shortages pose. They limit business opportunities, complicate growth and may even delay recoveries. When businesses think an economic slowdown will be temporary, they may hold on to as many employees as possible. As HR managers are well aware, finding

[2] Named after William Henry Beveridge (1879–1963), a British politician and economist known for his analysis of social programs and the unemployment insurance system. The curve was developed by economists Dow and Dicks-Mireaux in 1958.

GRAPH 8
A shift back to the pre-pandemic trend could mitigate the impact on the labour market

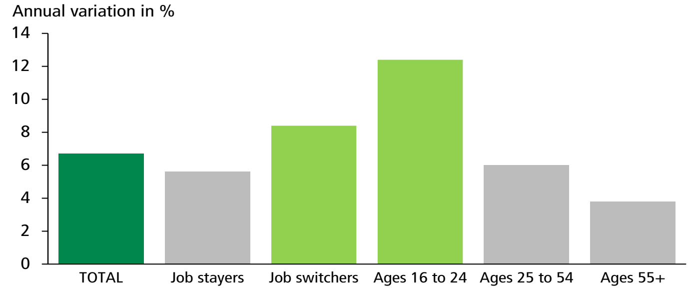
Beveridge curve – Relationship between job openings and unemployment



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

GRAPH 9
Wage growth for young people and job switchers suggests stiff competition among employers

Federal Reserve Bank of Atlanta Wage Growth Tracker – Average since the start of 2022



Sources: Federal Reserve Bank of Atlanta and Desjardins, Economic Studies

and retaining talent has been especially difficult in recent years because of the tight job market. So employers could be pretty reluctant to lay off employees, especially those with special skills. Labour hoarding seems to be the new norm. We'll see if that changes when an economic downturn ushers in uncertainty.

That said, job openings may not be enough to soften the economic blow. In other words, job vacancies could remain stubbornly high as unemployment rises. Different sectors will be affected by an economic slowdown; by the aging of the population, which will require businesses to keep job postings up permanently to fill positions left by experienced, productive employees as they retire; and by the mismatch between business needs and candidate skills.

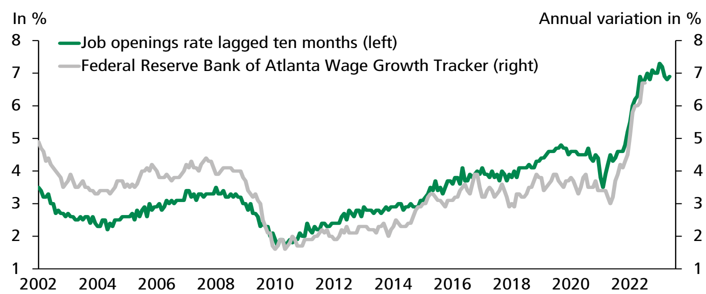
That's the crux of the debate currently raging over Beveridge curve shifts among economic heavyweights including Olivier Blanchard and Lawrence Summers, as well as Fed officials and analysts.[3]

Would a Drop in Job Openings Slow Wage Growth?

What about an economic downturn that has a bigger effect on job openings than on unemployment? Would that satisfy the Fed? If slower wage gains are needed to stabilize inflation as Jerome Powell says, would a modest increase in the unemployment rate do the trick?

The relationship between unemployment and inflation (or wage growth) is well established. But there's also a close relationship between job openings and wage growth. This makes sense. A high job openings rate indicates competition for workers, and

GRAPH 10
The high US job openings rate is driving up wages



Sources: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta and Desjardins, Economic Studies

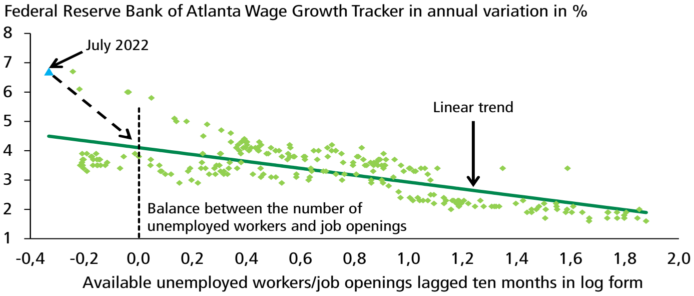
competition drives wages higher. Right now wage pressure is greatest for job switchers and young workers (graph 9).

There's a 10-month lag, but there's a close relationship between the job openings rate and annual wage growth (graph 10). The current job openings rate also suggests that wage gains will remain strong into next year.

Therefore, a drop in job openings may be enough to eventually slow wage growth. The relationship between the job openings rate and the number of unemployed workers is a reflection of the fit between job seekers and job openings. It's also relatively well correlated with wage growth (graph 11 on page 5). With a return to trend, matching the number of job openings to the current number of available unemployed workers (active job seekers plus discouraged workers) would slow annual wage growth (as determined by the Federal Reserve Bank of Atlanta's Wage Growth Tracker) by 2.2 percentage points, from 6.7% to 4.5%. And if the number of unemployed were to exceed the number of job openings, as was typical before the pandemic, annual wage growth could easily fall below 4%.

[3] Andrew Figura and Chris Waller, *What does the Beveridge curve tell us about the likelihood of a soft landing?*, Federal Reserve Board, *FEDS Notes*, July 29, 2022; Brandyn Bok et al., *Finding a Soft Landing along the Beveridge Curve*, Federal Reserve Bank of San Francisco, *FRBSF Economic Letter*, August 29, 2022; William M. Rodgers III and Alice L. Kassens, *What Does the Beveridge Curve Tell Us about the Labor Market Recovery?*, Federal Reserve Bank of St. Louis, *On The Economy Blog*, July 14, 2022.

GRAPH 11
A return to balanced unemployment and job openings could significantly slow wage gains



Sources: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta and Desjardins, Economic Studies

Of course, if we don't see a return to trend and the drop in job openings raises unemployment too modestly to slow wage growth and lower inflation, the Fed will have to take more forceful action. If this comes to pass, the US will be at a significant risk of a more severe economic contraction triggered by more aggressive monetary tightening.

Business behaviour will be key if the economy deteriorates badly. Is employee retention really sustainable if sales plummet? Could flexible working arrangements or reduced hours help businesses retain skills while maintaining some profitability so they can mount a quick recovery? It will likely depend on how severe the contraction is and how long businesses and workers think it will last.

The strength of the US economy over the coming quarters will therefore depend to a large extent on labour market dynamics and the number of job openings. But we hope that a drop in job openings will mitigate the economic slowdown and bring about the necessary slowdown in wages and inflation the Fed is hoping for.