Unnatural Economics (Wonkish)

Paul Krugman, *The New York Times*, May 6, 2018

Is the natural rate hypothesis dead? Maybe. Probably.

From the mid-1970s until just the other day, the overwhelming view in macroeconomics was that there is no long-run tradeoff between unemployment and inflation, that any attempt to hold unemployment below some level determined by structural factors would lead to ever-accelerating inflation. But the data haven't supported that view for a while; and the latest US employment report, with its combination of a low reported unemployment rate and continuing weak wage growth, seems to have brought skepticism about the natural rate to critical mass.

But what does it mean to question or reject the concept of a natural rate? Reading Mike Konczal's explanation for the layperson, or Olivier Blanchard's exposition for the pros, I wonder whether the point is coming across clearly enough. That's not to say that there's anything wrong with either Konczal or Blanchard – I completely agree with what both are saying, except that I would take a stronger stand than Olivier against the old orthodoxy (which probably says more about our personalities than about our take on the evidence, which appears to be identical.) But I thought it might be useful to restate the case and the implications.

The bottom line here is that the case for aggressive monetary and, when necessary, fiscal policies to sustain demand is much stronger than we used to think. Errors like the turn to austerity and the ECB's 2011 rate hike were much bigger mistakes than the previous doctrine allowed for; premature Fed rate hikes would be a bigger sin than even the Fed seems to realize now. For given what we now seem to know, output lost to weak demand is lost forever; there is no chance to make up for it later.

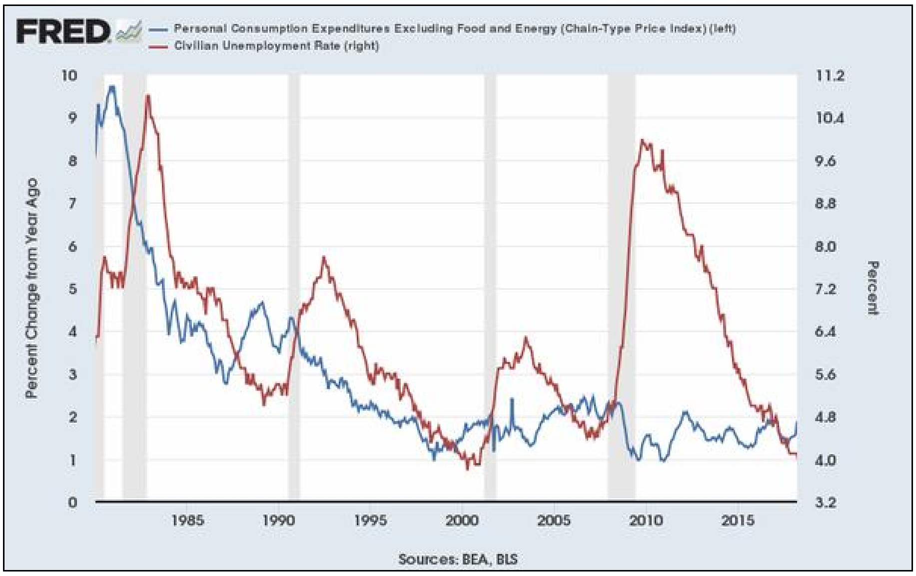
During the 1970s almost the whole macroeconomics profession was persuaded by the experience of stagflation that Milton Friedman (and Edmund Phelps) were right: there is no long run tradeoff between inflation and unemployment. Current inflation does depend on unemployment, but it also depends one-for-one on expected inflation:

Inflation = f(U) + expected inflation

where f(U) means some function of the unemployment rate. Meanwhile, expected inflation presumably reflects past inflation. So trying to keep U very low means raising inflation ever higher to keep ahead of expectations, which is not a sustainable strategy.

Actually, the speed with which the profession adopted the natural rate hypothesis was remarkable – and is especially extraordinary compared with the utter unwillingness of many macroeconomists to admit that experience since 2008 requires some change in their models, maybe even a concession that Keynesians were onto something. But that's a story for another time.

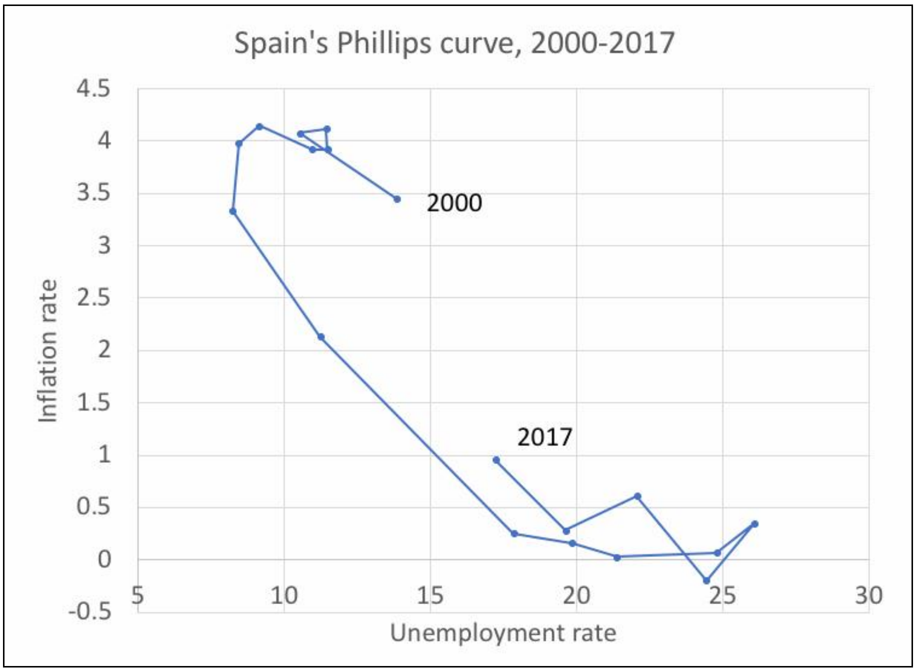
So what happened? Consider the behavior of unemployment and core inflation since 1980:



The first half of the 80s was marked by a huge rise in unemployment, which eventually came back down to roughly its original level; but inflation at the end of this cycle was a lot lower than at the beginning, seeming to confirm the accelerationist hypothesis.

But after 2008 we once again had a huge rise in unemployment, which eventually came back down to roughly its starting point (actually lower at this point). If this cycle had produced an 80s-level disinflation, we'd be well into deflation by now. Instead, inflation is also pretty much back where we started.

Does this mean that there's no relationship between unemployment and inflation? Despite some puzzles in recent US data, I'm not willing to go there. Extreme events are your friend in such cases, because the underlying logic is less likely to be obscured by special circumstances. So I look at things like Spain's disinflation in the face of massive unemployment:



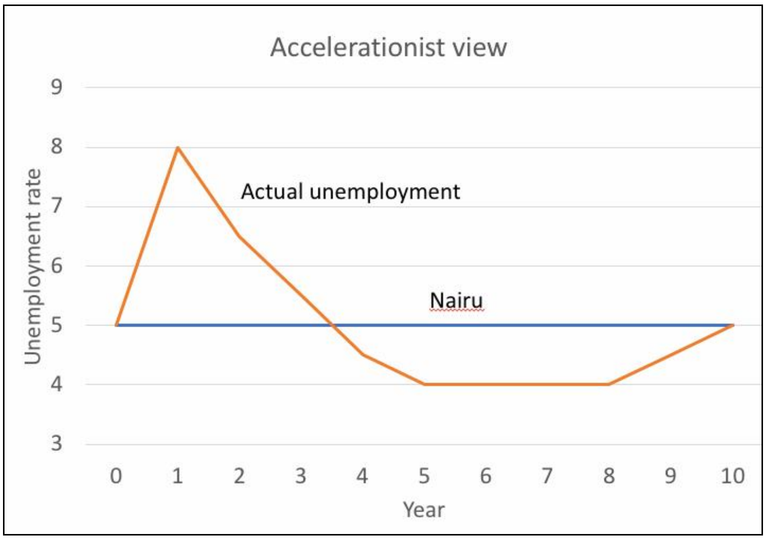
I'd say that the preponderance of evidence still supports the notion that high unemployment depresses inflation, low unemployment fosters inflation.

But this isn't what the natural rate hypothesis demands. This is what I've called the neo-paleo-Keynesian Phillips curve, in which there *is* a tradeoff between inflation and unemployment, even in the long run.

Why does accelerationism, which worked in the 80s, no longer seem to work? One way or another, I think we're into the realm of bounded rationality/behavioral economics. Downward nominal wage rigidity is a real thing, which becomes highly relevant at low inflation. And as Blanchard suggests, in a low-inflation world people may simply stop paying attention to overall inflation, or building changing expectations into their price-setting.

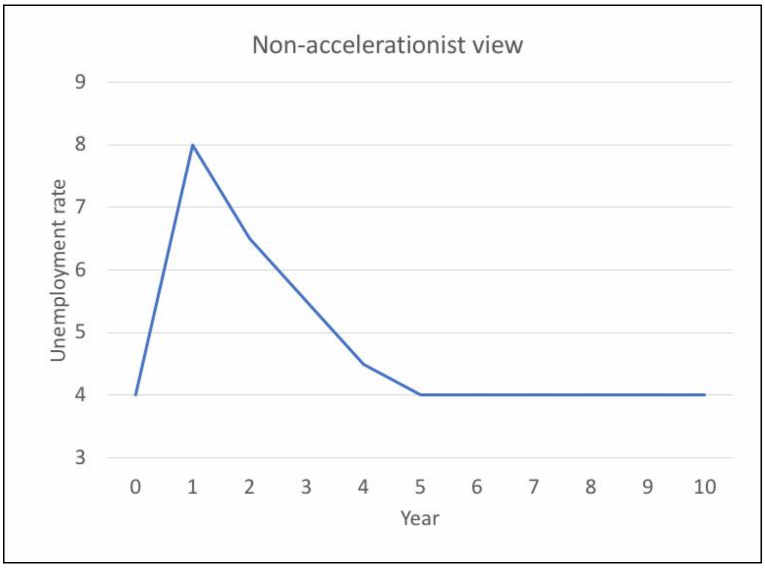
So why does this matter? Consider the following story; any resemblance to real events is entirely intentional. Imagine that we go through a severe economic slump that temporarily drives unemployment way up and reduces inflation, but that eventually inflation gets back to where it started.

On the accelerationist view, the period of high unemployment should lead to lower expected inflation, so to get inflation back up to its original level policymakers have to let the economy run hot for a while, with unemployment below its long-run sustainable level. Assuming they manage to do this, the period of running hot helps offset the cost of the initial slump; indeed, to a first approximation the average unemployment rate over, say, a decade is the same as it would have been without the slump:



On this view, the task of central banks and fiscal authorities isn't full employment; it's "stabilization", avoiding big swings in unemployment. You can think of reasons that might be important, but it would be wrong to simply add up the output lost during a slump and call that the loss to the economy.

But the paleo view – which is the one supported by the evidence – says that getting inflation back to the original level doesn't mean running the economy temporarily hot; it just means getting unemployment back down. So there is never any compensation for the initial slump:



On that view, the failure to supply enough demand after 2008 imposed an enormous cost, which we can never regain. And looking forward, the risks of being too loose versus too tight are hugely asymmetric: letting the economy slump again will again impose big costs that are never made up, while running it hot won't store up any meaningful trouble for the future.

Is this reality being reflected in policy? My sense is that a lot of economists in central banks have come around to a neo-paleo view of inflation. But actual policy still looks as if it's being run with an accelerationist Phillips curve in the background, at best; indeed, there's an obvious unwillingness even to temporarily let the economy run hot.

This matters. We should not let policy be driven by ideas that haven't worked for decades.