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Central Bankers' New Gospel: Spur Jobs, Wages and Inflation

By BINYAMIN APPELBAUM AUG. 24, 2014

JACKSON HOLE, Wyo. — The last time the economic policy conference held here every August devoted its agenda to labor markets, it was 1994 and the Federal Reserve's vice chairman scandalized the audience by suggesting central banks worried too much about reducing inflation and not enough about unemployment.

Twenty years later, heresy has become gospel. Leaders of the world's major central banks made clear in speeches at this year's conference, which ended Saturday, that they were focused on raising employment and wages. The pursuit of lower inflation has been replaced by a conviction that inflation is actually too low for the good of the economy.

The Fed's chairwoman, Janet L. Yellen, opened the conference with a patient explanation of the need to maintain low interest rates to support job growth.

Mario Draghi, the president of the European Central Bank, said it was expanding its stimulus campaign, and he called on European governments to do the same.

Haruhiko Kuroda, who leads the Bank of Japan, said it was committed to increasing its own campaign until annual inflation rose to 2 percent.

"Central bankers never used to say things like that," said Alan Blinder, the former Fed vice chairman who was criticized for doing so in 1994, and who now attends the conference as an economist at Princeton University. "Now I think you can go to the most hawkish end of the Fed and whoever you pick as the most hawkish will not say that we just shouldn't pay any attention to unemployment."

Looming over the conference, however, was the reality that central banks had made limited progress toward achieving these new goals. They also face mounting questions about how much more they have the power to do.

The Fed and the Bank of England have achieved slow progress, but both confront growing internal opposition from critics who say monetary policy is

reaching the limits of its ability to improve economic conditions. The European Central Bank and the Bank of Japan have accomplished little, and they must decide how much harder to try.

Dennis P. Lockhart, president of the Federal Reserve Bank of Atlanta, said it was "very challenging" to determine "how much work is left to be done by monetary policy."

But in a reflection of the sea change in central banking, he added that he would rather err on the side of driving down unemployment rather than retreating too soon. (According to commonly held economic theories, pushing unemployment too low normally would cause inflation to rise.)

"I would be concerned about being early or premature and then, for whatever reason — which could be something out of the blue — finding that in fact we have a reversal on our hands," Mr. Lockhart said. "That's more of a concern to me than being maybe a little slow to begin the normalization of interest rates."

Mr. Draghi similarly suggested that something fundamental had changed.

"The risks of doing too little outweigh the risks of doing too much," he said.

It was dogma for a generation that central banks should focus above all on stabilizing inflation, and that doing so would stabilize the economy, too. The impression that this worked was reinforced by a long period of apparent success that a former Fed chairman, Ben S. Bernanke, once called "The Great Moderation."

The crisis and its aftermath, however, suggested that this relationship between inflation and economic stability was just a coincidence. In the cautious formulation of Ben Broadbent, a deputy governor of the Bank of England who addressed the conference on Saturday, "the divine coincidence may no longer apply."

The Fed operates under a congressional mandate to maximize employment as well as minimizing inflation. In practice, it had largely ignored that mandate until employment failed to recover in the aftermath of the crisis. Now Ms. Yellen, like Mr. Bernanke before her, has made job growth the central focus of Fed's stimulus campaign.

Mr. Broadbent said the Bank of England, required by law to focus on inflation, had also concluded that it needed to consider labor markets, too.

"The performance during most of the inflation-targeting period suggests that we could have done better with some other kind of target," he said.

But in focusing on jobs, both banks have found another old truth crumbling

under their feet. The unemployment rate, long taken as the best indicator of the labor market, has proved to be an unreliable gauge in this recovery.

In 2012, the Fed started a drive to push the most common measure of unemployment — which only counts those actively looking for work — below 6.5 percent. Success came more quickly than it expected, but officials concluded that the progress in the unemployment rate overstated the health of the labor market because many more people than in the past were not even looking for work. Tellingly, wages have remained relatively stagnant, suggesting that employers are still finding an overabundance of workers.

The Bank of England said last year that it aimed to push unemployment below 7 percent within two years. It took only eight months, but there, too, wage growth has disappointed.

James Bullard, president of the Federal Reserve Bank of St. Louis, said the unemployment rate, currently at 6.2 percent, remained the best gauge of the economy. "It's been our workhorse indicator and there's a good reason for that," he said.

But both the Fed and the Bank of England have said they are now looking at wage inflation as well as price inflation to gauge how close the economy is to running at capacity.

Ms. Yellen and other Fed officials also have lately pointed to a new index the Fed has concocted from 19 separate measures as a gauge of labor market health.

"Most of us have come to the conclusion that we can't just look at the unemployment rate anymore," Mr. Blinder said in an interview. "That's a huge change and a kind of confession of our ignorance or uncertainty about the labor market."

John C. Williams, president of the Federal Reserve Bank of San Francisco, said the Fed was mounting an intensive research effort — and benefiting from the parallel efforts of academics — to better understand labor markets.

Mr. Williams contrasted these research successes with the 1970s, when he said policy makers were slow to understand structural changes in the economy, in part because they failed to look and in part because they failed to listen.

"They were unrealistic about how low you could get unemployment, and although adjustments eventually occurred, it took a long time," he said. "When I look at what's been happening here, research started immediately and now we have the data and resources to evaluate our views much more quickly."

Mr. Williams said that while the exact location of the finish line might be

unclear, it was clear the Fed remained some distance away. "We're still in a situation where the indicators are clearly on the side that the economy is too weak," he said. "When unemployment gets closer to a normal level, then these judgments become more difficult."

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