Maximum employment:
what we know (and don't know) about
THE LABOR MARKET

By Sandra Pianalto, President and CEO

Developing issues in the labor market are clouding the outlook for both the unemployment rate and the natural rate of unemployment over the next few years. Both rates at their current levels clearly argue for providing an accommodative monetary policy, as long as inflation remains consistent with the Federal Open Market Committee's price stability objective.

During the next few years, I expect that our economy will continue to grow, that unemployment will decline, and that inflation will average about 2 percent. Monetary policy will need to be adjusted in response to incoming data that may prompt economists to re-evaluate the outlook. In particular, I am closely watching developments in several highly uncertain features of the labor market. These include trends in job matching, unemployment durations, labor market participation, and wages.

THE DUAL MANDATE

The Federal Reserve Act mandates that monetary policy be set to achieve stable prices over the long run as well as maximum sustainable employment. I do not view these objectives as competing with one another because over the longer run, price stability is essential to achieving maximum sustainable employment.

In last year's Federal Reserve Bank of Cleveland annual report essay, I wrote about inflation and monetary policy, suggesting that the Federal Open Market Committee (FOMC) could enhance its monetary policy framework by establishing a specific numerical objective for its stable prices mandate. My reasoning was that ultimately, inflation is a monetary phenomenon, and its trend can be controlled by the central bank.

Others supported that view as well, and in January 2012, the FOMC established an objective for stable prices of 2 percent inflation over the longer term. Over the past three years (which is just enough time to include the offsetting high and low inflation periods around the recession and recovery), inflation has averaged 1.5 percent. I expect inflation to stay close to the FOMC's 2 percent objective over the next few years, in line with projections from most professional forecasters. So I think it is fair to say that the FOMC has been effectively fulfilling its mandate for stable prices.

In its statement of longer-run objectives in January 2012, the FOMC also acknowledged that "the maximum level of employment is largely determined by nonmonetary factors." But these questions remain: how to put the concept of "full employment" into practical use, and how monetary policy should promote it.

The underperformance of the U.S. labor market is one of the most defining aspects of the nation's recovery from the financial crisis and severe recession. More than 12.5 million people are unemployed today, almost three years after the end of the recession. That's more than the number of people out of work at the deepest points of any recession since World War II. As if the sheer numbers are not grim enough, the average length of unemployment spells also stands at a record high.

We clearly have not satisfied our maximum employment mandate—the unemployment rate remains quite high, and unemployment spells are still too long. So in this year's essay, I focus on the labor market in relation to monetary policy.

In my view, the FOMC's highly accommodative monetary policy has put the economy on a path toward achieving our maximum employment objective. However, as is the case with many policy issues, I have relatively more confidence in some facets of today's labor market and less confidence in others. Because of these labor market "unknowns," I want to keep an open mind and be prepared to make policy adjustments if the outlook changes.

THE "NATURAL RATE" AND TODAY'S UNEMPLOYMENT

Let's start with one aspect of the labor market that I am relatively confident about: Today's labor market is far from full employment. As intuitive as the term "full employment" might seem, economists tend to think of the labor market from a broader perspective, one that includes both labor demand and labor supply. More often, we ask how low the *unemployment* rate could go and stay steady if the economy had fully adjusted to any disturbances (such as recessions). This level of unemployment is the concept I refer to as the "natural rate of unemployment."

In this framework, zero unemployment is just not possible because people are always entering and returning to the workforce, people are always leaving jobs and searching for new ones, and some businesses fail or contract while others start up or expand. Because it takes some time to search for a job, at any given time there will be people who are looking for work and thus unemployed. These labor market frictions are always present and keep the natural rate of unemployment above zero. I find this concept of the natural rate fairly appealing and use it in my thinking about labor market dynamics and monetary policy.

Unfortunately, putting a specific number on the concept of the natural rate of unemployment is technically difficult, and economists have different estimates for this rate. Moreover, the natural rate of unemployment can shift up or down with changes in demographics, technology, the skill level of the labor force, and regulations, among other factors. In January 2012, FOMC participants had a range of estimates for the natural rate of unemployment between 5 and 6 percent. My staff and I currently estimate this rate at somewhere around 6 percent (see side essay, page 12). The difference between the current unemployment rate of 8.1 percent and the natural rate of 6 percent translates into roughly 3.5 million people. We have a long way to go.

GETTING BACK TO THE NATURAL RATE

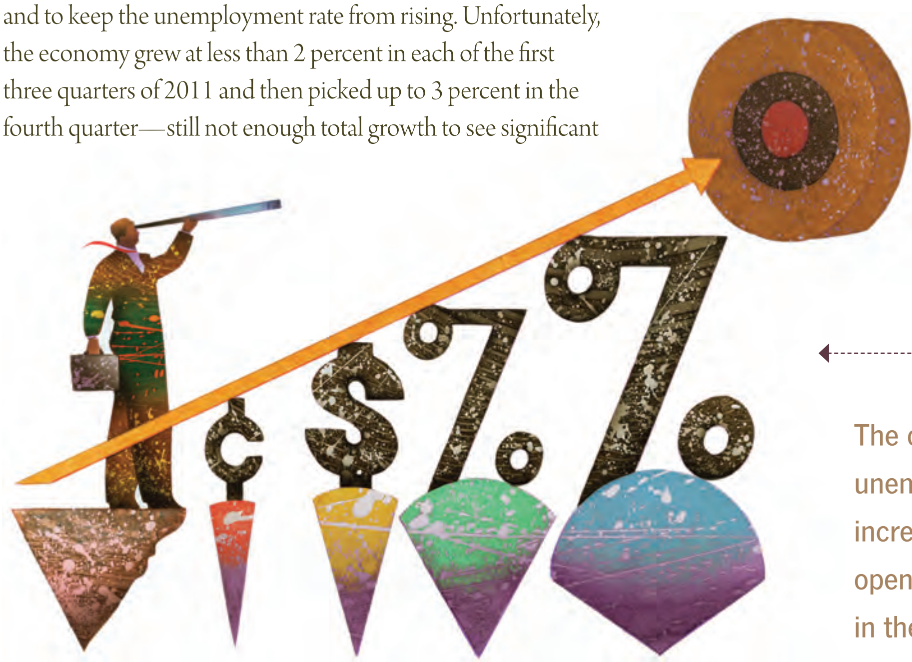
It seems remarkable that the unemployment rate should be this high nearly three years after the trough of the recession. And yet, I still don't expect the unemployment rate to reach 6 percent for another four years or so. Why is it going to take so long?

First, we fell into such a deep hole to begin with. We lost almost 9 million jobs during the recession (beyond the roughly 6.5 million people already unemployed). Since employment began to recover, we have regained only about 3 million of the lost jobs. Even if we continue to generate around 200,000 jobs each month (the average gain in the first four months of 2012), ongoing population growth implies that it would still be four years before we reached 6 percent unemployment. And that estimate assumes that the many people who stopped looking for work in the recession will not return to the labor force. If they do return, as they usually do when times get better, we will need to create millions of additional jobs to get back to full employment. So thus far, we have climbed only partway out of a very deep hole.

Second, our economy is generating job openings very slowly. Output growth has been weak over the recovery and looks likely to stay moderate over the next several quarters. The only real solution to the unemployment problem is to increase the number of job openings through more growth in the economy. Typically, our economy needs to grow at a rate of 2 percent just to accommodate new people who join the workforce and to keep the unemployment rate from rising. Unfortunately, the economy grew at less than 2 percent in each of the first three quarters of 2011 and then picked up to 3 percent in the fourth quarter—still not enough total growth to see significant progress on employment last year. This year's growth started out at 2.2 percent in the first quarter, which has produced only moderate gains in job openings.

Finally, there are reasons to think our economy is matching workers to job openings at a slower pace than in the past. This matching process may be permanently slower and less dynamic for several reasons. It could be that demand for more specialized skills—those requiring higher levels of education and training—makes it harder for employers to find candidates who meet the necessary requirements. Businesses create and destroy jobs all the time. This churning process causes some unemployment but also creates new employment opportunities. There is some evidence that this churning process has been slowing, and labor market adjustments have been slowing along with it (see side essay, page 14).

In sum, we generated a *lot* of unemployment in the recession, we are not generating job openings very quickly in the recovery, and employers may be taking longer to fill the open positions than they used to. While each of these three reasons helps to explain why it may take quite some time to reach maximum employment, none of them necessarily implies that the natural rate of unemployment has increased, although it may have. If there is any good news in all of this, it is that U.S. economic history supports the prospect that workers will eventually shift industries and get the training they need to meet the demands of the workplace.



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OPEN LABOR MARKET QUESTIONS

While I have confidence in some aspects of the labor market, I have less confidence in others. I am closely monitoring several "unknowns" in the labor market where conditions are historically unusual. How the labor market will perform over the next few years deserves careful analysis.

One issue we are following closely at the Federal Reserve Bank of Cleveland is the job-matching process, which is central to the economic models we use to estimate the natural rate of unemployment. These estimates can shift up or down over time in response to changes in the underlying trends in job-finding and job-separation rates. The process of matching workers to jobs appears to have slowed, but it is difficult to judge how much of this change will prove to be permanent versus a transitory response to our recent deep recession.

The slowdown in the job-finding rate (which would tend to raise the natural rate of unemployment) has been partially offset by a decline in the job-separation rate (which acts to lower the natural rate). While recent shifts in these rates over the course of the recovery have implied only a small increase in the natural rate of unemployment, further shifts in these rates could more substantially raise or lower the natural rate. Even without a shift in the natural rate, slower job-finding rates (offset by a reduced job-separation rate) would still slow the economy's adjustment toward a lower unemployment rate (again, see side essay, page 12).

A second aspect of labor market performance that is not so clearly understood is whether the long spells of unemployment that many individuals are experiencing—some exceeding two years—will have lasting impacts on their employability and lifetime earnings. We have reasons to be concerned about the job-finding outlook for these individuals (see side essay, page 18). Although some people do find work after a year or more of unemployment, a long unemployment spell does lessen the likelihood of finding a job, and the number of people with more than a year of unemployment is unprecedented. We also know from previous experience that these individuals often have reduced income levels for many years after they find work again, perhaps because their skills are fundamentally less valuable in their new work. If the adjustment of workers to new sectors were to slow, productivity in turn would be adversely affected. This is an important concern, given that productivity is ultimately the source of economic prosperity.

A third, less-well-understood aspect of labor market conditions is the reintegration back into the labor force of people who have stopped looking for work and those who are currently underemployed (see side essay, page 20). We know that a lot of people have moved out of the full-time labor force, and we know that long-term economic growth depends on their return. But we don't know the outcome if these individuals were to re-enter the full-time labor force suddenly—it could, for example, increase the challenges of those currently unemployed and cause the unemployment rate to decline more slowly than currently projected.

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To assess this risk, my staff used a forecasting model to analyze labor force participation and its trend. Based on past recovery patterns, a pickup in participation would likely be associated with *better* GDP growth. Historically, periods with stronger GDP growth have been associated with people being drawn into the labor force, and the higher GDP growth rates during these periods have been sufficient to keep the unemployment rate declining gradually. That finding would be an attractive possibility. It suggests that there is an economic upside to the re-entrance of a large number of people back into the labor force. But precisely how the extraordinary number of people out of the labor market or on reduced hours responds to improving conditions represents an important unknown.

Finally, although wage growth looks to be moderate over the next few years, it is critical to keep our eye on how wage patterns develop. To date, larger gains seem isolated to narrow occupations with exceptionally strong demand relative to the number of available workers. However, if demand grew beyond these relatively focused occupations and skills without being easily filled by unemployed workers, we could see broader pressure on overall wage growth. At some point in each of the past expansions, wages have headed higher, but at this point we do not see convincing evidence that wage acceleration is looming. Reports from our business contacts tend to emphasize subdued wages, with little pressure on firms' pricing decisions.

IMPLICATIONS FOR MONETARY POLICY

Maximum employment and stable prices are often discussed as if they are completely independent of one another—in other words, that monetary policy determines long-run inflation, while nonmonetary factors drive the natural rate of unemployment. Although this independence holds over the longer term, over shorter periods it is quite likely that inflation can affect labor market conditions and labor market conditions can affect the inflation rate. For example, if employers and employees expect higher inflation, firms may raise prices and grant wage hikes. Or, if wages are expected to hold steady, firms may see little reason to raise prices.

Wages are prices, too—the price of labor. Trends in wages are unusually persistent and can strongly affect business pricing decisions. I believe that wage trends contain reliably useful information about inflationary pressures over the medium run. Wage growth is clearly positive for the economy when accompanied by gains in labor productivity. Absent those gains, sustained wage growth can signal inflation pressures.

Subdued wage growth has already been playing a critical role in restraining the growth in core inflation during the past few years. Research at my Bank notes a clear connection between high unemployment periods associated with recessions and slower wage growth. The recession brought down wage growth from around 3.5 percent per year to less than 2 percent (see side essay, page 16). Following past recessions, wage levels typically remained low for quite some time, which has again been our current experience.

Because it implies little increase in the cost of producing goods and providing services, a low and stable wage growth trend should help to support a moderate inflation rate. Services are all about the costs of labor—whether those services are provided by a doctor, a hair stylist, an accountant, or a landscaper. Soft wage growth figures have been a significant factor holding down my inflation outlook.

With wages increasing only very slowly, and my outlook for inflation to remain stable, why not ease monetary conditions further to speed the decline in the unemployment rate? That logic is too simple. The average inflation rate of 1.5 percent during the past three years already reflects the moderate wage growth during that period. But even with moderate wage growth, there were episodes when the inflation rate rose above the FOMC's 2 percent long-term objective. Recent employment cost data show no trend toward even lower wage growth despite the elevated unemployment rates, so my outlook builds in continuing moderate wage growth rather than significantly greater downward pressure on inflation.

This outlook has important connections to how I see monetary policy. Given today's relatively high unemployment rate, I think monetary policy should remain accommodative. My outlook for unemployment and inflation is consistent with the federal funds rate staying low for some time. However, further policy accommodation in the context of my current outlook could result in more upward pressure on inflation, putting the FOMC's objective for stable prices at risk.

TOWARD FULL EMPLOYMENT

My research staff and I will be following these and other labor market issues, applying what we learn to our forecasting process. Between each FOMC meeting, we are also focused on evaluating incoming data, confirming or clarifying those data with business contacts and others, and most important, updating my economic outlook. Monetary policy is a forward-looking endeavor, but it relies heavily on previous economic relationships in the data and lessons learned from both good and poor decisions.

The past has also taught me that as a general rule, it makes sense for monetary policy to respond gradually to changes in incoming information, particularly when economic and financial conditions are unusually uncertain. Monetary policy involves economic analysis, informed estimates, and many judgment calls.

Americans have waited a painfully long time for a return to normal levels of unemployment. I believe that monetary policy is doing what it can to support progress toward maximum employment while continuing to maintain long-run price stability, which itself is essential to maximum economic growth. I remain committed to ensuring that we fulfill our dual mandate.