WHEN DOES CYCLICAL BECOME STRUCTURAL?

IN BRIEF

• US monetary policy has been predicated on the belief that slow economic and employment growth has been primarily cyclical (related to the business cycle) rather than structural (following a longer-term secular trend).

• The US central bank’s forward guidance indicates that, in the absence of any meaningful economic pullback, the federal funds rate will be raised to 4% between 2017 and 2020.

• The precipitous decline in the US labor force participation rate can be attributed to demographic trends, the younger cohort spending more time in school and a rising rate of workers going on disability.

• If new Federal Reserve chair Janet Yellen turns out to be wrong about the cyclical nature of unemployment, she may also be wrong about the pace of potential growth and the size of the output gap, with the risk that Fed policy could stay easy for too long.

The US Federal Reserve makes decisions about monetary policy based on its assumptions about the economy, and the effectiveness of that policymaking hinges on the Fed’s expectations playing out correctly. One key assumption is that the post-recession slow growth in jobs and the economy has been cyclical rather than structural — in other words, related to the shorter-term business cycle rather than a longer-term secular trend. If so, aggressive tools to stimulate the US economy out of a cyclical slump may be effective at lowering unemployment and accelerating the pace of economic growth.

On the contrary, we see signs that what the Fed has called a cyclical problem is increasingly becoming a structural problem. If persistent joblessness and the lackluster economy are structural, then we may need to change our baseline expectations for growth. We review the evidence that structural forces are working to lower the pace of US economic growth, and what that might mean for monetary policy.
Potential growth and the output gap

What is the rate of potential economic growth that can be sustained over the long term? How wide is the output gap between actual GDP and the estimated level of GDP that could be achieved when the economy is running at full capacity? Knowing the answers to these two key questions would make the job of a central banker much easier. Yet despite the best efforts of researchers at the Fed, potential growth and the output gap are unknowable variables.

Monetary policy history is filled with stories of what can go wrong if these estimates are off. After the 1973 – 1975 recession, for example, Fed chairman Arthur Burns believed that the output gap was huge, when in fact it was significantly narrower than he thought. To be fair, the data available at the time did suggest an extremely large output gap. Only after subsequent data revisions over many years could the output gap be seen as having been smaller than Burns and others had thought. Nonetheless, he got it wrong, and as a result of his misdiagnosis, Burns resisted raising interest rates early enough to stave off the rampant inflation that became a hallmark of the following period.

What is the US central bank thinking now? Based on the latest economic forecasts released on 18 December, the Federal Open Market Committee (FOMC) projects that GDP growth is going to ramp up over the next three years, allowing the US economy to finally work off the output gap that has persisted since the 2008 global financial crisis (see Exhibit 1). But after that, growth is expected to come back down to a long-run average of 2.2% to 2.4%, which is considerably lower than estimates of potential growth of around 3% that have prevailed for most of the past 20 – 30 years.

We agree with the Fed’s near-term projection that we are likely to see higher growth rates in the next few years as fiscal austerity becomes fiscal neutrality and the slow healing of the private sector continues. However, we think that potential growth will be even lower than the central tendency of 2.3%, given the longer-term constraints of demographics along with weak spending on capital and infrastructure and the misallocation of investments that has led to poor capital productivity growth — for example, too many housing starts and not enough bridge repairs.

It is important to note that while we are less constructive on potential economic growth over the long term, we are not saying the economy cannot grow above potential in any particular year. Therefore, our view that growth will be higher in 2014 is not at odds with our stance that potential growth is lower on average.

Perennial optimism of the Fed

Throughout the post-Lehman period, the Fed has consistently overestimated real GDP growth. At the beginning of each year from 2010 through 2013, growth in the subsequent three years was expected to range between 3.5% and 4%, but was later revised downward as the economy disappointed. For example, based on the Fed’s initial expectations, real GDP was projected to grow 4% in

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**Exhibit 1: Actual and potential GDP growth in the United States**

<table>
<thead>
<tr>
<th>Real GDP growth (annualized Q/Q%)</th>
<th>FOMC central tendency forecasts of GDP growth (Q/Q%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1/12</td>
<td>6%</td>
</tr>
<tr>
<td>Q2</td>
<td>5%</td>
</tr>
<tr>
<td>Q3</td>
<td>4%</td>
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<td>Q4</td>
<td>3%</td>
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<td>Q2</td>
<td>1%</td>
</tr>
<tr>
<td>Q3</td>
<td>0%</td>
</tr>
</tbody>
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Sources: Bloomberg and Federal Reserve. Data as of 12/18/13.
2011 and 2012, but ended closer to 2% in both years. Similarly, 2013 Fed forecasts came down to 2.25% from initial expectations of 4%. The Fed’s estimates have been off by about two percentage points, a large margin of error.

As we can see from Exhibit 2, the trajectories of these projections have mostly been above actual year-on-year growth, which indicates that the Fed has been overly optimistic — and its GDP forecasts continue to be optimistic. Initial expectations for 2014 and 2015 real GDP growth of 3.5% have come down to 3% and 3.25%, respectively. The first two Fed estimates for 2016 have been below 3%, but we suspect that even these may be too high.

**Appropriate pace of policy tightening**

The Fed’s quarterly projections also include estimates from each FOMC member of the federal funds rate at future year-ends — in other words, how the FOMC is expected to change its target short-term interest rate over the next few years (see Exhibit 3). All but two members think the target rate will still be 25 basis points at the end of 2014. The distribution widens in 2015, although most estimates are still less than 1%, which means about two hikes during the next two years. By 2016, the central tendency is closer to 2%, but at the two extremes, one FOMC member expects only one hike and another is up to 4.25%.
While there is a lot of disagreement year by year, there is more of a consensus over the longer run, when the federal funds estimates cluster around 4%, which looks like the neutral rate. That level is much lower than the previous high of 5.25% in 2006, after the FOMC raised rates in 17 straight meetings. And back in the 1990s, the rate peaked at around 6%. One reason the neutral federal funds rate has come down since then is that inflation is lower. We think another reason is that sustainable potential growth is below the Fed’s estimates.

When will we see the federal funds rate hit 4%? With Janet Yellen as the new Fed chair, we may wait for some time. She favors optimal control models based on economic forecasts that suggest the FOMC will not raise rates until 2016 or 2017. Academic papers presented by Fed researchers in early November reinforce that notion. Bernanke and Yellen have indicated through forward guidance that when the committee does begin to raise rates, they expect the pace will be slower than it was the last time, when rates went from 1% to 5.25% over two years. And embedded in the December policy announcement was a clear indication that the Fed expects to keep rates lower for longer — well past the time that the unemployment rate falls below 6.5%, as long as inflation stays under 2%. So a possible scenario — and one the Fed is desperate to make convincing to the markets — is that the rate hikes begin in 2017 and we get to 4% in 2020.

That timeline presumes that the current business expansion is still going 11 years after it started in mid-2009 — twice as long as the average business cycle since World War II, and longer than any business cycle in US history dating back to 1854. While there is no evidence of excesses in labor, capital or inventories that suggest any imminent risk of recession, it would be presumptuous to think that we can avoid a downturn before the end of this decade.

Unless the FOMC changes its tune and raises rates earlier (and perhaps a bit more aggressively), and given that it is unlikely to tighten into a recession, the federal funds rate may not reach 4% in this business cycle. With intermediate-term and long-term interest rates anchored to the front or short-term end of the yield curve to some degree, this implies that we will see lower rates for a longer period of time (barring the possibility that the Fed loses some credibility, in which case the yield curve would be anchored at the front end, but steepen sharply at the long end).

In short, while we believe yields are going higher, we think rates ultimately may not rise as high as others expect, at least during this business cycle.

US labor market still impaired

Notwithstanding the weather-induced weak payroll data for December, there has been some progress in hiring, with payroll gains around 200,000 in each of the previous four months. Nonetheless, the US employment situation is still relatively weak nearly five years after the recession ended. The degree to which the labor market impairment is cyclical or structural is a key question faced by the Fed — one with tremendous impact on the conduct of monetary policy.

As we discuss in What to Expect from Fed Chair Yellen (MFS Investment Insight, November 2013), Yellen believes strongly that the persistent unemployment during this recovery has been caused mostly by cyclical rather than structural factors. And she has told us that if the Fed pushes a little bit harder with monetary policy, then we can help to improve hiring conditions and prevent the temporarily weak labor market from becoming a structural problem.

Looking at labor force participation since 2000, we see that the rate has fallen a lot, with the steepest decline in the post-Lehman era (see Exhibit 4). Bear in mind that the participation rate measures the potential labor force — those either working or actively looking for work — among people 16 years old and over. With lower birth rates and aging populations throughout the developed world, including the United States, we have a greater share of the population moving into the over-65 retirement cohort. We estimate that about one-third of the labor-force decline can be attributed to these structural demographic trends.

If we consider only those in the prime earning years of 25 to 54, the participation rates are all falling significantly. Some younger members of this cohort may leave their jobs or postpone looking for employment to pursue higher education. They could come back to the workforce with productivity-enhancing skills, which would be good for the economy. Staying out of the labor force to get a better education is generally regarded as a cyclical factor. When high-paying jobs are abundant, the opportunity cost of higher education is greater, so the participation rate among 25 to 34 year olds would be more stable in a robust economy. Indeed, roughly another third of the labor-force decline can be attributed to this cyclical education factor.
Among older workers, labor force participation has fallen even more precipitously since the financial crisis. The evidence indicates that a growing number of this older cohort have filed disability claims. Because this tends to be a one-way street, they are likely to stay on disability until they qualify for Social Security at retirement age. So we view the rise in disability as a structural factor. While Yellen might say that those on disability would come back to work if the labor market revived strongly enough — which would make it a cyclical factor — we disagree. About a third of the participation rate’s decline is probably a consequence of this seemingly structural rise in disability.

Even among 35 to 44 year olds, labor force participation is falling, and neither education nor disability is likely to be the cause, but rather some other cyclical or structural factors that we cannot identify. For Yellen to be right about her cyclical view of labor market weakness, we need to see the biggest bounce in participation from this cohort as the economy recovers. We question whether that will happen.

To see how the labor market has taken a structural hit, consider the Beveridge curve, which measures the relationship between job openings and the unemployment rate (see Exhibit 5). From 2001 to 2008, the unemployment rate took a round trip from around 4.5% to 6.0% and then back to 4.5%. During that period, a job openings rate of about 4% was associated with unemployment of 4.5%, while job openings fell to 2.5% when unemployment rose to 6.0%.

Shortly after Lehman, the relationship shifted, with job openings falling modestly as unemployment climbed much higher. But by 2010, the economy began healing, and the situation started to improve. Job openings rose again as unemployment declined. There is a difference from the earlier period, however, which looks like a parallel shift of the Beveridge curve. Any given rate of job openings is now associated with unemployment that is much higher.

This shift indicates a growing mismatch in the labor market — that is, the labor market is unable to match the skill sets of unemployed workers with existing job openings. At this point, we have a 3% job openings rate, which used to be associated with about 5% unemployment, but is now associated with unemployment around 7%. We think that shift looks structural, not cyclical. If the slope of the shifted curve holds, as shown by the structural arrow, then we would need to have job openings closer to 4% to get back to 5% unemployment.

Yellen would argue that this shift in the Beveridge curve is what happens in deep recessions before the slope flattens as the economy improves, so that the curve would loop back, as shown by the cyclical arrow. Then we would again have job openings at 3% associated with unemployment around 5%. If the Fed’s prolonged stance of monetary accommodation fails to bring the curve back, unemployment may actually be more structural than Yellen would lead us to believe.
Implications for Fed policy

To sum up, Yellen believes that a significant portion of the decline in the participation rate is the result of a weak labor market rather than demographics or other structural factors, and therefore the unemployment rate is not accurately measuring the health of the labor market or the effective level of slack in the economy. Should she be wrong about this, Fed policy could stay too easy for too long, joblessness could fall below the nonaccelerating inflation rate of unemployment — or NAIRU — and upward wage pressure would eventually push inflation above the Fed’s long-term target.

If Yellen is wrong about the labor market, and unemployment is more structural than cyclical, then she may also be wrong about potential GDP and the output gap. Monetary policy based on the wrong estimates for potential growth and the output gap could be on a dangerous path. The Fed could wait too long to reign in liquidity, causing a resurgence of inflation — probably not 1970s double-digit inflation, but markedly higher inflation than we have seen in a long time. While this risk is unlikely to be an issue for 2014, we think that it may become a concern going forward.

In other words, the Fed is facing two issues that are critical determinants of monetary policy. The potential growth and output gap issue and the cyclical or structural labor market issue are related, though not inextricably linked. Making a bad call on either one of them would be a problem. Getting both wrong would be a nightmare.