BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

Date: December 5, 2014

To: Federal Open Market Committee

From: David Wilcox

Subject: Two notes on issues related to the labor market and cyclical dynamics

---

Attached are two notes that address issues related to the labor market and cyclical dynamics. The first note, prepared by Hess Chung, Charles Fleischman, Christopher Nekarda, and David Ratner—all of whom are members of the Division of Research and Statistics—focuses on the measurement of economic slack. The note presents a range of indicators of slack—some model-based, others not—and discusses the uncertainty that surrounds any plausible estimate of slack. Broadly, the note concludes that almost every indicator of slack has shown marked improvement in recent years; considerable diversity exists across indicators regarding the extent of slack that remains today; and the range of uncertainty surrounding any particular indicator of slack is wide. We continue to see the bulk of the evidence as suggesting that some slack in resource utilization remains. We intend to update the main exhibits in this note periodically and include them in future Tealbooks, perhaps quarterly, as the economy makes further progress toward the Committee's objective of maximum sustainable employment.

The second note, prepared by Stephanie Aaronson, Jean-Philippe Laforte, and Dennis Mawhirter—also all members of R&S—examines the relationship between increases in the unemployment rate and subsequent recessions. The note provides simulation-based evidence that when the economy is at full employment, the baseline risk of recession is substantial—between a fifth and a quarter, according to FRB/US. That risk would increase somewhat if the unemployment rate were to drop below its natural rate and then the Committee were to attempt to guide it back up to its natural rate; but, according to FRB/US, a recession would certainly not be foreordained in those circumstances. In the historical record, soft landings have been rarely attempted in the post-World-War-II era, and rarely achieved. Many post-WWII recessions resulted from deliberate attempts by the Federal Reserve to induce economic weakness to slow the rate of inflation.