Trump is determined to raise wages his way. It could work

The president is characteristically not waiting for the Phillips-curve theory that a low unemployment rate eventually will boost wages

By Philip Cross
January 31, 2018 – *National Post*

The number 1 conundrum facing central banks in Canada and the U.S. is how low they can push the unemployment rate before sparking higher inflation. A stable trade-off between inflation and unemployment has been one of the foundations of macroeconomics. In North America, low unemployment rates were expected to have boosted inflation and wages long ago, but this has failed to materialize. While economists theorize about the reasons for another breakdown in such a key relationship, U.S. President Donald Trump is taking a wide range of policy actions to boost American wages and prices.

The Phillips curve was named for A.W. Phillips, who in 1958 found that over the previous century, employers in England bid up wages when workers became scarce. In 1960, Robert Solow and Paul Samuelson, two pillars of Keynesian analysis, coined the "Phillips curve" and made a trade-off between inflation and the unemployment rate part of mainstream economics.

While immediately popular with Keynesian policy-makers, such conservatives as Milton Friedman and Edmund Phelps were skeptical about the Phillips curve. They said it lacked theoretical foundations — a problem with relying solely on evidence-based research — and rebelled at the implication that money was not the key determinant of inflation. Nor could the Phillips curve predict the exact level of unemployment that would trigger higher inflation. In his legendary 1967 Presidential Address to the American Economic Association, Friedman explained why the Phillips curve would soon break down.

Friedman's prediction was borne out before long, when the stagflation of the 1970s proved that both inflation and unemployment could rise at the same time. Soon, the emphasis shifted from inflation to inflationary expectations, which opened the door to the rational expectations theory of Robert Lucas Jr. and its searing critique that Keynesian fiscal stimulus would not work when people understood that future taxes would increase to pay for the stimulus. William White, formerly chief economist of the Bank for International Settlements, called this critique of the Phillips curve "arguably the most influential theoretical insight of the post-war period" in macroeconomics.

Despite being undermined during the 1970s, the Phillips curve has stubbornly never gone out of fashion any more than has deficit-financed Keynesian fiscal stimulus. The fundamental importance of the Phillips curve to Keynesian macroeconomics and policy-making explains why more studies have been made of it than any other subject in economics. A 2015 Wall Street Journal survey found two-thirds of economists still believed there was a trade-off between inflation and unemployment, despite the recent experience in the U.S. when double-digit unemployment rates barely affected the inflation rate.

Since then, falling unemployment in North America has not been reflected in higher wages. Not surprisingly, many theories have been advanced for why wages have not accelerated as expected. One is that the threat of globalization and possibly losing one's job to cheaper labour overseas has capped wage demands. A variant is that technological change and automation are having the same

effect. Many analysts have noted that financial crises such as in 2008–10 historically have a dampening effect on growth for years, creating hidden unemployment and curbing wage demands. Another theory is that our aging population is distorting the measurement of wages; as aging and higher-paid boomers retire, they are being replaced by lower-paid millennials. Others speculate that increased industrial concentration, especially in technology areas dominated by Amazon, Apple and Google, means there is less competitive bidding for workers.

The most interesting explanation comes from the Bank of International Settlements, one of the foremost critics of macroeconomics today. Its analysts argue that in fact prices have risen more than policy-makers believe, since conventional economists wrongly focus on just the price of goods and services in the Consumer Price Index and not prices in asset markets such as stocks, bonds and housing, all of which have been soaring. Still, this does not explain why wages remain depressed.

While economists and central bankers theorize about the reasons for low income growth, Donald Trump characteristically is not waiting for the Phillips-curve theory that a low unemployment rate eventually will boost wages. Trump was elected to reflate nominal income growth with a wide range of policies. He is using conventional tools such as tax cuts and encouraging a lower exchange rate (his Treasury secretary accelerated a run on the dollar last week using so-called "open mouth operations" in talking publicly about the benefits for U.S. trade from a low dollar).

Unconventionally, Trump is trying to boost wages by curtailing the supply of immigrant labour by reducing its inflow from abroad and by deporting people who are in the U.S. illegally, and by erecting trade barriers to reduce import competition. Notably absent from Trump's policy toolbox is raising the minimum wage; as a businessman, he has sworn to curtail such regulations. Trump's direct actions to reflate are more likely to bear fruit than the tried-and-failed policy of other governments — like Canada's — of waiting for the Phillips curve to return.

Philip Cross is a senior fellow at the Macdonald-Laurier Institute.