Economics from Washington

Statistical Shenanigans

March 22, 2017

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There is nothing unusual about people dropping out of the labor force during and just after a recession. This is especially true when people have been unemployed for a lengthy period, so it is not surprising that the number of dropouts would be large after a very deep recession like 2007 - 08. However, after labor markets recover and jobs become more plentiful, some workers decide to return to the workforce. This has been a topic of great speculation over the past few years, because many dropped out and have been slow to return. The rate at which they return has a major impact on the tightness of the labor market, which in turn affects the point at which wages begin to accelerate. An unemployment rate of about 5% or less has been associated with accelerating wages in the past, but this is not yet happening in the US, even though the unemployment rate was at or below 5% since the summer of 2015.

There are several factors making labor markets less tight than the 5% metric suggests. The first is the age composition of the labor force. Different age groups have different unemployment rates. Young people, for example, have a higher average unemployment rate than older workers. When the number of young people falls enough for their share of the labor force to decline, the unemployment rate will fall. This share has declined over time. As a result, when the unemployment rate reaches 5%, labor market condition are not as tight as they used to be at the same level of unemployment.

The behavior of different age groups has also changed. Over time, the share of high school graduates attending college has increased, delaying their entrance into the labor force. Many young people have pursued more advanced technical training which has also delayed entrance to the labor force. This is reflected as a decline in participation by younger workers. These and other behavioral changes mean the labor market is not as tight for any given level of unemployment as in the past.

The impact of changes in the number of people in different age groups is quite straightforward and predictable, because these numbers are well known and change quite slowly. Labor market analysts refer to this as a 'share-shift' adjustment. This type of adjustment suggests today's 4.7% unemployment rate is roughly equivalent to a 5% rate in the 70s or 80s. Behavioral changes are more challenging, but analysts have used flows into and out of the labor force by different age groups to estimate the impact of these changes. The conclusion is that the unemployment rate associated with the same degree of labor market tightness is several tenths of a point lower than in the past. This analysis suggests the unemployment rate can fall below 4.5% before wage acceleration is likely. Of course, behavior can shift more quickly than the age composition and is much less predictable.

Another behavioral shift may be underway. Chart 1 shows the number of people in various age groups who are not participating in the labor force. Not surprisingly, these numbers moved higher during and just after the financial crisis. For some age groups, especially those 65 and older, the numbers have continued to rise as older workers retire. However, the number in the 16 - 24 year group have stabilized in recent years and those 25 - 54 has declined slightly. The participation rate for both groups increased slightly in 2016. If this signals a change in behavior – that is, if these younger workers continue to return

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to the labor force – this means employment growth can be strong without causing the unemployment rate to decline. This is what occurred in 2016. The labor force participation rate was fairly stable, despite the rising number of older workers who dropped out; employment growth was strong; and the unemployment rate changed very little.

How long will this continue? The honest answer is no one knows. Yet, some simple 'what if's' can provide useful insight. What if those in the 16 - 24 year age group who dropped out of the labor force after the financial crisis had returned by 2016? Similarly, what if the 25 - 54 year old dropouts had returned? The answer is shown in chart 2. If dropouts in either age group had returned, the participation rate would be about ¾ point higher than the actual rate; if those in both groups had returned, it would be about 1 ½ points higher. The total participation rate would still have declined due to older workers dropping out, but it would be substantially higher than the current rate. Translating this into numbers more easily related to monthly employment reports, we estimate that if younger workers who dropped out after the financial crisis continue returning to the labor force, the economy can sustain monthly job growth of about 150,000 for another three years before labor markets become tight enough to cause significant wage acceleration.

Chart 1

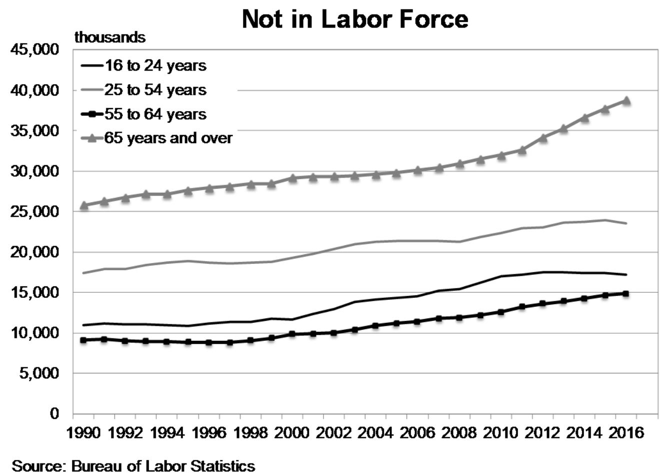
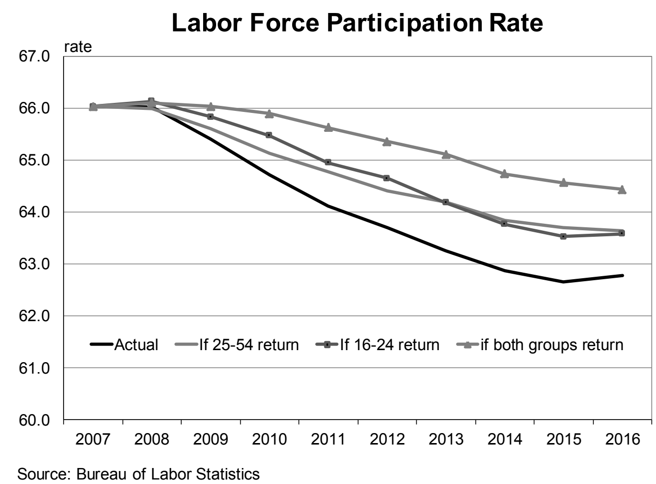


Chart 2



None of these estimates are especially precise and they depend on a variety of assumptions which could prove to be incorrect. Nevertheless, they show it is plausible for strong employment growth to continue for some time before wages accelerate significantly. This uncertainty makes policymakers reluctant to forecast that accelerating wage increases will translate into inflation pressure. This, in turn, means it is difficult to tighten monetary policy in anticipation of higher inflation. The Fed has been able to finesse this issue by describing recent policy as removing accommodation rather than tightening policy. At some point in 2018, this will change. If wages still show little sign of acceleration at that point, additional rate increases will be difficult to justify.

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