BROOKINGS

Up Front

Hutchins Roundup: Labor force participation, total factor productivity, and more

Lorena Hernandez Barcena, Jimena Ruiz Castro, Nasiha Salwati, and David Wessel Thursday, August 5, 2021

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The US labor force participation rate is highly cyclical and lags behind the unemployment rate

Using state-level business cycle shocks, Tomaz Cajner, John Coglianese, and Joshua Montes of the Federal Reserve Board find that the labor force participation rate (LFPR) is highly cyclical, but has a longer-lived response than the unemployment rate. A one percentage point decline in output growth leads to a 0.2 percentage point decline in the LFPR, they find, but the decline is gradual and participation does not reach its trough for four years; participation returns to pre-shock levels about eight years after the shock. In contrast, the unemployment rate takes only one year to reach its peak (a 0.4 percentage point increase for a one percentage point decline in output growth) and achieves full recovery six years after the shock. The cyclicality of labor force participation varies across groups, they find, with larger and longer-lived responses among younger workers, men, less–educated workers, and Black workers.

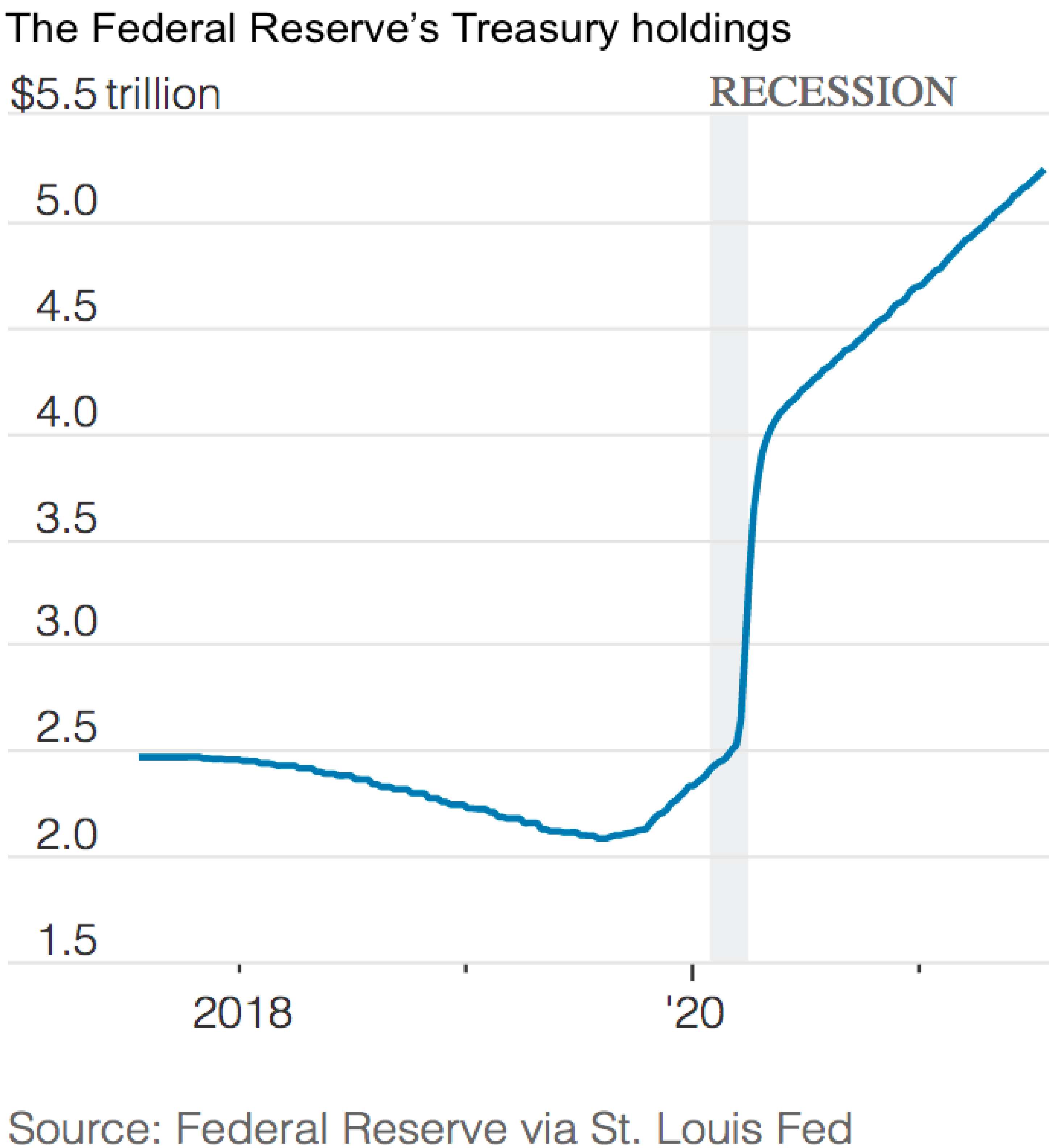
US total factor productivity growth is higher than typically estimated

Standards measures of total factor productivity (TFP)—the efficiency with which labor and capital are used—suggest that the TFP growth rate was 0.49% lower in the 1997-2018 period than in the decades preceding it. Nicolas Crouzet and Janice Eberly of Northwestern University find that much of this apparent decline may be the result of mismeasurement. In particular, the omission of investment in intangibles, such as spending on consulting, advertising, and management, along with rising markups bias the measured TFP growth rate downward. They estimate that the bias can account for one-third to two-thirds of the decline in measured TFP growth. "Since our adjusted measures suggest that more of total GDP growth since the 2000s was driven by TFP growth, investment-specific technical change might have contributed less to GDP growth than previously thought," the authors conclude.

The Federal Reserve's new employment objective increases employment and inflation levels

The Federal Open Market Committee (FOMC) recently revised its maximum employment mandate; going forward, the Federal Reserve will intervene when long-term employment falls "short"—rather than "deviates"—from its maximum level. Using a theoretical model that incorporates economic fluctuations over the last 25 years, Brent Bundick at the Federal Reserve Bank of Kansas City and Nicolas Petrosky-Nadeau of the Federal Reserve Bank of San Francisco find that the new rule is associated with 0.5% higher inflation, 0.2% lower unemployment, and 0.5% higher nominal policy rates on average. In addition, they find that while a "shortfalls" rule doesn't prevent high unemployment rates during recessions, it does ensure a more rapid return to full employment in a recovery and more sustained periods of low unemployment during expansions. Finally, the increase in employment and inflationary pressures also raise the nominal interest rate, the authors find, which results in less frequent and shorter zero lower bound episodes. "The reinterpretation of the employment mandate complements and reinforces the desired policy outcomes of the FOMC's flexible inflation targeting framework," the authors conclude.

Chart of the week: The Federal Reserve significantly increased its Treasury holdings After the COVID-19 pandemic Began



Source: The Wall Street Journal

Quote of the week:

"[T]here is no doubt that it is taking longer to fully reopen a $20 trillion economy than it did to shut it down. Although in a number of sectors of the economy the imbalances between demand and supply—including labor supply—are substantial, I do continue to judge that these imbalances are likely to dissipate over time as the labor market and global supply chains eventually adjust and, importantly, do so without putting persistent upward pressure on price inflation, wage gains adjusted for productivity, and the 2% longer-run inflation objective. But let me be clear on two points. First, if, as projected, core PCE inflation this year does come in at, or certainly above, 3%, I will consider that much more than a "moderate" overshoot of our 2% longer-run inflation objective. Second, as always, there are risks to any outlook, and I believe that the risks to my outlook for inflation are to the upside," says Richard Clarida, Vice Chair of the Federal Reserve.

"[M]y inflation projections for 2022 and 2023, which forecast somewhat higher inflation than do the SEP medians, would also, to me, satisfy the "on track to moderately exceed 2% for some time" threshold specified in the statement … My expectation today is that the labor market by the end of 2022 will have reached my assessment of maximum employment if the unemployment rate has declined by then to the SEP median of modal projections of 3.8%. Given this outlook and so long as inflation expectations remain well-anchored at the 2% longer-run goal—which, based on the Fed staff's common inflation expectations (CIE) index, I judge at present to be the case and which I project will remain true over the forecast horizon—commencing policy normalization in 2023 would, under these conditions, be entirely consistent with our new flexible average inflation targeting framework."