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Participation Rate At Center Stage

In last month's *Economic Outlook*, we discussed a relatively obscure data series – the JOLTS data – which we follow closely and feel deserves wider attention. This month, we discuss a previously obscure indicator that has managed to become the focus of great attention, not to mention an indicator whose path over coming quarters will have meaningful policy implications. The labor force participation rate, which for much of its existence has been an obscure and, frankly, not very interesting economic indicator only a labor economist could love, has managed to find itself the center of attention in any discussion of the labor market, particularly the unemployment rate.

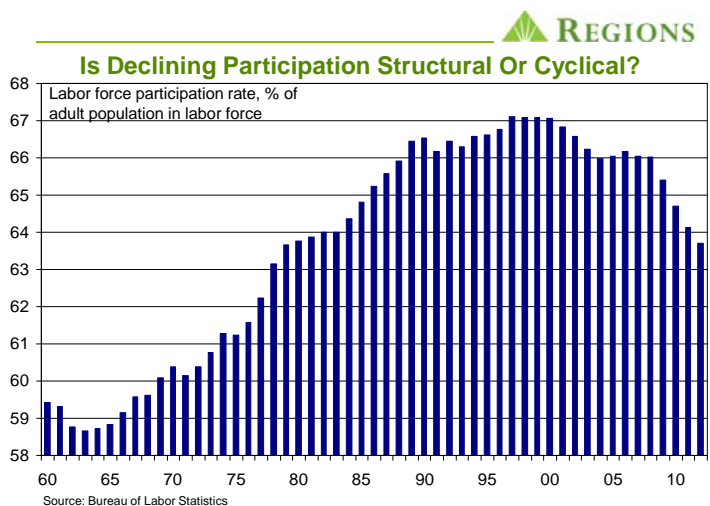
Without knowing the actual value of the participation rate, many of you reading this already know the labor force participation rate has been declining, not only during the Great Recession but also during the ongoing recovery. The declining participation rate has been one of the driving forces behind the falling unemployment rate, which stands at 7.5 percent as of April 2013 compared to the cyclical peak of 10.0 percent.

What is not as widely understood, however, is that the labor force participation rate has been declining for some time now, since May 2000 to be precise. A host of demographic and socio-economic factors are responsible for the longer term decline in the participation rate, which we define as structural. But, there is no denying the severity of the Great Recession and the sluggish nature of the subsequent recovery have also pushed the participation rate lower than it otherwise would be due to these structural changes, i.e., there is a cyclical component to the declining participation rate. Unfortunately, many of those who seize on the declining participation rate as a sign of just how bad things still are, or use it as cause to brush off any decline in the unemployment rate, miss this distinction.

Just as unfortunately, it is difficult to precisely segregate the declining participation rate into the structural and cyclical components. This is not, however, due to a lack of effort, as many analysts have put forth their estimates of the different components. So, for as many analysts who have endeavored to quantify the structural and cyclical components of the declining participation rate, there will be just as many distinct answers. We have done our own share of analysis in regard to this question and will simply state we have found about half of the decline in the participation rate since the downturn to be structural in nature.

But, instead of turning this into a detailed discussion of econometric modeling and the underlying assumptions that underlie any such effort, we'd rather use this space to lay out some of the factors, both cyclical and structural, behind the declining participation rate, and to discuss why this is such an

important question. In particular, we will address how this distinction comes into play in the Fed's monetary policy decisions and how it impacts the effectiveness of monetary policy. We suspect our readers will appreciate this choice on our part.

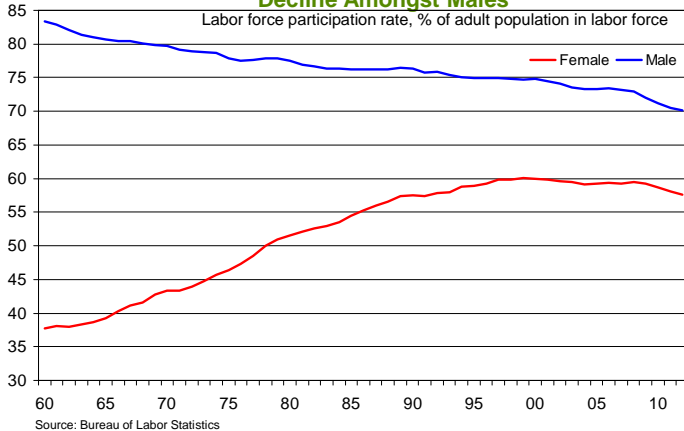


To start with, the chart above shows the behavior of the labor force participation rate over time, with annual observations from 1960 through 2012. And, to be clear, the participation rate refers to the percentage of the "civilian noninstitutional population," as defined by the Bureau of Labor Statistics (BLS), currently in the labor force – either employed or looking for and available for work. The BLS's population metric includes civilians age 16 and over. The participation rate rose steadily from the mid-1960s through 2000 but, since peaking at 67.3 percent in April 2000, has since declined. One of the biggest factors behind the prolonged increase in the overall participation rate was the steady inflow of women into the labor force, which more than offset a prolonged – and still ongoing – decline in participation amongst adult males, as seen in the chart that follows on Page 2. The overall participation rate has been falling since mid-2000 when female participation leveled off and then began to decline.

Longer life expectancies, increased household wealth, and structural changes in the economy, such as the permanent loss of manufacturing jobs, are some of the factors behind the long running decline in male labor force participation. The multi-year increase in female participation can be readily explained as a function of women taking advantage of increased career opportunity sets and investing more in education. Unfortunately, the leveling off and subsequent decline in female participation is not as readily explained, though hopefully further research will shed more light on this trend.



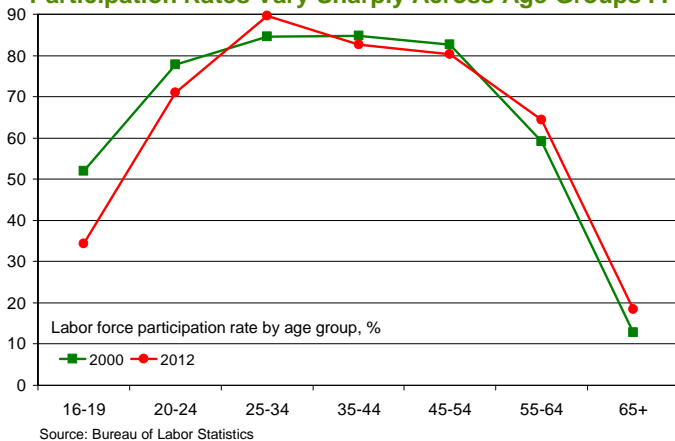
Female Participation No Longer Offsetting Decline Amongst Males



In addition to the divergence across genders, participation rates also vary widely across age groups. This basic fact, combined with underlying demographic trends, is critical to understanding the structural component of the declining participation rate. One of the main demographic trends at work here (okay, pun intended) is the aging of the Baby Boomer generation. Put simply, as the overall population has aged, greater shares of the population have migrated into age groups in which participation rates tend to be lower. These concepts are readily seen in the next two charts, the first of which shows participation rates across age groups in 2000 – the peak of the overall participation rate – and as of 2012. The second chart shows the breakdown of the working age population for the same periods.



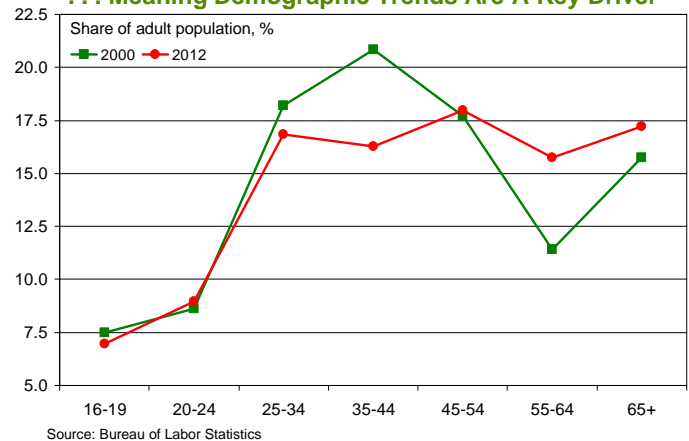
Participation Rates Vary Sharply Across Age Groups . . .



As seen in the above chart, with the exception of younger adults, participation rates across age groups did not exhibit much change between 2000 and 2012. But, the aging of the population has left us with greater shares of the population in the 55-to-64 and 65-and older age groups, for whom participation rates are lower than for those between 20 and 54 years old. Moreover, as the Baby Boom generation continues to age, this pattern will persist over the coming few years, which will act as a steady source of downward pressure on the overall participation rate.



. . . Meaning Demographic Trends Are A Key Driver



While the share of the total working age population accounted for by those 16-to-24 years old has not changed significantly since 2000, it is here we have seen the greatest change in the participation rate. For instance, in 2000 the participation rate for the 16-to-19 year-old age group was 52.01 percent but by 2012 had fallen to 34.26 percent. Over the same period the participation rate for the 20-to-24 year-old age group fell from 77.82 percent to 70.94 percent.

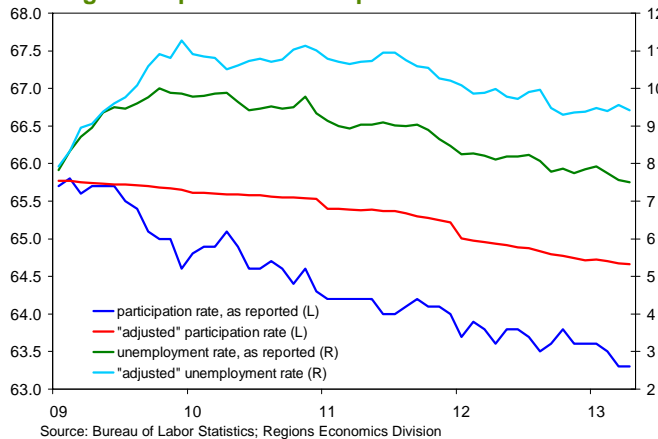
It should be noted that declining participation amongst younger adults dates back far longer than 2000 – the participation rate for those aged 16-to-24 peaked in the late 1980s. The declining participation rate has been mirrored by a corresponding increase in school enrollment amongst this age cohort. To some extent, this reflects structural changes, including the secular decline in manufacturing employment which has meant moving from high school to the factory floor has been an increasingly less viable option for younger adults. More generally, as the economy has evolved the return to higher education has increased while earnings for unskilled labor, as reflected by the inflation adjusted minimum wage, simply have not kept pace even following statutory increases in the nominal minimum wage. In our analysis, the inflation adjusted minimum wage is a key driver of the declining participation rate amongst younger adults.

It is, of course, an open question as to whether recent years have seen a greater incidence of school enrollment amongst younger adults as a means of buying time, if not a higher stream of lifetime earnings, until labor market conditions improve. This is likely the case, though we cannot at present quantify the extent of this effect. It is of interest, though, that enrollment amongst “older younger adults,” i.e., those aged 25-to-29 has risen in the years since the Great Recession. To the extent this increased enrollment is tied to current labor market conditions, i.e., is cyclical in nature, it will be reversed over time, such that today’s lower participation does not mean individuals in these age groups are permanently detached from the labor force.

To get a sense of the impact of the impact of demographic trends on the participation rate, we have calculated an “adjusted” participation rate. The adjustment entails us allowing for the aging of the population, i.e., using the actual shares of the working age population but holding the participation rate

steady for each age group at its year-end 2007 level. Note we are not suggesting these to be the “true” participation rates, but instead holding participation rates steady at their pre-recession values while allowing for the underlying demographic shifts helps us decompose the structural and cyclical components of the lower participation rate since the downturn.

Falling Participation Rate Helps Push Jobless Rate Lower



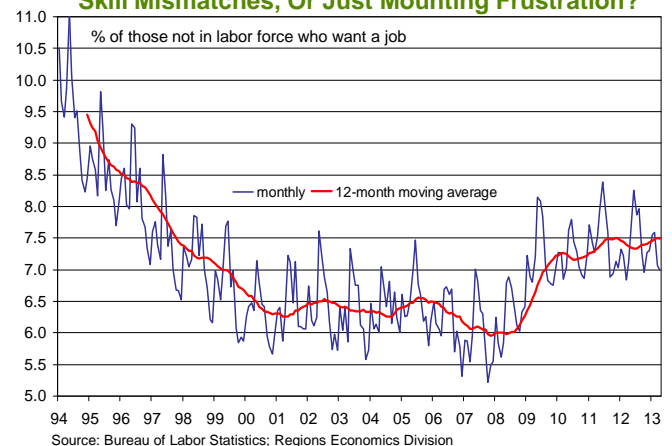
As seen in the above chart, this adjustment results in a participation rate and, in turn, an unemployment rate, above the reported values though both are trending lower. For instance, instead of the 63.3 percent participation rate reported for April 2013, our “adjusted” participation rate is about 64.5 percent, which yields an unemployment rate of 9.4 percent as opposed to the reported rate of 7.5 percent. In short, we estimate structural factors account for roughly half of the decline in the participation rate since the Great Recession, as opposed to cyclical factors.

Data from the Current Population Survey (CPS), the comprehensive monthly survey of households from which the many layers of labor force data are derived, offer another way to look at the underlying components of the declining participation rate. For instance, a widely held perception is that those who exit the labor force in any given month are frustrated job seekers who have simply given up looking for work. Instead, data on

labor force flows show the majority of those who go from being in the labor force one month to out of the labor force in the next month are employed, not unemployed, in the month prior to exiting the labor force, as seen in the preceding chart. The spike in the flow from unemployed to out of the labor force suggests a cyclical component of the lower participation rate but, while still above its longer-term average, this share did begin to turn down in 2011.

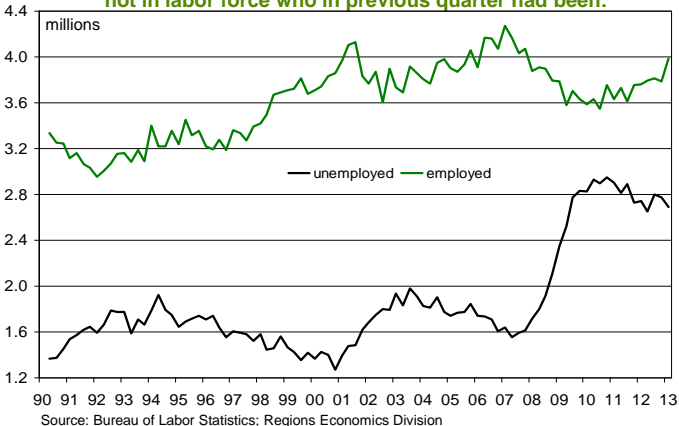
The CPS data also reveal the vast majority of those not in the labor force in any given month do not want a job, as seen in the following chart. Note that many of the data series derived from the CPS are not seasonally adjusted, meaning they can be volatile from month to month and exhibit clear seasonal patterns. As such, the 12-month moving average is a more telling way to look at the data. On this basis, as of April 2013, only 7.5 percent of those not in the labor force wanted a job. That this share has risen since the downturn after having been fairly stable, averaging between 6.0 and 6.5 percent, for several years prior does suggest there has indeed been a cyclical component to the declining participation rate. While the behavior of this series verifies “discouraged workers” are one factor behind the lower participation rate, they are by no means the primary factor, as is often claimed. It is possible the higher share of those not in the labor force wanting a job is evidence of structural unemployment, i.e., a mismatch between skills sought by firms and skills possessed by job seekers.

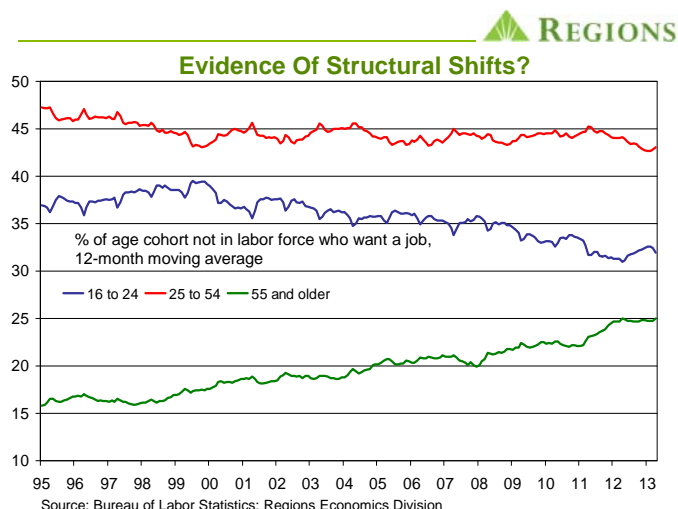
Skill Mismatches, Or Just Mounting Frustration?



Breaking the data down across age groups reveals some interesting patterns – patterns that pre-date the downturn. For instance, the share of those 16-to-24 year-olds not in the labor force who want a job has been drifting lower for some time, in part a reflection of increased emphasis on education. In contrast, the share of those in the 55-and older age group not in the labor force who want a job has been rising for years, though at an accelerated rate since 2011. It could be that more and more people in this age group are falling into structural unemployment, perhaps because their skill set has not kept pace with the increased emphasis on technical skills, though the possibility employer preferences in favor of/against certain age cohorts is at play here cannot be ruled out.

Labor Force Flows not in labor force who in previous quarter had been:





Finally, to the extent cyclical factors are behind the declining participation rate over recent years, one common concern is that when these cyclical factors reverse, drawing displaced workers and/or job seekers back into the labor force, the result will be a significant spike in the unemployment rate. We do not share this concern, based on the data on labor force flows which show the majority of those who go from not in the labor force in one month to in the labor force the next month enter as employed, not unemployed. As should be expected, these shares shifted during the downturn, but at no point in the life of the data has the majority of labor force entrants been unemployed upon entry. If structural factors are the primary cause of the lower participation rate, the volume of labor market entrants will not be as large as some expect to be the case, but the broader point is the data strongly suggest the majority of these entrants/re-entrants will be employed upon entry.

Implications For Monetary Policy

As previously noted the relevant question is not whether or not the labor force participation rate is declining. Rather, the relevant question is what portion of the decline seen since the Great Recession is a continuation of the longer-term secular decline and what portion is due to cyclical labor market weakness. One area the answer to this question has significant implications is monetary policy, particularly since the Fed has laid down a 6.5 percent unemployment rate as a threshold to be used in deciding the appropriate timing of the initial increase in the Fed funds rate.

Simply put, the unemployment rate can decline for the “right” reason, i.e., household employment growing at a faster rate than the labor force, or it can decline for the “wrong” reason, i.e., a labor force that is either barely growing or actually declining. In this context, it clearly matters whether the declining participation rate is more structural or cyclical in nature. That there is not a definitive answer to this question calls into question the value of a policy threshold, let alone a policy target, tied to a specific unemployment rate.

To be sure, this point is not lost on the FOMC. Indeed, FOMC Vice Chair Yellen has stated the need to look at a range of labor market indicators in addition to the unemployment rate, including

the number of job openings and the voluntary quit rate (both of which were discussed in our April *Outlook*). Still, as it now stands, the FOMC’s forward guidance mentions only an unemployment rate of 6.5 percent as a policy threshold.

That there is a cyclical component to the declining participation rate seen over recent years means there is scope for monetary policy to be effective, but that effectiveness may come at a cost. This is one conclusion reached by Federal Reserve economists Christopher Erceg and Andrew Levin who argue a labor market shock of the magnitude seen during the Great Recession can have profound and lasting effects on labor force participation to the extent we may not yet have seen the end of the decline in the participation rate. While the Fed can induce greater labor force participation, it may take significantly faster wage growth to bring this about, and the ultimate cost could be a higher rate of inflation than would otherwise be desirable.

Conversely, if the decline in the labor force participation rate is mostly due to structural factors, there is less scope for effective monetary policy and the longer the Fed remains accommodative the greater the upside inflation risks. Should structural factors will push the participation rate even lower over coming quarters, as we expect, the FOMC’s 6.5 percent unemployment rate threshold will be crossed sooner than the FOMC anticipates will be the case. According to the latest release of the Committee’s central tendency forecasts (March 2013), this will occur around mid-2015. Should the pace of job growth pick up later this year and into 2014, as we and most other analysts expect, the Fed’s unemployment threshold will be crossed even sooner.

The question then becomes what, in this scenario, a lower unemployment rate would really be telling us about underlying labor market conditions. Put another way, would reaching the 6.5 percent unemployment rate faster than the FOMC now expects really be a valid indicator of the timing of the initial funds rate hike? We think not, and we suspect the FOMC will agree, at least in the absence of other indications of material tightening in labor market conditions. These could include, but not necessarily be limited to, a faster pace of hiring, a decline in open, unfilled positions, and sustained upward pressure on average hourly earnings. It could be, should the unemployment rate continue to fall over coming months in conjunction with further declines in the participation rate, the FOMC will opt to alter its forward guidance and either lower its unemployment rate threshold, say, to 5.5 percent, or explicitly lay out markers for other labor market indicators, if not a combination of both.

Such a change is even more likely given the FOMC’s greatest fear, at least implicitly if not explicitly, is tightening monetary policy too soon rather than too late. But, remaining accommodative only has value to the extent the declining labor force participation rate is cyclical, in nature. Otherwise, the upside risks to inflation rise without the payoff of a material improvement in labor market conditions.

Either way, without a definitive answer to the structural versus cyclical question the broader point, at least for Fed policy, remains – a lower participation rate distorts the signaling value of a lower unemployment rate and confuses communications tied to a specific unemployment rate threshold.