Up the NAIRU without a paddle

In the 1970s, mainstream thinking on unemployment converted to a new conservative orthodoxy. Now, liberals are making those ideas their own

ECONOMICS FOCUS

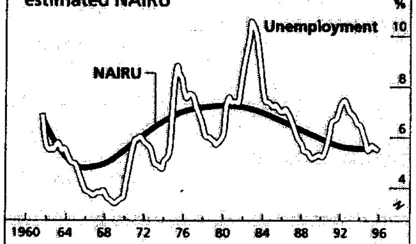
IN 1968 Milton Friedman and Edmund Phelps, in papers written independently, assaulted the prevailing consensus on unemployment. They said it was wrong to suppose, as most economists had up to then, that governments could lower the rate of unemployment if only they would accept a little more inflation. This imagined trade-off, they argued, was a trap: governments that tolerated higher inflation in the hope of lowering unemployment would find that joblessness dipped only briefly before returning to its previous level, while inflation would rise and stay put.

Unemployment, they argued, has an equilibrium or "natural" rate, determined not by the amount of demand in the economy but by the structure of the labour market. Only one level of unemployment, the "natural" rate, is consistent with stable inflation. The notion that there is a "non-accelerating-inflation rate of unemployment", or NAIRU, became a touchstone of free-market economic policies around the world. But now, economists who believe that governments should be more active in fighting unemployment are making the NAIRU their own.

Why did the NAIRU become identified with conservative thinking? The answer is timing. Just a few years after Messrs Friedman and Phelps unveiled their theories, many countries, including America, suffered rising inflation and rising unemployment at the same time. "Stagflation" appeared to confirm their view that macroeconomic policy could not conquer unemployment. That became conservative orthodoxy—in good part because the political mood was anyway turning against big government. As James Galbraith, a professor at the University of Texas, writes in a symposium in the current issue of the *Journal of Economic Perspectives**, "Since Friedman's [paper], orthodox macroeconomics has virtually always leaned against policies to support full employment. In spite of stagnant real wages, it has virtually never leaned the other way."

Yet it might have been otherwise. A crucial question had been neglected: whether, and under what circumstances, the natural rate might change. Increasingly, economists have concentrated on this question. As a result, by degrees, natural-rate theory has been recaptured by the centre-left.

Mr Friedman, staunch foe of the state, has consistently opposed government intervention in this area as in almost every other. But anticipating more recent work, Mr Phelps, the theory's other pioneer, has long emphasised the need for measures to lower the natural rate—essentially, by making more people employable at the prevailing level of wages. In a book to be published next month† Mr Phelps advocates an enormous programme of employment subsidies aimed both at lowering the NAIRU and at raising the incomes of the working poor.



Nature's ups and downs
American unemployment rate and estimated NAIRU
Source: Staiger, Stock and Watson

The initial association of the natural-rate theory and conservative ideas on policy was exaggerated in another way. Suppose, to take the extreme case, that the NAIRU were fixed after all. Even then, allowing inflation to rise in order to curb unemployment may not always be undesirable. It might be worth sacrificing a permanent increase in inflation for a temporary cut in unemployment—if the increase in inflation were tiny, and if the drop in unemployment were big and prolonged (albeit not permanent). In short, the success of the natural-rate paradigm need not have been the triumph for conservatism that it was initially.

These days, liberals have all but reclaimed the ground they surrendered in the 1970s. The main thing is that nobody any longer thinks that the NAIRU is fixed, which puts the spotlight back on policies that might reduce it. In another *Perspectives* article, Joseph Stiglitz, until recently the chairman of President Clinton's council of economic advisers, argues that the changing demographics of the labour force, as well as more vigorous competition in the markets for goods and jobs, have contributed to a fall of some 1½ percentage points in America's NAIRU since the early 1980s. He estimates it to be 5½% or a little less, which also happens to be the current rate of unemployment.

Robert Gordon of Northwestern University broadly agrees. And a third set of calculations, by Douglas Staiger and James Stock of Harvard and Mark Watson of Princeton, tells roughly the same story (see chart for their estimates).

Swimming lessons

There is less agreement over whether, given that the NAIRU is so changeable, the concept has any meaning at all. Certainly, without Mr Friedman's implicit claim that the natural rate was a constant, the theory would have made far less of a stir in the first place. Nonetheless, Mr Stiglitz says the idea makes sense theoretically. And in practice, he argues, the gap between the estimated NAIRU and actual unemployment turns out to be a good predictor of changes in inflation. Even if the NAIRU moves around and cannot be measured precisely, it still provides a helpful guide to thinking about economic policy.

But praise for the brainchild of Messrs Friedman and Phelps goes only so far. Mr Stiglitz, for one, gives the natural-rate framework a markedly anti-conservative spin. In particular, he argues for a more relaxed approach to fighting inflation. The new research, he says, does indeed suggest that the costs in higher inflation of driving unemployment below the NAIRU are small. So, "in testing the waters, we do not risk drowning. If need be, we can always reverse course. But by experimenting, and showing some hesitation about restraining the economy through higher interest rates... as the NAIRU draws nigh, we might learn a little more about the depth of the waters and possibly become better swimmers."

Mr Friedman would doubtless regard this plea for flexibility in monetary policy with disdain. Giving policymakers that kind of discretion, he would say, is exactly what gets economies drowned. As the American economy continues to expand vigorously, the Federal Reserve will soon have to decide how cautiously to swim.

* "Symposium: The Natural Rate of Unemployment", *Journal of Economic Perspectives*, Winter 1997

† "Rewarding Work". To be published by Harvard University Press