

Sources of Employment Uncertainty

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Thank you for the opportunity to speak at the college's annual business and industry breakfast. I want to congratulate Atlanta Technical College on being named the best community college by *Washington Monthly*. ATC certainly deserves such praise, but I think community and technical colleges in general deserve praise for their essential role in so ably preparing students for America's always fluid and still weak employment market. I am aware that a high percentage of community and technical college students are older than 30. In the case of ATC, almost 45 percent are over 30 and more than 21 percent are over 40. ATC and its sister institutions do a tremendous service in upgrading the skills and retooling workers in our economy and smoothing the adjustments—both macroeconomic and personal—that are necessary in a dynamic, open economy.

This morning I want to focus on what might be viewed as a puzzling and frustrating aspect of the economic recovery that is under way. Most indicators suggest that overall economic activity stopped contracting and began growing again starting around July 2009. So the economy is approaching 12 months of sustained recovery, and yet not much has happened in employment markets to reduce the high level of joblessness.

How can that be? During the last three quarters, gross domestic product (GDP) has expanded at an average annualized rate of 3.6 percent. Current estimates point to GDP growth of around 3 percent in the current quarter. These numbers are not off-the-charts strong, but they represent solid aggregate economic performance. Why haven't we seen rehiring accompany this growth? Why hasn't employment recovered at the same pace as the overall economy? Well, employment always lags recovery to some extent. Following the previous two recessions, where recovery has been modest, we've seen weak job growth.

The answer also lies in a surge in labor productivity growth, that is, output per hour of work. This productivity growth has allowed the economy to expand and firms to record better sales and profits without yet adding many workers to payrolls. Historically, productivity has always been strong just after recessions. So the pattern we're seeing is not abnormal.

Recently my staff and I have been trying to gauge the sustainability of recent strong productivity growth and its impact on prospects for reduction of unemployment. In the long run, labor productivity growth is the friend of all of us. It fuels broad-based improvement of living standards. Short term, productivity gains may be the nemesis of those whose prospects depend on job creation.

The Federal Reserve's monetary policy mandate from Congress is to pursue both maximum employment and low inflation. The possible tension between productivity and employment is a subtext of the larger story of economic growth and inflation and the question of whether there is a short-term tradeoff between the two. So I will try to connect the employment and productivity outlook to my views on appropriate monetary policy.

I should emphasize that what you'll hear this morning are my personal views. They are not necessarily shared by my colleagues on the Federal Open Market Committee or in the Federal Reserve System.

Economic summary

Let me set the scene with a quick summary of current economic conditions. As stated earlier, the broad national economy is in recovery as indicated by GDP growth for almost a year.

In the middle of last year government spending stimulated most of the economic growth. In the fourth quarter of 2009 and the first quarter of this year, inventory adjustments drove a lot of economic activity. Consumer activity over the last few months has exceeded the expectations of many analysts. This activity has occurred even while American households continue to deleverage, that is, pay down their debt. Business investment in equipment and software has been surprisingly strong considering the consensus forecast of modest growth ahead. Both consumer spending and business investment in capital goods may just be evidence of short-term and temporary satisfaction of pent-up demand following deferral of spending during the recession. The end game of this evolution is solid and broad-based final demand.

Although, as I have suggested, risks remain to a forecast of sustained growth, I think confidence is warranted. The mix of sources of strength underpinning the recovery will evolve. Former contributors to growth will beget new contributors.

As a consequence of the growth we've seen and the positive outlook, employment market conditions have begun to improve. Payroll employment is estimated to have risen by about 560,000 during the first four months of this year.

We will get another important reading on employment markets tomorrow. Even if that report shows further gains in employment (some forecasters expect 500,000, with 400,000 being U.S. Census jobs), it's fair to say there will remain a large excess of workers looking for jobs relative to the demand for workers in the economy. Total jobs lost in the recession and immediate aftermath approach 8 million. This gap is likely to close only gradually. And, further, the resulting slow growth of wages and salaries has the potential to limit growth of consumer spending for a while.

I'll round out this snapshot of the economy with a couple of comments on inflation. Because of the downward pressure exerted by the recession and the relatively modest recovery so far, the rate of consumer price inflation has slowed quite a lot. This recent disinflation has not yet translated into decline of longer-term inflation expectations. Most measures of inflation expectations have remained pretty stable. Overall, for now, the inflation picture is not a major concern, in my view.

So, to sum up, we've had growth of the economy and improvement in jobs markets. Among the factors pushing the economy forward—along with personal consumption, business investment, and inventory effects—is labor productivity. I'd like to take a deeper look at this element of economic progress and its relationship to employment.

Role of productivity as an element of economic growth

To simplify a bit, there are two causes of labor productivity growth. The first is improvements to technology that help people work better. The second is people working harder. People might be working harder because the companies they work for have cut employees in response to tough economic times and are trying to keep production levels, revenues, and earnings up with fewer people. Technological improvements tend to be durable, but squeezing more and more out of a diminished and, in many cases, reorganized workforce may not be sustainable.

In recent months, the U.S. economy has enjoyed especially strong productivity growth in the business sector (averaging 6 percent per quarter over the last three quarters versus the long-run average of 2.6 percent). I suspect that much of this productivity growth is of the second, work-harder type. Many employers reacted to the downturn by aggressively cutting their workforces, reorganizing remaining workers, and cutting other costs. They have reacted to the upswing by holding employment at or near recession levels, seeking efficiencies in supply chains, investing in labor-saving automation, and generally tweaking their business models to operate more efficiently than before the recession. We've heard this story frequently in anecdotal accounts of our directors and business contacts across the Southeast.

As long as efficiency and productivity gains can be achieved in this way, employers may remain hesitant to hire. So a key question with immediate relevance for the recovery and employment is, how long can firms ride this productivity growth before having to yield to new hiring to support greater activity?

International comparison

Before venturing a view on that question, let me frame an international context for better perspective on the ups and downs of labor productivity in this country. Even though the timing and extent of the economic downturn were similar in most advanced economies, resulting labor productivity patterns have varied widely. For instance, in the United States the level of GDP declined by 3.7 percent, while the unemployment rate rose 4.5 percentage points during the recession. By contrast, in Germany the cumulative GDP decline was about 6 percent, while unemployment rose by only about 1 percentage point. Germany—and several other advanced economies—experienced a serious recession but a significantly smaller increase in unemployment in comparison with the United States.

It's striking that the United States, even in good times, tends to see much greater flows into and out of unemployment rolls than other countries. This is an aspect of the vigorous turnover of jobs in our economy—the regular destruction and creation of jobs in a dynamic market economy. Other countries tend to experience relatively less such movement in labor markets over time. Their experience probably reflects institutional factors such as social laws that make separating employees more expensive and lower quotients of entrepreneurial activity.

It can be argued that the comparative absence of labor market rigidity in the United States results in comparatively large movements over time of workers between industries and sectors and across geography. We in the United States simply have more flexible employment arrangements across the economy, allowing employers to adjust rapidly and aggressively to downturns and requiring workers to be agile in response to changing conditions.

There is a point to be made for the benefit of ATC students here: Beyond the specialized skills you are acquiring in the college's excellent programs, there will be a high return to work skills that make you versatile and mobile—for example, computer and IT skills.

Outlook for labor productivity and employment

To return to the question I posed earlier, slightly rephrased: Will high productivity growth continue and have the effect of impeding employment growth?

I do not expect the recent outsized productivity growth to continue indefinitely and become a new, permanently higher trend rate. Some degree of "wait and see" behavior is at work and is no doubt reflected in the productivity numbers. With growing economic momentum, deferral of hiring will become riskier.

Some employment gains should result as labor productivity levels out and falls back over time to something resembling the historic trend rate. But the pace of hiring is likely to be gradual. Current data on the use of part-time workers suggest that businesses have some scope to increase hours without hiring new full-time employees. And there are other, more structural obstacles to the rapid reemployment of the jobless. Some jobs in the construction sector and certain manufacturing industries are likely permanently lost, requiring some amount of migration of workers to other sectors. And, for a time, skill and geographic mismatches may frustrate employers willing to hire.

Also, the weight of uncertainty about the future business environment makes a gradual pace of employment progress a reasonable assumption. I hear often from members of the business community that uncertainty regarding federal, state, and local fiscal fundamentals and regulatory rules-of-the-game are feeding reticence to pull the trigger on new ventures, new hires, and new investments. The recent European sovereign debt and banking pressures have added to uncertainty in financial markets.

Sizing all this up, I expect recovery in the medium term to be neither jobless nor job rich.

Appropriate monetary policy

As the recovery proceeds—as I believe it will—a central concern of monetary policy will be when and by how much the Federal Reserve raises the base level of interest rates.

The Fed has held its interest rate policy at close to zero for about a year and a half. This has been done to foster conditions that would end the contraction of the economy and then encourage recovery. Again, I believe a modest recovery has been under way for almost 12 months.

As I stated earlier, the Fed has a dual mandate from Congress to keep inflation low and promote maximum employment.

I've put forward the view that inflation is not currently a major concern. So one might ask, do you believe the base interest rate must remain near zero—at its current level—until unemployment is reduced substantially and most of the employment lost in the recession has been restored?

I'm not convinced that will be necessary. I continue to support the current stance of interest rate policy. But the time is approaching when it will be appropriate to consider recalibrating interest rate policy. I do not believe that time has yet arrived. The conditions that require a change of policy are not yet at hand. However, as the economy continues to improve and financial markets find firmer ground, extraordinarily low policy rates will not be needed to promote recovery and will become inconsistent with maintaining price stability.

The implication is that the policy rate may have to begin to rise even while unemployment is considerably higher than before the recession. I'm very concerned about unemployment, and certainly employment trends should be a critical consideration in setting policy. But I accept that good policy, even in circumstances of unacceptable levels of unemployment, may incorporate higher interest rates.

Again, I want to acknowledge the vital role that Atlanta Technical College plays in our community in equipping young people, and some slightly older people, to prosper even in difficult times. You do important work.

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