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Waiting, Wondering, Worrying What if 10% unemployment is the new normal?

[Randy Myers](#), CFO Magazine

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In 2007, Phoenix-based Goodmans Interior Structures, one of the Southwest's largest office-furniture retailers, booked record sales "well in excess" of \$100 million, according to CFO Douglas Klein. Asked about annual revenue for this year, Klein says, "We'll end up half that size."

Things are tough all over, of course, but this company's prospects are especially noteworthy because its sales are so tightly linked to the overall employment picture. "Job growth," Klein states flatly, "is what drives demand for our products."

In that case, hold on to your Aeron chair. More than a year after the official end of the Great Recession, unemployment continues to hover near 10%, and Goodmans has had to dip into the all-too-familiar recession playbook. It has deferred certain marketing initiatives, reduced travel, shed warehouse space, and, yes, cut the size of its workforce.

Thousands of companies have done the same, pushing up the unemployment rate to near double digits. The assumption has been that this situation will resolve itself as the business cycle turns. But what if it doesn't? What happens to an economy driven by consumer spending if 10% unemployment is the new normal?

The idea that the "natural rate" of employment — that is, the rate determined at the micro level by the costs a company must pay and the profit levels it wants to achieve, versus the actual employment rate, which is heavily influenced by the business cycle — has changed is a question businesses must now consider, says Steve Cunningham, director of research and education at the American Institute for Economic Research, a think tank in Great Barrington, Massachusetts. "The costs of doing business, including taxes and regulation, have risen," Cunningham says, "so a rise in the natural unemployment rate, although hard to measure, is a very real possibility."

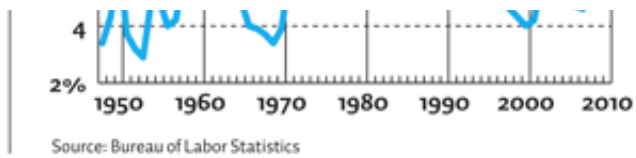
The Congressional Budget Office expects the actual (versus natural) unemployment rate to stay above 8% until 2012 and above 6% until 2014, dropping to 5.1% at the start of 2015, according to September testimony from director Douglas Elmendorf. By comparison, when unemployment reached 10% during the 1981–82 recession, nearly five years passed before it fell below 6%, in September 1987. Looked at that way, then, the current "Great Recession" will play out in much the same way, in terms of unemployment, as what now looks like the run-of-the-mill recession of 1981–82. (Long-term unemployment in 2010 of more than 4%, however, is far above the 1980s peak of 2.6%.)

But what happens to overall employment if the "natural rate" of unemployment has moved well north of 5%? As Cunningham notes, if companies are now paying more on overhead than they have in the past, they will be forced to seek savings elsewhere, and payroll is an obvious target. "It's a matter of profitability," he says. "The institutional framework has shifted in such a way that even in an environment with plenty of demand, this [the 9.7% average unemployment rate for the first half of 2010] is the kind of unemployment number that would result."



Whether or not today's high rate of unemployment is being bolstered by a rising floor of "natural unemployment," CFOs know that the bleak jobs picture has a direct bearing on demand for their companies' goods and services. In the most recent Duke University/CFO Magazine Global Business Outlook Survey (see "[More Trouble Ahead?](#)" October), half of all respondents said that current company profits, which remain strong, can be maintained for only another six months by hewing to the usual cost-cutting measures.

In other words, the usual recession-survival strategies are pretty



much played out.

"We need some breakthrough innovation to stimulate the economy," warns Mark White, CFO of SAP North America, a \$5 billion arm of German software giant SAP AG. "Otherwise, we're going to be stuck with unemployment in the 9% to 10% range, and I think that will be the new normal. In a strong economy, it

may dip below 8%, but the days of 5.5% to 6% unemployment are behind us."

If White is correct, this will usher in a new era of uncertainty for a country whose economy is highly dependent upon consumer spending and the strong job market that underpins such spending.

"If America continues to experience a jobless recovery without a corresponding increase in consumer spending, it probably means that we are achieving GDP improvements as a result of government spending and exports," says Gregory Ray, CFO of Heritage-Crystal Clean Inc., a \$100 million-plus parts-cleaning and waste-services company in Elgin, Illinois. "Both of these factors are unlikely to remain steady and positive for a long period of time. As a result, the recovery is likely to be volatile."

The Rudolphe/Libbe Cos., a \$280 million construction company based in Walbridge, Ohio, wouldn't like that. "It doesn't bode well for us, because it would mean there would be no real need for additional commercial and retail space," says Robert Pruger, the company's CFO and treasurer. Rudolphe/Libbe currently employs about 800 full-time-equivalent workers, he says, down from about 950 when the economy was booming. And even though it recently won a contract to build a 290,000-square-foot casino in Toledo, Ohio, it plans no permanent hiring right now. "We don't know whether this [contract] is the bridge to sunshine," he says, "or the bridge to nowhere."

Recapturing Our Manufacturing Mojo

Like millions of other Americans, many CFOs worry that the United States won't be able to create the new middle-class jobs it needs unless it is able to reestablish its role as a manufacturing power. But they fret that the forces that have conspired to diminish the country's manufacturing prowess — cheap foreign labor, global supply chains, lax trade laws, and an uncompetitive corporate income tax system — have become too entrenched to be reversed anytime soon, especially given the acrimonious political tone in Washington.

"This is a path we've been on for the past three decades," says Dean Baker, co-director and economist at the Center for Economic Policy and Research, a Washington, D.C., think tank. "You had this virtuous circle after World War II where productivity growth translated into wage growth, which led to more consumption, which meant business had to invest more to meet demand, which led to more productivity growth, and so on," he says.

"In the '80s," Baker continues, "we went in a different direction, with policies that were antithetical to manufacturing, and we deregulated a lot of major industries such as airlines and telecommunications, which put more downward pressure on wages in those industries. In the short term that may benefit companies, but over the long term I don't think it leads to healthy growth."

As recently as August, the manufacturing sector reported 403 mass layoffs, according to the U.S. Bureau of Labor Statistics, resulting in 46,540 lost manufacturing jobs. Combine that with the fact that between 2000 and 2009 the inflation-adjusted median household income fell by almost 5%, and CFOs become alarmed. "An economy built on shopping malls and serving lattes doesn't work," says Steven Kasok, vice president and treasurer of \$1.7 billion Millipore Corp., a unit of Germany's Merck KGaA. "In order to have a robust economy you need a robust middle class, and I think fundamentally that means you need to manufacture products." (For more on manufacturing trends, see "[Made in America](#)."

Blame It on Taxes?

Many CFOs contend that U.S. tax policy conspires against a manufacturing renaissance. The country's high corporate income tax rate — second highest in the world after Japan's — has prompted U.S. companies to reinvest overseas much of the money they earn there, rather than repatriate it. John Chambers, CEO of \$40 billion computer networking company Cisco Systems, recently said that if his company could bring home the roughly \$30 billion it holds in foreign countries without suffering onerous tax consequences, the company would boost hiring in the United States by 10%.

"In order to employ people, you have to bring manufacturing back into this country, and you are not going to be able

to do that until you give manufacturers an incentive to stay in this country," says Sue Hall, treasurer of Lewart Co., a small, privately held producer of injected molded-plastic products in Cleveland.

"There is no reason we shouldn't be able to have a tax policy and an investment policy encouraging the manufacture of products here," adds Kasok. "Then you would have this robust middle class of people buying."

The Obama Administration has recently floated a number of ideas aimed at jolting the economy, and the jobs market, back to life. In September, for example, the President proposed allowing companies to deduct the full cost of new capital investments in the year they are made, rather than writing them off over periods as long as 20 years. But as Cunningham notes, "Capacity utilization rates all around the country are already low. If I'm in a position where I have a lot of unused plants and equipment, why would I want to buy more?"

President Obama also has proposed permanently extending the tax credits that businesses get for investing in research and development. But those credits have been extended on an annual basis for so long now that most finance executives have come to count on them anyway.

"These are really small-bore initiatives," Baker says. "I don't understand the thinking. None of these things will have a big impact."

Not everyone is so pessimistic.

"The latest tax proposals could help," says Heritage– Crystal Clean's Ray. "The immediate expensing of capital investment would lead to companies accelerating their capital-spending plans, which would in turn increase employment. That increase could be the spark that restores consumer confidence and leads to increased consumer spending. A temporary surge may be just what we need to improve our economy."

On the small-business front, the President recently signed into law a \$30 billion lending bill designed to make credit more readily available to small companies. But an August survey by the National Federation of Independent Business showed that 91% of small-business owners claim their credit needs are already being met. That suggests the lending program may not help as much as its backers would like.

"It goes back to the issue of demand," says Craig Keenan, CFO of von Drehle Corp., a privately held paper-products manufacturer in Hickory, North Carolina. "No one is willing to kick-start employment by hiring people who are not needed."

"It would be nice if we could get a coordinated effort going and we all decided to hire one more person," Cunningham says. "But in the real world that doesn't happen. We are all operating independently and there is a certain kind of gamesmanship that goes on: I would like everybody else to have to hire somebody and me not to have to hire until demand comes up."

"Businesses are doing what they should do," Baker concedes. "They are trying to keep expenses under control, build cash, and prepare for the future."

Glimmers of Hope

And many are struggling to balance short-term self-interest with a longer-term outlook — plus some acknowledgement of the greater good.

Goodmans, for example, has cut back its workforce, but not in direct proportion to its revenue losses. "Our ownership made a conscious decision to maintain its core employee base at some financial cost," says Klein. "If we were primarily focused on maintaining profitability, we might have decreased employment even further, but the family that owns the company, which is now in its third generation, has a very long view. They're quite willing to accept personal short-term financial sacrifices to maintain what they view as the long-term strength of the company, which is our knowledge of our products and of our customers. And that is embodied in our people."

Rudolphe/Libbe also has tried to hold on to as many of its workers as it can, putting some on shortened schedules during the worst of the downturn rather than laying them off. In addition, it has pursued new business opportunities in the green market through its BHP Energy subsidiary, which markets and installs energy-efficient microturbine power-generation systems for commercial customers.

Examples such as these hardly negate the specter of a jobless recovery, but they do suggest that the "green shoots"

that companies have long been looking for will spring up only if companies think more about how to grow and less about how to cut.

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Do Layoffs Work?

Companies have a duty to shareholders to manage their businesses, including their workforces, for maximum profitability. But it is fair to ask whether they sometimes lose sight of what's good for the long-term in pursuit of short-term benefits.

"I think that with some of the larger publicly traded companies, especially at the beginning of the recession, layoffs were a way to keep Wall Street analysts happy," says Anthony Valente, CFO of Eliassen Group, a \$100 million-plus IT staffing agency based in Wakefield, Massachusetts. "If you're just laying people off to get your short-term numbers up, or to keep analysts happy, you're setting yourself up."

How so? "Overworked employees are less productive in the long term," says Kathleen Wolf, CFO of The Gibraltar Group, a \$1 billion-plus real estate development firm headquartered in Clearwater, Florida.

Academic research seems support both criticisms. Many studies have shown that downsizing announcements actually hurt stock prices, both over the short and long terms. And others have found that productivity improvements were as common at companies that increased their workforces as those that decreased them.

Maybe Corporate America's payoff from the latest round of layoffs is reaching its end point. The federal government recently reported that nonfarm-business-sector labor productivity fell at a 1.8% annual rate in the second quarter. That was the first such decline in nearly two years. — *R.M.*

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