The Biggest Threat to U.S. Jobs: The "Contestability" Nightmare

JOHN MAULDIN | November 7, 2014

Today's *Outside the Box* comes from Sam Rines of Chilton Capital Management in Houston, TX – a promising young economics contributor to *The National Interest* and a rising star who I met at Worth Wray's wedding a few weeks ago.

Worth and Sam have developed quite the friendship over the past several months, but it didn't take much convincing from Worth to get me to share Sam's latest article with you. Sam's work speaks for itself and I am VERY impressed by his insights on a wide range of economic issues – from the evolution of Fed policy and growing risk of a rising US dollar, to the long-awaited industrialization of India.

In his latest piece, Sam alerts us to a breakdown in the Federal Reserve's full-employment mandate (one leg of its dual mandate, the other being stable prices). In a normal recovery, Sam reminds us, "[W]age growth and the labor market move together in a lagged fashion – the labor market heals and tightens, followed by wage increases as labor becomes increasingly scarce. But this has not happened during the current recovery, and it has not occurred economy-wide in quite some time."

But why the breakdown? Janet Yellen herself points to growing inequality. Here's Yellen (as quoted by Sam): "[W]idening inequality resumed in the recovery, as the stock market rebounded, wage growth and the healing of the labor market have been slow, and the increase in home prices has not fully restored the housing wealth lost by the large majority of households for which it is their primary asset."

But again, why – why the laggardly wage growth? Sam drills down and finds the problem rooted in what he (and others) are calling the "contestability" of many US jobs, and especially those of middle-skilled workers, whose jobs are liable to international outsourcing or antiquation by computer technology (robotic or otherwise). To make matters worse, much of the post-Great Recession job growth has come in the form of low-paying and part-time work. Thus we have the "hollowing out of the middle class," which is tantamount to saying that the middle is slipping down the wage ladder, even as those on the top rungs continue to climb (since their positions require high levels of education and intellectual competence and are not very susceptible to competition from outside the country or from machines – or at least not yet).

So income inequality grows, and lower- and middle-skilled workers are unable to exert any pressure for their wages to increase. This trend, as Sam points out, is "at best disinflationary and may be deflationary. With stagnant wages across the economy, the middle cannot increase consumption – one can only borrow so much."

This is a major trend with huge implications for US economic growth – and thus for Fed policy. Sam concludes his piece by saying, "The Fed is muddling the mandate to fight a wage war, but the Fed will struggle to justify its continuous actions to counteract those forces. The middle skills squeeze is not a swiftly passing phenomenon. It may mean that extraordinary monetary policy and unconventional intervention are increasingly normal."

A conversation today triggered a memory. I just turned 11 years old, and it was Christmas morning. I'd retrieved a few toys out from under the tree and was looking forward to going out to play with friends. But my dad said that first I had a project to do. He had just bought all the equipment to open a small printing shop in Bridgeport, Texas. This was 1959 (we had just left the Stone Age), and printing was still done with hand-set type and on letter presses. The small press that was invented in the early 1900s was now powered by an electric motor.

My dad had brought home a type case full of 12-point Franklin Gothic lead type. He turned the case upside down on the kitchen table and said, "Put all the type back and then you can go out and play." There was nothing else to do but sit and look at each small piece of type, figuring out what each character was and putting in its respective small box. It took forever, but I eventually finished and got up to leave. My dad said "Wait a minute."

He asked me to come over and look at another case where he hadn't labeled all those individual little compartments with the letters that belonged in them. He pointed to one and asked me which letter belonged in there. I didn't know. Then he asked me a second one. I didn't know that one either. He went back over to the kitchen table and turned that type case – much like the one you see in the picture above – upside down. "Do it again."

I'm only a little slow. When I finished and Dad started asking questions, I knew the answers. It was the start of a decades-long process love-hate affair with the printing business. I Actually made money in college going around to the print shops and offering to clean up their "hell boxes," which were the boxes and buckets full of type that had gotten jumbled and that no senior printer wanted to take the time to put back. So what do you find in hell? You find a printer's devil, which is the young apprentice who does all the dirty work. And it was dirty. But by the late 1960s printing with actual type was on its way out, and then there were no young apprentices. Business was good, but within a few years all that knowledge was simply arcane trivia, of no use in the real world.

I was training with yesterday, and while he was putting me through my paces, he was reading a report on his phone about the political changes. "What's the GOP?" he asked. As I pumped away on the exercise bike I told him it stood for "Grand Old Party." I went on to explain the term and added, "In the early days, writers would often set their own type for their newspaper columns. *Republican Party* had a lot more letters in it than *GOP*." And then I explained setting type. You could see he was thinking I must be really old. And I thought back to all the hours I hand-set type as a young man.

And continued to pump. The Beast is pushing me harder as time goes on, and it's helping, but leg days just kill me for the following few days. My legs feel like they're wrapped in lead. For years I focused on upper body in my workouts, and my legs became appallingly weak. But knowing that as we get older our wheels take on ever more importance, I'm trying to get them in some kind of working order. They say no pain, no gain, so I must be gaining a lot. Surely?

Have a great week. Fall is in the air. Can Thanksgiving be far behind?

Your pretty much hurting somewhere every day analyst,

John Mauldin, Editor
Outside the Box

The Biggest Threat to U.S. Jobs: The "Contestability" Nightmare

By Samuel Rines
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The Federal Reserve's mandate has never been well defined, and there are no concrete definitions to adhere to. Federal Reserve Chair Janet Yellen has begun to deviate from the traditional characterization of full employment to something far more nebulous. Recognizing this shift is critical to understanding the Fed, and its new relationship with the two esoteric mandates of stable prices and full employment.

At a conference in Boston, Yellen stated that she was concerned about rising inequality. Before listing off a blistering round of statistics that show the US has become more unequal over the past few decades, Yellen succinctly articulates why the Great Recession was responsible for widening the gap further: "But widening inequality resumed in the recovery, as the stock market rebounded, wage growth and the healing of the labor market have been slow, and the increase in home prices has not fully restored the housing wealth lost by the large majority of households for which it is their primary asset."

One piece in particular of the above statement stands out – and has broad implications for understanding the Fed mandate. A normal recovery would see wage growth and the labor market move together in a lagged fashion – the labor market heals and tightens, followed by wage increases as labor becomes increasingly scarce. But this has not happened during the current recovery, and it has not occurred economy-wide in quite some time.

The new target for the Fed may be best described as not simply "full employment" but "full wages." At first glance, it seems unreasonable for the Chair of the Federal Reserve to be concerned with how the income of the country gets dispersed. However, in many ways, "full wages" are at the intersection of the fed mandates. In essence, Yellen is admitting that the past few decades were not kind to a significant swath of the US, and that this endangers future economic growth.

Many of the jobs US middle-skilled workers once took for granted can now easily be outsourced or contested – even some previously thought untouchable. This "contestability" is increasing as more jobs become relocateable or replaceable with computing power due to advances in communications technology. Contestability is fundamental to Yellen's concern. If a US job is contestable internationally, then US workers are competing with cheap labor around the world. This limits the bargaining power of the US worker, and keeps a lid on wage inflation in the US. The cheap-but-educated global labor force is becoming an increasing threat to the US worker.

Yellen sees this middle-skilled squeeze phenomenon in the data, but also sees the lack of deflationary wage pressure on the top of the income ladder. The highest-paying jobs tend to have little competition from outside – requiring creativity and high levels of education. The question to ask is why this has occurred, and whether the factors underlying it are dangerous to the US economy.

And in many ways – they are dangerous. If ignored long enough, the disintermediation of the middle class is at best disinflationary and may be deflationary. With stagnant wages across the economy, the middle cannot increase consumption – one can only borrow so much. If contestability continues to erode the wages of US middle-skilled workers, wages could be pressured or even decrease toward more internationally competitive levels. This would be disastrous for consumption and inflation expectations, especially in a service oriented economy where many of the jobs could be at risk.

If the U.S. continues to see this type of wage pressure, there may be enough jobs (for people who want them), but the ability to consume at previous levels will not be there. Deflation – generally – is bad for an economy, and wage deflation might be the worst kind. Deflation puts pressure on prices, making it more difficult to consume on the aggregate as the economy previously did. The standard of living declines. Further, the potential for wage pressures, in the current recovery, is low. The jobs created during the recovery disproportionately skew towards part-time relative to previous recoveries, and part-time jobs do not yield much bargaining power. There are few reassurances about the labor market.

This puts the Fed in a particularly odd place. Its mandate is supposed to be two separate pieces of a puzzle, but Yellen appears to have identified an intersection. The Fed runs the risk of missing both its "full employment" and "stable price" mandates without pursuing – either explicitly or implicitly – a "full wage" target.

Yellen's statement has little to do with fairness or equality. It is directly connected to ensuring the US has created enough *uncontestable* jobs for the Fed to step away, and these jobs are the type that will lead to – or at least allow for – future wage pressures. Prime examples are the jobs created by the current shale oil boom and housing construction during the boom through 2006. Many of the jobs created for the oil patch require the presence of the worker – and cannot be done without a significant amount of education. These characteristics make them difficult to offshore or relocate. As quantitative easing begins to roll-off, the ability of the US shale revolution to stand on its own will be tested, and the jobs engine of Texas may suffer. This would be a tremendous hit to a sector where wage pressures exist, and the contestability is low. The Fed should be watching this closely.

Yellen's wage war is a battle the US does not know it must win. For the Fed, it ties together both pieces of its mandate, and gives them a reasonable basis for stimulus when observers feel it unnecessary. The Fed is muddling the mandate to fight a wage war, but the Fed will struggle to justify its continuous actions to counteract those forces. The middle-skills squeeze is not a swiftly passing phenomenon. It may mean that extraordinary monetary policy and unconventional intervention are increasingly normal.

You can read more of Sam's work in The National Interest *by clicking here: http://nationalinterest.org/archives/by/10797*.

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