

## **In Fed Policy, the Exit Music May Be Hard to Hear**

By N. GREGORY MANKIW

Is it time for the Federal Reserve to start its exit from the extraordinary set of policies it has pursued over the past few years? That crucial question is on the minds of the nation's central bankers, as well as the stock and bond traders who follow the Fed's every move.

When Ben S. Bernanke and his Fed colleagues embarked on their policy of near-zero interest rates and large-scale asset purchases, they hoped that things would be back to normal by now. Unfortunately, events haven't gone as predicted. Even though the recovery began more than four years ago, it has been so meager that the economy, by some metrics, is still very sick. The slowness of the healing has delayed the Fed's exit — although minutes of last month's policy-making meeting indicate that it is considering some changes.

In her recent testimony before the Senate Banking Committee, Janet L. Yellen, the eminently qualified nominee to lead the Fed, made clear she didn't think the time for an exit had come. With inflation running below the Fed target of 2 percent and continued weakness in the labor market, she argued, the economy needs all the help the central bank can provide.

Many of the numbers back up that diagnosis. The unemployment rate is about three percentage points higher than it was seven years ago, before we got the first whiffs of the economy's financial problems. The employment-to-population ratio is about five percentage points lower, and it has not recovered much at all since the trough of the recession.

Some of the decline is attributable to an aging population. As more members of the huge generation of baby boomers retire, the employment-to-population ratio naturally declines.

But that is only a small part of the story. A relevant measure is the employment-to-population ratio for those in the prime working age group

—25 to 54. This statistic also shows the recession’s lingering effects: the ratio declined to about 75 percent from 80 percent over the course of the recession, and has recovered to only about 76 percent today. So we have recovered only about a fifth of what we lost during the downturn.

These numbers indicate that there is still much slack, or unused potential, in the economy. In turn, this suggests that inflation is unlikely to become a problem anytime soon, so the Fed can delay its exit. But the labor market data are hard to interpret, because this recession has been so different from those before it.

The most arresting piece of economic data is in the number of weeks the average unemployed person has been looking for work — statistics that have been compiled since 1948. Until recently, the largest such figure was 22 weeks, in the aftermath of the deep recession of 1981-82. In the most recent recession, however, the average reached about 41 weeks, and it still stands at more than 36 weeks. In other words, after more than four years of recovery, the economy still has an unprecedented number of long-term unemployed.

Some economists believe that long-term unemployment leaves permanent scars on the economy — a theory called hysteresis. One possible reason for hysteresis is that the long-term unemployed lose valuable job skills and, over time, become less committed to the labor market. In some ways, perhaps, they should be thought of as effectively out of the labor force. If this theory is right, the labor market today may have less slack than the unemployment rate and the employment-to-population ratio suggest. Policy makers at the Fed may have to accept that lower employment is the new normal.

Another clue to what’s happening in the labor market is the vacancy rate. Although less widely followed than unemployment figures, this rate is its mirror image. To compile the unemployment rate, the Bureau of Labor Statistics surveys households to find workers without jobs. To compile the vacancy rate, the bureau surveys employers to identify jobs without workers. In short, the vacancy rate measures the percentage of available jobs that are currently unfilled.

Not surprisingly, the vacancy rate is highly cyclical. In recessions, when customers are hard to find, businesses post fewer new jobs. In addition, because the number of job seekers expands, the posted openings are filled quickly. As a result, the vacancy rate falls. Conversely, when the economy recovers, businesses start posting new openings, and jobs are harder to fill, so the vacancy rate rises.

The recent recession is a case in point. Seven years ago, the vacancy rate was a bit over 3 percent. It fell to a low of 1.6 percent in July 2009, a month after the official trough of the recession. The most recent reading puts it at 2.8 percent. So according to this measure of labor-market tightness, the economy is almost back to normal.

Data on wage inflation also suggest that the labor market has firmed up. Over the past year, average hourly earnings of production and nonsupervisory employees grew 2.2 percent, compared with 1.3 percent in the previous 12 months. Accelerating wage growth is not the sign of a deeply depressed labor market.

How these conflicting signals are resolved will eventually determine the course of monetary policy. Because Ms. Yellen says the economy has a lot of slack, she isn't especially worried about inflation and isn't eager for the Fed to quit its stimulative policies. Many measures confirm her judgment, but this recession has been extraordinary, making historical norms hard to apply, and other statistics point to a different conclusion. Ms. Yellen may well turn out to be right, but as new data arrive, she had also better be prepared to change her mind.