



## The Unemployment Rate: A Reliable Statistic?

The release of the monthly unemployment rate causes markets to react and analysts to ponder the health of the economy. Others assign an even more important role to the unemployment rate, believing that if it drops below some crucial point a surge in inflation is inevitable. But how reliable is the unemployment rate as an economic indicator?

While low unemployment rates are generally associated with a strong economy, and high unemployment rates with a weak economy, the month-to-month fluctuations may indicate little about the economy's underlying strength.

The unemployment rate doesn't measure the change in the number of individuals without a job; instead, it measures the number of unemployed individuals as a fraction of the labor force. The labor force consists of individuals 16 and over who currently have a job (the employed) or do not have a job but are actively seeking work (the unemployed). Individuals who do not have jobs and have not looked for work in the past four weeks are not considered part of the labor force.

The labor force has increased over time, with its growth determined primarily by the growth of the population. In any particular month, however, the labor force may be rising or falling as individuals decide to enter and exit. People may exit the labor force because they no longer want jobs, are retiring, are returning to school or are raising children. Or they may have become discouraged looking for work and stopped searching.

During economic contractions, the number of discouraged job seekers is likely to increase and more individuals are likely to delay entry into the labor force, through additional schooling, for example. During economic expansions the opposite is likely to happen. Discouraged individuals may notice more help-wanted

signs and decide to re-enter the labor force. If job prospects are good, graduating students may decide to forego further education and enter the labor force.

While surges in the labor force may indicate a strong economy, the number of unemployed will actually rise if the entrants do not immediately find jobs. After all, an individual's status switches from not being in the labor force to being unemployed by merely looking for a job. Thus, these jumps in the labor force are often associated with increases in the unemployment rate. Then, as the entrants find jobs, the number of unemployed and the unemployment rate will decline. The surge in the labor force in January of 1996 fits this pattern, as shown in the graph.

In other periods, an initial surge in the labor force is followed by a sharp decline, with unemployment also exhibiting this pattern, as in March-May of 1995. One possible explanation is that individuals entering the labor market leave if they do not quickly find a job. Furthermore, declines in the unemployment rate associated with declines in the labor force, as in April 1997, are generally reversed when the labor force resumes its rise.

In summary, although the unemployment rate is an important indicator of the strength of the economy, its monthly movements need to be interpreted with care. Specifically, one needs to look at the underlying factors driving the changes.

—Patricia S. Pollard

