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The New Jobs Report Shows Janet Yellen’s Quandary in a Nutshell

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The biggest decision that Janet Yellen has faced in her year-old Federal Reserve chairmanship was laid bare in a single report on the domestic job market released Friday.

The unemployment rate fell to 5.5 percent as job creation continued at a strong pace. Joblessness is now within the 5.2 to 5.5 percent range that Fed leaders say reflects a sustainable level over the long run.

For a Fed that has spent the last seven years doing everything it can think of to try to get the job market on track, that translates to: Mission Accomplished. And by traditional central bank thinking, that would mean it’s waited long enough to raise interest rates to prevent the economy from overheating.

But by other measures in the same report, overheating is a distant worry. Average hourly earnings rose only 0.1 percent, and have now risen less than 2 percent over the last year — pretty much what they've been doing for five years straight. The number of people in the labor force actually declined, suggesting that the pool of potential workers who neither have a job nor are looking for one is growing, not shrinking.

All of that points to a job market that still has a great deal of room to run before the Yellen Fed needs to do much of anything.

For a Federal Reserve chairwoman who largely spent her first year implementing policies that had been agreed upon before she took office, this is a major decision point. Which set of signals should she and her colleagues on the Fed's policy-setting board listen to?

The battle of conflicting economic ideas was played out in the financial markets Friday. Reaction there was at odds with the reaction of some of the sharper Fed analysts to the new data. Longer-term interest rates soared Friday morning upon the release of the new data, as did the dollar, indicating that bond and currency traders saw the report as implying the Fed will raise interest rates sooner and higher than it had seemed just before the release.

Based on futures market prices, for example, investors on Thursday had seen a 49 percent chance of a Fed interest rate increase by September. It rose to 59 percent Friday after the new data. That is a clear signal that Wall Street is doing some simple math to conclude that More Jobs + Lower Unemployment = Tighter Monetary Policy.

Some Fed watchers aren't so sure that adds up. "Until we see gains in higher-wage jobs (and the trend has been flat for quite a long time), we won't see upward pressure on wages, and we won't see upward pressure on inflation," Megan Greene, the chief economist of John Hancock Financial Services, said in a note to clients. "I hope this would impact the timing of the Fed's next rate hike. Today's report supports the argument that the Fed should wait until at least the end of this year to start hiking rates."

"The softness in average hourly earnings tempers the case for a June rate hike," wrote Krishna Guha of Evercore ISI. "We view this as a close call but still lean to September."

Ms. Yellen, who studied labor markets in her academic career, has preached the gospel of studying a full range of indicators, some of them relatively obscure, to judge the true health of the job market. And by that measure the February numbers are a more mixed picture than the wariness on Wall Street might suggest.

At the same time, it is the job of Fed officials to make policy based on where the economy is going, not where it has been. The interest rate decisions they make now have their greatest effect many months down the road.

If you went back in time and told Janet Yellen, college professor, circa 2005, that the unemployment rate was 5.5 percent and the economy was adding 300,000 jobs a month, her reaction would probably be simple: It's time to raise interest rates. Excessive inflation will surely result if you don't.

But so much has changed in the last decade. The economy has been so deep in the doldrums for so long, the deflationary forces pulling down prices globally so strong. The Fed has done so much to try to get the job market revving again. Ms. Yellen will be wary of quashing the recovery. Why? The expansion's ability to translate into higher pay for ordinary Americans is not yet established.

That's why she was coy in congressional testimony last week when asked whether the Fed would need to see clear proof of rising wages before raising rates.

"There are perhaps hints, but we've not seen any significant pickup in wage growth," Ms. Yellen said. "But there are a number of different factors that affect the inflation outlook, and we will be considering carefully a range of evidence."

But assuming the next few months of data unfold the way they have been, with strong job growth, falling unemployment and continued disappointments on wages, she and her colleagues face a big decision that will shape how history views both Ms. Yellen and her leadership of the Fed.

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