The Wall Street Journal April 23, 1999

NAIRU , R . I . P .

Remember NAIRU? Just a few years ago, central bankers used to assure us that unemployment couldn't go below 5.5%, or the economy would explode like Mount Pinatubo. The Non-Accelerating Inflation Rate of Unemployment, as NAIRU is formally known, said that economies must always face a bitter trade-off between inflation and unemployment. Along with its sister graphic, the Phillips Curve, NAIRU has been the scourge of bond markets for decades, needlessly throttling growth and triggering countless Friday morning sell-offs after the 8:30 employment figures turned out to be "too strong."

Well, unemployment dropped below 5% a full 21 months ago. In March it hit 4.2%, the lowest level in three decades, with nary a trace of inflation in sight. Indeed, the Producer Price Index, an early inflation bellwether, would actually be declining, except for the price boost for tobacco caused by plaintiff-bar legal settlements. You'd think that NAIRU would be long dead and buried. Yet for many of the 1990s salad years, NAIRU and the rest of the Keynesian claptrap have continued to matter. This is so for a simple reason: many Fed officials have continued to cling to the old theories. And as long as central bankers are still believers, markets know that they must, willy nilly, go along for the ride.

Now, at long last, even the skeptical Fed crowd seem to be having a change of heart. This spring, Edward Kelley, the Fed's longest-serving governor, acknowledged that the new productivity brought by computers has revolutionized the economic picture: "We've gone from a rather traditional, well-understood era into new and uncharted territory," he told Barron's.

Robert McTeer, president of the Dallas Fed, proudly shredded the NAIRU myth in his 1998 annual report: "I'm not saying that inflation will remain low despite strong real growth," he told readers. "I'm saying it will remain low in part because of strong real growth. If inflation results from too much money chasing too few goods, more goods will help as much as slower money growth" (our italics). Says Brian Wesbury of Griffin, Kubik Stephens, a Chicago bond house: "You can sense there is a psychological revolution going on at the Fed."

To be sure, there are still laggards. Phillips Curve King Laurence Meyer of the Fed Board continues bravely to plug NAIRU; in February he traveled to that old Keynesian stronghold, London, to reiterate the NAIRU argument before the Society of Business Economists, probably the only group on the globe still receptive to it. But even some diehards are shifting. Robert Parry of the San Francisco Fed, long a trade-off man, has for example lately softened his line. Speaking earlier this month, Mr. Parry said that "understanding why productivity growth has strengthened is at the heart of many of our discussions on monetary policy."

It is a relief to see such important authorities finally recognizing that the productivity of computers has been an important source in driving overall productivity and inflation-free growth. Years ago, this page was among the first to argue that traditional inflation measures such as the Consumer Price Index failed to reflect the benefits the economy was seeing as the computer revolution took hold. Yet even before the outset of computer-driven productivity, we repeatedly observed that NAIRU and the Phillips Curve did not work.

The NAIRU theorists would be wrong even if the microchip revolution had never happened and Silicon Valley were still nothing more than a string of apricot groves, We had a bitter demonstration of the NAIRU fallacy back in the 1970s, with both high inflation and high unemployment generating the famous Misery Index. In the 1980s, we saw declining unemployment and declining inflation during the Reagan boom. The fundamental fact is that inflation is not caused by too many people working, and markets and citizens can only cheer if this lesson is sinking in among policy makers.