THE WALL STREET JOURNAL. ONLINE

February 26, 2007

PAGE ONE

Policy Makers At Fed Rethink Inflation's Roots

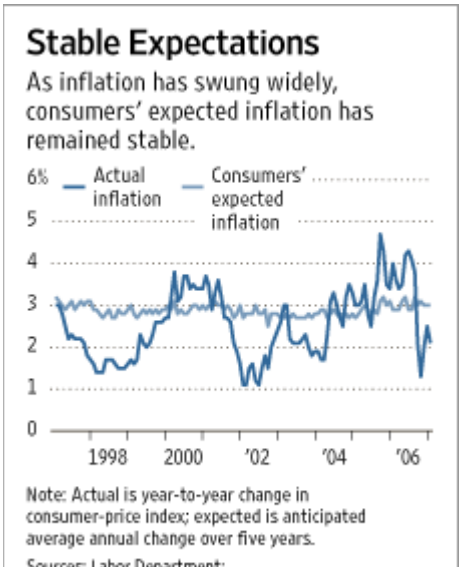
Low Unemployment Now Is Believed to Play A Less Important Role

By GREG IP
February 26, 2007; Page A1

For decades, a simple rule has governed how the Federal Reserve views the nation's economy: When unemployment falls too low, inflation goes up, and vice versa.

But Fed officials have rethought that notion. They believe it takes a far bigger change in unemployment to affect inflation today than it did 25 years ago. Now, when inflation fluctuates, they are far more likely to blame temporary factors, such as changes in oil prices or rents, than a change in the jobless rate.

One explanation for why inflation is influenced less by changes in unemployment is that the American public has come to expect inflation to remain stable. When inflation moves up or down, it is less likely to get stuck at the new level because companies and workers don't factor the change into their expectations -- or their behavior. Another explanation is that the Fed is better at adjusting interest rates in anticipation of swings in unemployment before those swings can affect inflation.



This new view of the economy, formed in recent years, helps explain why the Fed stopped raising interest rates last summer while core inflation, which excludes food and energy prices, was rising. And it helps explain why the Fed is reluctant to cut rates now even though it sees inflation edging lower over the next two years.

The new view "has profound implications," says former Fed economist Brian Sack, now at Macroeconomic Advisers, a St. Louis-based forecasting firm. That doesn't mean unemployment can be ignored. But it does mean that in the short run, a period of high or low joblessness would be less likely to alter the Fed's view of inflation and trigger an immediate change in interest rates. A shift in public expectations of inflation, however, would carry more weight

in the Fed's calculations.

In the late 1950s, economists discovered a tendency for inflation to rise when unemployment was low and to fall when unemployment was high. At lower unemployment rates, they concluded, companies paid more to attract scarce workers and recouped the higher wage costs by raising prices. This relationship was shown on a chart called the Phillips Curve, after Alban William Phillips, one of the first economists to identify it.

In the 1960s, American presidents and Fed officials sought to exploit the Phillips Curve by letting inflation edge higher in exchange for lower unemployment. But in the late 1960s economists Milton Friedman, who died last year, and Edmund Phelps, both of whom would later become Nobel laureates, independently deduced that the reduction in unemployment would be temporary.

Once workers began to expect higher inflation, they would want higher wages. In the long run, the economists argued, unemployment would gravitate to some "natural" level no matter what inflation did.

MORE

For more on the Phillips Curve:
http://www.econlib.org/library/enc/PhillipsCurve.html[1]

Although economists concluded there wasn't a *long-run* tradeoff between inflation and unemployment, they still believed there could be a *short-run* tradeoff. From 1979 to 2003, Fed Chairman Paul Volcker and his successor, Alan Greenspan, exploited this idea, periodically using interest rates to push unemployment higher to achieve lasting reductions in inflation.

But even as they were doing so, the short-run impact of unemployment on inflation began to diminish. Though the trend has been under way for 25 years, only recently has intensive research by Fed economists and others incorporated it into mainstream thinking. The new thinking on inflation will be the subject of a March 9 conference in Washington that brings together Wall Street Fed watchers, academics and Fed officials.

"Among the feet-on-the-ground Fed inflation forecasters, who do this for a living, there's been a lot of concern for the last 10 years about whether there's...less of a relationship between output and future inflation," says Harvard University economist James Stock. "The accumulation of evidence occurs at a snail's pace. The evidence now is a lot stronger."

Mr. Stock and fellow economist Mark Watson at Princeton University presented evidence to a Fed conference in late 2005 that inflation's long-term trend has varied little since 1984, and that most fluctuations were the result of temporary disturbances, such as a change in energy prices.

Indeed, when core inflation rose last year, the Fed blamed higher rents and oil prices, rather than an overheating economy. It appears to have been right: As energy prices have come down and rent increases moderated, so has core inflation.

Core inflation, now running at a 2.2% rate by the Fed's preferred measure, remains higher than the 2% ceiling most Fed officials are comfortable with. But Janet Yellen, president of the Federal Reserve Bank of San Francisco, noted earlier this year that over the past decade, when inflation has drifted away from the 1.75% to 2% range, it has later reverted to it. For this reason it "may move down from its elevated level faster than many forecasters expect."

Fed Chairman Ben Bernanke echoed that sentiment earlier this month, saying the public's expectations will determine whether temporary factors like changes in rents and oil prices "leave a lasting imprint" on inflation: "It is encouraging that inflation expectations appear to have remained contained," he said.

Mr. Phelps says the new thinking on the Phillips Curve doesn't change the implications of his Nobel-winning work. If the Fed never responded to higher inflation, consumers and businesses eventually would begin to expect higher inflation, and "then the game is up."

Fed officials agree. While a given drop in unemployment is less likely to spark inflation, the potential is still there. The Fed's staff estimates it takes up to twice as much additional unemployment to achieve a percentage drop in inflation as it did before 1984. "Imbalances between demand and potential supply [may] be slow to show through convincingly to inflation, but when they do, they may be costly to correct," Fed Vice Chairman Donald Kohn said in late 2005.

That's one reason the Fed, though it expects core inflation to ease this year, isn't relaxing. With unemployment currently 4.6%, at or below the Fed's view of its natural rate, inflation may edge up after the temporary impacts of energy and rent subside. That could require the Fed to raise interest rates enough to push unemployment up sharply and bring inflation down.

Write to Greg Ip at greg.ip@wsj.com[2]

URL for this article:
http://online.wsj.com/article/SB117245624842818971.html

Hyperlinks in this Article:
(1) http://www.econlib.org/library/enc/PhillipsCurve.html
(2) mailto:greg.ip@wsj.com