Inflation? Bring it on. Workers could actually benefit

By Isabel V. Sawhill
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After many years of slow growth, the economy is now humming along at a healthy pace. The unemployment rate is at 4.1 percent, its lowest level since 2000, and wages are edging up.

But, as is too often the case when workers finally start to see some of the benefits of growth, economists are warning that higher wages will lead to inflation, and they're calling for the Federal Reserve Board to hit the brakes by raising interest rates.

What if we tried an experiment and waited until inflation actually began to rise substantially before raising interest rates too quickly? Even if prices did rise, my hypothesis is that the benefits, especially for those who haven't gained from economic growth in recent years, would exceed the costs of higher inflation. The only way to know this for sure is to allow labor markets to tighten until the pressure is just too much.

Granted, there are some risks to doing this. Economics textbooks tell us that when the unemployment rate falls below standard measures of full employment (4.7 percent, according to the Congressional Budget Office) the "wage-price spiral" starts to take effect: Companies start paying more to find scarce workers, those higher wages necessitate higher prices and inflation soon becomes a nasty problem.

But recent experience has shown us that the economy can operate at low levels of unemployment — even lower than "full employment" — without inflation becoming a serious problem. Inflation, according to the Fed's preferred measure, has mostly remained well below its target of 2 percent since 2008.

It's not exactly clear why prices haven't risen very much. It may be because greater international competition keeps prices down; because the decline of union contracts means that fewer companies give automatic cost-of-living adjustments; because consumers can compare prices so easily on the internet; because oil prices have fallen recently; or simply because, after years of low inflation, people expect price increases to be limited.

Even if inflation does creep up above 2 percent, we shouldn't be too worried. The Fed's inflation target is not a ceiling; it's a desirable average. Having operated below it for many years, the economy may not be harmed if it runs for a few years above that target.

In fact, a high-pressure economy, with wages and prices a little higher than we've become used to, might actually do a lot of good for the people who need it most. Working families need a tight labor market — and higher wages — to get ahead. It would be a costly mistake to raise rates too much or too soon.

We are in the midst of a big fiscal and monetary experiment. And as with any experiment, the consequences are unknown. What we do know is that the costs of the Great Recession were enormous — at least $4 trillion in lost income, or about $30,000 per household, according to my calculations. The biggest losses were experienced by those in the bottom and middle portions of the income distribution who lost jobs and saw much of the equity in their homes destroyed.

They are the ones who stand to gain the most if unemployment continues to fall and wages keep rising. Businesses, desperate for workers, reach deeper into the ranks of those who are still jobless, do more training to get those workers up to speed, and pay higher wages as they compete to hire or retain their work force. Discouraged workers — the millions who've left the labor force — might actually re-enter it, and workers could find their shrinking share of national income rise again.

Besides, economists are not sure when super-low unemployment will set off inflation. The Congressional Budget Office's current estimate for full-employment, 4.7 percent, is down from around 5.7 percent in 2012. And models used by the Fed and the budget office have failed to identify the point at which further total spending growth in the economy will bump up against a ceiling and bring not just a little more inflation but possibly an unsustainable spiral of ever-rising price growth.

It may be that the United States economy's "potential" — estimates for what gross domestic product could be if all of our country's resources, including unemployed labor, were utilized — is much larger than we think. A recent paper by economists at the University of Texas and the University of California, Berkeley, argues that official estimates of potential are too pessimistic.

Moreover, it's possible that letting a high-pressure economy run over a longer period will actually increase that potential by pushing firms to improve productivity and draw more workers into the labor market. The evidence is mixed but can't be dismissed.

Of course, higher growth alone may not be enough to improve the lives of those left behind over the last few years. The recent tax bill's benefits are skewed and temporary, and people do need stronger safety nets and other help to pay for the rising costs of housing, health care and college.

But a stronger economy might help the left behind as much as, if not more than, any of these specific measures. The old models don't seem to be working, and the downside risks of this experiment are limited. Let's run a truly high-pressure economy and see what happens.

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