

Q: What is the full-employment rate/natural rate of unemployment?

by Dr. Larry Allen

The achievement of full-employment ranks as the holy grail of economic policy, an ideal, almost utopian condition in which everybody that wants a job can find one. The concept would be clear if full-employment meant a zero unemployment rate, but that is not the case. Economies in the full bloom of economic prosperity stubbornly register positive and measurable rates of unemployment, and unusually low unemployment rates invariably kindle and quicken inflation. To clarify and illuminate the meaning of full-employment, economists developed the concept of the full-employment rate of unemployment, which is the lowest unemployment rate permanently sustainable without injurious side effects such as inflation.

The difference between the terms "full-employment rate" and the "natural rate of unemployment" matters little to many economists. Economists who believe the economy has no natural, inherent tendency to veer and adjust toward a natural rate of unemployment, favor the term "full-employment rate," denoting the lowest non-inflationary unemployment rate possible with ideal government economic policy.

The concept of the natural rate of unemployment retreats a bit from the idea of a fully employed economy in which everyone wanting a job can find one. The natural rate of unemployment equals the prevailing unemployment rate when wages stand at a level that balances the demand for workers with the supply of workers. Theoretically, free market economies, free from disturbances, particularly unsuspected and unforeseen shocks, enjoy a natural tendency to seek the natural unemployment rate and remain at that rate indefinitely. A fluctuating unemployment rate is actually bobbing up and down from a hidden natural rate of unemployment.

According to one influential theory, actual unemployment rates drop below the natural rate when inflation beguiles workers into believing they are earning more in real wages than they really are. At the natural rate of

unemployment, individuals wanting to work at prevailing wages meet with ample job opportunities. Other potential members of the labor force will be patiently engaged in an uphill struggle wooing jobs at loftier wages, and these individuals push up the unemployment count. A sudden onslaught of inflation or added inflation lifts both wages and prices, and only workers keeping one eye on wages and one eye on prices catch the misclues given by money wages. In practice, many individuals focus on money wages received rather than the myriad of prices that make up the cost of living. Unemployed people proudly holding out for jobs paying above prevailing wages suddenly find and take jobs in pay ranges they want. They are unaware that higher prices have scaled back and disembodied the purchasing power of what used to be premium wages. Therefore, the actual rate of unemployment drops below the natural rate. Unemployment rates inch back up as these workers, irked that their higher money wages were a sham substitute for higher buying power, lose interest in their jobs and quit.

Thus far, economists have not pinpointed the precise unemployment rate that equals the natural unemployment rate. There seems to be more agreement among economists that the natural rate changes over time, probably due to changes in demographics. Between 1975 and 1985, the natural rate likely fell within a range of 5.5 and 6.5 percent. Today, a natural rate between 4.0 and 5.0 percent seems more realistic. The years 1999 and 2000 saw monthly unemployment rates drop to the 4.0 percent range, sliding to 3.7 percent in December 2000. As unemployment rates dropped to 30-year lows, inflation showed signs of re-igniting as crude oil prices began to climb, signaling that 4.0 percent was below the natural rate. No one can say with certainty that the natural rate was above 4.0 percent because inflation never became generalized and persistent. The trend toward lower natural rates of unemployment could continue, enabling the economy to reach lower rates of unemployment in the future. For historical data the natural rate of unemployment might be estimated at a point in time by

averaging all unemployment rates from ten years earlier to ten years later. Estimates of current natural rates are much more fuzzy and inexact.

To understand the concept of a full-employment rate or natural rate of unemployment it helps to understand why the unemployment rate remains at a positive level in the face of economic prosperity and abundant opportunity. Even when job vacancies outnumber job seekers, individuals losing a job find it economically rewarding to make an investment of time in searching for another job. Just as a family in the market to buy a house finds it rewarding to invest time in searching available houses, knowing that an investment of such time gives a chance at a better fit with family needs, members of the labor force have learned they can maximize lifetime incomes and rewards by making an investment of time in collecting information about job opportunities. Even the most economically disadvantaged households can fall back on programs

such as unemployment insurance to sustain a job search in hopes of finding the best job, or at least a job as good as their last job. Job search unemployment is not a symptom of an enfeebled and floundering economy, but it is reduced by programs offered through agencies such as the Texas Workforce Commission that help to match prospective employers with job seekers.

Another factor adding to unemployment at the peak of a zesty prosperity stems from shifting demand patterns as

various goods move in and out of favor with consumers, business, government, and foreign markets. In the 1970s high oil prices created a boom in oil-rich Texas and a depression in northern states with concentrations of industrial facilities devoted to producing spacious, gas-guzzling automobiles. Shifts in growth between individual industries are normal as the economy remolds itself in response to endless changes in taste and technology, changes that are healthy and occur under the most dynamic and prosperous economic conditions. Industry shifts may put a heavy burden on some workers because of age or industry-specific skills, acting to nudge up the unemployment rate.

Even when strong demand stretches the supply of workers drum tight, the labor market will still contain embedded air pockets of high unemployment rates among demographic groups and regions. Southeast Texas currently reports unemployment rates 2-3 percentage points above the national average, and the unemployment rate for teenagers invariably stays two to three times above the overall national average. These unemployment differentials remain even when nationwide unemployment rates fall within the 4.0 to 5.0 percent range.

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