Labor Markets and Federal Reserve Policy

Additional Information

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Columbus, Ohio

June 1, 2011

Introduction

This afternoon as I talk about the economy, I will point out that the economic dislocations we have experienced and continue to experience are not without historic precedent, however scary and unfamiliar they might feel.

For example, this is a beautiful room in an equally beautiful building. But when it was constructed in 1915, the nation was recovering from the recession of 1913. The world was at war, and the unemployment rate was around 9 percent.

During that same period, the Federal Reserve was established in response to a fragile banking system and a series of financial panics. The Federal Reserve Act of 1913 instructed the Fed to prevent financial panics and bank runs by providing loans to the banking system, a narrower charge than the Fed has today.

Of course, none of us in this room remembers 1915, but many of us remember the 1970s. In 1976, we celebrated the country's bicentennial while the Cold War still raged. Here in Columbus that year, a group of feisty women who wanted a voice and a platform for public discourse formed the Columbus Metropolitan Club.

At that time, the unemployment rate was nearly 8 percent, following the recession of 1973. And policymakers worried not only about elevated unemployment, but about an inflation rate of close to 6 percent.

A year later, in 1977, Congress validated these twin concerns by changing the Federal Reserve Act, giving the Fed the dual mandate we still hold - to promote "the goals of maximum employment" and "stable prices."[i]

In some ways, the events of today mirror those of the early 1900s and the 1970s. Our own economy is only gradually recovering from a deep recession. World events such as the Arab Spring uprisings capture our attention. The current unemployment rate is 9 percent. And some are concerned about rising inflation.

At the Federal Reserve, our mandate has not changed since 1977. We remain focused on doing our part to promote maximum employment while maintaining stable prices.

Toward that end and in my role as president of the Federal Reserve Bank of Cleveland, I make sure that the perspectives and needs of the people of my District - which includes all of Ohio, western Pennsylvania, eastern Kentucky and the northern panhandle of West

Virginia - are part and parcel of the national monetary policy debate.

My fellow Federal Reserve Bank presidents and I stay close to the communities we serve - talking to business and community leaders like you - to better understand your economic concerns.

Regular discussions with businesspeople, as well as Federal Reserve Bank and branch directors around the country, provide us with timely, anecdotal accounts of the economic landscape.

This way, we see emerging trends far ahead of when they would be reflected in the economic figures - which after all are backward-looking, not forward-looking data. And we incorporate those trends into FOMC deliberations and decisions.

The FOMC, or Federal Open Market Committee, is the policymaking arm of the Federal Reserve. We meet eight times a year in Washington. At each meeting, Committee members, me included, review economic and financial conditions and determine the appropriate monetary policy to meet our long-term goals of stable prices and maximum employment.

Today, we clearly do not have maximum employment, and many people are worried about jobs. Also, it seems that stories about inflation are in the news almost every day. I'll address both of these concerns in my remarks today.

First, I'll share what recent labor market developments say about the recovery. Second, I'll look at why today's unemployment rate is still so high. Third, I'll discuss what today's labor markets reveal about inflation. Finally, I'll wrap up with a few thoughts on what all of this means for the economy going forward.

What Labor Markets Tell Us about the Recovery

I probably don't need to remind this audience that nine million jobs were lost in the recession. Since we started seeing employment gains, in February of last year, only 1.8 million jobs have been added back.

As recently as the 1980s, it was common in a recovery for the economy to return to its previous employment level within 12 months. However, during the past two recoveries, employers hired at a far slower pace. So far, this pattern of the slower pace of hiring seems to be holding in the current recovery as well. We've got a long way to go before labor markets can be described as healthy again.

Still, we've had some encouraging news over the past few months. In April, private companies created 268,000 jobs, the fastest pace in five years. April also marked 14 straight months of net job creation.

In addition, some sectors important to this region have seen substantial employment growth. For example, manufacturing employment is up both nationally and in Ohio by 1.7 percent. Here in Ohio, employment in professional and business services is up 3.5 percent, and employment in educational and health services has risen by 2.4 percent year-over-year.

Improvement is also evident in job openings, pointing to continued gains. According to the Job Openings and Labor Turnover Survey conducted by the Bureau of Labor Statistics, job openings increased in March and 70 percent of industries have increased job openings over the last 12 months.

We're also seeing a growth in hours worked per week. The Bureau of Labor Statistics reports a 34.3-hour workweek for all employees right now, up from a low of 33.7 hours per week during the recession. And manufacturing hours are up to almost 40.4 from 38.5 at the height of the recession. This is hopeful because businesses will first restore hours or overtime before they begin to add new employees.

At the beginning of a recovery, companies can avoid hiring additional workers because they can ask employees to do more work or work longer hours. But after awhile, employees have been stretched so thin for so long - forced to work longer and harder and to give ground on raises and benefits - that firms literally run out of ways to get more productivity out of them. When productivity growth is dampened, firms begin to hire again.

Taken together, these recent gains in the labor market suggest that the economy is on firmer footing and that the recovery is likely to continue. However, growth may be frustratingly slow at times.

Why the Unemployment Rate Is Still So High

Which brings me to my second point: If the economy is recovering, why is the unemployment rate still so high?

The national unemployment rate for April was 9 percent. The rate in both Columbus and Ohio has declined in recent months. In April, the unemployment rate in Columbus was 7.2 percent, well below Ohio's, which was 8.6 percent. But these rates are still high, well above pre-recession levels, when Columbus' rate was under 5 percent and Ohio's unemployment rate was just under 5-1/2 percent.

These unemployment rates primarily reflect an unhappy but true fact - employment typically picks up only well after the start of a recovery.

Still, many people wonder if this long period of high unemployment that we are experiencing marks a fundamental shift in the economy. Is it something we'll have to live with over the long haul? Is it what some are calling the "new normal"?

Some people are concerned that the large job losses we experienced in construction and finance, for example, will be permanent because there's simply no place for these workers to go in the new economy.

But research reveals that jobs are scarce in most sectors. In fact, it shows that workers who have lost jobs in construction and finance have been moving out of the ranks of the unemployed at almost the same rate as those laid off in less-troubled industries.

The problem isn't about specific industries; it's that there were large layoffs across almost all industries and we have seen a slow pace of hiring as the economy recovers at only a moderate pace. This slow pace of hiring has caused a debate about whether high- and long-term unemployment is a structural or a cyclical problem.

Structural unemployment is caused by a persistent mismatch between the skill sets needed to do available jobs and the types of workers available.

Cyclical unemployment, on the other hand, is caused by a fall-off in sales and consumer demand resulting in less reason to produce products and services…or hire workers.

The research done by the economists at my Bank suggests that most of today's unemployment is cyclical. They don't believe that structural unemployment has risen very much at all. And I support their conclusions.

Their work has been paying particular attention to the nature of the labor market by analyzing something called labor market “churn” over the last few decades. Churn is how workers flow into and out of the job market through job findings and job separations, including layoffs, quits and fires, and the ending of seasonal or contract employment.

Their research reveals that historically, the more dynamism or churn in the job market, the faster the unemployment rate returns to its "trend" rate or "natural" rate, which we believe is between 5-1/2 and 6 percent. That's the rate where unemployment would settle if there were no "shocks" to the economic system such as those we've experienced.

Today, unfortunately, the rate of churn is not returning as quickly as it has after previous recessions. The high number of unemployed persons, coupled with a growth outlook that's weaker than in past recoveries, means the adjustment back to a natural rate of unemployment will take quite some time…but I believe it will come back.

So I don't view high unemployment as the "new normal," but I also don't see it as a quickly resolvable problem either.

What Today’s Labor Markets Tell Us about Inflation

Third, let's look at what today's labor markets tell us about inflation. In fact, the connection between employment - or labor markets - and inflation is a very old issue.

In 1958, Alban Phillips, studying unemployment and wage data in the U.K., concluded that one stable curve represents the trade-off between inflation and unemployment. If unemployment goes down, inflation goes up, and vice versa.

This relationship seemed to hold for some time, but history revealed that another factor - inflation expectations - played a large role as well. In the United States in the 1970s, unemployment was high and, nonetheless, wages and prices were spiraling out of control. Over time, the public came to expect higher inflation. I believe this expectation played a significant role in driving up both wages and prices without the expected reduction in unemployment.

This came to be known as "stagflation," and its presence threw into question the reliability of the Phillips curve. In the 1970s, we underestimated the role that inflation expectations would have - that is, that expectations were more or less a self-fulfilling prophecy. Today, we pay a lot of attention to inflation expectations. Our research shows that inflation expectations greatly influence the actual path of inflation over time. If people come to expect a higher inflation rate into the future, they tend to make decisions about wage and price setting that actually push inflation in that direction.

To break the 1970s wage-price spiral, the FOMC, under the leadership of Paul Volcker, decided that inflation was too high and that the Federal Reserve would accept temporarily higher unemployment rates to bring inflation back down.

To be sure, inflation expectations are still--in the longer run--most influenced by the actual behavior of inflation. And today, Americans' long-term inflation expectations remain subdued. However, some Americans are clearly concerned that inflation will rise because of higher prices at the gas pump or rising food prices at the grocery store.

My view is that those price increases are, in fact, likely to be transitory. Because food and energy prices are already so high this year, it's unlikely they would rise by as much in the coming year.

Just think, if you had to pay $5 for a gallon of gas, demand for gas might fall because you might alter your habits - consolidating trips, taking public transit, or riding your bike to work. This would lessen the demand for gas, putting downward pressure on the price of gas.

Historically, food and energy prices have been volatile. They rise and fall because of floods and droughts and wars and variability in global demand.

It's also significant that most other prices, such as rent, recreation and furniture, have seen relatively small increases or even price declines over the past year. These movements in less-volatile components of the consumer market basket turn out to be better predictors of inflation. In fact, well over half of all non-energy consumer goods and services had price increases of less than 2 percent over the past three months.

A critical factor behind slower growth in prices in most non-energy consumer goods and services is today's subdued wage growth. Research at my Bank notes that there is a clear connection between periods of high unemployment (associated with recessions) and slower wage growth.

Our most recent recession has already brought down wage growth from just below 4 percent per year to less than 2 percent. After a recession, wage increases typically remain low for quite some time.

This should keep the inflation rate lower because lower wage growth directly implies little rise in the cost of producing goods and providing services.

Consumers purchase more services than goods. And many services are all about the costs of labor - whether those services are medical, financial, a new haircut, or a lawn-mowing service.

So, overall in fact, today's circumstances are not like the 1970s. Instead, today we have temporarily elevated inflation from energy costs and food prices. But inflation expectations are stable and wage growth is moderate.

Concluding Thoughts

Let me conclude with some comments about my economic outlook. Today's labor market conditions are important to my outlook. I expect the economy to continue on a gradual recovery pace over the next few years, with annual growth just above 3 percent a year. And I anticipate it could take about five years for unemployment to reach its long-run sustainable rate of 5-1/2 to 6 percent.

I believe inflation will be temporarily elevated this year due to developments in oil and food prices, but I expect inflation to fall back below 2 percent in the next couple of years.

Given this outlook, I think that the current accommodative stance of monetary policy, with short-term interest rates close to zero, is appropriate and supports the FOMC's dual mandate of stable prices and maximum employment.

Monetary policy refers to actions undertaken by the Federal Reserve to influence the availability and cost of money and credit. Today's accommodative monetary policy is keeping interest rates low for borrowing so business owners can invest in new technologies, capital improvements, and additional workers. Consumers also benefit from lower rates on mortgages, student loans, auto loans, and so forth.

Nevertheless, monetary policy will eventually have to become less accommodative. The FOMC has been developing tools that we'll use to exit from our current policy stance, and we'll be ready to use them when the time is right.

As a Federal Reserve policymaker, I study the financial and economic situation carefully to determine the appropriate policy actions. I'll continue to do so, constantly evaluating the costs, benefits, and results along the way.

I began my remarks today by looking at how the economic dislocations of the past help us to understand and deal more effectively with those of our own day. I am committed to building on those economic lessons and vow to bring them to bear, every day, in my work at the Federal Reserve, to help improve all of our futures.

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1. Originally, there were three parts to the Fed's goals: "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."