# ECONOMIC POLICY INSTITUTE FACT SHEET

## How the Federal Reserve Can Help or Hurt the Economy: What's at Stake

### *The Fed's priorities should be spurring full employment and creating space for healthy wage growth.*

- In the short run, the Fed should keep providing support to economic activity and jobs until we reach a genuine full recovery from the Great Recession. At a minimum, this means keeping short-term interest rates low until wage growth is in line with the Fed's overall inflation targets and the labor market is back to pre–Great Recession health.
- In the medium run the Fed should:
  - Realize that even the pre–Great Recession labor market was far from healthy and continue to spur the economy to push unemployment down until—but not before—accelerating inflationary pressures reliably emerge in the data.
  - Target nominal hourly compensation growth to be at least two percentage points greater than 1.5 percent trend productivity (meaning roughly 3.5 percent).
- In the longer run, the Fed should use regulatory powers and not higher interest rates as the primary tool to rein in the speculative excess that leads to disastrous bubbles.

### *There is still substantial slack in today's economy and labor market, slack that Fed policy can help reduce.*

- The employment-to-population ratio of prime-age adults has recovered less than half of the decline from the pre–Great Recession labor market peak—and has been flat for the last four months.
- We still have a huge jobs hole: Employment is still 3 million below what is needed to return to the labor market health that prevailed in December 2007.
- This labor market slack is due to a continued shortfall of aggregate demand. GDP in 2014 still fell more than 2 percent below estimates of *potential* GDP, and even this "output gap" is one that has improved in recent years not because of strong real-world economic growth, but simply because estimates of potential GDP have been marked down, essentially defining "economic recovery" downward.
- When there is such slack in the economy, workers with fewer formal educational credentials, minority workers, and non–college-educated workers are hardest hit. For instance, roughly one in five blacks and one in six Hispanics are currently unemployed or underemployed. Similarly about one in six workers with only a high school degree are unemployed or underemployed.

## *There is a lot at stake: Slowing the recovery in the name of combatting hypothetical inflationary pressures would leave millions in considerable and unnecessary economic distress and would exacerbate troubling longer-term trends in wages and incomes for the vast majority of American workers and their families.*

- Failure to lower long-term unemployment, still an extraordinarily high 1.6 percent of the labor force, or to bring back into employment the millions who have left or failed to enter the labor force, means lost incomes and output and possible permanent scarring of those affected and of the economy. Given stagnant wages for most of the last four decades, cutting short the recovery means failing to restore broad-based wage growth, diminish poverty, lower inequality, and restore lost living standards.
- Many communities still face high unemployment and, even with a national unemployment rate of 4 percent, would still experience recessionary levels of unemployment. A full recovery is essential for any possibility of income growth in these communities.
- Achieving full recovery such as an unemployment rate of 4 percent would mean black unemployment would drop from over 10 percent now to a lower but still high unemployment rate of 7 percent. Nearly a third of young black men ages 20–24 are out of work and out of school, up from a fifth before the recession. Failure to dramatically reduce this non-employment will exclude this population from our economy in the future.

## *Inflation is well under control but wage growth is disappointingly slow.*

- Inflation, according to the Federal Reserve Board's preferred measure, is running below 1.5 percent, below the target 2 percent rate, and has been below that 2 percent rate for most of the last six years. Federal Reserve Board staff expect inflation to remain below 2 percent over the next few years.
- Various measures of wages and compensation show annual growth remaining at roughly 2 percent, as they have shown over the entire recovery. Given that the appropriate target is for nominal compensation growth of 3.5 percent, the only cause for alarm is that pay is growing so *slowly*.
- Over the last year wages have grown more slowly than inflation for the entire workforce, regardless of education (i.e., college graduates and high-wage earners saw real wage declines). So, even those workers facing lower rates of unemployment did not any obtain real wage gains.

## *Historically thick profit margins provide cushion for any possible wage-led inflation.*

It is expected and desirable that the historically high profit margins that have prevailed in the recovery from the Great Recession will get thinned out a bit by wage growth when wages begin to pick up later in the economic expansion. This pattern of profit margins growing thick in the early stages of recovery and then retreating to normal levels as wages grow in late recoveries has characterized most post–World War II recessions. The failure of profit margins to significantly fall so far is a clear demonstration of just how incomplete the current recovery is, and highlights another large cushion that should allow policymakers to pursue full employment without worrying about wage-led inflationary pressures.

*This fact sheet was prepared by EPI Research and Policy Director Josh Bivens in support of the Center for Popular Democracy and its efforts to make workers and families a priority in the Federal Reserve's policymaking activities. To reach Bivens for further insights on Fed policymaking, send an email to news@epi.org.*