Downsizing Plus Proper Monetary Policy

Author : James Annable

Date : Mar 15, 2019

As described last week, the stagflation decade was a macroeconomic version of a perfect storm, generating a prolonged period of stubbornly elevated wage/price inflation and unemployment. The global disruption, of course, greatly interested economists. Their contemporaneous work produced a three-part consensus description of the macrodynamic process (see Helliwell, 1988):

- Adverse shifts in the terms of trade (relative to labor) reduced the real wage that was consistent with full employment.
- Actual real wages did not shift down anywhere near the required amount.
- Wage rigidity – again playing a starring role – forced some combination of increased inflation and increased unemployment in response to the adverse macro shocks.

Generalized-exchange macro theory has finally microfounded that three-part stagflation process. No market-centric optimizing wage theory was able to do that. Rational-behavior modeling inside highly specialized firms additionally identified a fourth part of the process by working through the rational calibration of workplace reference standards (governing the intertemporal worker tradeoff between income and fair treatment by management) that are, with substantial lags, responsive to firm-specific job losses. That fourth step, never detected in the mainstream stagflation literature, greatly enriches our understanding of the macro market failures that occurred in late 20th-century.

<u>Downsizing Decade</u>.

The increased dispersion of the interindustry wage structure during the stagflation decade resulted from rising large-establishment-venue (LEV) wage rents, as about half of all employees were able to protect their real wages from the multi-faceted 1970's shift in the terms of trade against labor. Higher LEV rents were a significant real shock that necessarily had real consequences – the other shoe to drop in the stagflation crisis.

Economists today no longer pay much attention to the 1980s downsizing period. But it was an outsized crisis that produced many millions of permanently lost rent-paying jobs. Let's be clear here. The stagflation-decade recessions produced millions of *temporary* good-job layoffs, while the "other shoe" downsizing produced millions of *permanent* good-job losses. The advent of the rust-belt, with its devastated iconic industries, was a central economic story of the time. *The New York Times* ran a week-long series of in-depth analyses of every aspect of the massive market breakdown. The pieces were collected in *The Downsizing of America* published by Random House. That book should be taught in modern macro curriculums.

The GEM Project demonstrates that the1980's-centered downsizing that transformed the U.S. economy is best understood as part of overall stagflation phenomenon, closely tied to the 1970s blown-apart dispersion of the inter-industry wage structure. Sharply higher LEV labor costs damaged profits at a time when import competition was increasing. The two-part result, predicted by generalized-exchange theory, was job destruction and, with an inherent long lag, rationally recalibrated $\mathbf{K_j}$ (i.e., wage givebacks). Often, the givebacks were too late to save many good jobs.

A necessary initial condition for the existence of stagflation is a compact (relatively low-rent) wage structure, the alignment that existed in the United States in the 1960s and early 1970s. (For analysis of the relevant evidence on that wage structure, see Annable (1984), chapter 2.) By the mid-1980s, however, labor rents had risen dramatically, substantially altering the overall wage structure and helping to trigger crises of survival in bellwether industries such as basic metals and autos. The inevitable result was a prolonged period of good-job destruction and worker givebacks.

<u>Proper 1970s Monetary Policy</u>

In the circumstances of the 1970s stagflation, mainstream market-centric general-equilibrium advice to central bankers was then (and remains today) to aggressively pursue the single goal of low, stable product-price inflation. In arguing that little else matters, the macro academy implicitly promises that the whatever-it-takes use of tight credit will relatively quickly break any price-wage-price spiral, short-circuiting the damaging macrodynamics that characterized the stagflation decade. The wrong-headiness of that policy prescription reveals a great deal about the fatal flaws burdening the macro academy's consensus thinking about how highly specialized economies actually work.

The generalized-exchange model class draws on its capacity to rationally suppress wage recontracting to uniquely explain meaningful wage rigidity, involuntary job loss, and evidence-consistent causality from nominal demand disturbances to employment, output, and income. The GEM Project teaches us a great deal about proper stagflation policymaking. To the extent that a central bank listens to mainstream macro theorists and responds to 1970s-class labor-adverse shocks by preventing the higher prices and wages which generate price-wage-price spirals, it *must* then accept the millions of involuntary lost good jobs as output and profits contract at rapid rates. GEM modeling of nonstationary demand disturbances is informative in such circumstances. If spending contractions create investor/lender uncertainty with respect to the credibility of the central bank's trend real-side objective (triggering rational buyer inaction while waiting for asset-market bottoms to emerge), the risk of an uncontrollable nominal demand collapse into a modern version of the 1930s-class depression with its huge, unimaginable welfare loss is greatly increased. (See next week's post.)

The Fed's credibility with respect to its trend employment objective is what worried Arthur Burns, the Chairman of the Federal Reserve Board of Governors through most of the stagflation crisis. He understood that an all-out credit-tightening war on the structural 1970s price-wage-price spiral, with its consequent massive job losses and associated bankruptcies and wealth destruction, unacceptably risked a modern version of the 1930s depression. Instead, he pursued a more measured policy that allowed substantial inflation to coexist with high unemployment, as the structural consequences of the labor-adverse shifts in the terms of trade gradually played out.

I know what Burns was trying to do. I was there, eventually supervising the economists charged with figuring out the economics of stagflation and what the Fed should do about it. It says something important that Burns intuitively figured out what the GEM Project rigorously modeled decades later. Perhaps most significant, he understood what the soon-to-become-mainstream neoclassical theorists were advising him to do – vigorously pursue the single objective of low, stable price inflation – was dangerously wrong. The 1970's price-wage-price spiral was the product rational behavior that was much more deeply rooted than Lucas and the other neoclassical macro theorists realized. (Indeed, they dismissed the spiral as unimportant.) Attempting to stop the spiral in its tracks would have required a huge squeeze on total spending and employment, output, and income, putting the credibility of the Fed's real-side objective at great risk.

The GEM Project's analysis of nonstationary demand contractions strongly indicates that Burns' much maligned caution prevented a 1970s depression. His approach in the face of intense criticism was heroic, although he probably would have admitted that it did not require super smarts to reject policy advice from a general-market-equilibrium model class that could not accommodate involuntary job loss. What kind of unemployment did the academic critics think was being produced during the stagflation decade? Did they really think that higher joblessness resulted from an onset of millions of voluntary quits from rent-paying jobs? Or did they really believe that their model, ignoring the massive disruption occurring all around them, was somehow still good enough to support policy advice on how to manage that job loss?

The GEM Project demonstrates that the task of stabilization authorities in crises such as the stagflation decade is to bring down inflation without setting off a collapse in their real-side credibility. For elaboration, see the website's e-book, Chapters 4 and 10.

Blog Type: Wonkish San Miguel de Allende, Mexico