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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, Stephen Oliner, senior fellow, UCLA Ziman Center for Real Estate, discusses the Fed's interest-rate policy under Chair Janet Yellen.

The Fed: Watchful Waiting This Year, Tough Choices Next Year:

What Happens With the Labor Market and Inflation Will Be Crucial

By Stephen Oliner, senior fellow, UCLA Ziman Center for Real Estate

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Since the onset of the financial crisis in 2007, the Fed has taken extraordinary steps to support the economy and financial markets. Seven years later, a gradual return to more normal policy is now in sight. Barring a setback to the economy, the Fed has announced it will end the expansion of its balance sheet in October. The Fed also has been actively planning for the day when it will lift the federal funds rate from its current level near zero, where it has sat for almost six years.

The central question facing the Fed is when that "lift-off" will occur and how quickly rates will rise thereafter. The forecasts issued by the Federal Open Market Committee (FOMC) after its meeting in June provide some guidance in this regard. Twelve FOMC participants projected that the first rate hike would occur next year and another three thought it would be in 2016; only one participant expected the lift-off to be this year.

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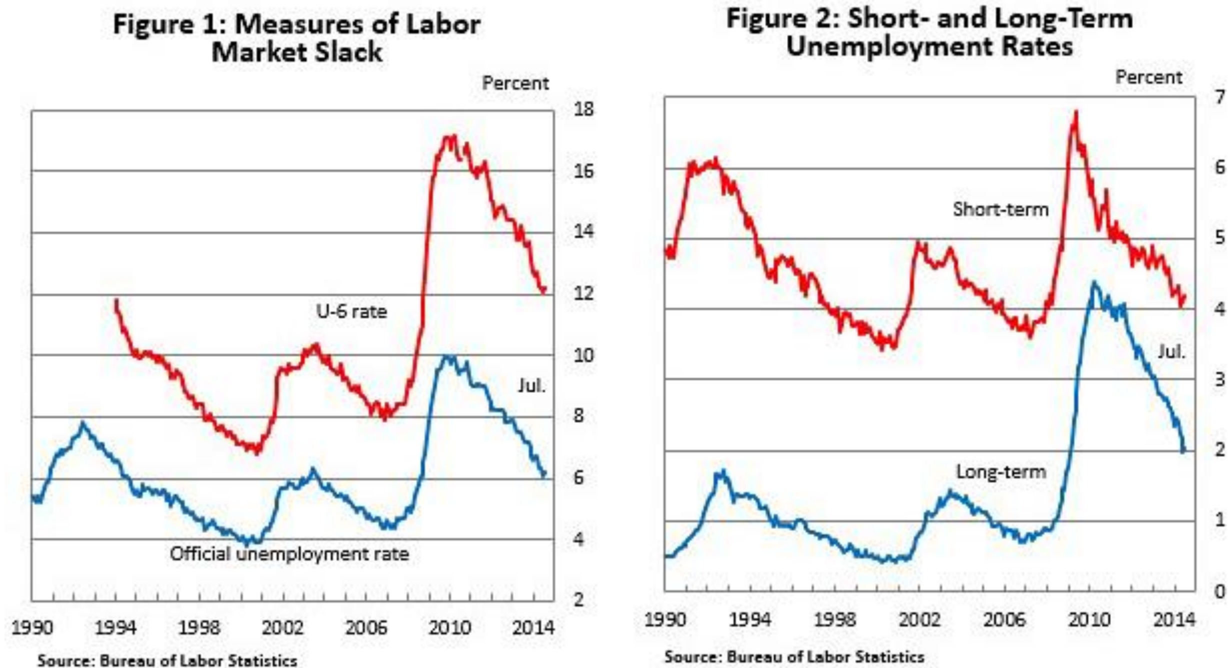
Forecasts are fine, but what the Fed actually will do depends on two key aspects of the economy: the pace of improvement in the labor market and the rate of inflation relative to the FOMC's 2 percent target. This makes sense, as these indicators map directly into the Fed's dual mandate to achieve maximum sustainable employment and price stability. The FOMC and Fed Chair Yellen have gone out of their way to emphasize that their policy actions will be "data dependent."

Yellen and the core of the FOMC believe that the economy is not yet approaching full employment, which leads directly to their prescription that monetary policy should remain highly accommodative for a while longer. This will remain the operating principle of the Yellen Fed until the data say otherwise.

Although the Fed monitors a vast array of data, the essence of what will guide their decisions can be captured by just four charts, which are shown by Figures 1 to 4 in this *Letter*. Figure 1 displays the official unemployment rate for the U.S., along with a broader measure of slack in the labor market known as the U-6 rate. The official unemployment rate measures the share of the labor force – people who are working or actively looking for work – that is unemployed. The

U-6 rate captures two important aspects of labor-market slack omitted from the official rate: (1) people who are working part-time but want a full-time job and (2) people who are out of the labor force but indicate they would like to work and have looked for a job sometime in the past 12 months. The second group includes discouraged workers who have not searched for work in recent weeks because they view jobs as scarce.

As shown in Figure 1, both the official unemployment rate and the U-6 rate have dropped substantially from their peaks in late 2009. The official rate is now at 6.2 percent, somewhat above the 5¼ to 5½ percent range that most FOMC members believe to be consistent with full employment. The U-6 rate has declined even more rapidly than the official rate, but it remains at a very high level relative to its short history before the financial crisis.[1] With the official rate still ¾ to 1 percentage point above the estimated full-employment level and with the large amount of additional slack captured by the U-6 rate, it is no surprise that most FOMC members see the need for policy to remain stimulative.



Another aspect of the labor market that concerns the Fed is the large amount of long-term unemployment. Such unemployment imposes a heavy cost on jobless individuals and their families and can reduce the productive potential of the economy through the erosion of skills and reduced attachment to the labor market. Figure 2 splits the official unemployment rate into the part that represents long-term unemployment (those who have been looking for work for more than six months) and short-term unemployment (all others). As shown, the short-term rate has dropped back to a low level by historical standards. In contrast, the long-term rate – while down sharply from its peak – remains above the highest levels reached after the 1990-91 and 2001 recessions.

Fed officials also pay close attention to trends in labor costs. Figure 3 shows the most reliable measure of these costs – the quarterly Employment Cost Index (ECI), which covers not only wages and salaries but also employee benefits. Since 2011, the four-quarter increase in the ECI has fluctuated in a tight band around 2 percent. Although the latest number was at the top of this narrow range, it remained far below the increases seen before the financial crisis.

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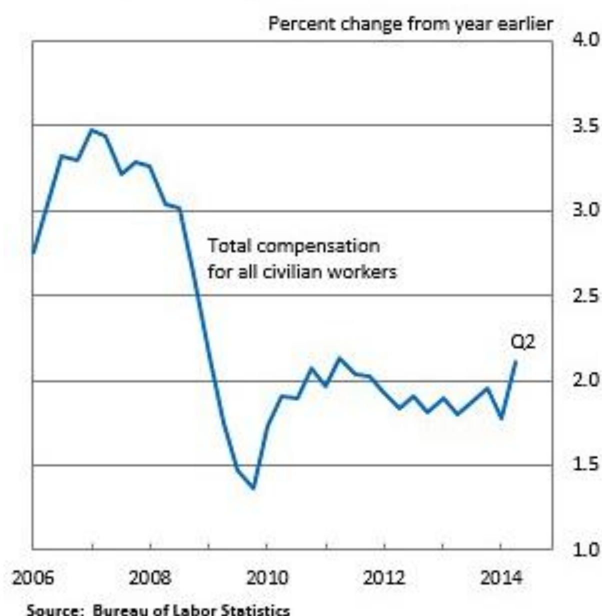
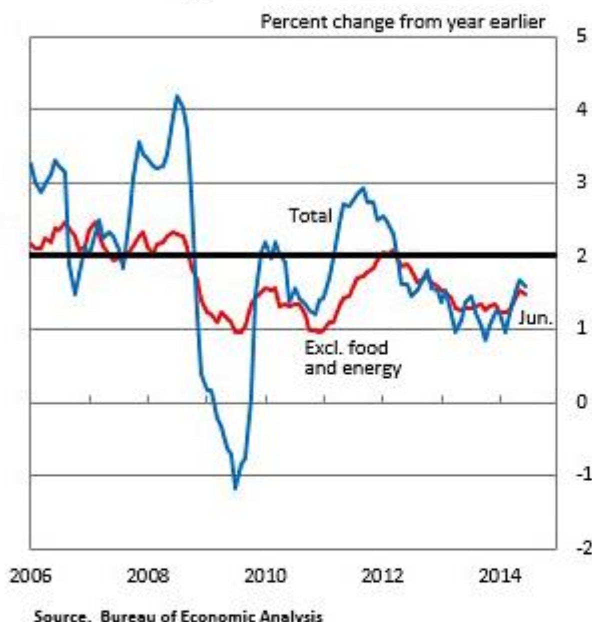
[1] *The U-6 rate is available only starting in January 1994.*





With labor costs still rising slowly, one would expect general price inflation to be low, and that is the case, as can be seen in Figure 4. Over the past year, the price index for total personal consumption expenditures (PCE) – the Fed's preferred measures of inflation – has risen only a bit more than 1½ percent; the less volatile index that excludes food and energy prices has risen about the same amount. Both indexes have moved up from their readings six months ago, but both remain below the Fed's 2 percent target for inflation.

Figures 1 to 4 explain why the Yellen Fed has been in no hurry to tighten monetary policy.[2] But if the labor market continues to improve and if inflation rises to 2 percent or above, 2015 will be a year of difficult decisions for the FOMC. How will the Committee set policy if the labor market hasn't yet approached full employment but inflation has heated up?

Thus far, the FOMC has provided only the vaguest guidance regarding this trade-off. The Committee has indicated only that it "will take a balanced approach" in promoting its dual objectives of full employment and stable prices. I do not expect the FOMC to provide any additional specifics about how they will implement that general principle, as there is simply no consensus among the Committee members.

However, Yellen's many public statements over the years make it clear that she has limited tolerance for inflation above the Fed's target.[3] The same is true for other FOMC members, even those who favor accommodative policy. In my view, the FOMC would allow only a small pickup in inflation – to 2½ percent at most – before the balance would tip strongly in the direction of restraining these price increases.

To sum up, the FOMC's policy decisions next year are likely to make those this year look easy, especially if inflation heats up. Translating the general principle of a balanced approach to policy into concrete actions backed by a large majority of FOMC members will be a challenging test of Yellen's leadership skills.

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[2] *Yellen presented her latest views on the labor market and monetary policy last week at the Fed's widely-followed Jackson Hole conference (http://www.federalreserve.gov/newsevents/speech/yellen20140822a.htm). Although Yellen mentioned a number of challenges in interpreting recent labor-market developments, she reiterated the view that "the underutilization of labor resources still remains significant."*

[3] *See Stephen Oliner, "The Myth That Janet Yellen Is 'Soft' On Inflation," UCLA Economic Letter, September 2013. http://www.anderson.ucla.edu/Documents/areas/ctr/ziman/UCLA_Economic_Letter_Oliner_9-04-13.pdf*

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