

Understanding Today's Employment Challenge

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Key points

According to Lockhart, the **economy is gaining a little momentum**. In the next one to two years, the economy is likely to grow at a sustained modest pace, and inflation should return to a trend of around 2 percent. However, the range of plausible scenarios is widening and the **balance of risks has been shifting** with world news, such as the unrest across the Middle East and North Africa.

In Lockhart's opinion, **unemployment will decline gradually**. A variety of factors may be holding back job growth. On the supply side, there is some elevated **skill mismatch** in the economy, although the extent of the mismatch is not materially different from what we saw in the past. Meanwhile, some research estimates that **long-term unemployment** insurance has added to the measured unemployment rate. On the demand side, difficulties getting personal credit appear to have reduced **formation of new businesses** that are traditionally an important source of job growth. **Higher productivity** and **heightened uncertainty** may have restrained employment growth, although those effects should start to decline.

In Lockhart's opinion, the **slow recovery of employment cannot be simply pinned on one or two causes**. He does not think it's realistic to expect a reflexive bounce back to prerecession employment levels as a result of the anticipated modest pickup in growth. The **achievable longer-run sustainable unemployment rate may be a bit higher than before the recession**.

Lockhart believes that **monetary policy** can contribute to lowering the unemployment rate, but it should not be expected to eliminate all the factors holding back employment growth.

Thank you for that introduction. John Kurowski sent me an e-mail last week with information about your president, Larry Snowden. It's an honor to address an organization led by a man of General Snowden's stature.

Although a long time ago, General Snowden remembers, I'm sure, his basic officer training at The Basic School in Quantico, Va., where he was taught the technique of the "sitrep," or situation report. A sitrep is a battlefield assessment of all the relevant factors that a unit commander must consider at that precise moment in pursuit of a mission—terrain, protected areas, weather, enemy positions, and the like.

Today I will start by providing an abbreviated sitrep of the nation's economic situation as I see it. The Federal Reserve has a two-part mission, commonly known as the Fed's dual mandate. The Fed's mission is to achieve price stability and maximize employment. Both present challenges at the moment, but in my view the more vexing of the two is employment.

I will devote the balance of my remarks to the problem of unemployment. By going a little deeper than normal into the data, I hope to give you a more complete sense of the challenges involved in returning the country to full employment.

As I always do, I must emphasize that the views I will express are my personal thoughts and may not reflect the views of my colleagues on the Federal Open Market Committee (FOMC) or within the Federal Reserve.

The economy

The economy ended 2010 with moderate strength. Gross domestic product (GDP) growth was a little faster in the fourth quarter versus the third—2.8 percent annualized GDP growth, up from 2.6 percent in the third quarter. Recent data suggest that this modest strength has carried over into the first quarter of 2011 and the economy is gaining some momentum. Manufacturing output continued to climb in January, growth of residential construction accelerated, and consumer spending appears to be improving.

Most economists think this picture will continue. The consensus baseline forecast for the next one to two years is a sustained moderate pace of growth in a range of 3 percent to 4 percent, inflation that returns to a trend of around 2 percent, and gradual shrinking of unemployment. My own forecast—that of the Federal Reserve Bank of Atlanta—is broadly in line with this outlook.

As the membership of an economics club can appreciate, economic forecasting is not a total confidence undertaking, so we commonly try to lay out a range of possible scenarios and identify the upside and downside risk factors that could throw the economy off the baseline trajectory.

Not many weeks ago I was ready to say—as regards growth prospects—that I could be pleasantly surprised to the upside. The economy might grow faster than my assumed moderate pace, with unemployment coming down more quickly. I still hold to the view that I could be pleasantly surprised but with a touch more caution.

My sense of the balance of risks has been shifting with world news. For example, the unrest across the Middle East and North Africa has affected oil prices. At this juncture it's unclear whether the unrest and political instability will spread and intensify, driving global oil prices even higher. Yesterday, the spot price for West Texas Intermediate crude closed at \$102 per barrel, up from \$85 just a few weeks ago. The range of plausible scenarios is widening. A sober assessment of prospects for continued economic progress has to factor in not only the risk of a sustained oil shock but also risks associated with fiscal policies and politics both here and in Europe.

I'm sure inflation concerns are on your mind, so let me address that subject. Food and energy account for 23 percent of an average consumer's expenditures. Some prices within these components have recently moved up steeply. My reading of the evidence is that these increases are driven primarily by the combination of supply disruptions in global markets and rapid economic growth of major developing countries. Rising global commodity prices appear to have pushed near-term inflation expectations higher, according to the University of Michigan survey of consumers. An upward drift in longer-term inflation expectations would be an unwelcome development.

I'm well aware confidence is being tested by inflation commentary that points to commodities, imports, and the energy ingredient in many products and services. However, longer-term expectations in the same University of Michigan survey have remained quite stable. This stability suggests there remains confidence that the inflationary impacts of recent movements in commodity prices will be temporary. My

staff and I know we must remain vigilant in looking for any uptick in broad-based inflation that could unanchor longer-term expectations.

State of the labor market

As I mentioned earlier, I want to spend the bulk of my time talking about the unemployment situation. Let me put current unemployment in context. The economy has been in recovery since the summer of 2009. By the end of last year economic output as measured by GDP had reached prerecession levels. But while the economy is now producing more than three years ago, it is doing so with almost 8 million fewer workers. The recovery has brought little relief to the labor market.

Over the course of the recession, the unemployment rate doubled to 10.1 percent. Even though job losses were not spread evenly across geography, industries, and generations, it's accurate to say the effects were broad and deep. While pain was widespread, some groups were especially hard hit. The rate of unemployment rose substantially more for males, for those with a high school diploma or less, and for construction workers.

Although the economy is no longer in recession and we have experienced more than six quarters of economic growth, employment is lagging other economic indicators. In January, the unemployment rate was 9 percent, with 14 million unemployed people actively looking for jobs. An additional 8 million people who wanted a full-time job were working part time—double the number prior to the recession. So well over 20 million people have an unsatisfactory work arrangement.

While unemployment remains high, the overall demand for workers is gradually improving. Employment has increased by almost a million on net over the last year, and the pace of job growth is picking up. Also, the large volume of announced layoffs that plagued the economy in 2008 and 2009 has declined, at least through January.

As a consequence, the unemployment rate dropped eight-tenths of a percentage point from November to January (although people leaving the labor force played a part.) And the four-week moving average of first-time claims for unemployment insurance is trending lower. Tomorrow, we will get a reading on employment data for February. Expectations are for a solid gain in employment, but it will be difficult to interpret these data because of the potential rebound effects from the severe weather in January. Separating signal from noise has been difficult recently.

Just as job losses were uneven in the recession, job growth in the recovery has not been evenly distributed across demographic categories. Take, for example, educational attainment. Employment is increasing for people with a college degree, while those with a high school degree or less are still losing jobs. Employment recovery has also been uneven when industries are compared. For example, the construction industry and information services such as publishing, broadcasting, and telecommunications experienced heavy employment losses in the recession. These areas continue to lose jobs, on net. Other industries, for instance automobile manufacturing, have seen a return to job growth. A few industries, notably health care, increased employment during the recession and continue to add to payrolls in the recovery.

The deep recession and the slow employment recovery have created a very worrying problem, long-term unemployment. Those out of work are staying out of work longer, on average. The average unemployed person has been jobless for about eight months, and half of the unemployed have been looking for work for more than 20 weeks. This situation could have lasting negative effects. Research shows that long-term unemployment reduces lifetime earnings and lowers financial stability in retirement. It also has been shown to adversely affect people's health and their children's potential for success.

Structural factors

Let me now talk about underlying causes of slow employment recovery. Economists, analysts, and various commentators have cited a variety of factors that may be holding back job growth and contributing to long-term unemployment. Some experts believe these factors include some that are structural in nature. On the supply side, skill mismatch, reduced geographic mobility, and effects of extended unemployment insurance are three frequently cited structural explanations.

Skill mismatch exists when work skills of job seekers do not match the requirements of jobs that are available. For example, a construction worker is unlikely to have the particular skills needed in the health care industry. When skill mismatch occurs, an unemployed person may need to first acquire new skills to get a job. It's surmised that the recession created some skill mismatch in the labor market.

Fed researchers recently looked at this proposition. They found that the extent of the mismatch is not materially different from what we saw in past. Anecdotal accounts from contacts here in Florida point to both classic skill mismatch and job redesign that requires higher skill levels and greater versatility. In my view, there is some elevated skill mismatch in the economy but mismatches alone cannot fully explain the unusual persistence of high unemployment in this recovery.

House-lock is cited as an impediment to geographic mobility. The phenomenon of house-lock is related to the state of the residential real estate market. Currently many people owe more on their homes than their homes are worth. It's claimed that job seekers don't accept jobs available in other geographic locations because of the difficulty or cost of selling their homes. Studies have not been able to find convincing evidence that unemployment is high because of reduced geographic mobility. In fact, migration across the United States has been declining since the 1980s, but the decline did not increase in the last three years.

As you know, unemployment insurance benefits have been extended to unprecedented long durations. It is argued that these benefits give job searchers the ability to hold out longer for a good job and may in some cases reduce the intensity of job search. According to this view, extended benefits act as a disincentive to accept an offered job, especially if the job pays less than the one lost. I have heard anecdotal accounts of this disincentive effect. Some research estimates that long-term unemployment insurance has added anywhere between 0.4 and 1.7 percentage points to the measured unemployment rate. So for this particular explanation there does appear to be some measurable effect.

Other impediments to job creation

Those are supply-side explanations. On the demand side, it's been argued that credit constraints affecting small businesses are holding back hiring. Banks are blamed for this situation and so are regulators. Getting credit at an affordable cost was a challenge during the recession. But credit conditions for established small businesses have been steadily improving for some time now. Recent surveys suggest that most small businesses are cautious about hiring more because of slow sales growth rather than lack of access to credit.

Furthermore, a recent National Bureau of Economic Research study showed that job creation is more correlated to young businesses than the broad class of small businesses. Start-ups and young businesses are often financed in ways other than direct business loans. Difficulties getting home equity loans and other personal credit appear to have reduced formation of new businesses.

Strong productivity growth is another much-discussed potential impediment to hiring. Stated simply, increases in productivity allow businesses to support a given level of sales with fewer people. In the longer term, rising productivity expands the economy's output, which in turn generates jobs. But in the short run, productivity investment can be the enemy of employment growth.

Productivity growth was unusually high during the recession and in the early stages of the recovery, limiting the need for additional workers. Recently, however, productivity growth has slowed below the pace of business sales. If this trend continues, the need to hire additional workers will increase.

Finally, in recent months, reluctance to hire has been attributed to heightened uncertainty, a common theme among my business contacts. A few weeks ago I argued that uncertainty has abated somewhat with the improving economy, the resolution of the November elections, the extension of tax cuts, and the apparent containment of the European sovereign debt crisis. I said that before Tunisia and before the fiscal struggle in Congress gathered steam. The restraining influence of uncertainty persists, to some extent.

Role of monetary policy

In my reading of the available information and research, the slow recovery of employment cannot be simply pinned on one or two causes. It's a multifaceted problem. I do not see one big factor that, if successfully addressed by policy, would rapidly bring the down the rate of unemployment. There is a lot we don't know. Forces at work are complex. Measurements are often imprecise. Not having all the answers clearly adds to the Fed's challenge of calibrating monetary policy.

Certainly sustained recovery and the accompanying rising demand will be a real help, if not a cure. I expect employment to grow if the economic momentum apparent today continues.

But I also expect a harder nut of unemployment to remain that will take time to work down. I don't think it's realistic to expect a reflexive bounce back to prerecession employment levels as a result of the anticipated modest pickup of growth. We haven't seen such a bounce back so far in the almost seven quarters of recovery.

The economy has evolved and moved on, to a significant extent, as a result of productivity gains and shifts of industry composition. Getting some of the unemployed back to work will call for human adjustments that take time—adjustments such as adapting skills to new work, new skills acquisition, relocations, and resetting of expectations as regards income.

The rise of employer demand for workers is also likely to be unhurried. After the trauma of the recession and financial crisis, it's understandable that the confidence needed to spur new business formation and new establishments—the confidence that will unleash the “animal spirits” of entrepreneurs and risk takers—will accumulate steadily, but not just snap back.

For a number of reasons, it's probable that the achievable longer-run sustainable unemployment rate is a bit higher than before the recession. Estimates vary among economists. At the Atlanta Fed, we currently see the longer-term sustainable rate of unemployment around 5.5 percent. I believe structural factors may be adding an additional 1 to 1.5 percentage points to this rate.

With unemployment currently at 9 percent, monetary policy certainly has a potential role to play in addressing this difference—the gap between 9 percent and 6.5 to 7 percent. In my view, shaping favorable macroeconomic conditions for demand-sensitive employment growth—consistent with price stability—is the appropriate role. Monetary policy can contribute, but it shouldn't be expected to eliminate all the factors holding back employment growth.

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