

The Economy in Perspective

On the road again ... U.S. stock markets rallied on news that employment grew only 43,000 in February; market participants had expected a figure five times that size. Reactions like this no longer puzzle readers of the business press, who have been conditioned to believe that strong economic growth increases the risk that inflation will accelerate. This outcome is not entirely unthinkable, but neither is it inevitable. Vigorous economic growth in itself does not cause inflation to accelerate, but it can appear to do so.

Inflation is a monetary phenomenon: Money growth in excess of the public's need eventually decreases the purchasing power of money or, equivalently, raises the general price level. This long-term relationship between money and prices has been documented for so many countries and eras that few economists doubt it. In theory, monetary authorities desiring to promote price stability need only gear supply to demand. Complications arise when monetary authorities cannot discern the true level of money demand. In the United States, for example, the inconsistency of the public's demand for money over the past few decades has given the Federal Reserve difficulty in gauging how much to supply. Federal funds rate targeting has filled the void.

The public cares about its economic welfare—the ultimate outcome—not directly about the price level and its fluctuations. But suppose short-term changes in underlying (nonmonetary) economic conditions depend partly on actual or expected movements in the price level, and vice versa. And suppose further that the public dislikes volatile business-cycle fluctuations. In these circumstances, monetary authorities must understand the interactions between price-level movements and fundamental economic activity, and how their own policy actions affect each of these factors.

Economists have been divided over the relative usefulness of money and labor market information for understanding, predicting, and controlling inflation over the past 40 years. One school of thought teaches that inflation accelerates in boom times because central banks mistakenly let money supplies expand beyond the quantities needed to meet the increased needs of commerce. Labor markets become tight, factories operate at high levels of capacity utilization, and

imports increase to fill the demand that domestic firms cannot supply. Implementing monetary policy in this framework requires knowing, among other things, when monetary growth is excessive. Boom conditions may reflect, rather than cause, this excess.

A competing school teaches that excessive labor market tightness can induce businesses to increase product prices in an effort to maintain their profit margins in the face of rising labor costs. Prudent monetary policy requires hiking interest rates to slow economic activity and relieve wage pressures that otherwise would lead to inflation. Implementing monetary policy within this framework entails knowing at what point labor market tightness will spark inflationary wage-setting practices. If money plays a role in this framework, it is a decidedly passive one.

Unreliable money-demand estimates, coupled with a statistical relationship between inflation and unemployment rates, encouraged U.S. policymakers to rely on labor market conditions for guidance in conducting monetary policy. After all, even if a tight labor market does not truly cause inflation to accelerate, why ignore the unemployment rate if its decline (arguably following prior excessive monetary stimulus) appears to foreshadow accelerating inflation?

It is easy to see why a sizeable pickup in the rate of productivity growth poses challenges for both designing and discussing monetary policy. When improved productivity can generate faster output growth and absorb the profit-margin impact of higher wages, how should estimates of labor market tightness be recalibrated? How much confidence can be placed in this indicator, which may be just as problematic as the money supply?

Experience in the practice of monetary policy over many decades shows that reliable guideposts come and go, sometimes requiring policymakers to adjust their theories and methods. At the same time, historical observation suggests caution after long periods of strong economic growth, if only because such periods have often been followed by inflationary and financial imbalances. The Federal Reserve's recent policy actions could be regarded as steps taken to keep the economy on a steady path.