Book Review: myths and macro: macroeconomics and the Phillips curve myth by James Forder

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Macroeconomics and the Phillips Curve

James Forder believes that neo-classical economists, following the work of Friedman and Phelps in the late 1960s, have misstated prior analytical work on the determination of wages and price inflation. Thus Forder describes as myths three main stories, that “Phillips (1958) discovered a negative relation between inflation and unemployment”, that “policymakers treated it as offering a selection of inflation unemployment combinations from which they could choose”, and that, consequently, “inflationist policy was pursued until Phelps (1967) and Friedman (1968a) revolutionized thinking” by developing the expectations-augmented analysis of the long-term vertical Phillips curve, (quotes from p. 1).

He has pursued this exercise with academic zeal. The bibliography runs from p. 253 to p. 300, around 1,000 references! Of these probably most are criticized for sloppy thinking, especially those mentioned in the detailed notes, pp 219-251. It is a lengthy, scholarly, and specialist book. Those interested in the history of macro-economic thought will want to read it from cover to cover. For the rest, the Introduction (pp 1-10) will probably suffice.

The book is timely as well as controversial. Recently, the traditional short-term downwards-sloping Phillips curve has seemed conspicuously absent. The location of the natural rate of unemployment (NRU) has become a will-of-the-wisp. We doubt whether we really understand the determinants of inflation, so a book that critically revisits earlier battles over such topics is welcome.

How far does Forder succeed in his revisionist approach to these three issues, i.e. Phillips’ 1958 contribution; the Phillips curve used for a trade-off; inflationism?

On the first I found Forder rather convincing. Phillips was not original in supposing and testing a negative relationship between the pressure of demand (or UE) and wages’ growth. His originality lay in discarding all those other variables that those then working in the field had considered relevant, e.g. bargaining power, profitability, fairness, key bargains, etc., and in suggesting that his simplified (simplistic) relationship had been stable over a long run, implying that constant economic
relationships (laws) were more important than shorter-term politico-sociological influences. That made the approach congenial to Lipsey, and later to Friedman, so the term, Phillips curve, became short-hand for the generalised treatment of inter-relationships between inflation (however measured) and the pressure of demand (however measured), without much reference to the original article.

Nor were other economists then working in this field unaware of the likely effects of current, or expected, inflation on wage demands. What they largely failed to appreciate, however, was the acceleration argument, that if UE is kept below (above) the NRU, then inflation would go on rising (falling) indefinitely, (a prediction that failed – fortunately – in 2008-10). There was some appreciation, prior to Phelps/Friedman, that the long-term Phillips curve might be steeper than its short-run version, but that is all.

I am less persuaded by Forder’s latter two claims. I recall that economists in the UK Civil Service in the 1960s were aware of the Phillips curve analysis, even though under Bretton Woods, the relevant trade-off in the UK was between growth and the Balance of Payments. Moreover, no one argued that we should generate more inflation in order to raise growth, or lower UE. Conversations were always the other way around, starting with the assertion that the (estimated) level of UE consistent with absolute price stability was (morally, politically, socially) unacceptable. What was an acceptable level of UE was influenced by political priors. If that target level of UE was such as to lead to a forecast of ‘reasonable price stability’, (see Chapter 5), then fine. But if inflation would run higher, then the response was not to tolerate that, best to bring in a second instrument, i.e. incomes and prices policy.

The opponents of the neo-classics were not inflationists; but they were, in the UK, advocates of incomes and prices policies. The Phillips curve analysis, especially in its vertical, long-run variant, implies that incomes policies cannot work. But it was not so much that analysis, but repeated practical failures of such policies that led to the dominance of the Phillips curve approach. But if incomes policies do not work, neither is the Phillips curve determinate or stable. So where does that leave macro-economics?