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The Big Economic Unknowns of 2015, From Unemployment to Oil

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Economic View

By JUSTIN WOLFERS

I wish I knew where the economy will be heading next year. If I did, I might become rich. But, alas, I don't — and even if we don't always acknowledge it, no economists do.

Too much uncertainty clouds the crystal ball to be confident that any particular course of events will play out in the real world. But we do know something about the sources of that uncertainty, and in a season for sharing, I'd like to offer six questions whose eventual resolution will shape the economic year ahead:

■ **How much slack really remains in the labor market?**

The unemployment rate stands at 5.8 percent. If it continues on its current trajectory, it will have fallen an additional half a percentage point by mid-2015, putting it at a level that some economists see as effectively full employment.

Yet much of the reduction in unemployment reflects a decline in the share of the population in the work force. If a stronger economy were to induce these people to return to work, the recovery would still have a long way to run before we got to full employment. Moreover, millions of those who are counted as employed remain stuck in part-time jobs but want full-time work.

Further improvements in the labor market also depend on whether the long-term unemployed — those who have been out of work six months or longer — will successfully transition into new jobs. Pessimists emphasize that high levels of long-term unemployment proved to be an intractable problem through much of Europe over the last 40 years. Yet more recent evidence from the United States — particularly from the early stages of this recovery — makes me more optimistic that we can get the long-term jobless back to work.

All of this means we really don't know how far unemployment could fall without prompting inflation. Get ready for a debate premised on artificial precision about whether the economy can sustain unemployment of 5 or 5.5 percent. That's the consensus range. But the best research on this question suggests that the lowest sustainable rate could easily differ from our best estimates by a full percentage point or more. Indeed, the Clinton-era boom pushed unemployment below 4 percent without setting off an inflationary surge.

■ Will the Federal Reserve treat its target for 2 percent inflation as a goal or a ceiling?

Officially, the Fed says it is as willing to tolerate the risk that inflation may rise above this level as it has been about inflation undershooting its goal over the last few years. Yet its actions suggest otherwise. Plans to normalize policy — a euphemism for raising interest rates — are already underway, even as the Fed's own projections suggest that inflation will not breach 2 percent in the next few years.

Higher interest rates could slow the economy. That leads to my third question:

■ How fast does the economy need to grow to stay healthy?

Many commentators assume that a healthy economy grows at an annual rate of at least 3 percent. Yet economic growth in the United States has averaged only 1.9 percent since 2000, and average growth of 2.3 percent during the current expansion has been enough to yield large drops in unemployment. To an important extent, this lower rate has been caused by demographic factors: slower population growth, the end of the transition of women into the work force, and baby boomers retiring.

All told, the work force is growing nearly a full percentage point slower than it was in the 1990s, and this is why 2 percent growth is the new 3 percent. Likewise, much as the economy once needed to generate 150,000 jobs a month just to keep up with new entrants to the labor force, that "break-even" number may now be as low as 50,000.

■ Can the American economy keep motoring without help from the rest of the world?

Among the world's major economies, the United States had the strongest economic growth in 2014. The picture elsewhere is grim. Japan has lurched from optimism about Abenomics — Prime Minister Shinzo Abe's program to kick-start the economy — to pessimism as the economy has shrunk over the last two quarters. And Europe hovers on the edge of a double- or triple-dip recession, depending on your definition. China has slowed, with economic growth moving below 8 percent a year from an extraordinary 10 percent. And the Russian economy is on the cusp of a full-fledged crisis. It's not just that foreign buyers have less money to spend; their weakness has become the dollar's strength, which also makes our exports more expensive. These global headwinds could easily knock a fragile recovery off course.

■ What will be the consequences of lower oil prices, which have fallen by about half since June?

Typically, an oil price decline is like a tax cut, leaving more money in consumers' pockets to spend elsewhere. That should spur growth. But since the shale boom, the United States is not only a leading oil consumer but also a leading producer. So lower oil prices also spell smaller revenue for some of our energy companies. And our producers have particularly high costs, so further investment in them may become unprofitable if prices fall too far.

This leads us back to the inherent uncertainty afflicting economics:

■ **What, as Donald H. Rumsfeld, the former defense secretary, asked, are the unknown unknowns?**

More often than not, the shocks that buffet the economy come out of the blue. Few predicted the huge swings in oil prices over recent years, and the same goes for the financial crisis and many other disruptive events. A few years ago, for example, the weakness in Greece's fiscal situation was successfully disguised, until it catalyzed the eurozone crisis. In 2011, the tsunami that brought huge damage to Japan also caused global economic tremors. And while we have often seen political gridlock in Congress, the extreme brinkmanship over financing the federal debt in recent years has been a form of economic self-sabotage that was once unimaginable.

I wish I could offer clearer guidance about next year, but an honest account focuses on the limits of our knowledge. We're not sure how much further the economy can improve next year, or even if it will actually do so, and we don't know what might drive it off course.

So instead of a forecast, I'll offer advice: Prepare for the worst, hope for the best and count on being surprised.

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