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MACROCOSM

The Low Hanging Fruits of Our Labor

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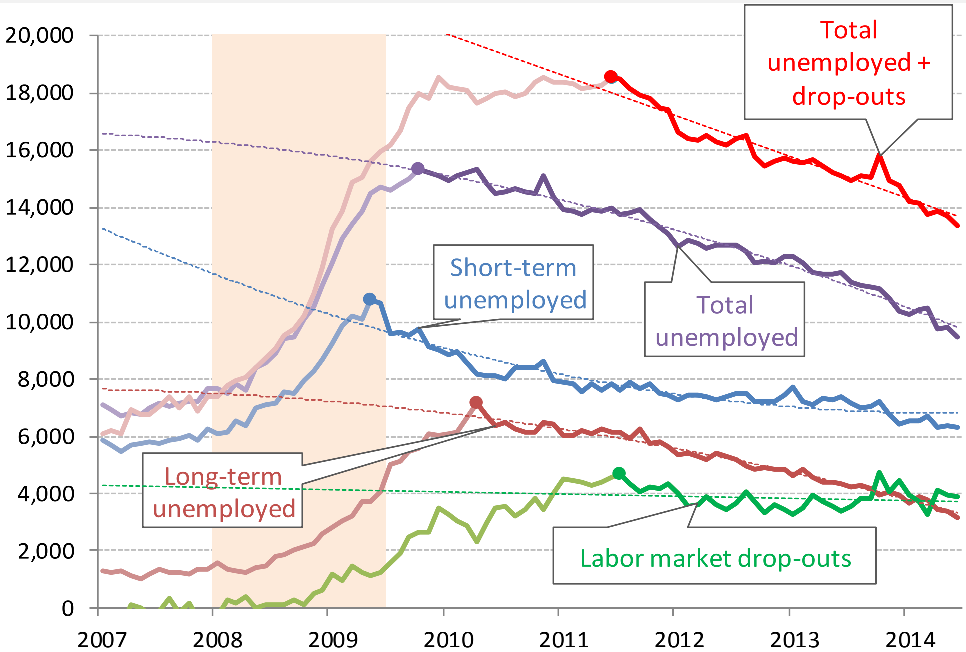
Short-term unemployment has all but vanished -- long-term is on the way down now, too.

The Not So Great Expansion following the Great Recession has seen the largest and most persistent long-term unemployment and the largest wholesale dropping out from the labor force in the history of modern data.

Problems remain, to be sure -- but we think that distracted from the market's recognizing the recent acceleration of improvement.

- *Short-term unemployment has been almost entirely absorbed. Long-term unemployment remains, but has started to fall rapidly. And the labor force drop-outs have abated* (please see the chart below).
- *This has significant implications for judging where we are in the course of this business cycle, for inflation expectations, and for Fed policy under new chair Janet Yellen.*

Unemployment and drop-outs — Level • Peak ···Trend from peak
SA, thousands Underemployment = labor force vs 20-year trend **Recession**



Source: Bureau of Labor Statistics, NBER, TrendMacro calculations

Update to strategic view

US MACRO, US FED: Short-term unemployment has been almost entirely absorbed, but that doesn't mean this business cycle expansion is mature. There is still considerable long-term unemployment, and it has been falling at twice the rate of short-term. Drop-outs from the labor force have stopped, and are now slightly declining. Based on these trends, unemployment should be at 5% next spring. The Fed's cyclical response will be to initiate "liftoff" from the zero funds rate at that time. But its structural response will be to keep policy highly accommodative for many years. There are no wage pressures arising from labor market improvement, but Yellen doesn't see higher inflation as a binding constraint, but rather as a policy objective.

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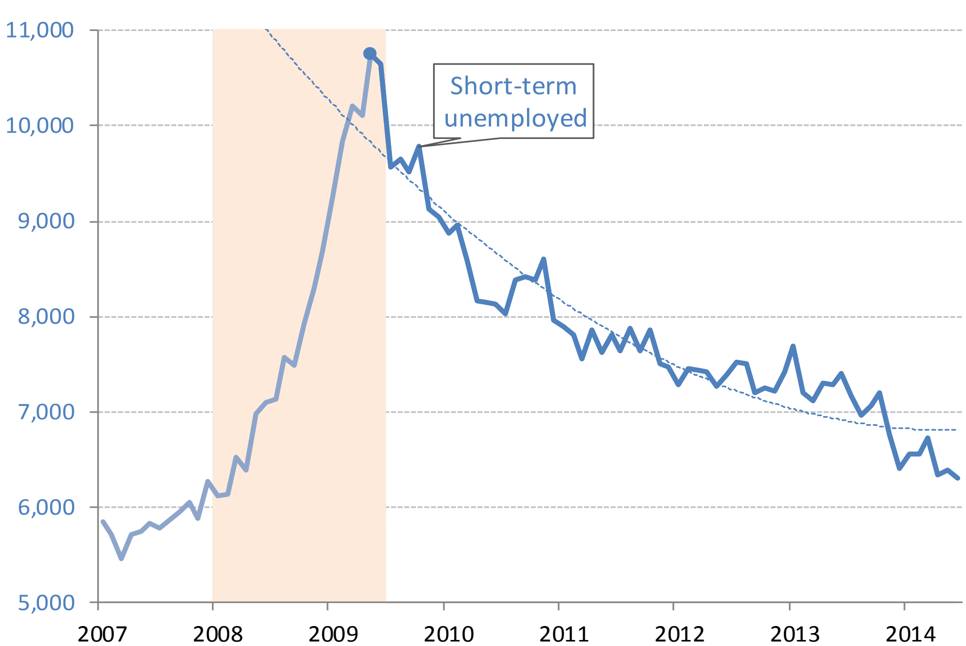
First, short-term unemployment has already improved almost entirely to pre-recession levels.

- At 6.3 million, the number of short-term unemployed -- that is, persons unemployed for 27 weeks or less, but still in the labor force -- has fallen 4.6 million from its highs in May 2009, one month before the official recession trough.
- From peak, short-term unemployment has been reduced by 41.4%.
- It is now only 27,000 from its level in December 2007 at the official peak of the prior expansion (please see the chart below).
- It is 847,000 from its March 2007 low in the prior expansion.
- The trend rate of improvement is flattening.
- At the present rate of improvement seen over the last year, short-term unemployment will be entirely gone in about 9 months.
- *In other words, the largest cohort among the unemployed -- currently twice the number of long-term employed -- is nearly back to full employment.*
- *This is the low-hanging fruit of the labor market, and it has almost all been harvested.*
- *If the long-term unemployed are to be written off an unemployable -- because their skills are mismatched to present employer needs, or because they are too stale and discouraged to acquire skills or even look effectively for work -- then in that sense at least the present business cycle expansion is fully mature.*
- The strong form of this view comports with recent research that treats long-term unemployment as exogenous to the business cycle (see, for example, Kruger 2014: "Are the Long-Term Unemployed on the Margins of the Labor Market?"). Based on this view, already

Short-term unemployed — **Level** • **Peak** ··· **Trend from peak** **Recession**
SA, thousands



Source: Bureau of Labor Statistics, NBER, TrendMacro calculations

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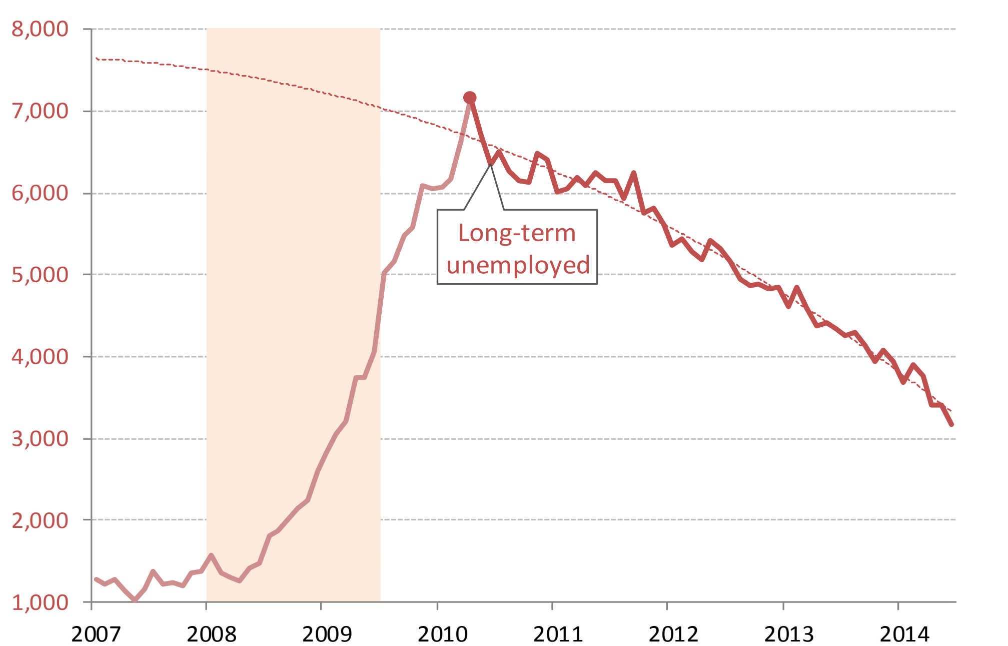
slow growth should slow even further -- and inflationary pressures should reawaken -- as the economy runs up against capacity constraints in labor.

Long-term unemployment, while persistent, has actually improved even more. Yet is still has farther to go.

- At 3.2 million, the number of long-term unemployed -- that is, persons unemployed for 27 weeks or more, but still in the labor force -- has fallen 4.0 million from its highs in April 2010, ten months after the official recession trough.
- From peak, long-term unemployment has been reduced by 55.6%, a larger percentage reduction than that of short-term unemployment, and in a shorter time period.
- But this good news tends to be crowded out, for most observers, by the fact that long-term unemployment still remains 1.8 million from its level in December 2007 at the official peak of the prior expansion (please see the chart below).
- Indeed, it is 2.2 million from its October 2006 low in the prior expansion.
- But what's important is that the trend rate of improvement is steepening.
- *Over the last year, long-term unemployment has fallen by 27%, while short-term has fallen by 15%.*
- *<u>This is the high-hanging fruit of the labor market. Long-term unemployment worsened as the present expansion began, and when improvement began it was modest at first. Yet this high-</u>*

Long-term unemployed **Level** **Peak** **Trend from peak** **Recession**
SA, thousands



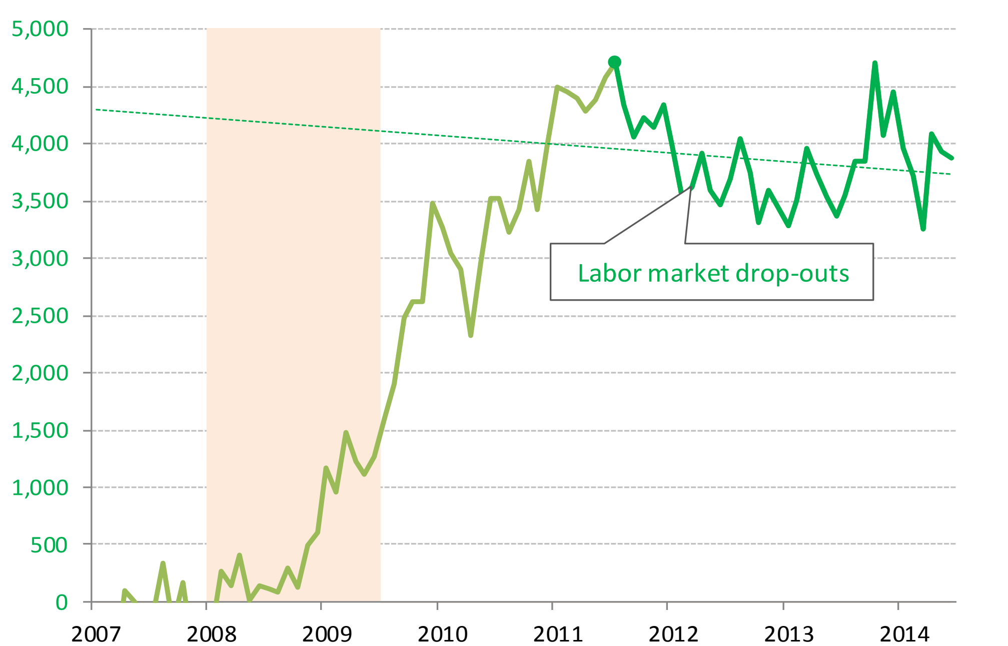
Source: Bureau of Labor Statistics, NBER, TrendMacro calculations *hanging fruit is being harvested, and the harvesting is accelerating. Based on how much improvement has occurred, we can't write off the long-term unemployed as unemployable.*

- *At the same time, much long-term unemployment remains to be harvested. So we can't conclude that this business cycle expansion is mature, when so many remain to be employed.*
- And with so many long-term unemployed still in the labor force, we would not expect any intense wage pressure yet that might arguably feed into inflation.

The improvement in long-term unemployment can't be written off by assuming that discouraged workers have dropped out of the labor force, and so are no longer counted as unemployed.

- At 3.9 million, the number of persons who have dropped out of the labor force has fallen 828,000 from its highs in July 2011, 25 months after the official recession trough (please see the chart below).
- Up until that point, from the official recession trough, the number of drop-outs had grown by 3.4 million, while over the same period total unemployment (short-term and long-term combined) *fell* by 922,000. So until three years ago, drop-outs had more than explained the fall in unemployment -- making labor market improvement largely illusory.
- But from its peak in July 2011 to now, while the number of unemployed has fallen by 4.3 million, the number of drop-outs has fallen, too -- by 828,000. Thus the majority of the improvement in unemployment over the last two years is real, not illusory.

Labor force drop-outs — Level • Peak ··· Trend from peak   Recession
SA, thousands, labor force versus long-term trend

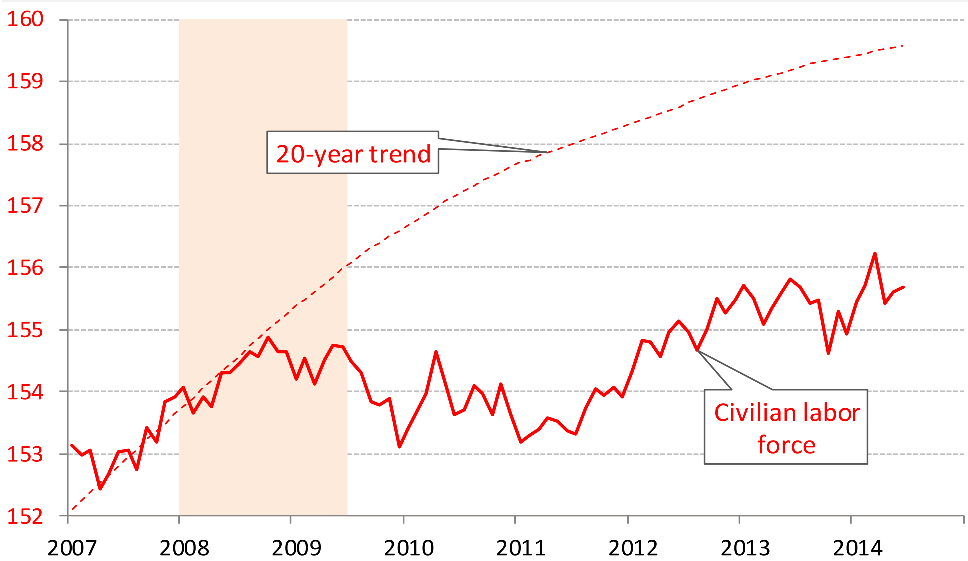


Source: Bureau of Labor Statistics, NBER, TrendMacro calculations

- *Going forward, drop-outs are the ultra-high-hanging fruit of the labor market. This fruit is being harvested to some small extent, and it remains to be seen whether the economy can grow sufficiently to pick up the pace -- or perhaps drop-outs are a durable structural feature of the economy now.*
- *Be that as it may, it has been three years since drop-outs from the labor force has offset the fall in unemployment.*

- **A methodological note:** The number of drop-outs from the labor force cannot be measured objectively, and there are no official statistics on it. It is a slippery concept, which necessarily includes not only those persons once in the labor force who left it, but also those who never joined the labor force in the first place but should have. We measure it as *the gap between the civilian labor force versus its 20-year trend*. As labor force participation has fallen since 2000, the trend has decelerated, which serves to narrow the gap (please see the chart below). This has the effect of reducing the number of dropouts, all else equal. That the trend can be altered by persistent changes in new data imparts a structural element to this methodology, which accounts for about half the reduction in the number drop-outs over the last three years.

Civilian labor force **— Level** **··· 20-year trend** **Recession**
SA, thousands



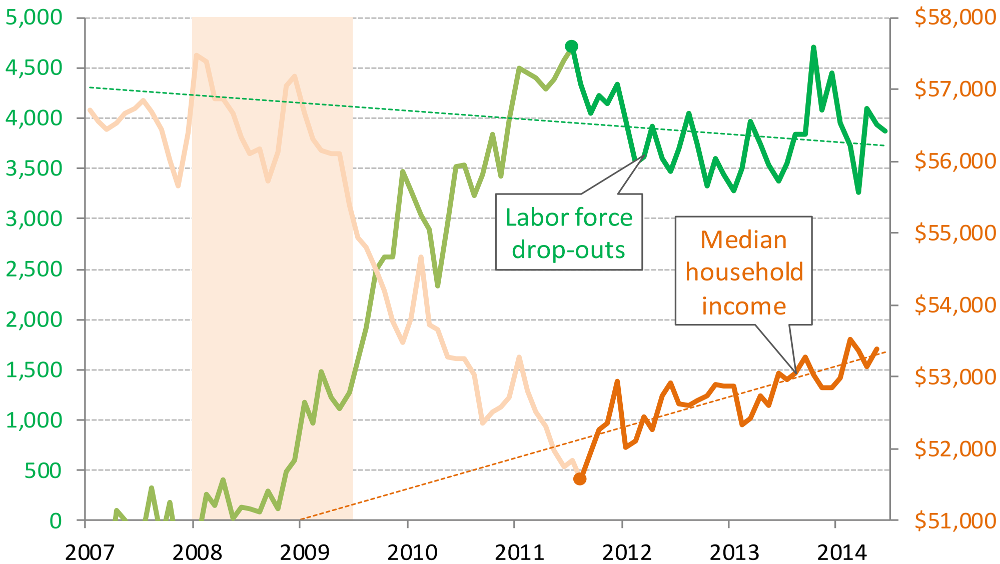
Source: Bureau of Labor Statistics, NBER, TrendMacro calculations

A revival in household income has coincided with the stabilization of labor force drop-outs.

- At $53,385, real median annual household income has fallen $3,017 or 5.3% from its December 2007 level at the peak of the prior business cycle.

- It didn't trough until August 2011 -- despite a considerable period of falling short-term and long-term unemployment. The trough in median income didn't come until one month after the peak in labor force drop-outs (please see the chart below).

Labor force drop-outs **— Level** **• Peak** **··· Trend from peak** **Recession**
SA, thousands, labor force versus long-term trend
Median real household income SA **— Level** **• Trough** **··· Trend from trough**



Source: Bureau of Labor Statistics, NBER, Sentier Research TrendMacro calculations

- From its trough, median income is up $1,811 or 3.5%, at the same time as the number of drop-outs has fallen.
- *<u>It seems that incomes are coming back only as slack comes out of the most intractable and perhaps structurally challenged cohort in the labor market.</u>*
- This flies in the face of arguments that wage pressures will come back in full force -- and arguably feed into inflation -- now that short-term unemployment has been nearly completely exhausted (again, see Kruger 2014, and Gordon 2013: "The Phillips Curve is Alive and Well: Inflation and the NAIRU During the Slow Recovery").

How will these labor force dynamics play into Fed policy?

- It may seem incredible -- but simply based on the trends we have documented here, the unemployment rate next spring will be about 5%.
- If so, and holding inflation rates constant, the version of the Taylor Rule that Yellen prefers will be calling then for a funds rate of 5.6%!
- **First, cyclical improvement will drive "liftoff."** We know from the minutes of the June FOMC meeting that the Fed recognizes the improving labor market, citing "solid gains in nonfarm payrolls, a low level of new claims for unemployment insurance, [and] uptrends in quits and job openings..."

- And we know that new Fed chair Janet Yellen has argued all along that lingering long-term unemployment is mostly cyclical: "whatever problems there may be today with labor market functioning are likely to be substantially resolved as the broader economy improves and bolsters the demand for labor."
- *So we expect a cyclical response from the Fed. As the labor market returns this year to maximum employment in terms of the reabsorption of the short-term unemployed -- and as continued strong progress gets made on long-term unemployment -- we would expect Yellen to be as good as her word. That is, "liftoff" from zero interest rates should happen, as she blurted out at the March FOMC press conference, about six months after tapering is complete -- which puts it at next spring.*
- **Second, structural issues will drive continuing policy ease.** While "liftoff" will be driven by cyclical improvement in the labor market already well underway, Fed policy will remain highly accommodative -- even at positive interest rates -- for many years to come.
- *The millions of remaining drop-outs from the labor force are a structural matter for Yellen, which she described in her press conference following the June FOMC, as a "secular decline in the labor force participation rate for demographic reasons." She is also concerned with "residual effects of the financial crisis" including "reduced credit availability."*
- *We could easily add to the list of structural dynamics that have been discussed in various ways going all the way back to Alan Greenspan -- disruptive technologies, global competition, and excessive global savings.*
- *Just because Yellen believes a problem is structural, as opposed to cyclical, that doesn't mean she won't target Fed policy to deal with it. She's saying quite clearly that she will.*
- But we are now on what we have called "The Yellen Rule" -- 38 words repeated verbatim now three times in the March, April and June FOMC statements (see "The Yellen Rule is Taylor Minus Two" May 19, 2014) Here are those 38 words, with the critical policy intention called out in red:

> **The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.**

- **Third, inflation is not a binding constraint -- it's an objective.** As we have shown here, income gains are only coming to the small extent that drop-outs from the labor force are being gradually absorbed. *There is no evidence of worrisome wage pressures. In Yellen's neo-Keynesian model, that is tantamount to saying that inflation risk is negligible. Thus inflation is not a constraint on prolonged policy accommodation.*

- *Indeed, under Yellen's theory of "optimal control," significantly higher inflation is an urgent policy objective, to counteract the deflation of 2008 and 2009 and the too-low inflation ever since* (see Minnesota Fed President Narayan Kocherlakota's July 8 speech, and "It's Yellen's World, and We're Just Living In It" June 18, 2014).

Bottom line

Short-term unemployment has been almost entirely absorbed, but that doesn't mean this business cycle expansion is mature. There is still considerable long-term unemployment, and it has been falling at twice the rate of short-term. Drop-outs from the labor force have stopped, and are now slightly declining. Based on these trends, unemployment should be at 5% next spring. The Fed's cyclical response will be to initiate "liftoff" from the zero funds rate at that time. But its structural response will be to keep policy highly accommodative for many years. There are no wage pressures arising from labor market improvement, but Yellen doesn't see higher inflation as a binding constraint, but rather as a policy objective.