

FEBRUARY 14, 2017

PARADOXES OF THE U.S. LABOR MARKET

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Although job growth has been solid the past six years, there continues to be certain paradoxes and fundamental weaknesses in the U.S. employment market. This report covers some of the key issues facing American workers, including:

- Slow wage growth
- Job erosion in higher-paying industries
- Impact of lagging labor force participation rates
- The impact of isolationism and tighter immigration policies
- Changing age dynamics in the workplace



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Acknowledgement

The authors thank various seminar participants for their valuable suggestions, and Gene Walden, Senior Finance Editor, Thrivent Mutual Funds, and Greta Peterson for their editorial and design and layout support.

Disclosure

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Job growth in the U.S. has been decent for the past six years. The pace of job growth is just around the average pace of job growth since the 1960s. The pace of job growth is less so than during the expansion phase of most post-World War II business cycles (see Figure 1). In essence, job growth during this recovery has been decent but not great.

Given the depth of the Great Recession of 2007 – 2009, one might have expected stronger job growth. The U.S. economy has recovered at a modest pace, with trend growth a bit less than 2.0%, since the end of the Great Recession (Akram 2016). However, thanks to the sustained pace of jobs for the past six years, the unemployment rate has declined notably from its peak of around 10% in October 2009 to 4.7% as of December 2016, and a wide range of indicators point to the tightening of the labor market. Yet, there are still areas of weakness in the labor market, and certain paradoxes exist.

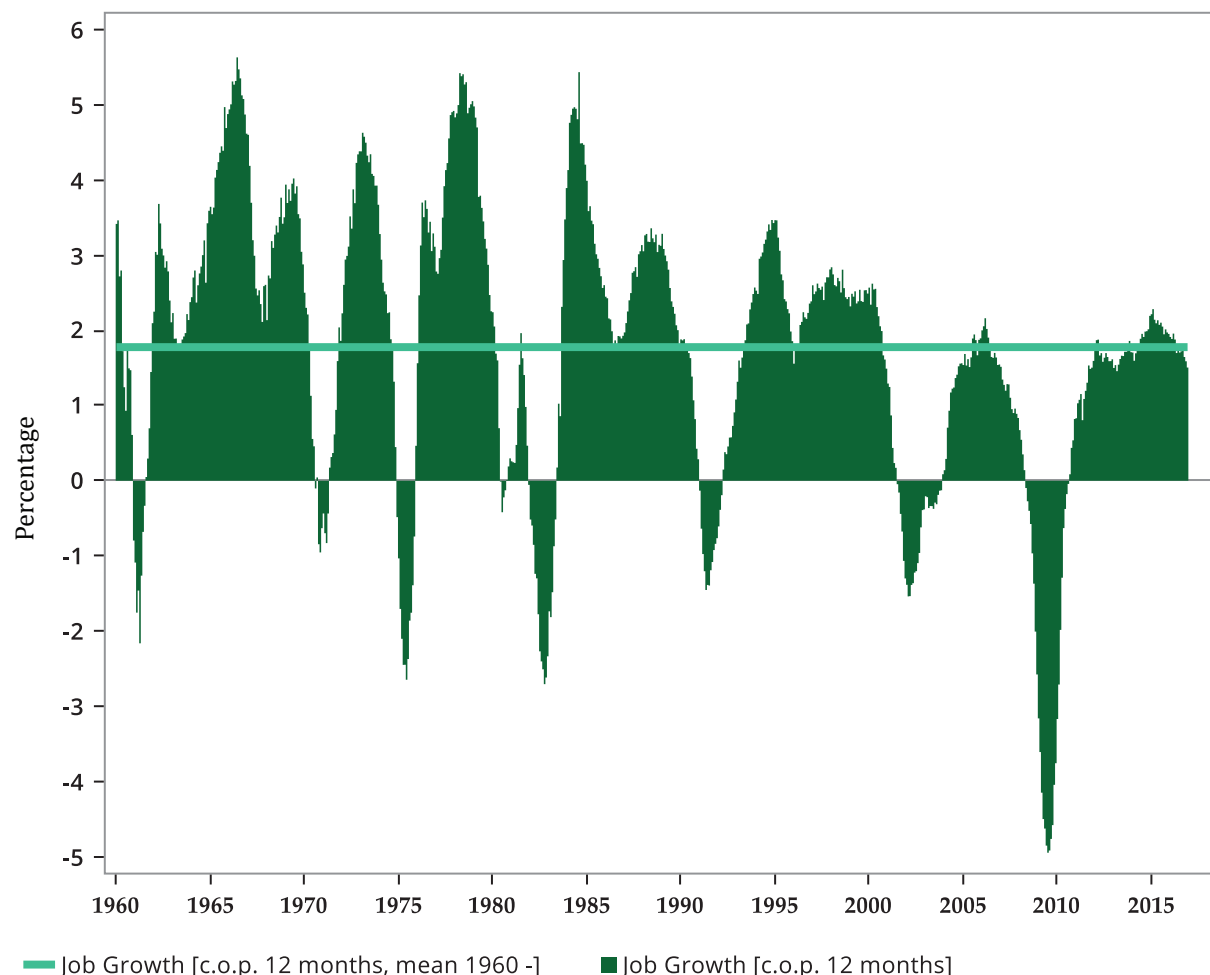
Wage Growth Tepid Despite Jobs Recovery

First, real wage and real disposable income growth have been tepid in spite of the low unemployment rate. Second, labor force participation rates for most age and demographic groups are lower than before the crisis. A combination of weak aggregate demand and demographic changes is responsible for the decline in the labor force participation rates. Third, inflationary pressures are still in check and remain below the Fed's target despite the low unemployment rate. Lower growth in nominal wages is keeping inflationary pressures well-contained. Fourth, the gap between growth in labor productivity and growth in labor compensation has been widening.

Productivity growth rates, which are measured in various ways, have also slowed in recent years. Slower productivity growth is troubling for economic prospects

Figure 1: The current pace of job growth is around the mean pace of job growth since the 1960s

United States, Job Growth, % Change, y/y, SA



Source: Macrobond

going forward. With slowing labor force growth, labor productivity growth would be the key driver for growth and the improvement of the quality of life. Although there are several aspects of the labor market that appear paradoxical—with the unemployment rate dropping below 5.0% since January 2016 and job growth continuing at a strong pace—as expected, the Federal Reserve raised the fed funds target rate end of the last year. Fed board members and regional Fed presidents have indicated that they hope to continue to gradually tighten monetary policy in 2017.

An Improving Labor Market

Job growth in the U.S. has been decent since 2011 (see Figure 2). Since the end of the Great Recession, the U.S. economy has added about 15 million jobs. The U.S. economy lost nearly 8 million jobs during the crisis. As a

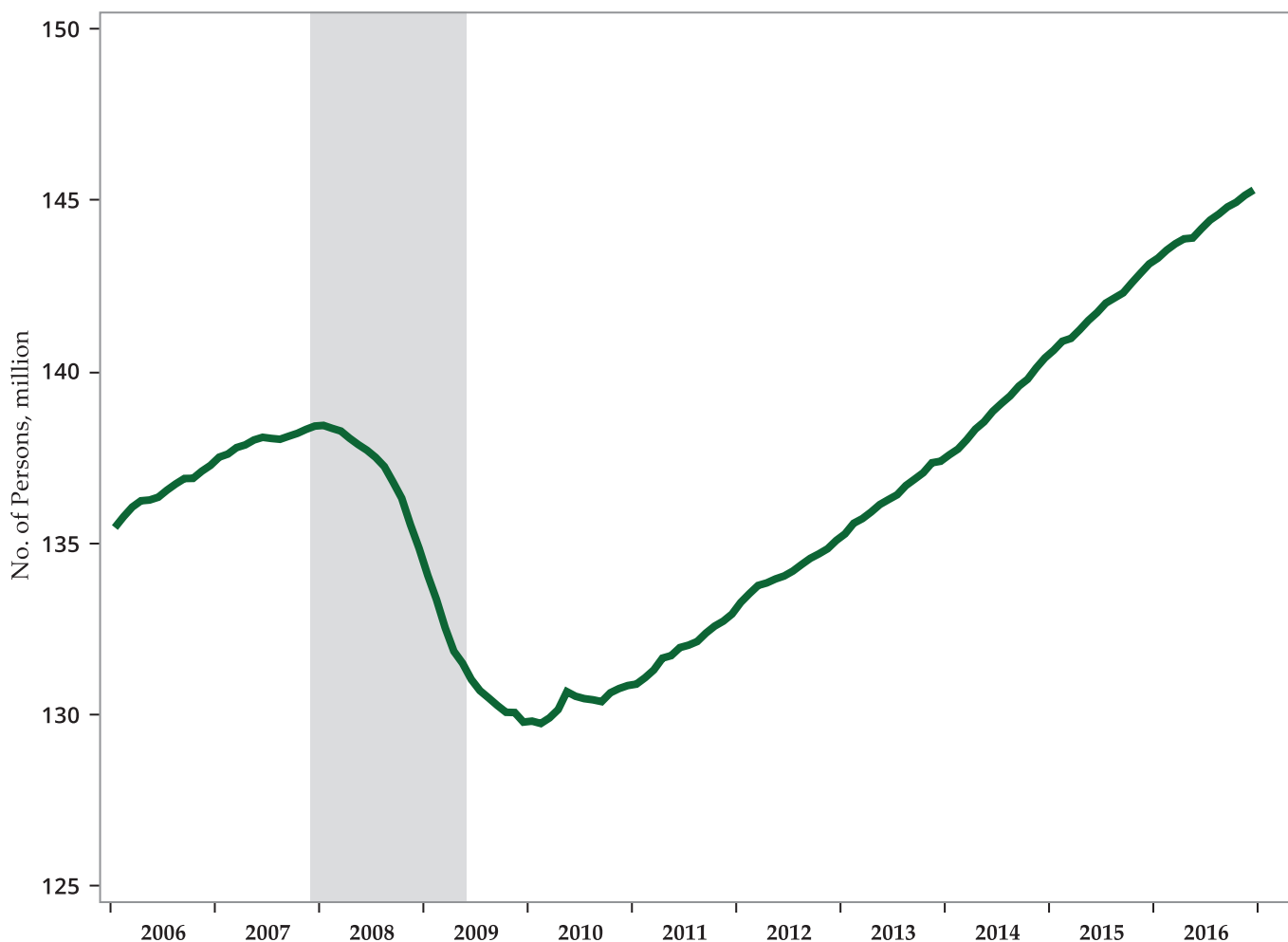
result, the unemployment rate rose quickly and sharply, peaking at 10.0% in Oct 2009. The recovery in the labor market has taken more time than it usually does compared with recoveries from previous recessions.

A wide range of labor market indicators points to the tightening of the labor market. Besides the official unemployment rate, this trend is also apparent in broader measures of slack in the labor market, such as “U-4,” “U-5,” and “U-6” unemployment rates. The concepts of U-4, U-5, and U-6 unemployment rates deserve some explanation.

The U-4 unemployment rate measures total unemployed plus discouraged workers as a percentage of the civilian labor force plus discouraged workers. The U-5 unemployment rate measures total unemployed plus discouraged workers plus all other persons marginally attached to the labor force as a percentage of the civilian

Figure 2: The evolution of nonfarm payroll employment

United States, Employment, Level, SA



Source: Macrobond

labor force plus all persons marginally attached to the labor force.

Finally, the U-6 unemployment rate measures total unemployed plus all persons marginally attached to the labor force plus total employed part time for economic reasons, as a percentage of the civilian labor force plus all persons marginally attached to the labor forces. Contrary to popular beliefs and misconceptions, the decline in these other measures of slack in the labor market aligns closely with the decline in the official (“U-3”) measure of the unemployment rate (see Figure 3), even though the spread between the U-6 unemployment rate and the official unemployment rate is wider than usual.

Declines in jobless claims also reveal the ongoing improvement in the labor market. Both initial jobless claims and continuing claims, as share of the labor force, have declined steadily since peaking in 2009. Initial

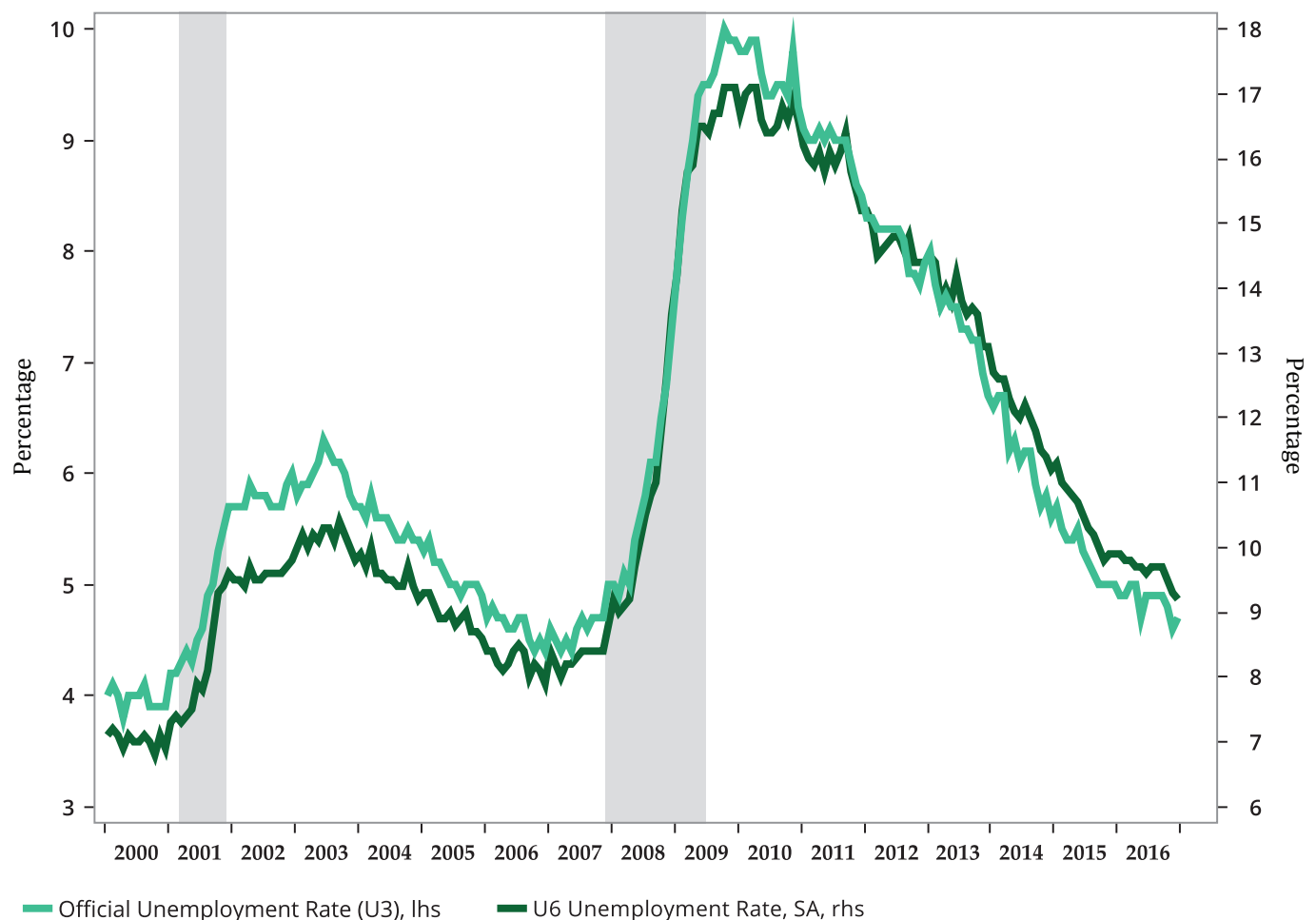
and continuing jobless claims—which respectively are the flow of new unemployment claims and the stock of outstanding unemployment claims at a given time, measured in comparison to the total labor force—have also been declining.

Indeed, both of these measures of unemployment claims, as a share of the labor force, are actually lower than they were during the expansion phase of the business cycles during 1999-2000 and 2002-2007. The durations of unemployment spells, calibrated as the median and the average numbers of weeks an individual has been unemployed, have fallen somewhat since the crisis.

The Job Openings and Labor Force Turnover Survey (JOLTS) provides a broad-based assessment of the labor market, including: the “job openings rate,” which is the number of job openings on the last business day of the month as a percentage of total employment plus

Figure 3: The decline in the broader measure of labor underutilization aligns with the decline in the official unemployment rate

USA Official & U-6 Measures of Unemployment rate, SA



Source: Macrobond

job openings; the “hires rate,” which is the number of hires during the entire month as a percentage of total employment; the “total separations rate,” which is the number of total separations during the entire month as a percentage of total employment; the “quits rate,” which is the number of quits during the entire month as a percentage of total employment; and the “layoffs and discharge rate,” which is the number of layoffs and discharge during the entire month as a percentage of total employment.

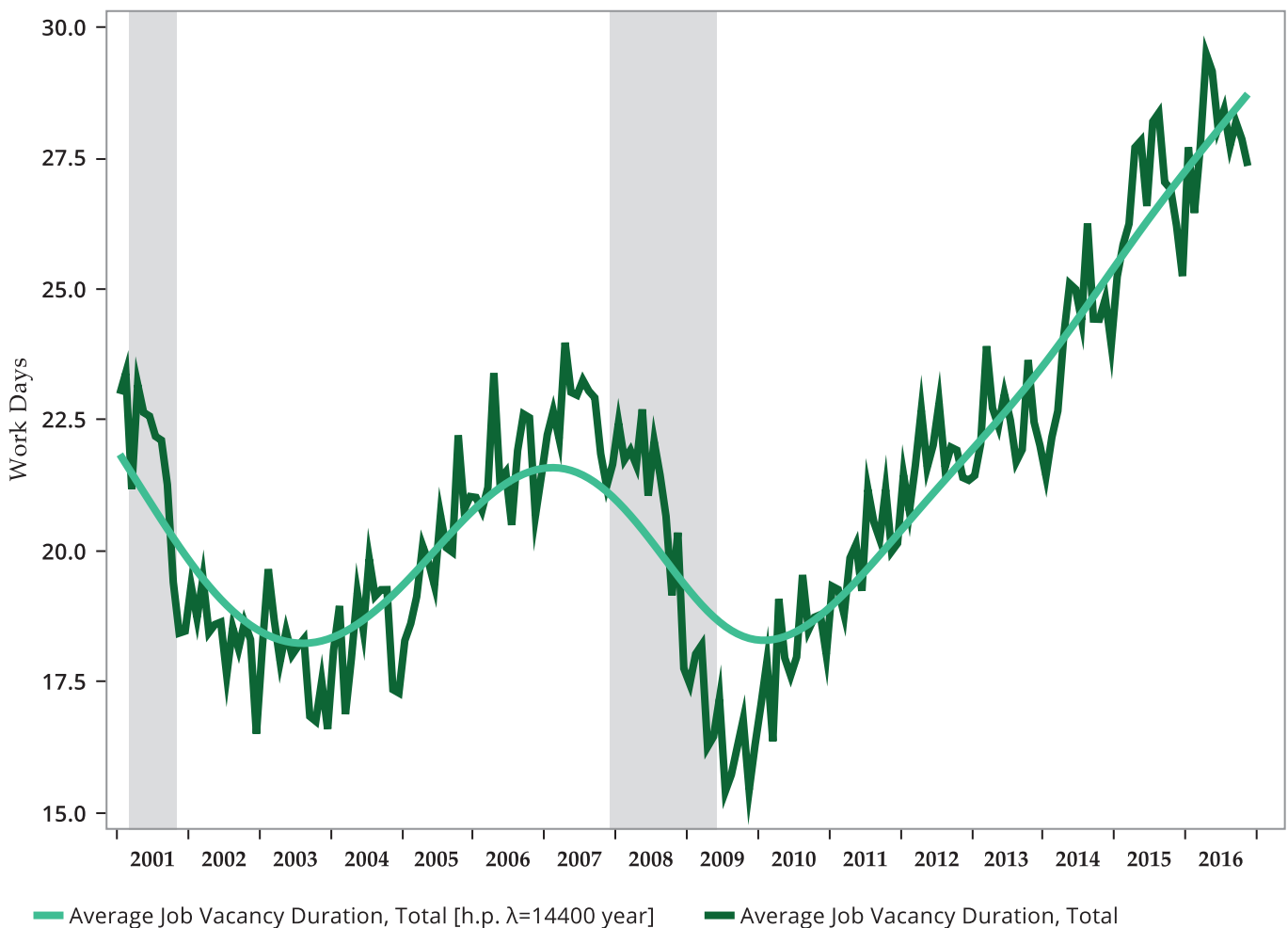
The JOLTS survey shows an improving labor market based on trends in job opening rate, hires rates, separations rate, quits rate, and layoffs and discharge rate. The job openings rate has risen as firms are creating more positions and are finding it harder to fill those positions. The hires rate has increased as firms expand their payrolls. The separations rate and quits rate have risen as workers are finding opportunities elsewhere due

to a tight labor market. The layoffs and discharge rate has declined as the economy expands and firms have scaled backed on mass layoffs and firings. With a tighter labor market, firms need more time to find suitable candidates to hire as employees. Whereas in 2009 firms took on average less than 17 days to hire someone, now they take on average about 27 days (see Figure 4).

Average hours worked for all employees and for production and nonsupervisory employees fell during the Great Recession and did not recover until mid-2011. Since then average hours worked have stabilized, though at a level slightly less than in the past. The Fed’s Labor Market Condition Index (LMCI), a broad index of key indicators concerning the labor market constructed by the staff of the Federal Reserve, has steadily improved since it bottomed after the Great Recession. Since late 2015 it has been essentially flat. The LMCI is based on a wide range of key labor market indicators. It uses a

Figure 4: Rising vacancy duration suggests a tighter labor market

United States, Labor Market Indicators, Dice-DFH Vacancy Duration Measure



Source: Macrobond

statistical model that examines the common trends and variations among 19 different labor market indicators related to unemployment and underemployment, employment, workweek, wages, vacancies, hiring, layoffs, quits, and consumer and business surveys of conditions in the labor market.

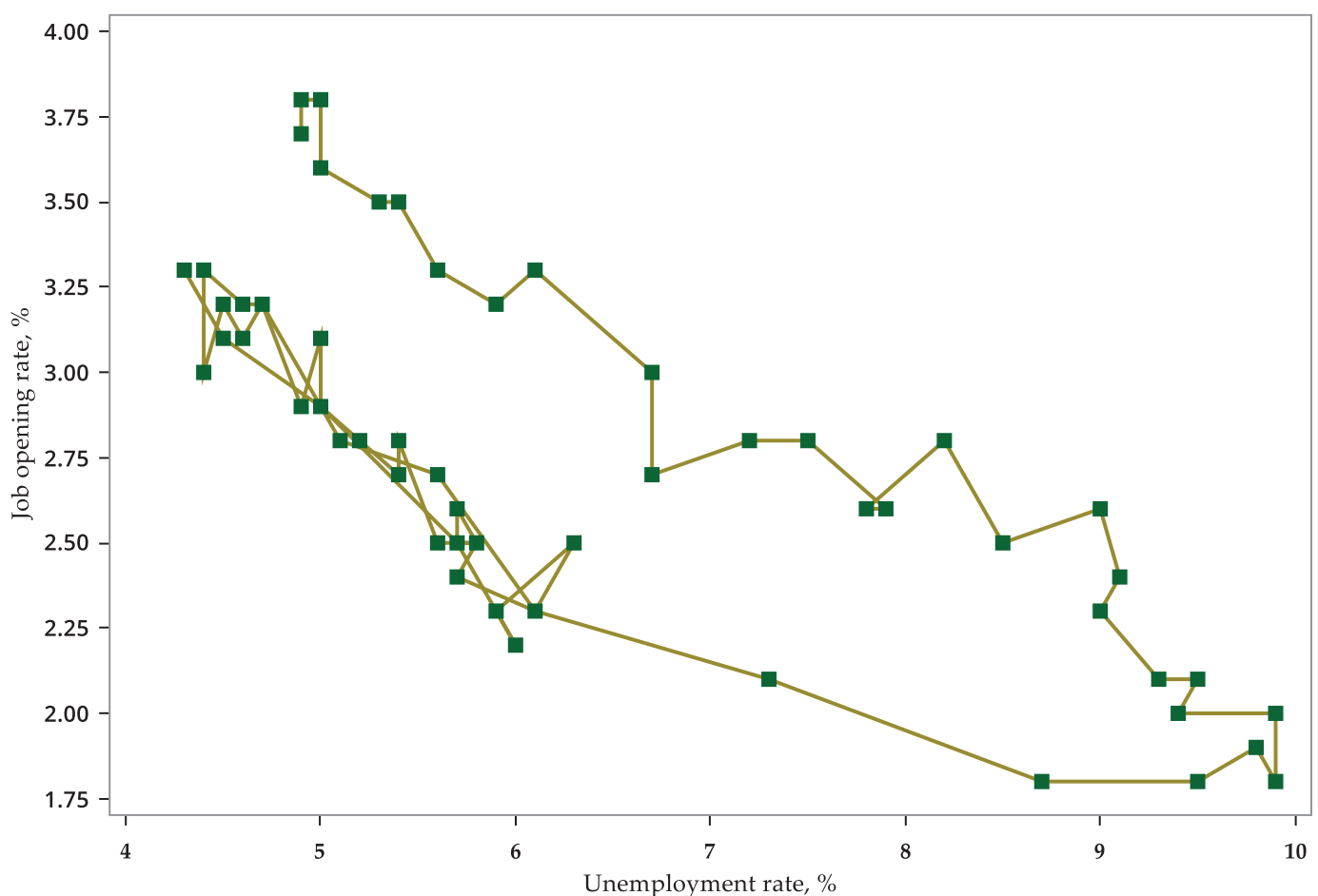
With the decline in the unemployment rate, the job openings rate has risen as mentioned earlier. However, given the decline of the unemployment rate, the job openings rate is higher than in the past. This helps explain why since late 2009 there has been an outward shift of the Beveridge Curve,¹ which is a relationship that compares the unemployment rate with the rate of unfilled jobs, expressed as a proportion of the labor force (see Figure 5).

This outward shift one can see in the Beveridge Curve graph implies that the mismatch in the labor market has increased since the Great Recession, though it must be emphasized that the Beveridge Curve can shift both inward and outward from time to time over the course of the business cycle and due to ongoing structural changes in the economy. It is probably a bit premature to conclude that the degree of mismatch in the labor market in the U.S. has increased markedly and permanently since the end of the Great Recession.

Despite the general decline of the unemployment rate, there are still considerable variations in labor market experiences for different individuals and groups. The unemployment rate among people with different levels of education and different ethnic groups varies.

Figure 5: The Beveridge Curve, which denotes the relationship between the unemployment rate and the job opening rate, appears to have shifted outward since late 2009

USA, Beveridge Curve, 2001 to Present

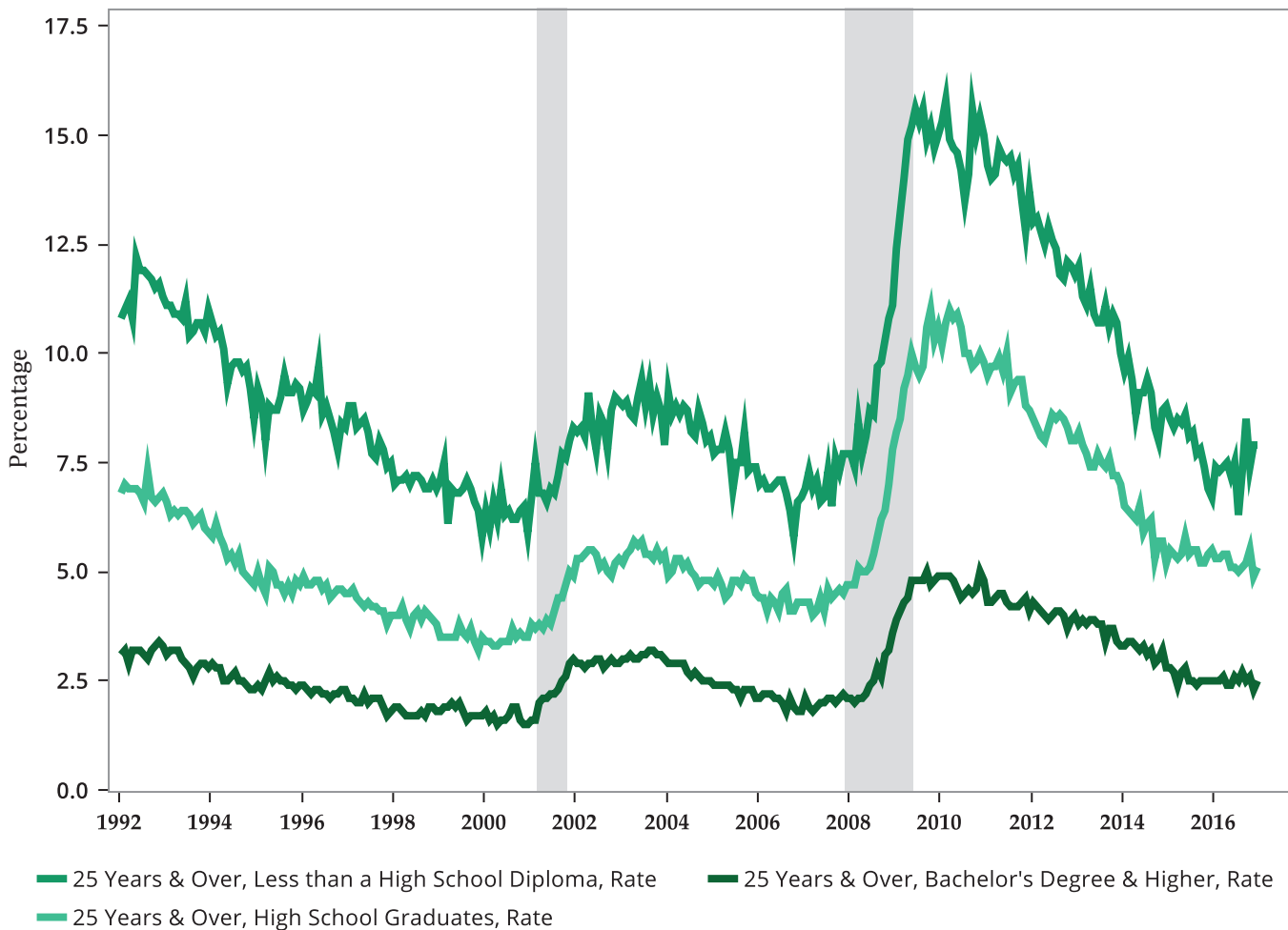


Source: Macrobond

¹ The Beveridge Curve, named after the British economist William Beveridge (1879-1963), is the relationship between the job openings rate and the unemployment rate. It usually has a hyperbolic shape. It slopes downward as higher unemployment rate occurs with a decline in the job openings rate. A shift in the curve signifies change.

Figure 6: The unemployment rate is highest for those without high school diplomas

United States, Unemployment, CPS, by Education, SA



Source: Macrobond

For instance, the unemployment rate for workers aged 25 years and over is higher for those with lower education compared to those with higher education (see Figure 6). This indicates the demand for higher-skilled and better-educated workers is much stronger than the demand for lower-skilled and less-educated workers.

As of Oct 2016, the unemployment rate among whites is 4.3%, while the unemployment rate among African Americans and Latinos was noticeably higher respectively at 8.6% and 5.7% (see Figure 7). The unemployment rate among African Americans is double to that among whites. There are many reasons for the differences in the unemployment rate among various ethnic groups, including differences in history and geography of their communities, skill and education levels, human capital, work experience, access to jobs, information, and networks, transport costs, and labor market discrimination and social barriers.

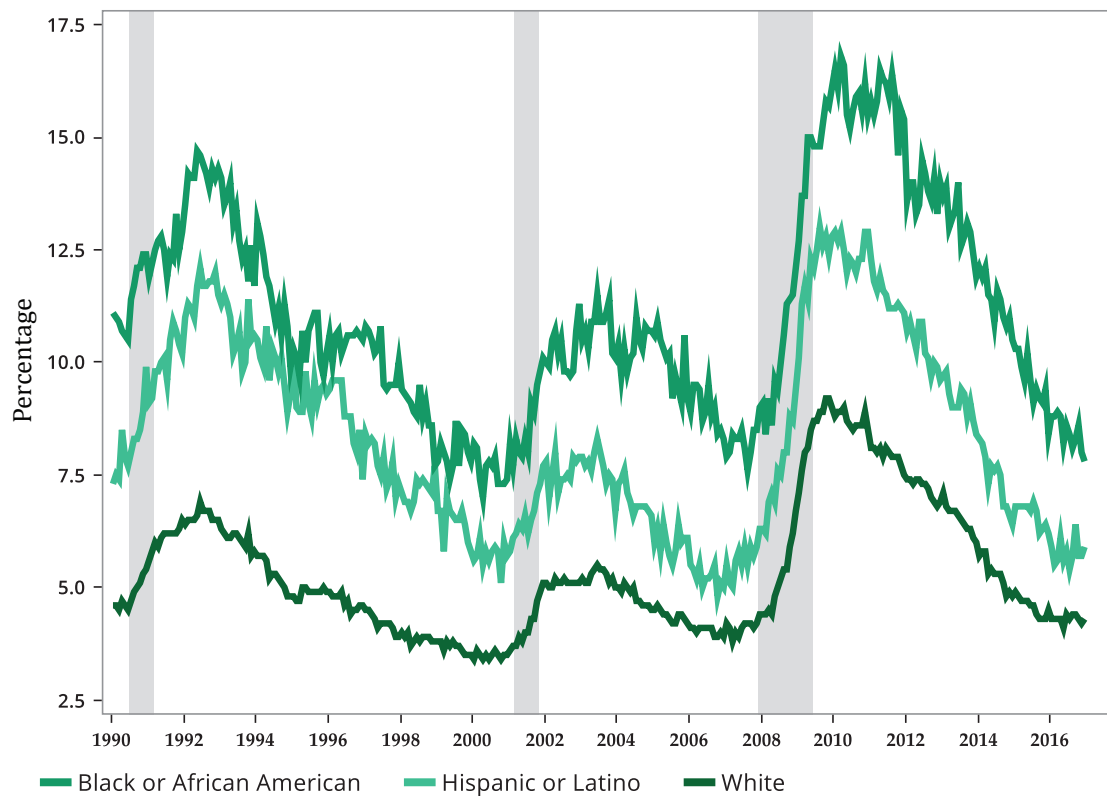
Changes in the Composition of the Labor Market

The U.S. labor market has continued to evolve since the Great Recession. It is useful to have a snapshot of the labor market. Table 1 provides the number of nonfarm payroll employment in different key industries, services and sectors and their share of total employment as of October 2006 and October 2016.

It is worthwhile to examine not just the pace of job growth in different industries, but also the evolution and the level of jobs in these industries since the Great Recession. The manufacturing industry has been shedding jobs for a long time (see Figure 8), but particularly so since China joined the World Trade Organization (WTO) in late 2001. The decline in manufacturing jobs was quite stark during the Great Recession. The manufacturing industry has added some jobs since 2013.

Figure 7: African Americans and Latinos face higher unemployment rates

United States, Unemployment Rates, by Race & Ethnic Origin, SA



Source: Macrobond

**Table 1: Nonfarm payroll employment levels and composition of the employment
October 2006 and October 2016**

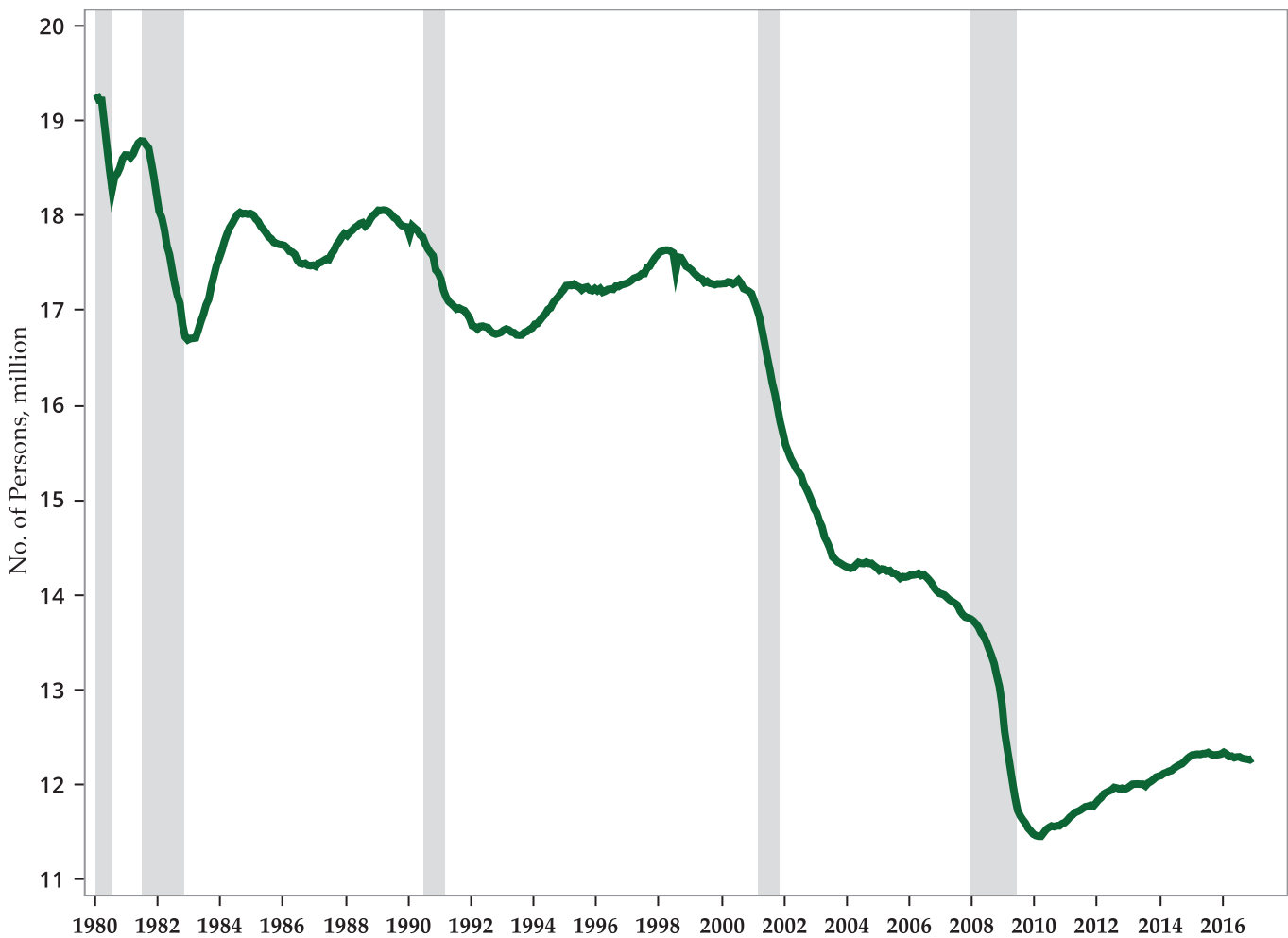
U.S. Nonfarm payroll employment, seasonally adjusted

	October 2006		October 2016 (provisional)	
	Level, in thousands	% of total employment	Level, in thousands	% of total employment
Total	135,452	100.0%	144,952	100.0%
Total private	113,605	83.9%	122,717	84.7%
Goods producing	22,467	16.6%	19,615	13.5%
Mining and logging	656	0.5%	678	0.5%
Construction	7,601	5.6%	6,679	4.6%
Manufacturing	14,210	10.5%	12,258	8.4%
Private service providing	91,138	67.3%	103,102	71.1%
Trade, transport and utilities	26,165	19.3%	27,423	18.9%
Information	3,053	2.3%	2,781	1.9%
Financial activities	8,307	6.1%	8,336	5.8%
Professional and business services	17,297	12.8%	20,415	14.1%
Education and health services	17,940	13.2%	22,861	15.8%
Leisure and hospitality	12,945	9.6%	15,565	10.7%
Other services	5,425	4.0%	5,721	3.9%
Government	21,847	16.1%	22,235	15.3%

Source: Bureau of Labor Statistics, Macrobond, Bloomberg

Figure 8: Manufacturing industry has shed jobs since the early 1980s

United States, Manufacturing, SA



Source: Macrobond

The construction industry has lost nearly 1.5 million jobs as the housing bubble collapsed and construction activity fell. However, since 2012 the construction industry has been again adding jobs (see Figure 9). Jobs in the information technology industry had peaked around the time of tech bubble in 2001. The industry had cut nearly 1 million jobs in the first decade of the twenty-first century. It is only since 2014 that the industry has been slowly adding jobs. The number of jobs in financial services is still lower than before the recession, though the industry has been adding jobs steadily since 2012. The number of jobs in government is less than before the recession. Government jobs continue to decline sharply from mid-2009 till late 2013. Since then, government jobs have been added but at a fairly paltry pace.

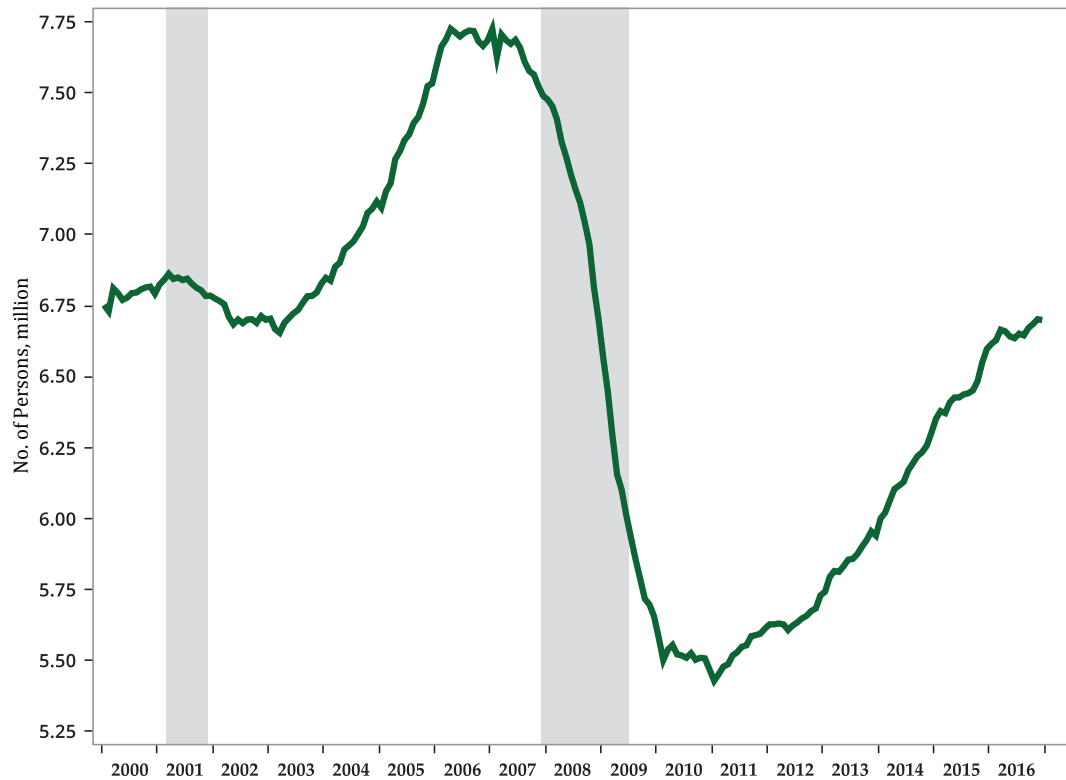
While the U.S. economy has been successful in creating jobs since the Great Recession, the bulk of the jobs have been in industries and sectors that are generally low

paying. As a result, average hourly earnings and average weekly earnings have risen at a fairly restrained pace. Aggregate labor income, as measured by both nominal and real income from the disbursement of wages and salaries to employees, has risen modestly.

Jobs in the leisure, hospitality and food services have been rising gradually with only a brief pause during the recession (see Figure 10). Similarly, professional business services have been adding jobs. Notably, job gains in the temp services—often a harbinger of overall job growth—have been rising markedly since 2010, though the pace has slowed a bit in recent months. Retail trade lost 1.25 million during the recession, but due to steady job growth in the past six years, retail trade currently employs nearly 16 million workers, nearly 750K more than before the recession. Both health services and education services have contributed markedly to job creation on a sustained basis (see Figure 11). Jobs in these services were barely

Figure 9: Construction industry is again adding jobs after large cuts during the Great Recession

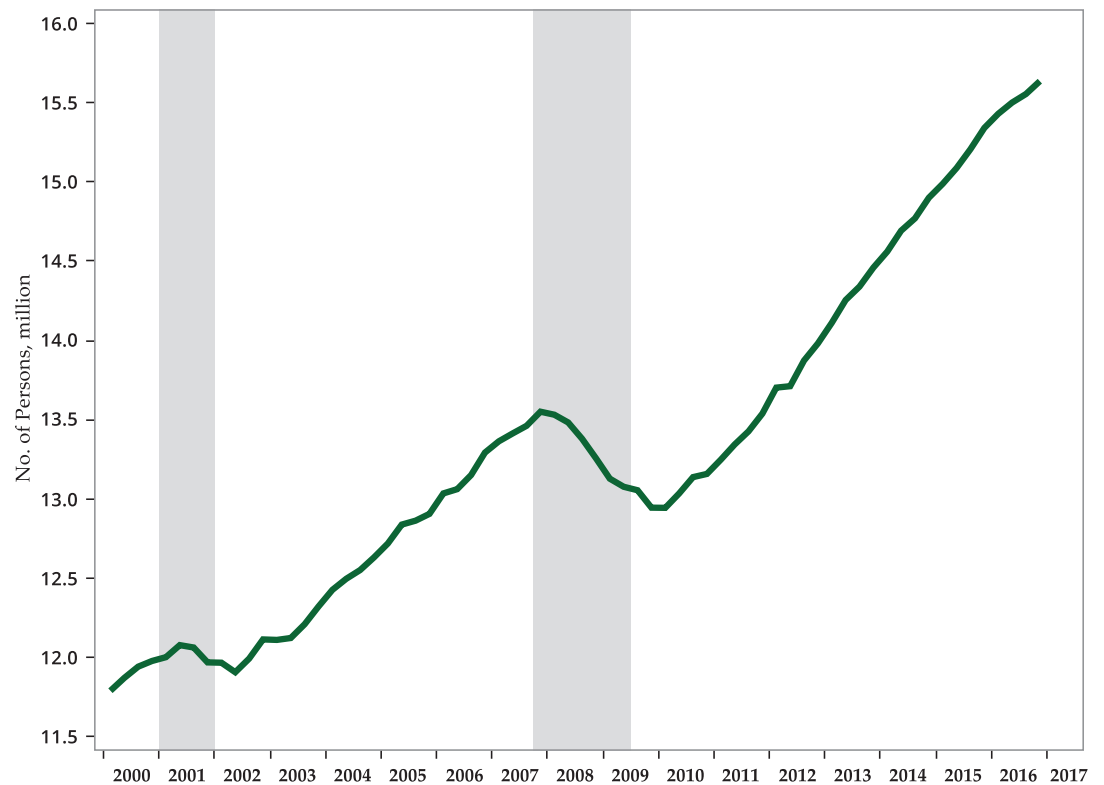
USA Construction Employment



Source: Macrobond

Figure 10: Strong job gains in leisure/hospitality and food services

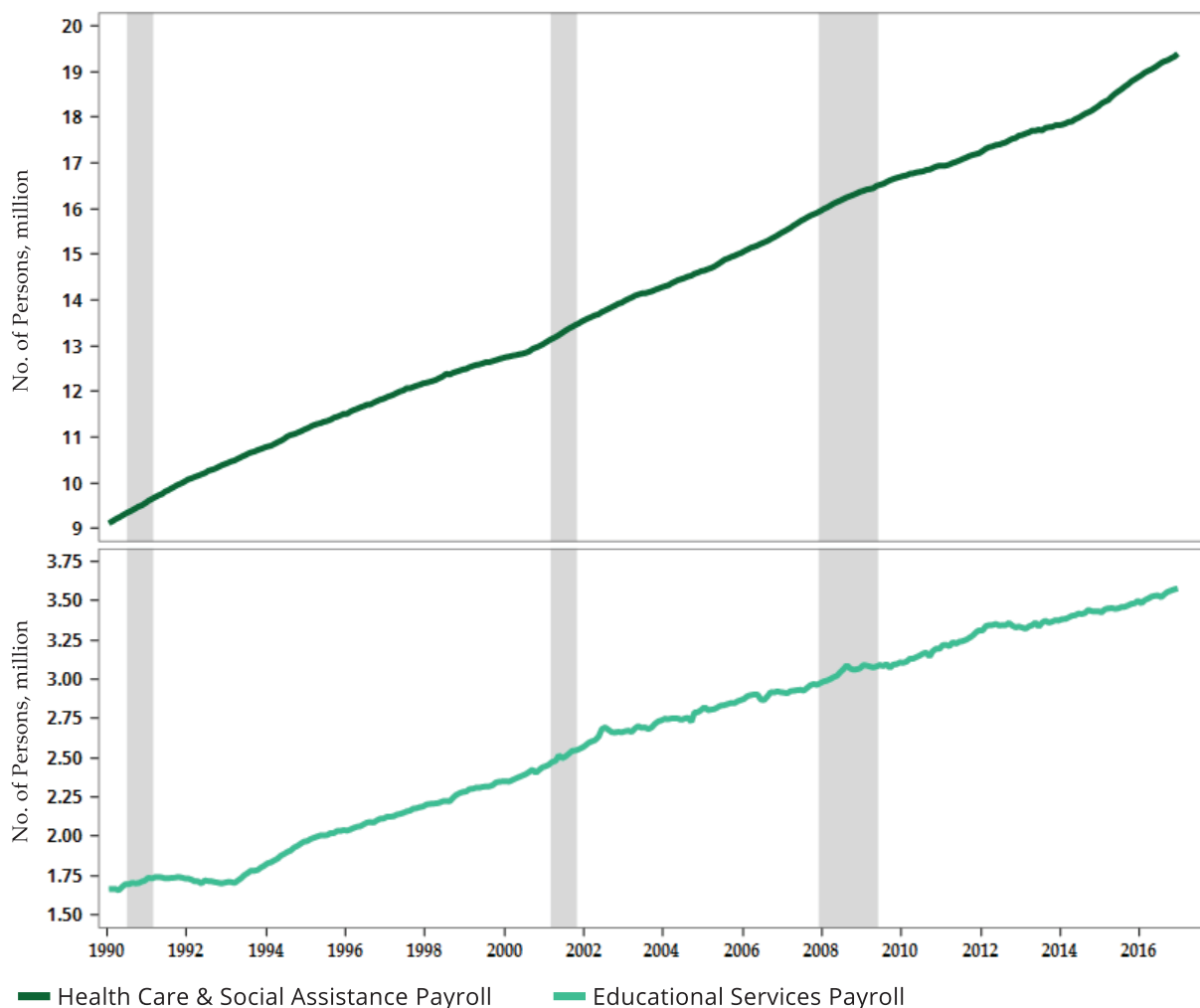
United States, Leisure & Hospitality, including Food Services, SA



Source: Macrobond

Figure 11: Education and health services have added jobs

United States, Employment, Education & Health Services, SA



Source: Macrobond

affected by the recessions of 2001 and 2008-2009. The number of job gains in the health services has been particularly impressive, rising from nearly 16 million in 2007 to 19 million in 2015.

Understanding the Decline in Labor Force Participation Rates

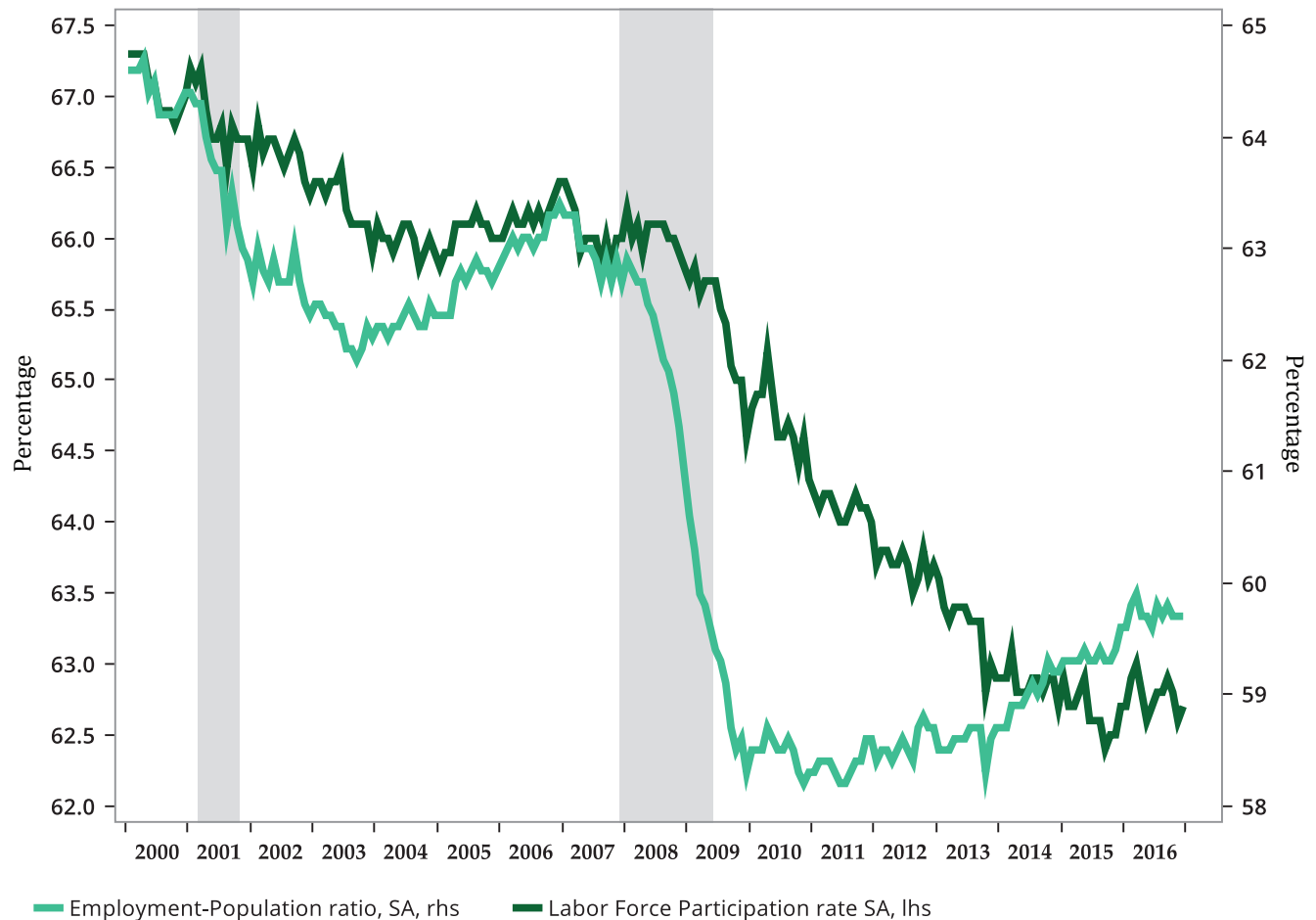
The labor force participation rate and the employment-to-population ratio remain notably below their levels prior to the Great Recession (see Figure 12). The labor force participation rate is the ratio of the labor force, whether employed or unemployed, to the working age civilian population, excluding those who are confined in prisons and asylums. The employment-to-population ratio is just the proportion of the employed people to the working age civilian population.

During the recession, the employment-to-population ratio fell sharply as many people lost their jobs due to the rise in mass layoffs, increased firings, and the rise in business shutdowns and bankruptcies. The labor force participation rate also declined, but less markedly so since initially those employees who lost their job moved from being employed to being unemployed but still looking for jobs, thus remaining attached to the labor force. However, as the recession continued and economic activity stayed weak, many unemployed individuals became discouraged due to the lack of job openings and finally they stopped looking for jobs. If someone is neither working nor actively seeking a job, they are no longer considered as part of the labor force. Hence, the labor force participation rate gradually fell as the number of individuals stopped looking for a job in the midst of a weak economy.

The labor force participation rate has not fully recovered, though it does appear to have stabilized since mid-2015

Figure 12: The labor force participation rate and the employment-to-population ratio are below their levels before the Great Recession

Labor Force Participation Rate & Employment to Population Ratio, SA



Source: Macrobond

and, in fact, has shown a modest improvement since then. Meanwhile the employment-to-population ratio has risen moderately since late 2013 as the U.S. economy added jobs at a decent pace.

A combination of factors is responsible for the decline in the labor force participation rate and the employment-to-population ratio.

There are ongoing debates among specialists about the causes of the decline in labor force participation rate. There is difference in opinion about underlying causes of the decline. The relative importance of demographic changes and the weakness of aggregate demand is contested. Aaronson *et al.* (2014) attribute more than half of the decline to demographic factors. But Dantas (2016) maintains the tepid growth in aggregate demand is mainly responsible for the subdued labor force participation rate.

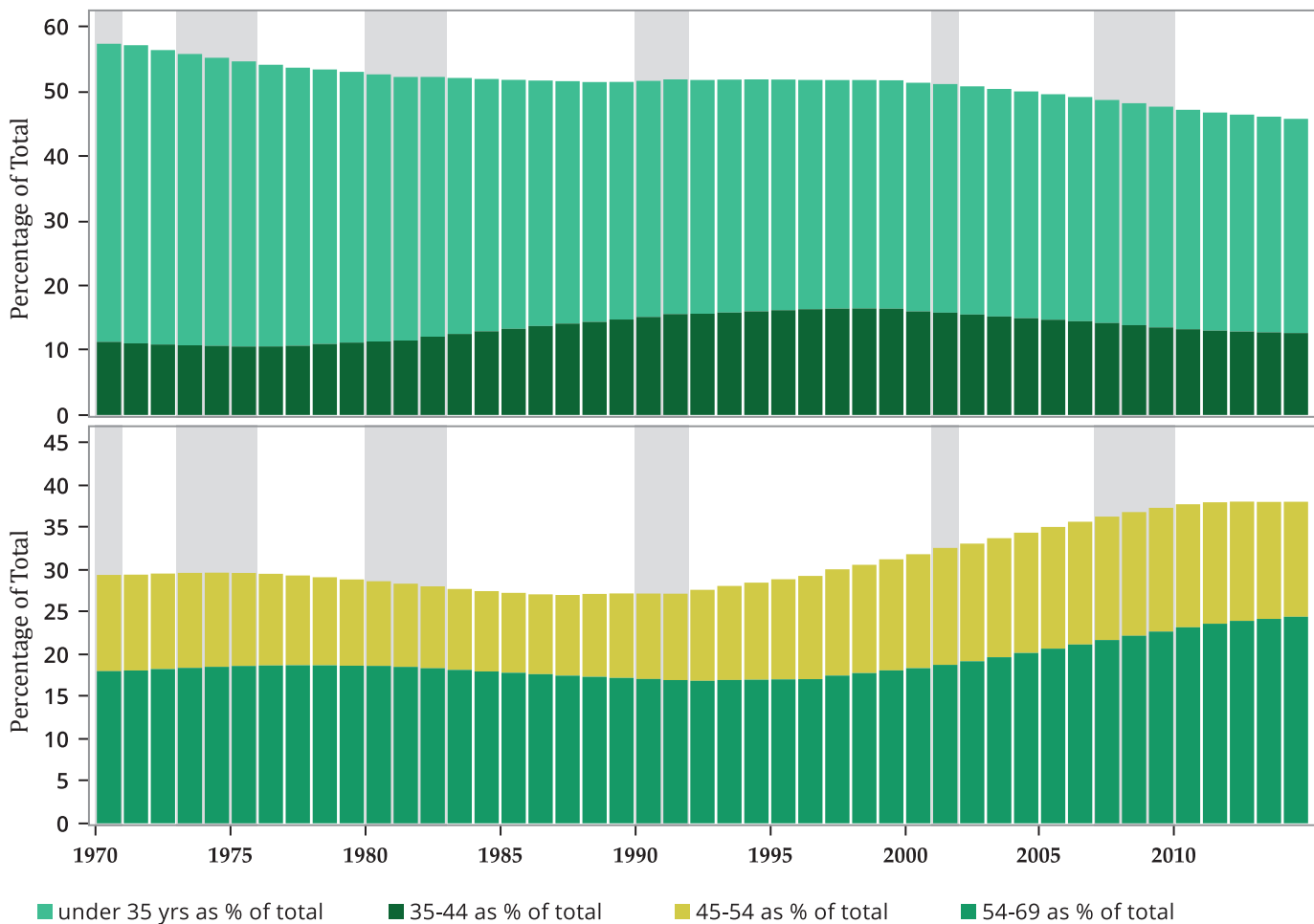
There is also debate about the role of disability insurance in lowering the participation rate. Autor and Duggan (2003) argue that disability insurance has reduced the labor force participation rate, particularly among the less-skilled working-age population. This trend appeared to have started well *before* the Great Recession. Bound, Lindner, and Waidmann (2014) find that the availability of disability insurance reduces the participation rate somewhat. However, they report that it does not explain the large decline in the participation rate since the crisis.

Changing Age Dynamics in the Labor Force

Another factor that is affecting the labor force is the aging of the U.S. population (see Figure 13). The median age of the population has been gradually rising. The share of the population in the age groups of 45-54 years and

Figure 13: The changing demographics of a gradually aging population

Population Segments by Age



Source: Macrobond

55-69 years has been rising notably, while the share of the population in the age groups of under 35 years and 35-44 years has been declining. The aging of the population can partly explain the decline in the labor force participation rate (Aaronson *et al.* 2014) as the participation rate for individuals in older age groups tends to be less than that for individuals in younger age groups. However, it does not *fully* explain this decline.

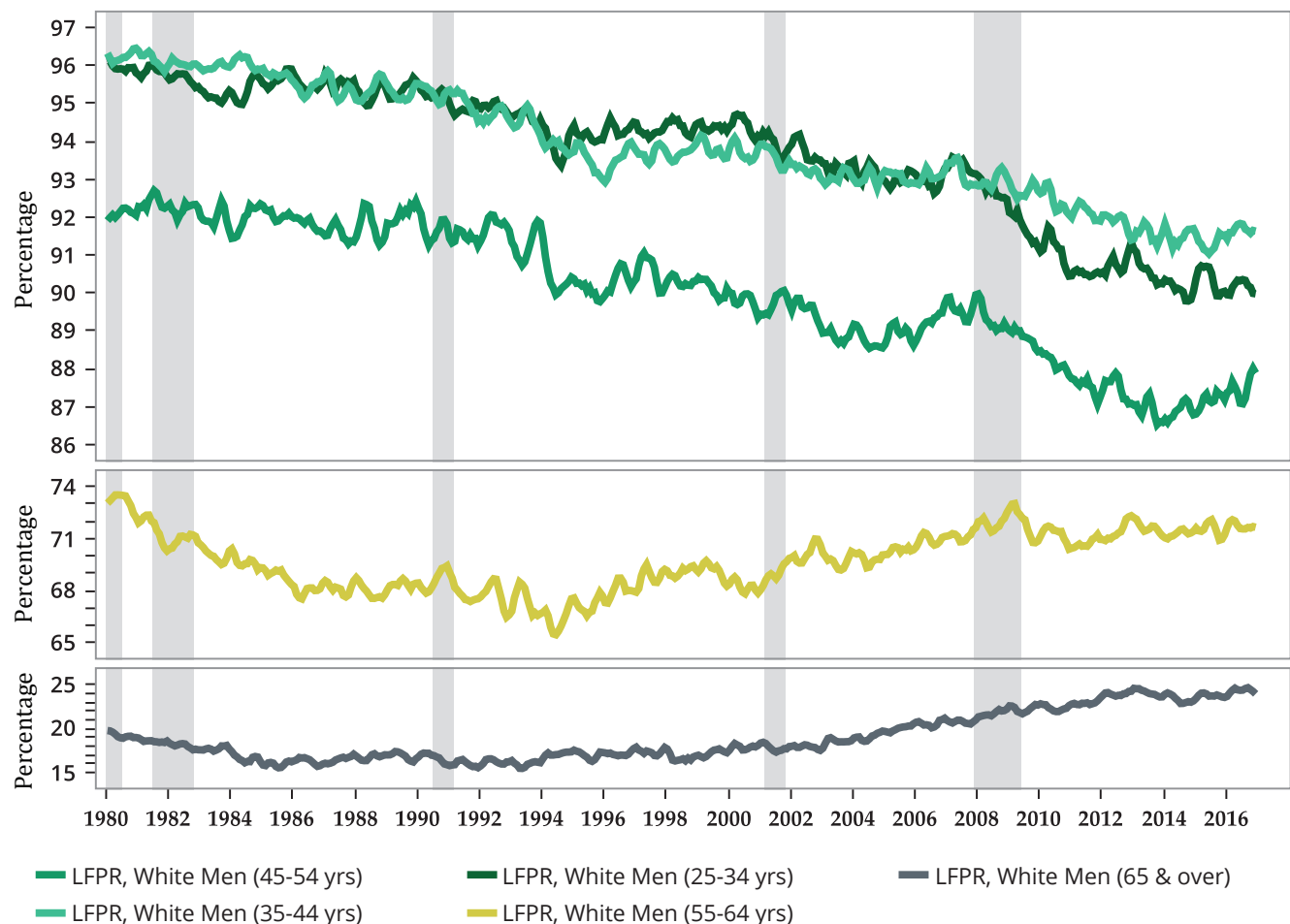
Participation rates have *also* declined among groups that are not affected by the aging of the population. The rise in the labor force participation rates among older individuals has not been sufficient to offset the decline in total labor force participation rates as the participation rate fell among younger individuals.

There has been a decline in the participation rates among white men in the prime of their working age (see Figure 14). The participation rate among white men in age groups of 25-34 years, 35-44 years, and 45-55 years has been falling. This fall has continued since the last recession.² Meanwhile, labor force participation rates among older individual have risen. The participation rates among white men in age groups 55-64 years and 65 years and over have risen, albeit from quite low rates. The rise in the participation rate of these groups is due to increased longevity, better health status, more opportunities for elder workers to get back to work, along with changes in Social Security rules, and higher educational attainment among older individuals. The shocks to real incomes and the balance sheet of households may have also spurred older workers to remain in or return to the labor market.

² The labor force participation rate for males has been on a secular decline since in the 1950s. Since the mid-1960s the labor force participation rate for females rose with social, economic, and legal changes that led to great access to jobs. The rise in the female participation rate continued until late 1990s. The labor force for participation rate for females began to decline after the tech bubble. The labor force participation rates for both sexes peaked in early 2000.

Figure 14: The labor force participation rate has declined among prime-aged white men but has risen for older white men

United States, Labor Force Participation Rates, White Men



Source: Macrobond

Moreover, the labor force participation rate has fallen among young workers in the age group of 15-25 years. The fall in the labor force participation rate among the youth has been ongoing since at least the early 1990s. The participation rate among prime age males (25-54 years old) has been declining steadily, particularly among those with just a high school diploma. This suggests that the decline in the labor force participation rate is not solely due to the aging of the population but also due to the weakness of aggregate demand.

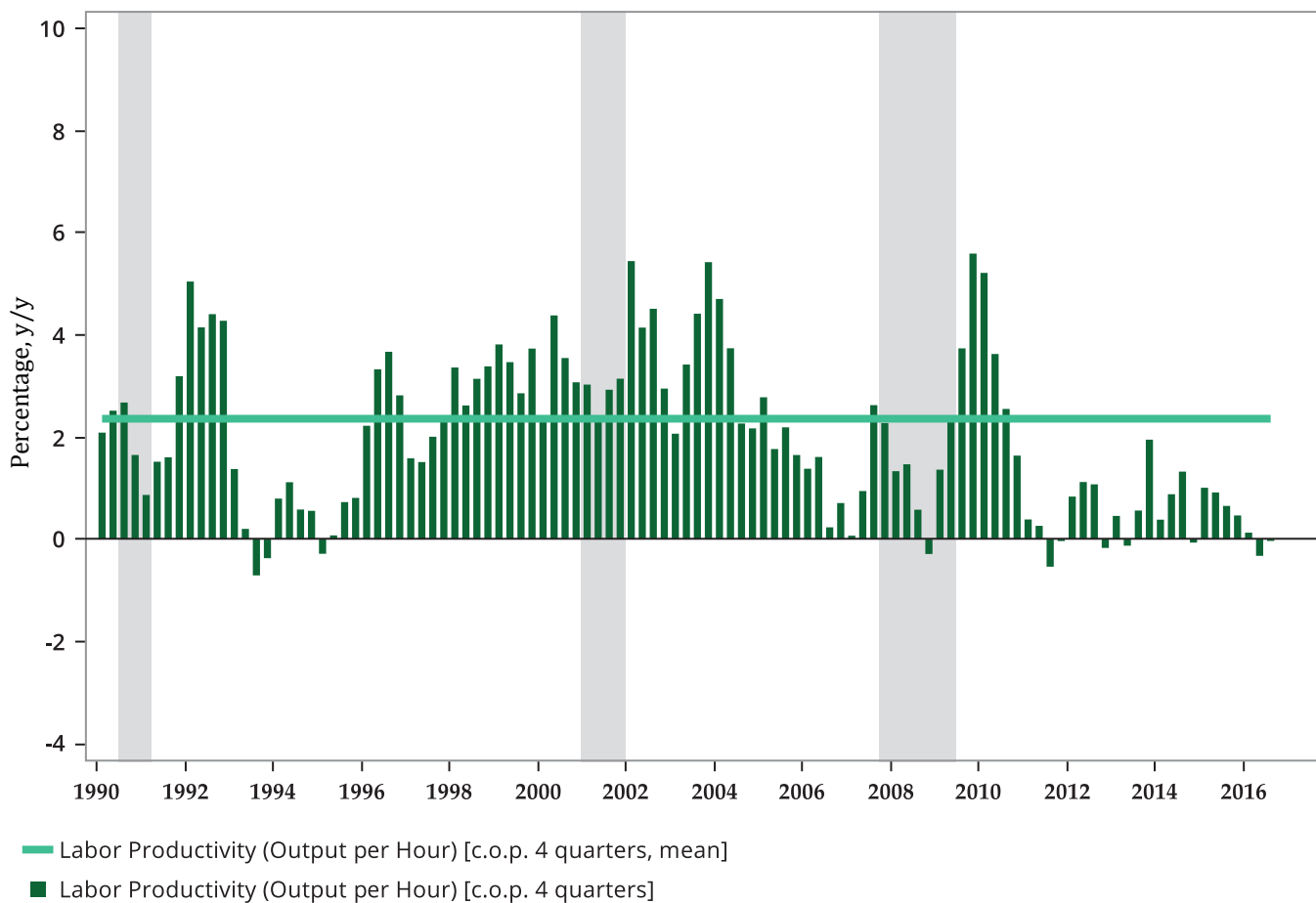
Some people who lost jobs during the Great Recession have experienced great difficulty in getting back to work. As a result, some have dropped out of the labor force altogether. There has been a decline in the demand for lower-skilled labor due to technological changes and the effects of the globalization of production.

Low Productivity Growth Implies Slower Economic Growth

Labor force productivity growth has slowed since 2007 (see Figure 15). Labor force productivity is measured as the output per worker per hours worked. Total factor productivity growth has slowed since the Great Recession. Total factor productivity growth is output growth after controlling for growth in inputs, such as labor and capital. Total factor productivity growth is largely a measure of the contribution of technological changes to output growth. Despite the profusion of a wide range of technologies and technological innovations, such as mobile phone, cloud computing, advanced robotics and artificial intelligence, the Internet of Things, new genomics, 3-D printing, and new technologies in the oil & natural gas sector, the observed data do not suggest that total factor productivity has increased much in recent years.

Figure 15: Labor productivity growth has slowed since 2007

USA Labor Productivity, Output per hour of all persons, business



Source: Macrobond

The causes behind low productivity growth in the U.S. and elsewhere in other advanced countries are not fully understood. However, the low levels of business fixed investment in capital, equipment, and intellectual property and subdued public investment in infrastructure and public goods in the past decades probably have contributed to slower productivity growth. Though there is no consensus about the causes of productivity slowdown, its implications are fairly clear.

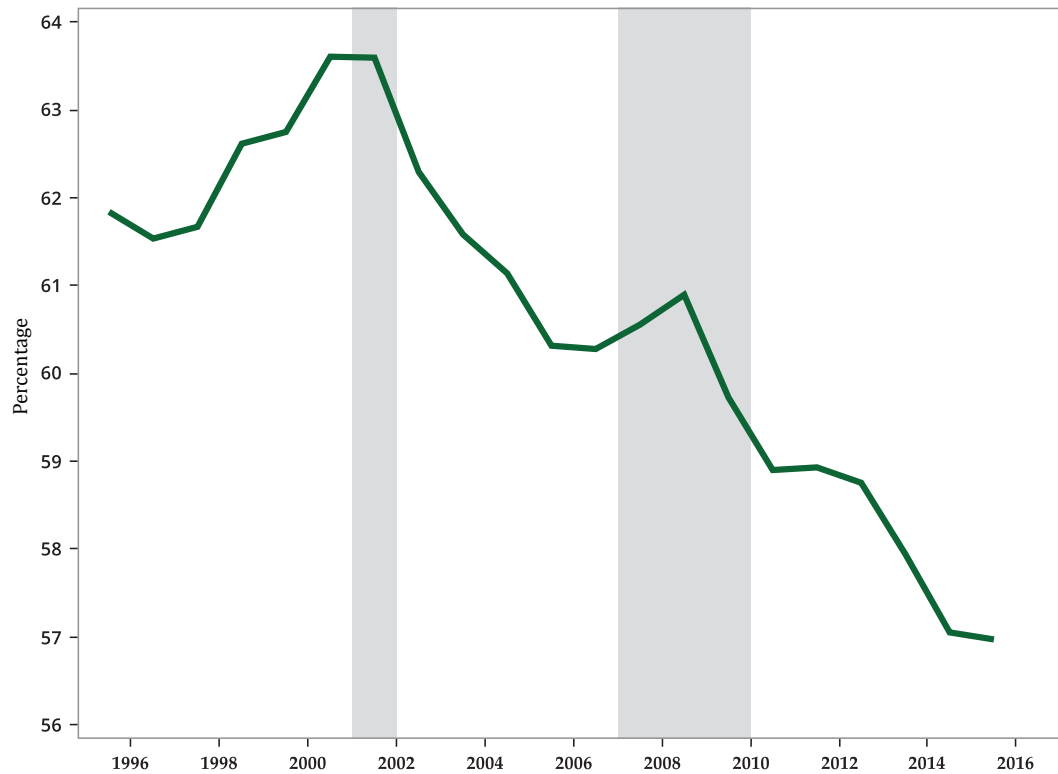
Economic growth is driven by two key drivers, namely the growth in labor productivity and the growth in available labor force. Due to the aging of the population and the decline in fertility rate, growth in labor force is bound to slow in the U.S. in the coming years. Hence, productivity growth would need to be the main driver of growth going forward. Slower labor productivity growth means that economic growth is likely to stay low. Tepid economy growth would limit the rise in the quality of life and the growth in real income per capita.

Meanwhile, the gap between labor productivity growth and workers' compensation growth has widened sharply in the past few decades. The divergence between productivity growth and hourly compensation started in the early 1970s and has continued to widen over the years. The share of national income going to labor in the form of total labor compensation has declined noticeably since the turn of the century (see Figure 16). Underlying the decline in the labor share of national income and the growing gap between labor productivity growth and labor compensation growth is low nominal wage growth. There are probably many reasons for this, ranging from skill-biased technical changes to the globalization of production and from the rise of the services sector to the widespread de-unionization of workers.

The gap between labor productivity growth and the growth in labor compensation is troubling as labor is not getting rewarded for its contribution to output. The slower pace of labor compensation growth limits effective demand as workers' and low income groups'

Figure 16: The labor share of national income has declined in recent years

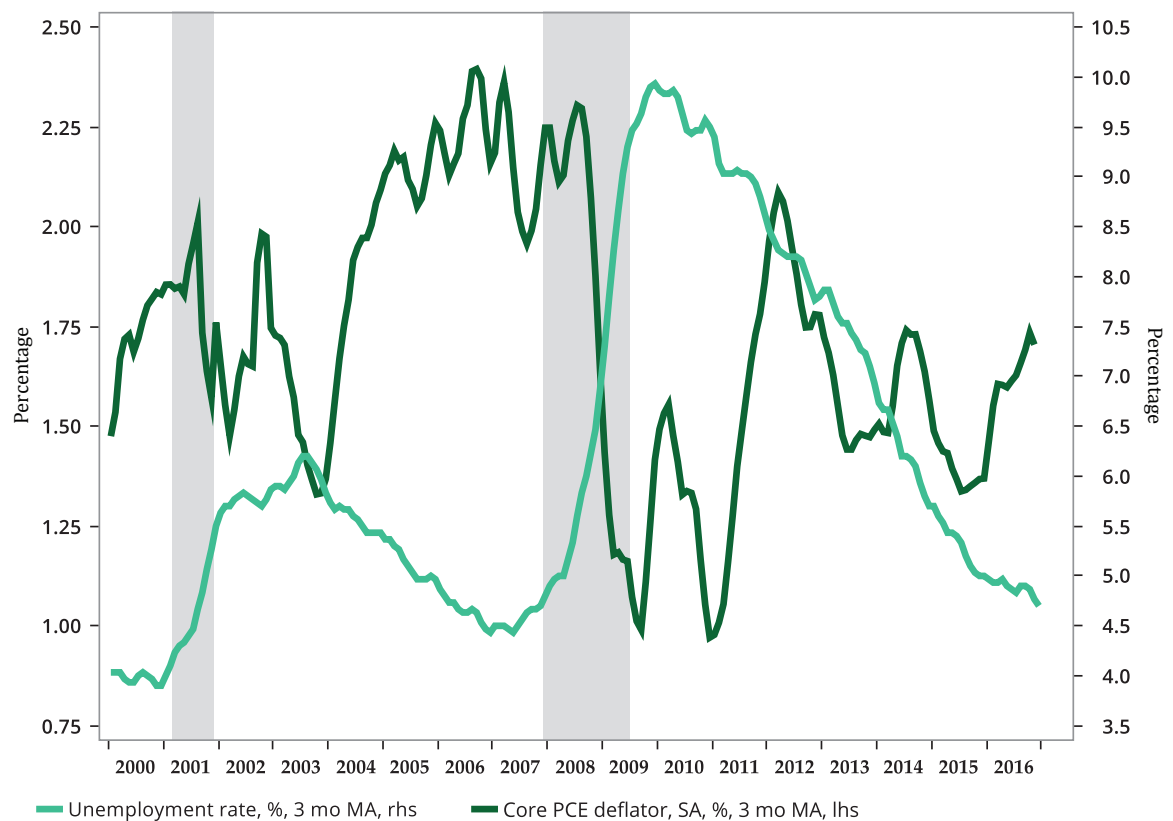
United States, Share of Total Labor Compensation in Gross Domestic Product, %



Source: Macrobond

Figure 17: Core inflation has stayed low despite the fall in the unemployment rate

Unemployment and Core Inflation, SA



Source: Macrobond

marginal propensity to consume tends to be higher than employees' and owners' and high income groups' marginal propensity to consume. The increased in the gap between labor productivity and labor compensation contributes to the rise in inequality in income, wealth, social well-being and political power.

Subdued Wage Growth Is Keeping Inflation Low

A paradox of the U.S. labor market is that despite low unemployment rate and the reduction of slack, the nominal wage growth has been restrained. In the past few months, average hourly earnings and average weekly earnings have risen, but the pace of increase is still quite moderate. Core inflation has stayed low (see Figure 17). Core inflation is total inflation excluding energy and food inflation. It is useful to look at core inflation because

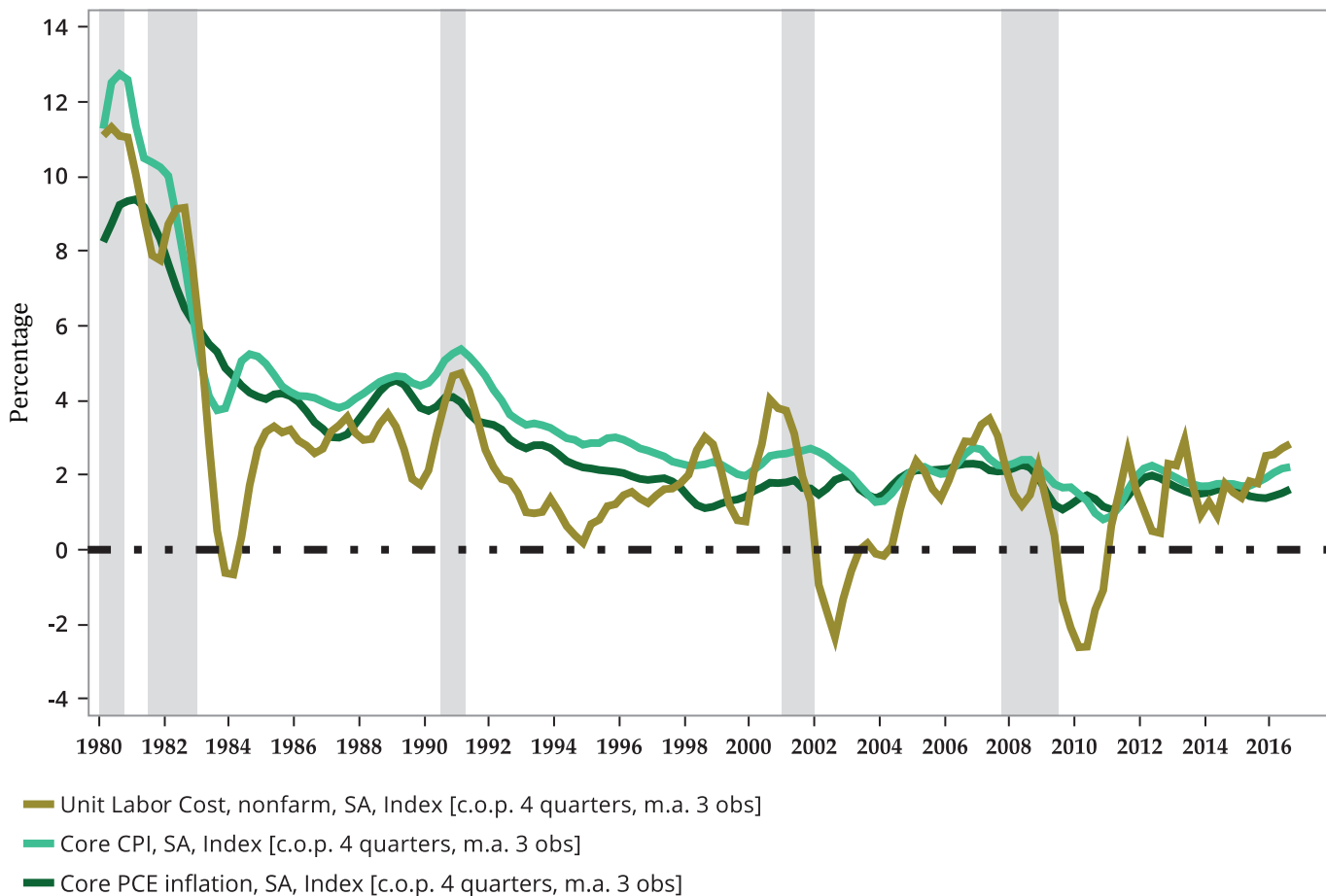
energy and food prices tend to be far more volatile. The main drivers of core inflation are labor costs, as reflected in nominal wages. Nominal wages have been rising at a fairly moderate pace. Labor costs have risen at a fairly restrained pace. The two key indicators of labor costs in the U.S. are unit labor cost and the employment cost index.³ Both of these indicators show that the rise in labor costs has been fairly restrained. Core inflation tends to track labor costs (see Figure 18). The restraint in labor costs would suggest that the rise in core inflation will remain contained in the coming months of 2017.

Prospects for Nominal Wage Growth

Going forward, as the labor market tightens, nominal wage growth may rise but only moderately. There are several reasons to expect that nominal wage growth will

Figure 18: Tepid increase in unit labor costs implies core inflation will stay contained

Core inflation and unit labor costs, smoothed



Source: Macrobond

³ Unit labor costs are calculated by dividing total labor compensation by real output, while the employment cost index measure of the change in the cost of labor, after controlling from the influence of employment, shifts among occupations and industries.

be moderate. First, more individuals are likely to get back to the labor force if the prospect for getting a job rises with a tighter labor market. Second, most of the jobs that are being created are in low-wage industries and service sectors. Unionization in these industries and sectors is typically weak. Third, the bargaining position of workers remains weak due to increased competition for imports as manufacturing activity has shifted to labor abundant Asian economies, such as China. Fourth, firms can resort to outsourcing and threaten to outsource production if they face wage pressures. Fifth, technological changes, new production methods and processes tend to be skill-biased and labor-saving, and work to lower firms' labor compensation expenses. Jobs of unskilled and semi-skilled workers are being automated. Sixth, the political and business environment is unlikely to favor increases in labor compensation anytime soon. Seventh, the gap between labor productivity and labor compensation has not yet shown any signs of narrowing. It will take a protracted period of sustained economic growth and continued tightening of the labor market to inch up nominal wage growth. The prospect of wage-price spirals and inflation push is limited in the near future.

The Impact of Isolationism and a Tighter Immigration Policy

The impact of the current Administration's stance against immigration and trade agreements on economic activity and wages remain to be seen, but it is unclear whether workers in the U.S. will benefit. President Trump has threatened to impose tariffs on goods imported from China and other countries during the presidential campaign.

Tariffs on imported goods would increase prices and raise margins for domestic producers of substitutes, but it is unclear whether workers would stand to benefit. First, even if the domestic production of substitutes of imports rises, nominal wages may rise less than prices. As a result, workers' real wages may decline. Second, it would lead to an inefficient allocation of resources and may harm economic growth. Trump had also threatened to deport undocumented immigrants and tighten immigration laws. Immigrant workers play an important role in a number of industries and sectors, including agriculture, construction, and food services. Farmers and businesses would find it hard to replace immigrant workers with native-born workers at current wages.

While employers may be able to attract native-born workers at higher wages, most likely output would decline. In the high tech industries and various services, foreign-born workers employed under the H1B1 visa program bring in high skills that are in strong demand. If the labor force growth slows due to the deportation of undocumented immigrants and tighter immigration laws, economic growth is likely to be lower. It is unlikely that nominal and real wages would rise amid a slower pace of economic growth. The Obama Administration had actually deported a large number of undocumented workers, but nominal wages did not pick up. This suggests that more deportations and tighter immigration may not be beneficial to workers, particularly if this means slower growth ahead.

The Implications for Monetary Policy

The main reasons for the persistence of low long-term U.S. interest rates for so long are low short-term interest rates and low core inflation, according to Akram and Li (2017). Long-term interest rates started rising right after the U.S. presidential election as investors expected that in the coming years short-term interest rates would rise with a tighter monetary policy, and core inflation would also rise.

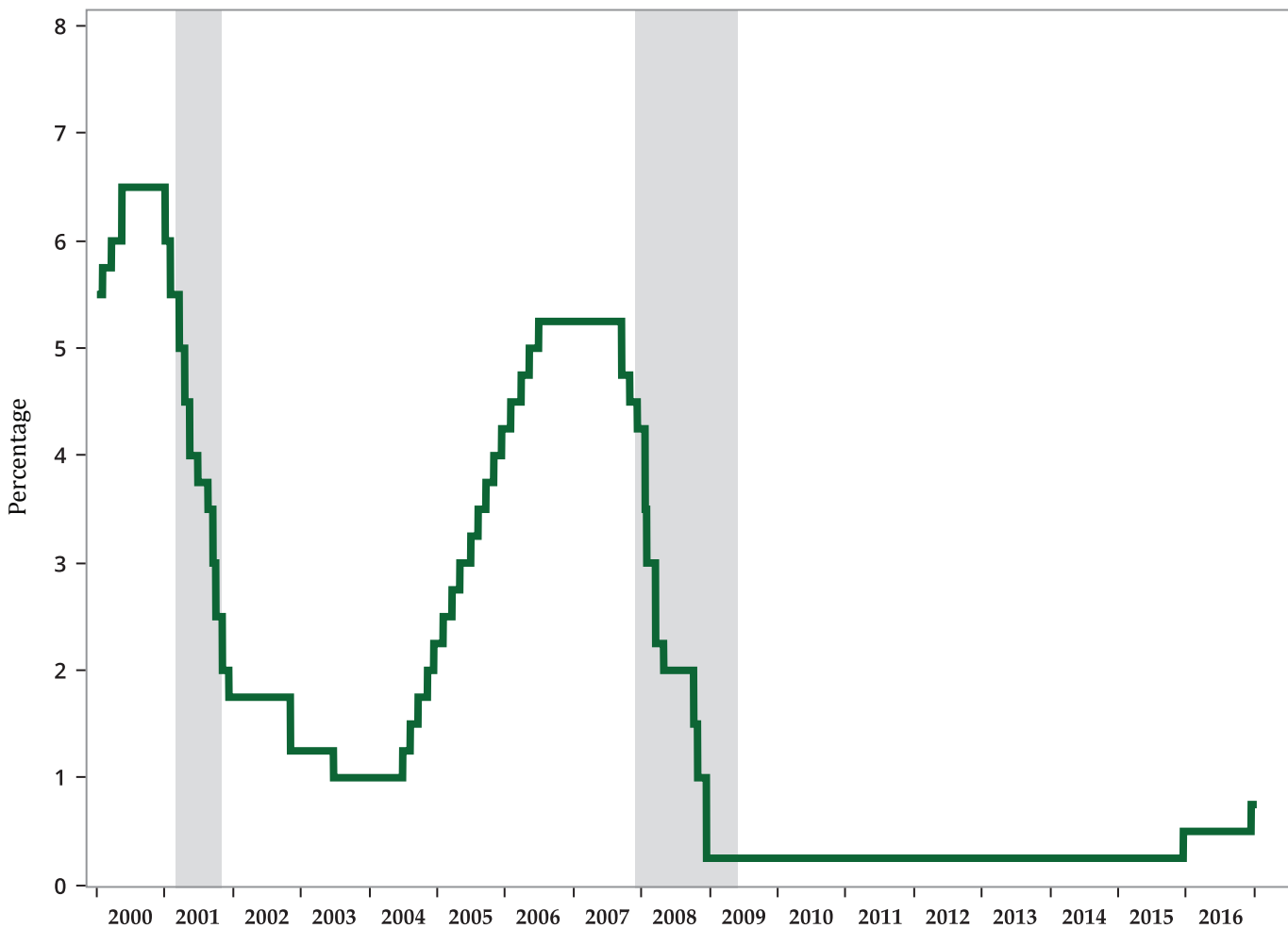
The Fed raised the fed funds target range (see Figure 19) in December 2016. It had started the process of raising the policy rate the previous year. In deciding to continue raising the interest rate, policymakers noted that the labor market has continued to improve and that the U.S. economy has been growing at a moderate pace since mid-2016. The policymakers stated they expect that U.S. economy will evolve in a manner that will warrant only moderate and gradual increases in the federal funds target rate. However, they also emphasized that the actual path of the federal funds target rate will depend on incoming information.

Conclusion

The U.S. economy has added jobs at a moderate pace since 2010, following the sharp job losses during the Great Recession. The unemployment rate has fallen sharply and other measures of slack have diminished notably. Job growth has occurred in several private industries, including professional services, health and education, and retail trade. However, several industries, such as financial services, manufacturing, construction,

Figure 19: The Fed is likely to tighten monetary policy soon but retains a cautious and gradualist stance contingent on incoming data

Fed Funds Target Rate



Source: Macrobond

and information services, still employ fewer people than before the Great Recession. Manufacturing jobs are unlikely to come back since the cost of production and wages are much higher in the U.S. compared to those in Asian and other emerging markets.

There are some paradoxical features of the current recovery in the labor market. The labor force participation rate is much lower than in the past. This is partly due to the aging of the population. However, the weakness of aggregate demand is also partly responsible for the decline in productivity growth. Productivity growth has slowed notably for the past several years. Inflationary pressures are subdued despite the low unemployment rate and the decline in other measures of labor utilization. Labor costs have risen at a moderate pace. In a modern service economy with a large service sector, the rise in labor costs is the key driver of inflation. Nominal wages have been restrained even though the

unemployment rate is low. As a result, inflationary pressures are contained.

The sustained pace of job growth and the low official unemployment rate have given policymakers a justifiable basis for tightening monetary policy, even though there are some areas of weakness in the U.S. labor market. As expected, the Fed raised its policy rate in December 2016. The Federal Reserve's objective is to attain 2.0% year over year personal consumer expenditure inflation on a sustained basis. Though there has been a slight increase in inflation in recent months, inflationary pressures may stay below the Fed's target in coming months. In 2017, the Fed is likely to retain a gradual and cautious approach to tightening its monetary policy. Developments in the labor markets, nominal wage growth, inflationary pressures, inflationary expectations and global financial conditions will determine the Fed's decisions in the coming quarters. ■

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