SPEECHES

Prospects for Sustained Recovery and Employment Gains

Dennis P. Lockhart
President and Chief Executive Officer
Federal Reserve Bank of Atlanta

Business Leaders Luncheon
Hartford, Conn.
March 31, 2010

After the deepest and longest recession in the past half century—a recession largely precipitated by a financial crisis in which the global financial system came close to unraveling—the U.S. economy is now in recovery. Today I want to discuss the prospects that the recovery will proceed forward—is sustainable—and the implications of the outlook I will present for perhaps the most vexing current problem coming out of the recession: unemployment. I will close by connecting these views to the direction of monetary policy.

At the outset I must emphasize that my remarks today will reflect my personal views only and don't necessary reflect the views of my colleagues on the Federal Open Market Committee (FOMC).

The economic situation and outlook

Today is the last day of the first quarter of 2010. I expect the first quarter to extend the recovery that began last summer and accelerated in the fourth quarter of 2009. Fourth quarter gross domestic product (GDP) growth was revised down a little last week but still was measured at 5.6 percent, a rather strong number. I don't expect growth of that strength to repeat itself in the first quarter. A big contributor to fourth quarter growth was the slowdown of inventory liquidation, in all likelihood a transitory phenomenon. When inventory liquidation slows, more activity is required to maintain inventory-to-sales ratios. For the first quarter, I expect a more moderate growth rate, a little below 3 percent.

Underpinning the continued growth we're experiencing is steady improvement in private spending in the United States. Private spending has two elements. The first, consumer spending, is expanding. Despite low levels of confidence and constrained access to credit, consumer spending, is growing at a moderate pace.

The second element is business spending on inventory and capital goods. This category of private spending has been rising quite briskly in recent months. Last week we got another positive reading for February but at levels that disappointed analysts. As a consequence, many forecasters revised down their estimate of equipment and software spending for the first quarter.

Nonetheless, business spending on equipment and software is helping to offset softer housing and commercial construction. Problems in the housing sector vary by location and have been especially acute in my part of the country, the Southeast. Nationally, the pace of home sales slowed late last year, and sales have eased further so far this year. Continued stabilization of the housing sector—especially house prices—is likely a precondition for sustained economic recovery.

The economy remains in a transitional phase from a period that depended on support of public sector programs to a period of resumed growth based on private spending. For the recovery to be sustained, we need consumers to consume and businesses to spend on inventory, investment goods, and human resources. Economic forecasts hinge on how formidable those positive forces will be and on the strength of countervailing headwinds.

Views about the economic outlook fall roughly into two narratives. The more optimistic scenario is a V-shaped bounce back from severe recession. This has been the historic experience for the most part. In this scenario, growth exceeds the underlying long-term potential of the economy for a number of quarters, and unemployment declines at a steady pace. Both consumer activity and business investment show rising growth. Exports contribute meaningfully to GDP, reflecting growth of our principal trading partners, particularly in Asia. And the banking system navigates a troubled commercial real estate sector and expands credit to both businesses and consumers, fueling a rather strong recovery.

By contrast, the second scenario is a relatively modest recovery, with slow reduction of unemployment. Various headwinds hold back GDP growth. They include (1) a banking sector that is slow to expand credit in part because of weak loan demand and commercial real estate problems, (2) a weak state and local public sector that is adjusting to fiscal pressures by cutting expenditures and employees, (3) as referenced earlier, a housing sector that is slow to stabilize, and (4) an extremely cautious business sector as regards investment and hiring. You can add to this list the impact of some level of subdued consumer activity reflecting a more frugal mindset.

In our contacts with business executives, my staff of economists in Atlanta and I have been probing the questions that underlie the headwinds hypothesis. We have been getting a lot of anecdotal confirmation. As a consequence, our outlook is closer to the second narrative.

Perspective on labor markets

As already suggested, an implication of this slow recovery scenario is the very gradual decline of today's unacceptably high rate of unemployment. For perspective, let me recount the movement of the official unemployment rate reported by the Bureau of Labor Statistics (BLS) in my short tenure as a Fed policymaker. I became Atlanta Fed president in March 2007, just over three years ago. When I started, the unemployment rate was 4.5 percent. Today, the rate stands at 9.7 percent, down from a high of more than 10 percent in October.

I view unemployment as a daunting economic challenge—and very likely a dominant political issue—of the period ahead. So, for the next few minutes, I'd like to attempt a deeper examination of the topic of unemployment.

Unemployment is a multifaceted problem. I will comment on what happened to labor markets through the recession, the current state of employment and unemployment in the country, and what has to happen to bring unemployment down to its optimal level. I will touch on trends in labor force participation, underemployment, job destruction and creation, and structural dimensions of unemployment.

Employment situation

First, let me relate what has happened since the start of the recession. Today, there are about 130 million payroll jobs in the United States, and that number is about 8.4 million lower than at the beginning of the recession. At its peak in January of last year, monthly job loss reached 779,000.

It's evident that a lot of jobs were lost. Job loss was very broad based, and the resulting unemployment has been of long duration. That said, men were disproportionately affected during this recession, specifically young men. Men's share of unemployment was greater than their share of the labor force.

Given troubles in the housing sector, it is not surprising that the construction industry has shed 26 percent of its jobs—a decline of almost 2 million jobs since the start of the recession. The manufacturing industry has shed 16 percent of its jobs, with an employment decline of 2.2 million, of which about one-fourth is related to declines in the housing sector. The construction and manufacturing labor markets are dominated by men, as reflected in their disproportionate increase in unemployment. These industries are unlikely to return to prerecession levels of employment any time soon. The challenge ahead is transitioning workers—whether men or women—to areas of growth.

About 15 million people in the United States are unemployed. Of these, about 70 percent are covered by some type of unemployment insurance, and half of those are covered under federal extended benefit programs. These extended benefit programs are helpful to unemployed workers making a transition to new jobs. But the programs also may partially explain the unusually high and persistent unemployment rate, with some estimating the effect to be 1 percentage point or even higher.

Also, underemployment is prevalent. The underemployed include both discouraged workers (defined as people who want to work but are not currently actively looking) as well as individuals who are working part-time but want to work full-time. The unemployment rate that combines the fully unemployed and underemployed workers is about 17 percent.

Another indication of underemployment is reduced hours of work. Average hours of work per week are still well below prerecession levels although up from the lowest point seen last fall.

Despite the weak state of labor markets, there are signs that the worst may be behind us. The rate of job loss is slowing. The rate of decline in payroll employment has been close to zero in the last couple of months. Also, while initial and continuing unemployment claims are at historically high levels, both have fallen.

Another bright spot is temporary employment. The temporary services sector shed more than 800,000 jobs during the recession but has seen a notable increase since last fall. This improvement is noteworthy as temporary employment is often viewed as a leading indicator.

Deconstructing unemployment and labor market rigidities

The normal state of affairs in the country's labor market is a dynamic mix of separations from employment and new job creation. There are two causes of separations—layoffs and voluntarily quitting a job, or so-called quits. The BLS began collecting data on these factors in 2000.

In 2008 and 2009, layoffs surged. Fortunately, the number of layoffs per month has recently returned to prerecession levels.

In addition, quits are at a decade-low level likely in part because of the uncertainty of job availability.

Today's slow pace of employment gains is due more to the slow pace of job creation, not the high rate of layoffs. Job gains, as conventionally understood, require two things: a vacancy and a worker able to fill that vacancy. For most of 2009, vacancies were relatively flat while unemployment continued to rise. This condition suggests the existence of what labor economists call "match inefficiencies."

There are two key types of match inefficiency. One is geographic mismatch. In 2008, the percentage of individuals living in a county or state different than the previous year was the lowest recorded in more than 50 years of data. People may be reluctant to relocate for a new job if the value of their house has declined. In addition, many who would like to move are under water in their mortgage or can't sell their homes.

The second inefficiency is skills mismatch. In simple terms, the skills people have don't match the jobs available. Coming out of this recession there may be a more or less permanent change in the composition of jobs. Skill mismatches require new training, and there is evidence that adult education institutions have responded to this need. For instance, officials at Miami-Dade College in Florida, which is the largest college in the country and a grantor of associate and vocational degrees, told us they have recently seen a strong increase in enrollment, especially of men in their 20s.

This evidence of retooling is encouraging, but, to be realistic, structural adjustment takes time.

Prospects for labor market recovery

Looking forward, the consensus forecast for March is that the economy will add 200,000 new jobs. That number includes a boost from temporary government hiring for the census.

However, according to an Atlanta Fed estimate, we need to add about that number to payrolls each month for the next year to bring unemployment down a full percentage point. This estimate assumes that the growth in the labor force stays in line with the growth in the population.

All things considered, labor market trends appear to be headed in the right direction. But it's quite possible the recovery could be well advanced before any significant reduction of unemployment materializes. It's also quite possible circumstances justifying the start of a cycle of policy tightening will develop well before the unemployment rate has found a satisfactory level.

A realistic level might be above the level I saw when I joined the Fed. I do believe the structural rate of unemployment has risen. Calibrating monetary stimulus to a goal of bringing unemployment fully to prerecession levels would be a mistake.

So let me now comment on how I'm thinking about the relationship between the Fed's employment mandate and monetary policy.

Implications for monetary policy

As you know, monetary policy is highly accommodative. And I think this stance is appropriate at present. I continue to support the substance of the policy the FOMC articulated in recent meetings. That is, economic conditions warrant a low federal funds rate target for an extended period. Markets are highly interested in the meaning of "extended period." I don't think it is appropriate to talk in terms of a specific timeframe or number of meetings. As long as inflation remains subdued and inflation expectations anchored, a key factor for me is improvement of employment markets.

Going forward, I will be looking for signs that employment gains are likely to repeat and accumulate and, once achieved, are likely to be durable.

What might such signs be? One indication would be that the process of job creation is improving. In January, we saw a sizable increase of job openings, according to the BLS. I'm looking for that to become a trend. A second sign would be a decline in the measured rate of underemployment. And the third sign would be a string of employment gains large enough to appreciably move the unemployment rate down over time.

There are hopeful, if tentative, signs of improvement in employment markets. We have a long way to go, and for that reason I believe it is premature to assume an imminent reversal of the Fed's accommodative policy. But you can interpret the fact that I am here discussing the conditions under which such a reversal will be appropriate as an indication of my conviction that we are, finally, moving in the right direction.

Contact: Jean Tate 404-498-8035

RELATED LINKS: Play Speech MP3 • Play Question & Answer Session MP3 • Dennis Lockhart's biography • Speaker's Bureau • Atlanta Fed Speeches