

The Surprisingly Elusive Number That Suggests Full Employment

By Jared Bernstein

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Last month the national unemployment rate fell from 5.9 to 5.8 percent, ticking one-tenth of a point closer to the rate of full employment in the American job market. Of that, I'm confident. What that rate of full employment is, no one knows. As the Federal Reserve prepares to begin removing its monetary support from the economy, acknowledging that uncertainty becomes increasingly important.

Economics maintains that there is a rate of unemployment that is consistent with full employment such that if the actual jobless rate falls below that rate, inflation will accelerate.

As you can imagine, this number means a lot to central bankers interested in maintaining so-called well-anchored inflation. In fact, the core job of the Federal Reserve — its dual mandate — directly embodies these concepts: to use monetary policy to obtain the lowest unemployment rate consistent with stable inflation. That rate even has a nickname: the Nairu, or nonaccelerating inflation rate of unemployment. It's pronounced either nye-roo or nay-roo but the cool kids just call it the natural rate.

The Congressional Budget Office sets the natural rate at 5.5 percent. The Federal Reserve says it's between 5.2 and 5.5 percent. By those measures, we're within spitting distance today. If you believe they are correct, you might want the Fed to tap the brakes about now.

But there are reasons to doubt whether they are correct. If the economy were close to full employment, wage growth and inflation would probably be substantially stronger than they are right now.

We know that economic slack and price pressures are usually negatively correlated. (Slack is the quantity of labor and capital that could be employed productively, but isn't.) So more slack, less inflation. But we don't know the strength or magnitude of the correlation between the two factors, in no small part because it changes over time, buffeted by factors ranging from the known, like changes in the supply of goods that feed directly into inflation, and the unknown, like speedups or slowdowns in productivity growth. We can see it happening, but we just don't know why. It's often hard to identify what's behind productivity growth.

Most recently, two factors are playing an important role in dampening the so-called reaction function that translates diminished slack into faster price and/or wage growth. First, the bargaining clout of the American worker is unusually low right now; even steadily falling unemployment hasn't translated into wage gains. Second, an important part of what drives inflation is expectation about its future path, and the Fed has worked hard over the years to ensure "well-anchored inflationary expectations" around its target of 2 percent inflation.



Protesters outside a McDonald's in Chicago in September. They were calling for an increase in the minimum wage. M. Spencer Green/Associated Press

Given all of these moving parts, we don't know what the Nairu is. And we haven't for quite some time.

As Dean Baker and I document in our recent book on the importance of returning to full employment, back in the 1990s, the consensus was that the Nairu was 6 percent. "Ye who dares tread below that rate risks triggering an inflationary spiral," went the mythology of the time.

As unemployment fell below this alleged natural rate in the 1990s, wage pressures did in fact begin to build. But the Federal Reserve chairman at the time, Alan Greenspan, recognized that because productivity growth was accelerating, wage growth didn't obviously have to feed into price growth. Firms could maintain healthy profit margins and still raise pay (those were the days!).

Long story short, in the last few months of 2000, the unemployment rate fell below 4 percent and inflation was still well behaved. Economists' Nairu estimates were way off. A group of top econometricians took a careful look at our ability to

accurately pin down the Nairu and concluded: “Our main finding is that the natural rate is measured quite imprecisely.” They found margins of error to be wide, to the tune of three to four percentage points.

So, is the Federal Reserve flying blind, with no quantitative benchmarks to reliably guide their tightening schedule?

Not at all. There are at least a few variables they can (and do) look at to get direct information on any overheating threats from diminished slack in the job market, and two of them are annual wage and price growth (shown in the accompanying chart with a composite wage series and the core price index by which the Fed mainly tracks inflation).

The two used to move together, but inflation appears “well anchored” since the latter 1990s, and wage growth has hugged 2 percent since 2009 despite the steep decline in unemployment since then.

Another way to consider this dynamic is to track the evolving correlation between slack and wage growth. I’ve found the correlation has become less negative, meaning tighter labor markets simply aren’t pushing employers to bid wages up. I’m convinced that weak worker bargaining power is a critical factor in this flattening correlation between slack and wage growth.

While we can’t nail down the natural rate, we’re more likely, just as in the 1990s, to think it’s higher, not lower, than it really is. So it’s important that policy makers keep our imprecision in mind, especially as we approach rates close to the current estimates of the Nairu. As I read the evidence, the paychecks of a lot of workers depend on a natural rate that may be lower than we think it is.

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