

Research Briefing | US

Lasting Covid imprint on labor force participation

Economist

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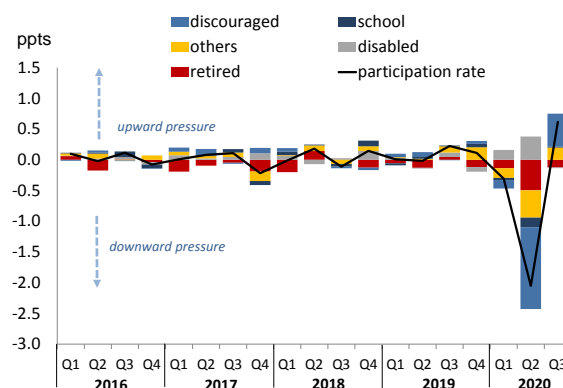
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- Labor force participation is expected to recover from its historical plunge over the next two years, but not to its pre-pandemic peak. Our decomposition analysis shows that younger workers have largely returned to the workforce, while older workers are less likely to be back. We expect the participation rate to rise from 61.4% currently to 62.4% by Q4 2021, and 62.6% in Q4 2022.
- We estimate 65% of the drop in the labor force participation rate (LFPR) in Q2 last year, or 1.3ppts, was due to discouraged workers. Discouragement was more prevalent among younger workers, who were overrepresented in the hard-hit services industries. Encouragingly, young workers' participation has already regained two-thirds of its drop.
- An acceleration of retirement trends, reflecting early retirement decisions and more disabled workers retiring, has weighed on overall participation by an estimated 0.5ppts in Q2 2020.
- We estimate that around 2 million workers have left the workforce to retire since the start of the pandemic. This is more than double the number of people who left the labor force to retire in 2019, and will leave a permanent dent of about -0.4ppts on the participation rate.
- Fed Chair Jerome Powell recently stated that the realization of such rebound in participation will indicate a broader recovery in the labor market – a signal that policy normalization can slowly begin. We expect the tapering of QE asset purchases to begin in mid-2022, followed by rate lift-off in mid-2023.

The collapse in the LFPR has been one of the most striking labor market developments of the global coronavirus recession. The 3.1ppts plunge last year was unparalleled, and nearly as large as the seven year decline in the aftermath of the 2008-2009 recession. As of January 2021, the LFPR has only regained just over a third of its drop, with 4.3 million more people out of the workforce than in February last year.

Figure 1: Key drivers of the labor force participation rate

US: The ins and outs of the participation rate



Most of the drop in the labor force participation rate during the global coronavirus recession was due to discouraged workers leaving the workforce and older workers retiring earlier than expected.

Source: Oxford Economics/ Shigeru Fujita, Federal Reserve Bank of Philadelphia

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Analyzing the contributions to the decline in the participation rate from workers who are retired, disabled, discouraged as well as working-age students (Figure 1) reveals two important trends. First, an unprecedented wave of discouraged younger workers left the workforce last year. Second, the early retirement of baby boomers and disabled workers amplified the existing structural demographic decline in the LFPR. Together, these two trends accounted for 85% of the overall drop in the LFPR in 2020.

Younger workers on their way back

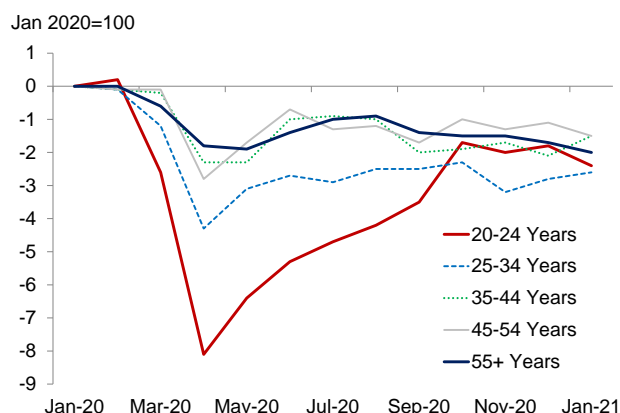
Across the age groups, the most significant decline in labor force participation was observed among younger workers who dominate the hard-hit services industries (Figure 2). The LFPR among young adults aged 20-24 and 25-34 suffered the largest decline in the wake of the coronavirus crisis, falling by a cumulative 8.1ppts and 4.3ppts, respectively, between January and April 2020. Together, these age groups accounted for about 45% of the drop in the working-age participation rate (Figure 3). Yet younger workers' participation in the labor force has recovered very rapidly, with the 20-24 age group regaining two-thirds of its drop. Lower health risks from the virus, the partial reopening of some services activities, and a decline in college enrolment help explain the swift rebound.

Baby boomers take the nearest exit

While participation among workers aged 55 and over fell less during the initial stages of the pandemic, it has been on a downtrend since last summer, and it is currently lower than at the worst of the crisis. We see three factors behind this development: the job losses associated with the coronavirus recession, the health risks posed by the virus for the most senior workers, and early retirement decisions boosted by well cushioned 401k accounts supported by strong financial market performance.

We estimate that ageing of the population would reduce the LFPR by about 0.06ppt every quarter, or 250,000 workers, under normal circumstances. But that drag on LFPR was a large 0.5ppts in May 2020, and will reach a cumulative 1.2ppts by the end of 2022. More than 2 million workers have left the labor force to retire since the start of the pandemic (Figure 4). This is more than double the number of people who dropped out of the labor force to retire in 2019.

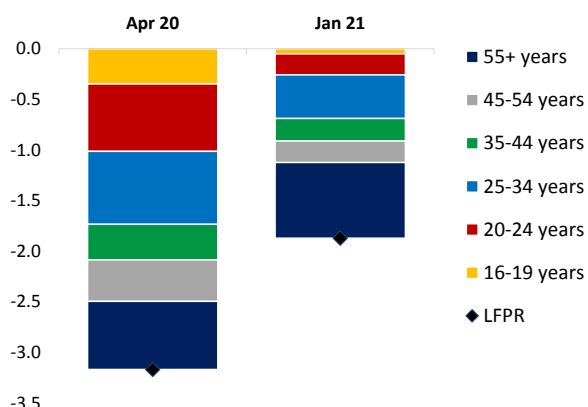
Figure 2: Youth participation has rebounded markedly, while older workers continue to drop out
US: Labor force participation rate



Source : Oxford Economics/Haver Analytics

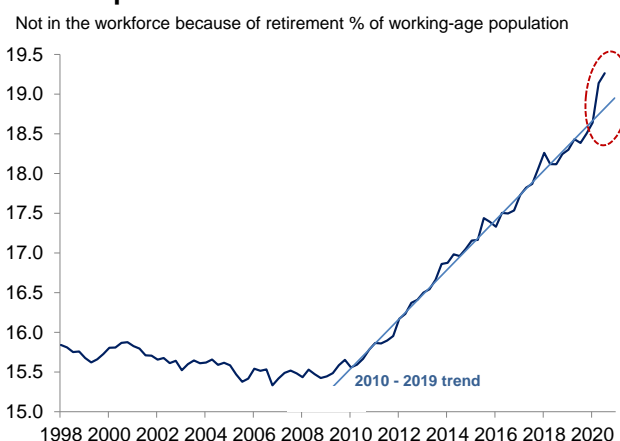
Figure 3: Older workers now account for over a third of the participation rate shortfall

US: Contributions to participation rate shortfall
Change from Feb 2020 level, weighted as share of working-age population



Source: Oxford Economics/Haver Analytics

Figure 4: The number of people who have left the labor force because of retirement has surged
US: Drop of the workforce because of retirement



Source : Oxford Economics/Haver Analytics

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Historical labor market flows data indicate that once an individual has left the labor force for retirement, the odds of returning (employed or unemployed) are slim at around 2% per month (Fujita, 2014). The 16% rise in stock prices over the past year likely provided a welcome lift to retirement accounts, and further reduced the need to return to the labor market for some. We therefore believe this early retirement phenomenon is unlikely to reverse once labor market conditions improve and will permanently reduce the LFPR by about 0.4ppts.

There may not be much of a participation rate boost from returning retirees, but early retirement will result in fewer future retirees than the natural aging of the population would imply over the coming years.

Disabled workers transitioning to retirement

The evidence concerning disability is more puzzling, since this component provided a surprisingly positive offset to the decline in labor force participation in Q2. At first glance, a positive contribution would be interpreted as the re-entry of disabled workers into the workforce, a trend that was taking place before the pandemic hit (Figure 5). However, anecdotal evidence suggests that workers with disabilities were severely impacted by the crisis because they were more susceptible to the virus. As such, **we suspect that some of the older disabled workers who were out of work could have transitioned into retirement.** This appears to be corroborated by data on social security benefits, which show that the number of older recipients declined markedly in 2020 (Figure 6).

All eyes on prime-age participation

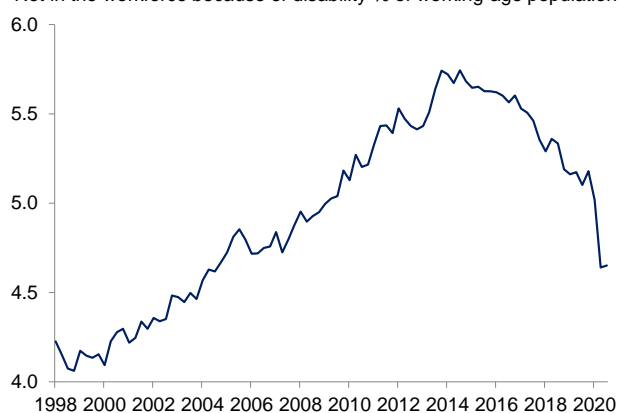
Given the ongoing downward pressure from the retirement of baby boomers, it's important to neutralize the effect of the aging of the population to get a more accurate picture of labor market participation. **While the reported participation rate is at its lowest level since the 1970s, our age-adjusted measure of labor force participation is at its lowest level since 2015**, or 1.8ppts below its pre-pandemic level (Figure 7).

Fed Chair Jerome Powell [recently](#) stated that examining the share of prime-age workers holding or actively seeking work is another way of stripping out the effects the aging of the population. After rebounding strongly in the latter phase of the prior economic expansion, the prime-age participation rate plunged 3.1ppts last year. Following a tepid recovery, the rate is currently 1.8ppts below its pre-pandemic peak.

Figure 5: Disabled workers likely retired rather than rejoining the workforce

US: Where have disabled workers gone?

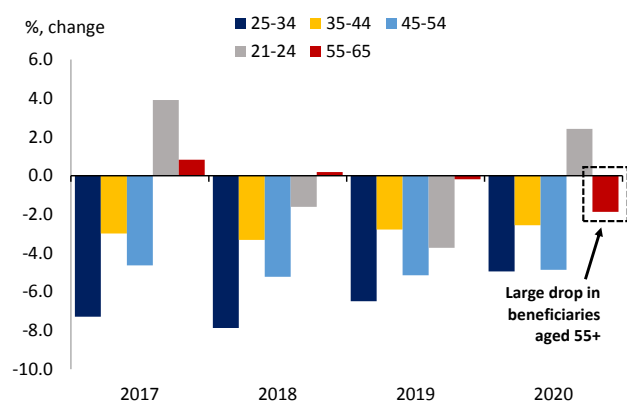
Not in the workforce because of disability % of working-age population



Source : Oxford Economics/Haver Analytics

Figure 6: The number of older workers receiving disability benefits has dropped significantly

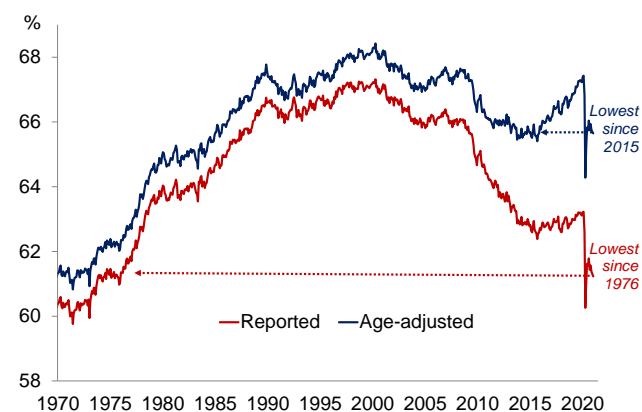
US: Social security benefit recipients, disability



Source: Oxford Economics/ Haver Analytics

Figure 7: Adjusted for the aging of the population, the LFPR is at its lowest since 2015

US: Cyclical versus structural participation rate



Source : Oxford Economics/Haver Analytics

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The evolution of the prime age participation rate will be important to monitor, as it will indicate how complete is the labor market recovery. The GFC experience shows us that labor market scarring can continue to depress labor force participation even as **the unemployment rate falls toward pre-recession levels (Figure 8)**.

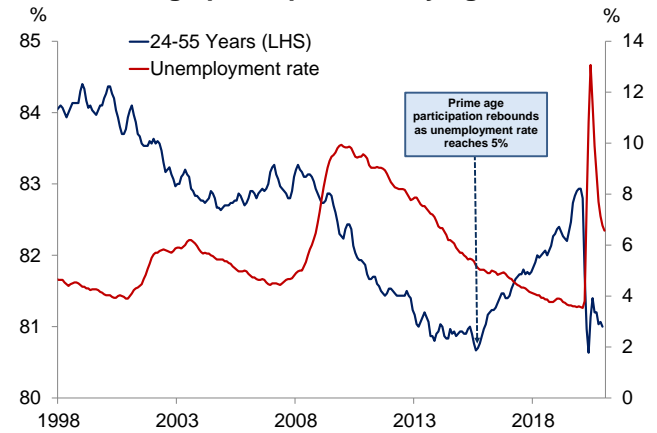
Fed in no rush as healing will take time

Broader vaccine distribution and increased fiscal support should boost labor demand this year and pull many discouraged workers back into the workforce. As the economic and labor market recoveries accelerate, **we expect the aggregate participation rate to recover to around 62.4% by year-end (Figure 9)**. By the end of 2022, we believe the rebound in labor force participation will be near-complete at a rate of 62.6%, While this is lower than the pre-pandemic rate just above 63%, the shortfall will mostly reflect the ageing of the population. We anticipate the unemployment rate should sit around 4.3% by the end of 2022 as the rebound in the participation rate slows the implicit decline in the unemployment rate.

Our forecast aligns with a generally dovish monetary policy stance over the coming years. Powell has stressed that the Fed will wait for realized broad-based and inclusive labor market gains and inflation before deciding to tighten policy. We believe the Fed won't consider raising the federal funds rate before mid-2023. Importantly, the Fed has now incorporated into its reaction function the economy's ability to sustain a robust job market without triggering a surge in inflation. As such, the Fed will therefore be in no rush to remove policy accommodation even in the event of a more rapid non-inflationary tightening in labor market conditions than anticipated.

Figure 8: Prime-age participation rebounded in the latter part of the last expansion

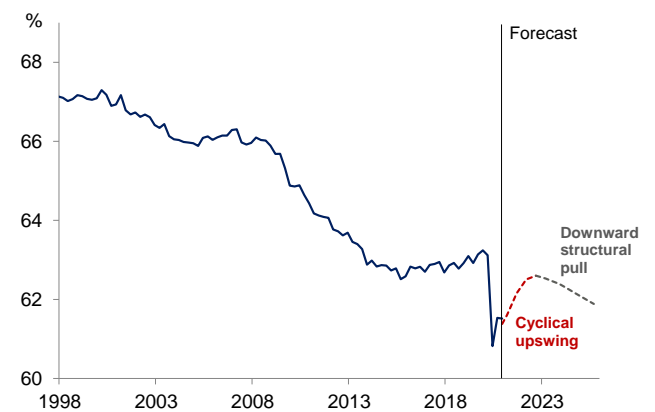
US: Prime-age participate rate by age



Source : Oxford Economics/Haver Analytics

Figure 8: After a cyclical upswing in 2021-2022, the LFPR will resume its structural downtrend

US: Labor force participation rate



Source : Oxford Economics/Haver Analytics