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US rate rise to come later rather than sooner

Labour force participation is an important variable

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INSIGHT

With the US Federal Reserve set to end its quantitative easing programme of largescale asset purchases some time in late 2014, the debate is turning to the timing of future interest rate increases. Janet Yellen, the Fed's new chairwoman, has been scattering some clues.

In March, Ms Yellen said the federal funds target rate could rise as early as six months after the end of QE. Investors were caught off guard by this, widely interpreting the statement to mean rates would rise by mid-2015.

Then in April, remarks by Richard Fisher, president of the Federal Reserve Bank of Dallas, that new purchases would end in October left many market participants believing rate increases could come as early as the first quarter of 2015.

However, neither interpretation may be correct. Ms Yellen's assertion that rates could rise as early as six months after the end of QE seems to have been largely misunderstood. The Fed chairwoman was signalling that any increase to the federal funds target rate would come at the earliest six months after the end of large-scale asset purchases, in June or July of 2015.

However, Ms Yellen's monetary policy blueprint laid out on April 16 in her first major speech as Fed chairwoman suggested her inaugural rate increase might come much later.

In that address, at the Economic Club of New York, Ms Yellen clearly set out the conditions for future rate increases with particular regard to unemployment and inflation. Some historical analysis helps put her comments into context.

Payroll growth

When considering labour markets, the Fed has historically raised interest rates when unemployment has dropped to levels below which it would expect a pick-up of inflation – the non-accelerating inflation rate of unemployment, which the Fed believes is about 5.5 per cent.

At the average rate of payroll growth of about 200,000 jobs per month in this and prior US economic expansions, the Fed could anticipate reaching the 5.5 per cent unemployment rate in late 2015. This assumes that the percentage of the population working or seeking work, the labour force participation rate, remains unchanged.

Fed policy makers have been troubled by the decline in the labour force participation rate during the current expansion, and the reasons for its fall have been the subject of vigorous debate among Federal Open Market Committee members.

One theory is that US workers have been discouraged by chronically high unemployment and had such difficulty in finding meaningful work they may never return to the labour market.

The argument goes that as time has passed their job skills have become stale, rendering them structurally unemployable and permanently excluded from the labour market.

Supporters of that view, therefore, believe the labour force participation rate will not rise and we are on course for an interest-rate increase in late 2015 once unemployment drops to 5.5 per cent.

Participation rate

A second theory for the decline in the labour force participation rate is that these discouraged workers are merely the victims of a slow economic recovery from the deepest recession since the Great Depression, and they will slowly return to the labour force as the US economic recovery gathers pace.

This would cause the unemployment rate to fall at a more modest rate as more workers opt to return to seeking employment, causing the labour force participation rate to increase.

During the current economic expansion, the labour force participation rate fell by about 3 percentage points. If only 1 percentage point, or a third of that number, were to return to the labour market, that would push the date at which the economy reaches 5.5 per cent unemployment into the second quarter of 2016.

Recent US employment data show there has been an uptick in the participation rate, rising from 63 per cent to 63.2 per cent in March. While it is unclear whether this is a statistical blip or the start of a trend, the likelihood of further declines in labour force participation seems remote.

True to her commitment to transparency, Ms Yellen used her April 16 speech to spell it out clearly for investors. "The larger the shortfall of employment or inflation from their respective objectives, and the slower the projected progress toward those objectives, the longer the current target range for the federal funds rate is likely to be maintained."

So, financial markets should be on notice. The risk is increasing that US interest rates will remain at the zero bound longer than currently anticipated, well into 2016.

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