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Labor Markets and the U.S. Economic Outlook

With two years of solid growth, the economy has moved well past the recession and now lies squarely in an expansion mode. Most of the earlier questions surrounding the strength and sustainability of the recovery—namely weak job growth and sluggish manufacturing activity—have faded.

Now that the expansion is solidly in place, the issue of inflation becomes increasingly important. The recession and relatively slow growth of 2002 led to the emergence of a significant output gap. By output gap, I mean that an unusual amount of the economy's labor and capital resources went underutilized. With such slack in the economy, inflationary pressures were minimal.

Since 2003, growth has been above potential, so the output gap is shrinking. In response, the FOMC has been removing policy accommodation at a measured pace. The question now is: how much of the output gap remains? If the gap is still significant, lingering slack resources will diminish inflationary pressures, and policy accommodation can be removed at a gradual pace. However, if the output gap has nearly closed and inflation becomes more of a threat, then monetary policy can respond accordingly.

So today I'd like to discuss some of what we know about the current state of the output gap. In particular I'd like to focus on assessing the amount of slack in labor markets.

Recent Economic Conditions

During the 2001 recession, output fell below potential, creating the gap. The gap widened further because of weak growth during the early stages of the subsequent recovery. The recovery was restrained, in part, because of the relatively mild nature of the recession and, in part, because of a series of shocks that hit the economy. 9/11, revelations of corporate malfeasance, and the buildup to the war in Iraq all led to heightened

uncertainty and diminished confidence about the economy. In this environment, firms were reluctant to increase spending. They were especially reluctant to hire new workers. As a result, by mid-2003 payroll employment was more than 2.5 million below its pre-recession peak.

In response to these developments—and given the outlook for low inflation—the Fed aggressively eased policy. We lowered the federal funds target to 1 percent and stated that such accommodative policy could remain appropriate for a considerable period of time. Partly because of this very accommodative monetary policy and expansionary fiscal policy, the economy improved significantly. Over the last two years, real Gross Domestic Product—the broadest measure of output in the economy—has grown at an average rate of 4.2 percent. Firms increased their capital spending and hiring. Employment began to increase in mid-2003 and over the last 12 months the economy has added almost 2.4 million jobs and employment is now above its pre-recession peak. The February labor market report released last Friday confirmed that employment growth continues at a solid rate. This transition from an expansion supported by accommodative fiscal and monetary policy to one broader-based is essential for the expansion to be self-sustaining.

The Midwest Economy

Of course, conditions vary by region and industry. Here in the Midwest, the recession hit harder than in the rest of the nation and the economy has been slower to recover. Employment began to decline earlier and remains 3.7 percent below its pre-recession peak.

The regional economy has largely been shaped by the performance of the manufacturing sector, and in particular, the domestic automakers. The Big Three have been struggling to maintain their market share in an increasingly competitive auto industry. And foreign automakers have built their new plants in southern states rather than in the upper Midwest. The Big Three's weakness has restrained activity in other sectors of our region's economy. This has been most apparent in Michigan, where the unemployment rate has been rising for the past year. At 7.3 percent, Michigan now ties Alaska for the highest state unemployment rate in the country.

Despite these weaknesses, the Midwest economy as a whole continues to expand at a moderate pace, and many of our business contacts report a steadily growing demand for workers.

The National Outlook

Going forward, a number of factors suggest growth will remain solid nationally and strengthen in the Midwest. In particular, productivity growth continues to be strong, raising incomes and stimulating demand. Moreover, despite our recent rate increases, monetary policy remains accommodative and so is providing ongoing support to economic growth. In our recent Monetary Policy Report to Congress, the central tendency of the projections by Fed Governors and Reserve Bank Presidents is that real GDP will grow between 3¾ and 4 percent in 2005 and about 3½ percent in 2006. Such growth rates should continue to shrink the output gap and lower the unemployment rate. Our forecasts call for unemployment to fall to between 5 and 5¼ percent by the end of 2006. Meanwhile, the core PCE inflation rate is expected to remain between 1½ to 1¾ percent this year and next.

A key element of this forecast is how much slack is left in the economy and when the output gap will be fully closed. Unfortunately, making this judgment is as much art as it is science. We look at a wide range of data and do a variety of analyses when trying to gauge the output gap.

A number of indicators are important to examine, such as capacity utilization, commercial vacancy rates, and the factors underlying long run trends in productivity growth. Many others have to do with labor market conditions. We look at these markets closely, because labor accounts for roughly two-thirds of all business costs.

Unemployment and the Labor Force Participation Rate

The most often cited measure of slack in the labor market is the unemployment rate. The unemployment rate has already declined a good deal, from 6.3 percent in June 2003 to 5.4 percent now. This is not far from the 5 or 5¼ percent rate that many analysts suggest could effectively be full employment.

However, the unemployment rate potentially understates the degree of labor market slack. People who become discouraged over their prospects for finding jobs often stop looking for work. In the Bureau of Labor Statistics calculations, these people are not counted as unemployed because they are not counted in the labor force. Although the number of discouraged workers always increases during recessions, observers believe that this has been especially notable during the current cycle. They point to the unusually large decline in the labor force participation rate—the fraction of the population either working or looking for work. The participation rate has fallen 1.5 percentage points over the last five years. If all of these people instead had been looking for a job, the unemployment rate would be over 7 percent. Although this is an important consideration, this calculation most likely exaggerates the amount of slack in the labor market. The drop in the participation rate may well have been from an unsustainable level. The hot job market in the late 1990s drew in many people who were unlikely to remain in the labor force on a permanent basis.

There are other indicators that attempt to measure the number of discouraged workers or the difficulty in finding a job. Some of them indicate that there is a bit less slack in the labor markets than the unemployment rate would suggest. Others indicate a bit more. On the whole, however, we don't believe that the official unemployment rate understates the amount of slack in the labor market by a large margin.

So what does explain the decline in labor force participation? Most of the drop in participation comes from declines within two demographic groups—young people and women. The aging of the baby boom generation is also playing a role.

About half of the decline in overall labor force participation is the result of a sharp drop among 16 to 24 year olds. Before the recession, around 66 percent of this age group was in the labor force. Today, only about 60 percent are. At the same time that they have been dropping out of the labor force, they have also been going to school more. This may just be their way of making the best of a bad situation. School enrollments have often increased during weak labor markets.

But, the decline in participation among 16 to 24 year olds has been larger than in previous economic downturns. So, perhaps, a portion of the decline in young people's labor force participation reflects a calculation that the long-term benefits of more education outweigh the short-term costs of less current income from work today. The economic return to education has risen greatly over the last generation. And though many groups of young people have responded to these increased incentives by staying in school longer, many groups have

not. If recent developments reflect a long-running increase in school attendance, it would be beneficial for the nation going forward.

The other demographic group with a significant decline in labor force participation is women between 25 and 44 years old. To some, this is especially surprising, given that the longer term trend showed a dramatic increase in labor force participation for this group of women: from 40 percent in 1960 to 77 percent in 2000. During this time, new technologies have reduced the time needed for housework, and cultural changes have encouraged women to work outside the home. The women of my generation entered the labor force in greater numbers than the women of my mother's generation. And the women of my daughter's generation participate in greater numbers than the women of my generation.

Since 2000, however, labor force participation for 25 to 44 year old women leveled off and then fell to 75 percent. Although we do not know exactly why participation rates for women have been falling, we can explain why they are no longer rising. The generational differences appear to be narrowing and the steady increase in female labor force participation may have nearly run its course. It's likely that the women of my granddaughters' generation will participate at the same rate as my daughter's generation.

Another important demographic trend to consider is the aging of the baby boom generation. The oldest boomers are about to reach age 60, and many of them are starting to leave the labor force. This explains about a sixth of the decline in labor force participation, according to our calculations.

Where does all of this leave us? While we do not have a full explanation for the decline in labor force participation since before the recession, it is likely that a portion of the decline is due to long-running factors such as increased desire for education by young people, the leveling off of female participation, and the aging of the baby boomers. Another part likely reflects the undoing of some unsustainable increases in participation that occurred during the late 1990s. But part of the decline can also be attributed to a modest increase in the number of discouraged workers. And we know from experience that as the economy continues to strengthen many of these people will be drawn into the workforce. So as the economy continues to expand, the participation rate will increase, providing some additional buffer against the kind of shortages and bottlenecks often associated with rising inflation. But, it probably is unrealistic to expect a return to the levels of 2000.

This means that there is somewhat more slack in the labor market than the unemployment rate suggests—but not much more. Combined with the moderate slack in other sectors of the economy, this suggests that the current level of output is only modestly below the level of potential output.

But I also want to emphasize the uncertainty of this assessment and how difficult it is to quantify the output gap. So, while we don't think that the gap has fully closed, we must be vigilant for any signs of emerging resource constraints generating inflationary pressures.

Energy Prices

Another inflation concern is energy prices. Oil prices have risen rapidly over the last several weeks, returning to their peak of last fall. Moreover, the price of oil for future delivery up to five years ahead indicates that oil prices are expected to remain well over $40 per barrel.

Will higher oil prices eventually lead to a permanently higher inflation rate? Not necessarily. Suppose oil prices stop rising and stay at their current high levels. Once the cost adjustments in the economy are complete, there will be no reason for prices to rise further, and inflation should return to its earlier rate. In other words, there would be a temporary spike in the overall inflation rate. This process, however, may take time to work through the economy, so that inflation may be elevated for more than a short period.

There is a concern, though, that when people see prices rise, they may come to expect them to continue to rise. We saw this in the 1970s when higher expected inflation became built into business and household plans. When I was in business in the late 1970s, we would estimate our cost increases of say 5 percent and then fully expect to be able to increase the prices we charge by a similar amount to offset the cost increases. Today, firms often assume zero price increases in their planning.

This illustrates why inflation expectations are important. So, the Federal Reserve must monitor inflationary pressures and expectations carefully, and be prepared to act if they threaten price stability. Thus far, though, we have seen little evidence that long-run inflationary expectations have risen.

First, current inflation remains low. The Consumer Price Index rose 3.3 percent over the last year. But taking out the effect of volatile food and energy prices, the core CPI moved up just 2.2 percent. The broader price index of personal consumption expenditures rose 2.2 percent in 2004, with the core index excluding food and energy prices rising just 1.5 percent. Back in 2003 when we were concerned about the possibility of unwelcome disinflation, the core PCE rose at a rate of 1.3 percent, not far below the rate from last year.

Long-term inflation expectations also remain in check. Surveys of households and professional forecasters suggest no increases. In addition, long-term inflation-protected Treasury securities imply well-contained expectations.

Conclusion

By any measure, monetary policy remains accommodative. Accommodative policy has been necessary to support economic growth, but as the economy continues to strengthen and employment picks up, interest rates will need to return to a neutral level.

We started this process last June, and since then, we have raised the federal funds rate six times from its 40-year low of 1 percent to 2½ percent. The degree of policy accommodation that was appropriate early in the expansion was clearly no longer appropriate. There is certainly more ground to cover, because even with these increases, policy remains accommodative. But given the low level of inflation, well-contained inflationary expectations, and the remaining slack in the economy, we believe we can remove the remaining policy accommodation at a pace that is likely to be measured.

Of course, we will respond appropriately to any indications of a threat to price stability. Price stability, as you well know, is essential for obtaining long run maximum sustainable growth. So, in order to give the current expansion its greatest chance to last for an extended period of time, we must keep inflation under control. And I can assure you that the Federal Reserve is committed to those objectives.