



***“Labor Market Slack and
Monetary Policy”***

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It is great to be back to speak at the Boston Economic Club, and I do so with my usual note – that the views that I will express are mine, and do not necessarily reflect the views of my colleagues on the Federal Open Market Committee (FOMC) or the Federal Reserve’s Board of Governors.

I am particularly happy to have the opportunity to speak to this group given the abundance of questions and debates surrounding the economy these days. Indeed, much of the recent discussion among economists who focus on the near-term economic outlook seems to be

centering on whether weakness in recent incoming data reflects just the severe winter weather or more fundamental trends. While locally we have had a notable spate of snowstorms, that is to be expected – New England tends to experience snowstorms in the winter. If, however, misery loves company, we have had plenty of companions this year. What is unusual this winter, according to many retailers, is that they can usually count on bad weather in the Northeast being offset by good weather in the Mid-Atlantic and South – but that has not worked out this year.

The most recent employment report is a good example of the difficulty encountered in discerning trends from anomalies (such as weather). Payroll employment grew by a disappointing 113,000 jobs in January, well below expectations. December was similarly disappointing, with the addition of only 75,000 jobs.¹ The average of 94,000 jobs a month over the past two months stands in sharp contrast to the average of 256,000 jobs added in October and November.²

Since the February survey took place over the week when snowstorms resulted in widespread disruptions up and down the East Coast, it is likely that the February employment report released next month will also be difficult to interpret – given that the movement in the data was certainly influenced by Mother Nature.

In short, economists and policymakers face the difficulty of determining whether recent employment reports are just anomalies induced by things like weather, or reflect a slowing trend in the economy – a pattern that we have certainly seen repeatedly since the onset of this recovery. In my view, this uncertainty provides an additional strong rationale for taking a patient approach to removing the monetary policy accommodation that the Federal Reserve has been deploying.

However, today I plan to discuss another justification for a patient approach to removing monetary policy accommodation. That reason is that the traditional measure of unemployment probably understates the degree of “slack” remaining in labor markets and the economy more generally. My colleagues and I at the Boston Fed have been studying and speaking about these issues, and I would like to return to and expand upon them with you this afternoon, given their central importance at this point in time.

While the unemployment rate has recently fallen to 6.6 percent, there remain 7.3 million Americans who want full-time work but are currently working part time – a number that is dramatically higher than the 4.6 million workers in that situation in December of 2007 as the financial crisis and recession were taking hold. In contrast to the observable decline in labor force participation – which prompts a debate about whether workers remain qualified and willing to work – this “part time for economic reasons” group involves workers who currently have jobs. They have the skills to do the work, and they state that they would prefer to work full time. So these individuals likely reflect a large supply of underutilized workers – an assessment that is supported by other indicators of slack labor markets like the very low inflation rate, and very slow growth in labor compensation.

Recent Economic Data

While the payroll employment numbers have been disappointing of late, there has been better news in the household survey. The unemployment rate declined to 6.6 percent in January, and in contrast to many previous declines, this recent decline reflects more jobs rather than a

smaller labor force. As **Figure 1** shows, the unemployment rate was 7 percent as recently as last November, so we continue to enjoy noticeable improvement in this standard measure.

The horizontal green line shows the 6.5 percent threshold that was first included in the FOMC's policy statement for the December 2012 committee meeting, when the unemployment rate was 7.9 percent. This threshold was used in the form of guidance that the committee would not raise short-term interest rates as long as the unemployment rate was at or above the 6.5 percent threshold. It is important to recall that the Committee made the distinction between this benchmark as a *threshold* – i.e., a point at which discussion about policy options should begin – versus a *trigger* – a point at which a specific policy action would automatically begin. It also included other markers that would guide the discussion, including inflation and inflation expectations.

As the unemployment rate has fallen, the Committee's forward guidance has been amended to state that it likely will be appropriate to maintain very low short-term interest rates well past the time that the unemployment rate declines below 6.5 percent.³ This reflects the assessment that while the unemployment rate has approached the threshold, there still remains significant slack in labor markets, actual inflation remains well below the Federal Reserve's 2 percent target, and inflation expectations remain stable. In my view, this is completely consistent with the FOMC's intended interpretation of the 6.5 percent marker as a threshold, not a trigger.

The crux of my talk today is this: When we reach 6.5 percent unemployment, the economy will still be characterized by significant labor market slack. I will offer several ways of

looking at this, including historical perspectives on the level of unemployment, as well as additional measures of labor market slack.

With regard to historical perspective, as the green line shows, the 6.5 percent threshold was set at a level higher than the highest unemployment rate reached during the 2001 recession. I would add that it is well above my own estimate of “full employment,” which is 5.25 percent unemployment. So the 6.5 percent threshold was set conservatively, to essentially serve as a point where the Fed’s monetary policy committee would begin to focus on a much broader set of economic variables in order to consider whether it was appropriate to begin raising short-term interest rates.

Figure 2 provides an indication of how long it might take to reach my estimate of the full employment level of unemployment – 5.25 percent – under two different assumptions about the evolution of the unemployment rate. The first path assumes that the unemployment rate continues to decline at the same rate it has since unemployment reached 10 percent. This simple extrapolation (the dotted line) shows that we would reach my estimate of full employment by mid-2016.

A very similar result arises in the second scenario (the dashed line), which assumes that a simple Okun’s Law⁴ holds and that GDP will grow at 3 percent for the next few years, somewhat above my 2 percent estimate of the economy’s potential growth rate. Of course, this scenario assumes that the unemployment rate is currently a good measure of labor market slack – and assumes that as the economy continues to improve, there will not be a large inflow of workers who were waiting for stronger employment prospects before entering the workforce or moving from part-time to full-time employment.⁵

Unfortunately, **Figure 3** provides one reason to believe there *is* significant labor market slack not fully captured by the standard unemployment rate. A broader measure of labor market underutilization is the U-6 measure of unemployment produced by the Bureau of Labor Statistics (the BLS). The U-6 measure includes the widely reported U-3 unemployment measure, but also includes workers who are “marginally attached” to the workforce (that is, who looked for work in the past year but not the past 4 weeks) and individuals working part time for economic reasons.

While there is always a difference between U-3 and U-6, as there are always some marginally attached and part-time workers in the economy, the spread between the U-3 and U-6 measures of unemployment has increased dramatically since the start of the financial crisis. To return to full utilization of labor as measured by this broader indicator, we will need stronger economic growth – which would pull workers out of unemployment into employment – but we will also need sufficient demand to see the re-employment of some of those marginally attached to the workforce *and* the conversion of many part-time workers to full-time workers.

Part Time for Economic Reasons

Figure 4 highlights the data on persons who are working part time for economic reasons. The left panel shows that 7.3 million Americans are working part time but would prefer full-time employment. While the number working part time for economic reasons is down from a peak of approximately 9 million Americans after the recession, it remains dramatically higher than was experienced from 1994 until the financial crisis, and, in fact, remains well above the past few

times when the most commonly used measure of unemployment stood at or near 6.5 percent. The right panel shows that roughly 5 percent of the labor force includes workers who are part time for economic reasons.

The BLS employment survey includes detailed questions on the status of part-time workers, and as such is able to provide additional context. For example, the survey reports “slack work or business conditions” as the reason underlying the largest category of people working part time for economic reasons. These are people who would be working full time if there were sufficient demand, but firms have reduced their hours because of business conditions. **Figure 5** shows that these 4.4 million workers account for roughly 3 percent of the labor force. Notably, the numbers in Figure 4 and 5 remain much higher than prior to the recession.

Figure 6 shows the second-largest category of workers whose status is part-time for economic reasons – those who could only find part-time work. About 2.6 million Americans currently can only find part-time work. This series does not show the same declines as those that have reduced hours because of slack business conditions. And while the current reading for these part-time workers is at an elevated level, it is not as dramatic as for those whose reduced hours stem from slack business conditions.

Figure 7 provides the numbers working part time for economic reasons, broken out by industry classification. The wholesale and retail trade and the leisure and hospitality industries have the largest number of individuals working part time for economic reasons. Both are industries that one might expect to be significantly impacted by a slow recovery – but also industries that should be capable of adding hours for workers as business improves.

Figure 8 shows that being part time for economic reasons is a problem for those generally thought to be of “prime working age” and not just the youngest and oldest workers. Such workers typically demonstrate strong attachment to the labor force, with fewer spells of unemployment and less tendency to work part time. Prime working-age individuals follow a pattern quite consistent with the overall figures shown in Figure 4.

Figure 9 brings in a consideration of race and ethnicity.⁶ White workers show the greatest decline from the recession peaks among workers who are part time for economic reasons. Black or African American workers have actually shown no decline in this measure, while workers of Hispanic or Latino ethnicity have seen some improvement. However, the slow recovery has not only resulted in very elevated minority unemployment rates, but also made it more difficult to move from part-time to full-time employment.

Overall, I see these charts providing evidence that there remains significant slack in labor markets, above and beyond the slack usually represented by the standard unemployment (or U-3) rate. Observers of the economy and labor markets have been debating whether marginally attached workers are likely to return to the workforce – whether they left because they are (perhaps temporarily) discouraged, lack requisite job skills, or are less willing to work. This debate suggests some uncertainty about the degree to which labor force participation rates will actually improve.

However, the labor market slack that is revealed by the large numbers working part time for economic reasons is different. Employers have hired these workers (so they have the necessary skills), and they are available to work – but economic conditions have not been sufficiently robust to convert their part-time work to full-time work. This may indicate that the

true overall slack in the labor markets is better captured by a portfolio of the unemployment measures, including the U-6 measure, rather than only the more traditional and widely reported U-3 measure.⁷

Other Indications of Labor Market Slack

Another indication of what I believe to be significant labor market slack is the absence of inflationary pressures. **Figure 10** shows the Summary of Economic Projections for inflation provided by the presidents and governors within the Federal Reserve System. The forecasts for 2013 inflation, made in 2011 and 2012, significantly overestimated how quickly inflation would return to the Federal Reserve's 2 percent target. The 1.1 percent inflation⁸ for 2013 was outside the range of earlier forecasts, and remains well below the 2 percent inflation target set by the FOMC.

Figure 11 shows that the 2 percent growth rates of wages and salaries and of total compensation are well below levels experienced prior to the most recent recession. If some labor markets were already tightening, we would expect to observe more of an upward trend in wages and salaries and total compensation. **Figure 12** shows that there is little evidence of compensation pressures, even when viewed by varying occupations.

The evidence provided by prices and compensation corroborate my argument that there continues to be significant slack in labor markets. The absence of pricing pressure is consistent with the still-elevated number of unemployed workers, as well as the very elevated number of workers who are part time for economic reasons.

Concluding Observations

As the unemployment rate falls and approaches the 6.5 percent threshold, the Federal Reserve needs to make an assessment of the degree of remaining labor market slack as it sets monetary policy. I believe the elevated number of workers who are part time for economic reasons, the still-high unemployment rate, and the very low inflation rate are all consistent with significant slack in labor markets. Such conditions call for a very patient approach to removing monetary policy accommodation, particularly given the softness in recent economic data.

It is vitally important that labor markets continue to improve. Monetary policy should continue to be accommodative, supporting a return to full employment, given the very low inflation rates.

Thank you.

NOTES:

¹ The initial report of 74,000 jobs has been revised upward to 75,000.

² Payroll employment increased by 237,000 jobs in October and 274,000 in November for an average of 256,000 over the two months.

³ See the committee statement at <http://www.federalreserve.gov/newsevents/press/monetary/20140129a.htm>.

⁴ Former Fed Chairman Ben Bernanke described Okun's Law in a 2012 speech as follows: "About 50 years ago, the economist and presidential adviser Arthur Okun identified a rule of thumb that has come to be known as Okun's Law. That rule of thumb describes the observed relationship between changes in the unemployment rate and the growth rate of real gross domestic product (GDP). Okun noted that, because of ongoing increases in the size of the labor force and in the level of productivity, real GDP growth close to the rate of growth of its potential is normally required just to hold the unemployment rate steady. To reduce the unemployment rate, therefore, the economy must grow at a pace above its potential. More specifically, according to currently accepted versions of Okun's Law, to

achieve a 1 percentage point decline in the unemployment rate in the course of a year, real GDP must grow approximately 2 percentage points faster than the rate of growth of potential GDP over that period. So, for illustration, if the potential rate of GDP growth is 2 percent, Okun's Law says that GDP must grow at about a 4 percent rate for one year to achieve a 1 percentage point reduction in the rate of unemployment."

<http://www.federalreserve.gov/newsevents/speech/bernanke20120326a.pdf>

⁵ It is important to note that there have been large errors in Okun's Law recently reflecting periods where the economy has grown around its potential but the unemployment rate has fallen substantially.

⁶ The BLS Table A-27 presents the following classifications: 'White,' 'Black or African American,' 'Asian,' and 'Hispanic or Latino ethnicity.' (Data are not presented for all races.) The numbers may add to more than the total as a worker may be counted under more than one classification.

⁷ For a discussion of the various measures of unemployment in relation to the current economic situation and the implications for policy, see my recent remarks on underutilization in U.S. labor markets, at <http://www.bostonfed.org/news/speeches/rosengren/2014/020614/index.htm>.

⁸ As measured by the Personal Consumption Expenditures price index, or PCE.