# The Phillips Curve Does Not Work

The principal difference between those who believe in the earth being flat and those who believe in the Phillips Curve tradeoff between the rates of inflation and unemployment is you can get through an average day believing the earth is flat without causing undue harm to others. But as Nobel Laureates Milton Friedman and Edmund Phelps argued, employment would adjust to the inflation-adjusted cost of labor; their work was confirmed by the coexistence of high inflation and high unemployment in the 1970s or, conversely, by the combination of low inflation and low unemployment in the 1990s.

Why is this important for investors? One reason is those who would otherwise be engaged in harmless flat-earth symposia and colloquia have been banging the drum for a higher rate of inflation, as if this would solve the problems of low output and high unemployment.

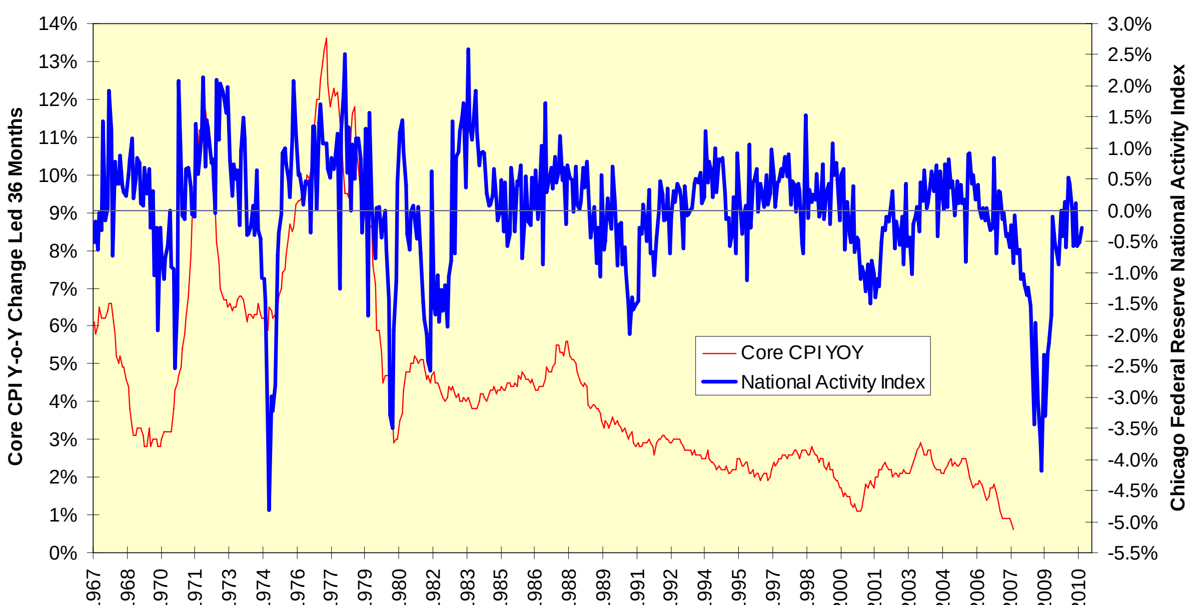
Let's stipulate if the U.S. economy were to start growing faster and unemployment were to start shrinking significantly, I would be willing to accept a higher rate of inflation; like everything else in life, this would have to be considered a cost of doing business. However, if we were to create inflation just for the sake of fulfilling some arbitrary inflation number set by some unelected officials whose track record of being right is spotty at best and horrific otherwise, I would have to stand in protest.

**National Activity Index**

The Chicago Federal Reserve, which sits across LaSalle Street from the former Continental Illinois Bank building, long ago taken over by Bank of America and across Jackson Street from the Chicago Board of Trade building, taken over recently by the Chicago Mercantile Exchange, publishes something called the National Activity index, which sounds like the execrable National Brotherhood Week of my youth.

The NAI is based on 85 different indicators, irrefutable evidence a committee was involved in its creation, divided into five broad categories, one of which is employment. If the rates of change of the NAI and core inflation were somehow linked as posited by the Phillips Curve, we should be able to see it in the forty-three years of data below. We do not: Prior to the elimination of Regulation Q interest-rate ceilings in the early 1980s, the NAI sort of led core CPI by 36 months. Regulation Q allowed the Federal Reserve to crush housing at will by lifting short-term interest rates over the rates savings & loans could pay on deposits; its removal led to the blooming of a thousand flowers and to the creation of the mortgage derivative industry that has threatened our existence as surely as Godzilla has threatened Tokyo on occasion.

**Core Inflation And Real Economic Growth**




What about core CPI? According to this chart, it has been trending downward irregularly since the mid-1970s. Whatever the NAI did was irrelevant: It has been going down as a combination of import competition and productivity increases have put downward pressure on core prices.  In fact, while the NAI has a statistically significant regression relationship with core CPI at the 36-month lag, that relationship collapses if we add the lagged values of the core CPI into the mix.

Yes, Virginia, core CPI is an autoregressive timeseries.

Should national policies be designed to push core CPI higher or should they focus on something useful?  Let’s go with the “something useful” answer until someone can explain why I am better off paying more to get less.