

Contrary to popular opinion, the low rate of unemployment does not signal a strong labor market

Comments like this one: “This is a good job-creation number, *but on the other hand we see still continued soft wage growth*”, should signal that things in the labor market are not as good, or strong, as generally thought.

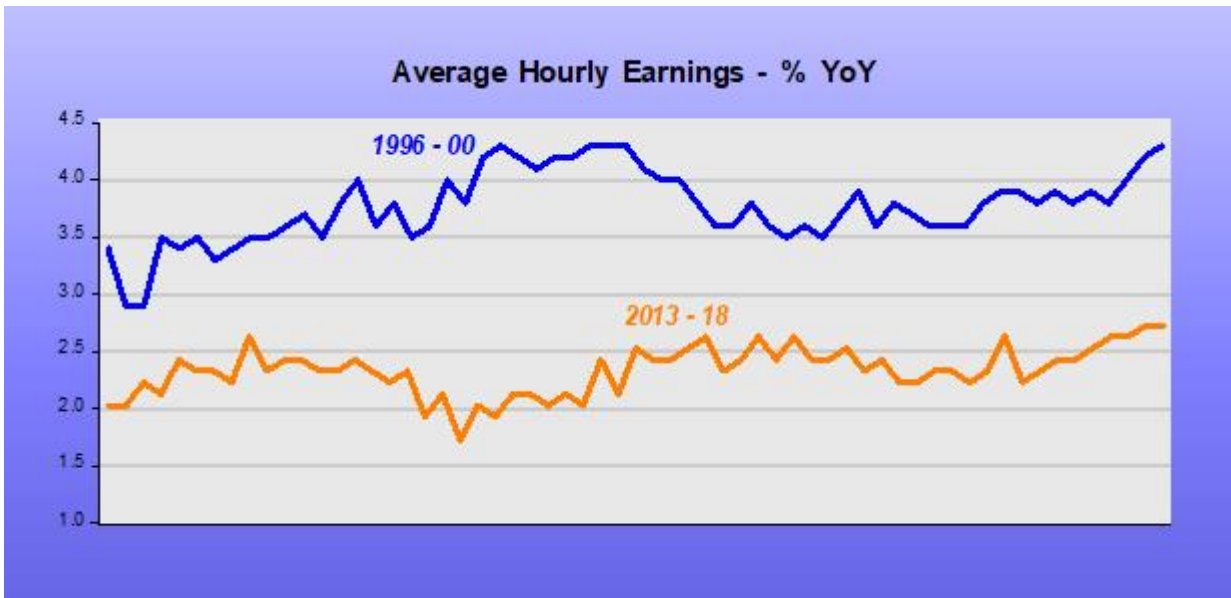
A strong labor market is characterized by a high employment population ratio (EPOP) and a high labor force participation rate (LFPR). The ratio of these two quantities define the unemployment rate.

Therefore, a low unemployment rate is consistent with both high EPOP and high LFPR as well as with a low EPOP and low LFPR, as long as their ratio is similar.

The charts below show that both in the late 1990s and over the last five years, the behavior of the unemployment rate is similar. However, while in the late 1990s this reflected a strong labor market; the same cannot be said about the labor market more recently, characterized by both low EPOP and low LFPR.



The presently weak labor market could be explaining why wage growth is also low, despite similar unemployment rates. The chart shows wage growth in the late 1990s and for the past five years.

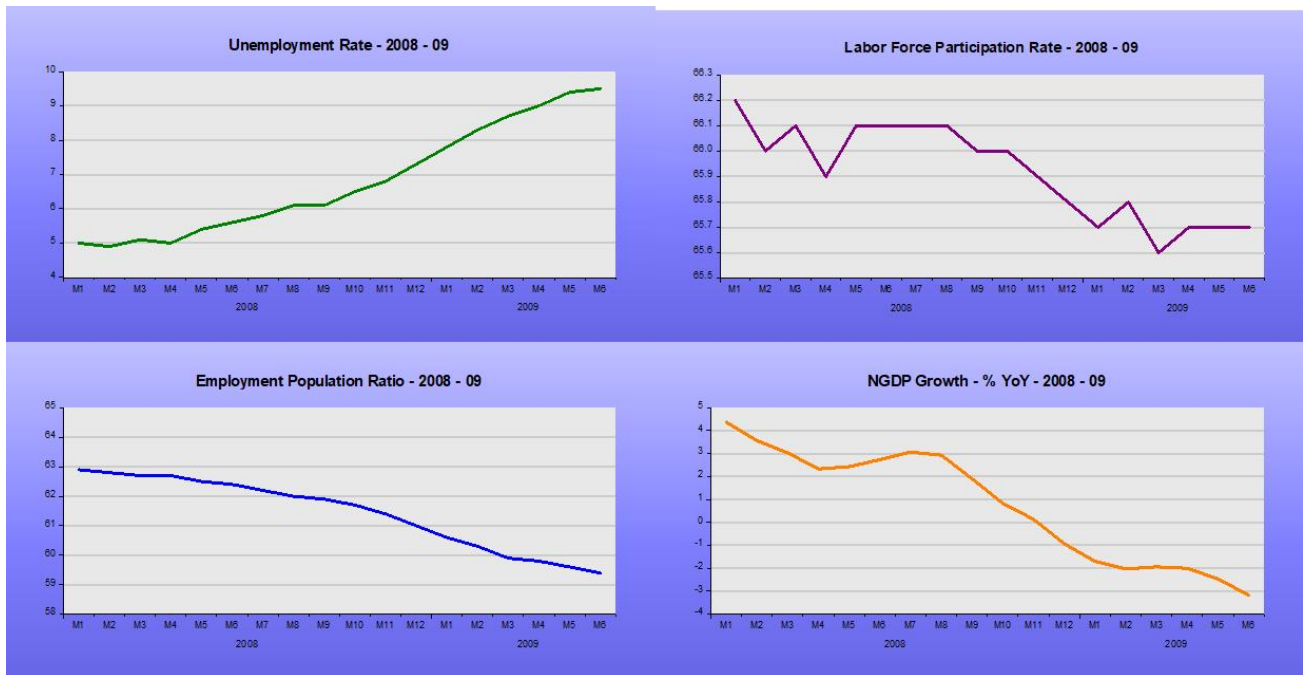


What, however, explains the weakness of the labor market at present?

You get a hint by looking at nominal spending (NGDP) growth in the two periods, strong in the late 1990s, and weak more recently.

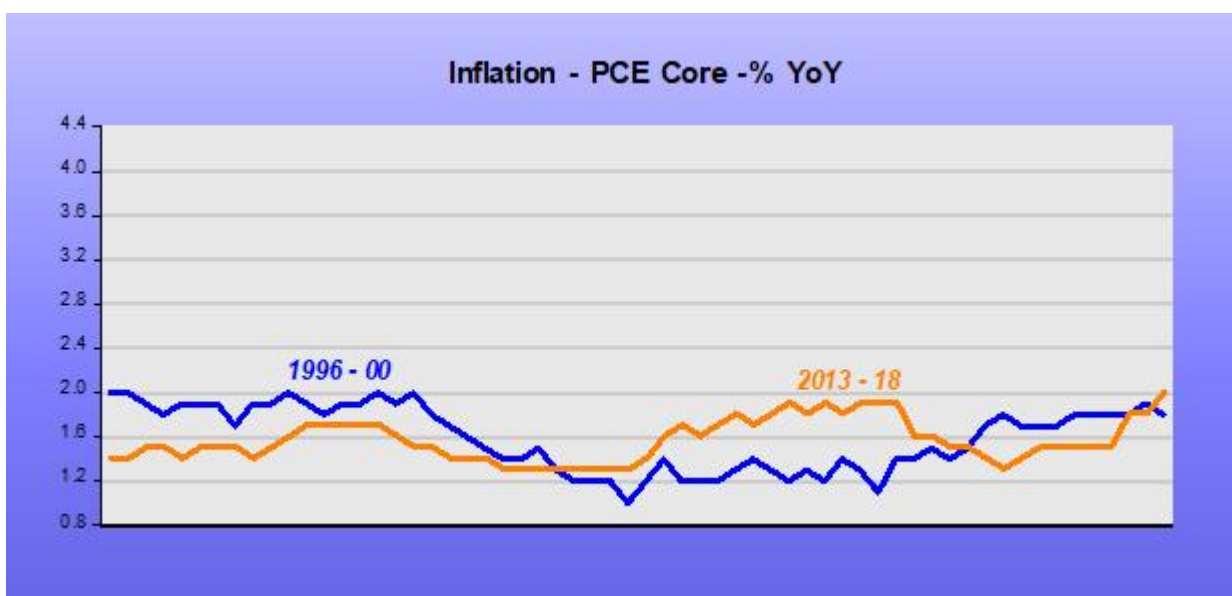


Many however attribute the low LFPR mostly to structural (demographic) factors. I find it extremely hard to believe that it was mostly coincidence that the big drop in the LFPR and the EPOP and the strong rise in unemployment between 2008 and 2009 happened together with the crushing of NGDP growth.



The fact that nominal spending growth never rose enough to take NGDP back to trend is likely the best explanation for the weak labor market and low wage growth, in addition to the low real growth experienced for the past several years.

PS What about inflation? In both the late 1990s and more recently, inflation averaged 1.6%. It seems that low and stable inflation is consistent with stable NGDP growth, even if that stable growth is on the low side!



Bottom Line: If the Fed remains “concerned” about “low unemployment”, mistakes will be made. It is not surprising, in this context, that yield spreads are falling, falling...