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July 1996
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The Economy in Perspective

Good news bears ... Financial markets were rocked on July 5 when the Bureau of Labor Statistics (BLS) released its report on labor market conditions for June, along with revised data for April and May. The Bureau reported a 239,000 net increase in June employment as measured by the survey of employers' payrolls, plus a combined upward revision of 45,000 for April and May. Average earnings expanded by 9 cents per hour in June, the largest monthly gain ever reported. Moreover, the BLS household survey registered a decline in the national unemployment rate to 5.3%.

Despite weak trading over the holiday period, the stock market took a sharp hit that Friday (115 points on the Dow Jones Industrial Average), and U.S. Treasury bond prices plummeted. The yield on a 10-year Treasury bond jumped from 6.77% to 7.06% during the day.

Long-term bond yields have been on a roller-coaster ride for the past few years. The pace of economic activity quickened during 1994, putting pressure on capital market interest rates. At the same time, concerns about accelerating inflation prompted the Federal Reserve to slow the rate at which it was supplying reserves to the banking system. The federal funds rate rose from 3.0% to 5.5% during the year.

Capital market rates declined during 1995, as market participants expected growth to gear down a bit to keep pace with additions to productive capacity. By year's end, in fact, capital market rates had fallen about 200 basis points from the beginning of the year, and some analysts spoke of a recession in the latter half of 1996. Last January, the Federal Reserve reduced the federal funds and discount rates to keep them in line with open market rates, and in anticipation of a decline in inflationary pressures. However, the BLS reported a strong employment gain for February, and subsequent economic data have convinced most economists to expect moderate economic growth to continue for the next year or so. Before BLS's July report, capital markets had retraced about 100 basis points from their 1995 low point, and the July 5 news accounted for another 25 to 30 points.

Interest rates have been volatile because market participants are responding to underlying forces which themselves are volatile. People revise their plans for saving, investment, and consumption as they adjust their views of future economic activity. These revisions, in turn, affect the real interest rate prevailing in capital markets. People also may change their view of the inflation rate they expect to prevail over the next several years. Although the inflation rate as measured by the Consumer Price Index has been following a 3% trend during the past several years, many observers believe the trend will be strongly influenced by the pace of economic activity. Since by most accounts the economy has been operating at very high rates of capacity utilization for the past year or two, financial market participants are especially leery of an acceleration in the price level.

The association of economic growth with inflation, sometimes referred to as the Phillips curve, stems from positive correlations between changes in the unemployment rate and unanticipated inflation observed during business cycles—particularly before 1981. This has encouraged some analysts to think that policymakers can alter inflation's trend by affecting the unemployment rate, that is, by designing policy so as to speed up or slow down the pace of economic activity. The non-accelerating inflation rate of unemployment (NAIRU) is thought to keep the prevailing inflation rate steady. If NAIRU is 6%, for example, unemployment rates below 6% will likely generate accelerating inflation.

Econometric estimates of Phillips curves and NAIRU reveal that the relationships between inflation and economic growth are not very stable. Moreover, since the early 1980s, inflation has declined during a prolonged period of economic expansion, at apparent odds with predictions from standard Phillips curve models. At the outset of this decade, mainstream estimates of NAIRU centered on 6%, but this figure is now widely regarded as 5.75%, or even 5.5%. If the inflation trend continues to hold this year, we may see estimated NAIRU fall to 5.25%.

Those who forecast inflation from a Phillips curve view have occupied the high ground in the media during the last few years, even though this approach has been overpredicting the amount of economic slack required to reduce inflation. The Phillips curve/NAIRU framework puts policymakers in the position of being responsible for fluctuations in economic growth on a year-to-year basis, when their more likely objective is to maximize employment and promote price stability over business cycles. Excessive *money* growth, not economic growth, creates inflation. Though rapid economic growth may sometimes accompany excessive money growth, the good news need not bear bad tidings.