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The Fed's Latest Balance-Sheet Policy: What Constitutes Substantial Labor-Market Improvement?

Monetary policy should be dependent on the state of the economy, or “state-contingent,” rather than based on fixed dates. As I have argued since 2009, the Federal Open Market Committee (FOMC) should take this approach to balance-sheet policy, such as large-scale asset purchases or “quantitative easing,” just as it did with interest-rate policy prior to the financial crisis.¹

The Committee moved in this direction in the statement following its September 2012 meeting. At that time, the FOMC began a third round of large-scale asset purchases, which is commonly referred to as “QE3,” and stated that this policy will continue until the outlook for the labor market improves substantially. In contrast, the FOMC’s announcement of the start of the previous round of asset purchases (“QE2”) was accompanied by an end date of the second quarter of 2011.

While the Committee’s move toward a more state-contingent balance-sheet policy was appropriate, the language in its September statement leads to the question: What would constitute substantial improvement in the labor market? There is no simple answer to this question. The FOMC looks at many different indicators to assess the health of the labor market.

Although some focus on the unemployment rate, it is only one aspect of the labor market. By itself, this indicator is an incomplete measure of overall labor-market health. The Fed’s dual mandate to promote maximum sustainable employment and price stability refers to employment rather than unemployment. To follow the mandate literally, then, would mean focusing on some measure of employment. Nonfarm payroll employment, a key metric each month, is one of the FOMC’s and financial markets’ preferred measures of labor-market

performance. Thus, when it comes to tying monetary policy closer to labor-market performance, nonfarm payrolls may serve as a better measure than the unemployment rate.

Along with payroll employment and the unemployment rate, the FOMC monitors the labor force participation rate, which has been a very important factor in recent years. Since 2000, this indicator has experienced a declining trend, which was accentuated by the Great Recession. Currently, the labor force participation rate is at roughly the same level as it was during the early 1980s. Given that this rate has fluctuated so much over the past few decades, a good question to consider is where the labor force participation rate should be in the long run. Not everyone will participate in the labor market; many people (e.g., students and retirees) choose not to work or are unable to work for various reasons.

Other labor-market indicators that the FOMC examines include measures of hours worked, which address part-time vs. full-time employment. Changing practices in labor markets could bring more people into part-time and temporary work; from that point of view, hours might be a better indicator of the state of the labor market than simply counting the number of jobs. The quality of jobs is also an important aspect of the health of the labor market. For instance, measures of hours worked and the number of jobs could be good, but policymakers may not like the mix of jobs because many of them are low-wage. In addition, the FOMC considers data from the Job Openings and Labor Turnover Survey (JOLTS) in assessing the labor market. The list goes on.

Measuring the overall health of the labor market involves many dimensions and is a complicated matter.² The state of the labor market cannot be adequately summarized



in one number, whether it’s the unemployment rate, payroll employment growth, the labor force participation rate or some other measure. Therefore, evaluating the overall labor market by simply looking at a single indicator would not be appropriate for monetary policy.

A possible alternative is to build an index of labor-market health that gives weight to all of these different dimensions and provides some idea of the health of the labor market in an overall sense. Even in this case, however, the Committee would likely weight the dimensions differently; so, agreement on a specific index would be problematic. What is clear is that, evaluating in a comprehensive way whether the outlook for the labor market has improved substantially and, thus, when to bring the latest balance-sheet policy to an end, will require the FOMC to consider numerous factors. 

ENDNOTES

¹ For example, see my speech on Dec. 4, 2009, “Three Lessons for Monetary Policy from the Panic of 2008.” http://research.stlouisfed.org/econ/bullard/BullardPhiladelphiaDec2009PolicyForum_FINAL.pdf

² For additional information, see Andolfatto, David; and Williams, Marcela M. “Many Moving Parts: The Latest Look Inside the U.S. Labor Market.” *Federal Reserve Bank of St. Louis Review*, March/April 2012, Vol. 94, No. 2, pp. 135-52. <http://research.stlouisfed.org/publications/review/article/9163>