

Isn't pursuing a low and stable inflation rate going to cost the economy jobs?

On the contrary: Low and stable inflation is an essential ingredient for growing jobs. It can help promote maximum employment by eliminating uncertainty about the evolution of monetary policy and by allowing relative prices to act as clear signals to consumers.



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It's true that monetary policy has been highly stimulative for the past couple of years, which could risk creating higher inflation while creating higher employment. At first glance, it might appear that efforts to place more policy focus on low and stable inflation could cost jobs. In fact, many believe that we must have higher inflation to have lower unemployment—this is the premise of the Phillips curve, which shaped economic debate for much of the last part of the 20th century.

When monetary policy attempts to raise employment above a level consistent with stable inflation, however, consumers, businesses, and wage earners eventually catch on and begin to anticipate the inflationary effects of the policy on all prices and wages. Producers of goods discover that they can increase their profit margins by raising prices at the cost of lower levels of output and therefore demand fewer employees. So any tradeoff between inflation and unemployment eventually breaks down, resulting in permanently higher inflation but no lasting gains in employment.

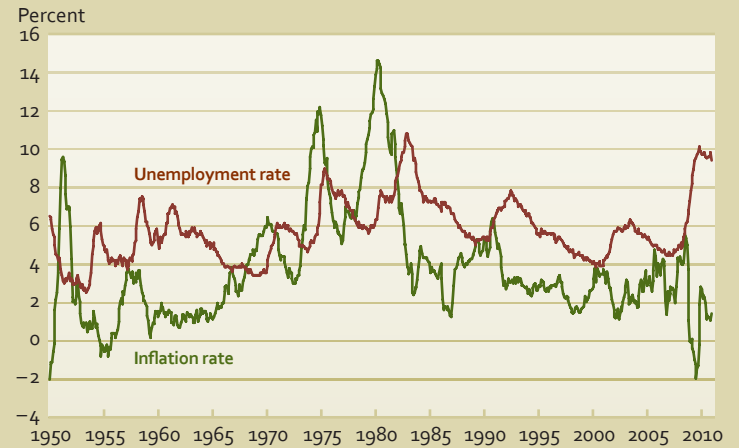
Attempts to maintain a level of unemployment below the economy's full employment rate also create uncertainty about the implications of such a policy for the relative prices of goods and services. Thus, such policies interfere with efficient spending choices by adding noise to price-setting decisions, and hence to the signals consumers need to make their best choices.

The overall correlation between inflation and the unemployment rate since 1950 is weak, but it is nonetheless significant and positive—not negative as a permanent tradeoff would indicate. In other words, the lower the inflation rate, the lower the unemployment rate—contrary to what many economists had once thought to be the case. But the data also suggest that, over short periods, monetary policy can be used to bring employment in line with full employment levels, provided inflation expectations remain stable.

Consider the 1970s: Excessively stimulative monetary policy during this decade persistently failed to account for accelerating inflation and its ultimate effect on inflation expectations. As illustrated in the figure, both inflation and unemployment rose throughout the decade. After this dismal experience, many central banks set numerical objectives for inflation in the neighborhood of 2 percent per year. This objective is broadly accepted as being most consistent with maximum levels of employment; 2 percent is a low enough target level to be credible with the objective of price stability. Such credibility in turn creates an environment in which monetary policymakers can aggressively ease to offset the negative consequences of shocks that threaten economic stability. And, as the figure also shows, since the 1980s, both U.S. inflation and unemployment have trended lower until the 2007–09 recession.

To the extent that the recent policy measures to produce low and stable inflation help speed economic activity and employment to their potential levels, such policies would, if anything, add—not cost—jobs. ■

U.S. Inflation and Unemployment Rates



Note: Inflation rate given as an annualized percent.

Source: U.S. Department of Labor, Bureau of Labor Statistics.



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