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ECONOMIC VIEWPOINT

By Robert J. Barro

The Tea Leaves That Matter To The Fed

The key numbers are jobs and inflation, not GDP growth

The monthly report by the Bureau of Labor Statistics (BLS) on payroll employment has become one of the most watched statistics. Thus, the increase by 308,000 jobs in the March report, the best one-month performance since April, 2000, caused a stir. Stocks rose, and bond prices fell sharply. The higher interest rates reversed the declines that followed February's weak report.

One reason for the focus on the payroll numbers is the political as well as economic concern over the sluggish labor market. Despite the strong recent performance of real gross domestic product (GDP), payroll employment growth has been weak. Since the start of the recession in March, 2001, payroll employment has fallen by 2 million jobs, even after the surge last month and the upward adjustments for previous months.

The BLS' other survey of national employment – household employment – provides a brighter picture of the labor market over the past three years. From March, 2001, to March, 2004, it rose by 0.6 million. The discrepancy between the two surveys, 2.6 million jobs over the last three years, is not well understood, despite considerable research. The two surveys have different pluses and minuses and, in my analysis of the labor market, I give weight to both.

BUT IN SETTING INTEREST RATES the Federal Reserve clearly puts a lot more weight on the payroll survey. This connection with rates is another reason the payroll employment number gets so much attention. When I examine changes in the federal funds rate over the Greenspan era since August, 1987, I find that two factors are critical: the strength of the labor market and the inflation rate.

As regards the labor market, increases in the federal funds rate are predicted by higher payroll employment growth over the previous three months and by a reduction in the unemployment rate in the previous month. Interest rates do not respond significantly to the actual growth rate of real GDP. To put it another way, the Fed tends to raise rates when an increase in real GDP reflects higher employment but not when the increase reflects higher labor productivity.

The second key determinant of the federal funds rate is the inflation rate. I find that the Fed raises rates in response to an increase in a broad measure of inflation – the GDP deflator, the price index used to calculate real GDP on a quarterly basis. But the Fed also reacts to recent inflation as gauged by the consumer price index (CPI).

My analysis shows that the recent increases in payroll employment growth and in CPI inflation make it likely that the Fed will raise the rate in the near term. A continuation of March's strong payroll employment growth for another month or two would likely trigger a rise in the funds rate by at least one-quarter point. Similarly, if the inflation rate shown by the GDP deflator were to increase from today's 1 1/2% to 2 1/2%, the funds rate would rise.

I have also used a simple statistical model to forecast changes in payroll employment. Month-to-month changes can be predicted from recent unemployment insurance claims and from the history of employment growth. My prediction for April payrolls (to be released on May 7) is for a rise of 109,000 jobs. But a reasonable error range for this forecast is from -65,000 to +283,000. Thus my forecast, along with those of others, is subject to a large margin of error.

I can also use the model to project payroll employment growth over the longer term, say, the next 12 months. These changes can again be predicted from unemployment insurance claims, past employment growth, and, in this case, from prior growth rates of real GDP. The prediction is that payroll employment will grow at an annual rate of 1.5%, implying that the number employed will rise by 1.9 million jobs from March, 2004, to March, 2005. But there's again a considerable range of error – this time from +0.2 million to +3.6 million.

Now that I have my forecasts, the only thing left for me to do is to sit down with the rest of the world for the employment report Friday morning and wait for the payroll announcement at 8:30 a.m on May 7. Will it be another strong report or something disappointing? Quite a bit economically and politically rides on the number.

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