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# On Yellen at Jackson Hole

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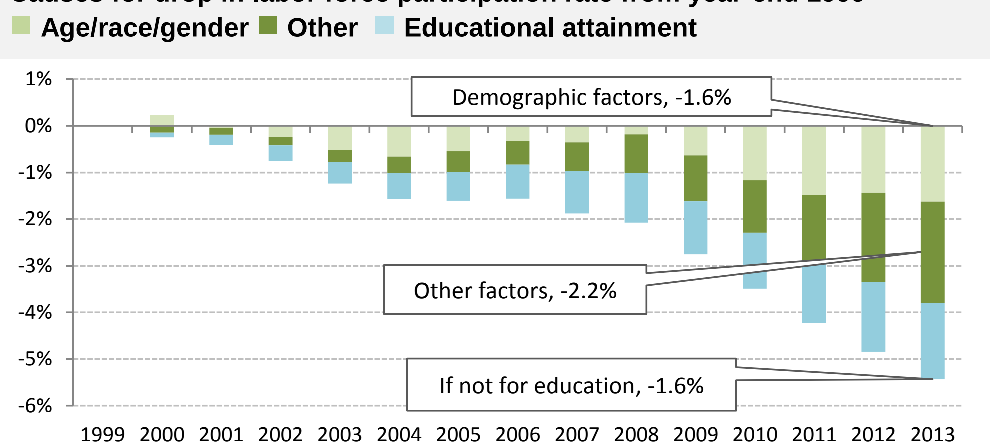
**Donald Luskin**

## Unemployment is cyclical. No, it's structural. Wait -- it's both!

Janet Yellen's maiden speech at Jackson Hole as Federal Reserve chair explains how she is thinking about the relationship of cyclical and structural factors in the labor market. As in her major speech last year on the same subject, or another this March, her first speech as Fed chair, made to an audience of community organizers (see "On Yellen's First Public Speech as Fed Chair" March 31, 2014), *Yellen comes down firmly on both sides. It's cyclical. No, it's structural. Wait -- it's both. She calls that a "nuanced" assessment.*

- And she's probably about right. We believe -- as Yellen does -- that there is still cyclical slack in the labor market, but we recognize that this particular cycle is unique in the extent of structural or at least long-cycle factors present at the same time.
- The cyclical element can be seen in the improving trend rate of amelioration of record long-term unemployment, and the rise in median incomes over the three years since workers stopped dropping out of the labor force (see "The Low Hanging Fruits of Our Labor" July 15, 2014).
- But the structural element can be see just as clearly in the 14-year fall in labor force participation from its peak in early 2000 (please see the chart below). Demographic changes explain 1.6% of the 3.8%

**Causes for drop in labor force participation rate from year-end 1999**




Source: Bureau of Labor Statistics, TrendMacro calculations

**Update to strategic view**

**US FED, US BONDS:** Yellen's first Jackson Hole speech as Fed chair repeats her ambivalence about the interplay of cyclical and structural forces in the labor market. But we don't see how any of that matters -- Yellen is committed to using policy to address structural issues too, or at least be tuned to them. Thus "The Yellen Rule" under which rates, while positive, will be lower than normal virtually forever. The speech gave no timing guidance, nor implementation plan. Much of this was addressed in Wednesday's minutes of the July FOMC, guiding market expectations for a sooner-than-expected liftoff from the zero-bound, and for a new regime of overnight rate management in a corridor defined by interest on excess reserves and the overnight reverse repo rate.

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drop in participation. And participation would be lower by another 1.6% if it were not for improvements in education attainment (that is, without education attainment, the drop would have been 5.4%, not 3.8%).

- In the end, it's not certain for us that the distinction between structural and cyclical even matters to Yellen. To be sure, she said in the March speech that if "unemployment were mostly structural… then the Federal Reserve's efforts to create jobs would not be very effective." But unless inflation were to become a binding constraint, there is nothing in the Fed's statutory mandate that lets it off the hook for "maximum employment" just because its roots are structural.
- With respect to structural causes, it is clear from numerous statements that Yellen has adopted a version of the "secular stagnation" narrative. And it is equally clear she believes that Fed policy can address it, or at least be tuned to it. For example, why shouldn't Fed policy price credit with awareness of the reality that credit intermediation has been made more difficult and expensive by Dodd-Frank and Basel III -- an issue to which Yellen has alluded many times?
- *We believe this is what fuels the underlying engine of her policy vision -- what we call "The Yellen Rule" -- a regime of positive interest rates well below normal standards, and virtually forever* (see "The Yellen Rule is Taylor Minus Two" May 19, 2014).
- The 38 words repeated verbatim in the March, April, June and July FOMC statements make it perfectly clear. Once again -- because this is so important -- 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.**

This morning's speech did not shed any new light on near-term timing decisions, nor how policy would be implemented once overnight rights rise above the zero-bound. But the minutes of the July FOMC meeting, released Wednesday, spoke extensively to these topics.

- As has been widely reported, the minutes said "many participants noted…it might become appropriate to begin removing monetary policy accommodation sooner than they currently anticipated." This is consistent with our view that markets should take Yellen at her word -- remember, at her first FOMC press conference in March, she blurted out that the "considerable period" after the completion of asset purchases, before rates could lift off from zero, "probably means something on the order of around six months or that type of thing." *That means April -- or that type of thing.*
- Once the zero-bound has been breached to the upside, the minutes state that the fed funds rate will continue to be "the key policy rate." But then they continue to say that it won't. Rather, rates will be set as

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**Recommended Reading**

**Skill Gaps, Skill Shortages and Skill Mismatches: Evidence for the US**
Peter Cappelli
NBER Working Paper No. 20382
August 2014

**Under What Circumstances Should You Worry That the Stock Market Is "too High"?**
Brad DeLong
Washington Center for Equitable Growth
August 16, 2014

**Complex Tax Incentives**
Johannes Abeler and Simon Jäger
Harvard University
June 25, 2014

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a corridor -- the top will be the rate paid on the overnight reserves (IOER), and the bottom will be the rate paid on overnight reverse repurchases (ON RPR).

- But then the minutes go on to say that ON RPR will be limited in scope -- surely a response to scare stories and pleadings from the banking lobby.
- So policy normalization remains something of a sketch. The minutes commit to fleshing it out "later this year, well before most participants anticipate the first steps in reducing policy accommodation to become appropriate."

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**Bottom line**

Yellen's first Jackson Hole speech as Fed chair repeats her ambivalence about the interplay of cyclical and structural forces in the labor market. But we don't see how any of that matters -- Yellen is committed to using policy to address structural issues too, or at least be tuned to them. Thus "The Yellen Rule" under which rates, while positive, will be lower than normal virtually forever. The speech gave no timing guidance, nor implementation plan. Much of this was addressed in Wednesday's minutes of the July FOMC, guiding market expectations for a sooner-than-expected liftoff from the zero-bound, and for a new regime of overnight rate management in a corridor defined by interest on excess reserves and the overnight reverse repo rate.