

JARGON ALERT

Full Employment

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Since the 2007-2009 recession ended, unemployment has slowly declined, but most would agree that today's level of 7.6 percent unemployment does not represent the economy's full potential. Full employment is often described as the level of employment at which virtually anyone who wants to work can find employment at the prevailing wage. One might assume that if everyone who wants a job has one, then the unemployment level would be zero. Yet in the last half century, the unemployment rate in the United States has ranged from 2.5 percent to 10.8 percent; it has never been zero. Does that mean we have never had full employment?

Not according to economists. Full employment is not the same as zero unemployment because there are different types of unemployment, and some are unavoidable or even necessary for a functioning labor market. At any given time, jobs are being created and destroyed as industries evolve, and the transition from old jobs to new is not seamless. For example, frictional unemployment occurs because workers who lose their jobs or quit typically do not accept the first new job for which they qualify. Unless they are facing extreme pressure to replace lost income, most people take the time to find a job that fits their skills well. Because of this lag, some percentage of the workforce is between jobs at any given time and classified as unemployed.

Persistent unemployment also arises from mismatch between the supply of workers and the demand for labor at a given wage, which is known as structural unemployment. In a fully flexible market, wages would adjust to the point where the number of people seeking work equaled the number of positions employers were willing to provide at that wage. Wages can be set above this level for a variety of reasons, however, such as minimum wage requirements or because employers choose to set higher wages in order to get better productivity from their workers. As a result, the supply of labor can exceed the demand for it, and structural unemployment arises.

Since some degree of frictional and structural unemployment exists at any given time, economists define full employment as the unemployment level resulting from a combination of these two components, which is always greater than zero. Unemployment can rise above this level due to shocks in the economy, such as the housing market collapse that occurred in 2007-2008. It can also temporarily fall below this level if the economy is operating above its efficient capacity, resulting in rising prices and wages.

In the 1950s, many economists argued that fiscal and monetary policy could steer the economy toward the full employment level. By the end of the decade, policymakers came to believe they could permanently increase full employment in exchange for some inflation. This idea was embodied in the Phillips Curve, which depicted a trade-off between unemployment and inflation. Indeed, in the 1962 *Economic Report of the President*, the Kennedy administration opined, "If we move firmly to reduce the impact of structural unemployment, we will be able to move the unemployment target ... to successively lower rates." While policymakers succeeded initially, inflation and unemployment both rose in the mid-1970s.

Around this time, Milton Friedman and Edmund Phelps modified the ideas behind the Phillips Curve by including a natural rate of unemployment for the economy. Policy

actions to reduce unemployment below that level could succeed in the short run, but in the long run, unemployment would return to the natural rate and inflation would be higher as a result of expansionary policy. This idea was largely a return to the pre-Phillips Curve understanding of full employment as a generally fixed level.

Although the natural full employment level is relatively stable, it can change over time. Changes in the composition of the labor market or structural changes in industries can shift the full employment level. Some economists have argued that changes during the 2007-2009 recession may

have increased the natural rate of unemployment. They point to the fact that job vacancies have increased without the expected decline in unemployment, suggesting a potential mismatch between industry demands and worker skills.

The shifting nature of the natural rate of unemployment makes it difficult to estimate. Since the 1970s, the Fed has steered clear of targeting a specific level of unemployment, choosing instead to target low and stable inflation. In its December 2012 action, the Federal Open Market Committee (FOMC) indicated that it planned to maintain accommodative monetary policy at least until unemployment fell below 6.5 percent, but Chairman Ben Bernanke explained that this rate was not the Fed's estimate of the natural rate of unemployment. Additionally, the FOMC conditioned its accommodative policy on inflation remaining near 2 percent. Reflecting the lessons of the 1970s, Bernanke noted that attempting to target a precise level of full employment risked missing the mark and could "compromise the FOMC's longer-term inflation objective." **EF**

