

Discussion of "The United States Labor Market: Status Quo or A New Normal?" by Edward Lazear and James Spletzer

Discussion by Athanasios Orphanides at the Federal Reserve Bank of Kansas City Economic Symposium on *The Changing Policy Landscape*

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The starting point for the Lazear and Spletzer paper is the observation that the US unemployment rate has risen considerably as a result of the recent recession and remains stubbornly high. They investigate if the increase is structural or cyclical, noting that the answer is important because central banks may be able to reduce cyclical unemployment but not structural unemployment. The authors focus their analysis on various aspects of the US labor market. Quoting their summary, they do not find "any compelling evidence that there have been changes in the structure of the labor markets that are capable of explaining the pattern of persistently high unemployment rates" (p. 33). Thus, they conclude that the increase in unemployment is primarily cyclical in nature.

The policy recommendation that follows, although not stated explicitly in the paper seems clear: Since the persistently unemployment rate is not structural, the central bank should take action to reduce it. And since the unemployment rate increase was not due structural reasons, the central bank should keep taking action until the unemployment rate returns to its pre-recession normal.

In my remarks, I will try to explain why I do not entirely share the reading of the evidence suggested by the authors and provide some words of caution regarding the implied policy conclusion.

The issue under discussion is being hotly debated and there are diverging views on the new normal unemployment rate. The recession has been deep and traumatic. As the authors point out, a number of other papers have already investigated whether the "normal" or "natural" rate of unemployment has risen following the recent recession. For example, some excellent research has been done at the San Francisco Fed and the New York Fed looking with related data. (See e.g. Daly and others, 2012, and Weidner and Williams, 2011.) The results are not always read in identical fashion and the conclusions could be read differently. For example, Daly and others (2012) conclude that "the natural rate of unemployment has risen from its pre-recession level of 5 percent to a value between 5.5 and 6.6 percent, with our preferred estimate at the midpoint of approximately 6 percent" (p. 23).

Let me give you an example of differences in reading the evidence. Consider the Beveridge curve, shown in figure 1, reproducing figure 4 of the paper. The most recent observation, for June 2012, seems quite a bit off the constellation of data that seems to describe a pre-recession Beveridge curve. Has the Beveridge curve shifted? And if so, by how much? For

the June 2012 observation, the deviation is between 2.5 and 3 percentage points, measured in terms of the unemployment rate. If this represents a more or less permanent shift in the Beveridge curve, it would suggest that the new normal unemployment rate is significantly above its pre-recession value, and surely much closer to the current unemployment rate than anyone holding the view that there has not been any structural changes would suggest.

One source for the difference in interpretations has to do with the judgment as to whether a dislocation or shift that is observed in the data is temporary or permanent. Looking at the Beveridge curve, for example, the authors admit that it may suggest a structural shift that would result in an assessment of a new higher normal unemployment rate. But their preferred interpretation seems to be that the deviation seen in recent data merely reflect cyclical dynamics that take longer to work out than in earlier recessions. To me, the key question would be how can one tell? And if one cannot tell, what are the policy conclusions to be drawn?

Fundamentally, today, on September 1, 2012, can we tell whether the 2.5 to 3 percentage point aberration in the June 2012 observation of the Beveridge curve is permanent or not. Can we tell by looking at labor market data alone if there has been a structural change or not? In my view, looking at the labor market is insufficient to provide a good answer.

Importantly, when our objective is to frame monetary policy decisions, prudence would suggest against dismissing the possibility that following the recession we may be facing a much higher normal unemployment rate.

This brings me to another point I consider to be of primary importance in framing the issue. After my first reading of the paper I was struck by the observation that there is no discussion of inflation developments in assessing whether the economy has moved to a new normal rate of unemployment or not. The word "inflation" is not mentioned in the body of the paper. It only appears in footnote 6, to note that if the cause of unemployment were nominal wage stickiness, monetary policy could undo some of the harm through inflation. I am no longer a central banker, but perhaps my reflexes instinctively kicked in and this left me rather uneasy as an economist.

The natural rate of unemployment, whatever it may be at any point in time, must be the rate such that if the actual unemployment is equal to it then price stability is achieved. In my mind, this is perhaps the most important monetary policy lesson we have learned over the past half century. Milton Friedman's presidential address on December 29, 1967 is much more than a key reference in the history of thought (Friedman, 1968). It is surprisingly current in its policy warnings and prescriptions on this issue.

The notion that full employment and potential output must be understood as consistent with price stability cuts across the monetarist/Keynesian and related divides. Recall that before Friedman, in 1961, Arthur Okun who was one of the key Keynesian policymakers of

the 1960s had been explicit about this in his seminal work on estimating potential GNP, the first such attempt with quarterly data in the United States, and the cause for much praise and grief since then (Okun, 1962).

Figure 2, plots together the inflation rate (using core CPI) and the unemployment rate since World War II to give some perspective from this angle. First look at the past few years. Judging from the recent performance of inflation, despite the unemployment rate being so high, it could be argued that the actual unemployment rate may not have been as far from its natural rate in the recent past as some suggest. If it had been, one should have expected to see this in recent developments of inflation. A deceleration of inflation or even deflation should have been expected if the unemployment gap were very large, as long as the Phillips curve has some slope. This is not observed.

Yesterday, Chairman Bernanke reminded us that following every previous U.S. recession since World War II, the unemployment rate has returned close to its pre-recession level. This is a fact. But is it a fact that suggests recessions do not generally change the natural rate of unemployment, or is it evidence that policymakers have tended to take action to push the unemployment rate to its pre-recession normal, and if so, has that always been a happy experience?

I would argue the latter. Recall the experience observed twice in the 1970s, first following the recession of the 1970 and then again following the recession in the mid 1970s. Observe the path for inflation and unemployment in these two episodes. It is true that on both occasions policymakers pushed the unemployment rate following the recession close to its pre-recession levels. But, as it turned out, at a huge cost. On both occasions, doing so was followed by increasing inflation, indeed the two episodes that defined the whole decade as the era of the Great Inflation. Not a happy experience.

Observing subsequent inflation, it became clear many years after the fact that policymakers had overdone it. The mistake was to be guided by what was believed to be the natural rate of unemployment at the time, that proved severely underestimated in retrospect. The problem is that we can never tell in real time if there has been or has not been a structural change.

Seeing little evidence of structural change in real time is par for the course. It does not mean that there has not been substantial structural change. Only after observing the subsequent behavior of inflation can we tell whether and how much structural change may have occurred in the past. Consequently, real-time assessments of the natural rate of unemployment can differ substantially from the view formed with the benefit of hindsight.

Figure 3 presents one summary view of how large the differences between real-time and retrospective perceptions of the natural rate can be. This updates joint work with John Williams (Orphanides and Williams, 2005). The real-time line plots CBO estimates as

published early in each year for that year since the CBO started operating, complemented for the 1960s and until the mid 1970s from CEA and related estimates. The 2012 line is the historical series from this January's CBO Budget Outlook. As can be seen, differences can be large and persistent. Judging from the historical experience, should a revision to the tune of 2 percentage points in the estimate of the natural rate for, say 2010, be ruled out? I think not.

The figure can also explain policy mistakes of the 1970s. Based on real-time estimates it seemed sensible for policymakers in, say, 1970 to keep pushing the unemployment rate further down, much below what the CBO now tells us the natural rate was at that time. A huge mistake. Years after the fact, Herbert Stein stated that believing the natural rate of unemployment was 4 percent was the biggest mistake of the Nixon CEA at that time (Stein 1996).

In the aftermath of the recent recession, thinking about the natural rate has been evolving and surveys can give us some hints regarding this evolution. Figure 4 summarizes graphically some of these evolving views. It includes the consensus long-term forecast of the unemployment rate as collected twice a year in the Bluechip Economic Indicators survey and the median estimate of the NAIRU, collected once a year in the Survey of Professional Forecasters. The figure also superimposes the CBO estimates and the upper and lower bound of the central tendency of the FOMC's long-term projection of unemployment. Long-term projections may be interpreted as indicators of changes in the natural rate, though not necessarily equivalent to the concept pertinent at the time the question is answered but many years afterwards. The survey evidence suggests that most private forecasters as well as policymakers accept that there has been structural change regarding the natural rate, where there is disagreement is about the magnitude.

Comparing policymaker projections with the private sector, I would have felt more comfortable if the FOMC projections were higher than the norm of private forecasters than lower or if a better explanation why they may be lower or slower to adjust upwards were available. Thinking about the political economy of maintaining price stability, having policymakers who are more cautious than average on the risk for being overly optimistic serves a useful role similar to having conservative central bankers as in Ken Rogoff's (1985) work.

I end with two comments on the implications of this discussion for monetary policy. First, taking for granted that the goal of the central bank is to aim for both price stability and maximum sustainable employment over time and recognizing the absence of a long-run tradeoff between unemployment and inflation, what should be the primary focus of the central bank? The central bank can aim to achieve the natural rate of unemployment, and if it always succeeds that should also preserve price stability. But if it miscalculates, and chases the wrong natural rate, disaster will follow on the price front. Alternatively, it can aim to achieve price stability. Since the measurement of price is subject to considerably less

uncertainty, this is much easier to achieve. And if the central bank succeeds in achieving and maintaining price stability, it will have also succeeded in maintaining the unemployment rate at its natural rate.

Considering the likely sources of error and their consequences, it should be clear that focusing on price stability is the more robust policy approach. Using the terminology of the paper, a key lesson from history is that we cannot know the "new normal" unemployment rate with the certainty necessary to use it for policy purposes.

We do not need to know the "new normal" to conduct policy. Focusing on maintaining price stability should be the primary guide, recognizing that by maintaining price stability policy also manages to guide the actual rate of unemployment towards its natural level.

The second comment regards how to make this operational. Optimal control mentality in policy making can tempt policymakers to try to measure and close gaps as a way of conducting policy. Unemployment gaps, output gaps and so on. But is it necessary to think about policy in these terms? The answer is no. A more robust approach is to ignore gaps altogether.

A simple difference rule can serve as a policy guide, as long as we are not at the zero lower bound:

$$\Delta i = \alpha (\pi - \pi^*) + \beta \Delta u,$$

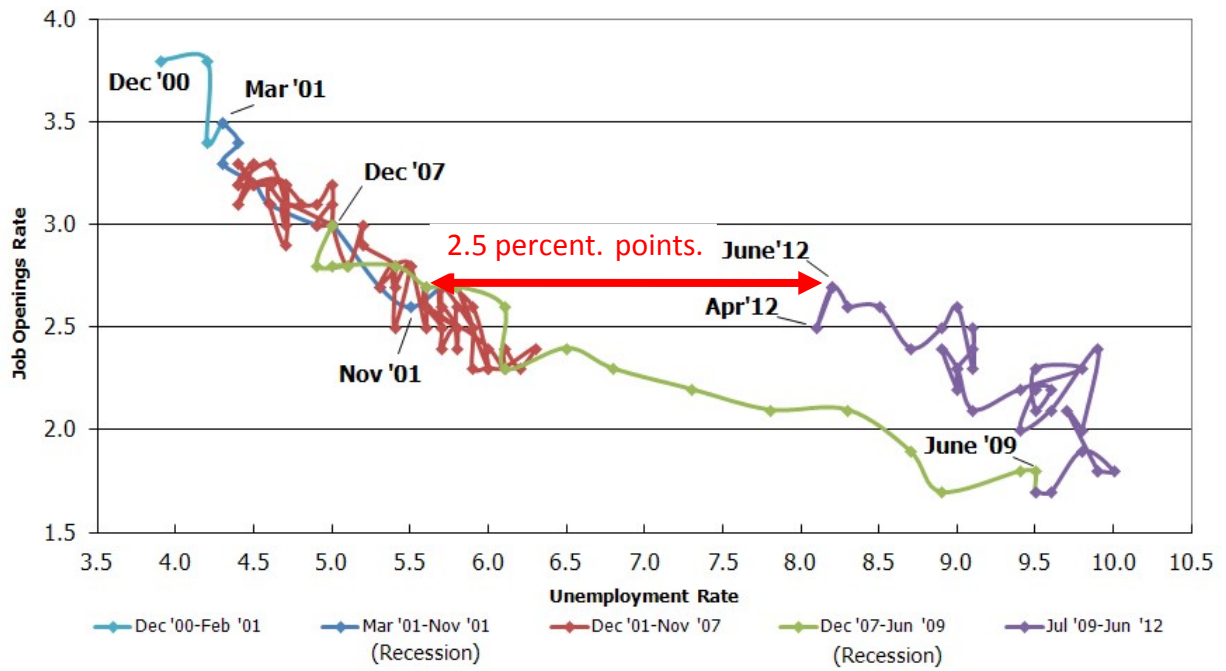
where $\alpha > 0$, $\beta < 0$. The guide would suggest that policy should be tightened or eased by looking at whether the inflation outlook is above or below its target and whether the unemployment rate is falling or increasing. Although no reference is made to the natural rate of unemployment rate, this policy robustly guides the economy to price stability and full employment. (See Orphanides and Williams, 2002, for a pertinent robustness exercise for the US economy and Orphanides and Wieland, 2012, for a related exercise pertaining to the euro area.)

To conclude, history has shown that overemphasizing real targets in formulating monetary policy, be it the current guess of the natural rate of unemployment or the current estimate of the level of potential output can lead to persistent policy errors. Only after observing subsequent inflation developments can we ascertain with any degree of confidence if the US labor market has shifted to a new normal unemployment rate. I am confident that at a Jackson Hole Symposium before the end of this decade we will have managed to work towards a consensus about what the natural rate of unemployment is on September 1, 2012. For now, it is best to admit we don't know and focus on maintaining price stability as a means to guide the unemployment rate towards its natural rate, whatever it may be.

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Figure1: Beveridge Curve



Source: BLS JOLTS, also reproduced as figure 8 in paper

Figure 2: Inflation and Unemployment

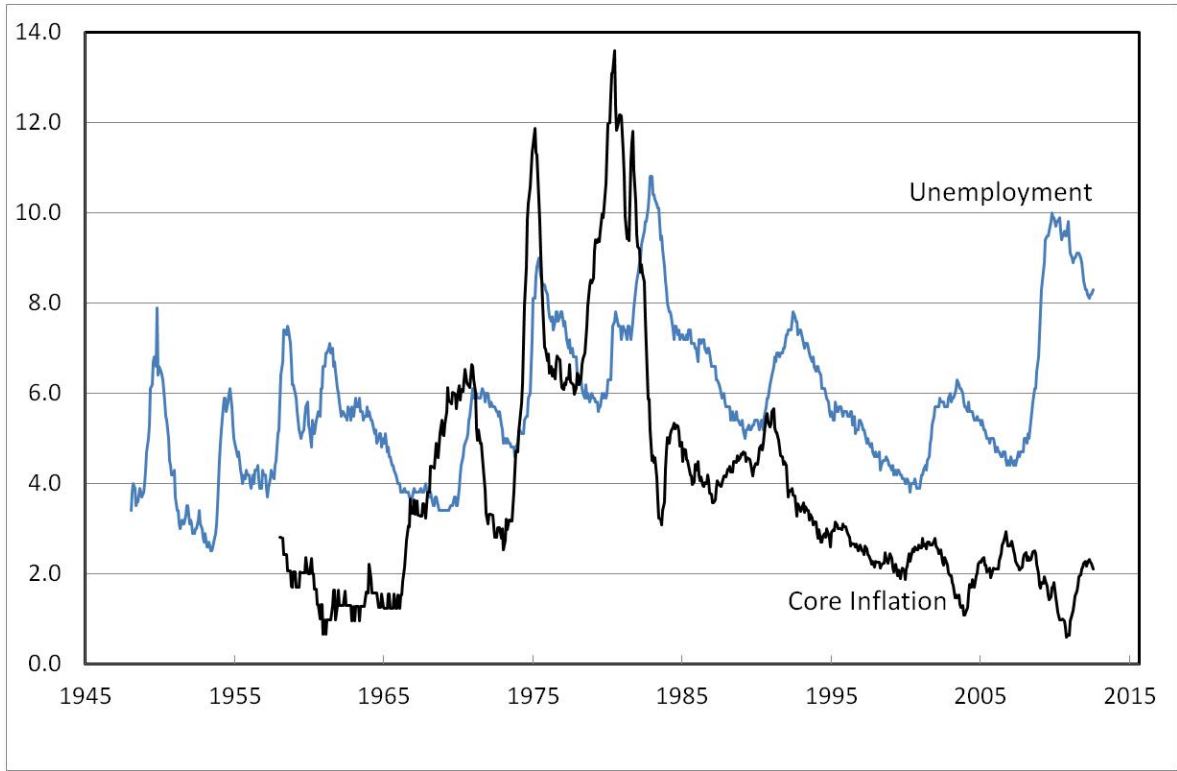


Figure 3: Unemployment and CBO natural rate estimates

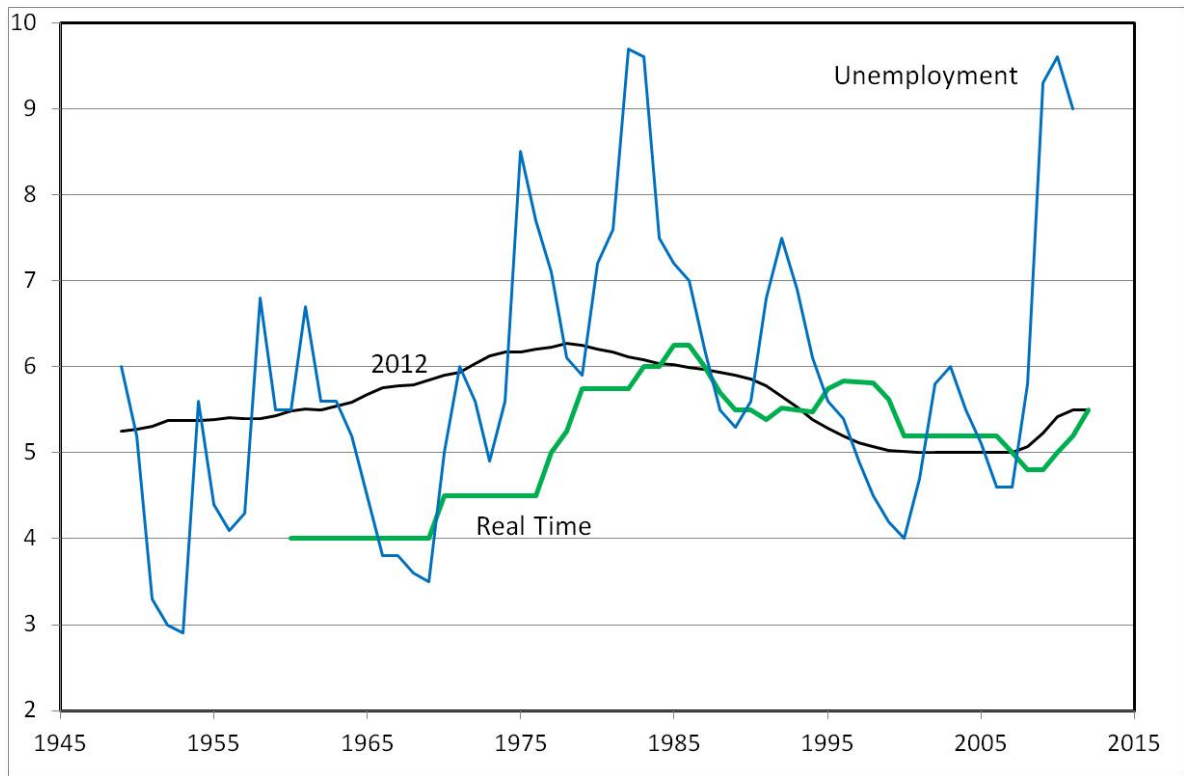


Figure 4: Recent evolution of natural rate estimates

