

Box 1

IS THE UNEMPLOYMENT RATE A SOUND GAUGE OF LABOUR MARKET DEVELOPMENTS IN THE UNITED STATES?

The assessment of the US labour market has gained prominence in the context of the unconventional monetary policies of the Federal Reserve System. Until recently, the Federal Open Market Committee had indicated in its forward guidance that it would not raise interest rates while the unemployment rate remained above a threshold of 6.5%. On 19 March 2014, with the unemployment rate approaching 6.5%, this communication was replaced with a qualitative form of guidance that still included an assessment of labour market conditions.¹ Against this background, this box aims to assess the underlying strength of the US labour market and to evaluate the extent of labour market slack.

¹ See statement by the Federal Open Market Committee, 19 March 2014, Board of Governors of the Federal Reserve System.

The improvement in the labour market and the decline in the participation rate

In the course of 2013 the recovery in the labour market gained further traction. Job creation – the change in total non-farm payrolls – proceeded at a relatively steady pace, with the US economy creating an average of 194,000 jobs a month in 2013 (see Chart A). At the same time, the unemployment rate declined from 7.9% in December 2012 to 6.7% in February 2014. However, most of the improvement in the unemployment rate resulted from declines in the labour force participation rate, which fell by 0.8 percentage point in 2013.² Meanwhile, broader measures of unemployment that include “discouraged workers”³ and part-time workers who would like to work full time, as well as the long-term unemployed, remain elevated. Developments in the employment-to-population ratio (see Chart B) and labour turnover rates (the hiring and quit rate) also suggest a less healthy picture of the labour market.

The decline in the participation rate over recent years stands out by comparison with past economic cycles. In particular, the recovery since 2009 has not been associated with an improvement in the participation rate, unlike the pattern observed in most of the previous recoveries in the United States. Instead, the participation rate declined by 3.0 percentage points between December 2007 and February 2014. By contrast, the participation rate in the euro area increased by 1.2 percentage points from the end of 2007 to the third quarter of 2013, which had an immediate adverse impact on the unemployment rate. This feature might partially help to

Chart A Employment change and unemployment rate

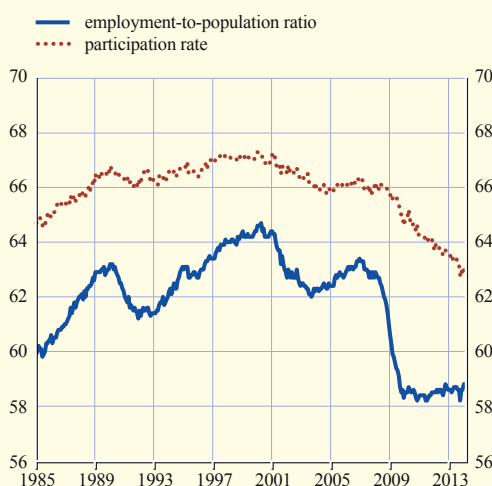
(left-hand scale: monthly change, in thousands; right-hand scale: as a percentage of labour force)



Source: Bureau of Labor Statistics.
Note: The latest observation is for February 2014.

Chart B Employment-to-population ratio and participation rate

(as a percentage of civilian population)



Source: Bureau of Labor Statistics.
Note: The latest observation is for February 2014.

² The labour force participation rate is defined as the percentage of the civilian non-institutional population that is part of the labour force (either employed or unemployed but actively looking for a job).

³ “Discouraged workers” refers to those who did not actively look for work in the four weeks prior to the reference week because they thought there was no work available, they could not find work, they lacked schooling or training, a potential employer considered them to be too young or too old, or they have encountered other forms of discrimination.

explain the observed divergence in the trends of unemployment rates between the euro area and the United States.⁴

There may be several reasons for the unprecedented decline in the participation rate in the United States since December 2007. First, the share of people over 55 years of age in the total population has increased steadily, while there has been a decrease in the share of prime-age workers (aged 25-54). As older people have lower participation rates, such demographic changes are estimated to account for around one-third of the decline in the overall labour force participation rate since December 2007 (see Chart C). Second, a fraction of the decline in the participation rate can be explained by a greater number of people on social security disability programmes, which has increased strongly since 2007, far above its pre-crisis trend, possibly acting as a support mechanism for

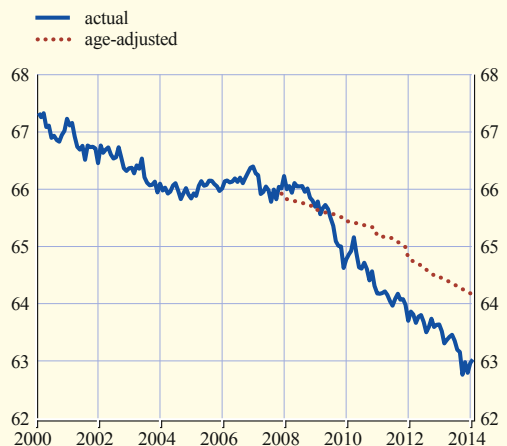
displaced workers. Empirical research suggests that people who become beneficiaries of disability benefits tend to remain permanently out of the labour force, and eventually move into retirement once eligible.⁵ Hence, these first two factors can be seen as structural.

A third factor is that the lack of available jobs has induced young people to extend their education in recent years to improve their chances on the job market once the economy gains traction. Accordingly, the fraction of students enrolled in education (secondary school and university) among the 16-24 age group, who are thus not part of the labour force, has risen markedly since 2007. This is likely to be a largely cyclical phenomenon, as the students will return to the labour force once their education is completed and economic prospects have improved. Finally, the deterioration in economic prospects during and after the recent recession led to a significant number of people dropping out of the labour force. As a result, the number of “marginally attached workers”⁶ and discouraged workers rose substantially. There is significant uncertainty regarding the extent to which discouraged workers may permanently leave the labour force owing to loss of skills, and it is therefore unclear whether this factor will turn out to be largely structural or will gradually reverse over time.

Available external estimates, such as those produced by the Congressional Budget Office (CBO), show that two-thirds of the 3 percentage-point decline in the participation rate between the end of 2007 and the end of 2013 was the result of structural factors, primarily the ageing of the

Chart C Actual and age-adjusted participation rate

(as a percentage of civilian population)



Sources: Bureau of Labor Statistics and ECB calculations.

Notes: The age-adjusted measure is computed after 2007 and allows the labour force participation rate to vary only as a result of changes in population shares. The latest observation is for February 2014.

4 For an overview of the differences in labour market adjustments in the euro area and the United States since the beginning of the financial crisis, see the box entitled “Labour market developments in the euro area and the United States since the beginning of the global financial crisis”, *Monthly Bulletin*, ECB, August 2013.

5 See, for example, Sherk, J., *Not Looking for Work: Why Labor Force Participation Has Fallen During the Recession*, Background Paper No 2722, The Heritage Foundation, September 2013.

6 “Marginally attached workers” refers to those who looked for work over the previous 12 months and were available to take a job during the reference week.

population (1.5 percentage points) and the slow recovery, which led discouraged workers to drop permanently out of the labour force (0.5 percentage point).⁷ By contrast, a report by Erceg and Levin in 2013 argued that the bulk of the decline was attributable to cyclical factors.⁸

Measuring labour market slack

As the unemployment rate declined, labour market slack as defined by the unemployment gap – the difference between the non-accelerating inflation rate of unemployment (NAIRU), estimated by the CBO, and the actual unemployment rate – fell rapidly, from -2.4 percentage points in the last quarter of 2012 to -1.5 percentage points in the last quarter of 2013 (see Chart D). However, a more encompassing assessment of prevailing labour market slack would entail adding workers who have temporarily left the labour force to the unemployment gap. This can be measured by the participation rate gap, which is defined as the difference between the potential labour force – estimated by the CBO – and the actual labour force. The participation rate gap reflects the part of the decline in the labour force that results from weak labour demand.

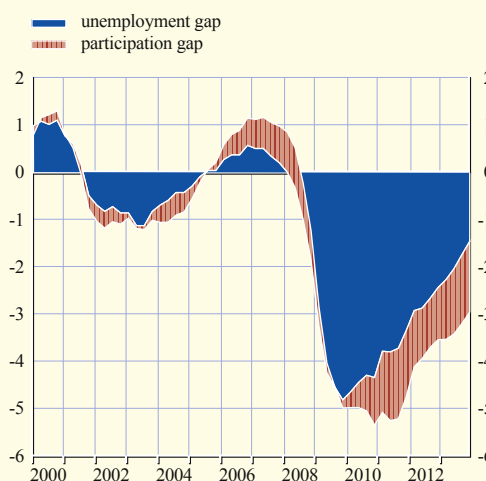
The combined participation rate gap and unemployment gap suggests significantly greater slack in the US labour market than the unemployment gap alone (see Chart D). Accordingly, the US labour market retains a fairly high level of “reserve labour supply”, which may be absorbed once economic prospects brighten and labour demand rises. Overall, this suggests that slack in the US labour market increased during the recent recession to peak at 5.4 percentage points below full employment in the last quarter of 2010, with the unemployment gap initially being the main contributor. Since 2010 the participation rate gap has played a bigger role in driving total labour market slack. Total labour market slack has declined substantially, reaching 3.0 percentage points by the last quarter of 2013, largely as a result of the narrowing unemployment gap, while the participation rate gap has continued to widen. It is estimated to have stood at -1.5 percentage points at the end of 2013, the same as the unemployment gap.

Conclusions

The analysis presented in this box highlights the need to monitor labour market developments more broadly, and not to rely solely on the unemployment rate.⁹ A broader analysis suggests that labour market conditions remain relatively weak overall and that considerable labour market slack is still present in the United States.

Chart D Participation gap and unemployment gap

(as a percentage of labour force)



Sources: Bureau of Labor Statistics, CBO and ECB calculations.
Note: The latest observation is for the fourth quarter of 2013.

⁷ See *The Slow Recovery of the Labor Market*, Congressional Budget Office, February 2014.

⁸ See Erceg, C. and Levin, A., “Labor Force Participation and Monetary Policy in the Wake of the Great Recession”, *IMF Working Papers*, No 245, International Monetary Fund, 2013.

⁹ See Yellen, J., *Semiannual Monetary Policy Report to the Congress*, 11 February 2014.