Contact: Mark Primoff
845-758-7749
primoff@bard.edu

FOR IMMEDIATE RELEASE

INFLATION TARGETING COULD HURT LOW-SKILLED WORKERS, WOULD DO LITTLE TO ADDRESS PRICES, NEW LEVY STUDY SAYS

ANNANDALE-ON-HUDSON, N.Y.—Though many countries established formal inflation targets during the 1990s, the United States remains a notable exception, with the Federal Reserve retaining a dual mandate to pursue both price stability and full employment. Last year, Federal Reserve Board Governor Ben Bernanke proposed that the Fed announce its optimal long-run inflation rate (OLIR) as an incremental move toward inflation targeting. A new report from the Levy Economics Institute of Bard College suggests, however, that any move toward inflation targeting could make unemployment more volatile and hurt unskilled workers at the bottom of the labor pool.

In his policy note, *Inflation Targeting and the Natural Rate of Unemployment*, Levy Research Associate Willem Thorbecke maintains that measurements of optimal or natural rates of inflation are not only imprecise and indirect, but that a shift in focus to inflation would inevitably detract from efforts to maintain full employment. "Inflation and deflation are dangers, but not *the* danger," writes Thorbecke. "Unemployment is also a scourge, both for the individuals who are out of work and for society. Recent experience suggests that slack in the labor markets too should be a focus."

Though many economists predicted that low unemployment rates in the 1990s would spark inflation, Thorbecke argues that inflation remained stable because of structural changes in the U.S. economy. He contends that a decrease in the bargaining power of workers, a decrease in the pricing power of firms due to more domestic and foreign competition, and an increase in productivity growth helped prevent a surge in inflation, even when unemployment dipped below 4 percent. "In reality, unemployment fell to 3.8 percent with inflation never reaching 3 percent," he writes.

-continued-

Furthermore, Thorbecke argues that unskilled workers—because they make up the bulk of the unemployed during periods of low unemployment—would be hit hardest by inflation targets. Evidence in recent years, he says, shows that falling unemployment enables low-skilled workers, who can be trained on the job, to improve skills and gain work experience without reducing firms' productivity. "Expansionary monetary policy at low levels of unemployment will largely reduce unemployment among unskilled workers, who have less ability to push for wage increases in excess of productivity growth. Furthermore, even if they did receive such increases it is unclear that firms would be able to pass on these higher labor costs in the form of higher prices," Thorbecke writes.

Thorbecke asserts that the inflationary patterns of the 1960s did not hold true during the 1990s, suggesting strongly that falling unemployment does not necessarily lead to rising inflation and that efforts to create inflation targets are unnecessary and could even cause volatility in unemployment. "Over the last 10 years, core inflation has averaged 2.4 percent and fluctuated between 1.1 and 3.1 percent, and unemployment has averaged 5.1 percent and fluctuated between 3.8 and 6.6 percent," writes Thorbecke, concluding, "rather than switching to a new paradigm for monetary policy based on inflation targeting and the OLIR, it seems appropriate to try to extract and distill lessons from monetary policy making under the current modus operandi."

# # #

Public Policy Note 2004/1, *Inflation Targeting and the Natural Rate of Unemployment*

(3.19.04)