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BIG BOOM THEORY

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Economists see tradeoffs and tough choices everywhere. They feel nervous and bewildered if there are too many good things going on at the same time. It could be a genuine Pavlovian response. Or maybe a fear that if all economic problems disappear, theirs will be the only trade that will offer no jobs.

Is the current economic ?miracle? in the United States posing such a threat for the economists? profession? Even though the rest of the world is catching cold, Uncle Sam doesn?t even pause to sneeze! At the same time that Russia lies in a heap, the Asian tigers screech to a halt and Brazil misses more than a beat, the US economy is enjoying its longest running peacetime boom. The Dow Jones, in a seeming conquest of vertigo, is reaching dizzying heights every day. The unemployment rate is at a record low of 4.2 per cent by most recent estimates, and falling. The inflation rate, standing at 1.6 per cent, is the lowest in the last three decades. Add to this impressive productivity growth and a federal budget surplus for the first time in ages. No wonder Bill Clinton could laugh all the way from the impeachment dock back to the White House. It?s the economy again, stupid!

Ever since World War II, as macroeconomic management became an accepted duty of governments in industrialized nations, economists never tired of reminding policymakers of the ?inflation-unemployment tradeoff?. Inflation and unemployment, the twin evils of modern capitalism, are like two ends of a see-saw. If you bring one down, the other will have to go up. A society in which everyone has a job and prices never rise is only a dream. The task of the politician and the policymaker is to achieve a judicious mix

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of the two evils. Or so it was said.

The idea was motivated by an empirical pattern observed by A.W. Phillips in the late Fifties. He looked at inflation and unemployment rates in the United Kingdom over several years, and found that the observations can be neatly fitted into a curve ? the famous Phillips curve ? showing a significant negative relationship between the two.

Other studies found a similar pattern for other countries. The Phillips curve soon found theoretical underpinnings in Keynesian macroeconomics, which had become mainstream after the war. Recessions, argued John Maynard Keynes, are caused by lack of sufficient demand for goods and services. When demand picks up for whatever reason, the economy initially responds by expanding output, drawing on the reserve army of the unemployed. As demand continues to increase, however, and unemployment falls, it becomes more and more difficult to sustain this growth. Industry runs out of new workers, and the ?tight? labour market translates into higher wages, and eventually, higher prices. If demand swells up and unemployment is pushed too low, the economic machine overheats and lets off steam through inflation.

For decades, economic advisors have wielded the Phillips curve as one of their favourite tradeoffs and cautionary notes. Unemployment down to five per cent? Put on the fiscal and monetary brakes immediately. You don?t want another Latin America to happen. Last quarter?s results show serious deflationary trends? Let?s pump in more money and beat that recession closing in on our heels.

Coming to the end of the millennium (as the clich? goes), has the Phillips curve finally died? Can the US live without it from now on, much like the smallpox and the bubonic plague? Otherwise, how do you explain this happy assortment of statistics for the past few years ? low joblessness, coupled with stable prices?

Macroeconomics is a strange discipline. It is perhaps the subfield of academic economics in which practitioners have the most squabbles and disagreements. But it also happens to be an area which is most avidly discussed in the popular press. Communication between the two worlds is not always perfect. So it may come as a surprise to many that the demise of the Phillips curve is nothing new to insiders. It suffered a setback more than two decades ago, after the Organization of Petroleum Exporting Countries oil price increase in the early Seventies.

Immediately after the hike in crude oil prices, most of the industrial nations of North America and western Europe plunged into a deep recession. But this one was special, because along with it came sharply rising commodity prices. It is as if the two ends of the see-saw went up at the same time. Much like what we are seeing today, only in the other direction. Some prominent economists, such as Edmund Phelps, Milton Friedman, and Robert Lucas (the last two went on to win Nobel prizes for their work) argued that there is no good theoretical basis for a Phillips curve like tradeoff between unemployment and inflation to persist indefinitely.

To see this, let?s turn the question around, and instead of asking: will low unemployment cause inflation, ask: will inflation reduce unemployment? Let?s think of any producer, say a shoemaker. Suppose he goes to work one morning, and notices that consumers suddenly have more cash to spend on his shoes. His rival stores across the street have marked up their price tags, so he follows suit. But beyond this, he faces a dilemma. Should he work harder now, and employ a few more assistants to make more shoes, expecting consumers will make a beeline to buy them? Or should he let things be as they were?

How he should react depends on what he believes is the cause behind this sudden increase in spending. Is it because the recession is finally over, real incomes are soaring, laid off workers have got back their jobs and are out on a shopping binge to celebrate their change in fortune? Is it because people have started appreciating the importance of what they wear on their feet? Or is it merely the case that the central bank has secretly pumped more cash into the system? If it?s a true upturn of the economy or his own business, it makes sense to increase production to take advantage of the new conditions. If it?s really inflation caused by increased money supply from the Fed, then nothing of essence has changed. True he can charge more for his shoes, but very soon, he will also have to pay higher rents and more for his groceries. If what has gone up is not merely the price of shoes but all prices, then everything cancels out, and there is no reason to do anything different.

As an intelligent shoemaker, he will consider both possibilities and place some weight on each. Thus, he might increase production somewhat, but will also hedge his bets and not exactly want to go overboard.

Herein lies Lucas?s insight. People?s expectations and beliefs matter, and the Fed?s reputation in conducting monetary policy plays an important role. Once in a while, the Fed can increase output and employment by injecting more money into the economy. The resultant inflation might ?fool? people like our shoemaker into believing that it?s not really inflation after all, but an improvement in their own business conditions relative to others, calling for business expansion.

However, this trick tried too often will lose all its effect. As in the story of the lad who cried wolf one too many times, people will start calling the bluff. Every sign of a price increase in any market will be interpreted as part of a Fed induced inflation, leading to passivity and absence of any reaction. Thus, the Phillips curve may well be like the Cheshire cat: here now, and gone the very next moment, leaving behind only its mischievous smile.

While the essential points of the fable above are now well accepted within the profession, yet there are important differences of opinion among rival camps regarding how a market economy adjusts to various shocks. Keynesians believe that the economy is riddled with frictions and market imperfections, that often lead to a short run rigidity of wages or certain prices, which in turn can have important consequences. The Chicago school, represented by Friedman and Lucas, is of the view that prices adjust quickly to clear markets. How does such a view explain the existence of unemployment?

The key lies in the concept of a ?natural rate? of unemployment. Due to mobility and search costs, there will be an irreducible minimum amount of unemployment even if the number of vacancies equals the number of job seekers. Actual unemployment may exceed or fall below the natural rate in response to demand shocks and business fluctuations. While everyone agrees that there will be a tendency for the economy to gravitate towards the natural rate in the long run, the main disagreement between Keynesians and the Chicago school is how quick or painless this adjustment is. Still, the main thrust of Lucas?s argument is accepted by both sides: as long as it is transparent what the Fed is up to, the effect of changes in money supply must be ?neutral?, that is, it shouldn?t affect employment or growth but will only dissipate in appropriate inflation or deflation. In other words, any amount of inflation is compatible with the natural rate (or any other rate) of unemployment, in principle.

The natural rate for the US economy has long been estimated to be around six per cent. The curious thing over the last couple of years is that the actual unemployment figures have remained consistently below this. At the same time, the Fed?s policy has remained more or less steady. There has been no drastic hike in interest rates, or tightening of monetary policy to check inflationary tendencies. Lucas has taught us that high inflation need not cause low unemployment. Nevertheless, unemployment too far below the natural rate for too long, coupled with an easygoing approach by the Fed, may be expected to cause some inflation for all the traditional reasons of overheating. That doesn?t seem to be happening yet. And the ?unnaturally? low unemployment rates and unusually high growth rates show no sign of reversing themselves till now.

The current upswing of the American economy has given rise to a new class of optimists in the business world, the fringes of academe and the popular press. Paul Krugman derisively calls them the New Economy cultists. The central tenet of this new philosophy seems to be that advances in computer technology and the internet have transformed the very way in which an advanced economy is going to function, altering its fundamental laws and characteristics. From now on, argue the new messiahs, we can expect unprecedented and unfaltering growth, vanishing unemployment, and zero inflation forever.

Beyond naive optimism and futuristic jargon, not much reason or evidence is usually provided for this view. Physicists have long discarded the possibility of a perpetual motion machine; so have economists, but it is less widely appreciated. Sustained economic growth can only be based on a continuous spate of innovations, creating new products and new technologies without cease.

This process will always have ups and downs, and can never be taken for granted. The New Economy enthusiasts complain that conventional statistics undervalue the true contribution of the computer and information revolution, since improvements in quality, particularly of services, are hard to measure. Be that as it may, the sustainability of current rates of productivity increase (whatever be its magnitude) will require effort and luck, and will not be automatic. The New Economy proponents also argue that the era of stable prices is an outcome of globalization, and is here to stay. Critics like Krugman point out that the result is only likely to be temporary.

Once foreign economies recover from recession, the strength of the dollar declines and oil prices recover from their recent low, the very same logic should imply inflationary tendencies. In fact the first glimmer of this may be already visible: in April, consumer prices rose by 0.7 per cent in one month, the highest since October 1990. Nevertheless, it is true that low prices of imported inputs and similarly low prices of competing international manufactures may have played a major role in keeping US inflation in check so far, in spite of a tight labour market.

Business cycles have always been a fact of life for capitalist economies. For reasons only broadly understood and often beyond our control, economic activity tends to alternate between a lull and a frenzy. Moreover, history abounds with examples of ?leading sectors? which seemed to drag entire economies forward by their own strength (textiles in Britain during the Industrial Revolution, railways and automobiles in the US, or consumer electronics in Japan) till their markets got saturated and the wind went out of their sails! Although the ebb and flow of economies is ageold, every boom or slump throws up its fresh band of prophets, predicting eternal bliss or impending doom, depending on the latest trend of gross domestic product.

The current boom of the US economy is just that ? a prolonged boom.

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