JOINT ECONOMIC COMMITTEE
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Full Employment and Stable Prices

Pursuing the Dual Mandate in a Changing Economy

"I think we really have learned, though, that the economy can sustain much lower unemployment than we thought without troubling levels of inflation."

Federal Reserve Chairman Jerome Powell

The Federal Reserve faces a fundamental question that will have an enormous impact on the livelihoods of millions of Americans—what is the lowest unemployment rate possible that doesn't cause an unacceptable level of inflation?

Economists long have thought that the economy is at "full employment" at a rate of around five percent. Below that, employers would be forced to pay higher wages to attract and retain workers, which in turn would compel them to raise prices, sparking inflation. The theoretical trade-off between unemployment and inflation is what is known as the Phillips Curve.

However, while the current unemployment rate is extremely low at 3.6 percent, inflation remains below the Federal Reserve's two percent target. Wages have risen, but below expectations. For this reason, some suggest that the Phillips Curve no longer applies.

There are substantial benefits to very low unemployment. The most obvious is that a higher share of those seeking work are able to find jobs. Some will get paid more. Another important outcome is that Americans who typically suffer much higher rates of unemployment experience desperately needed gains. For example, Black Americans, who historically have about twice the unemployment rate as whites, have seen their unemployment rate drop to 5.4 percent.

Another benefit of very low unemployment is that workers who previously had given up looking for work are able to rejoin the labor force and find jobs. This helps the economy as a whole, since higher rates of labor force participation contribute to faster economic growth. However, the fact the many Americans are rejoining the workforce could be one factor keeping wage growth below expectations. When that process slows, inflation could accelerate.

The Federal Reserve has a "dual mandate" to promote maximum employment and low inflation. Chairman Jerome Powell has demonstrated unusual willingness to consider the argument that the non-inflationary rate of unemployment may be lower than previously thought. He also has praised the benefits of low unemployment for Americans of different races, ethnicities and other characteristics who in the past have suffered exceptionally high rates of unemployment.

If the Federal Reserve decides that the non-inflationary unemployment rate is lower than previously thought, it will keep interest rates very low, helping millions of Americans who before hadn't benefited fully from a strong economy. But if it is wrong, inflation could spike, hurting lenders, those on fixed incomes and individuals whose savings grow slower than inflation. The stakes are high.

The Federal Reserve has a mandate to promote maximum employment and low inflation

The Employment Act of 1946 established the federal government's responsibility to foster economic conditions such that "there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power." In 1974 and 1975, Congress considered legislation that would have had the government provide jobs directly as an "employer of last resort." if explicit employment targets were not met. The final 1978 Humphrey-Hawkins Act offered less commitment by Congress or the Federal Reserve to achieve employment goals through direct action; instead, the act strives to achieve full employment while keeping other concerns in balance.

Over time and especially due to the work of monetarist economists including Milton Freidman, practical use of the term "full employment" evolved to take inflation into account. The experience of stagflation in the 1970s—a period of high unemployment and low growth with simultaneous rising inflation—cemented inflationary pressure as a prime concern in the consciousness of monetary policymakers. Today, full employment is considered by many to be synonymous with the non-accelerating inflationary rate of unemployment (NAIRU)—the rate of unemployment that neither stokes nor slows inflation. In a broad sense, full employment means the number of people seeking work is matched by the number of jobs being offered by employers.

The Federal Reserve is committed to keeping the unemployment gap—the difference between the unemployment rate and the NAIRU—as narrow as possible. However, since the Great Recession, estimates of the NAIRU increasingly have become the subject of debate. In 2015, economists estimated NAIRU at around 4.7 percent, though with a 50 percent confidence interval of anywhere as high as 6.1 percent as and low as -4.3 percent. In 2016, the Council of Economic Advisers estimated that for each year unemployment was below the NAIRU by one percentage point, the inflation rate would increase by only 0.03 percentage point. Today, the short-term estimate of the NAIRU is around 4.6 percent, despite the fact that the unemployment rate in October 2019 was only 3.6 percent. Nevertheless, inflation remains low even with the unemployment rate approximately a full point below estimates of the NAIRU.

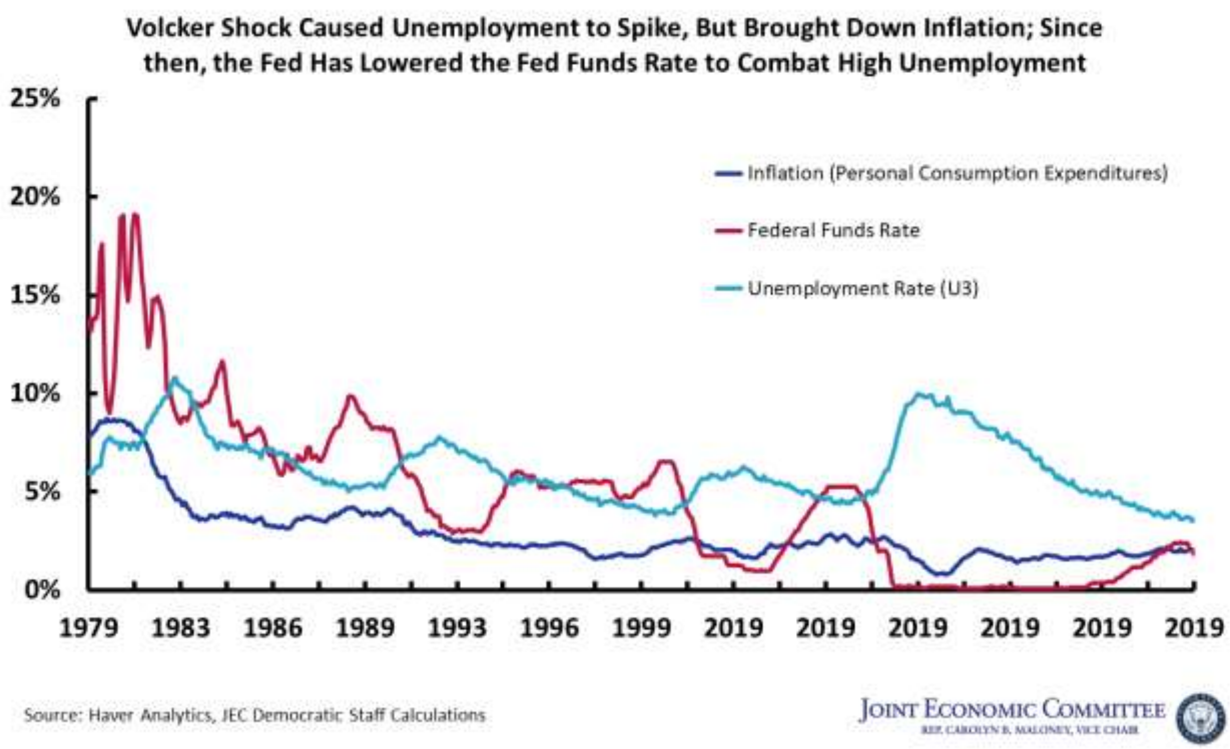
The predicted trade-off between unemployment and inflation has weakened over time

In theory, low unemployment stokes inflation because tight labor markets force employers to pay higher wages to attract and retain workers. As a result, firms in competitive markets must charge higher prices, passing wage increases onto consumers. Higher prices then theoretically induce consumers (who are also workers) to seek even higher wages, continuing the inflationary spiral.

This relationship between unemployment and inflation is known as the Phillips Curve. In recent years this correlation has become increasingly difficult to identify, creating a puzzling situation in which unemployment is *below* estimates of the NAIRU without appreciable price inflation. Some question whether the Phillips Curve is an accurate reflection of the relationship between unemployment and inflation.

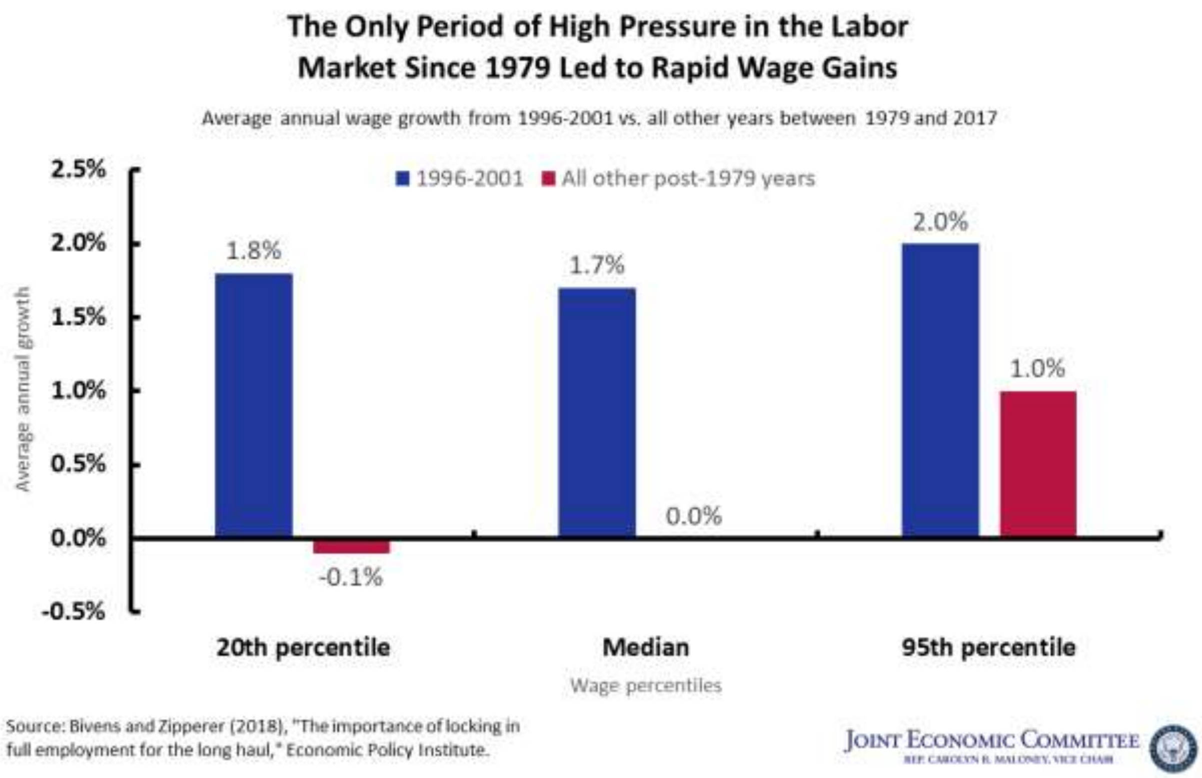
While unemployment is high on the list of concerns for low- and middle-income working Americans, inflation is most costly for savers and those living on a fixed income or as landlords and lenders. Many retirees suffer when inflation increases, especially those who rely on defined-contribution retirement plans built over a working career or pensions that are not adjusted for inflation. Landlords and lenders are worse off when inflation rises as the debt they issue is paid back in dollars that are less valuable than when leases were written and loans were issued. Persistent, high inflation also makes it more difficult for firms and investors to make sound investment decisions. These inflationary concerns make it necessary for the Federal Reserve to keep a watchful eye on price levels and to do what it can to keep inflation at a manageable rate.

Historically when the Federal Reserve has engaged in contractionary monetary policy and raised interest rates to keep inflation at bay, workers have suffered through the resulting rise in unemployment and even recessions. In 1980, in what is known as the Volcker Shock, Federal Reserve Chairman Paul Volcker raised the Fed's prime interest rate to the astronomical rate of nearly 20 percent to fight high inflation. The price level stabilized while sparking a recession that saw unemployment surge to its highest level since the Great Depression. In this way, balancing the goals of full employment and price stability often implies balancing the interests of workers and those who earn income outside of work.



Full employment benefits workers and the economy

There are clear economic benefits when the unemployment rate falls and the labor market approaches full employment. Tight labor markets force employers to pay higher wages and better fringe benefits, possibly as a result of collective action by workers. The increased bargaining power associated with tight labor markets also translates into workers receiving a larger share of private-sector income. When workers earn a larger share of the nation's income growth is shared more equitably between labor and capital and inequality generally decreases. A full-employment economy also helps alleviate fiscal constraints at local and federal levels, as tax revenues tend to increase and spending on social safety net programs falls. Employing as much of the labor force as possible allows the economy to remain on its highest potential path for growth. Tight labor markets have some benefit for employers as well; the increased time and money spent on finding qualified workers result in better matches.



Labor market slack, where there is less work available than there are people willing to work, is as harmful to workers as full employment is beneficial. Workers in an economy with high rates of unemployment see stagnant wage growth and fewer opportunities to change jobs. If a worker loses their job in a harsh labor market, it could take them much longer to find new employment. This culminates in a vicious circle where employers are even less likely to hire those who have been unemployed for an extended period, with potential adverse effects for their entire career. Young workers who enter the labor market during periods of high unemployment are significantly worse off in terms of numerous social indicators, from marriage rates to health outcomes.

Workers who lose their jobs experience higher rates of mental illness and mortality, as well as lower rates of life satisfaction. The risk of suicide increases as unemployment drags on, as do mortality rates from cancer. These negative social effects even extend to the family; divorce rates climb with unemployment, and the children of the long-term unemployed often suffer academically.

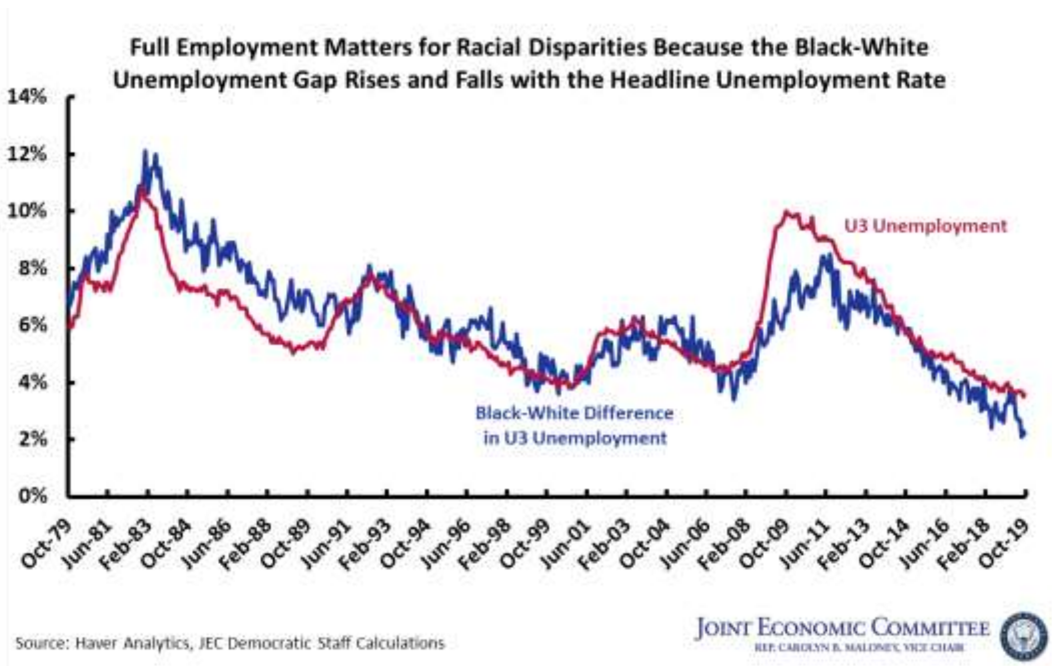
At a macro level, labor market slack can increase inequality by reducing the income of those in the bottom half of the income bracket. It can increase fiscal burdens by lowering the tax base and increasing reliance on social safety net programs. State and local governments often exacerbate these problems when they cut programs and spending to alleviate the budgetary shortfall, locking themselves into an austerity-driven downward spiral of slowing economic growth. Persistently high unemployment can permanently move an economy off its potential growth path through inducing *hysteresis*, the deterioration of skills and diminished investment.

Aggregate estimates of full employment mask persistent disparities between racial/ethnic communities

"The benefits of this strong economy and sound financial system have not reached all Americans. The aggregate statistics tend to mask important disparities by income, race, and geography."

--Federal Reserve Chairman Jerome Powell

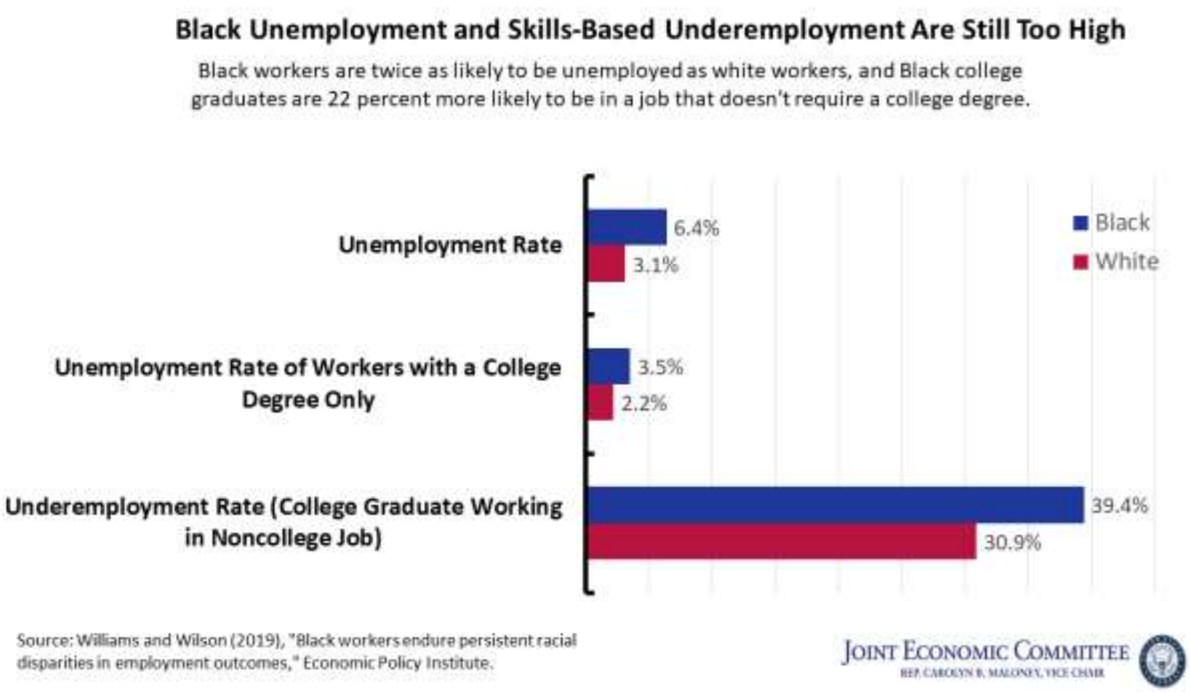
Racial and ethnic communities who suffer from persistent high unemployment enjoy the greatest benefits of a full-employment economy and suffer the most in times of labor market slack. Racial disparities in unemployment are countercyclical; at the peak of a business cycle, when the unemployment rate falls toward full employment, racial disparities in unemployment rates have historically been at their lowest (see figure). This could be due to employers responding to strong aggregate demand throughout the economy by increasing their search effort for new hires, resulting in less labor market discrimination and more hiring from the ranks of the long-term unemployed. When unemployment rates rise as the result of a recession, the gaps between Black or Latino and white unemployment balloon. This is an empirical expression of the "first fired" phenomenon used to describe the experiences of Black workers in the labor market, whereby they are often the first let go in the event of a downturn.



Claims that the economy is at full employment can have a bitter edge for Black and Latino communities, as their unemployment rates persistently exceed whites' even when the economy is healthy. Black job-seekers are consistently half as likely to find work as white job-seekers at the national level, whether in a recession or at the height of an economic boom—a trend that has lasted for over 40 years. While the overall unemployment rate peaked at 10 percent during the Great Recession, the Black and Latino unemployment rates reached almost 17 percent and 13 percent, respectively.

Disparities are stark at the local level as well; the average Black unemployment rate among the 28 Black-majority cities with over 65,000 residents was around 11 percent in May, compared to a national rate of 3.6 percent. Racial disparities in both unemployment and underemployment persist at every education level, ruling out group-level productivity differences as an explanation for employment gaps.

Persistent racial disparities in unemployment raise important questions about the Federal Reserve's goal of achieving full employment. Should Black and Latino communities have to face unemployment rates that would be considered unacceptable for the general population in order to prevent inflation from going too high? How should the Federal Reserve consider the implications of its dual mandate for different demographics of the United States? Even now, in an exceptionally tight labor market, there are large gaps between racial groups; while white unemployment is 3.2 percent, Black and Latino unemployment are 5.4 percent and 4.1 percent, respectively.



There currently are few signs of runaway/high inflation

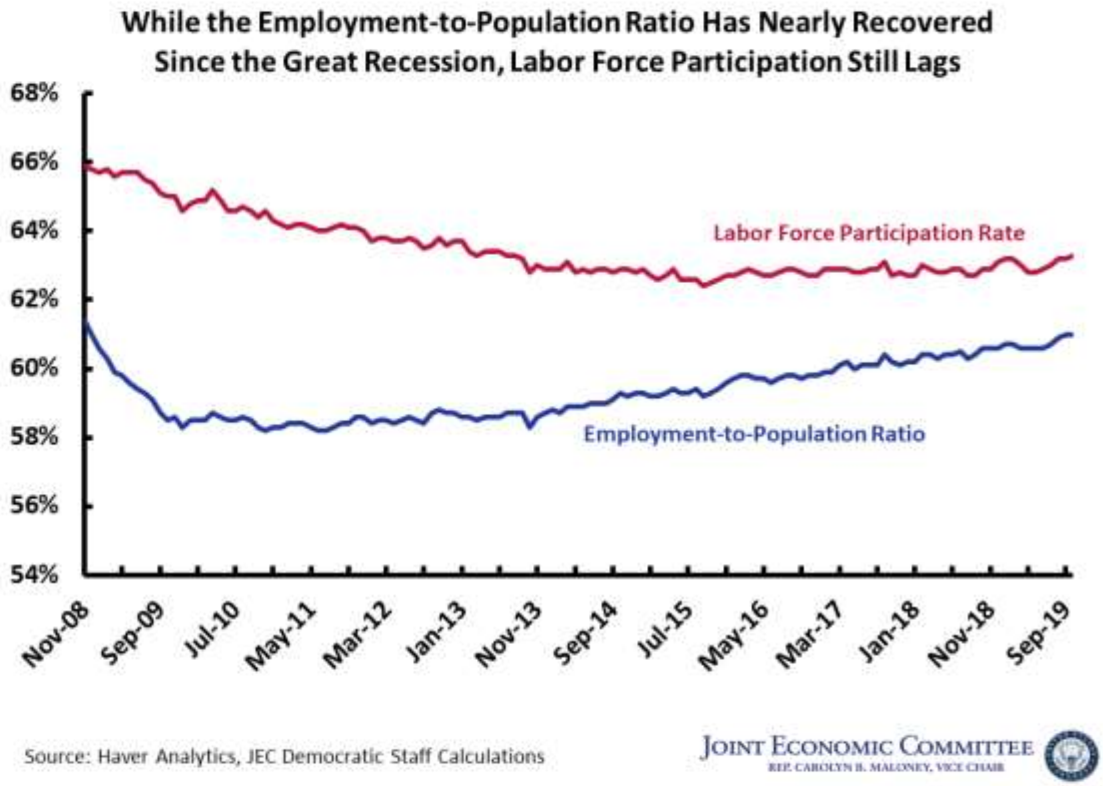
"We've just touched 2 percent core inflation to pick one measure. Just touched it for a few months, and then we've fallen back . . . I think we would need to see a really significant move up in inflation that's persistent before we even consider raising rates to address inflation concerns."

--Federal Reserve Chairman Jerome Powell

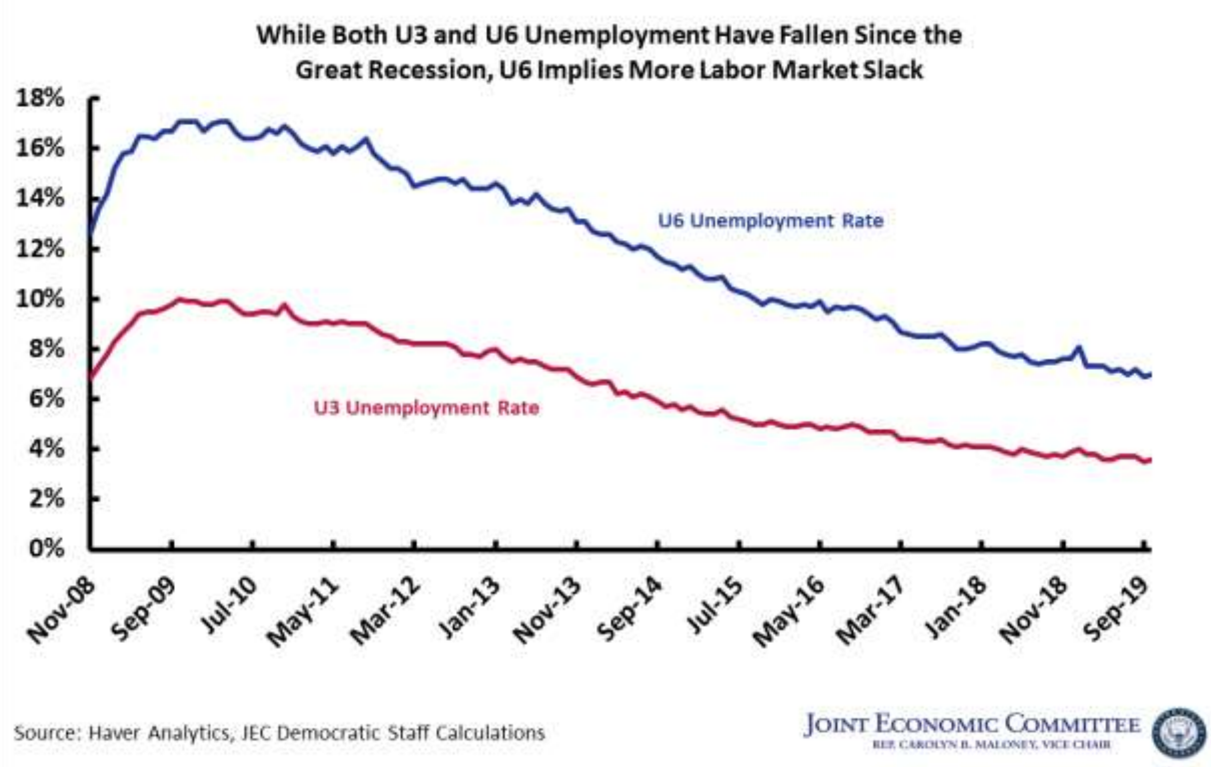
There is substantial evidence that monetary policymakers should be less concerned about the risk of significant inflation today than they were in past decades. Inflation driven by tight labor markets has become a rarity in the United States since the 1980s; after the Volcker Shock, the Federal Reserve learned to manage inflation expectations through careful and predictable adjustments to its headline interest rate. Furthermore, depressed worker bargaining power and wage growth, as well as increased international competition via globalization in recent years, have kept inflation and inflation expectations low. Even as the economy enters its 11^{th} straight quarter with the unemployment rate below Congressional Budget Office estimates of the NAIRU, the inflation rate is shy of Federal Reserve target at 1.7 percent. This suggests there is still room for policymakers to pursue labor market tightening policies without setting off inflation.

Even with exceptionally low unemployment the economy may not be at full employment

The U.S. labor market in October 2019 was at about its tightest since the recession, continuing a multi-year trend of falling unemployment and an increasing employment-to-population ratio. However, there is some evidence to suggest that the economy may not be at full employment. Not everyone willing and able to work can find a job, meaning the economy is not at full employment in that sense. The labor force participation rate has also remained low by historical standards, which suggests that the headline unemployment rate that does not account for people outside the labor force may not be the best measure of tightness.



Alternative measures that include discouraged workers (those who have dropped out of the labor force but would be willing to search if they believed jobs were available) or the ratio of hires to job vacancies suggest that the labor market is not as tight as the unemployment rate shows. The U6 unemployment rate that includes discouraged workers, workers who are willing and able to work but are not actively seeking employment, and those working part-time for economic reasons, was 7 percent in October—nearly double the headline U3 rate. While U6 is also low by historical standards, it could still be showing that the labor market has room to tighten.



Achieving a full-employment economy takes well-coordinated monetary and fiscal policy

The key to achieving a full-employment economy is sustainable and growing aggregate demand; that is, consumers and investors need the confidence and ability to spend on goods and services and invest in new projects to keep the economy growing and in need of labor. During the Great Recession, the housing crisis and associated credit crunch choked off investment and consumer spending, bringing the economy to a grinding halt. At that time, the Bush and Obama administrations, as well as the Federal Reserve, took action through fiscal and monetary policy to jump-start the economy.

The Federal Reserve should continue to explore both conventional and unconventional policy responses in the event of a downturn

The Federal Reserve used conventional and unconventional monetary policy to fight sluggish demand and rising unemployment during and after the Great Recession. The federal funds rate was close to 5 percent when the recession began, leaving little room for reductions to spur further investment. Conventional open-market operations brought interest rates down close to zero, where they were allowed to stay for nearly seven years. Even after the Federal Reserve cut rates close to zero, banks remained reluctant to lend and preferred to hold excess reserves. Businesses were similarly hesitant to pursue new investment opportunities. Some economists have compared using conventional monetary policy to spur economic activity during times of significant slack and low aggregate demand to “pushing on a string.” Interest rate cuts are less effective when the appetite for borrowing is low, but conversely, under these conditions, interest rate hikes can slow economic activity even more than normal.

The Federal Reserve engaged in multiple rounds of quantitative easing (purchasing long-term assets to inject cash into the economy) with the goal of encouraging banks to lend and end the credit crunch. The Federal Reserve also gave investors forward guidance as to where interest rates would be in future quarters to help them make sound investment decisions. The move toward the unconventional monetary policy tools of quantitative easing and forward guidance helped keep the Great Recession from becoming a second Great Depression. Notably, the Federal Reserve's use of these expansionary tools did not result in high inflation, even though economic theory predicted it might do so. That said, monetary policy alone—conventional or unconventional—is not enough to push the economy to full employment after a severe downturn.

Today, as the economy approaches full employment, interest rates are again low at a range of 1.5 percent to 1.75 percent. This again leaves little room for conventional monetary policy to spur further investment in the event of an economic downturn that may leave American workers unemployed. Conventional monetary policy is unlikely to be the most effective way to jump-start aggregate demand and would likely be ineffective at achieving full employment were we to experience a recession in the near future.

Targeted fiscal policy and automatic stabilizers are most effective at maintaining full employment and responding to a downturn

The Obama administration's American Recovery and Reinvestment Act (ARRA) provided the economy with nearly $840 billion in stimulus in the form of tax relief, stimulus checks to households, expansion of unemployment benefits and direct government spending on infrastructure, education and health care. This strategy is widely held to have been successful at ending the economic contraction, restarting growth and reversing rising unemployment, though many economists criticized and continue to criticize the plan for being too small relative to the severity of the crisis.

The ARRA is notable in that its tax relief and stimulus programs were targeted to benefit low- to middle-income households. This stands in contrast to the more recent Tax Cuts and Jobs Act under the Trump administration, which disproportionately benefited corporations and the wealthy—and has comparatively minor impacts on growth to show for it. Instead of using the saved money to invest in new jobs and structurally increase aggregate demand, corporations mostly pocketed the extra cash or bought back shares of their own stock. The savings pooled at the top of the income distribution and did not 'trickle-down' to the rest of the economy. Whether tax relief has any long-term benefit for the health of the economy is dependent on how the government targets that relief.

Our experience with this most recent recovery and of past recoveries shows that well-designed and targeted fiscal policy can grow the economy in a sustainable way and push us toward full employment. Long-term investments like infrastructure projects, expanded education spending and health care provide the foundation for economic growth in a structural way, increasing productivity and making expanded investment more viable for businesses. Coordinating our policies to promote fair terms of trade with our international partners can ensure that the dollar remains competitively valued, keeping demand for U.S. goods, services and labor high.

The government could develop more creative and bold fiscal policies to push our economy toward full employment in good economic times and in recessions. One proposal would see the creation of a subsidized jobs program that would provide federal funds to states where the unemployment rate passes a certain threshold. A subsidized jobs program would help employers hire or keep workers in positions that otherwise would not exist given economic circumstances, providing an important automatic stabilizer during economic downturns. A federal job guarantee is a policy that goes further in pushing the economy toward full employment, effectively ending involuntary unemployment altogether. Providing guaranteed work for all those who are willing and able would come close to the spirit of the original Full Employment Bill of 1945 (which later became the Employment Act of 1946), and of the Civil Rights tradition that birthed the Humphrey-Hawkins Act.

Political gridlock represents a significant risk when fiscal policy is needed to bring the economy to full employment, especially in the event of an economic downturn. This is part of the reason why historically monetary policy has been the more popular option for stimulating the economy. When economic conditions are such that monetary policy will be less effective, there should be institutions in place that allow the federal, state and local governments to provide that stimulus where it is needed. The implementation of automatic stabilizer programs like unemployment insurance, job subsidies, employment guarantees and direct stimulus payments to individuals that activate during recessions can allow governments to respond nimbly and eliminate or mitigate the worst effects of increased unemployment. That would put the economy back on the path toward full employment quickly and efficiently.

Conclusion

Full employment is the most important part of the Federal Reserve’s dual mandate for workers and those wanting to enter the labor market. The pursuit of full employment is critical in reducing racial economic disparities and inequality in general. Historically the Federal Reserve has had a responsibility to balance the pursuit of full employment against the maintenance of stable prices. While fighting persistent and rising inflation remains an important part of the Federal Reserve’s mandate, the lack of recent signs of inflation suggests there is room for monetary policy that continues to accommodate increased employment until further notice. Unconventional monetary policy like quantitative easing and forward guidance may be more effective in fighting the next downturn than conventional open market operations given low interest rates.

However, full employment cannot be reached or sustained through monetary policy alone. Bold discretionary fiscal policy and automatic stabilizer programs will both be necessary to keep the economy as close to full employment as possible. Fiscal and monetary policy will be most effective in achieving economic policy goals when developed and implemented in coordination with one another.