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Noisy jobs data and Taylor Rule prescriptions

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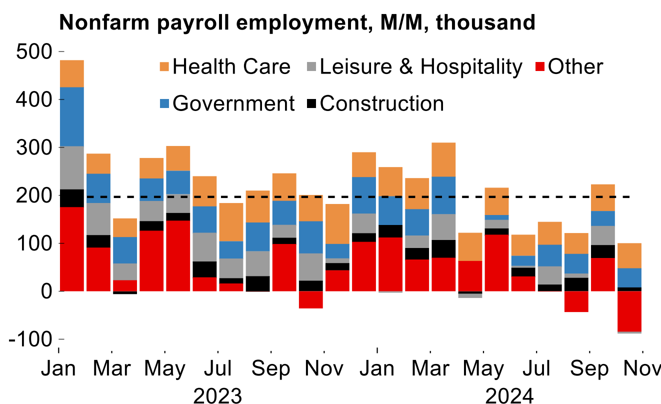
- Payroll employment growth slowed sharply in October from the effects of Hurricane Helene and Milton, as well as from strike activity in the manufacturing sector.
- The household survey was largely unaffected by the extreme weather events, with the unemployment rate remaining at 4.1% in October. Job losers as a share of the total unemployed remains low, and growth in the labor supply is now less of a contributing factor to total unemployment. Growth in the share of new entrants into the labor force has stalled, and the labor force participation rate of prime-age workers has fallen for three consecutive months.
- When using the unemployment rate to measure economic slack, the Taylor Rule suggests that the current policy rate is overly restrictive, but the position changes when using GDP. Historically, wage and inflation pressures rise when the Fed cuts rates during periods of above potential growth. Right now, wage growth is moderating for the vast majority of workers, but an overly dovish Fed can stall progress that has been made to ease inflationary pressures coming from the labor market.

Distorted establishment survey

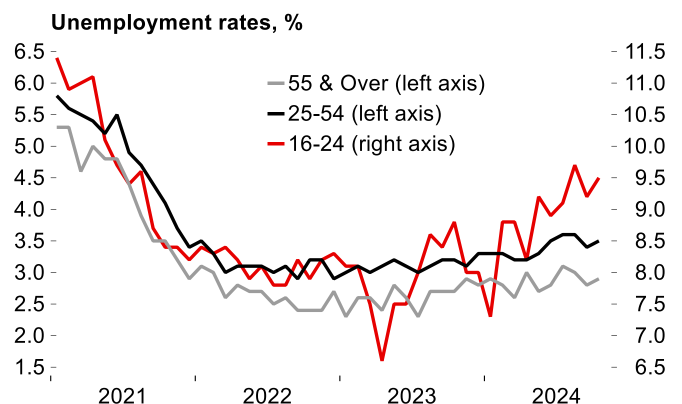
Total nonfarm employment increased by only 12,000 in October, a significant but inconsequential slowdown. Residual effects from Hurricane Helene (made landfall before the refence period) and prime effects from Hurricane Milton (made landfall during the reference period) severely impacted payroll employment growth in October. Additionally, work stoppages at Boeing negatively impacted manufacturing employment growth, much of which is expected to reverse once the strikes are settled.

Chart 1: Hurricanes Helene/Milton along with manufacturing strike activity distorted job gains in October



Source: BLS, MUFG Bank Economic Research Office

Chart 2: With rounding, the national unemployment rate was unchanged at 4.1% in October



Source: BLS, MUFG Bank Economic Research Office

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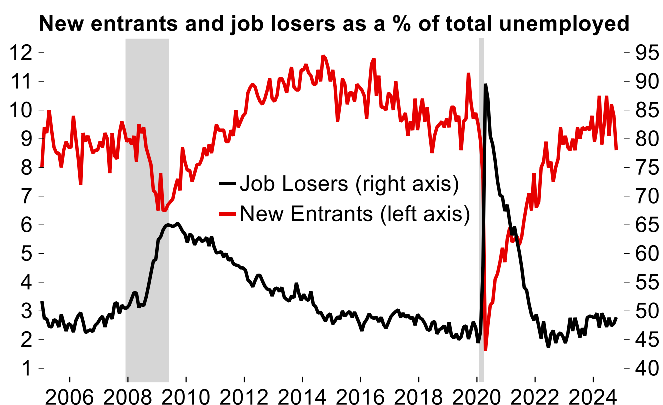
In general, the CES establishment survey is not equipped to isolate the effects of extreme events, leading to October payroll jobs data that is largely filled with noise, with respect to assessing underlying labor demand (Chart 1).

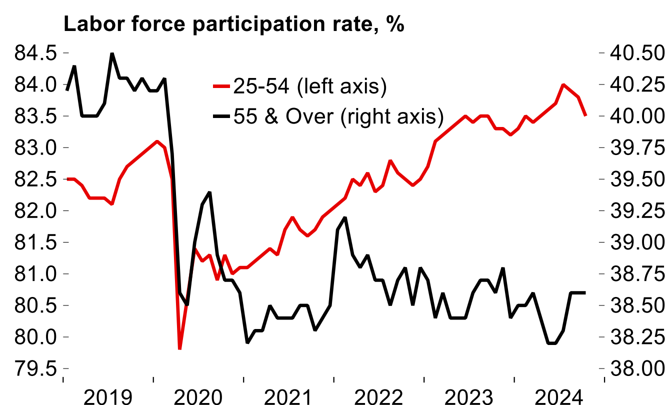
The household survey, on the other hand, appears to have been largely unimpacted by the hurricanes. BLS notes that "there was no discernible effect on the national unemployment rate from the household survey." With that in mind, the unemployment rate was unchanged at 4.1% in October, with the visibly small uptick across the different age groups being a function of rounding (Chart 2). Though there was a rise in layoffs in September from the establishment survey JOLTS, it coincided with increased hiring and strong monthly job gains last month. The timelier CPS household survey measure of job losses continues to show that job losers comprise a small share of the total number of unemployed persons (Chart 3).

Chart 3: The rate of new entrants joining the labor force has slowed considerably while job losses remain low



Source: BLS, MUFG Bank Economic Research Office

Chart 4: The participation rate of prime-age workers has fallen for three consecutive months



Source: BLS, MUFG Bank Economic Research Office

So far in 2024, much of the growth in the unemployment rate was driven by increased labor supply as opposed to job losses, where both new entrants (those with no previous work experience that are now looking for work) and re-entrants (those that left the labor force for a period of time before starting to look for work again) drove up unemployment (those without a job but are looking for work). The trend has since slowed, with the share of new entrants in the labor force stalling (Chart 3), potentially from slowing immigration, and the labor force participation rate of prime-age workers falling for three consecutive months (Chart 4).

Taylor Rule and wage growth

Immigration has been less of a driving force over the past few months, which helps to explain the relatively flat national unemployment rate. But effectively, labor supply growth drove the unemployment rate to a level that is now much closer to the natural rate, which is estimated to be around 4.4%, implying greater economic slack than unemployment driven primarily by job losses.

This has significant implications for monetary policy, where the often referenced Taylor Rule provides prescriptions of what the appropriate policy level should be based on the values of inflation and economic slack, such as the output gap or unemployment gap. Shown in Chart 5, when GDP and the output gap is used to measure economic slack, the Taylor Rule suggests that the current federal funds rate is approximately where it should be.

This is perhaps not surprising, where if economic output expands at a pace that is above or near potential, it presumably means that the policy rate is less than restrictive. The latest and robust Q3 real GDP growth figures suggest exactly that (see previous brief).

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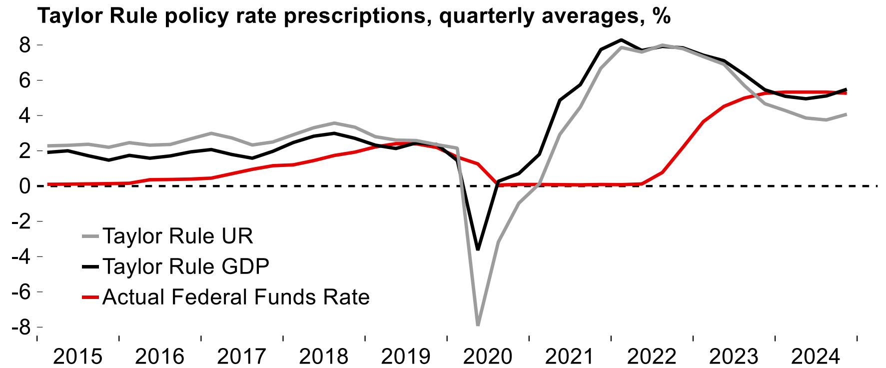
But when using the unemployment gap as a measure of economic slack, the Taylor Rule suggests a lower policy rate that is more consistent with the Fed's current expansionary policy (Chart 5).

Now, it's not uncommon for the actual federal funds rate to fall below Taylor Rules, but the risks are perhaps greater in today's environment where annual inflation remains above the Fed's 2% target. If the unemployment rate is indeed misrepresenting the amount of slack in the economy, then more accommodative monetary policy can risk increasing inflationary pressures.

Chart 5: Depending on how the economic slack is observed, the Taylor Rule prescribes noticeably different policy rates

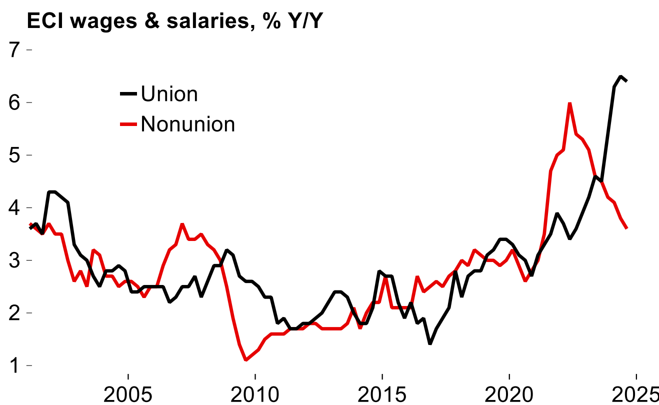


Note: Measures use core PCE for inflation and 2% for target, FOMC median projection for r*, CBO for GDP gap, and Survey of Economic Forecasters for unemployment rate gap. Federal funds rate is lagged by 1 quarter
Source: Atlanta Fed, MUFG Bank Economic Research Office

Barnichon and Matthes (2016)[1] estimate that in tight labor markets (unemployment around 4%), expansionary shocks (i.e., decreases in the federal funds rate) generate no significant drop in unemployment but lead to bursts of inflation. The logic here is that prices and wages are less upward rigid and expansionary monetary policy is more likely to prompt a rise in wages and subsequent prices rather than increased output.

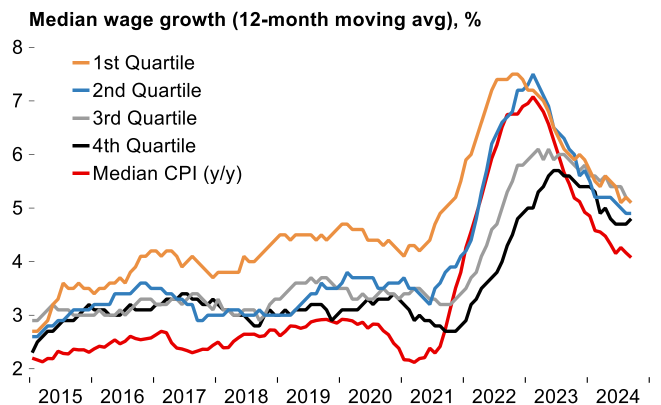
Right now, the inflation risks stemming from the labor market appear to be somewhat balanced. The most reliable wage measure, the Employment Cost Index, shows that wage growth continues to ease for the vast majority of workers, but the level remains above what would be consistent with 2% inflation. The exception is for union workers, which have experienced significant wage gains in recent quarters (Chart 6).

Chart 6: Wage growth continues to ease for the vast majority of workers, but those in unions continue to see strong growth



Source: BLS, MUFG Bank Economic Research Office

Chart 7: Wage growth is broadly exceeding inflation in all income quartiles



Source: Atlanta Fed, Cleveland Fed, MUFG Bank Economic Research Office

[1] Barnichon and Matthes (2016), Gaussian Mixture Approximations of Impulse Responses and the Nonlinear Effects of Monetary Shocks

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Relative to inflation, median wage growth is easing at a slower pace, implying real wage gains for all income quartiles. But if the labor force can manage continued productivity growth, there would expectedly be less passthrough into prices.

This will likely give the Fed some confidence that inflationary pressures are subsiding, despite strong Q3 real GDP growth and a potential overestimation of economic slack that the unemployment rate is showing. This should, however, be a cautionary note that overly accommodative monetary policy and aggressive rate cuts could upend progress already made.

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