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Economics Group

WELLS FARGO SECURITIES

Special Commentary

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Labor Market Slack Diminishing? Fed to Follow?

In the Federal Reserve's pursuit to balance maximum employment and price stability, accurately assessing slack in the labor market is a necessity. Labor market slack—viewed as an excess supply of labor relative to firms' demand—or a lack thereof, is an important determinant of wage pressures and, ultimately, the Fed's benchmark measure of inflation, the PCE deflator. For the case where there is an abundance of spare labor, employers have little need to increase wages in order to retain or attract new workers. In contrast, relative scarcity in available labor will generate upward pressures on wages and, typically, inflation, with possible Fed actions to follow.

Labor market slack is an important determinant of wage pressures and, ultimately, inflation.

With the Great Recession having ended five years ago, the labor market is increasingly taking on the characteristics of the latter scenario. An index of six labor market variables shows the employment picture continuing to improve faster than its historical trend, although not as fast as in previous recovery and expansion phases of the business cycle (Figure 1).[1] By most measures, slack in the labor market persists—but by how much? Unemployment is still above estimates of its natural rate, more than 7 million workers are underemployed and another 6 million Americans are out of the labor force but would take a job if it were available.[2] However, the amount of slack is diminishing, and, by some measures, rapidly so. The headline unemployment rate has fallen 1.2 percentage points over the past year, while the broader U-6 measure, which captures the underemployed and discouraged workers outside of the labor force, has fallen 1.6 percentage points (Figure 2).

Figure 1

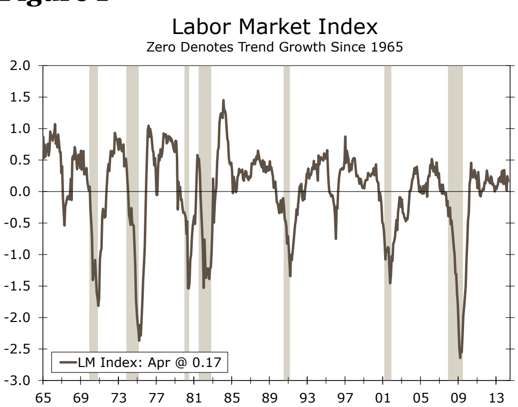
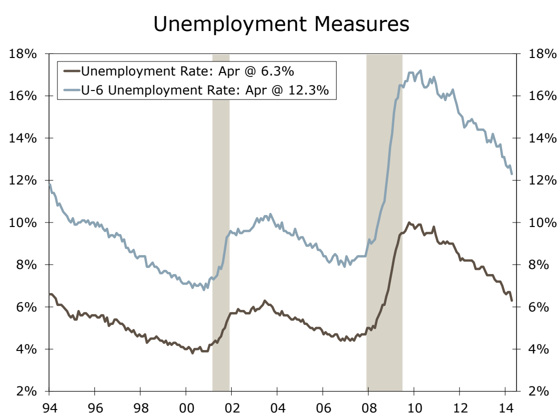


Figure 2



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

[1] **For more details, see "*Measuring the State of the U.S. Labor Market: A New Index*" by John Silvia, Azhar Iqbal and Blaire Zachary (Oct. 28, 2013), which is available on request.**
[2] **As of April, the unemployment rate was 6.3 percent, while the Congressional Budget Office estimated the natural rate of unemployment at 5.5 percent as of February 2014. The FOMC's central tendency range for the unemployment rate over the longer run was 5.2-5.6 percent as of March 2014.**

The debate over how much slack remains in the labor market is heating up within the FOMC. Minutes from the March meeting stated that "While there was general agreement that slack remains in the labor market, participants expressed a range of views regarding the amount of slack," and the discussion continued at the FOMC's April meeting. Where participants' views currently lie and how they evolve in the coming months will shape members' outlooks for the two sides of the Fed's mandate and, by default, the timing of when to raise interest rates.

Recent trends amid a few key indicators point to a strengthening in wage growth in the not-so-distant future.

Fed Chair Janet Yellen has emphasized a range of data indicative of labor market slack beyond the traditional measure of the unemployment rate. In this note, we review many of the alternative data points that have formed what is frequently being cited as Chair Yellen's "dashboard." On a level basis, we agree with Chair Yellen that there remains a "considerable degree of slack" in the labor market, but recent trends amid a few key indicators point to a strengthening in wage growth in the not-so-distant future.

The Unemployment Rate: A Good Starting Point for Measuring Slack

The unemployment rate is the most frequently cited measure of slack in the labor market. Although the unemployment rate has improved markedly since peaking at 10 percent in October 2009, it remains half a percentage point above its historical average since 1948 of 5.8 percent (Figure 3). Moreover, at 6.3 percent, the unemployment rate still stands higher than the level Fed indicates is appropriate over the long run (5.2-5.6 percent according to the Fed's latest central tendency).

Figure 3

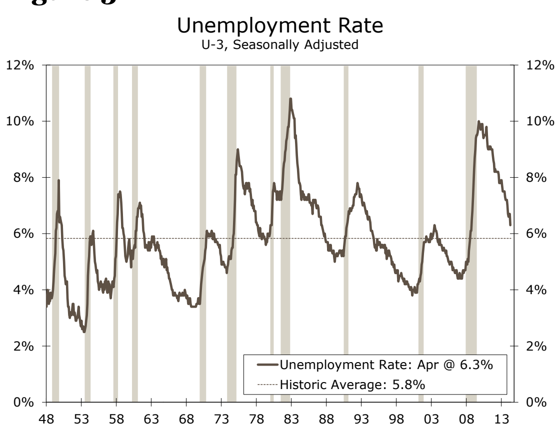
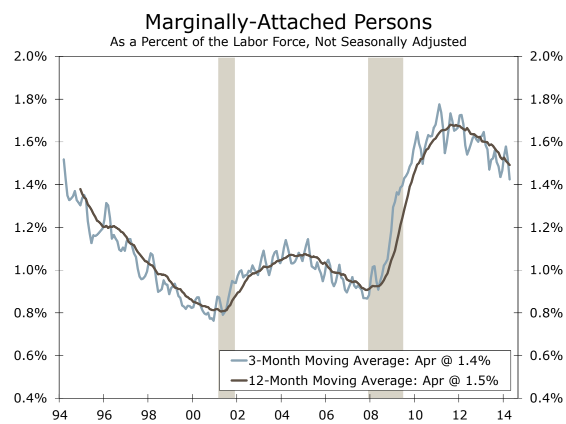


Figure 4



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

In the current labor market recovery, however, the unemployment rate has become a less reliable gauge of labor market slack. The rate of labor force participation has fallen to more than a 30-year low, as a sizable number of persons are no longer looking for work. This could be viewed as another sign of labor market slack, as some of these workers may come back into the labor force. However, about half of the decline is due to the baby boomers beginning to reach retirement age. The other half is due to declining participation among younger workers. As noted in a previous report, even if participation rates were to recover over the next few years, demographics will continue to drive the overall labor force participation rate lower.[3] The participation rate of prime age workers—ages 25-54—has fallen a little over 2 percentage points since the recession started as many workers have left the labor force to acquire new skills or are simply waiting for hiring to improve further. More than four years after employment began to recover the prime participation rate has not yet shown any clear signs of rebounding. If participation among prime-age workers remains depressed, growth in the labor force would be more constrained, leading to a tighter labor market on balance.

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[3] **See "*Labor Force Participation: Where to Now?*", April 9, 2014, which is available on request.**

Many of those who have dropped out of the labor force by official survey definitions continue to be interested in employment. The Bureau of Labor Statistics keeps track of workers who are marginally attached to the labor force, defined as persons who have searched for a job within the past year and are available to work, but are not currently searching for employment. The pool of marginally attached workers is shrinking relative to the labor force but remains high by historical standards, showing additional labor market slack beyond the more narrow definition of the unemployed (Figure 4).

Wage Pressures and the Long-Term Unemployed

For policymakers, a key subset of the unemployed to be considered in this recovery has been the number of workers out of a job for more than six months, also known as the long-term unemployed. Currently, the number of long-term unemployed stands at 3.5 million—35 percent of unemployed workers. The long-term unemployed face skills becoming out of date and deteriorating networks that can help land the next job. Evidence has shown that the long-term unemployed are less likely to find a job, even when having similar skills and experience.[4]

With fading skills and less likelihood of finding a job, a debate has risen as to what degree the long-term unemployed influence wages. If, on the demand side, employers write off the long-term unemployed, the pool of available labor would be smaller than indicated by the total number of unemployed. Similarly, on the supply side, if the long-term unemployed search for jobs less intensively because they are discouraged over their job prospects, the labor pool would appear smaller to employers.[5]

Some recent research has pointed to the short-term unemployment rate, rather than the headline unemployment rate, as being a better predictor of inflation.[6] However, given muted wage growth over the past few years, the long-term unemployed still appear to play an important role in wage setting. That said, the total unemployment rate and long-term unemployment rate remain historically high, but the short-term unemployment rate has fallen below its longer-run average, possibly suggesting a tighter labor market and greater inflationary pressures than the headline unemployment rate (Figure 5).

The short-term unemployment rate possibly suggests a tighter labor market than the headline unemployment rate.

Figure 5

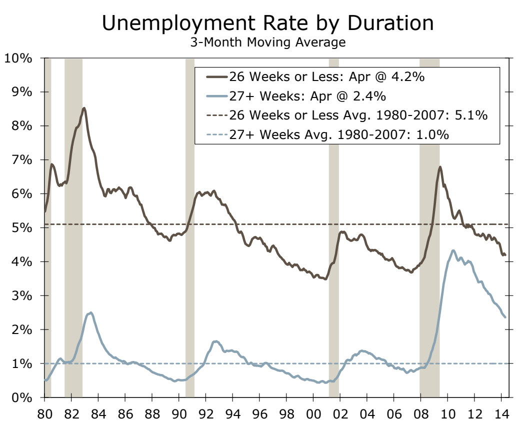


Figure 6

Source: The U.S. Department of Labor and Wells Fargo Securities, LLC

[4] **Valletta, Rob. Feb. 4, 2013. "*Long-term Unemployment: What Do We Know?*" Federal Reserve Bank of San Francisco Economic Letter. 2013-03.**
Ghayad, Rand. "*Long-term Unemployment in the Great Recession*" (2014). Economics Dissertations. Paper 17. http://hdl.handle.net/2047/d20004938
[5] **Krueger, Alan, Judd Cramer and David Cho. 2014. "*Are the Long-Term Unemployed on the Margins of the Labor Market?*" Brookings Panel on Economic Activity, March 20-21, 2014.**
[6] **Gordon, Robert. 2013. "*The Phillips Curve Is Alive and Well: Inflation and the NAIRU During the Slow Recovery*", National Bureau of Economic Research Working Paper 19390.**

The Underemployed: Slack Even Amongst the Employed

Although the short-term unemployment rate has returned to more normal levels, slack in the labor market can also be measured beyond just the number of persons out of work. In any given period, there are millions of workers who have jobs but want to work more hours. The willingness of these underemployed workers to pick up additional hours is another form of excess supply in the labor market.

Underemployed workers who cite weak business conditions for the reason they work part time remains elevated.

Currently, the number of persons employed part time but wanting to work full time stands at a little over 7 million. Also known as involuntary part-time workers, this group can be classified into two categories: those who cannot find full-time employment and those whose hours have been cut back due to weak business conditions. Not surprising given the sluggish pace of growth since the recession ended, underemployed workers who cite weak business conditions for the reason they usually work less than 35 hours per week remain elevated by historical standards (Figure 6). This is suggestive of cyclical weakness as these workers have the necessary skills to do a job, but perceived final demand remains weak. The size of this group, however, has declined notably since the recession ended, dropping from a peak of 5.0 percent of employed workers to 3.1 percent in April. The share of the employed working part time due to the inability to find full time work has remained little changed since the recession ended, which may also be suggestive of weak aggregate demand, or possibly mismatch between some workers' skills and job availability.

Labor Turnover: Good for Wage Growth

While the net volume of job growth in a given period garners the attention of most analysts and policymakers, the level and mix of job turnover can offer additional insight into the strength of the labor market. Higher turnover, i.e., the number of people being hired or leaving a job, in the labor market is typically a good sign for the economy (the exception being job separations due to layoffs). Clearly, robust hiring activity is also a strong sign for the labor market. The current hiring rate is about half a percentage point below its peak during the past expansion, but has trended to a post-recession high in recent months, indicating further improvement in the labor market (Figure 7).

Figure 7

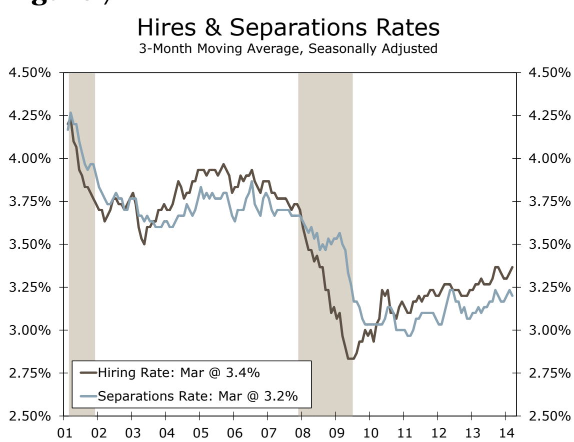
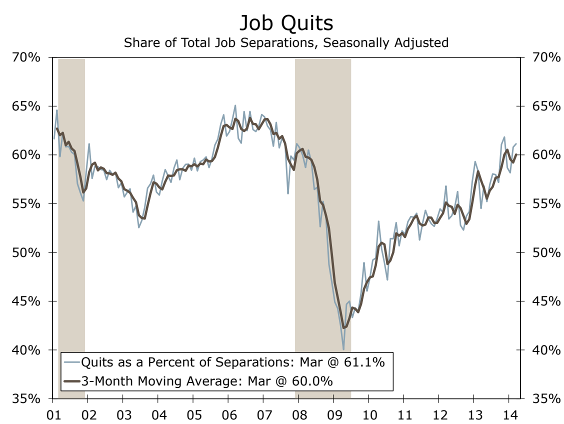


Figure 8



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

On the separations side of the equation, most workers do not quit a job unless they have another job, have adequate savings—perhaps for retirement—or feel confident in their prospects to land another job. Although still depressed relative to the past cycle, the number of workers quitting their jobs in a given month has also reached a post-recession high and now accounts for 61 percent of separations (Figure 8). While job-to-job churn may not raise the total level of employment, it does have implications for wage pressures. Workers who move directly from one job to a new job typically see their wages rise noticeably, reflecting the better matching of skills or increased competition for workers, with a 2012 study finding a median increase of 8.6 percent.[7]

Wage Growth Still Tepid, But Signs of Firming

With such a broad array of indicators still pointing toward an ample supply of labor, wage growth has remained modest. Average hourly wage growth for all employees has shown barely any improvement since 2010 and is up only 1.9 percent over the past year. Looking at production and nonsupervisory employees, which account for about 80 percent of employment, wage growth has shown a bit more improvement as slack in the labor market has diminished. On a year ago-basis, wage growth is rising faster than when the FOMC first raised the fed funds target during the 2004-2006 tightening cycle (Figure 7). However, growth remains more tepid than the 3-4 percent range Chair Yellen would expect to see given productivity growth.[8]

We expect wage growth to accelerate later this year.

As most measures of slack are pointing toward a tightening labor market, we expect wage growth to accelerate later this year. The latest NFIB small business survey showed a growing share of employers increasing wages over the past 3-6 months. With a growing share of businesses reporting positions hard to fill, future plans to increase wages are also rising (Figure 10). On the supply side, labor force growth remains weak, with the labor force participation rate for prime age workers yet to rebound in a meaningful way.

Figure 9

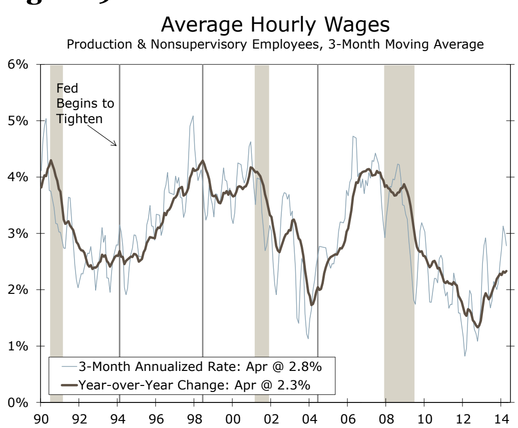
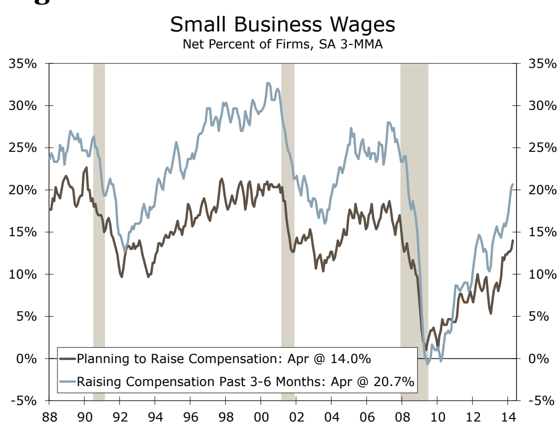


Figure 10



Source: U.S. Department of Labor, NFIB and Wells Fargo Securities, LLC

Diminishing Slack and Blunt Tools: How Much Can the Fed Help?

Since September 2012 when the Fed announced its most recent round of asset purchases, or QE3, the labor market has improved substantially. The headline unemployment rate has fallen 1.5 percentage points, while the U-6 measure of unemployment, which captures involuntary part-time workers and persons marginally attached to the labor force, has declined 2.4 percentage points. The Fed is on pace to continue asset purchases through the fall of this year, and the FOMC has stated its plans to keep the fed funds target rate low for a "considerable time" after purchases end. Yet, will the labor market have already tightened sufficiently to where wage growth and broader inflation are rising ahead of the Fed's expectations?

At 6.3 percent, the unemployment rate indicates that the labor market is quickly approaching what the Fed considers full employment. Other gauges of the labor market show slack is tightening, including declining rates of involuntary part-time employment and an acceleration in average hourly wages. The large number of long-term unemployed workers remains a broad concern, particularly as their chances for reemployment remain weak relative to their newly unemployed peers.

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7 Lazear, Edward and James Spletzer. 2012. "*Hiring, Churn and the Business Cycle.*" National Bureau of Economic Research Working Paper 17910.
8 Press conference from Fed Chair Janet Yellen, March 19, 2014.

The blunt tools of monetary policy, however, mean there is likely to be little the FOMC can do to help this subset of workers besides stoking overall demand, which may jeopardize the balance between the Fed's mandates on employment and price stability. If current forecasts for a strengthening in GDP growth later this year and through 2015 unfold, further tightening in the labor market could lead to wage acceleration and broader inflation heating up faster than the Fed expects.

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