About that NAIRU jacket … The Bureau of Labor Statistics’ just-released May labor report failed to settle differences of opinion about labor market tightness. The unemployment rate declined to 4.2%, equaling March’s 30-year low. For those who regard the non-accelerating inflation rate of unemployment (NAIRU) to be 5% or greater, May’s report brought disquieting news about future inflation prospects. At the same time, however, net new job creation for the month slowed to only 11,000, a dramatic reduction from the pace of the last 12 months. For those who expect economic activity to slow in the coming months, May’s report could be a long-awaited harbinger.

Thus the labor market continues to be an enigma. When the expansion continued its progress into 1996, many mainstream forecasters expected inflation to accelerate as the unemployment rate fell below the NAIRU, then estimated to be 6%. Despite economic growth strong enough to push the unemployment rate ever lower, many analysts clung to their belief that inflation would accelerate. The NAIRU concept, after all, had served inflation forecasting well for several decades. Surely, the thinking went, if unemployment has dropped below 5%, accelerating inflation must be just around the corner.

The idea of the NAIRU comes from a view of price-setting behavior which supposes that businesses tack a markup onto their unit labor costs. As business cycles lengthen, productivity growth typically slows. Moreover, as labor markets tighten, firms often must bid up wage rates to compete for the available labor supply. The combination of these two trends normally raises unit labor costs and with them product prices. In this view, accelerating inflation results when the process becomes persistent and is generalized throughout the economy.

Most people who don the NAIRU garb think that persistent increases in the price level—inflation—stem from excessive money growth. Gauging money demand can be difficult, so the NAIRU appeals to those who think labor market relationships better reveal the balancing point between money supply and demand. But the NAIRU is more than just a model of how strengthening economic activity translates into accelerating inflation; it also presumes an exact estimate of the unemployment rate at which labor markets become so tight that they set off inflation. This estimate is not obtained from economic theory so much as it is gleaned from earlier business-cycle experiences. So current NAIRU estimates derive from circumstances that prevailed in the last 40 years, including the ways businesses, employees, and policymakers responded to rising inflation.

NAIRU estimates can fall wide of the mark for several reasons. Referring to the markup-over-cost notion of product pricing, it should be plain that miscalculations about productivity growth can derail pricing projections. Changes in trend productivity growth are notoriously difficult to forecast because productivity’s quarterly movements fluctuate widely, masking its evolving trend growth rate. High rates of business fixed investment throughout this expansion seem to be driving productivity’s growth rate trend upward, but the size of the adjustment is unclear. Some analysts conjecture that the trend rate has shifted from just under 1% to 2%, while others are hopeful that 3% will prove a better estimate. With productivity growth averaging 2¼% in the past four quarters, the correct number is anyone’s guess.

Stronger productivity growth, however, should only depress the NAIRU temporarily. Eventually, employees should expect their pay to capture some of the newfound wealth. At this point in the expansion, wages’ inexplicable moderation in the face of tight labor markets contributes to inflation forecasting errors. It is possible that official statistics fail to include some forms of compensation, notably stock options, but the under-recording is probably not meaningful. Besides, there is another mystery to solve: Why have labor force participation rates risen to record levels without registering a strong gravitational pull from sharply rising labor compensation?

One needn’t believe in an estimable NAIRU to think that tight labor markets lead to accelerating inflation. Some have given up on the NAIRU but not on the notion that “low” unemployment rates foreshadow inflation. Such a position raises two questions. How does one judge just when labor market conditions signal trouble? More importantly, given that inflation is a monetary phenomenon, why dress inflation in labor market clothing at a time when the pattern no longer fits?