Economic Research Note

US: labor market debates, past and future

- **The state of the labor market will remain central to debates about the monetary policy outlook**
- **The short-term vs. long-term unemployment debate is becoming less germane**
- **The decline in the participation rate is increasingly viewed as structural**
- **However, debate about the best estimate of the natural rate of unemployment may heat up**

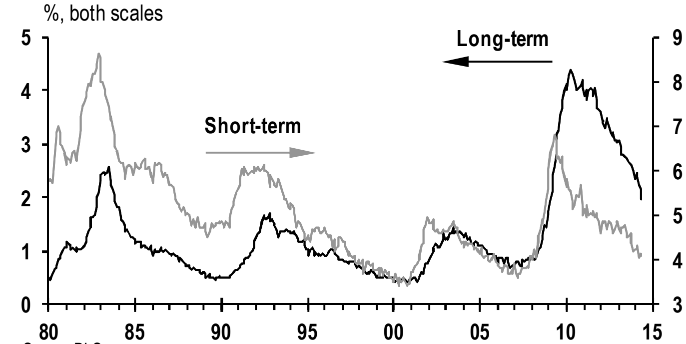
As one leg of the Fed's dual mandate, the health of the labor market is always of interest to the policy debate. And with labor issues the subject of this year's Jackson Hole conference, this interest likely won't fade any time soon. The nature of that debate may evolve over time, and below are some aspects we see receding in prominence and others rising.

We begin with the debates we expect to fade into the rear-view mirror:

Short-term versus long-term unemployment. The debate as to whether short-term unemployment or total unemployment is more important from an inflation perspective really heated up at the beginning of the year. At that point, the disconnect between short-term and long-term unemployment was quite wide. Since that time the divergence has narrowed a good bit, making the debate less important. In particular, the short-term unemployment rate was 4.2% in December and 4.1% in June. The long-term unemployment rate, however, has come down much more, from 2.5% in December to 2.0% in June. The long-term unemployed account for 91% of the decline in unemployment since December. By historical standards, the long-term unemployment rate is still somewhat more elevated than the short-term rate, though the disparity is shrinking.

As an aside, the growing irrelevance of the short-term vs. long-term unemployment debate may be related to the possible resolution of another labor market debate: the effect of extended unemployment benefits on the measured unemployment rate. The lapsing of those benefits at the end of last year could arguably be putting downward pressure on the unemployment rate, and that should be occurring entirely through long-term unemployment. State-level data are broadly consistent with this story. At the end of last year, 15 states were not eligible for extended benefits and so might be expected to have a different experience from the rest of the

Unemployment rates



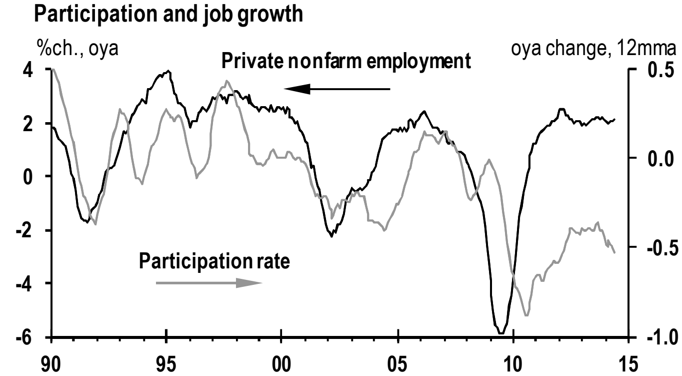
Source:BLS

Average unemployment rates (%)

	Dec-13	May-14
States with EUC as of Dec.	7.0	6.4
States without EUC as of Dec.	4.6	4.3

Source: DoL. EUC: Emergency Unemployment Compensation

Participation and job growth



Source:BLS

country. In fact, those 15 states have seen somewhat smaller declines in their unemployment rates relative to the other states that did lose extended benefits at the end of the year—a finding consistent with the idea that the expiration of extended benefits has pulled down measured long-term unemployment.

Participation rates. For most of the recovery, the depressed state of labor force participation rates was debate number one when it came to the labor market. The dovish view was that participation rates were depressed for cyclical reasons, and would bounce back when the labor market regained some vigor. The hawkish view was that participation rates were depressed for structural reasons, and would not bounce back (absent an ill-advised overheating of the economy). Increasingly, the structural side of this debate appears to have the upper hand.

Last year we wrote a piece documenting the latest vintage of Fed research on participation rates, which leaned more toward the structural side (link here). Since then, that trend seems to

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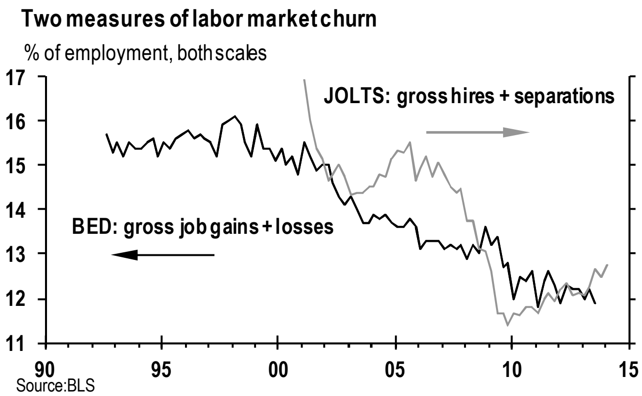
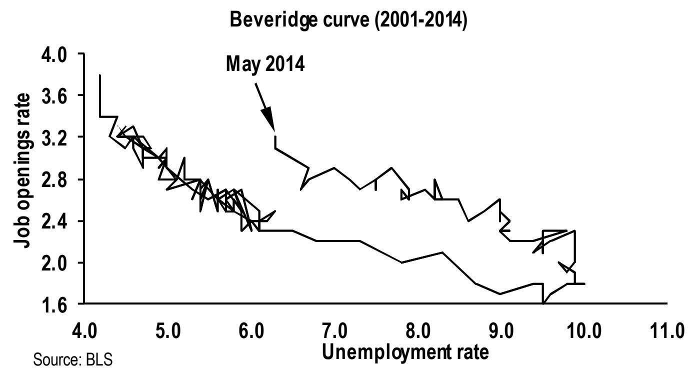
have continued, for example in this piece from the Philadelphia Fed (link here). An even simpler counter to the cyclical view is that the past four years have featured average annual job growth of over 2 million, and yet participation has leaked lower. Perhaps the clearest indication of the cyclical camp waving the white flag came earlier this year when in a speech Chicago Fed president Evans conceded that he had been convinced that about 75% of the decline in the participation rates was due to structural factors. If even the dovish Evans sees structural factors explaining three-fourths of the decline in the participation rate, then more centrist members might see close to the entire decline as structural.

While debates on short-term unemployment and participation may fade, one other debate could start to heat up:

Natural rate of unemployment: While the doves may not be winning the participation argument, they could take the offensive in the debate about the right estimate of the natural rate of unemployment (or NAIRU). Unemployment can be categorized as cyclical, structural, or frictional. When cyclical unemployment is zero, unemployment is said to be at its natural rate. There are some reasons to suspect that structural and frictional unemployment are coming down. In particular, structural unemployment could be morphing into structural nonparticipation. The decline in participation rates may be due in part to workers who were previously structurally unemployed leaving the workforce altogether. As individuals move from structural unemployment into structural nonparticipation, estimates of the natural rate of unemployment could come down. At first blush this outcome may look somewhat perverse, as a lower natural unemployment rate is often associated with better social outcomes, whereas structural nonparticipation is a worse social outcome.

Frictional unemployment—the other main category of unemployment captured in the natural unemployment rate—could be coming down as well. Labor market "churn" has been trending lower, as seen in subdued gross hiring and separation rates; this might imply less frictional unemployment. As was the case with reduced structural unemployment, a lower level of frictional unemployment is not necessarily a good thing, as less churn is associated with fewer business births and deaths, and thus reduced dynamism and productivity growth in the economy. These considerations regarding structural and frictional unemployment may be contributing to the modest reduction in the midpoint of the Fed's central tendency estimate for the natural unemployment rate, from 5.6% a few years back, to 5.35% more recently. A lower natural rate of unemployment will allow the doves on the Committee to argue that policy can be kept accommodative for longer without generating inflation.





One important counter-argument that leans in favor of a higher natural unemployment rate is the recent behavior of the Beveridge curve. The Beveridge curve, which relates job vacancies to unemployment, has continued to display an outward shift. Normally, such an outward shift is associated with a rise in the natural rate of unemployment, as it indicates that the labor market is less efficient at matching job seekers with job openings. In the recent past, two factors were offered as mitigating considerations. First, extended unemployment benefits could temporarily be shifting out the Beveridge curve, even if there were no deterioration in job matching efficiency. Second, there is evidence that early in recoveries the Beveridge curve tends to shift out. Extended unemployment benefits expired at the end of last year, and we are no longer early in a recovery, both of which suggest the message from the Beveridge curve should not be dismissed out of hand. Taken at face value, the Beveridge curve would suggest that the natural unemployment rate has increased by over a percentage point relative to pre-crisis levels. In weighing these competing considerations we continue to estimate that the natural unemployment rate is in the neighborhood of 5-1/2 %, though as the preceding discussion should make clear, a fair bit of uncertainty attends to this estimate.