Scapegoating the Natural Rate

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Some commentators and economists have been arguing that an economic doctrine, the natural rate of unemployment, is blocking America's return to abundant jobs, ample pay and rapid growth. Monetary officials at the Federal Reserve, the argument goes, have swallowed the thesis that inflation will sooner or later rise higher and higher if unemployment is driven to a level below its "natural rate."

This myth combines with the Fed's fear of rising inflation to produce an overly tight monetary policy that holds down output, employment and long-term economic growth, the critics of natural-rate theory argue. A true understanding of unemployment and inflation, they say, shows that much higher employment can easily occur without a threat of accelerating inflation. The Fed should therefore reject natural-rate theory and ease up on interest rates.

Stronger Than Ever

Having invented a version or two of the natural-rate theory back in 1968, I may be biased. Nonetheless, I find the charges against it wanting. In fact, the evidence for the theory is stronger than ever.

Critics of natural-rate theory cannot help drawing advantage from the fact that many laymen are temperamentally opposed to it. Consider: Natural-rate theory states that, barring unforeseeable shocks or erroneous expectations, the unemployment rate is pulled down if it is temporarily above the natural rate, and pushed up if it's below. To laymen the notion of such a self-correcting equilibrium sounds ridiculously deterministic. But they might also recoil at the idea of a supply and demand equilibrium for the output of trucks--a basic concept of economics. And they may have missed that structural shocks in the economy shift the equilibrium level.

It is when they come to the doctrine's central thesis, however, that the critics go in for the kill. They say it is fantasy to believe that if easier money drove unemployment below some critical level (the theorists' natural rate), that would cause inflation to rise without limit. Data from the years since 1968, they say, refute this thesis. Let us weigh their arguments.

The critics point out that inflation never gets very high except in response to exceptional events, like wars or oil shocks. But this suggests only that policy makers jump to contain inflation when there is no outside force to blame for it.

The critics observe that unemployment is currently far below expert estimates of the natural rate made two years ago, and yet the inflation rate has not increased. They conclude that there is no natural rate--thus ignoring the possibility that the experts missed some recent data. But this rejection of the doctrine also rests on a fundamental

misreading. It is a mistake to think of the natural rate as the "nonaccelerating inflation rate of unemployment," as some do. Natural-rate theory says that when unemployment is below the natural level, the tightness in the labor market will cause prices and wages to be reset above expectations. The inflation rate, that is, will exceed the expected inflation rate. But a rise in the inflation rate relative to expectations need not translate into an actual rise of the inflation rate if the expected inflation rate is falling.

It is plausible that the decline of inflation over the early 1990s inspired public confidence that the inflation rate was on its way to zero. Businesses may thus have expected less inflation in 1994 than they expected in 1993, and less in 1995 than they expected in 1994. So the fact that the rate of inflation in consumer prices did not pick up and actually fell a little in 1994 and 1995 leaves open the possibility that the inflation rate exceeded expectations and that unemployment was already below its natural rate. The climb of U.S. interest rates in 1996 thus suggests that the honeymoon of falling inflation expectations is over. In that case, if unemployment is indeed below the natural rate, the inflation rate will turn up later this year. Wage inflation has already turned around (see nearby chart).

Some of the critics acknowledge that demand stimulus pushing unemployment below today's natural rate will increase the inflation rate, and ultimately the expected inflation rate too. But, they say, both of these rates will level off. In order to make that claim they argue that increased employment has a transforming effect that lowers the natural unemployment rate until it has reached the actual unemployment rate.

This phenomenon, called hysteresis, received wide attention in the 1980s when the rise of unemployment in European countries was not widely followed by partial recovery, as was seen in the U.S. Europe's slump, it was suggested, pushed up its natural unemployment rate. Olivier Blanchard and Lawrence Summers made the argument that with fewer fellow employees around, workers helped themselves to higher wages, which kept the unemployed from regaining work. Other economists recalled Jacques Rueff's thesis on the 1920s slump in Britain: When fired workers can go on a generous dole, they have less incentive to regain employment than they had to seek employment in the first place. Another explanation is that when an unexpected economic upturn intrudes and some workers are hired, their jobs are protected. But there are problems with this story.

First, America's economy differs significantly from Europe's. Unemployment benefits are limited and run out after six months, jobs are not protected, and most employers can set wages with little fear of worker reprisal. There is an American version of hysteresis: Booms transform unreliable workers into dedicated ones and slumps turn dedicated workers into unmotivated ones. But are the effects of this American hysteresis so large that, if the unemployment rate were cut one percentage point, the inflation rate would level off at some single-digit figure? Economists lack a precise estimate. But most are sure that such a major demand stimulus would mean at least a huge rise in inflation, whether or not it is limitless.

Second, even in Europe the rise in unemployment may be the result of shocks or evolutionary developments, not the inability to recover from recessions. What looks like hysteresis may be nothing more than a gradual rise in the underlying natural rate owing to structural forces.

Finally, the critics suggest that the natural rate theory lacks empirical foundations: It's up in Europe; it was up here, now it's down. But statistical studies have been chipping away at that deficiency in the past few years. We now have a rough idea how taxes, wealth and other factors affect the natural rate.

Good News

What has been embarrassing is that, precisely as this wave of research in the early 1990s was generating natural-rate estimates around 6.4%, based mainly on the record of the three prior decades, the natural rate apparently was falling, and fast. One cause was demographic. In the 1970s the U.S. labor force exploded by 29% and in the 1980s by another 16%, while job creation owing to nonmonetary factors did not keep up. The result was that the natural rate rose. In the 1990s the labor force has been growing at the equivalent of only 12% per decade, which has helped the natural rate to subside to a more normal range.

Wealth and education have also played roles. The earlier surge of the natural rate followed the continuing rise of wealth after the rise in the median wage came to a halt in the mid-1970s. For years this factor overcame the salutary effect on the natural rate of the past several decades' advances in educational attainment. Now that the wealth factor has done its worst, the influence of education is being felt.

The critics of low pay, urban idleness and slow growth have misdirected their fire in attacking natural-rate doctrine. The debate we need is over fiscal initiatives to shift down the natural rate, pull up low pay and spur productivity.

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