How companies are curbing labor costs

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With the job cuts and rise in productivity, companies have been able to limit the impact of the recession on their bottom lines.

In times of economic weakness, U.S. businesses have learned that slash and burn is the quickest way back to profitability. And in a recession as bad as this one, the massive cutbacks companies are making in their payrolls, inventories, and capital spending should come as no surprise. But with these cuts, businesses are rapidly putting themselves into a position to respond quickly to any spur on demand that's already on its way from Washington, increasing the chances that the economy can return to at least modest growth in the second half.

Of course, labor is most companies' biggest cost, and based on the March employment report, cost-cutting is still in high gear. Nonfarm payrolls fell by 663,000 in March, only a shade below the 691,000 average loss in the three previous months. The size and distribution of the March declines were similar to those in February, with manufacturing shedding an additional 161,000 jobs, construction losing 126,000, and the service sector down 358,000.

Payroll losses pushed the unemployment rate to 8.5% last month, up from 8.1% in February and up 2.3 percentage points from six months before. There's so much slack in the labor markets that increases in hourly pay have become significantly smaller. Over the past three months, average hourly earnings rose at only a 2.2% annual rate, about half the 4.2% pace during the previous three months.

Attention to costs in a recession is nothing new, but what's different now is the speed at which companies have moved in response to the ups and downs in demand. They actually began their current round of cost cutting more than a year ago, just as the economy was beginning to labor under the initial effects of tight credit conditions. Companies began trimming their payrolls in January 2008, and job losses now total 5.1 million.

Rapid inventory response

But it's not just labor costs. Businesses reduced their outlays for new equipment in each quarter of 2008, and they have whittled down their inventory levels for five quarters in a row. The pace of cost cutting since the economic paralysis following the Lehman Brothers bankruptcy has been stunning. More than 70% of payroll reductions have occurred in only the past six months, and in the fourth quarter of last year companies slashed their equipment outlays by 28%, the most in 50 years, with another big decline expected in the first quarter.

Businesses' reaction times are faster now partly because intense global competition has increased shareholder pressure on companies to protect profitability and partly because technology allows a faster response. For example, systems that offer real-time order tracking and inventory control promote rapid adjustment of production schedules. The result: fewer excess buildup that, in the past, led to drawn-out adjustments to inventories, production capacity, and payrolls, prolonging recessions.

In particular, the latest job numbers imply that service-sector industries, which account for more than 80% of private-sector jobs, have shown much more flexibility in paring back their labor costs compared with past recessions. Manufacturing and construction have accounted for a big share of job losses, but these declines have not been out of line with past recession experience. On the other hand, service jobs have fallen much more than past trends would have predicted, given the strong support service payrolls have received from the health-care and education industries. Over the past six months, private service-sector employment has

fallen at a 4.2% annual rate, the steepest such decline in the history of the data, which go back to 1947.

Businesses have always known that profits and labor productivity go hand in hand, but there has never been as much competitive pressure to maintain high productivity, especially amid new labor-saving technologies and abundant sources of foreign labor. Those influences show up in the latest productivity data. During 2008 output per hour worked grew 2.2%. In recessions prior to 2000, productivity typically has fallen. Moreover, based on the March job data, overall hours worked in the first quarter plummeted at an 8.7% annual rate. If the economy contracted about 5% last quarter, as most economist believe, then productivity appears to have posted another sizable gain.

Income support programs

With productivity increases offseting the small rise in hourly pay, unit labor costs are up a very tame 1.8% from the year before. That means, even though pricing power is virtually nil, companies at least have been able to limit the impact of the recession on their bottom lines. Government data show that domestic operating profits in the fourth quarter were down 27% from the previous year, but the finance sector accounted for 77% of that loss. While profit margins at nonfinancial companies are down from the past year, they have fallen from record levels, and current readings are still on a par with the high rates achieved in the late 1990s. That means even modest increases in sales will flow much more quickly to the bottom line than in previous post-recession periods.

In the months ahead, with labor markets expected to remain weak, much depends on consumers and the help they will be getting from Washington. In the first quarter consumer spending was showing signs of stabilizing, and economists think it might even post a slight rise after big losses in the prior two quarters. Already several income support programs from the $787 billion stimulus package are starting to kick in. A per-worker tax credit to be paid out via lower withholding beginning Apr. 1 will provide an ongoing rise in pay for many households. A one-time payment to Social Security recipients in May also will boost incomes as will the expansion of unemployment benefits, food stamps, and other income securitiy programs. Adding further to purchasing power is the housing program, which is designed to lower mortgage rates and boost refinancing activity, which in turn will lower mortgage payments.

As the contraction in the economy moderates, so will job losses. Economists at JPMorgan (JPM) note that the worst payroll declines in a recession tend to occur in the quarter following the largest drop in gross domestic product. If so, payroll losses will most likely be less in the second quarter than they were in the first quarter. Nevertheless, as economist Sung Won Sohn at California State University notes, "Even if the economy continues to show signs of improvement, businesses will cut jobs and trim fat to stay lean and mean for the tough times ahead."

BusinessWeek, New York, 3 abr. 2009, New Analysis, online. Disponível em <www.businessweeek.com>. Acesso em: 6 abr. 2009.