December 14, 1999

Study Suggests Jobless Rate Could Fall Below 4% Without Igniting Inflation

By JOHN D. MCKINNON
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON -- A recent study for the Department of Labor shows that states with low unemployment have been experiencing no more wage-inflation pressure so far than those with high unemployment.

A possible implication: The national unemployment rate -- already at 4.1%, a 29-year low -- might safely sink even further without dragging the economy into an inflationary spiral.

The study compared state unemployment rates and wage gains over the period 1995-1998. "We found very little evidence that wage pressures were higher in the very low-unemployment areas than in the above-average-unemployment areas," said Robert I. Lerman, an economist with the Urban Institute in Washington, who conducted the study. "We may well be able to go even below 4%" unemployment at a national level, he said.

Just a few years ago, many economists might have considered such a result impossible. Conventional wisdom held that there was a national level, typically set at 5.5% to 6%, below which unemployment couldn't go without setting off a chain reaction of wage and price increases.

In recent years, however, as unemployment has fallen further and further below assumed safe levels, some economists and policy makers have begun to re-examine the evidence for their position and confront the puzzling reality that some regions have very low unemployment rates compared to the nation as a whole. As of October, 32 states had unemployment levels below 4%. The lowest,
in Iowa, stood at 1.8%.

A few economists have abandoned the idea of a safe floor for unemployment altogether. Many others have retained the idea of a safe floor and simply lowered it.

Some say the safe level "might be as low as 4% or even a touch lower," said Ken Matheny, senior economist at Macroeconomic Advisers in St. Louis. His firm, however, believes the optimum level is 5.5%, which it finds to be "relatively stable" over time, he said. Mr. Matheny also noted that wages alone, on which Mr. Lerman's report focuses, aren't necessarily the best measure of labor costs, and other benefits must also be weighed.

The safe floor also retains its advocates among policy makers. In a Nov. 30 speech, Federal Reserve Governor Laurence Meyer said he now estimates the safe floor to be from 5% to 5.25%.

Speaking after the Fed last raised rates in mid-November, Mr. Meyer added that the time might be approaching for a further rate increase, if unemployment continues to drop. "In my judgment, we are already in a range in which such a normal response to further declines in the unemployment rate is warranted," he said.

But Mr. Lerman says the unemployment rate could drop as low as 3.5% without sparking inflation, provided the change occurs gradually and inflation expectations haven't already built up.

"People were wrong to believe we couldn't go below 5.5% and might be wrong to believe we can't go below 4%," he said. "I realize having some states do it is different from having the whole country do it, but we ought not to feel it's a settled matter that 4% is really the limit."

Write to John McKinnon at john.mckinnon@wsj.com