How the jobless rate underestimates the economy's problems

By Jared Bernstein
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Here's a riddle for you: How many economists does it take to figure out the extent of slack in the economy?

Sorry, I don't have a punch line. (Hey, I'm an economist. Assume a funny punch line!) But that was the question put before a bunch of us at a conference held by the Peterson Institute for International Economics last week.

The answer, broadly speaking — as you'd expect, there was a fair bit of "on-the-one-hand-on-the-other-hand" — was that there's considerable slack, in terms of underutilized resources, in the American economy in general and the labor market in particular.

I'll get into some details in a moment, but first, why is it important to gauge the amount of slack in the economy? For one thing, it's a critical input into the thinking of the Federal Reserve. They've been providing extensive monetary stimulus to the lagging economy for years now, and as the recovery has slowly taken hold, they need to gauge when it would be safe to start pulling back on their support.

Second, businesses, governments, employers and investors all need to know how the near-term economy is doing in order to plan for the future, including hiring, sales and budget outlays and receipts.

Third, Congress, functional or not, needs to know the level of slack to calibrate temporary policy measures, like extended unemployment insurance benefits or a job-creating infrastructure program — to offset the slack until the private market is once again firing on all cylinders.

So why not just look at the unemployment rate and call it a day? Because special factors in play right now make the jobless rate an inadequate measure of slack. In fact, at 6.1 percent last month, it's within spitting distance of the rate many economists consider to be consistent with full employment, about 5.5 percent (I think that's too high, but that's a different argument).

There are at least two special factors that are distorting the unemployment rate's signal. First, there are over seven million involuntary part-time workers, almost 5 percent of the labor force, who want, but can't find, full-time jobs. That's still up two percentage points from its pre-recession trough. Importantly, the unemployment rate doesn't capture this dimension of slack at all — as far as it's concerned, you're either working or not. Hours of work don't come into it.

The second special factor masking the extent of slack as measured by unemployment has to do with participation in the labor force. Once you give up looking for work, you're no longer counted in the unemployment rate, so if a bunch of people exit the labor force because of the very slack we're trying to measure, it artificially lowers unemployment, making a weak labor market look better.

That's certainly happened over the recession and throughout the recovery, but it's been mixed in with a more benign source of labor force exits: the retirement of aging baby boomers. So economists have scurried about trying to figure out how much of the three-percentage-point decline in the labor force participation rate, from about 66 to 63 percent, to attribute to slack and how much to so-called structural (vs. cyclical) factors.

And the answer, according to the economist Jan Hatzius, is that about one percentage point, or about a third of the total, is because of slack. By itself (not accounting for the involuntary part-timers), that implies an unemployment rate more like 7 percent. That's another 1.6 million people worth of slack, people who could get pulled back into the job market if the jobs were there.

But there was new evidence presented at the conference regarding this question of the extent of slack that I found to be especially convincing. David Blanchflower, an economics professor at Dartmouth, and Adam Posen, president of the Peterson Institute, added a critical variable to the slack analysis: wage growth. The persistently slow growth of wages in recent years is Exhibit A in the case for slack, and bringing it into the mix provides an important finding.

You would expect the unemployment rate to correlate negatively with wage growth: tighter job market, faster wage growth. But when people give up the search and leave the job market, if they're truly out of the labor force, neither working nor looking for work, they shouldn't be contributing to slack, right?

Yet according to the two scholars, they are. The economists found that labor force inactivity correlates consistently with wages, implying that a significant share of those who've left the labor force are adding to existing slack.

My own work presented at the conference builds off theirs. I show that statistically speaking, even once you control for unemployment, the relationship between wage trends and the declining labor force becomes stronger as the recovery proceeds. The implication is that those who are seemingly out of the picture could be brought back in. As Mr. Blanchflower and Mr. Posen put it, "A substantial portion of those American workers who became inactive should not be treated as gone forever but should be expected to spring back into the labor market if demand rises to create jobs."

Thus, the answer to my riddle may not be funny, but it's important and clear: There's more slack in the American job market than you'd glean from the unemployment rate alone. Moreover, some of those who've left the labor market would come back if the jobs were there. Congress won't help, so it will be up to the Fed to keep pushing until the recovery absorbs a lot more of that slack.

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