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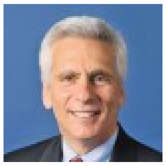
Why would the Fed want to raise the unemployment rate a full percentage point?



by Jared Bernstein June 18 Follow @econjared

Jared Bernstein, a former chief economist to Vice President Joe Biden, is a senior fellow at the Center on Budget and Policy Priorities and author of 'The Reconnection Agenda: Reuniting Growth and Prosperity'.

Last week, after the Federal Reserve committee that sets interest rates raised the benchmark rate it controls, Fed Chairman Jay Powell held a news conference to explain his team's rationale. It was all going fine until someone asked him a particularly hard question: "How are you going to get unemployment from 3.5 percent up to that 4.5 percent rate?" To which I would have added: "And why would you want to?"

Here's the background:

The Fed forecasts that by late 2019, the unemployment rate will be 3.5 percent. Now, the last time unemployment was 3.5 percent was late 1969, so we're talking low unemployment. And yet, the current rate — 3.8 percent — is already pretty close, and given all that deficit-financed government tax cutting and spending over the next couple of years, the Fed's forecast is defensible.

No question, there's a lot that could happen between now and then — recession, trade war — but assume for the moment that it's right. So, where does that 4.5 number come from?

That's the Fed's estimate of the "natural rate" of unemployment: the lowest jobless rate it thinks is consistent with stable inflation. As Powell usefully underscores every time this comes up, it's a rough estimate, surrounded by a wide margin of error. That said, what the Fed is telling us is that the current economy is overheated because the unemployment rate is a full point below its "equilibrium" rate, i.e., where it would "naturally" settle at full employment.

But an extra point of unemployment is far from costless. A point less means 1.6 million more people with jobs; add to that the fact that, because their bargaining clout is so low, the benefits of tight labor markets do not accrue to the least advantaged until a very low unemployment rate lasts a long time.

Moreover, if the jobless rate is truly running a full point below its steady-state rate, why aren't price or wage growth shooting up? How will the Fed orchestrate a significant increase in the unemployment rate over the next few years? Why would it want to?

Powell's key response was, "We can't be too attached to these unobservable variables," meaning that although the Fed puts itself in the awkward position of having to report a "natural" rate of unemployment, it doesn't want us to take it too seriously. When Powell said, "We have to be practical about the way we think about these things … we do that by being grounded in the data … and what we see happening in the real economy," he was, if I'm reading him correctly, saying, with good reason: If capacity indicators such as inflation suggest 3.5 percent unemployment is a sustainable rate, maybe we'll stay there. After all, I guarantee you that neither the Fed's very smart staff nor any other economist can reliably tell you whether the "natural" rate is 3.5 or 4.5 percent.

In other words, to quote yet another distinguished expert, Dr. John, "Refried confusion is making itself clear."

Every utterance, and even more so every number, put out by the Fed is subject to tremendous scrutiny by market watchers and journalists. Why say it's targeting 4.5 percent unemployment, when that's not necessarily the plan? If I tell you we're driving to Cleveland, you reasonably believe that's where we're headed. But what if I really mean is that we might, depending on how the trip goes, not go to Cleveland? How will you know what to pack? Surely, you'd lose trust in my pronouncements of our trip's itinerary.

It's certainly possible, even likely, that as fiscal stimulus fades, circa 2020, growth will slow and the unemployment rate will rise. Also, the Fed now intends to tap the growth brakes a bit more aggressively than previously planned, and that, too, should bump up the jobless rate. Finally, although economists do not know the true parameters of the economy's capacity, we are surely closer to it now than we've been for many years, so supply constraints could start to bind.

Any one of these factors, together or alone, could nudge up the jobless rate. Thus far, however, inflation — both actual and expected — has only picked up a bit, suggesting that supply constraints are not yet binding, and even with the accelerated rate agenda, the Fed's still plans are still for a slow, gradual "normalization" of interest rates.

Fiscal policy is a wild card, but, to put it mildly, D.C. politicians seem willing to pile their preferences on the budget deficit. If anything, Democrats, who, contrary to popular mythology, are more fiscally responsible than Republicans, are asking why they always have to be the fiscal grown-ups.

Depending on how these factors break, we may end up at 4.5 percent unemployment, but I see no reason to go gently into that higher rate. The U.S. economy's capacity is unknowable (in part, because persistently strong demand pulls labor-market sideliners back in, so capacity is a moving target), and, given that wage growth has been slow, the benefits of full employment have yet to fully reach all comers.

So, with respect for its tough job of steering in the dark and deep appreciation of the fine work it has done in recent years, I'd urge the Fed to stop printing and targeting "natural" rates that aren't particularly natural at all. I know that I don't believe them, and I'm starting to think the Fed doesn't either.

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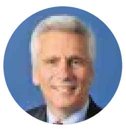

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