

THE 2006 NOBEL PRIZE: UNEMPLOYMENT IS BAD, UNEMPLOYMENT WITH HYPER INFLATION IS WORSE

Dear All:

The Nobel prize for economic sciences for 2006 was announced today, October 9, 2006. It went to Ed Phelps. I had guessed Phelps for my second choice. In previous years, my first or second choice has usually won the Nobel (with the exception of last year).

Ed Phelps was born in 1933 in Illinois. He obtained his BA from Amherst College in 1955 and his Ph.D. from Yale University in 1959. He has been a professor at Yale University, MIT, and at Columbia University ever since 1982.

- So what did this 73-year old man do that makes him so Noble?

In a nutshell, he helped us understand the tradeoffs between inflation and unemployment and its policy implications for governments and central banks.

Well, what does that mean? First let's study a little bit of history. In 1958, an economist named Phillips took a bunch of data on British inflation and unemployment and plotted it on a graph. He then connected the dots and found that higher inflation was accompanied by lower unemployment and vice versa. So people got very excited because it meant that a central bank (like the Fed) in each country had a choice, either institute policies to have low unemployment and accept higher inflation or institute policies to have higher unemployment and face lower inflation. Did it make sense? Well, yes. Lower unemployment leads to workers having more bargaining power (or a relative shortage in supply of labor) and thus, wages go higher and firms increase prices in line with increased costs of labor. Thus, low unemployment leads to higher price rises and hence higher inflation. Simple and cute.

However, in the 1970s, if you plotted inflation against unemployment, all you would see was a great scatter plot of random dots. It made the Phillips curve look like a British data fluke and nothing more. And guess who predicted this would happen? Ed Phelps in 1968, along with Milton Friedman (another Nobel prize winner). Ed Phelps sat down and thought hard about the relationship between unemployment and inflation. He realized that people in the economy weren't just little puppets that could be manipulated, they actually think a little bit. He believed that people's expectations of future inflation effect the current inflation rate. In fact, inflation today is influenced not only by the level of unemployment (that part was right), but also by people's expectations of future inflation.

That is, if people believe inflation will be very high in the future, then they will adjust right now, at whatever rate of unemployment, and inflation today will already be higher. This occurs because workers can demand higher wage contracts today in order to anticipate higher prices in the future. This feedback effect can be devastating. If people believe future inflation to be very high, then it will effect today's inflation rate immediately

regardless of the level of unemployment. Thus, you get something “bad” without a tradeoff. This modeling by Phelps of a more complete relationship between unemployment and inflation led to the creation of the “expectations-augmented Phillips curve.”

- You might say, “Who cares, how does this affect me?”

It affects every one of us in many ways. Every country has a central bank to help manage the U.S. economy. The central bank has the luxury to alter interest rates, which ultimately effects output and inflation in the economy. His analysis meant that a central bank should not just look at the current tradeoff between unemployment and inflation, but rather to a dynamic inter-temporal view of the tradeoff. That is, the policy maker must consider how current policies affect beliefs about future inflation, and it may also mean that reducing inflation in the present, despite its adverse effects on employment in the short-run, may be of extreme importance for the benefit of all people over the long-run.

In the United States, the inflation rate released in August was 3.4% over the past year. Some countries in Latin America have inflation rates of 14-15% and this is good news! Careless monetary policy that ignored inflationary expectations led countries to massive problems in the past. In 1990, inflation in Brazil was 2,938%, in Argentina it was 2,314%, and in Peru, it was a staggering 7,482%. Their economies were in utter turmoil, with political leaders being executed almost as often as we have coffee in the morning. Part of this was due to unfortunate negative external shocks to the economy, but a good deal of this was due to central banks in those countries forgetting (or not even being aware of) the Phelps's rule-of-thumb, inflation depends on people's expectations of future inflation. Central banks in those countries were printing money like Starbucks pops out coffee. And soon enough people figured it out and inflation started spiraling out of control to where the economy stagnated, even though the original motivation was to increase output in the economy. The reason they are out of that mess today is partly due to new central bankers who read some of the work of Phelps and managed policy accordingly (not to mention a sprinkle of dictators, executions, and good luck).

Even in the US, a former chairman of the Fed, Paul Volker used some of those tactics in 1980 to bring inflation in the US from 13% per year to 2% per year partly by changing people's expectations of inflation.

So let's be happy our central bankers understand this. Bernanke, as well as the ECB, believe in inflation targeting, which in some part is due to the work of Phelps.

- Ok, cool. Anything else we should know about this guy?

In addition to his main contribution, Phelps also was one of the first to bring microeconomic foundations to the field of macroeconomics, which was mostly devoid of

such underpinnings. He also did some interesting work on the optimal level of saving in an economy. He also hinted at the idea of efficiency wages, something that would become more popular amongst academics in the 1980s. Phelps also believed that monetary policy could not affect the economy in the long-run and thus, temporary fiddling with output gaps might lead to longer-term bad outcomes. It was probably better to have monetary rules, like inflation-rate targeting.

Also, since his original work was published, people have modified and built upon his work, including adding rational expectations to the formation of expectations in the Phillips curve. He also mentored several students that are now very well known, like Guillermo Calvo and John Taylor.

And in case you're wondering, the augmented Phillip's curve does explain the 1970s tradeoff between inflation and unemployment just fine. Some estimates indicate that a 1% decrease in unemployment leads to a 1.15% increase in inflation.

- So is that it?

Basically, that's it. I'm glad to see the Nobel committee has stopped playing games and has chosen someone that focused on real issues with our real economy. We have so many important problems to explore --- and solve. Real problems that affect our everyday lives. I'm encouraged by this.

For more information on the winner:

http://nobelprize.org/nobel_prizes/economics/laureates/2006/

Enjoy!
Ludwig

p.s. As with all great work, many people were involved in the research and concepts I have discussed in this email. Some built upon work by Phelps, while others preceded the work of Phelps. It is their entire contribution that has helped us understand how to manage an economy better.