

## *The Economy in Perspective*

*Laboring under a false impression ...* If inflation is, as Milton Friedman once said, always and everywhere a monetary phenomenon, why do so many Fed-watchers scan the labor market for clues to future inflation? Why do they think that the unemployment rate, the employment growth rate, or wage changes foreshadow inflation movements?

Two reasons come to mind: Some prominent economists say it is so, and history provides us with certain examples where it appears to be true. Nevertheless, it would be a mistake to think that labor market conditions *cause* inflation; accepting this idea uncritically could create serious misunderstandings about monetary policy.

In a simple textbook economy with a stable money-demand function, the monetary authority has the straightforward job of supplying a quantity of money that matches the amount demanded at the prevailing price level. Supplying too much or too little will eventually raise or lower the price level.

What happens if productivity improves? For the simplified economy as a whole, more output can be produced with the same amount of land, labor, and capital; as a result, the standard of living rises. When the real value of output expands, nominal spending increases at a constant price level. To accomplish this result, the monetary authority must enlarge the money supply to accommodate a greater value of transactions. In other words, noninflationary growth requires an expanding money supply.

The relative prices of various goods, services, and other necessities of production will change during the transition to the new equilibrium. Labor markets' response depends on the nature and magnitude of the initial impetus for change. For example, with technical progress, real wages may rise for some skills and in some regions, and decline elsewhere. Wage changes may affect peoples' inclination to look for jobs and their success at finding them. Another possibility is that workers take some of the productivity gain in the form of more leisure time (which could show up as an increase in part-time employment).

Suppose an innovation expands aggregate supply, making people wealthier in real terms. Their nominal demand for goods and services increases, and the monetary authority expands the money supply in an effort to steady the price level. Next, suppose the money supply increases more than necessary, but people don't realize it. They notice only that their nominal income and wealth are improving. As aggregate demand outstrips supply, markets for productive factors like raw commodities, land, and labor eventually become tight enough for most prices and wages to

rise persistently. This is the condition we call inflation, which, in the short run, exhibits a negative correlation with unemployment.

Now consider the connection between labor markets and monetary policy. The textbook economy features a natural rate of unemployment, which exists in equilibrium because of labor markets' structural characteristics. Inflation holds steady at the natural rate, but rises or falls as actual unemployment is driven below or above the natural rate by sustained shifts in aggregate demand relative to aggregate supply. There need be nothing special about the labor market in this example. In principle, natural rates of industrial capacity utilization, real estate vacancy, inventory stocks, and delivery lead times exist along with the natural rate of unemployment. Inflation is no more *caused* by tight labor markets than by shortages of office space or railroad boxcars.

As a practical matter, inflation forecasters have examined a wide variety of leading indicators at different times. Even a partial list would include gold prices, capacity utilization rates, the exchange value of the U.S. dollar, money growth, help-wanted advertising, unemployment insurance claims, industrial commodity prices, asset prices, surveys of inflation expectations, and long bond prices. None of these variables has proven an infallible leading indicator, because their underlying demand and supply functions have not been stable. Time and again, indicators that formerly seemed useful fail to hold up. Labor market variables are no exception.

The Federal Open Market Committee (FOMC) has been employing a federal funds rate operating procedure, providing whatever money growth the economy wants at the intended funds rate. If the FOMC felt confident that money demand was stable, it could rely more on money growth rates in assessing when—and how much—it should change its intended funds rate to control inflation. Instead, the FOMC recently has relied more heavily on nonmonetary attributes of economic activity to guide its actions.

Federal Reserve Chairman Alan Greenspan told Congress last month that there are some signs the M2 monetary aggregate may be reestablishing a stable relationship with nominal spending, in which case the FOMC would be willing to regard it more seriously. Such a development would be welcome on two counts. Having a reliable indicator of future inflation is desirable in its own right. Moreover, since monetary policy does *not* seek to restrain either employment or real wage increases, it would be helpful to replace rhetoric that unfortunately creates the contrary impression.