



Unemployment and the Great Recession



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If unemployment is the single most important indicator of the job market's health, the patient is unquestionably sick. According to the most recent data from the Bureau of Economic Analysis, total economic activity contracted by 5.1 percent during the recession; as a result, unemployment jumped from 5 percent in December 2007 to 10.1 percent by October 2009. Since then, unemployment has stabilized at around 9 percent, still an uncomfortably high rate.

Typically, the unemployment rate increases whenever the overall economy undergoes a recession. The rate peaks about 15 months after the recession begins, or four months after it ends, then drops gradually as the economy recovers (see the first figure on page 15). Our current experience has been unusual on two counts. First, unemployment has risen much more than in other recent recessions; second, the unemployment rate has remained high for an exceptionally long time.

So the main labor market-related questions facing Generation Recession are these: Is high unemployment here to stay? If so, what does it mean for the millions of Americans who are out of work — not to mention the rest of American society?

Why Unemployment Is Still High

Our work at the Federal Reserve Bank of Cleveland shows that most of the increases in the unemployment rate results from cyclical factors; that is, factors that ordinarily would have only a temporary effect and should gradually fade as the economy recovers. That's the good news.

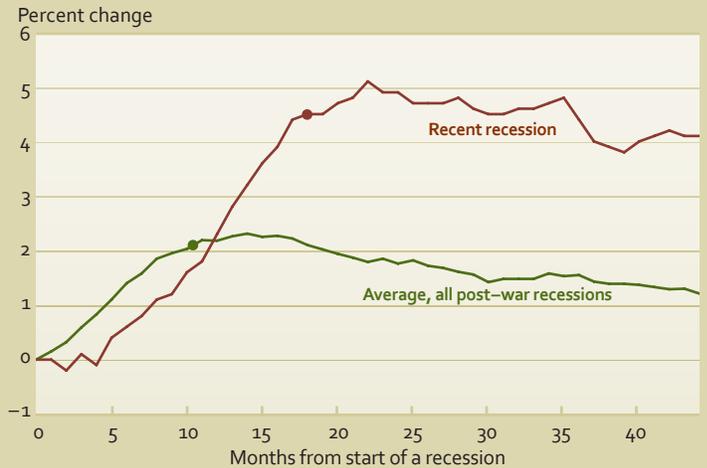
The bad news is that we also have found at least two reasons why the unemployment rate could stay high for some time: the weakness of the recovery in real economic output and the slow rate at which workers find new jobs. To understand these reasons, we need to take a closer look at how workers move into—and out of—unemployment.

The unemployment rate reports the number of jobless workers as a fraction of the labor force. But in any given month, some employed workers lose their jobs and some unemployed workers find new ones; in this way, they flow into and out of the unemployment pool. Thus, the overall number provides scant information about the actual extent of churning in the labor market. Worker flows largely determine the unemployment rate, but the rate says nothing about them.

Typically, the start of a recession is marked by an increase in layoffs and a decrease in hiring. As the economy begins to recover, layoffs usually stabilize just before the unemployment rate peaks. Most of the subsequent rise in unemployment results not from layoffs but from a low hiring rate.

In some ways, the recent recession was no exception; toward its end, layoffs stabilized. However, even two years into the recovery, unemployed Americans still have trouble finding work. To better understand when we might expect this situation to improve, my colleague Saeed Zaman and I developed a new measurement of the long-run unemployment rate that incorporates worker flows into the analysis. This helps us distinguish between two potentially different reasons for a high unemployment rate: long periods of unemployment for laid-off workers and the very high number of layoffs overall. Underlying trends in these flow rates determine where the unemployment rate will settle in the long run.

Unemployment Rate during Recessions



Note: Dots indicate average length of unemployment period.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

Job Flows and Unemployment Rate



Note: Shaded bars indicate periods of recession.

Sources: U.S. Department of Labor, Bureau of Labor Statistics; author's calculations.

When measured in this new way, the unemployment rate trend—commonly called the “natural rate”—has been relatively stable in the last decade, even after the most recent recession. This natural rate has hovered around 6 percent for a few decades, and there it remains (see the second figure above).

How could the trend have changed so little when unemployment was so high? There are two reasons behind this outcome: First, the recent recession was a terrible recession, in terms of both duration and depth.

Unemployed Feel Recession's Sting

Understandably, out-of-work Americans feel worse about their financial conditions than those with jobs.

Using data from the Ohio State University's *Consumer Finance Monthly's* survey and breaking it down by employed versus unemployed households, we reach predictable results. Compared to families with at least some employment, unemployed families are 16 percentage points more likely to say they are worse off than a year earlier. Unemployed households are less than half as likely as employed households to say they are "better off."

It's probably premature to draw broad conclusions from these results. One thing to watch, though, is whether we are witnessing a "two-speed" recovery, in which people with jobs aren't feeling the after-effects of the recession at all, while the unemployed—and in particular the long-term unemployed—are getting hammered.

—Doug Campbell, Editor

Households' financial situation in 2010 compared with a year earlier



Sources: Center for Human Resource Research at the Ohio State University; Federal Reserve Bank of Cleveland.

Second, the two flow-rate trends have both been declining; the job-finding rate started to decline over the past decade, and separations have been declining since the 1980s. Whatever impact these trends would have had on the natural rate, therefore, have been offset. What emerges is a portrait of a job market where workers change employment status much less frequently than before.

This is not a welcome development. In theory, the more labor market churning there is within an economy, the faster unemployment returns to its natural rate. Intuitively, we would expect that as more unemployed workers start finding jobs, unemployment would decline more quickly toward that rate.

Our model generates an unambiguous conclusion: The low rate at which unemployed workers are finding jobs predicts a slower decline in the unemployment rate. In other words, it will take a long time, longer than it normally did, for unemployment to move back to around 6 percent.

Whether the labor market situation becomes better or worse depends primarily on the growth rate in the aggregate economy. Our research provides a stark example of this potentially important factor. For instance, if real GDP growth had been 4.9 percent annually during the first

two years of the recovery (as was the case after the 1982 recession), the unemployment rate would have come down to around 7 percent by now. Instead, growth was only 2.5 percent annually, leaving unemployment around 9 percent.

Long-run unemployment trends are important for understanding an economy's productive potential. The longer we exceed the natural rate, the longer we waste our resources—in this case, human capital. For instance, almost half of the unemployed remain jobless for 27 weeks or longer; their odds of finding a job become further reduced as their skills decline and they lose professional contacts.

Potentially, a large pool of long-term unemployed might start losing their skills to the point of being a bad match for new jobs when the economy finally starts to recover robustly. This is one particular danger the Great Recession poses for the U.S. labor markets. ■

Recommended reading



Murat Tasci and Saeed Zaman. 2010. "Unemployment after the Recession: A New Natural Rate?" Federal Reserve Bank of Cleveland, *Economic Commentary* (September). www.clevelandfed.org/research/commentary/2010/2010-11.cfm