Chairman Greenspan Wants Your Job

The American Prospect, October 23, 2000, 26 - 28.

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For the last year and a half, the stewards of the American economy have been worrying that too many Americans are drawing regular paychecks. The fear is never quite put that way, of course, but as the national unemployment rate has dropped to 4 percent the Federal Reserve has been getting restive. Six times in 15 months, the governors of the Federal Reserve Board have voted to raise interest rates, which is their way of saying the economic news is a little *too* good.

The goal of this monetary tightening is to slow down the economy, ideally bringing it to a "soft landing." So far, under the leadership of Chairman Alan Greenspan, the Fed is moving cautiously, trying not to trigger an outright recession. Yet, there are signs higher interest rates are having some effect. Before this summer, national employment was increasing by an average of 251,000 jobs per month. In July and August, employment decreased by an average of 78,000 jobs. Since it takes from nine to 18 months for interest rate increases to work their way through the system, this slowdown is the result of the early rate hikes. There could be more job losses to come.

We ought to be asking why. Could it be that the thinking behind current Fed policy is dangerously out of step with today's economic realities? The old saw is that the job of the Fed is to walk into the party and take away the punch bowl. But that assumes the party is getting out of control. If it's not and the Fed barges in anyway, it's more like turning off the music just as the appetizers are being served. Except in the real economy, the result isn't to unplug a stereo -- it's to put more people out of work.

The Fed's argument is that because labor markets are so tight, an acceleration of inflation is imminent. Yet, this is the same argument that was made in late 1994 when unemployment fell below 6 percent, and again in 1997 when unemployment fell below 5 percent, and again in 1998 when it fell below 4.5 percent. Each time, the inflation prediction has proved wrong.

But maybe now, the thinking goes, we are finally pushing our luck. The Fed's reasoning rests on the theory of the natural rate of unemployment, which maintains that if the unemployment rate falls below a certain level, inflation will accelerate. No one knows what this minimum unemployment rate is – some have said 8 percent, some now say 3 percent. The estimates tend to change as the economy changes, so that the whole concept becomes tautological: the natural rate is what the actual unemployment rate happens to be. This in turn means that as long as unemployment is low, the Fed always wants to do something about it.

This kind of thinking ranks the danger of inflation above all else. While no thought is given to the goal of zero unemployment, Chairman Greenspan's Fed has dreamt of zero inflation. In their zeal, the inflation-fighters fail to distinguish between different causes of inflation, which may demand different policy responses. This kind of undiscriminating inflation phobia, of course, carries its own risks. It could prove to be dangerous for the economy's health if it leads to the unnecessary sacrifice of jobs and living standards.

It is impossible to imagine stronger evidence discrediting the theory of the natural rate of unemployment than events of the past five years. These events ought to give us the opportunity to decisively break with natural-rate thinking, and to put in place a new framework for making monetary policy. A progressive full-employment-minded Federal Reserve would need a new set of economic principles. In that spirit, here are 10 basic principles for sustained prosperity.

1. Higher productivity can mean lower inflation. Productivity growth is good for the economy because it provides us with the means to produce more from our existing pool of resources, and in doing so it provides the basis for a rising standard of living. Moreover, not only does it contribute to higher living standards, productivity growth also lowers inflation by continually adding to the supply of goods, thereby reducing price pressures.

2. Low unemployment goes with higher productivity. The jump over the last four years in productivity growth coincides with unemployment falling below 5 percent and with an end to real wage decline for those in the bottom half of the wage distribution. A tight labor market appears to have forced firms to use workers more efficiently and to invest in new equipment that enhances the productivity of workers. As well, strong demand conditions have meant that existing capacity has been more fully used, thereby adding to supply. A mass production economy needs robust mass markets to capture efficiencies fully. The implication is that running the economy at low rates of unemployment offers the prospect of a virtuous circle whereby demand creates supply, and supply then creates non-inflationary demand.

3. Zero inflation would require high unemployment. The theory of the natural rate instructs policy makers that inflation is an unmitigated bad, and that they should aim for zero inflation. Yet, the problem with zero inflation is that it requires a higher unemployment rate -- in the range of 7 or 8 percent. The optimal rate of inflation is that associated with minimum sustainable unemployment. It's not zero – it's in the 3 to 6 percent range. The reason is that inflation helps grease the wheels of adjustment in a dynamic economy. Such economies are subject to constant shifts of demand between sectors, and it is easier to accomplish the needed adjustments by raising prices and wages in expanding sectors rather than forcing them down in contracting sectors. Conversely, too much inflation creates economic distortions in financial markets, which throws sand in the wheels of adjustment.

4. High unemployment is costly. Though the optimal rate of inflation is not known precisely, we can say that policy makers should err on the side of slightly more inflation rather than slightly less. Erring on the low side means higher unemployment, and that imposes massive economic losses. According to Okun's Law (named after the economist Arthur Okun) every one percent increase in unemployment costs about two-and-half percent in lost output. The costs of higher inflation, on the other hand, are hard to measure.

5. Full employment helps those at the bottom. American society is economically divided, and that divide has gotten bigger over the last 25 years. A strong economy with low unemployment is the *sine qua non* for remedying this condition. U.S. labor markets work on a "Last In, First Out" basis. The last onto the ladder of prosperity are also the first off when labor markets weaken. This is vividly illustrated by data from the last recession. In March 1990 the white unemployment rate was 4.5 percent; it rose to 6.9 percent in June 1992. By contrast, black unemployment rose from 10.9 percent in March 1990 to 14.6 percent in June 1992. Hispanic unemployment rose from 7.4 percent to 12.1 percent, an even larger jump. By this April, unemployment rates for African

American and Hispanic workers were the lowest on record, having fallen to 7.2 percent for black workers, and 5.4 percent for Hispanic workers. These conditions have been an enormous boon to our society, putting a brake on the relentless increase in income inequality, and contributing to reduced welfare rolls, reduced child poverty rates, and reduced crime. The strong economy has served as the most cost-effective social program imaginable. This provides a double-barreled justification for aggressive pursuit of full employment.

6. Inflation isn't sudden. The theory of the natural rate has the Fed believing that if unemployment is pushed too low, the result will be a sudden and substantial increase in inflation, hence the Fed's tendency to think in terms of pre-emptive strikes against inflation. Yet there is absolutely no evidence that the inflation process works in this way. Instead, inflation increases gradually, and it can be tamped back down by raising interest rates once it has become evident. The lesson is that monetary policy should be conducted on the basis of firm evidence about inflation rather than fear that inflation is always around the corner.

7. The Fed should not overreact to oil prices. Over the last 12 months there has been a small uptick in consumer price inflation. This uptick has resulted from higher energy prices, itself the result of OPEC getting its act together. After stripping out the volatile food and energy component of the price level, the core rate of inflation remains stable. Indeed, it is lower now than it was through much of the 1990s, when unemployment was higher.

The Fed should not respond to oil-price-induced inflation by raising rates. Oil prices are outside the control of the Fed. Raising interest rates merely stands to compound the problem -- by adding higher unemployment to the problem of higher energy prices. Instead, the economic system should be allowed to respond on is own. Higher oil prices will induce increased energy efficiency and a substitution away from oil to other sources of energy, and these measures will reduce oil demand and control prices. Attempting to lower oil prices by causing a generalized economic recession is an instance of the cure being worse than the disease.

Moreover, there is even a case for lowering interest rates if the rise in energy prices is pronounced. An increase in OPEC oil prices is analogous to a tax on American consumers, the only difference being that the tax is paid to OPEC governments rather than to Uncle Sam.

Consequently, aggregate demand can fall since consumers have less income with which to buy domestically produced goods and services. Also, obtaining energy efficiencies requires new investment, and keeping interest rates low is the best way to encourage such investment.

8. The Fed should not overreact to health care costs. A second source of recent inflation has been health care. This is not the result of excess demand. It is the result of the nation's system of health care production and delivery. Raising interest rates does nothing to solve this problem, which is rooted in the supply-side. Instead, higher interest rates may compound the problem by raising unemployment and contributing to more people losing health insurance.

9. Policy-makers should be rational about "irrational exuberance." For the last 20 years the U.S. economy has enjoyed a sustained bull market. In the 1980s the Dow Jones index roughly tripled and in the 1990s it quadrupled. Prompted by a fear that stock prices might be significantly overvalued, Chairman Greenspan mused four years ago about the dangers of "irrational exuberance." At that time the worry was that households and firms might get into risky financial positions. Since then the worries have turned to the "wealth effect," whereby increased wealth leads households to cut back on saving and increase consumption spending, thereby increasing demand and adding to inflationary pressures.

The dangers of financial fragility, excessive speculation, and a stock market crash remain real, and it is appropriate that the Federal Reserve concern itself with such matters. However, raising interest rates may not be the right response. First, it stands to slow the economy and impose the largest costs on ordinary working families who have little to do with speculative excess on Wall Street. Second, raising interest rates after the event risks precipitating the very type of crash that the Fed should be intent on avoiding. This is because higher interest rates make equities less attractive as an investment, and they also raise the cost of servicing debts incurred on the basis of inflated asset values. Instead, the Fed should use policy tools such as margin requirements, which can precisely target speculative buying of equities on credit. Unfortunately, the Fed has failed to do this.

10. A lasso works better than a blunderbuss. Both the expansions of the 1980s and the 1990s reveal the problem of imbalances in different economic sectors arising from speculation in financial markets and property markets. The farm debt crisis of the early 1980s, the stock market crash of October 1987, the New England Property market crash of the early 1990s, and the NASDAQ crash of April of this year all show how property and equity markets are prone to booms and busts. At the moment the only policy instrument the Fed appears willing to use is the blunderbuss of interest rates. But using this weapon to deal with sectoral imbalances threatens to impose huge collateral damage on the rest of the economy. The problem of sectoral imbalances is a recurrent one, and the Fed needs to develop new methods that can lasso specific sectors without roping in the rest of the economy.

In particular, the Fed needs to develop new regulatory arrangements that can influence how credit is allocated in different economic sectors. Financial instability arises when lenders and investors acquire assets without proper regard for risk. By imposing “asset-based reserve requirements” that require risky assets be backed by some cash, and then varying these requirements in accordance with current conditions, the Fed can discourage unduly risky portfolios. It can also discourage credit flows to over-heated sectors.

For the better part of 50 years, the New Deal’s financial supervisory framework ensured that government was able to regulate finance and harness it to public purposes such as full employment and expanded home ownership. However, financial innovation and deregulation have contributed to the breakdown of that kind of regulation. Today Wall Street appears to regulate government instead of the other way around. And rather than seeking to develop a new regulatory framework, the Federal Reserve has thrown in the towel, claiming that it is impossible to regulate complex innovative financial markets. This surrender is an unacceptable abdication of public policy.

The evidence of the last six years compels a need for the Fed to rethink the way it understands the relationship between inflation and unemployment. By keeping its foot off the break through mid-1999, the Fed allowed our economy to expand. The benefits in terms of reduced unemployment, increased productivity, higher wages, and reduced budget deficits have been enormous. But now the Fed has lost its nerve and allowed the failed understandings of old to reassert themselves. The result is we risk putting our prosperity at risk.

On the broader front, the Federal Reserve has been willing to regulate the economy through its control over the blunderbuss of interest rates. But just as it takes a new kind of understanding to come to grips with the inflation - unemployment question, so too does coming to grip with the problem of speculation and instability in financial markets. To borrow a phrase from candidate George W. Bush, we have an opportunity for an era of “prosperity with a purpose.” That purpose should be to emphasize full employment and to let the beneficial effects ripple through each region, each sector, and each economic class.

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