unemployment compensation, long-term unemployment, and the Fed

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On December 28, the federal Emergency Unemployment Compensation (EUC) program[1] expired, leaving 1.3 million long-term unemployed without extended unemployment benefits to start 2014. Some 3.3 million more people could find themselves without extended benefits if they don't secure a job before their standard benefits run out.[2]

Congress took up a debate over whether to renew the EUC program when it reconvened on January 6, but so far, nothing has changed. The stage is set for a protracted battle: Congressional Republicans are open to renewal on the condition that it be paid for by cutting spending elsewhere in the budget, whereas Democrats would prefer to fund a renewal with additional borrowing. Congress has extended EUC benefits 11 times since the 2008 financial crisis, but with the US economy showing signs of increased strength and the Federal Reserve (the Fed) beginning to taper its quantitative easing program, this time may be different.

KEY TAKEAWAYS

- We do not expect Congress to renew the Emergency Unemployment Compensation Program.
- Permanent expiration will trigger a small drop in labor force participation, incremental employment gains, and somewhat lower unemployment.
- The bond market may—incorrectly—believe the Fed will tighten policy sooner as unemployment falls, and long bond yields could spike temporarily.

The expiration of EUC is a relatively small piece of fiscal austerity, but what might it mean for US labor force participation, the unemployment rate, monetary policy and fixed income markets? To jump to our conclusions, we think the most likely scenario (70% odds) is that Congress will not renew the EUC program for another year, although it may renew it for just a few more months. In our view, a permanent expiration will trigger a small drop in the labor force participation rate, a small boost to employment, and a drop in the unemployment rate—changes likely to play out over the year. We don't think the Fed will tighten policy any sooner because of that drop in the unemployment rate. But financial markets, which are on high alert for rate hikes, could easily overreact to a drop in the unemployment rate with a spike in bond yields. The Fed would have to do a lot of explaining to calm the bond market.

AFTER THE EUC

The US Department of Labor classifies those of working age into one of three categories:[3]

1. EMPLOYED	2. UNEMPLOYED & SEEKING WORK	3. UNEMPLOYED & NOT SEEKING WORK
Included in the labor force	Included in the labor force and eligible for unemployment benefits	Excluded from the labor force and the unemployment rate, and ineligible for unemployment benefits

The labor force is the sum of those in categories 1 and 2. The labor force participation rate is the labor force as a percentage of the working age population. The unemployment rate is the number of unemployed (category 2) as a percentage of the labor force.

[1] *Under the most recent EUC program, those unemployed longer than 26 weeks (or less, in some states) were entitled to up to an additional 47 weeks of federal unemployment benefits.*
[2] *Data Source: US Department of Labor.*
[3] *Categories apply to the civilian noninstitutional population ages 16 and older, which the US Bureau of Labor Statistics defines as the universe for labor force data.*

What will happen if the EUC program is not renewed? Will the long-term unemployed accept less desirable jobs and drive real employment gains? Will they soldier on despite the loss in benefits, looking more intensively for work? Or will they give up, stop looking for work, and drop out of the labor force? How they respond to the expiration of the EUC will matter for the economy, Fed policy, and therefore, the bond market.

THE NORTH CAROLINA CASE STUDY

Those searching for clues about how the national unemployment picture might change if the EUC program is permanently discontinued are looking at what happened in North Carolina last year as a case study.[4]

In February 2013, the North Carolina legislature decided to cut the level and duration of state unemployment benefits, effective July 1, 2013. North Carolina, which had exhausted its tax-funded unemployment trust fund and borrowed extensively from the federal government, trimmed its maximum weekly benefit to $350 from $535 and cut the duration of benefits to a maximum of 19 weeks from 63 weeks. The move meant the state's eligibility for participating in the federal EUC also ended July 1, making North Carolina the only state excluded from the program before it expired. Job gains followed, but so did an even greater contraction in the state's labor force. Here are the details:

- *Employment*: From June to December 2013, North Carolina's household employment rose 1.0% whereas national employment rose a more modest 0.4%. During this time, North Carolina saw nonfarm payrolls rise 1.3%, whereas the US saw a 0.7% rise. (June was selected as the starting point because it was the last month before the EUC expired; December is the latest month of complete data available.)
- *Labor Force Participation*: North Carolina's labor force participation rate lagged the national rate during the Great Recession and recovery, but by January 2013, the rates were almost the same. Then, from June to December, North Carolina's participation rate fell a sharp 1.0 percentage points, compared to a 0.7 percentage point drop at the national level.
- *Unemployment Rate*: Over the same period, North Carolina's unemployment rate fell 1.9 percentage points. By contrast, the national rate fell 0.8 percentage points. North Carolina had experienced a higher unemployment rate than the national rate since the financial crisis, but after the EUC expired, unemployment in North Carolina essentially converged on the national rate—due mostly to lower labor force participation, not better job growth.

Partisans in both parties are looking at North Carolina's experiment for evidence to support their views about how the expiration of EUC might play out on a national scale, but the data tells an ambiguous story. Those in favor of renewing EUC point to the substantial, rapid decline in North Carolina's labor force participation, arguing that without EUC, many just drop out of the labor force. The economy doesn't benefit if the long-term unemployed simply give up. On the other hand, those who oppose the renewal highlight the state's better-than-national job gains. They also note that North Carolina's labor participation rate has been falling for years and actually plummeted more in the six months *before* the July cut in benefits than it did in the six months after the cut.

In our view, the timing of the large decline in North Carolina's labor participation rate—four years into economic recovery—is curious. The housing and technology industries, mainstays of the North Carolina economy, have rebounded nationally, yet the state's labor force has not grown in response. We think the cut in unemployment benefits contributed to the labor force decline but was not the only factor. There may be hard-to-identify special factors driving North Carolina's labor market that are independent of the EUC and don't apply at the national level. Neighboring states like Georgia, Kentucky and Tennessee saw labor force participation rate declines larger than North Carolina's even though they remained in the EUC program, which suggests regional factors may be at work.

[4] *Data Source: US Bureau of Labor Statistics.*

IMPLICATIONS FOR THE US ECONOMY

It is uncertain whether the North Carolina story will play out on a national scale. Every state is unique, and each is vulnerable to special shocks that don't matter at a national level. Six months of data are not enough to draw strong conclusions, but North Carolina delivers a warning that the national unemployment rate could fall more than we and many other forecasters expect for 2014.

The expiration of the EUC program nationally will pressure some of the long-term unemployed to search more actively for work or to take jobs that they may have previously regarded as undesirable. The recent household employment gains in North Carolina have outpaced many neighboring states, suggesting such pressures are real. On the other hand, the fiscal tightening associated with the expiration—which would take between 0.1 to 0.2 percentage points off of US GDP growth—is likely to restrain job creation somewhat. On balance, we believe that the national expiration of the EUC will deliver a mild boost to job growth.

The national labor force participation rate has declined substantially over the past five years. Part of that decline was predictable as baby boomers retired, but much of the decline is a puzzle. Without a full understanding of the reasons for this decline in the participation rate, we need to be cautious making a forecast. Part of the problem is that recent economic studies do not agree on the mix of structural and cyclical factors behind the recent drop in the participation rate, and they do not agree on how much the EUC program may have held back declines in the participation rate.

Our best guess is that a permanent expiration of the EUC program will put downward pressure on the national participation rate, but we are reluctant to say it will be large. It could take up to 0.3 percentage points off the participation rate. The decline in labor force participation won't happen instantly; it likely would be stretched out over many months. As the participation rate drops and jobs increase, the unemployment rate would also drop.

Of course, the expiration of EUC is not the only thing changing in the economy. We see signs of greater vitality. Examples include declining mortgage delinquencies, revived housing sales and construction, a boom in the oil and natural gas industry, improving bank lending, the end of cuts in state and local purchases, less federal fiscal drag, still easy monetary policy, and rising equity and real estate prices. This more favorable economic backdrop ought to boost labor markets and may be far more important to labor market activity than the fate of the EUC program.

Having said all this, we prefer that Congress give the EUC program just one more year to give those suffering long-term unemployment additional time to take advantage of the improving economic environment. With a year's notice, we trust that those able to work will find some employment as job openings increase. A year from now, the country would have to find a solution for those no longer able to work.

IMPLICATIONS FOR THE FED AND FIXED INCOME MARKETS

How would the Fed respond to a permanent expiration of the EUC program? In speeches and press conferences, Ben Bernanke and Janet Yellen have bluntly stated that they regard the unemployment rate as just one metric of the labor market. The December 2013 Federal Open Market Committee press release stated:

> In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee now anticipates, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6-1/2 percent, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal.

The Fed is looking at "additional measures of labor market conditions." That includes the participation rate. If, indeed, the labor force participation rate tumbles after EUC expires, the Fed will not prepare to tighten just because the unemployment rate falls as a result. The Fed has not formally lowered its threshold of a 6.5% unemployment rate, but informally, it has. The Fed is not going to be fooled by a measurement issue.

Alas, financial markets are something else. If the labor force participation rate tumbles in 2014, taking the unemployment rate down with it, the bond market may believe the Fed will prepare to tighten sooner than currently expected. The result would likely be a spike in long bond yields. We won't like it, and it would be irrational, but it may well happen anyway. How long such a spike would last is another question. The new chairman of the Fed may be tested very soon. Janet Yellen will need great diplomacy to convince financial markets that—absent data signaling rising broad-based price and wage inflation—a lower unemployment rate due to the EUC expiration would not hasten Fed tightening. She will need to explain very clearly what guides Fed policy. Such clarity would be most welcome after the Fed's botched attempt to explain "tapering" in 2013. Depending on her communication skills, the bond market might relax and yields return to prior levels.

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