THE WALL STREET JOURNAL.

THE FED'S BIGGEST DILEMMA: IS THE BOOMING JOB MARKET A PROBLEM?

Jerome Powell, the chairman of the Federal Reserve, has to figure out whether inflation is around the corner. The wrong choice could cripple the economy.

By Nick Timiraos
June 11, 2018

No question looms larger for Federal Reserve Chairman Jerome Powell than this: How low can the U.S. unemployment rate safely go?

Only twice in the past half-century has unemployment fallen to its current rate of 3.8 percent–for a few years in the late 1960s and for one month in 2000.

The '60s episode spurred years of soaring inflation that would take a decade for policy makers to corral. The latter coincided with a technology bubble that, when it burst, caused the 2001 recession.

The Fed is likely to announce Wednesday it is raising its benchmark short-term interest rate to a range between 1.75 percent and 2 percent, the latest in a series of increases aimed at avoiding such outcomes by keeping the economy on an even keel.

Then, Mr. Powell will have to answer the unemployment question. His response will determine how high and fast interest rates will rise.

That call could define his four-year term as the Fed's new leader–the first in more than 30 years who isn't an economist. It will shape whether millions left behind in this expansion will get a chance to join in; whether inflation–stamped out and buried over the past quarter-century–makes an unexpected comeback; or whether financial bubbles, which crippled the economy twice in the past 20 years, return.

It will also test Mr. Powell's ability to guide the economy through a patch when historic models don't seem to apply.

Mr. Powell, a lawyer and financier, is no stranger to the Fed. He joined its board of governors in 2012 and managed unglamorous operational issues: payment-processing systems, the revamp of a major interbank lending rate and relations with the system's 12 regional banks as the board's primary go-between.

In his first months as chairman, he has cleared his desk. Monetary policy and taking measure of the economy now consume his time and energy, according to interviews with Fed officials.

He and other Fed officials have been studying the low unemployment episode of the 1960s for clues, poring over simulations to understand what might happen if unemployment keeps falling and debating whether traditional models for joblessness and inflation still work. The

Fed has long operated under the framework that if joblessness falls too low, rising labor costs dominate and lead to higher inflation.

Mr. Powell secured two monetary policy experts as top lieutenants. With his extensive input, the White House nominated Columbia University's Richard Clarida to become the Fed's vice chairman.

The White House had interviewed for the job another favorite of Mr. Powell's, San Francisco Fed President John Williams. After the administration passed on Mr. Williams for vice chairman, Mr. Powell played a behind-the-scenes role engineering his selection as the next leader of the New York Fed, considered one of the most important jobs in the Fed system, according to people familiar with the process.

As a Fed governor, Mr. Powell sometimes chafed at the central bank's academic bureaucracy. It generates world-class analysis but sometimes grinds such a fine point that weeks could go by before he would receive an elaborate presentation delivering the answer to a question.

As chairman, Mr. Powell prefers more informal, direct and immediate interaction with the Fed's staff of Ph.D. economists. He frequently arrives for work at 6:15 a.m. and peppers them with questions via email at all hours, according to people familiar with the matter.

The Fed is closer than it has been in at least a decade to achieving both of its congressional mandates–to maximize employment and maintain low, stable inflation. Officials seek 2 percent annual inflation because they view that as consistent with an economy with healthy demand for goods and services.

The employment debate is taking on more urgency because joblessness is expected to keep falling due to a burst of economic stimulus from recent tax cuts and government spending increases.

If hiring and workforce participation trends since January continue, unemployment would reach as low as 3.3 percent by December, way below Fed officials' estimates of the level that is sustainable over the long run.

Among the questions preoccupying Mr. Powell: Could a tighter labor market bring in people not already in the job market and raise workforce participation rates? If that happens, the economy will be in a position to draw on those unused resources and keep growing without overheating. That would allow the Fed to raise rates more slowly than it otherwise would.

If there aren't people outside of the labor market ready to enter, the Fed could raise rates more aggressively. Higher inflation requires tighter credit to keep price pressures in check.

The wrong choice could trigger a recession. For now, the Fed is on a course to gradually raise interest rates, and Mr. Powell has signaled continuity with the approach of Janet Yellen, his predecessor. But economists who worked with both Fed leaders said differences in their backgrounds could ultimately lead the current chairman, who uses the nickname Jay, to steer a slightly different course.

"Yellen had 30 years of background in macroeconomic modeling," said Alan Detmeister, an economist at UBS Securities who used to lead the prices and wages section of the Fed. She was convinced that low unemployment rates eventually will lead to higher inflation, he noted, though she resisted a rigid interpretation of the rule in recent years.

"Jay is more willing to look at alternative formulations since he doesn't come with a huge amount of baggage," he said.

The risk of economic overheating was a central topic of discussion last month at a gathering of central bankers at the Bank for International Settlements in Basel, Switzerland, which Mr. Powell and current New York Fed President William Dudley attended.

Key to the Fed's considerations is an economic concept developed in the late 1960s by Milton Friedman known as the natural rate of unemployment. Some economists believe this level balances the supply and demand for labor, and that below it, inflation accelerates–driven by employers paying higher wages to attract workers.

Fed officials' estimates of the natural rate have dropped in recent years as unemployment fell faster than they predicted. Their estimate tumbled from 5.1 percent three years ago to 4.7 percent last year to 4.5 percent in March. By this measure, unemployment is already below safe levels.

Under Ms. Yellen, the Fed held off on multiple rate increases in 2015 and 2016, when the unemployment rate was reaching some officials' estimates of the natural rate. It raised rates just once each year.

"I, frankly, think the committee has done the right thing in doing that, because you do have a recovery of participation," Mr. Powell said in response to questions after a New York speech in February 2017, referring to gains in the share of adults holding or seeking jobs from post-recession lows. "That wasn't at all clear three or four years ago. People were saying…those people aren't coming back."

Officials now seem less sure that low interest rates will keep boosting workforce participation, which has returned to prerecession levels, adjusting for the aging population.

Mr. Powell has said the natural rate of unemployment could be anywhere from 3.5 percent to 5 percent.

The uncertainty reflected in these estimates isn't new, said former Fed Vice Chairman Alan Blinder. "What's new is how very low the unemployment rate is compared to what we thought the natural rate was not very long ago," he said.

Estimates of the natural rate are particularly important to the Fed because economists have long held that inflation rises as unemployment moves down, and vice versa. This so-called Phillips curve, named for the New Zealand economist, A.W. Phillips, who first advanced the framework in 1958, is controversial within the economics profession but remains popular within the Fed.

Fed officials "are tightening on a theory, and that theory is the Phillips curve," said Vincent Reinhart, chief economist of Standish Mellon and former director of the Fed's monetary policy division.

Complicating matters for the Fed, the Phillips curve has been flat for the past 20 years, meaning big swings in unemployment haven't significantly affected U.S. inflation.

Conservatives including President Donald Trump's top economic adviser, Lawrence Kudlow, have dismissed the Phillips curve. They say inflation accelerates not because of hiring booms but due to excess money creation by the Fed.

A few Fed officials have grown skeptical of the central bank's devotion to the Phillips curve for other reasons. They hesitate to rely on a model that would have called for more aggressive interest-rate rises in 2015 and 2016, because the jobless rate implied inflation would soon heat up. In fact, millions of Americans found jobs and inflation remained low.

"We are too focused on the unemployment-rate number," Minneapolis Fed President Neel Kashkari said in an April interview. He calls it a "broken gauge" that doesn't capture extra labor-market slack.

This group argues that if inflation is the worry, the Fed should wait until it sees it moving higher before raising interest rates much, if at all. This would upend the Fed's practice of adjusting rates based on economic forecasts, because monetary policy works with long time lags.

The "traditional and well-founded preference for acting pre-emptively on a forecast is very much called into question" by the feeble response of inflation to declining unemployment, said Mr. Blinder.

A second group of officials rejects this thinking. They say unemployment is well below a sustainable level. They worry it is just a matter of time before imbalances emerge – either excess inflation or financial bubbles – and if they wait until then, they will have to raise rates aggressively, causing a recession.

"When we overshoot by too far, something becomes unsustainable – wages and prices, or assets," said Boston Fed President Eric Rosengren in an interview last month. When the Fed has to play catch-up, unemployment rises "not by tenths of a percentage point, but by percentage points. It's very, very costly."

Mr. Rosengren is an example of how the ground is shifting under Mr. Powell's feet; for most of the expansion Mr. Rosengren was among the Fed's strongest advocates of easy money policies. Now he favors higher rates.

A paper last year by former Fed staffers underscores his worries. Looking at city-level data, economists found inflation picked up more quickly once the jobless rate fell below 3.75 percent. One of the researchers, UBS's Mr. Detmeister, said the paper argues for maintaining the Fed's current approach of raising interest rates with the goal of anticipating where the economy will be 12-to-24 months ahead. The findings were shared broadly within the Fed, including with Mr. Powell.

Many Fed officials, including Mr. Powell, appear to sit somewhere between these two camps. They aren't ready to dismiss the traditional models. But they also say globalization, technology and demographic changes mean a low-unemployment economy may not face the same price pressures as it did in the 1960s.

Today's economy has more college-educated workers than in the past, which depresses the natural rate of unemployment because they have lower unemployment rates than others.

Fed officials are also hesitant to draw too many lessons from the low-unemployment episode from the late 1960s because people now expect inflation to remain stable.

In the 1960s and 1970s, if inflation went up one year, consumers expected it to rise by at least as much the following year. Officials believe such expectations can be self-fulfilling as workers demand pay increases and businesses raise prices in anticipation.

But in the early 1980s, the Fed ratcheted interest rates up into the double-digits, slowing inflation dramatically by pushing the economy into a severe recession. It demonstrated the central bank's commitment to keep prices in check, and the approach has held since then.

Fed research published in 2016 used the 1960s experience to measure the point where inflation pressures begin to harm the economy, including by leading expectations of higher prices to become self-reinforcing as they did in the 1970s. The research, which was presented to Mr. Powell, concluded this happens when inflation rises by 3 percent on a sustained basis, using the Fed's preferred gauge and excluding volatile food and energy categories. Using this gauge, inflation is currently rising 1.8 percent.

Given the anchoring of inflation expectations, Mr. Kashkari said it is no surprise that inflation is unresponsive to low unemployment today. "The more credibility we have with the market and with employees and employers, the less responsive they are going to be to minor changes in the economy," he said.

In the late 1960s, when inflation began to accelerate just months after the unemployment rate dropped below 4 percent, the Fed cut interest rates, partly due to political pressure.

"Nobody on this committee will allow that to happen," said Mr. Kashkari. "I just don't see any echoes of that today."