

The Economist explains

How low can unemployment go?

The idea of jobs for all is a chimera

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by H.C.

THE Federal Reserve, America's central bank, is tasked by Congress with seeking full employment. But its policymakers do not wage all-out war on joblessness. Instead, they ask themselves: how low can unemployment fall sustainably? Four times a year monetary policymakers write down where they think unemployment will settle over the long term—a number that they see as beyond their control. Where does the idea of a “natural” rate of unemployment come from?



There are several reasons why unemployment cannot be eradicated fully. It takes time for people to move from one job to another. This is said to cause “frictional” unemployment. If people cannot find jobs because they have outdated skills—think weavers, after the invention of the loom—they might become “structurally” unemployed. Trade unions might keep wages too high to employ all workers in an industry. Equally, employers might use their buying power in the job market to keep wages low and jobs scarce.

Monetary policy does not affect how efficiently workers can be matched to jobs, or the level of unionisation. The only tool central bankers have to fight unemployment is to increase the level of spending in the economy, which can induce firms to expand and take on more workers. This is easy enough after a recession, when there are plenty of jobseekers around. But in more normal times, when unemployment reflects frictional and structural factors, firms must pay higher wages to attract more staff. That means charging higher prices, too. If most firms raise prices, the ensuing inflation will erode the purchasing power of the pay rises that brought unemployment down to begin with. The natural rate of unemployment will eventually reassert itself. All central bankers will have achieved is a nasty rise in inflation—which, if it raises expectations of further inflation, might be tricky to undo.

How does the theory apply to today's world? The only way economists can estimate the natural rate is by watching how inflation and unemployment move in reality. American unemployment is only 4.4%, yet inflation is strangely low. This has caused Fed policymakers to cut their estimates of the natural rate of unemployment in recent years. Some argue that the wrong data are being used, because the unemployment rate excludes those who have stopped looking for work. Others say that inflation expectations are stuck too low. Sceptics have even begun to doubt the existence of the natural rate. But this requires a belief in one of two things. Either central banks cannot influence the rate of unemployment, even in the short term, or they can peg unemployment as low as they like—zero, even—without sparking inflation. Neither claim is credible. The natural rate of unemployment surely exists. Whether it is knowable is another matter.

Read the full brief on [the natural rate of unemployment](#)