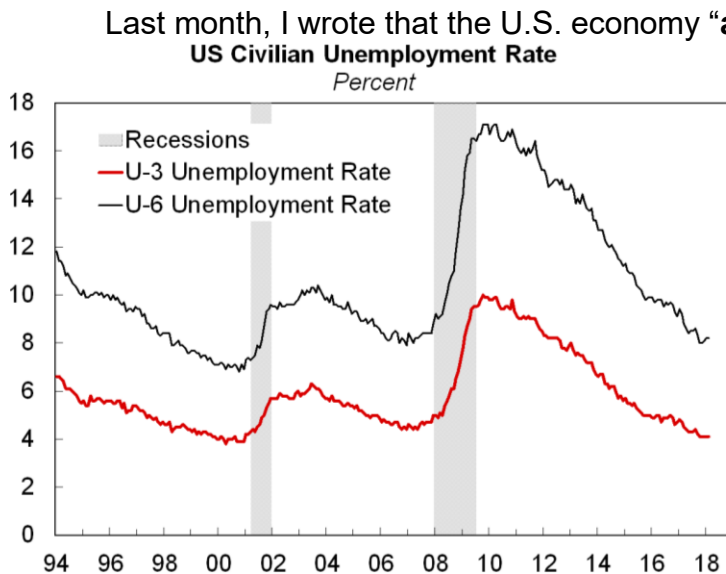


Current Economic Conditions

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IS THE U.S. ECONOMY REALLY AT FULL EMPLOYMENT?



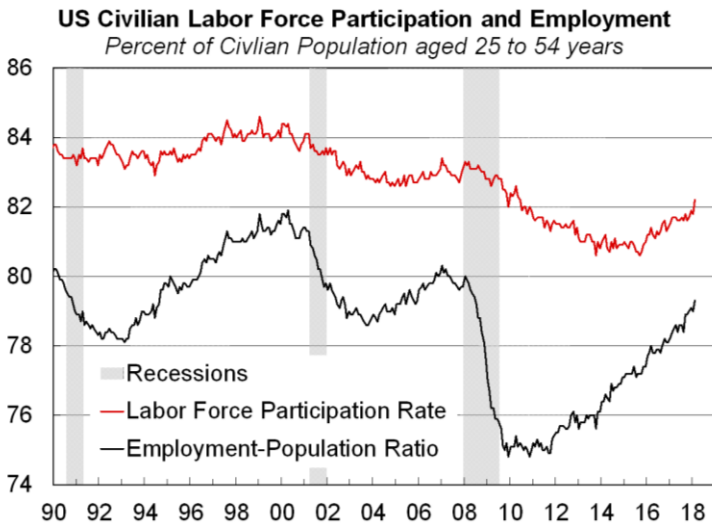
Being at full employment has implications for both economic growth and inflation. If an economy is at full employment, growth must come from growth in the working age population and from productivity growth, not from simply putting the unemployed back to work. Barring a big increase in immigration, unlikely under a Trump Administration, growth in the working age population will remain slow for at least the next two decades, leaving productivity growth the only potential source of faster growth.

According to the (expectations-augmented) Phillips Curve used by many economists, inflation accelerates when the unemployment rate is below the natural rate of unemployment. That’s why the natural rate is also known as the non-accelerating-inflation rate of unemployment, or NAIRU. But there are problems with this theory of inflation. First, a tight labor market should raise real (inflation-adjusted) wages and salaries, not prices. Theoretically, the Phillips Curve relationship should be between unemployment and real wage increases, not between unemployment and price increases. Higher wages do not exert upward pressure on unit costs (and therefore on prices) unless wages grow faster than productivity. An increase in real wages and salaries that exceeds productivity growth can be inflationary. An increase in real wages and salaries that is matched by an increase in productivity is the single best thing that can happen to an economy. For most people, it’s better than an increase in Gross Domestic Product, corporate profits, stock prices, employment, or any other single economic measure.

But even an increase in wages and salaries that exceeds productivity growth is inflationary only if markets for goods and services are tight enough to allow businesses to push higher labor costs through to their customers. Ultimately, inflation is caused by tightness in goods and services markets, not in labor markets. A broader approach to inflation compares GDP to CBO’s estimate of potential GDP, the highest level of GDP consistent with stable inflation. Actual GDP surpassed the CBO’s estimate of potential GDP in the third quarter of 2017. Potential GDP depends not only on the available labor force, but also on the

stock of capital and on technological progress. The problem with the CBO's estimate of potential GDP is that it relies on forecasts of productivity growth that may be little more than extrapolations of short-term trends. In CBO's own words, "CBO's projections for 10 year periods are based on its estimates of economic trends during the most recent full business cycle and in the as-yet-incomplete, current cycle."

Several indicators suggest that there may be more slack in the labor market than suggested by the unemployment rate. This is because people don't count as unemployed **and as part of the labor force** unless they've looked for a job within the last month. (If they haven't looked for a job within the last 12 months, they aren't even counted as unemployed in the U-6 unemployment rate.) The many people of



working age who are not employed but are not counted as unemployed and included in the labor force show up as a low labor force participation rate, the ratio of labor force to working age population. The labor force participation rate (LFPR) for the 25-54 age group rose in February, but it is below 2007 levels and well below the peak reached before the admission of China to the World Trade Organization in 2001 started the hollowing out of American manufacturing. This suggests there is still slack in the labor market. (Economists focus on the LFPR for the 25-54 age group because it is not affected by the aging of the population.) The employment-population ratio, which is probably a better measure of slack, is also well below 2007 and 2000 levels.

Recent growth in employment doesn't tell us how tight labor markets are now, but does suggest that there was still significant slack in the labor market when the unemployment rate fell below the CBO's estimate of the natural rate in November 2016. Since then, payroll employment has grown by an average of 195,000 per month. Over the same period, civilian employment, from the household survey used to calculate the unemployment rate, has grown by 206,000 per month, while the labor force has risen by 158,000 per month. Over the last five months, with the unemployment rate stable at 4.1%, payrolls have grown by 243,000 per month. No more than 100,000 are needed to absorb growth in the working age population. Continued slow growth in wages and salaries also suggests that there has been more slack in the labor market than unemployment rates indicate. If labor markets were tight, wages would be rising more rapidly, and employers would be spending more on employee training and labor-saving technology.

History confirms that the U.S. economy can grow rapidly for an extended period even when the unemployment rate is below the CBO's estimate of the natural rate. Unemployment fell below the natural rate in the fourth quarter of 1987. Over the next 10 quarters, real GDP grew at a 3.8% annual rate. Unemployment again fell below the natural rate in the fourth quarter of 1997. Over the next 10 quarters, real GDP grew at a 4.8% annual rate. I expect the CBO to revise down its estimate of the natural rate, confirming that there has been more slack in labor markets than they initially thought and suggesting that the economic expansion has further room to run.

If we've really reached (and gone beyond) full employment and exceeded potential GDP, this economic expansion isn't likely to last beyond 2019: inflation will rise above the Fed's 2% target; the Fed will raise the Federal Funds rate until it exceeds the 10-year bond yield; and the expansion will end. But if rising wages and salaries (and changes in policies regarding Social Security Disability Insurance, the Supplemental Nutrition Assistance Program, and other aid to the non-working population) induce people to return to the labor force and if deregulation and investment in plant and equipment boost productive capacity and worker productivity – **so that growth in supply keeps up with growth in demand** – inflation will remain under control, the Fed will raise rates very slowly, and growth will continue for several years.