Should central banks target employment?

By Kemal Derviş
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On December 12, US Federal Reserve Chairman Ben Bernanke announced that the Fed will keep interest rates at close to zero until the unemployment rate falls to 6.5%, provided inflation expectations remain subdued. While the Fed's governing statutes, unlike those of the European Central Bank, explicitly include a mandate to support employment, the announcement marked the first time that the Fed tied its interest-rate policy to a numerical employment target. It is a welcome breakthrough, and one that should be emulated by others – not least the ECB.

Central banks' statutes differ in terms of the objectives that they set for monetary policy. All include price stability. Many add a reference to general economic conditions, including growth and employment or financial stability. Some give the central bank the authority to set an inflation target unilaterally; others stipulate coordination with the government in setting the target.

There is no recent example, however, of a major central bank setting a numerical employment target. This should change, as the size of the employment challenge facing the advanced economies becomes more apparent. Weak labor markets, low inflation, and debt overhang suggest that a fundamental re-ordering of priorities is in order. In Japan, Shinzo Abe, the incoming prime minister, is signaling the same set of concerns, although he seems to be proposing a "minimum" inflation target for the Bank of Japan, rather than a link to growth or employment.

The spread of global value-chains that integrate hundreds of millions of developing-country workers into the global economy, as well as new labor-saving technologies, imply little chance of cost-push wage inflation. Likewise, the market for long-term bonds indicates extremely low inflation expectations (of course, interest rates are higher in cases of perceived sovereign default or re-denomination risk, such as in Southern Europe, but that has nothing to do with inflation). Moreover, the deleveraging underway since the 2008 financial implosion could be easier if inflation were moderately higher for a few years, a debate the International Monetary Fund encouraged a year ago.

Together with these considerations, policymakers should take into account the tremendous human and economic costs of high unemployment, ranging from the millions of shattered lives, skills erosion, and disappearance of opportunities for an entire generation, to the dead-weight loss of idle human resources. Is the failure to ensure that millions of young people acquire the skills required to participate in the economy not as great a liability for a society as a large stock of public debt?

Nowhere is this reordering of priorities more needed than in the eurozone. Yet, strangely, it is the Fed, not the ECB, that has set an unemployment target. The US unemployment rate has declined to around 7.7% and the current-account deficit is close to $500 billion, while eurozone unemployment is at a record high, near 12%, and the current account shows a surplus approaching $100 billion.

If the ECB's inflation target were 3%, rather than close to but below 2%, and Germany, with the world's largest current-account surplus, encouraged 6% wage growth and tolerated 4% inflation – implying modest real-wage growth in excess of expected productivity gains – the eurozone adjustment process would become less politically and economically costly. Indeed, the policy calculus in Northern Europe greatly underestimates the economic losses due to the disruptions imposed on the South by excessive austerity and wage deflation. The resulting high levels of youth unemployment, health problems, and idle production capacity also all have a substantial impact on demand for imports from the North.

Contrary to conventional wisdom, the ECB's legal mandate would allow such a re-ordering of priorities, as, with reference to the ECB, the Treaty on the Functioning of the European Union states that "The *primary* (emphasis added) objective of the European System of Central Banks…shall be to maintain price stability," and there is another part of the Treaty dealing with general eurozone economic policies that emphasizes employment. This would seem not to preclude a temporary complementary employment objective for the ECB at a time of exceptional challenge.

Moreover, the ECB has the authority to set the eurozone-wide inflation target, and could set it higher for two or three years, without any treaty violation. The real problem is the current political attitude in Germany. Somehow, the memory of hyperinflation in the early 1920's seems scarier than that of massive unemployment in the early 1930's, although it was the latter that fueled the rise of Nazism. Maybe the upcoming German elections will allow progressive forces to clarify what is at stake for Germany and Europe – indeed, the entire world.

In a more global context, none of this is to dismiss the longer-term dangers of inflation. In most countries, at most times, inflation should be kept very low – and central banks should anchor inflation expectations with a stable long-term target, although the alternative of targeting nominal GDP deserves to be discussed.

Moreover, monetary policy cannot be a long-term substitute for structural reforms and sustainable budgets. Long periods of zero real interest rates carry the danger of asset bubbles, misallocation of resources, and unintended effects on income inequality, as recent history – not least in the US and Japan – demonstrates.

For the coming 2-3 years, however, particularly in Europe, the need for deleveraging, the costs of widespread joblessness, and the risk of social collapse make the kind of temporary unemployment target announced by the Fed highly desirable.

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