Mitchell's Musings 11-9-15: The New Abnormal?

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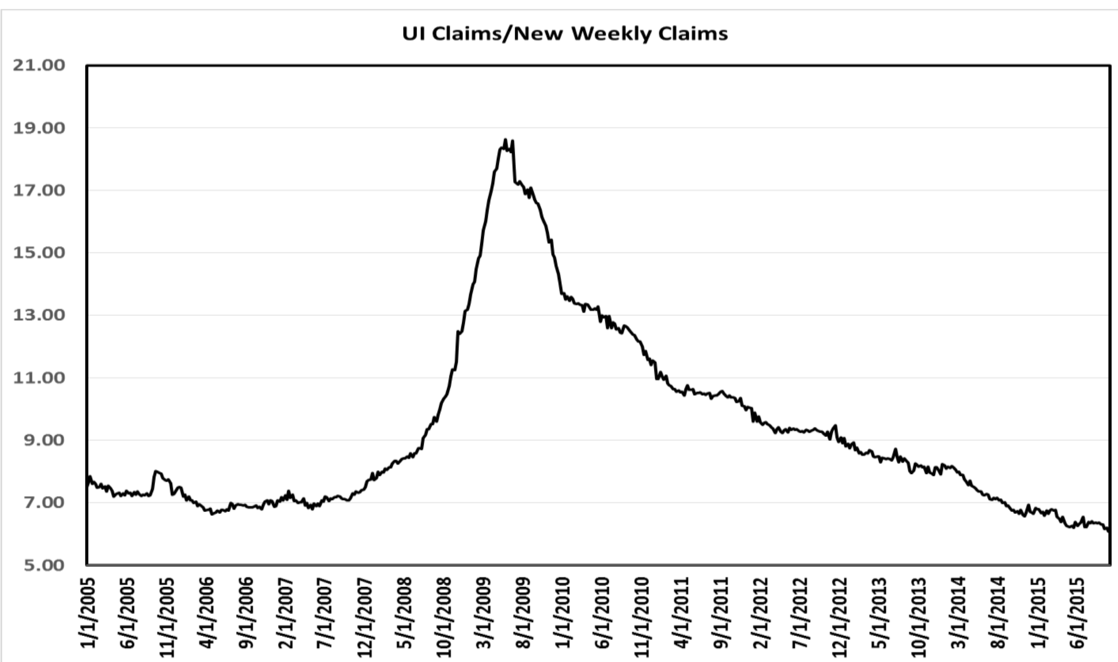
We are again at a point where there is speculation about whether the Federal Reserve will raise interest rates. This time, the speculation is for December. As usual, the news media and – to some extent – the stock market, carefully parse every word of Fed chair Janet Yellen.[1] And, of course, she carefully chooses her words to be ambiguous. (Some would say she chooses her words to be clear that no decision has been made.)

There continues to be a focus on the state of the labor market. Is the la market reaching a level of tightness where wages will be bid up and thus push up prices? The most recent data release on unemployment and payroll employment suggests a strong labor market. Unemployment is down to 5%. That level is still somewhat higher than at the prior pre-Great Recession peak when the rate was as low as 4.4%. Added monthly payroll jobs reported in the latest release show a strong number after some (supposed) prior softness. (I say "supposed" because we are talking about seasonally-adjusted monthly data subject to revisions.)

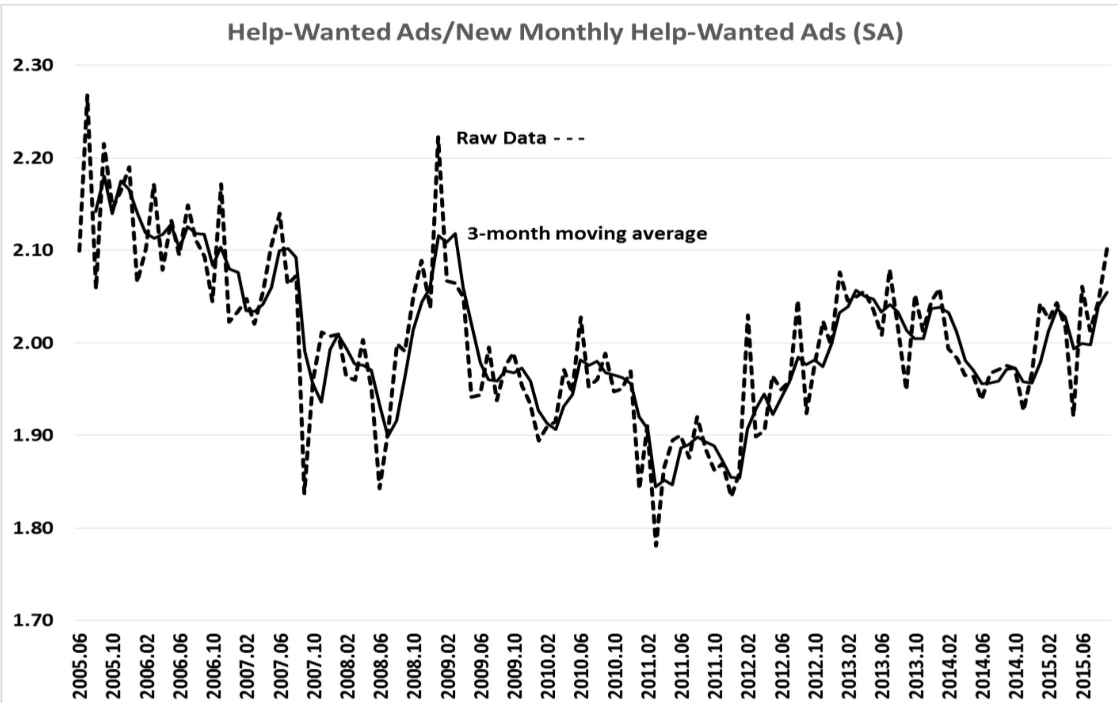
Let me throw some other numbers into the decision pot. The chart below shows outstanding claims for unemployment insurance (UI) divided by new weekly claims. That ratio is suggestive of how long benefit claimants are receiving payments.[2] Not surprisingly, the ratio shot up during the Great Recession when jobs were hard to find. But it is now lower than it was at the pre-Great Recession peak. So by that measure, you might say that the labor market is tighter now than then.



[1]http://www.nytimes.com/2015/11/05/business/economy/fed-yellen-congress-interest-rates.html

[2]In a steady state with, say, 100 claimants at any point in time and 20 new claimants each week, the ratio is 5. If each claimant on average stays 5 weeks, the number of claimants at any point in time remains 100. Each week 20 new claimants come into the system and 20 old claimants depart. Of course, the number of claimants at any point in time is not constant in practice, nor is the number of new weekly claimants.

On the other hand, if you look at help-wanted advertising – a series maintained by the Conference Board measuring the number of online ads – you get a somewhat different picture. The chart below shows the ratio of continuing ads to new monthly ads. So the ratio is related to how long an ad stays in place. We might expect available new jobs to be snapped up relative fast when the labor market is soft (as in a recession and its aftermath) but more slowly when the labor market is tight. (Ads should stay around longer during tight markets as suitable workers are hard to find.) Because the data are quite noisy, we present the raw data (the dashed line) and a three-month moving average (the solid line). The numbers suggest that we are not yet quite back to the prior peak of labor market tightness.



We could go on this way pointing to indicators that give conflicting signals of the degree of labor market tightness. And one suspects the Fed's decision makers will be looking at such data. But there is a problem with a focus on the state of the labor market.

What the Fed is interested in is avoiding excessive PRICE inflation. Up to now, there hasn't been much price inflation. So the Fed is really looking ahead and trying to find indicators that might forecast accelerating inflation. At best, labor market indicators tell you something about the outlook for WAGE inflation, not price. At one time, when unions were strong – say in the period from the end of World War II through the 1970s – one might plausibly tell a tale of tight labor markets empowering unions to push up wages through collective bargaining. But unions are no longer a factor for the vast majority of private-sector workers who are nonunion. So at most you can tell a tale of employers competitively bidding against each other for scarce labor. And then you might argue that if labor costs rise, prices would go up as firms try to maintain their markups.

There is a problem, however, with that approach. As a recent study from the San Francisco Fed indicates, there is scant current evidence that knowing something about wages helps you forecast prices *when you have other measures that directly are pricing indicators*.[3] That is, if you have a forecasting model for price inflation, throwing in wages doesn't add information. You can forecast just as well omitting wage data. If that is the case, looking at the state of the labor market to give you information on likely wage behavior may not be a useful approach for the Fed even if, at some point in the past, it was.

There is no doubt that wage and price data are highly correlated. And there is no doubt that labor market measures of macro-level economic activity are highly correlated with product market measures. (Ups and downs of employment are correlated with ups and downs of real GDP.) It may well have been the case in the past that labor market information and wage information added to the ability to forecast inflation as part of a larger forecasting model. But institutions and economic processes change over time.

In short, the fact that the unemployment rate is down and that last month's payroll job gains were strong may well influence what decision the Fed makes in December on interest rates. But if so, the decision will be based in part on prior assumptions about a labor-market-to-wage-to-price linkage. What has been normal in the past, however, may not be relevant in the present and future.

There has been much talk in the post-Great Recession period of a "new normal" in various economic contexts. *But what is meant by that phrase is that the current circumstance is really a new abnormal when compared with the pas*t. Yes, in the past, interest rates have not been held so low by the Fed at this point in the business cycle. But maybe, given the way the economy works now, that's what it takes to sustain the current rate of (non-inflationary) economic advance. We do know that up to now, price inflation has not been a problem. Even though unemployment fell last month and there were strong job gains, is that really a signal that interest rates should rise?

[3]http://www.frbsf.org/economic-research/files/el2015-33.pdf