A Great Embarrassment: How economists Got Stagflation Wrong

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Date : Jan 8, 2021

This and the following three posts use the GEM Project's generalized-exchange theory to analyze the prolonged stagflation debacle. The analysis is needed. Mainstream theorists have gotten that costly period of market failure wrong for decades. What's worse, the academy's economic advice – rooted in erroneous modeling – has badly misled monetary authorities.

The Stagflation Decade

The stagflation decade that began in the early 1970s was the 20th century's second most damaging stabilization crisis, behind only the 1930s depression. Like the Great Depression, it fundamentally altered how macroeconomics is done. Early Keynesians attempted, using their then-mainstream Neoclassical Synthesis, to contemporaneously model the broad market breakdown. But that effort was in relatively short order crushed. Partly resulting from the professional disarray caused by simultaneously high inflation and unemployment, EK macro hegemony was challenged, and then relaced, by a reassertion of market-centric rational-behavior macro modeling. By the 1990s, the revolt had evolved into the modern New Keynesian consensus organized around friction-augmented general-market equilibrium, i.e., the New Neoclassical Synthesis. The NK explanation of stagflation fundamentally differs from the one being constructed by their EK predecessors.

Farmer (2010b, p.60) has summarized the durable FGME explanation of the stagnation decade: "During the 1970s, the U.S. economy experienced high inflation and high unemployment at the same time and the data did not lie anywhere near the [original Keynesian] Phillips curve…. The Phillips curve broke down because firms and workers began to increase wages and prices in an inflationary spiral. Wages went up because workers believed that prices would rise. Prices went up because higher wages were passed on to consumers." Macro textbooks today accept that the engine of the 1970s stagflation was workers' anticipations of inflation being unanchored by the central bank. According to modern theorists, the root cause of the simultaneous wage-price spiral and high unemployment was a less-than-credible monetary-authority commitment to low, stable price inflation. This GEM Blog series will show that the consensus NK story is wrong. It does not align with critical evidence. Its policymaking advice is reckless. Its economics are embarrassing.

Stagflation Facts

An important albeit typically ignored combination of facts, beyond the simultaneity of high inflation and unemployment, provides insight into the stagflation decade. The evidence is organized into three interrelated groups: labor-adverse shifts in the terms of trade, the price-wage-price spiral that caused inter-industry wage dispersion to increase substantially, and the nature of joblessness. Accurate explanation of the stagflation crisis must accommodate, not ignore, the facts that accumulated during the prolonged episode of macro market failure.

Terms-of-trade shift. There was, in the early 1970s, a powerful confluence of terms-of-trade shifts against labor. Contemporaneous stagflation analysis assigned an important causal role to those real disturbances in initiating the destructive macrodynamics:

- The quadrupling of oil prices, associated with the OPEC embargo, in 1973 was the largest single shock. By the end of the stagflation decade, the cartel had helped engineer more than a fifteen-fold price increase. During this period, energy costs directly accounted for a tenth of the total consumer price index.
- Food prices more than doubled in the early 1970s. The 1972 Russian crop failure put substantial pressure on world grain markets. Meanwhile, there was a mysterious collapse in the anchovy catch off Peru; and meat prices jumped as animal-feed (produced from grain or fishmeal) costs rose sharply.
- The over-valued dollar became unsustainable, and the subsequent depreciation and higher import prices further pressured real wages. The gold window was closed in mid-1971 as a prelude to the Smithsonian agreement, which realigned rates of dollar exchange. The agreement was followed, in 1973, by two additional dollar devaluations.

As has been noted, almost all the economists who contemporaneously worked on the stagflation problem assigned great significance to the terms-of-trade shifts. Somewhat later, theorists began dismissing their relevance and, relatively quickly, that dismissal became mainstream.

Price-wage-price spiral. A virulent price-wage-price spiral was at the heart of stagflation mechanics. It had two phases. Initially, product prices associated with the terms-of-trade shift pushed up wages in information-challenged workplaces – a rational labor-pricing process familiar to readers of this Blog but out of the reach of market-centric theorists. Higher wages then pushed up product prices. Subsequently, the early dynamics were reinforced by the more general interaction of wage catch-up interacting with cost-plus pricing. The sustained breadth and power of that nominal feedback had never before been experienced in the United States. Any theorist seeking a policy-relevant explanation of the disruptive, costly stagflation decade cannot ignore the existence and implications of that spiral.

The most insightful contemporaneous stagflation analyses identified the sharply increased dispersion of the interindustry wage structure as the keystone of stagflation macrodynamics. But the phenomenon was then and continues today to be ignored in mainstream thinking. My argument will return interindustry wage dispersion in the third post in this four-part series.

Nature of unemployment. The workhorse Table reprinted below demonstrates that, in the stagflation recessions of 1974-75, 1980, and 1981-82, involuntary job loss was the overwhelming engine of rising unemployment. Job-losers incidence rose by 16.0, 7.4, and 11.2 points respectively during the three contractions, roughly in line with the 2007-09 experience when three-quarters of the increase in overall unemployment was attributable to the upsurge in forced job separation.

INVOLUNTARY JOB LOSS BEHAVIOR IN U.S. RECESSIONS

	Peak-to-Trough Change in:		
	Unemployment Rate	Job-Losers Incidence	Job Losers (000)
1969-70	+2.4 points	+8.2 points	+1,230
1973-75	+3.8 points	+16.0 points	+2,599
1980	+1.5 points	+7.4 points	+1,315
1981-82	+3.6 points	+11.2 points	+3,433
1990-91	+1.3 points	+6.8 points	+1,373
2001	+1.2 points	+6.0 points	+1,423
2007-09	+4.8 points	+13.1 points	+5,807

Additional facts. Other, albeit less significant, political and economic shifts relevant to labor and product pricing helping to set the stage for the stagflation period should be noted. Wage-price controls were imposed in the United States 1971, changing the time distribution of inflation. Global recession also encouraged the spread of protectionist measures. In the U.S., there was a brief surcharge on imported autos, trigger prices on Japanese and European steel, and voluntary quotas imposed on the import of shoes, textiles, and television sets. Moreover, labor productivity gains decelerated significantly from the immediate postwar period. Average annual (nonfarm) productivity growth was 1.3% from 1973 to 1989, half the 2.6% annual 1950-1973 average.

More Analysis

Next week’s post more fulsomely summarizes the FGME and generalized-exchange alternative explanations of the stagflation. Week 3 looks at powerful predictions made by the GEM Project’s analysis that are unavailable to market-centric modelers. Finally, week 4 assesses the two theories’ differing policy prescriptions and rights a wrong.

Blog Type: Wonkish Saint Joseph, Michigan