Can Participation Keep Rising and Keep the Unemployment Rate Steady?

Executive Summary
Employment growth has remained strong over the past year, yet the unemployment rate has moved sideways due to gains in labor force participation. The rebound in participation has kept wage pressures from building to the point where labor costs would set off inflation or severely strain profits. As such, the increase in labor force participation has provided the FOMC another reason it can be patient with additional rate hikes.

With strengthening wages and plentiful job opportunities, we expect labor force participation to improve somewhat further. However, participation continues to face a number of structural challenges, which, along with slower growth in the working-age population, is expected to lead to further tightening in the labor market and the unemployment rate falling to 3.6% by year end.

Rising Participation Has Kept the Unemployment Rate Range-Bound
An underappreciated reason in our view for the FOMC’s more dovish policy since late last year has been the flattening of the unemployment rate. After steadily declining over the expansion, the unemployment rate has fluctuated within a range of 3.7-4.0% over the past year (Figure 1). The level is consistent with FOMC members’ estimates of “full-employment.” The stability, however, suggests the near-term risks of the labor market over-heating and setting off a bout of inflation have diminished. Is this a mere pause in the unemployment rate’s decline this cycle, and is the labor market set to tighten further?

A key reason for the leveling-out of the unemployment rate over the past year has been the participation rate rising to a five-year high (Figure 2). Employment growth has been little changed, but with more people looking for a job, it has been tougher to chip away at the unemployment rate. Can the participation rate continue to rise, and will it be enough shore-up labor force growth in light of an aging and slower-growing population?

Figure 1

Figure 2

Source: U.S. Department of Labor and Wells Fargo Securities
Population-Induced Supply Constraints on Horizon

Whether the labor market will tighten further will depend on both the demand and supply of labor. Demand for labor remains generally strong, with layoffs near the lowest levels in 50 years and job openings near a record high, although the pace of improvement has eased a bit in recent months. Meanwhile, the labor supply hinges on population growth and the share of the population that participates in the labor market.

Population dynamics are becoming less supportive of the labor supply and are making it more difficult for businesses to recruit new workers. While the total adult population is expected to grow closely in line with its 1% average over the past 40 years, growth disproportionately rests among seniors, who are much less likely to be in the labor force than younger adults (Figure 3). Population growth amid the under-65 crowd is expected to slow to just a quarter of percent, or about 45,000 people a month (Figure 4). To put that in perspective, the economy added an average of 211,000 jobs per month over the past year.

Immigration can raise the domestic labor supply, and foreign-born labor has accounted for half of the growth in the labor force over the past 10 years. More recently, however, the foreign-born workforce has grown more slowly, and immigration could be a headwind on the labor supply if policy tightens and/or economic opportunities improve elsewhere.

**Figure 3**

Labor Force Participation & Demographic Shifts

**Figure 4**

Labor Availability Is Not What It Once Was

*Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities*

Can Participation Continue to Rise?

That puts the onus on raising participation among the current U.S. population to buoy the labor supply and keep the labor market from overheating in the current demand environment. But can participation continue to rise at its recent pace? The depth of the recession and steep decline in labor force participation highlighted a number of structural issues facing the labor force, such as declining real wages for lower-skilled jobs, the availability of social support and a geographic dispersion of growth.1 As the economy has improved and the labor market has tightened, however, the overall labor force participation rate has stabilized (refer back to Figure 2). That’s an impressive feat considering that population aging alone is shaving off about a quarter of a point from overall participation.2 Labor force participation among prime-age workers (25-54) has staged a more clear comeback, increasing half a point over the past 12 months.

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The rate at which labor force participation has improved recently, however, may be tough to maintain. Wider availability of job opportunities along with stronger wage growth is fueling the cyclical recovery in labor force participation (Figure 5). More than 70% of people enter the labor force with a job, illustrating the pull of a strong job market. As long as demand for labor remains solid and wages continue to pick up, we would expect prime-age labor force participation to move higher as well. Recent readings on job openings, hiring plans and layoffs hint at a modest slowdown in the pace of labor demand, however, which suggest wage growth would need to strengthen more markedly to continue to pull workers into the labor market at the recent pace.

Boomers Clocking More Time in the Labor Force, but Not Enough to Turn the Tide

In addition to job opportunities and wages, some structural changes in the economy are also supporting higher participation. Overall labor force participation has been held down by a growing share of the population reaching the traditional retirement age, but this has been partially offset by senior participation rising to a nearly 60-year high. Better health and less physically demanding jobs as the economy has shifted more toward services have allowed workers to push back the timing of retirement. Financial need is also at play, however, as today’s seniors face longer life expectancies and more responsibility to save as defined benefit plans have become increasingly scarce.

We would expect labor force participation among seniors to continue to rise, especially as the Baby Boomers remain on the young end of the 65+ cohort. The recent pace, however, looks somewhat dubious compared to the trend the past few years when the labor market was similarly strong, and could be noise stemming from the small size of the survey used to derive labor force participation. For example, participation among women ages 65-69 increased 1.6 percentage points over the past year after having been close to flat for the prior three years, while participation among men ages 65-69 increased a full percentage point, the biggest increase in nearly eight years (Figure 6).

Varied Trends in Prime-Age Male and Female Participation Rates a Warning Sign?

An uneven recovery in participation rates among “prime-age” men and women also suggests that challenges to pulling people into the workforce remain, which may limit the extent of the rebound. Participation among women ages 25-54 has fully reclaimed the ground lost since the recession (Figure 7). Stronger job growth in industries that employ a relatively high share of women, like healthcare, education and hospitality, has helped fuel the rebound. Most pronounced has been the increase in participation among young women since the recession, which stands in stark contrast to men the same age (Figure 8). Women now outnumber men among college graduates, and educational attainment is positively associated with higher labor force attachment. Waiting longer

Source: U.S. Department of Labor and Wells Fargo Securities

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To start a family is also keeping more young women in the workforce, but participation among mothers with young children has also climbed to a record high.³

**Figure 7**

**Prime Labor Force Participation**

**Figure 8**

**Change in Participation Since the Recession**

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Source: U.S. Department of Labor and Wells Fargo Securities

The skewed increase in female participation, especially for young mothers, suggests that some of the structural headwinds to female participation are easing. But the disparate movements also highlight that a number of challenges remain for participation among men. The decline in manufacturing jobs since the 1970s has hit men disproportionately, although the job opening rate for the factory sector is near a record high, indicating there is more to the story. Higher incarceration rates, which leave men with a criminal record, as well growing use of pain killers, including opioids, have also been linked to lower participation among prime-age men and suggest it will take more than a tight labor market to increase participation among this group.⁴

**Where Does this Leave the Unemployment Rate?**

The rebound in labor force participation over the past few years has been a welcome development for the FOMC. The boost to the labor supply at a time when demographics are not supportive of growth has kept wage pressures from building to a point where labor costs have set off inflation or severely strained profits. The need for the FOMC to be restrictive with policy has been limited as a result, and the expansion has been elongated.

With wages continuing to strengthen and job opportunities remaining abundant, we see participation trends among individual cohorts as likely to improve further. The extent, however, is unlikely to be as impressive as in recent months. Secular forces are keeping older Americans in the workforce longer, and preventing more young women from exiting. Yet participation among prime-age men remains strained by the disappearance of manufacturing and mining jobs, among other issues, and the increase in participation among seniors over the past year seems somewhat exaggerated when compared to the trend of the prior few years. With population growth among 25-64 year olds slowing to a crawl, we expect that the unemployment rate will break out of its range of the past year and fall to a new cycle low of 3.6% by year end. The additional tightening in the labor market would strengthen the case for further Fed tightening this year, although it is unlikely to be sufficient on its own. Until labor market strength translates into stronger inflation, we see the FOMC remaining “patient” and keeping rates on hold.

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³ The average age at which a woman has her first child has increased to 26.8 from 25.0 10 years ago. Labor force participation among mothers with children under age 6 climbed to a record high of 65.1 in 2017 and 2018.

