J.P.Morgan

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Dr. Williams or: How I learned to stop worrying and love the falling unemployment rate

Last week we remarked on a speech by San Francisco Fed President John Williams where he observed that "structural factors account for most of the decline in participation over the past several years," and because of this "the unemployment rate remains the best overall summary statistic" of the labor market. To the extent this sentiment is shared by others on the Committee it would have important implications for policy. First, it would mean that the 7% terminal condition for asset purchases need not be qualified with participation rate considerations. Second, it would defang the argument for lowering the unemployment threshold because of concerns that this measure understates the degree of slack in the labor market.

Williams was an accurate bellwether for the Committee when he started discussing a second half tapering in April, almost two months before Bernanke's "next few meetings" remark -- though he was largely ignored or dismissed at the time. So how reflective are his remarks on the unemployment rate regarding current Fed thinking on the labor market? The Atlanta Fed has a compendium of labor market research from around the Federal Reserve System. Below we link to and copy the abstracts of the three most recent studies on the participation rate, all from July or August. Interestingly, all the pieces give some reasons to doubt the commonly-told story that declining participation is overwhelmingly cyclical, and that re-entrants of non-participants is impending and will slow the decline in the unemployment.

Two qualifications are in order. First, three works of research do not constitute a consensus. Rather, we think these may indicate that there are some cracks in the facade of the cyclical non-participation story. Second, even accepting these conclusions would mostly represent a shift, rather than an about-face, in how the decline in participation is viewed. In other words, we believe it is very likely most on the Committee will continue to see some cyclical non-participation, but gradually more weight may be placed on the structural side of the participation rate story. If so, Williams may once again have served as a valuable barometer of thinking with the FOMC.

Below are links and abstracts of the research referenced above:

Boston Fed. We find that since 2008 trend movements account for a significant portion of the decline in labor force participation. The cyclical response of the labor force participation rate over most of the Great Recession and ensuing recovery has been smaller than usual given the estimated cyclical behavior of the employment-to-population ratio. If the cyclical behavior of the labor force participation rate had followed historical norms, the unemployment rate over the period 2009–2011 would have been lower on average by roughly three-quarters of one percentage point.

Richmond Fed. Some economists and journalists have questioned whether recent improvements in the labor market will cause non-participants to re-enter the labor force at a faster rate, thus off setting job growth and impeding further declines in the unemployment rate. But recent worker-flow research suggests that this scenario is unlikely.

Kansas City Fed. The number of individuals expressing interest in work, but who are not looking for a job, has swelled in the years since the Great Recession. While a rapid return of this group into the labor force is possible, their flow rate back into unemployment has been declining and, therefore, their potential to slow or reverse the decline in the unemployment rate appears modest.

Michael Feroli
(1-212) 834-5523
michael.e.feroli@jpmorgan.com
JPMorgan Chase Bank NA