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Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

FEBRUARY 16, 2012

IT'S STRUCTURAL, NOT CYCLICAL, FOMC MINUTES EDITION

"It is tempting, if the only tool you have is a hammer, to treat everything as if it were a nail." – Abraham Maslow

In our "Three Macro Themes For 2012" we talk about how the economic recovery is "structural, not cyclical". You may wonder to yourself: why does this distinction matter?

Here's why: if the problems the economy faces are structural in nature, there is little monetary stimulus can do to speed the coordination process along by providing a cyclical boost to aggregate demand. The example we've often highlighted is the job skills mismatch ***(see chart attached)***. Our version of "structural" adjustment even goes a few steps beyond. It's not *just* a matter of fitting the labor market pieces (job seekers) with the labor demand pieces (firms seeking talented workers), it's that entire new firms and industries altogether need to sprout up before we adjust back to full employment. This coordination process takes time.

Meanwhile, in a world of central bankers wielding monetary policy hammers, every nail is a cyclical slump in aggregate demand waiting to be stimulated. This explains several years of unprecedented, unconventional monetary policy across the developed world and, in part, all-time low interest rates.

But, buried in the minutes from the January Federal Open Market Committee (FOMC) meeting was this insight:

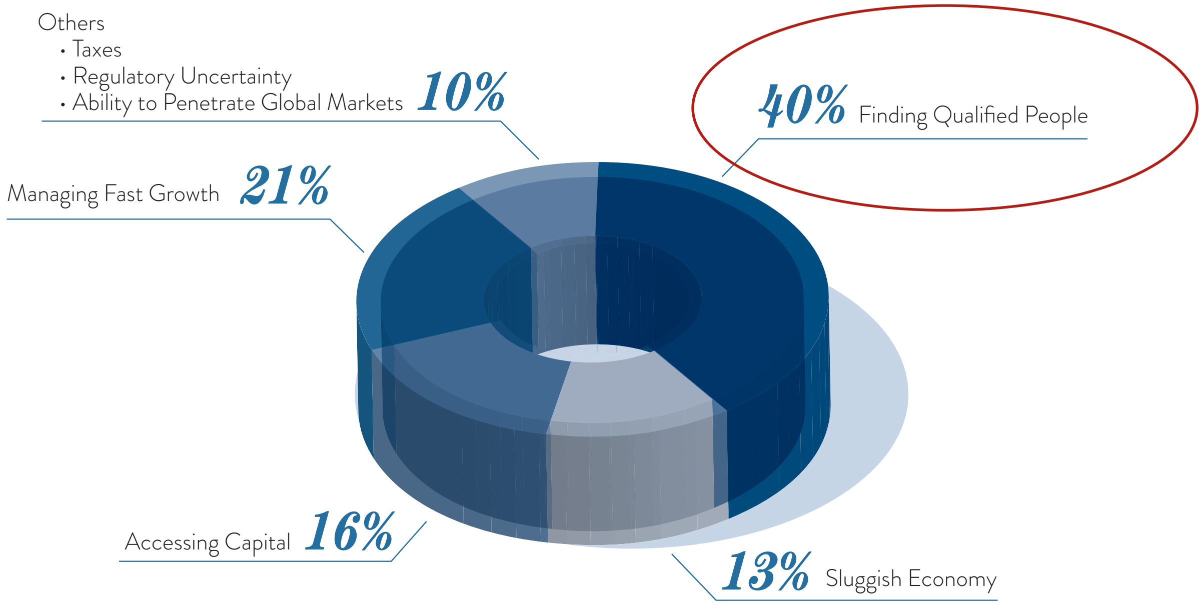
> "Participants expressed a range of views on the current extent of the slack in the labor market. Very high long-duration unemployment might indicate a mismatch between unemployed workers' skills and employers' needs, **suggesting that a substantial part of the increase in unemployment since the beginning of the recession reflected factors other than a shortfall in aggregate demand.**" [Emphasis ours]

They refuse to use the word "structural" but that's what they mean!

Bottom line:

- Given that central bankers have hammers and see nails everywhere, QE3 is still on the table if economic growth slows and core inflation moderates below the Fed's 2% flexible target. We will monitor these trends carefully. As of January, only "a few members" of the FOMC favored QE3.
- Further, the forward guidance issued in the January FOMC statement to keep the federal funds rate "low until at least late 2014" could change as the economic data and the views of FOMC members evolve. In fact, the minutes state that "some members underscored the conditional nature of the Committee's forward guidance and noted that it would be subject to revision in response to significant changes in the economic outlook."
- Finally, to the extent some FOMC members are open to our "it's structural, not cyclical" theme, then QE3 becomes a less likely strategy to address high unemployment. We detect more openness to this view in 2012 than just a few years ago.

ENTREPRENEURS WERE ASKED: "WHAT IS THE BIGGEST IMPEDIMENT TO THE GROWTH OF YOUR BUSINESS?"



Sources: BLS; Kauffman Foundation