

Expectations and Monetary Policy

The cover story of this issue explores the possibility that there may be a new and higher “natural” rate of unemployment. The natural rate notion itself has historically been linked to another important mid-20th century idea — the relationship between inflation and unemployment known as the Phillips curve. The early analysis of this relationship posited a negative correlation between unemployment and inflation: When one of these variables went up, the other went down.

The Phillips curve relationship heartened ambitious policymakers in the 1960s and 1970s. If they wanted to drive unemployment lower, the reasoning went, all they needed to do was tolerate a bit more inflation.

The article in this issue explores some of what we know about the Phillips curve trade-off today and whether we can realistically expect that statistical relationship to remain stable over time. These are important questions — ones that captivate the attention of academic economists and policymakers, and rightly so. The debate over these issues has been intense not just within the economics profession but also at Federal Open Market Committee meetings.

This is especially important because of the way the traditional Phillips curve relationship broke down in the 1970s. The Federal Reserve allowed somewhat higher inflation in the late 1960s in an effort to keep unemployment low. But inflation kept rising, forcing policymakers to change direction and tighten policy, causing a recession that pushed unemployment rates into double digits. The result was that both inflation *and* unemployment were high and variable throughout the 1970s. That was not supposed to happen according to the classic Phillips curve story.

So what happened? People eventually reoriented their expectations about inflation. If the Fed wanted to try to drive unemployment down further, it needed to increase the money supply even more the next time. So that's what it did.

Meanwhile, a rethinking of these policies had begun in earnest in the 1960s by economists such as Milton Friedman, Edmund Phelps, and Robert Lucas. Each in their own way, and others pursuing similar research in this area, came to the conclusion that the expectations of market participants mattered a great deal. In fact, these expectations could alter the traditional Phillips curve relationship. Money was, as economists say, “non-neutral,” but only in the short term. In other words, inflation would produce more employment only if the Fed were able to surprise markets with a higher-than-expected inflation. After folks caught on, the effect on employment would go away.

The Fed lost credibility in the 1970s as an institution committed to keeping the money supply in check. A persistently high rate of inflation was seen as a fact of life.

The classic Phillips curve trade-off evaporated. This reality even caused some to speculate that monetary policy might be unable to influence employment growth unless, for instance, the pressure of labor unions to raise wages could be resisted. In retrospect, it may not be surprising to note that those who shared this “cost-push” view of inflation, in which the labor input costs to production were the primary drivers of general price increases, were missing the real story.

The good news is that there is a broad consensus today that this monetary policy experiment of the 1970s failed. While many economists and members of the FOMC still use a fundamentally Keynesian framework to view the relationship between elements of the economy, they all generally acknowledge that the traditional Phillips curve story cannot stand on its own.

It's also helpful that the Fed has well-trained economists employed in studying these important macroeconomic relationships over time. And the level of economic knowledge on the FOMC itself has gotten stronger over the past 20 years as more professional economists have ended up on the Board of Governors and as regional Fed presidents. This is a change from previous decades when FOMC members often didn't have much formal economic training or might have even been distrustful of economists.

There are still differences of opinion over how to interpret economic trends, of course. But the tone of the discussion is always tempered by the knowledge that it's important for policymakers to take into account the expectations of market participants when making monetary policy decisions. That insight will be especially important in the near term. The Fed will at some point change its stance on the federal funds rate, and it has started closing the lending facilities it created to provide liquidity during the recent recession. These “exit strategies” will be executed best if they are firmly based on what history has taught us about market expectations. **RF**



JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND