The Myth of Full Employment and Why the Fed Won't Raise Rates This Year

By James Hickman Follow | 04/14/16 - 12:12 PM EDT
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Despite what you've heard, the Federal Reserve won't raise interest rates again this year. Inflation is below target; the economy isn't growing quickly enough; and full employment, one of the metrics Fed Chair Janet Yellen has been watching and citing as cause to raise rates, is a myth. Other than the understandable impetus to finally depart from zero-bound interest rate policy, there is no macro data supporting the move toward tightening.

The mandate of the Federal Open Markets Committee (FOMC) established by the Federal Reserve Act is to achieve maximum employment, stable prices, and moderate long-term interest rates. As to the full employment objective, the federal funds rate has been increased on several historical occasions when unemployment exceeded 7%, as this factor seems particularly idiosyncratic over time. In short, rates have been increased historically despite high unemployment because of other objectives deemed weightier at the time (e.g., the Volcker/Reagan war on inflation). I will explain here why the real unemployment rate is near 7.5%, and the FOMC surely knows this -- and why, as I wrote in January of this year, the Fed won't raise rates again in 2016.

GDP growth is a leading or coincident indicator of inflation rates. The FOMC has never implemented rate increases in the presence of below average GDP growth and low inflation -- until December 2015. The Fed's stated desire to implement "moderate" increases in rates appears to be solely motivated by the desire to normalize after seven years of zero-bound interest rates, given the third leg of its congressional mandate to "moderate long-term rates." The Fed wants to have some levers to pull in the event of another recession and is surely wary of risk apathy in markets.

But, for now, let's look at the only leg that the Fed has to stand on in regards to raising rates: the myth of full employment.

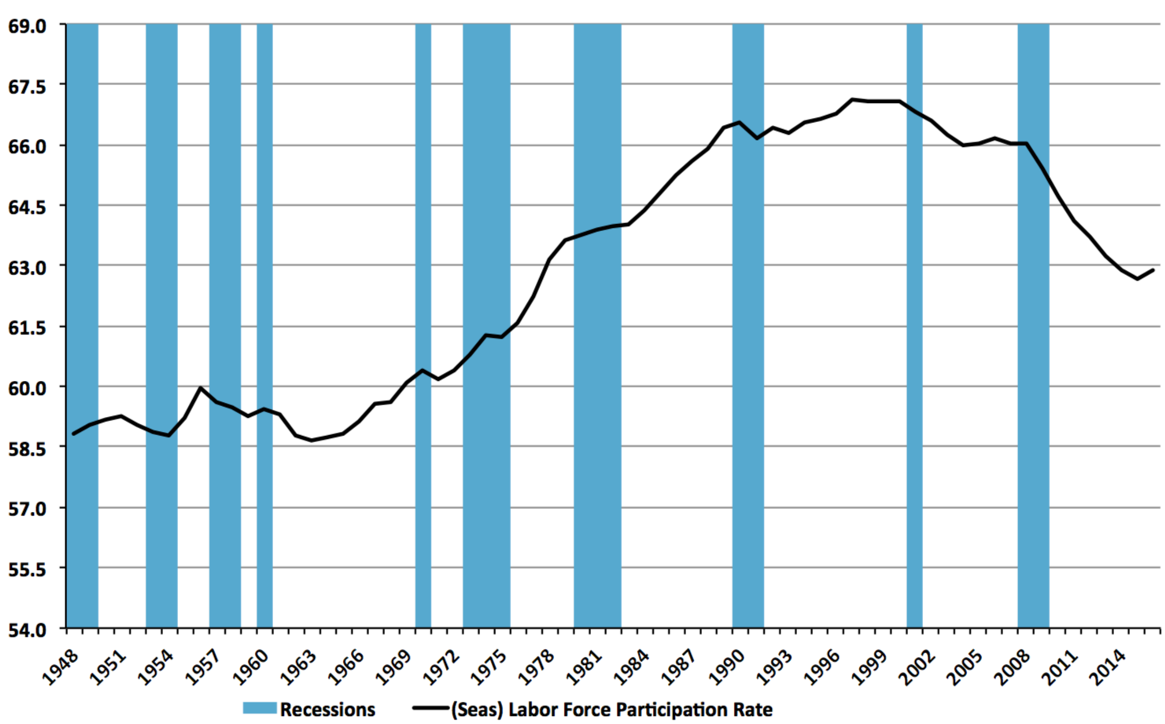
As Yellen recently stated, "We're near full employment or maximum employment ... but there remains some margins of slack in the labor market ...."

Well, which is it?

In all fairness, her allusion to slack makes her an outlier among a majority and nearly consensus view that the U.S. economy is already at full employment. It's just not true, and it is hard to imagine the Fed raising rates to anywhere near "normal" in the current economic milieu. Even if it does, it will likely only have the effect of further flattening the yield curve, as markets are not going to begin pricing higher rates given the deflationary global landscape. Full employment would seem to be the only substantive hook upon which the Fed could hang its hat to justify meaningful rate increases, and it is hedging its bets on that score, with good reason.

Adjusting for the increasing share of the overall civilian working-age population occupied by older folks who participate less in the work force, overall participation rates are still historically low and mask millions of unemployed workers in official labor statistics.

U.S. Labor Force Participation Rate and Recession History



Source: Bureau of Labor Statistics

The chart above shows a steady historical rise in U.S. labor force participation, with a couple of relatively modest corrections following recessions between 1957-to-1961 and in 2001, followed by a modest drop to 66% after the technology bubble burst in 2001. A precipitous and unprecedented drop for the post-WWII era was observed from 66.4% prior to the recession of 2008 to the 63% level observed over the last three years.

Is 63% simply the new normal or evidence of serious labor force slack masked by official Bureau of Labor Statistics (BLS) numbers, particularly the unemployment rate? In order to believe the U.S. economy is currently near full employment, one must also believe the labor force participation decline from 66% to 63% between 2008 and 2013, equivalent to 7.6 million individuals, was "structural" and does not reflect labor force slack. Analysis of the numbers says otherwise.

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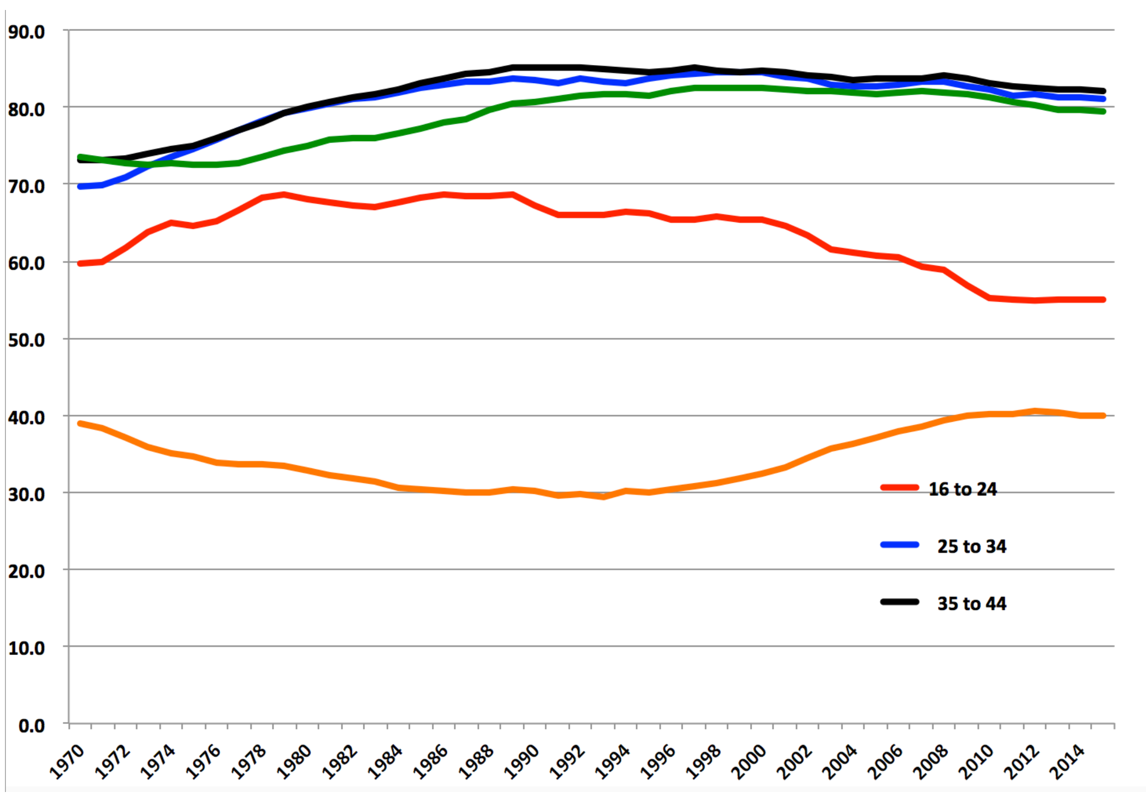
Applying 2008 participation rates by age cohort to the respective 2015 civilian populations suggests just over half (1.6%) of the overall 3% decline in labor force participation is related to the retirement of baby boomers. Interestingly, the negative impact on overall participation rates owing to more over-55s in the work force has been mitigated by a significant increase in the participation rate of that cohort (see the chart below). Accounting for these structural changes, labor force participation should currently be closer to 64.5%, suggesting there are over 4 million unemployed not counted in official BLS reports and an actual unemployment rate of almost 7.5%, not the 5% reported.

U.S. Labor Force Participation Trends by Age Cohort 1970-2015



Source: Bureau of Labor Statistics

Are there other structural factors behind lower participation rates?

Other factors contributing to decreases in participation rates frequently cited include the following:

1. Decreasing participation by women. Female participation rate was roughly flat from 2000 to 2008. Since 2008 participation rates have fallen for all groups, except the 55+ age cohort.

2. More high school graduates attending college. The opposite is true since the financial crisis.

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3. An increase in worker disability. Using Social Security Disability Program statistics as a proxy for broader disability trends, there was a significant spike in beneficiaries from 2008 to 2010, representing only 0.3% of the 1.3% participation rate decline in that time. From 2010 to present, when almost 60% of the 3% drop in participation rates occurred, the rise in disability beneficiaries was roughly commensurate with the growth in the working-age civilian population.

4. Rise of the "gig" economy. **Uber** is the poster-child for the so-called "sharing economy" and many imitators in various industries have either already come and gone or are struggling. But despite its rising litigation budget, Uber continues to prosper and recently reported having shared data on 583,000 drivers with various regulatory agencies. As many as half those drivers may not be active with Uber any more, given the 50% attrition rate per year it reported. Uber plays the role of "bridge" income provider for many of its drivers who are in between jobs, rather than a new profession. Moreover, the weighted average hours driven per week was reported to be under 23 in 2014. Of the relatively small percentage of Uber drivers who are full time, most are former black car or taxi drivers, and thus do not represent net job gains in the economy. **Airbnb**, the other most successful sharing-economy company, does not provide a job at all, but an opportunity to monetize the idle time of existing assets. In short, the gig economy is not likely an explanation for a meaningful share of the unexplained decline in participation rates.

Are we close to full employment?

At 220,000 jobs per month, the average increase over the last three years (as a percentage of total jobs, a level ranking roughly 500th highest out of almost 950 monthly observations since 1940), it would take 29 months to reach real "full employment" and start seeing real wage growth. Notwithstanding, the fact that 2.5 years is still a long wait for full employment, how likely is it those jobs growth numbers will materialize in that time? I will return to that question momentarily.

I still have not accounted for high levels of under-employed members of the labor force or the skew in rising employment toward lower-paying jobs. At peak employment prior to the 2008 recession, the rate of underemployed was 3.0% (as low as 2.3% at height of tech bubble). That figure is currently 4%, suggesting another 6.1 million people are underemployed, 1.5 million more than should be expected in a full-employment environment.

Finally, real median household income is up 1.1% per annum since the post-recession trough in 2011, to levels not seen since 1996. The income trends say the U.S. economy has not reached full employment (labor scarcity produces significant real wage increases) and the jobs added have broadly been of the lower-pay variety.

So, what are the prospects that an average of 220,000 jobs are added for 29 straight months?

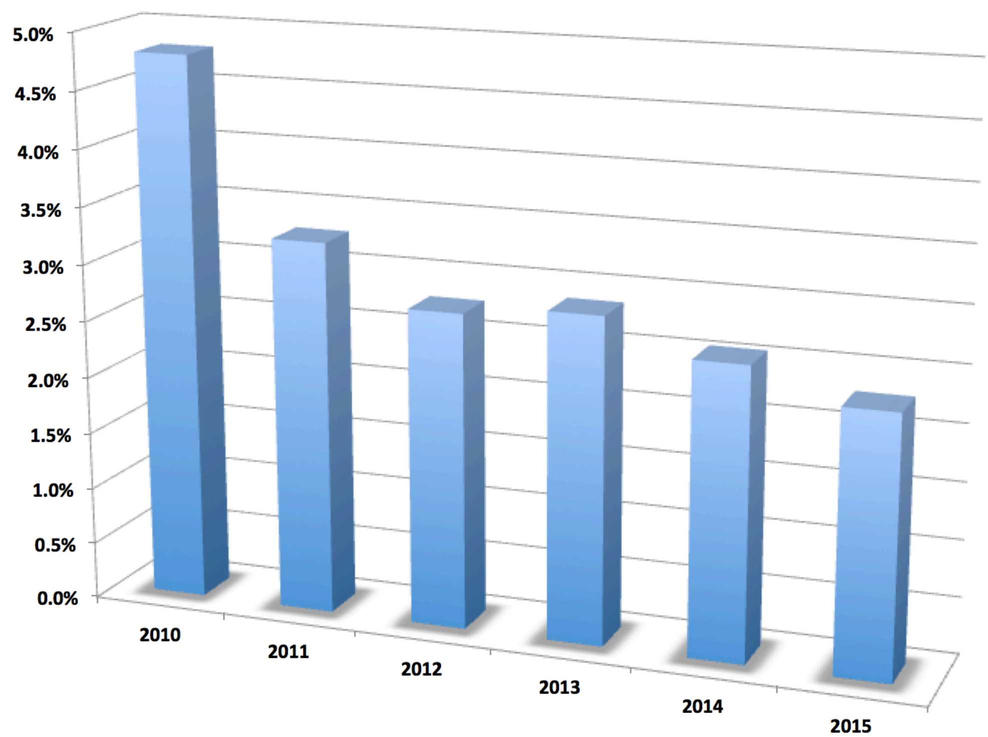
The global economy enters a sixth year of decelerating growth (see chart below), and the IMF recently cut its 2016 forecast for the fourth time in the last twelve months (the IMF has proven optimistic on its growth forecast for each of the last three years, even after accounting for multiple downward revisions).

The U.S. economy is in the fourth-longest period without a recession since 1948 (81 months and counting -- albeit the weakest recovery since WWII). The optimism is hard to explain given readily identifiable global productivity headwinds in that time. It is difficult to conjure a convincing scenario in which the U.S. manages to sustain recent job growth trends as the global landscape deteriorates.

In the absence of capital spending increases to drive production growth the muddle through global and U.S. economies and weak corporate earnings will persist.

The good news? As predicted in these pages, easy money policies will persist and risk assets will continue to enjoy a safety net, until the music inevitably stops and the proverbial fiddler gets paid.

Global Economic Growth for Top 10 Economies (65% of Global GDP)



Source: IMF, World Bank and various primary, country-specific sources

This article is commentary by an independent contributor. At the time of publication, the author held no positions in the stocks mentioned.