

There is No Tradeoff Between Inflation and Unemployment

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Shortcomings of the Phillips Curve

by Chris Casey, Mises.org

Anyone reading the regular Federal Open Market Committee press releases can easily envision Chairman Yellen and the Federal Reserve team at the economic controls, carefully adjusting the economy's price level and employment numbers.

The dashboard of macroeconomic data is vigilantly monitored while the monetary switches, accelerators, and other devices are constantly tweaked, all in order to “foster maximum employment and price stability.”[1] The Federal Reserve believes increasing the money supply spurs economic growth, and that such growth, if too strong, will in turn cause price inflation. But if the monetary expansion slows, economic growth may stall and unemployment will rise. So the dilemma can only be solved with a constant iterative process: monetary growth is continuously adjusted until a delicate balance exists between price inflation and unemployment. This faulty reasoning finds its empirical justification in the Phillips curve. Like many Keynesian artifacts, its legacy governs policy long after it has been rendered defunct.

In 1958, New Zealand economist William Phillips wrote *The Relation between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957*. [2] The paper described an apparent inverse relationship between unemployment and increases in wage levels. The thesis was expanded in 1960 by Paul Samuelson in substituting wage levels with price levels. The level of price inflation and unemployment were thereafter linked as opposing forces: increasing one decreases the other, and vice versa. The US data from 1948 through 1960 comparing the year-over-year increases in the average price level with the average annual unemployment rate seemed irrefutable.

The first dent in the Phillips curve came from Chicago-School economist Milton Friedman (as well as, independently, Edmund Phelps) who suggested it was more temporary than timeless, more illusion than illustration. Friedman's “fooling model” posited that price inflation fooled workers into accepting employment at “higher” wage rates despite lower real rates as measured after the impact of price inflation. Once they realized the difference between “real” and “nominal” wages (the fools!), they would demand higher nominal rates as compensation. As inflation rose, unemployment declined, but only temporarily until a new equilibrium was achieved. This simple insight created quite a stir and troubled noted econo-sadist Paul Krugman:

“when I was in grad school, I remember lunchtime conversations that went something like this; ‘I just don’t buy the ... stuff — it’s not remotely realistic.’ But these people have been right so far, how can you be sure they aren’t right now?”[4]

The Friedman criticism was somewhat clever, but unnecessary, minor, and misguided, for cold data was far more damaging than Chicago doctrine. The Phillips curve not only evaporated with the 1970s, but reversed to show a positive correlation between price inflation and unemployment:

In light of this, like many Keynesian concepts, the Phillips curve should have been forever abandoned when the 1970s proved high price inflation and unemployment rates can coexist. But now the Phillips curve is back from the dead. Krugman, writing in 2013, introduced new data demonstrating the Phillips curve’s “resurrection.” According to Krugman: How many economists realize that the data since around 1985 — that is, since the Reagan-Volcker disinflation — actually look a lot like an old-fashioned Phillips curve?

This Krugman comment is correct, US data from 1985 through 2013 again shows an inverse correlation between the year-over-year increases in the average price level with the average annual unemployment rate:

Has the Phillips curve, as Krugman suggests, regained its former acceptance? Since 1985, why has its inverse relationship between price inflation and unemployment reappeared? The question is irrelevant: the fact that it had previously disappeared forever strips the Phillips curve of legitimacy.

Any apparent correlation between two variables may be coincidental and unrelated, directly casual, or linked by a third variable or sets of variables. For price inflation and unemployment, the last explanation is the correct one. Price inflation and unemployment are not opposing forces, but in large part effects deriving from the same causation — the expansion of the money supply.

More money cheapens its value and the price of goods and services accordingly rise in terms of money — hence price inflation. More money lowers interest rates which induce malinvestments (including the hiring of workers) which (who) are eventually liquidated (terminated) in a recession — hence unemployment. While both phenomena largely share a common origin, the timing of their manifestations may be quite different and heavily dependent upon other variables, including fiscal policy.

The death of the Phillips curve will eventually be served not from Chicago School gimmicks, not from the experience of the 1970s, but from greater acceptance of the Austrian School’s explanations of price inflation and business cycles. Unfortunately, in the interim, the monetary policies promoted by the Phillips curve have moved from 1970s lunchtime academic discussion to official government policy. In the hands of the Federal Reserve, the Phillips curve becomes weaponized Keynesianism.

Due to its unjustified acceptance of the Phillips curve and its related misconceptions about price inflation and business cycles, the Federal Reserve will never be able to trade higher price inflation for lower unemployment. Nor can it sacrifice higher unemployment for lower price inflation. But it can, and likely will, generate high levels of both. If the Federal Reserve's economic controls appear broken, it is because they never really worked in the first place.