The Fed Has a Target. It's the Unemployment Rate: Caroline Baum

Commentary by Caroline Baum

May 9 (Bloomberg) -- As central banks the world over are shedding their focus on growth and adopting inflation targets as policy guides, the Federal Reserve is falling back on the old idea that there's a tradeoff between growth and inflation, a phenomenon described by the **Phillips Curve**.

The Phillips Curve, you will recall, posits an inverse relationship between the change in the unemployment rate and the change in wages. That relationship is also described generically as a tradeoff between growth and inflation -- at least it was until **Milton Friedman** and **Edmund Phelps** came along to upend the theory and augment the curve.

There is no long-term tradeoff between growth and inflation, the two Nobel Laureates found. The idea of the expectations-augmented Phillips curve, for which Phelps won the **2006 Nobel Prize**, demonstrated that central banks could buy a little more employment/growth, but only at the expense of continuously accelerating inflation.

The 1970s' stagflation -- high unemployment and inflation - - challenged Phillips Curve thinking. Yet it has an annoying habit of finding its way back into our collective unconscious.

This time, the charge is being led by the Fed, which is holding its policy meeting today. Starting with the June 29, 2006, meeting -- the last one at which the Fed raised rates -- every policy **statement** has focused on ``the high level of resource utilization,'' which has the potential to spark or sustain inflation.

In a world where the U.S. has shifted goods production off- shore, a high level of resource utilization can mean only one thing: The unemployment rate is too low.

Part-time Help

The **unemployment rate** has been drifting down from a cycle peak of 6.3 percent in June 2003 to a low of 4.4 percent in October 2006. The rate has been bumping around between 4.4 percent and 4.6 percent since then.

Why focus on the inflation rate, a lagging indicator that has remained above the Fed's implicit ceiling for three years, when the Fed is signaling that the unemployment rate, another laggard, holds the key to the next move?

At what point will the Fed determine that there's enough slack in the labor market to lower its benchmark **overnight rate**? When the unemployment rate rises to 4.8 percent? 5 percent? How about three consecutive monthly increases in the rate, signifying a change in the trend?

``It makes me wonder why the Fed bothers to employ so many economists,'' says **Ian Shepherdson**, chief U.S. economist at High Frequency Economics in Valhalla, New York. ``They only need one guy, half a day a month, to monitor the unemployment rate.''

Unemployment Guidance

Shepherdson says the Fed's focus on unemployment is nothing new.

``History shows over and over that **changes in policy**, in both directions, come either when the unemployment rate changes direction or when it's blindingly obvious it's about to change direction,'' he says. ``Neither condition has been fulfilled. So no change in rates just yet.''

Just because the Fed has a dual mandate -- maximum sustainable growth and price stability -- it doesn't mean the two are mutually exclusive. It's only when the economy is bursting at the seams, growing faster than its ability to produce goods and services, that expansionary policy yields higher prices, not faster growth.

Last week's employment report for April contained good news for the wage-inflation crowd (the folks who think wages push up prices). **Average hourly earnings** rose 3.7 percent in April from a year earlier, down from a recent peak of 4.3 percent in December. Inflation as measured by the core consumer price index, which excludes food and energy, rose 2.5 percent in March, down from its peak of 2.9 percent in September.

Construction Disconnect

And while the unemployment rate and **weekly jobless claims** have yet to signal much, if any, weakening in the demand for labor, there is every reason to believe that it's coming.

``Every time construction expenditures fall, construction employment falls,'' says **Joe Carson**, director of global economic research at AllianceBernstein.

Not this time. Given the magnitude of the decline -- **private construction spending** is down $50 billion, or 5 percent in the past year -- construction payrolls should be down 200,000 to 300,000, Carson says. Instead, **construction employment** has barely budged from its September highs.

Carson says that the ``time element'' is different in construction than it is in, say, manufacturing or financial markets.

``When you have an inventory overhang in manufacturing, you slow or shut down production to bring supply and demand in line,'' he says. ``With financial markets, the adjustment is violent and quick.''

Unfinished Business

The adjustment in housing, on the other hand, takes longer.

``Builders have to finish projects they start,'' Carson says. ``It's hard to sell an unfinished unit.''

That said, housing is well past its prime, and it's hard to explain ``why the decline in employment hasn't shown up yet,'' he says. ``**Housing starts** peaked more than a year ago, and it typically takes six to nine months to complete a house.''

Hopefully it won't take the Fed six to nine months to realize the cycle has turned.

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