SPEECHES

The Challenges of Understanding Labor Market Trends

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Key points

- Atlanta Fed President and CEO Dennis Lockhart says that as the Federal Open Market Committee contemplates how to assess "substantial improvement" in labor markets, it will be helpful to consider the complexity and dynamism surrounding those markets and how improvements are measured.
- Lockhart outlines several moving parts in this area, including the huge amount of movement within the labor pool, the different forms of employment, the decline in labor force participation, variations in labor market performance across regions, and how new jobs are generated.
- Lockhart notes that not all important trends are captured well in the data, so reliance on a single statistic to judge the health of the labor market may not be sufficient. Only by analyzing broader trends can a clearer picture emerge.
- Lockhart suggests that a holistic framework for assessing labor market improvement may expand beyond the headline unemployment rate and payroll jobs numbers to include elements such as lower unemployment rates driven by increased flows of job seekers, growing public confidence as measured by increasing labor force participation that is positively motivated, employment gains that are associated with reductions in underemployment, and forward-looking indicators of labor market health such as falling claims for unemployment insurance.

Introduction
I'm happy to be back in Chattanooga. Chattanooga stands out among mid-sized cities in the Southeast and, indeed, nationally as a place that has mustered the civic leadership and popular support to change the trajectory of its economic destiny. You have seized economic development opportunities, generated new jobs to replace those that were disappearing, and made investments in workforce development that should pay dividends for many years. I have frequently cited Chattanooga as a city where interesting and impressive things are happening. I'm sure many who are responsible for the inspiring story of Chattanooga are in this room.

Your city's resurgence cannot, I suspect, be attributed to a single strategic decision or program of action. But to highlight one thing—you have done something about employment. Today I want to talk about the challenges of understanding employment trends and prospects at the national level, particularly as they are linked to recent decisions by the Federal Open Market Committee (FOMC) as regards monetary policy. I'll begin with a brief summary of the country's economic situation and outlook. I'll then review the current posture of Fed policy and draw attention to what is now a defining aspect of our policy—that is, a focus on improving employment outcomes. And, finally, I'll share some work-in-progress thinking on how to assess the "substantial improvement" in labor markets that we will need to see before discontinuing the bond-buying program popularly known as QE3.

All the views I will express are my personal views. My colleagues on the FOMC and in the Federal Reserve System may not agree.

Summary of current economic situation and outlook
Let me try to summarize in a few words the current state of the economy and the medium-term outlook. The advance estimate of real GDP growth in the second quarter was posted a week ago. It came in at 2 percent. The number is subject to revision in the weeks ahead and could be revised either lower or higher, but I doubt revisions will be so substantial that the basic narrative will change.

In my view, the economy has been operating at a pace of growth of around 2 percent since recovery began 40 months ago. There have been quarters of faster growth and certainly quarters that clocked in below 2 percent, but the summary trend rate approximates 2 percent. The economy is stuck in a slow-growth mode.

The slow and halting progress in bringing down unemployment is mostly attributable to the slow pace of growth. In the prerecession period, the national unemployment rate reached a low of 4.4 percent in May 2007. Unemployment peaked at 10 percent in October 2009. And, as you know, the unemployment rate was 7.8 percent in September of this year. We will get another reading on unemployment tomorrow.

Inflation has been well-behaved for the better part of two decades, and that trend has continued over the past few years. Headline inflation has spiked in some quarters because of volatile energy and, to a lesser extent, food commodity prices. But the underlying trend looking back, and I would add looking forward, is close to the FOMC's official target of 2 percent. Inflation expectations—which are a very important factor in determining realized inflation—remain stable.

A mix of positive and negative elements is at work in the economy at this juncture. The housing sector is showing definite signs of improvement as indicated by sales, building activity, and rising house prices. Rising house prices affect consumer confidence, which contributes to growth in consumer spending. Consumer activity has continued to grow at a modest pace in spite of a still-weak economic picture overall.

In contrast, business investment has slowed in recent quarters. I hear a lot of anecdotal support for the view that many decisions are on hold pending the election results and the hoped-for resolution of the fiscal cliff problem. Europe is also top of mind. At the moment, we are in a bubble of uncertainty that is restraining the economy.

As to the outlook beyond these immediate concerns, I think the most plausible forecast is continued modest growth with gradual employment gains. Around this more-of-the-same forecast are downside risks of economic shocks as well as chances of somewhat better economic performance if certain risk elements are eliminated or attenuated.

Current stance of monetary policy
One aim of the current set of monetary policies, in my view, is to construct a floor of support under a still-vulnerable economy. To this end, monetary policy continues to be very accommodative. Let me detail its components.

The policy interest rate remains at effectively zero. When the policy rate cannot go any lower, central banks resort to so-called balance sheet policies to add further stimulus. In the United States, the Federal Reserve has implemented such programs by purchasing Treasury securities and mortgage-backed securities issued by government-sponsored enterprises. This has the effect of increasing the scale of the Federal Reserve's balance sheet.

The FOMC recently initiated its fourth round of policy initiatives using the balance sheet as the delivery vehicle of stimulus. On September 13, the Committee announced a new program of bond buying concentrated in agency mortgage-backed securities.

This action supplements what the public knows as "Operation Twist," due to end in December. Operation Twist is the Fed's simultaneous purchase of long-term Treasury securities and sale of short-term Treasuries designed to put pressure on longer-term rates. The short-term sales have the effect of neutralizing the potential balance sheet scale effects. In addition, since September 2011, the Fed has been reinvesting proceeds of maturing Treasuries and mortgage-backed securities to avoid any semblance of tightening.

What distinguishes the newest round of bond purchases from earlier ones is the open-ended nature of the commitment. In its post-meeting statement on September 13 , the FOMC said, "**If the outlook for the labor market does not improve substantially**, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate **until such improvement is achieved** in a context of price stability."

So what is meant by *substantial improvement in the outlook for labor markets*? I want to devote the remainder of my time to that question. Arriving at an answer is not so straightforward.

Complexity and dynamism: Many moving parts of employment market reality
The U.S. labor market is complex with many moving parts. I won't do justice to its complexity and dynamism in my few minutes here today, but let me highlight five important aspects of the employment environment in the United States.

First, there is a huge amount of movement within the labor pool. An estimated 17 million people change their employment status each month. That is more than 11 percent of the total labor force. What I'm calling "movement" includes people finding jobs; people separating from jobs because they quit, are fired, or are laid off; people entering or reentering the labor market to look for a job; and people leaving the labor market for some other activity.

Second, being employed takes different forms—full time, part time, temporary, contract worker. Approximately 115 million people currently hold full-time jobs. That's 7 million fewer than before the recession. There are about 28 million people with part-time jobs. That's 3 million more than before the recession. Some part-time workers are satisfied with their status, while some are working part time but really want a full-time job. There are considerably more in this underemployed category—called "part time for economic reasons"—than before the recession.

A third aspect is the decline in the rate of participation. Participation in the labor force has been falling since the early 2000s. Some of the decline is attributable to factors that are independent of the current economic situation. One ongoing participation trend relates to young adults. This cohort is pursuing postsecondary education and not entering the work force as early as in the past.

The largest such factor is demographic—an aging population. An obvious point: older people are more likely to exit the labor market into retirement. The first group of baby boomers is now reaching traditional retirement age. Partially offsetting what would seem to be an inevitable trend is a tendency of older workers to remain attached to the labor market longer than earlier cohorts. The participation rate of older workers in fact has been rising steadily over the last two decades. This reflects factors such as improved health and the need to build, or restore, retirement savings. So, there is a trend within a trend, so to speak. The trend is not one direction only.

While some of the drop in participation reflects longer-term trends, some of it is certainly attributable to recent economic conditions. For example, just over 1 million more individuals than before the recession indicate that they are willing and able to work but are not actively searching. If you are not looking, you are not part of the unemployment calculation. It is likely a large share of these individuals considered "marginally attached" to the labor force will return to the labor market when conditions improve.

This discussion highlights that movements in labor force participation can occur for benign reasons, like population aging, and not-so-benign reasons, like a rise in the number of marginally attached workers. Labor force participation can move the unemployment rate both up and down. It is sometimes difficult to interpret changes in the unemployment rate as unambiguously good or bad.

Fourth, there are meaningful variations in the performance of labor markets across regions and sub-markets within regions. It's important, I believe, to consider whether weak employment conditions are widespread or concentrated in a few regional labor markets reflecting idiosyncratic local circumstances. Neither North Dakota nor Michigan is representative of the nation overall.

A fifth aspect of the employment picture relates to generating new jobs. Job creation and job destruction are occurring continuously and, to an extent, go hand in hand. Research shows that new and early-stage businesses account for a significant share of jobs created. At the same time, a high fraction of early-stage businesses do not survive beyond five years. When we think about job creation in our society, we should think, at least in part, of impermanent jobs that disappear due to business failure and that are replaced by jobs in other, often newer, entrepreneurial ventures, many of which also fail in time. The reality is one of continuous churn.

We would like to have more and better information on the formation of new businesses and the jobs they create. The statistical tools in this area leave something to be desired. We do, however, have good and reasonably current information on job openings and job postings of a broad cross-section of businesses including both mature and early-stage firms.

I hope this commentary gives you a sense of how complex and dynamic the country's employment market truly is. There is much we don't know about the labor market. Not all important trends are captured well in the data. The data are prone to normal measurement error and revision. In my view, reliance on a single statistic to judge the health of the labor market may not be sufficient.

In support of this opinion, let me contrast recent official job growth numbers with the official unemployment rate. Total monthly employment gains at the national level in the first quarter of this year averaged 225,000. That pace slowed in the second quarter to a monthly average of 67,000. Although job growth moved higher in the third quarter, the month-to-month progression from July to September showed a decline. Job growth has hardly begun to build positive momentum.

Meanwhile, the unemployment numbers are showing a somewhat different picture. Nationally, the unemployment rate changed little during the first half of 2012. From January through July, the unemployment rate hovered between 8.1 percent and 8.3 percent. By September, the rate had fallen half a percentage point from 8.3 percent as of July to 7.8 percent a month ago.

For policy purposes, I think it's appropriate to be cautious about relying on a single indicator of labor market trends—for example, the unemployment rate—to determine whether the condition of "substantial improvement" has been met. The official national unemployment rate published by the Bureau of Labor Statistics is the most prominent statistic in the mind of the general public. As a policymaker, I want to have confidence that a decline of this headline number is reinforced by other indicators and evidence of broad labor market improvement in its many dimensions. The challenge my FOMC colleagues and I will face is communicating in simple and trackable terms what this phrase "substantial improvement" means while respecting the complex reality of many moving parts.

A working concept of "substantial improvement"
Remember that at the beginning of my remarks I characterized my thinking on the meaning of "substantial improvement" as a work in progress. In that spirit, let me share a qualitative framework for defining "substantial improvement."

The starting point certainly should be the headline unemployment rate and the payroll jobs number. The interpretation of movements in these two statistics would be enriched and reinforced by a review of additional data elements.

Here are examples of what I would look for:

First, I would look for lower unemployment rates that are driven by increased flows of job seekers into employment. I would not interpret discouraged workers dropping out of the labor force as a sign of improvement, even if the unemployment rate falls as a consequence.

Conversely, I'd like to see growing public confidence in the labor market as measured by increased movement of people from out-of-the labor-force status into the labor force—that is, growing labor force participation. I would interpret a reduction in the number of marginally attached workers as a sign of improvement, even if the unemployment rate goes temporarily higher.

Third, I'd look for employment gains that are associated with reductions in underemployment. I would interpret a pickup in job growth less positively if it is associated with increases in part-time jobs for people who seek full-time work.

Finally, I'd like to see signs that improvements in all these indicators are gaining momentum and are sustainable. A framework for assessing labor market conditions needs to include forward indicators of labor market health, such as falling claims for unemployment insurance.

Close
To sum up, the FOMC continues to marshal an aggressive attack on the serious employment challenges that beset the nation. The Committee has conditioned any further monetary stimulus on improvement—**substantial improvement**—in labor market prospects. In my view, it's desirable to put more definition around the term "substantial improvement" since so much rides on the Committee's assessment of that economic milestone.

In closing, I again want to express my admiration for what's been accomplished here in Chattanooga. Back in 1969, CBS news anchor Walter Cronkite called Chattanooga the dirtiest city around. Today you are aptly known as the "scenic city." While achieving this visible transformation, you have transformed the economy of the city in so many fundamental ways. This afternoon, I'm taking a tour of the Volkswagen plant to see firsthand evidence of what you have done.

Thanks for having me here.

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