U.S.

Economic Watch

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Economic Research

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Labor Market

Labor market conditions continue to remain weak

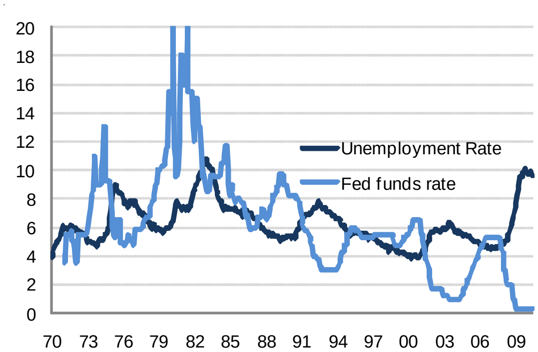
- **Median number of weeks unemployed reached its historical high in June**
- **Unemployment is likely to remain high in the near future**
- **Fed is likely to keep interest rates low for an extended period of time**

Changes in tax laws alter the dynamics of temporary layoffs

The FOMC minutes and members' speeches indicate that the Fed is closely watching labor markets (i.e. unemployment rates) for its monetary policy actions. On all occasions, Bernanke stressed the vulnerability and weakness of the labor market implying that the Fed will not start rate hikes before seeing significant improvements in the employment situation.

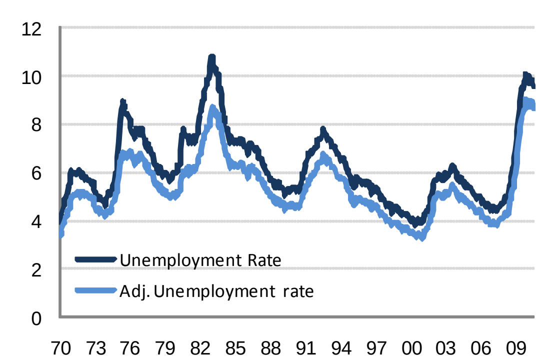
Unemployment in the U.S. peaked at 10.1% in October 2009 more than one year after the Lehman Brothers bankruptcy. Since then, the unemployment rate has been slowly descending, consistent with the moderate recovery in the overall economy. In retrospect, the U.S. economy experienced an even higher unemployment rate in 1982 of 10.8% and it took five years to fall below 6%. However, as pointed out by James Hamilton,[1] a significant portion of the unemployment in 1973-75 and 80s recessions stemmed from temporary layoffs, which were boosted by the regulations in effect at that time. However, the Revenue Act of 1978 and the Tax Reform Act of 1986 eliminated the incentives created by Social Security Amendments of 1958. These new enacted policies have decreased the share of temporary layoffs within total unemployment starting in 2Q86. The adjusted unemployment rates, which exclude temporary layoffs, indicate that the current financial crisis resulted in the highest unemployment rate in U.S. history. One implication of this is that it will take more years than the 1982 recession to converge to a pre-crisis unemployment rate given the higher starting point and the expectation of a slower recovery. Therefore, it is worrisome that current recovery dynamics might be far from pulling unemployment rate down to its pre-crisis levels.

Graph 1
Unemployment Rate and Federal Funds Rate, %



Source: BLS and Federal Reserve

Graph 2
Unemployment Rate, %



Source: BLS

[1] Econbrowser, http://www.econbrowser.com/archives/2010/06/jobless_recover.html

Long term unemployment will be a key issue

There are important details in the U.S. unemployment data. The median number of weeks unemployed continues to increase and reached its maximum point of 25.5 weeks last month. The previous record was 12.3 weeks, which was observed in May 1983. Among the unemployed, some are having a harder time finding a job -- waiting for as much as 15 weeks. For example, almost 6 percent of the labor force is unemployed and could not find a job after 15 weeks, indicating high long term unemployment. It is expected that people who have been searching for a job for a long period of time would eventually leave the labor market if they cannot find one. The participation rate and the number of marginally attached and discouraged workers support this finding. While the participation rate is decreasing, the number of marginally attached and discouraged workers continues to climb and is currently at its historical high. The trends indicate that the U.S. economy will have an unemployment problem for a long time. In addition, there is a high probability that the unemployment rate in the U.S. settle at a level higher than its pre-crisis levels. Therefore, it is likely that the economy will experience a structural shift in the unemployment rate and the natural rate of unemployment will be higher than its pre-crisis level.

High unemployment urges the Fed to keep interest rates low for an extended period of time

The U.S. economy lost 7.2 million jobs since its peak. Even as the economy recovers and creates new jobs, the unemployment rate will be slow to come down because people will become more optimistic about the economy and many of the marginally attached or discouraged workers will re-enter the labor market, which will keep the unemployment rate high. Therefore, the unemployment rate will converge to a level higher than its pre-crisis level, which implies –*ceteris paribus*- lower potential GDP growth. In addition, social frictions could increase and give way to trade protectionism, market barriers and other elements that could lower productivity gains.

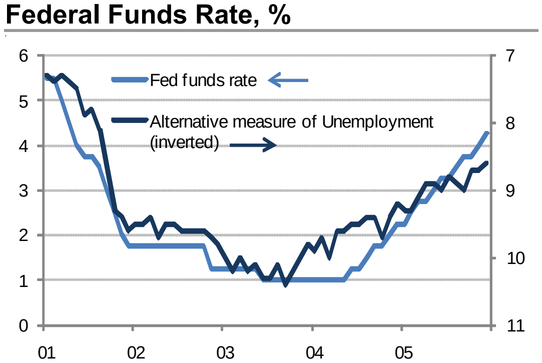
A simple calculation shows that if the economy creates 150K new jobs every month, it will take four years to recover all job losses during the crisis. However, with a growing population and labor force, the economy must create even more jobs than that. Thus, it could take much longer for the unemployment rate to drop below 6%, unless the economy experiences a positive structural change like in the 90s.

Graphs 3 and 4 depict alternative measures of unemployment and fed funds rate during last two crises in which the Fed kept interest rates low. The graphs indicate that in the 2001 recession, the Fed started increasing rates with a lag after observing improvements in the unemployment rate. If this is the case again, the Fed will wait for a downward trend in unemployment. Given the absence of clear positive signs of recovery in unemployment, the Fed is likely to keep fed funds rate close to zero for some time.

Given current trends, we should expect employment issues to be on the table for a long time. Therefore, knowing that the Fed follows labor market conditions closely, it will maintain its "low interest rate" policy for an extended period of time, particularly if deflationary pressures exacerbate. We expect the Fed to start increasing the fed funds rate in 1Q11 but the probability of postponing first rate hike is increasing.

Graph 3

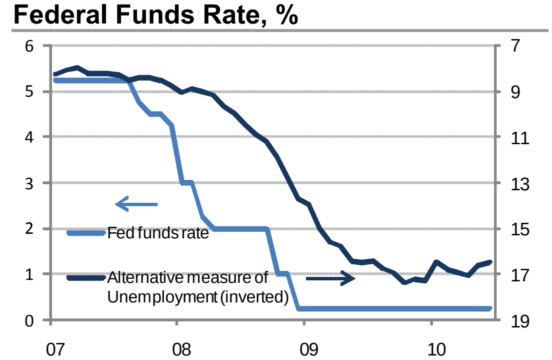
Alternative Unemployment Rate and Federal Funds Rate, %



Source: BLS and Federal Reserve

Graph 4

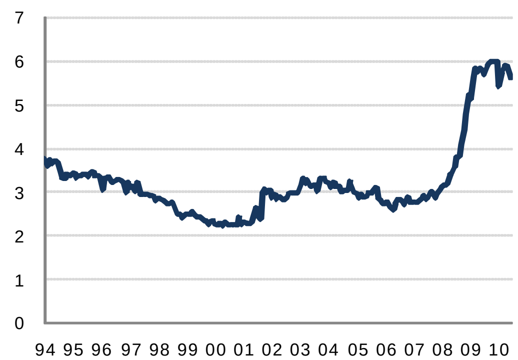
Alternative Unemployment Rate and Federal Funds Rate, %



Source: BLS and Federal Reserve

Graph 5

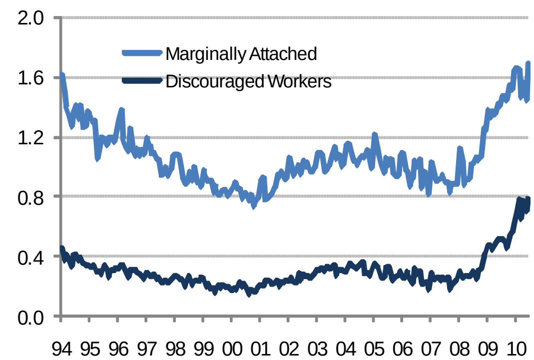
Persons Working Part-time for Economic Reasons, %



Source: BLS

Graph 6

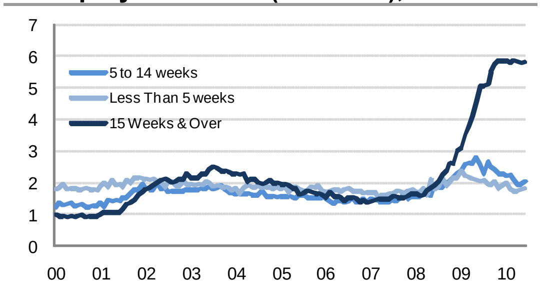
Marginally Attached and Discouraged Workers, %



Source: BLS

Graph 7

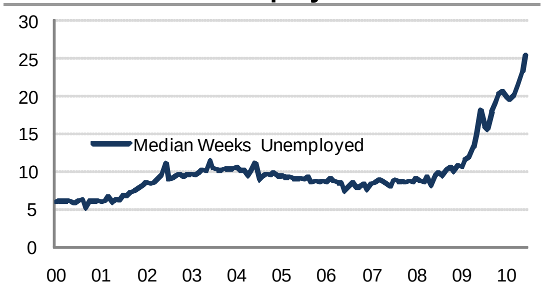
Unemployment Rate (Duration), %



Source: BLS

Graph 8

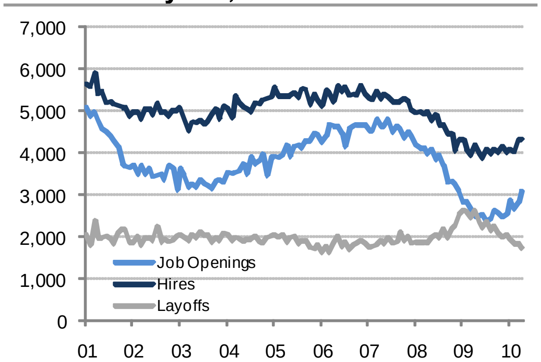
Median Weeks Unemployed



Source: BLS

Graph 9

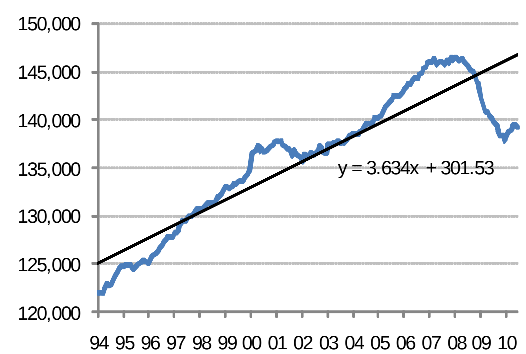
Hires and Layoffs, thousands



Source: BLS

Graph 10

Employment, thousands



Source: BLS