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Why Edmund Phelps' Economic Theory Matters

The newly minted Nobel Prize winner helped establish the relationship between unemployment and inflation—and what the Fed can and can't do about jobs

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On Oct. 9, Edmund S. Phelps, 73, of Columbia University, was named the winner of the 2006 Nobel Prize in Economics. Or, as it is officially known, the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel (Sveriges Riksbank is Sweden's central bank, which funded the prize in 1968).

Phelps was the lone name on the Nobel this year, making him the first sole winner of the economics prize since 1999. Here are some questions and answers about Phelps and the Nobel.

What did Phelps do to win the prize?
In the 1960s, along with famed Chicago economist Milton Friedman, Phelps helped create the concept known as the "natural rate of unemployment." (The natural rate of inflation is also called the "long-run rate of unemployment" or the "non-accelerating inflation rate of unemployment"—NAIRU for short.) What the natural or long-run rate means is this: If unemployment is lower than its "natural rate," then inflation tends to increase. If unemployment is greater than the natural rate, then inflation tends to fall.

Why was this important?
This was a big deal at the time. Before Phelps and Friedman, many macroeconomists believed that it was possible to permanently lower the unemployment rate if the Federal Reserve was willing to cut rates and accept more inflation. But Phelps and Friedman, in separate research, argued that the stimulative effect of low rates would eventually wear off and unemployment would rise back to the natural rate, leaving behind a higher inflation rate.

An important implication of Phelps's work is that the long-term rate of unemployment cannot be changed by monetary or fiscal policy. While the Fed can fight recessions by cutting interest rates, it can't expect to permanently boost employment once the recession is over.

The 1960s seem like such a long time ago. Does Phelps' work still matter today?
Very much so. Despite more than 30 years of subsequent research, most macro forecasting models are still built around some variant of the natural rate of unemployment. Certainly the two leading private forecasters, St.Louis-based Macroeconomic Advisers and Global Insight of Waltham, Mass., rely on Phelps-type equations in their models. "In the end, we keep coming back to what he's done," says Nariman Behravesh, chief economist of Global Insight who was also a graduate student at the University of Pennsylvania while Phelps was teaching there.

The conduct of monetary policy today is also influenced by Phelps' work. Central bankers have given up on the idea that interest-rate changes can influence the long-run rate of unemployment. Instead, they concentrate on controlling inflation. One tool: If the unemployment rate is below its long-run level, then the Fed is more likely to raise interest rates.

Oh, that's interesting. I want to know what the Fed is going to do next. So tell me—is unemployment above or below its natural level?
The Bureau of Labor Statistics just reported that the unemployment rate was 4.6% in September. Joel Prakken, chairman of Macroeconomic Advisers, estimates that the natural rate is around 5.25%, though it could be as much as a half-point higher or lower. Behravesh pegs it somewhat lower, perhaps between 4.5% and 5%.

In either case, unemployment has fallen close to the level that would create an acceleration of wage growth. That would mean the Fed might be more likely to raise rates.

Why is the Nobel committee just honoring Phelps now?
By reaching back to Phelps, the Nobel prize committee is tacitly acknowledging that old wine still may be the best. N. Greg Mankiw, a Harvard professor and former chairman of the Council of Economic Advisers, recently wrote: "The sad truth is that the macroeconomic research of the past three decades has had only minor impact on the practical analysis of monetary or fiscal policy." Adds Prakken: "The neoclassical paradigm that evolved in the 1960s is still the best organizing framework to think about the economy."

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