UBS

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Asset management

Going spare

Economist Insights

After last week's strong US labor market report market is now pricing in a Fed rate hike in December as a near certainty. Although growth in non-farm pay-rolls has recently slowed, it might be still strong enough to push down the unemployment rate further. Hence, everything boils down to how much spare capacity there is left in the US population.

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What a difference a day makes. It took just one strong labor market report to shift the mood of the market from doom and gloom to optimism about the US economy. As if the change in the Federal Reserve's language in October was not enough, this pretty much put the seal on expectations that interest rates will rise in December. And this was not just due to the fact that this labor market report was outright strong, it was also because the previous report was seen as unusually weak.

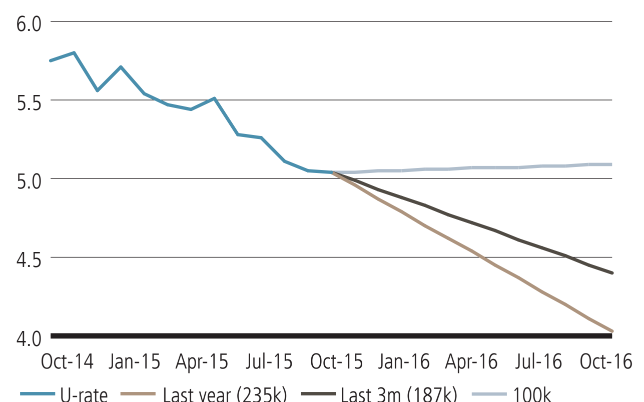
But was the previous report really that weak? The monthly change in the crucial nonfarm payrolls (nfp) number was a revised 137k; certainly down from the 200k+ pace seen earlier in the year but was it actually low? How many jobs does the US economy have to generate to keep the unemployment rate steady? According to a convenient little tool provided by the *Atlanta Fed*, under some reasonable assumptions it really only takes just over 100k jobs a month to keep the unemployment rate steady.

In short, even the weaker numbers of the prior report would still mean an ever tighter labor market. The NFP number is notoriously volatile, but consider what would happen to the unemployment rate if the US economy kept adding jobs at the same average pace as the last three months (187k). Within a year the unemployment rate would drop to just 4.4% (chart 1). And if jobs continue to be created at the same pace that they have averaged over the last year, the unemployment rate would hit 4% before Christmas next year.

Clearly this pace of growth cannot continue, otherwise the unemployment rate would reach zero within five years. There has to be some unemployment in the system: some people have just quit or been laid off but have yet to start a new job; others have recently left education or just re-joined the labor market. Not even an old school classical economist would believe that the labor market can clear that quickly. Does that mean that the pace of NFP growth has to slow down? Not necessarily, because some other things could change too, most importantly the participation rate (and, of course, wages). If lots of people decide to re-join the labor force, more jobs will need to be created to absorb them. But the participation rate has continued to fall. Perhaps a stronger labor market will encourage people to look for work again. If the participation rate reverses the decline of the last year (just under half a percentage point), then the pace of job gains over the last three months would still be enough to keep the unemployment rate steady.

Chart 1: What cannot go on forever …

US unemployment rate and projected rate depending on pace of non-farm payroll growth, assuming other variables hold constant

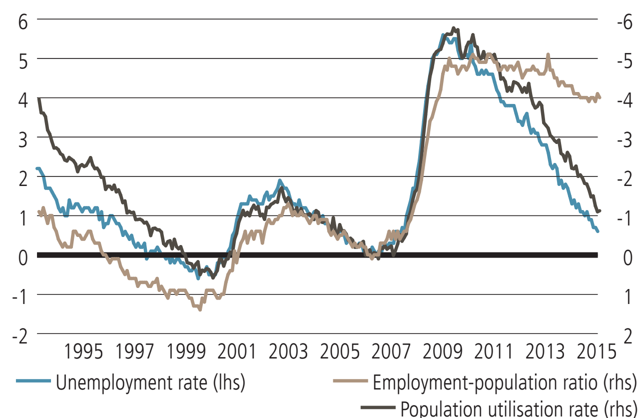


Source: BLS, Federal Reserve Bank of Atlanta, UBS Asset Management

Some critics would argue that the unemployment rate is the wrong variable, because so much of the improvement has come as a result of lower participation. Not enough jobs, just more people giving up. In contrast to the unemployment rate, the ratio of employment to jobs has barely improved (chart 2).

Chart 2. Otherwise engaged

Change in unemployment rate, employment-to-population ratio, and population utilisation rate relative to pre-crisis peak, %



Source: BLS, Federal Reserve, UBS Asset Management

But what this argument really says is that the only reason you leave the labor force is because you are discouraged by how hard it is to get a new job. There are plenty of other reasons: retirement, further education, changing family circumstances and so forth. So Fed researchers have devised an alternative measure, which they call the population utilisation rate. Obviously anyone who is fully employed is utilised, but so is anyone who is part-time because they want to be (e.g., because they also do child care), or is in education, or is not looking for work because they do not want work. And in the last category fall many baby boomers that have already retired or are close to it. Essentially, if you are occupied in work or elsewhere then you are being utilised. The under-utilised are only those who are unemployed, work part time but would like to work longer, or who want a job but have given up looking.

What is striking is that the utilisation rate has improved almost hand-in-hand with the unemployment rate. So those who are not looking for jobs are otherwise busy, which means that they are unlikely to be re-joining the labor force simply because it is easier to get a job. That means the low unemployment rate is actually a good indicator of the tightness of the labor market: there are no hidden spare workers. Of course, this is not good news for trend growth (all those people not working) but it means that wages may rise sooner.

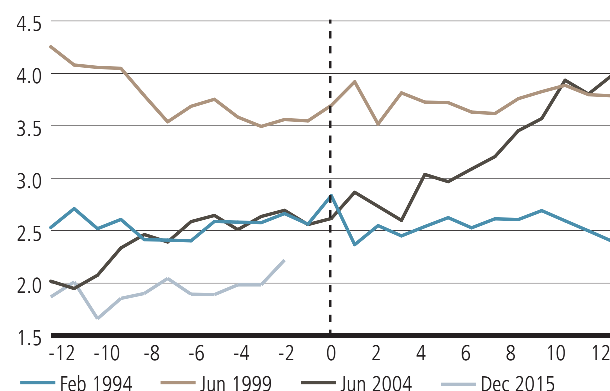
But if the labor market is so tight, where is the wage inflation? And if there is no wage inflation, why should the Fed raise interest rates?

There has always been a pretty long lag between a tight labor market and wages. Wages tend to adjust only once a year, so most increases in between come from people changing jobs, but that is not really enough to change the overall average by much.

While it would be nice for central bankers if they could wait until wages and inflation were evident, that would mean they are too late. It takes a year or more for monetary policy to really feed through into the real economy, so it is a bit like deciding to turn into a side street after you have already passed it. And the Fed never has behaved this way; looking at the past three rate hiking cycles, the Fed started each one before wages started to rise (chart 3).

Chart 3. The Fed waits for no man

Hourly average wage growth for production and non-supervisory workers, months before and after first Fed rate hike, % YoY



Source: BLS, Federal Reserve, UBS Asset Management

Wages have in fact started to accelerate, but in part because they are exceptionally low. But monetary policy is also exceptionally loose, so perhaps that matches well. The Fed has indeed set itself a relatively low hurdle: their median forecast for the unemployment rate at the end of next year is 4.8%. This only requires an average monthly NFP of around 137k, provided the participation rate stays the same. Funnily enough, this level is not very different to the number that disappointed the market last month. But it looks like there are very few workers going spare, which should reassure the Fed that (despite what Chairperson Janet Yellen has said in the past) the participation rate is unlikely to rise anytime soon.

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