THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
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A SYMPOSIUM OF VIEWS

Broken Rules

Prior to the coronavirus economic meltdown, workers were returning to the U.S. labor force at unexpectedly high rates, contrary to the secular stagnation theories of several years ago. Did this development suggest that today's low labor participation rate was not the new normal? What are the implications, if any, for the Phillips curve and for Federal Reserve monetary policy from these recent developments?

Economists in both parties were just blowing smoke when they beat the drums all these years about the danger of inflation arising from some kind of Phillips Curve trade-off.

THOMAS FERGUSON
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Debates over economic policy in this election year often seem right out of Borges—or maybe Brecht. Few economists associated with the Democrats can bring themselves to admit that the Trump administration could do anything right. Republican economists, by contrast, usually sound like the Tweeter in Chief is really on the verge of MAGA—Making America Great Again.

Part of the problem is that assessments center on a glass that can be made to look either half full or half empty thanks to decades of bipartisan economic policy failure. By selectively picking your baseline, it is easy to create dramatic contrast effects that seem to tell radically different stories.

Income growth under Trump is a case in point. A favorite variable in many models of presidential voting—real disposable per capita income—is up by more than $3,000 from 2016, and median family income has risen, too. But because the improvement started in the waning days of the Obama administration, if you want you can try to write it off as a cyclical phenomenon that has little to do with Trump.

But that retort is too clever by half. It gives the Obama administration a free pass for its timid economic policies that delayed recovery for years and helped lose the White House for the Democrats. More importantly, it ignores Trump's incessant drumbeating against Federal Reserve rate increases. Whatever you think of the "proper" relationship presidents should maintain with the central bank, his stance against rate rises has surely intimidated inflation hawks. It has also neutralized the vast GOP netherworld of gold bugs and other monetary partisans who saw inflation around every corner as long as Democrats were in power.

Thanks to this striking natural experiment, it is now obvious that central bank and mainstream economists in both parties were just blowing smoke when they beat the drums all these years about the danger of inflation arising from some kind of Phillips Curve trade-off. It is equally apparent that the complicated mainstream econometric models of potential output were just as wide of the mark. They really just track where the economy has recently gone, incorporating into their estimates every mistake of pessimistic policymakers.

Post-Keynesian economists such as Servaas Storm, Antonella Stirati, Steve Fazzari, Mario Seccareccia, Mark Lavoie, Lance Taylor, and Orsola Costantini, whose working papers are available online at the website of the Institute for New Economic Thinking, were right all along, as were James Galbraith, Thomas Palley, Alain Parguez, and others who made similar arguments.

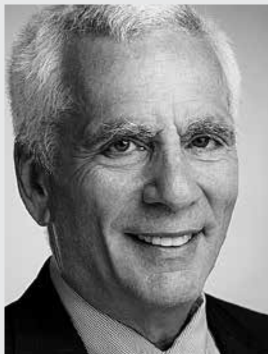
Growth in the long run cannot be a function only of supply factors. Demand matters, too, not least because of the way costs behave as output rises, new techniques of production come into play, and Kaldor-Verdoorn and other effects of expansion kick in.

But if Trump should get some of the credit for what has happened, we are still a long way from MAGA. Two striking papers by Claudia Fontanari, Antonella Palumbo, and Chiara Salvatori for INET show how different the world looks when someone steps out of the tautological world of the NAIRU to look empirically at who's still on the sidelines. The U.S. economy still has some slack, a central reason why improvements in the standard of living of ordinary Americans that the administration touts stem more from the availability of additional hours of work than increases in wages. Under both Obama and Trump and many other

presidents before, those have hardly risen at all, making it easy to understand the rises in mortality rates for many groups of Americans and why Bernie Sanders is winning so many votes in Democratic primaries.

And, as my colleague and occasional coauthor Peter Temin described in yet another INET working paper, the United States under Trump is in important respects "eating the family cow." The administration's tax bills and revenue policies continue to fuel rising inequality and its promised investment boom has never materialized. Ditto the programs to rebuild the American infrastructure. The U.S. economy is still mired in a "new normal" of low productivity, increasing degrees of monopoly, and low wages, even as more Americans pile up hours of work.

The views expressed here are the author's own and not those of any institution with which he is affiliated.



The goal is to build on the cyclical labor-supply gains we're now achieving.

JARED BERNSTEIN
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For those willing to update their priors, recent trends in U.S. labor market and price variables have been instructive. The price Phillips curve is much flatter than many thought, there's a deeper pool of labor supply than most thought, and our point estimates of the "natural rate" of unemployment have had a clear, upward bias. Really, we just don't know the level of the lowest unemployment rate consistent with stable inflation; all we know is it's lower than we thought.

The moment is thus rich with important policy lessons. For example, given the uncertainty surrounding the natural rate, central banks must be data-driven, setting policy based on actual and expectational outcomes. Thanks to insightful leadership by Federal Reserve Chair Jerome Powell and others, this lesson is actively being implemented to the great benefit of millions of economically vulnerable people left behind in slack markets. The trend in flows from not-in-the-labor-force into employment, as a share of the working-age population, is at an all-time high; the employment rate for prime-age (25–54) year-olds just hit its cyclical peak.

But there's a related question that I urge fellow economists and policymakers to contemplate: what is the necessary policy alchemy to turn cyclical gains into structural ones? While the persistently tight job market is pulling workers in off the sidelines, leading employers to more highly value incumbent workers and discovering labor supply we didn't know we had, there's a risk of last-hired-first-fired when demand contracts. The risk is that new workers would head back to the sidelines, possibly, depending on the depth and shape of the downturn and next expansion, for years to come.

Smart policies can preempt this outcome. Laid-off workers should have access to training and apprenticeship opportunities. Especially important would be to ramp up subsidized employment, a policy that worked well in the last recession. In this spirit, I've argued for a Full Employment Fund that expands and contracts with the business cycle. Resources from the fund would be triggered by increases in slack variables and would support subsidized employment and/or direct job creation.

The goal is to build on the cyclical labor-supply gains we're now achieving so they become lasting, structural gains.

What will be the Fed's take on this? Plenty of strategic patience.

GREGORY D. HESS
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The U.S. labor force participation rate—the fraction of the U.S. civilian population over age sixteen that is employed or unemployed and seeking work—has begun to rise over the past few years after systematically declining since the early 2000s. Is the labor force participation rate going to reverse course and spring back to new heights? Not likely. Here's why. Historically, demographic, cyclical, and secular factors have affected labor force participation. For example, the increase of women into formal labor markets is prominent in the data and explain much of the overall rise since the early 1960s, as do the data's pro-cyclical movements over the business cycle.

The secular decline from the early 2000s reflects the maturing of the baby boomers, macro-cyclical factors, and a decline in labor force productivity. The further deceleration since the 2008 financial crisis led several prominent economists to identify this as a co-incident indicator of secular stagnation. A standard explanation would be that discouraged individuals remain outside the labor force when wages and the likelihood of finding work are low.

The uptick in the labor force participation rate in the past few years reflects business cycle factors such as the low and declining unemployment rate over at least the past five years (more prospects for work) and recent tax changes (better returns for working). Unfortunately, productivity growth remains muted, which means that real wage growth will also be modest, so the financial rewards for work will rise slowly. The good news is that labor markets have likely digested most of the demographic impact of the aging of the Baby Boom, and increased job flexibility for at least some workers will ameliorate any further downward pressure on the labor force participation rate.

What will be the Fed's take on this? Plenty of strategic patience. Sorting through economic cyclical and secular trends is the Fed's responsibility to fulfill its dual mandate to keep prices stable (that is, 2 percent inflation) and maximize employment. As U.S. inflation has been below the target for a sustained period, statements by the Fed indicate that it is willing to place relatively more weight on labor market developments in monetary policy decision-making in the short to medium run. Moreover, a fair number of FOMC members have lost faith in the empirical Phillips curve relationship between the labor market and inflation. For the time being, I believe they think that labor markets and inflation are decoupled, and policy will reflect that belief.

In the absence of real evidence of inflation, the Fed should allow the unemployment rate to continue to fall.

DEAN BAKER

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Anyone who has followed trends in unemployment and inflation over the last five years cannot possibly believe that the concept of the non-accelerating inflation rate of unemployment (NAIRU) is a useful guide to monetary and fiscal policy. In 2015, most economists put the NAIRU at 5 percent or higher. Very few believed the unemployment rate could get much below 5 percent without triggering spiraling inflation.

We have now seen the unemployment rate not only fall below 5 percent, but well below 4 percent, with no evidence whatsoever of accelerating inflation or wage growth. It is not possible to see this pattern and still maintain that the NAIRU, or the Phillips Curve that underlies it, can be a useful guide to macroeconomic policy.

Clearly a big part of the story is that there was much more room for labor force participation to respond to increases in labor demand. Early in the last decade there was a cottage industry for explanations as to why young men no longer were interested in working. Popular explanations in policy circles included the high quality of video games and access to Internet porn.

These stories look rather silly today. In January of 2020, the employment-to-population ratio (EPOP) for men between the ages of 25 and 34 stood at 85.6 percent. This is up by more than three full percentage points from where it was in 2014. For all prime age workers (ages 25 to 54), the EPOP rose from 76.7 percent in 2014 to 80.2 percent last month.

While this increase in employment rates was a surprise to many economists, there is little reason to believe that there cannot be further increases. Over the last year, the EPOP for prime age workers increased by 0.8 percentage points, with the EPOP for men rising by 0.2 percentage points, and the EPOP for prime age women rising by 1.3 percentage points. There is no reason to believe that we are reaching any ceiling in the percentage of prime age workers who would be interested in working, if the jobs were available.

It is also worth considering how much economic and social damage would have been done if we had run monetary policy over the last five years as though a 5 percent NAIRU imposed a binding constraint. We would have denied millions of people the opportunity to get jobs, and denied tens of millions the bargaining power to secure wage increases. The beneficiaries have been disproportionately African Americans, Hispanics, less-educated workers, and other disadvantaged groups in the labor market.

This fact should caution against embracing a new estimate of the NAIRU as a target for monetary policy. In the absence of real evidence of inflation, the Fed should allow the unemployment rate to continue to fall and we will see how low we can go. ◆