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Inflation vs. Jobs: Fed’s Move Can Seal Its Fate

By MARK THOMA, The Fiscal Times March 29, 2011

The Federal Reserve announced last week that Chairman Ben Bernanke will begin holding four press conferences a year to “further enhance the clarity and timeliness” of the Fed’s monetary policy communications. But Fed watchers know there is a lot more to this move than simply providing more transparency in policy making.

After several tumultuous years of being second-guessed by Congress, the markets and public for its response to the financial crisis, the Fed is worried about further deterioration in its credibility and, ultimately, loss of its independence and authority.

The Fed has a difficult task ahead of it. Once the economy begins recovering robustly, the Fed must unwind the measures it has taken to stimulate the economy at just the right pace. If it tightens policy too soon, it will slow the recovery of output and labor markets – meaning unemployment will be higher than it needs to be. And if it waits too long to tighten, the result will be inflation. To make things worse, if inflation becomes a problem while unemployment is still high, the Fed will have to decide which problem to fight. The Fed is well aware of these dangers, and its decision to hold press conferences at the conclusion of four of the Fed’s eight rate setting meetings each year gives it the opportunity to explain its policy decisions and hopefully avoid the wrath of Congress and the public.

I wish I could say with a high degree of certainty that what the Fed is most worried about – the factor that could do the most damage to it as an institution – is high and persistent unemployment. Or even that worries about unemployment are on a par with worries about inflation. But inflation is the bigger worry for the Fed.

Why is the Fed more concerned with inflation than employment?

- First, the uptick in core inflation observed in recent data is causing the inflation hawks in Congress and elsewhere to wring their hands with worry. With its damaged credibility, and with Rep. Ron Paul, R-Tex., and other critics waiting to pounce, an outbreak of inflation carries threats to the Fed’s credibility and independence that are not present if employment recovers at a slower than desirable pace. Unfortunately for the unemployed, the main threats to the Fed come from the inflation hawks – largely because of concern about long-term growth.

- Second, the modern macroeconomic models that the Fed uses for guidance have a property known as the Taylor principle. According to this principle, the Fed should respond far more aggressively to inflation than to unemployment.

- Third, if employment is slow to recover, the Fed can blame it on other things – such as structural problems in the economy, the difficulties of recovering from balance sheet recessions, problems in Japan or the Middle East, international competition, technology, and so on. But while short-run bursts of inflation can be blamed on factors such as oil and food prices, it is not as easy to find scapegoats for high and persistent inflation. Thus, while the Fed can potentially deflect criticism over a slow recovery of employment, it will take the blame for persistent inflation problems.

- Fourth, the Fed is determined that it will not monetize the debt and risk inflation even if this means allowing interest rates to rise before employment has fully recovered.

Thus, if the Fed has to make a choice – as it may need to do – it will choose to battle inflation first and foremost. Employment problems will once again take a back seat to worries about inflation.

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One of the reasons the Fed is concerned with inflation is its potential to reduce long-run growth. However, it’s not clear that moderate levels of inflation have this problem. Furthermore, the risks to growth are not one-sided. When unemployment is persistently high because of too much concern about inflation, this can also reduce long-run growth. The longer a person is unemployed, the more likely he or she will become permanently unemployable, or drop out of the labor force altogether. For younger workers there is evidence that a high unemployment rate at the time they accept their first job translates, on average, into lower lifetime income. The first permanent job – and the opportunities that may or may not come with it – is a very important determinant of lifetime earnings.

Many people are worried about the "new normal," in particular whether this will mean higher unemployment rates than we are accustomed to. But the new normal is not completely out of our control. Through a combination of monetary and fiscal policy designed to stimulate employment, build infrastructure, and help with the structural transitions the economy needs to make, we have some control over how the "new normal" will turn out. By taking action now, we can make the long-run unemployment rate lower and the long-run rate of output growth higher.

Fiscal policy is the best tool for this job, but it is constrained by worries over the deficit along with ideological opposition to government intervention. So, even though helping in the short-run would have little impact on our long-run debt problem, it's unlikely that fiscal policy will come to the aid of the unemployed.

That leaves monetary policy. However, worries over inflation are standing in the way of the aggressive action such as a QE 3 that may be needed to prevent an alarmingly slow recovery of employment. I think worries about inflation are overstated, but – unfortunately for the unemployed and for future economic growth – the inflation hawks have the upper hand.