

Economics focus

Curve ball

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A link between unemployment and inflation is fashionable again

IF HAIRCUTS and dress styles can come back into fashion, then so can economic theories. That is why policymakers have recently been debating the implications of the shape of that very 1960s concept, the Phillips curve.

The Phillips curve was named after A.W. Phillips, whose research suggested a trade-off between British unemployment and wage inflation over the period 1861 to 1957. The curve was widely used in the 1960s. Economists developed models that gave politicians a neat way to find the right balance between the two factors; for every percentage-point fall in unemployment, inflation would rise by, say, half a point.

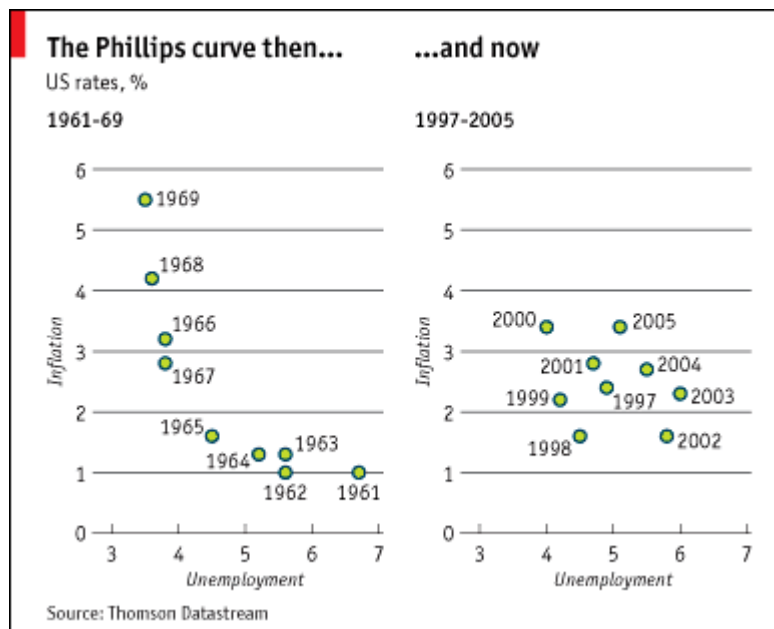


But in the 1970s, the trade-off between unemployment and inflation seemed to evaporate; both rose at the same time, a phenomenon known as stagflation. As Stephen King, chief economist at HSBC, says, "The Phillips curve relationship did exist as long as governments weren't perceived to be exploiting it. When they did, they ended up with accelerating inflation."

Even before the curve began to break down in practice, Milton Friedman had cast doubt on the theory, as had Edmund Phelps, another American economist. The doubters argued that workers would demand higher wages to protect themselves against the rise in inflation. Thus the only effect of government stimulus would be to increase inflation for the same level of employment; in the long run, the Phillips curve became vertical.

So the Phillips curve fell out of favour and was replaced by its corollary, the NAIRU, or non-accelerating inflation rate of unemployment (in effect, the natural rate). Economists spent much of the 1980s and 1990s debating what the rate might be. In the late 1990s indeed, many forecast that the Federal Reserve would be forced to raise interest rates to counter inflationary pressures when unemployment fell below 6% (and then 5%). But the Fed decided that productivity improvements had driven down the NAIRU and so left policy on hold. Growth duly flourished without causing inflation at the consumer level—although some argue that the laxity of monetary policy caused the tech bubble.

Why has the Phillips curve, displaced by the NAIRU and the output gap (which suggests that inflation will rise when economic growth is above trend), come back into the economic debate after so long in the cold?



In part because, while the NAIRU and the output gap are nice ideas, it is often hard to agree, at any given moment, on the value of either number. But the main reason is that the relationship between unemployment and inflation has settled down again. Low unemployment has not been accompanied by significant increases in inflation; in other words, the Phillips curve has flattened considerably.

A fillip for Phillips

Most commentators have put this down to globalisation. As Paul McCulley, a strategist at PIMCO, a large American fund-management firm, remarks in his latest commentary: "The Fed need not worry that a falling US unemployment rate will quickly generate a rapid acceleration in US wage-driven inflation, as US labour's pricing power is diminished by competition from an augmented global labour supply."

A flatter Phillips curve is good news when unemployment is falling. But it also implies bad news if inflation rises significantly. It would then take a much larger increase in unemployment (a more severe recession) to bring inflation down again. This may explain why the European Central Bank has found it so difficult to get euro-zone inflation back below its target of 2%.

This is where the credibility of a central bank may matter a lot. If consumers believe the central bank will keep inflation low, then they will not react to temporary shocks (such as high oil prices) by demanding higher wages. Mr King says it is all down to "rules of thumb" concerning the likely level of inflation. "It is easier to control inflation if the public has the same rule of thumb as the central bank. But if the public adopts a different rule, notably that inflation will be higher, the task of the central bank becomes much more difficult."

That makes it all the more important to decide exactly why the Phillips curve has flattened. In particular, are central banks responsible for the favourable trade-off between unemployment and inflation over the last ten years? Or, as Ken Rogoff of Harvard University suggested recently^{*}, have policymakers merely had a dash of luck: that globalisation happened to coincide with the independence of central banks?

If the answer is luck then central banks need to be on their guard, especially as headline rates of inflation have been rising recently. Some, including the Bank of England, seem to have recognised this problem. They say that while globalisation has caused the prices of manufactured goods to fall, the corollary has been that sharply higher demand for raw materials has caused commodity prices to rise sharply. Core inflation numbers, which exclude food and energy, may thus reflect the good news about globalisation, but ignore the bad.

The Federal Reserve may focus on the low core rate of inflation but workers may be watching the headline numbers, which in most countries have been significantly higher. The sharp drop in oil prices in recent weeks may reduce this differential, but could easily be reversed by supply disruption or a harsh winter.

If workers begin to focus on the effect of higher commodity prices on their spending power, and regard the effect as permanent rather than temporary, then they may push up their wage demands. That could lock higher inflation into the system, giving central banks a devil of a job to bring it back down again.

*" [Impact of Globalisation on Monetary Policy](#)"