Learning from 3.7 percent unemployment: It's more than just a number

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Economists like to bury their mistakes. Rather than owning up to them, they tend to rewrite the past and obscure the issues involved. Because most people have little understanding of economics, they often get away with it.

This is a problem, and not just because it allows economists to avoid being held accountable for their errors. It is also a problem because the denial and obfuscation prevent us from learning from the mistakes and therefore make it more likely they will be repeated.

The country saw a great example of this sort of obfuscation around the 10th anniversary of the crash of Wall Street's Lehman Brothers, which is generally regarded as the peak of the financial crisis. The 10th anniversary stories were all about the financial crisis and how it was caused by complex financial instruments that regulators were not able to monitor. In short, history is being written to show that the crisis was a system failure, not the fault of the people guiding economic policy.

In reality, the main factor causing the Great Recession (and the financial crisis) was the collapse of a massive housing bubble that had been driving the economy. Recognizing the bubble and its impact on the economy didn't require great insight, it just required paying attention to widely available government data on house prices, construction and consumption that were released monthly. The problem of the housing bubble is basically that the people at the Federal Reserve Board and other economic policy makers were not doing their jobs.

We see the same rewriting of history around the Federal Reserve Board's policy on unemployment. With its control over interest rates, the Fed cannot necessarily lower the unemployment rate as much as it would like, but it certainly can raise the unemployment rate. When the Fed raises its short-term interest rates it typically leads to higher interest rates on mortgages, car loans, business loans and other forms of credit.

Higher interest rates discourage borrowing, which means less construction, less investment by businesses and governments, and less consumer borrowing for houses, cars and other items. This slows growth, which means fewer jobs and higher unemployment.

While the Fed did try to boost employment by lowering interest rates in the years following the Great Recession, more recently it has been raising interest rates, citing concern that the unemployment rate would become too low and spark inflation. Whether or not this is a realistic concern depends on how low the unemployment rate can go before inflation starts to spiral upward.

While we can't say with certainty how low unemployment can go before inflation becomes a problem, we do know that we have been here before. In the early- and mid-1990s, there was near unanimity within the economics profession that the unemployment rate could not get much below 6.0 percent without triggering spiraling inflation. In fact, the Fed under Alan Greenspan raised rates sharply in 1994 precisely because of this concern.

However, in the summer of 1995, with the economy slowing and the unemployment rate already under 6.0 percent, Alan Greenspan decided to lower interest rates to provide a boost to growth. Over the next five years the Fed was content to allow the unemployment rate to fall below 5.0 percent, below 4.5 percent, and eventually to settle at 4.0 percent as a year-round average for 2000. Whatever his

other faults, Greenspan was not an orthodox economist, and therefore was prepared to depart from the consensus in the profession on this issue.

The benefits were enormous with millions more people getting jobs. African Americans, Latinos and other disadvantaged groups disproportionately gained the most in the labor market. Not only did millions get jobs, but tens of millions also suddenly had the bargaining power to get pay increases as a result of the tight labor market.

In addition to the immediate benefits of lower unemployment, there was also a longer-term benefit. Economists had to rewrite the accepted wisdom. The leading economists could use their credentials to impose their 6.0 percent floor to the unemployment rate as long as the unemployment rate was not actually below 6.0 percent. But when reality disagreed, and we had 4.0 percent unemployment and no inflationary spiral, the conventional wisdom had to be adjusted to reality.

We are in the same boat today. Just a few years ago, the vast majority of economists would have placed the floor to the unemployment rate at 5.0 percent or higher. As we have seen, the unemployment rate fell to 4.0 percent and more recently somewhat lower, with no takeoff of inflation. The Congressional Budget Office (CBO) projects that the unemployment rate will bottom out at 3.3 percent next summer.

If CBO's newest projections prove correct, and there is no spike in inflation, then we will have a new benchmark for how low the unemployment rate can go. This can change the debate on Fed policy for a decade or more.

It is important to realize that when economists declare there is a floor to the unemployment rate, whether it be 6.0 percent, 5.0 percent, or even 3.7 percent, they are just shooting in the dark, even if they have impressive credentials. We benefit enormously by pushing down the unemployment rate as much as we can, as we did in the 1990s and may do again today.

If we don't push the unemployment rate as low as possible, then we are needlessly keeping millions of people out of work as a matter of government policy. That is not the sort of thing the government should be doing.