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FOCUS NOTES

US unemployment rate will keep falling, underpinned by the structural decline in the labor force participation

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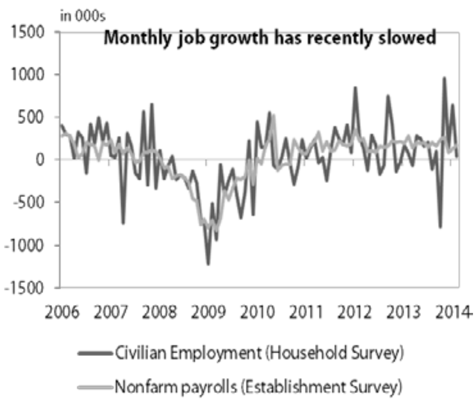
- After the recent slowing in the pace of employment growth, the nonfarm sector experienced modest payroll growth with diminishing weather effects.
- Although labor market slack is on a downward trend, it still remains elevated reinforced by the high levels of long-term unemployed and employed part-time who cannot find a full time job.
- A large part of the recent decline in the unemployment rate is due to the downward trend of the labor force participation rate. Given than at least half of the decline in the labor force participation rate during the crisis is due to structural factors, the downward trend driven by demographic factors will more than offset any cyclical participation rebound.
- Hence, we expect the unemployment rate to trend lower to 6.0% by Q1 2015. The Fed will probably reduce its monthly pace of asset purchases by about $10bn at its FOMC meeting on March 18-19, concluding its asset purchase program in Q4 2014. The first rate hike won't come until mid-2015, when the unemployment rate should hopefully have reached 5.8% and core PCE inflation 1.7% y-o-y.

Modest job growth, with diminishing weather effect

After two consecutive months of a significant slowing in the pace of job growth due to adverse weather conditions, nonfarm payrolls increased by 175k in February, with private payrolls expanding 162k and the government sector rising 13k. The drag from weather was smaller than expected in the establishment survey, with broad based gains across service providing sectors (+140k) which have trended lower in December and January. Nevertheless, the impact from the weather was more evident in the February household survey, with civilian employment rising only 42k and the unemployment rate rising from 6.6% to 6.7% (Figure 1). Besides, in the household survey there were 601 thousand workers who reported that they have been unable to work due to the weather, while the long-term average of the series is about 350K, suggesting a significant impact from the weather close to 250K. All in all, the labor market report was not as weak as previously expected and suggests a rather modest job growth, with the three month moving average hovering around 130k, down from 225k reported in H2 2013.

Figure 1

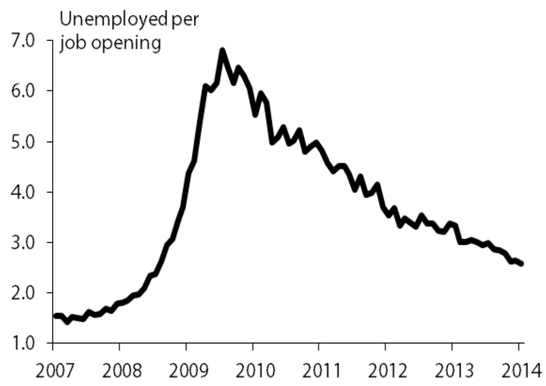


Source: Bureau of Labor Statistics (BLS)

Labor market slack on a downward trend, but still elevated

The Job Openings and Labor Turnover (JOLTs) January report has shown 3,974k job openings, registering a 60k rise from the previous month and leaving job openings rate steady at 2.8%. As is evident in Figure 2, unemployed job seekers for each job opening fell to 2.57 in January from 2.64 in December, which is down significantly from the level 3.33 at the beginning of 2013, suggesting that labor market slack is on a downward trend, albeit not at its pre-crisis level. Unemployment and job openings rates tend to vary in a systematic way during the business cycle. The negative slope between the two variables is widely known as the Beveridge curve (Figure 3). The dots in the green cycle represent low job openings and high unemployment with a position low and to the right on the curve, indicating a period of economic contraction. On the contrary, the dots in the blue cycle (high and to the left on the curve) represent high job openings and low unemployment rates, indicating a period of economic expansion. Figure 3 shows that there is increased recruiting activity on the part of the business sector as is evident by the high openings rate, while there is a relatively smaller decline in the unemployment rate (red dot). The 2.8% job openings rate reported in January 2014 would correspond to an unemployment rate of about 5.5%, while the current rate of unemployment currently stands at 6.6%.

Figure 2



Source: Bureau of Labor Statistics (BLS), Eurobank Research

There are several possible reasons for this mismatch between available jobs and the unemployed. From the cyclical point of view, the economy usually takes time to adjust to changes in job openings and unemployment as it may take longer for unemployment to decline than for job openings to increase. This could be attributed to the reentry into the labour force of jobseekers who had stopped looking for a job when the economy was in decline. Furthermore, there are structural forces that create mismatches between the types of job openings and the skill set of available workers. Long-term joblessness, which has been a key feature of the latest recession and recovery (Figure 4), tends to create structural unemployment, as long-term unemployed workers tend to lose skills and contacts and find it difficult to get a job. Moreover, alternative measures of underemployment such as involuntarily part-time employees who would rather be full-time suggest that the skills of part time workers are not consistent with the current types of full time jobs. In particular, Figure 5 shows that part-time employees (working less than 35 hours per week) who had their hours reduced due to unfavorable business conditions (cyclical reasons) are falling, while part-time employees who searched but could not find a full-time job is holding steady (structural). Last but not least, structural shifts in the Beveridge curve could be industry or geography-related. In particular, looking at the unemployment rates and the job openings rate among different sectors of the economy (Figure 6), we find that there is high unemployment in the construction sector (12.3%) with a jobs opening rate of 2.8%, while there is high demand for workers in financial services (3.3%), where the unemployment rate is currently hovering around the low level of 3.8%.

Figure 3

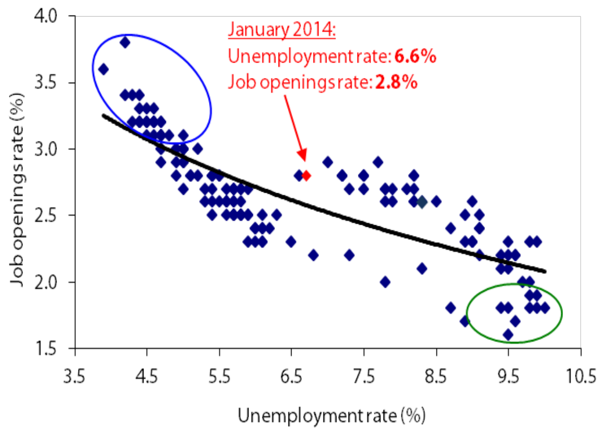


Figure 4

Source: Bureau of Labor Statistics (BLS), Eurobank Research

Figure 5

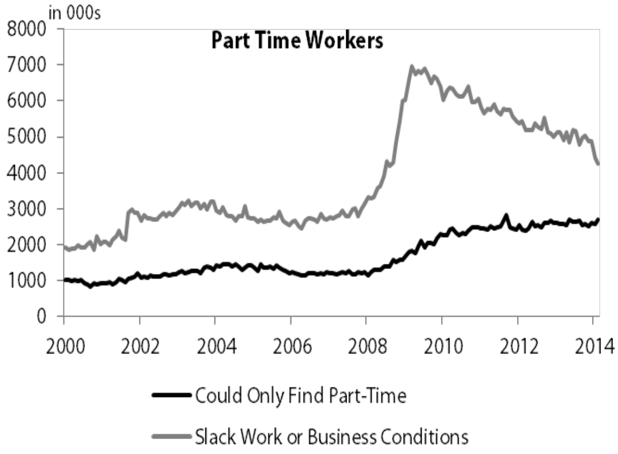
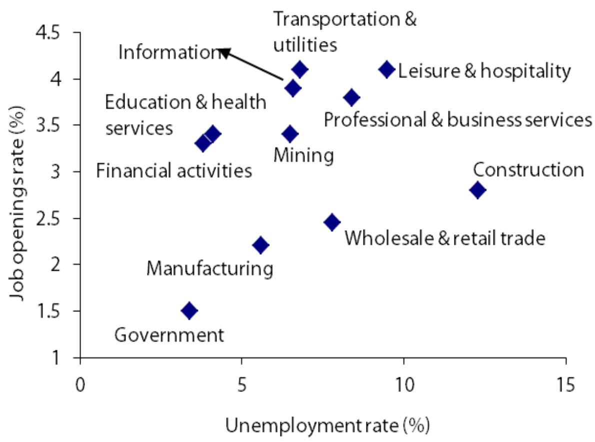


Figure 6



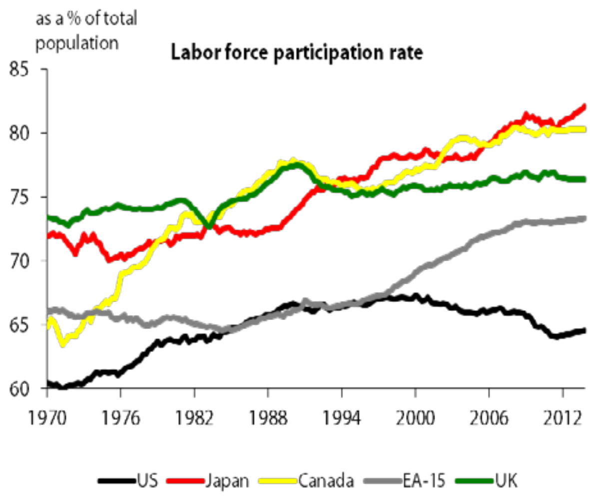
Source: Bureau of Labor Statistics (BLS), Eurobank Research

A large part of the labor force participation decline is due to structural factors,…

Labor force participation, which measures the proportion of adults either working of trying to find a job, has been on an upward trend from 1970 to 2000, mainly to the entering of women into the labor force. After reaching its peak at the beginning of 2000, the participation rate has been falling due to demographic factors, as opposed to the euro zone countries and some major industrialized countries (Figure 7). As is evident in Figure 7, the baby boom[1] generation reached their 50s, and early retirement has pushed participation rates to considerably lower levels. With the aging of the baby-boom generation, the older age group has made up a much larger share of population over the last decade and is expected to continue trending higher towards 2020 (Figure 8). According to Census Bureau's projections, the 55-years-and-older age group will total 96.3 million in 2020, composing 36.6% of the 2020 adult population, compared with 31.4% in 2010 and 27.1% in 2000.

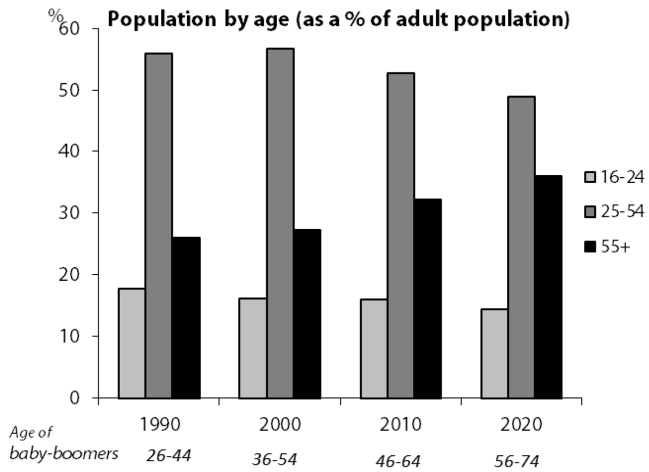
[1] A baby boomer is a person who was born during the demographic Post–World War II baby boom between 1946-1964.

Figure 7



Source: OECD

Figure 8



Source: Census Bureau, Eurobank Research

The labor force participation in the US has declined by about 3 percentage points from its pre-crisis level -from 66.2% in January 2008 to a 30-year low of 63% over the last couple of months. The unemployment rate is computed as the number of unemployed people actively looking for a job as a proportion of the overall labor force and, therefore, is vulnerable to fluctuations of the active labor force. As a result, the labor force participation decline has been a determinant factor in the decline in the unemployment rate from its recent peak of 10.0% in October 2010 to 6.7% in February 2014. The decline in the participation rate since 2008 was driven by demographic factors (aging of the baby-boom generation), as well as cyclical factors during the 2008-09 recession, as many workers became discouraged by fewer labor market opportunities and quit their efforts to find a job. Quantifying the structural and cyclical factors that have led to the decline in the labor force participation rate since the onset of the last recession would be very useful for the path of the unemployment rate ahead and the evolution of the monetary policy. For this reason, we try to isolate the demographic effect on the labor force participation rate by holding the age group participation rates steady at their 2007 levels (before the crisis) and allowing the population shares of each age group to vary[2]. According to our estimations, if we took into account only demographics, the labor force participation rate would have been 64.2% in February 2014 instead of the actual 63.0%. Hence, it seems that at least half of the decline in the labor force participation rate during the crisis is due to structural factors, and this view is consistent with the findings of two recent studies of Bureau of Labor Statistics and Kansas City Fed[3]. Furthermore, looking at the breakdown of persons not in the labor force, we find that persons not in the labor force as a percentage of total population increased by 3.2% from January 2008 to February 2014, and the majority of this increase represents persons who do not want a job (Figure 9), reinforcing the view that structural factors account for a very large part of the labor force participation decline. Besides, most of those who do not want a job are 55 years and over, suggesting that the aging of baby boomer generation has led to an increase in the rate of retirement which, in turn, led to a decline in the labor force participation rate since the 2008-09 recession. According to a research paper from the Federal Reserve Bank of Philadelphia[4], the decline in the participation rate in the past 18 months is mainly attributed to retirement. Nevertheless, there are other studies that underpin that the bulk of the post-2007 decline is cyclical[5].

In her testimony at the Semiannual Monetary Policy Report to the Congress, Fed Chair Janet Yellen when asked replied that a significant part of participation decline is structural, due to the ageing and retirement of the baby boom generation. She said that that this pattern is a characteristic of the past several years and that she expects to continue in the years ahead. Yellen's comments represent a shift relative to prior Fed's view that the decline in the labor force participation rate was mainly cyclical. Our estimates agree with this more recent assessment; although there could be some cyclical rebound in the participation rate as the recent strength in the labor market should encourage more potential workers to join the labor force, the upward pressure from new entrants will not fully offset the downward trend driven by demographic factors. We do not believe that a large come back of job seekers to the labor force will reverse the downward trend in the unemployment rate. Meanwhile, unemployed reentrants as a share of the civilian labor force has increased from its recent trough of 1.3% in mid-2007 to 2.3% at the beginning of 2013 and is currently at 1.9% over the last couple of months, without playing a determinant role in the development of unemployment rate dynamics. Figure 10 portrays the breakdown of the unemployed with regards to reasons for unemployment to job losers and persons who completed temporary jobs, job leavers, reentrants and new entrants, and suggests that movements in the rate of unemployment have historically been driven mainly by workers that have lost their job and looked for a new position.

Figure 9

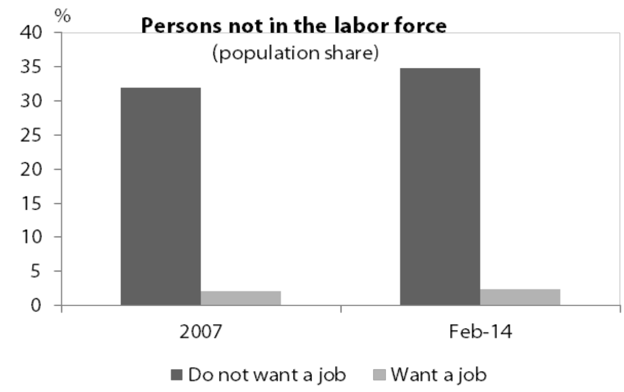
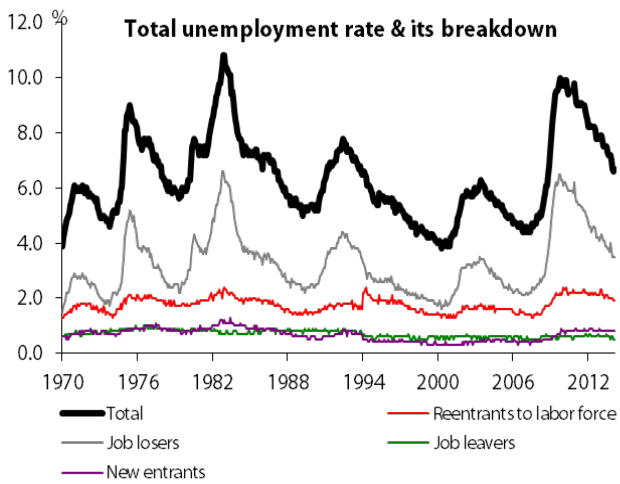


Figure 10



Source: Bureau of Labor Statistics (BLS), Eurobank Research

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2 Labor Force Participation Rate = Σ([Labour Force (Group i) / Population (Group i)]*[Population (Group i) / Population]

3 Toossi (2012), "Projections of the labor force to 2050: a visual essay", BLS Monthly Labor Review,October and Van Zandweghe (2012), "Interpreting the Recent Decline in Labor Force Participation", Kansas City Fed Economic Review.

4 Shigeru Fujita (2014), " On the Causes of Declines in the Labor Force Participation Rate" , Federal Reserve Bank of Philadelphia, February.

5 See for instance: Aaronson, Davis and Hu (2012), "Explaining the Decline in the U.S. Labor Force Participation Rate", Federal Reserve Bank of Chicago, March.

…so the unemployment rate will continue to decline, with the Fed maintaining its taper path

Given our view that the structural decline in labor force participation rate will exceed any cyclical upturn, the labor force participation is expected to continue its downward pressure on the unemployment rate. Our calculations suggest that the unemployment rate will trend lower, reaching 6.0% at the beginning of 2015, with expectations of payroll growth of roughly 200k per month. Labor market conditions will gradually improve, after the hit from adverse weather conditions in winter. Hence, we expect the Fed to continue its taper path and reduce its monthly pace of asset purchases by about $10bn at its FOMC meeting on March 18-19 and at each subsequent meeting as well -with a further strengthening of its forward guidance- concluding the asset purchase program at its October or December 2014 meeting. We continue to believe that the first rate hike won't come until mid-2015, when the unemployment rate should hopefully have reached 5.8% and core PCE inflation 1.7% y-o-y.

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