The Cross and the Curve

by Richard M. Salsman

IT IS MORNING IN AMERICA. While sipping your coffee, you glance at the newspaper headlines which tell of yet another drop in the nation's unemployment rate. Economic times are good and getting better. Your spirits are lifted. But not for long. Turning to the financial section, you read that stocks and bonds fell, reacting badly to the favorable jobs report. You learn that this is a regular occurrence. One journalist puts a "class warfare" spin on the story: "Good news for Main Street," he writes, "tends to be bad news for Wall Street." And vice versa, you're told. When joblessness rises, Wall Street rallies.[1]

You are troubled by the implications of this conflict. How can good news be bad news? Is the economy laced with contradictions? Are financial markets schizophrenic? You recall that your savings are invested in stocks and bonds—could they lose value because of business prosperity? And if your portfolio rises along with unemployment, does that put your own job at risk? You cannot solve such riddles. You must turn to other matters. But your doubts linger.

The nation's central bank—the Federal Reserve—will not solve the riddle for you. It is too busy perpetuating it. The Fed declares repeatedly that a falling unemployment rate (or, put otherwise, rising economic growth) causes inflation. If so, it says, the best way to "fight inflation" is to slow or reverse job creation and economic growth. This is the Fed's dismal policy of using a recession to fight inflation. How? By raising the short-term interest rate under its control. Or by denouncing a rising stock market as "over-valued" and driven by "irrational exuberance."[2]

What are the roots of this paradox? The idea that Main Street and Wall Street are locked in some inevitable conflict is not new. It is the Marxian theory of class struggle dressed in contemporary garb. Main Street represents physical labor, the "working man," the only true creator of wealth, in the

---

Richard Salsman is Senior Vice President and Senior Economist at H.C. Wainwright & Co. Economics, Inc., an investment research and forecasting firm based in Boston.

Marxian view. Wall Street symbolizes capital, the parasite which profits by exploiting labor, by expropriating its effort. These antagonists wage a battle over profits. According to Marx, capital can temporarily win such battles, preserving profits and keeping wages down by maintaining a "reserve army of the unemployed." Labor tries to wrest occasional wage gains. But the capitalists, as monopolists, can pay for such wage hikes simply by raising prices. Thus the class struggle creates a trade-off between unemployment and inflation.

How did such premises come to influence today's Fed? The very origins of central banking are Marxist. In 1848, the *Communist Manifesto* called for a "centralization of credit" in the hands of the state. A few decades later, Marxism influenced the Progressive and Populist movements in America, which sought to adopt European-style statism, including central banking. These groups agitated against the gold standard. They were inflationists, then called "silverites," who claimed that stable money (gold) was incompatible with prosperity and the well-being of workers. In a famous speech at the Democratic Party convention of 1896, populist William Jennings Bryan condemned the Republicans for defending the gold standard against inflationists. For Bryan, the fight over money's value was "a struggle between the idle holders of idle capital and the struggling masses who produce the wealth and pay the taxes of the country." As for the Republicans, he said, "we will answer their demand for a gold standard by saying to them: You shall not press down upon the brow of labor this crown of thorns, you shall not crucify mankind upon a cross of gold."[3]

The Republicans won both the gold debate and the presidency in 1896, but the tide was turning. Progressives and Populists blamed falling prices and the occasional "money panics" (caused by onerous banking laws) on the "monied interests." They demanded a government monopoly of an "elastic currency." Thus the Federal Reserve was formed in 1913. Two decades later its "elastic" monetary manipulations contributed to a stock market crash, a nationwide banking collapse, and the Great Depression. Statist monetary reformers blamed private bankers and the gold standard and granted the Fed still wider powers.[4]

The growing dominance of Keynesian theories in the 1930s fostered still more active manipulations of money by central banks. Keynes resuscitated the pre-Classical, statist doctrines of Mercantilism. Widespread unemployment during the Great Depression was attributed to "overproduction" or "underconsumption." Business was faulted for being "too productive," for producing more than could be purchased by underpaid laborers. There was "insufficient demand," according to Keynes. But demand could be boosted by government.

How? By deficit spending and inflation. Keynes echoed the Mercantilists by reversing economic causality: He believed the creation of more money, the effect, could stimulate the creation of more wealth, the cause. Prosperity was now possible, said the Keynesians, because it was unobstructed by stable money.

The total adoption of Keynesian policies in this century has caused growth rates in output, productivity, and real wages to fall well below those achieved in the 19th Century. Much of the blame for this stagnation lies with the Keynesian theory of inflation known as the "Phillips curve." The curve represents a union of Marxist and Mercantilist myths. In the four decades since its introduction, it has been used by central banks worldwide to justify both inflationary and recessionary policies—the twin enemies of economic prosperity.

Understanding the theory behind the Phillips curve helps solve the riddles in today's headlines.

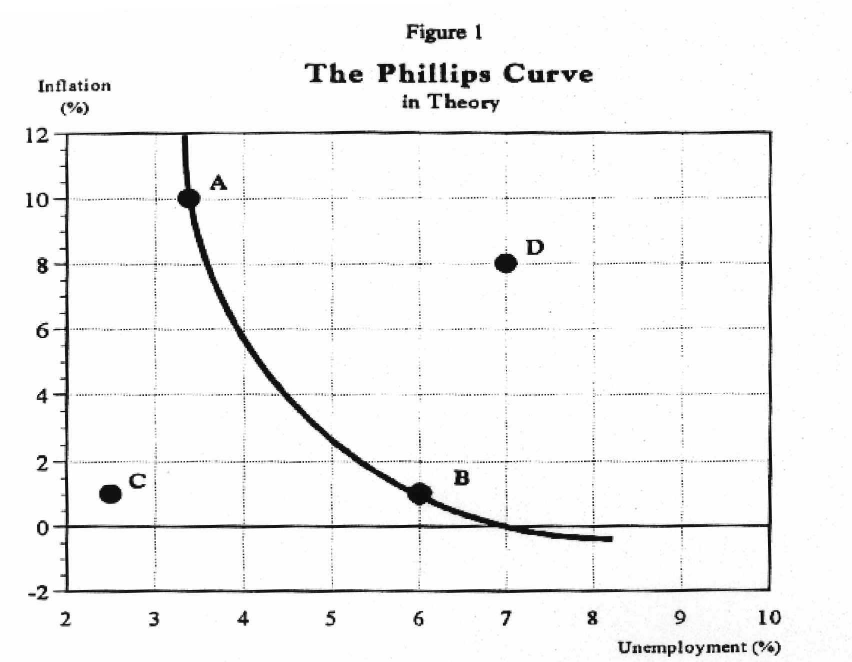
A.W. Phillips (1914–1975) was trained in Keynesian precepts at the London School of Economics in the late 1940s and began lecturing there in 1950. His doctoral thesis described the economy as a machine with hydraulic levers, ably manipulated by the Bank of England. In 1958 he published an article claiming a long-term, inverse relationship between unemployment and wage growth in Britain.[5] That is, when the unemployment rate was low, wages seemed to rise quickly; when unemployment was high, wage growth seemed to slow. Phillips and subsequent interpreters surmised that a low unemployment rate induces companies to bid up the wages of those in the smaller pool of jobless labor, and thus emboldens these workers to demand higher wages. They further insisted that higher wages caused higher prices—a process dubbed "cost-push" inflation. Inflation fell only when joblessness rose. The curve codified the Marxian precept that an economy can favor labor (Main Street) or capital (Wall Street), but not both.

Initial reaction to Phillips' article was skeptical. "Old school" economists were right to doubt that inflation could be caused by higher wage demands, unaccompanied by excessive creation of money. Phillips' method was also suspect. He used different samples for unemployment and wages and recorded standard wage rates posted by unions, not wages actually paid. Unions were then a minor part of the work force and their excessive wage demands hardly mirrored the national labor market. A low unemployment rate nationally could easily coincide with high wage rates asked by unions, without assuming one caused the other. Even sympathizers of Phillips' work could not verify it.[6] A few economists dismissed it outright as statistical gimmickry.

But Keynesians, enamored with the premises underlying the curve, kept it alive and began presenting it to students as if it were a law of nature. Figure

1 is a typical textbook illustration. The downward-sloping curve depicts the alleged inverse pattern of unemployment and inflation. At the extremes, there are only two possibilities. "A" couples a low unemployment rate with a high inflation rate (measured as the change in a consumer price index); alternatively, "B" exhibits a high unemployment rate coupled with low inflation. The area near "A' is the "pro-growth" combination, said to favor Main Street, while that near "B" is the "anti-inflationary" combination favoring Wall Street. The disturbing implication is that an economy cannot enjoy "C" (low inflation and low unemployment). Supposedly, neither can it suffer near "D," where high inflation accompanies high unemployment.

The curve took on added importance when two professors at MIT, one a Marxist (Robert Solow), the other a Keynesian (Paul Samuelson) argued that government could actively exploit the Phillips "relationship."[7] That is, government could influence the outcome of the "conflict" between labor and capital. The curve was said to offer a "menu of choices."[8] To lower unemployment ("stimulate the economy") planners could purposely inflate the money supply. Alternatively, to fight inflation they could purposely slow the economy and create unemployment. Even today Keynesians refer to the "sacrifice ratio" when discussing details of this alleged trade-off.[9] They could sacrifice sound money for the sake of jobs or sacrifice jobs for the sake of sound money. Since



Keynesians sympathized with labor unions, they began to push for the first option—for jobs to be "created" through a policy of inflation. "Instead of being on a Gold Standard," two Keynesians crowed in 1959, "we are now on a Labor Standard."[10]

Active attempts by government planners to manipulate the curve began in the early 1960s. Keynesian advisors to JFK adopted a policy of favoring labor by urging the Fed to issue excessive amounts of money and thus to "print jobs." Inflation (reflected in consumer prices) began to accelerate, from an average of only 1.4% per annum under Eisenhower, to over 4% in the late 1960s. The unemployment rate fell during the decade, from 5.5% of the labor force to 3.5%. The curve seemed substantiated. In actual fact, the Vietnam War was slowing youth participation in the civilian labor force, making unemployment artificially lower. Still, Keynesians were giddy about the prospect of ordering the economy from their "menu."

Then, in the late 1960s, inflation and unemployment rose together (toward "D" in Figure 1). The combination, considered impossible under the curve, was called "stagflation" (economic stagnation together with inflation). Instead of rejecting the curve, Keynesians blamed stagflation on labor unions and greedy businessmen. They urged planners to press down upon the brow of labor and business a crown of thorns known as wage and price controls.[11] Nixon obliged them, from 1971 to 1974—yet stagflation persisted. In 1973, Samuelson pled ignorance, saying it was "the single most important problem not yet solvable by modern economic science."[12] In the recessions of 1974–75 and 1981–82, stagflation worsened. Prices increased by 13% while unemployment reached 10%. Yet Keynesians said the curve was still operative; it had simply "drifted" upward due to "inertial inflation," inflation which allegedly continues merely because people expect it to. They insisted that markets create inflation, while government creates jobs. The Phillips curve permitted the statists to blame inflation on its victims (markets) rather than on its perpetrator (government).

Some economists who claim to oppose Keynesian economics, such as Milton Friedman, have tried to defend the idea of a "floating" Phillips curve (depicted in Figure 2).[13] The economy is said to begin on curve #1 (at "E," where unemployment is 6% and inflation is 1%). It then drifts upward to curves #2 and #3. Why? At first, workers are fooled by the new inflation. Prices rise faster than wages, lowering the real wage, which in turn widens profit margins and induces business to boost its hiring ("F," where inflation has risen to 4% and unemployment has fallen to 4.5%). But wage-earners will not remain fooled for long. They discover that their wages do not buy what they used to (real wages fell); they demand higher money wages. The unemployment rate rises again, but now at a higher rate of inflation (“G”). The curve is said to “work,” but only in the short run, when wage earners are deceived, and it can keep “working” only if they are deceived randomly or subjected to accelerating inflation (hyperinflation). Only in the long run, says Friedman, does inflation lose its power to create jobs (the long-run “curve” is vertical).

These criticisms contain kernels of truth, but they do not refute the curve or its premises at root. To say a trade-off “works,” albeit temporarily, still implies that it exists. Keynesians are not deterred by such objections. They deflect the “criticism” that their curve really exists, only in the short run, by arguing for a central bank that is secretive and “eclectic” (i.e., arbitrary) about its short-run policies, so as to maximize the inflationary deception imposed on wage earners. And as inflationists the Keynesians welcome the implication that hyperinflation, while not a boon to jobs in the long run, at least will not destroy them, a claim that simply defies history.

Most economists today believe in a “short-run” Phillips curve. They speak of a “natural” rate of unemployment, termed the “non-accelerating inflation rate of unemployment” (“NAIRU,” see Figure 2). When the unemployment rate lies above this estimated NAIRU, they say inflation will fall; when it lies below, inflation will rise. Aside from its arbitrariness, the NAIRU turns out to be no more stable than the Phillips curve. It was estimated to be 5% in the 1960s, then 7% in the 1970s. In the 1980s the unemployment rate fell, even below 7%, alongside a declining inflation rate. Again, this defied NAIRU; but instead of rejecting it, in the early 1990s economists re-estimated it to be 6%. The unemployment rate has fallen every year since 1992, and it fell below 6% over two years ago (today it is 5.2%) with no rise in inflation rates. Wedded to the curve and to NAIRU, most economists simply cannot believe recent US performance or low-inflation growth.[14] The Fed also expects a low jobless rate to accelerate inflation. That is why it raised interest rates recently: to slow the economy and “pre-empt” inflation.

A deadly corollary of the Phillips curve is the notion, which is now enshrined in Fed policy, that the economy has some natural “speed limit” beyond which it cannot grow without “overheating.” Keynesians calculate this “limit” by adding the growth rate of the labor force to the growth in output per laborer (productivity). This maximum rate of growth is allegedly 2.5% per annum. Thus, if the economy is seen growing beyond this rate (as it has been for the past few years), it is projected to cause inflation and hence to warrant a speeding ticket by the cops at the Fed. In the 19th Century, America grew about 5% per annum—twice today’s rate—or a doubling in

Figure 2

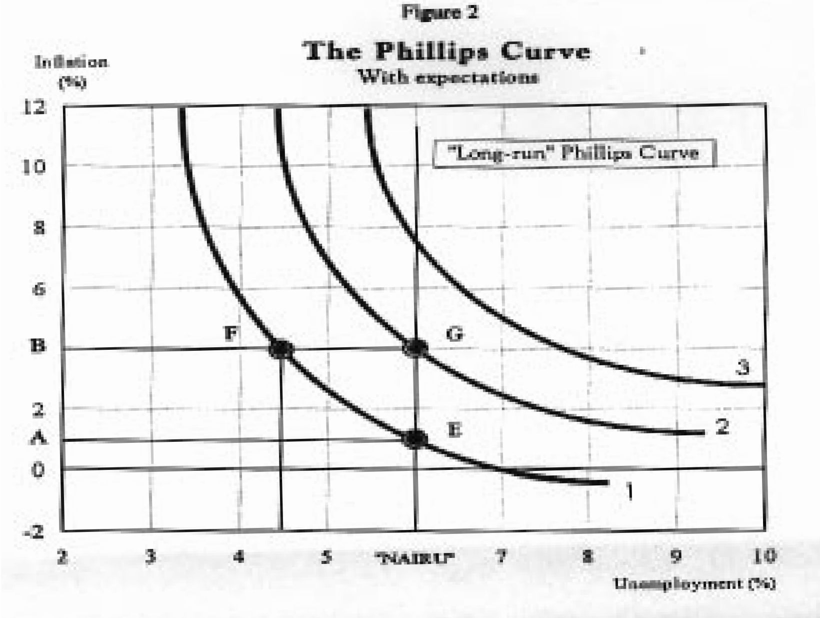
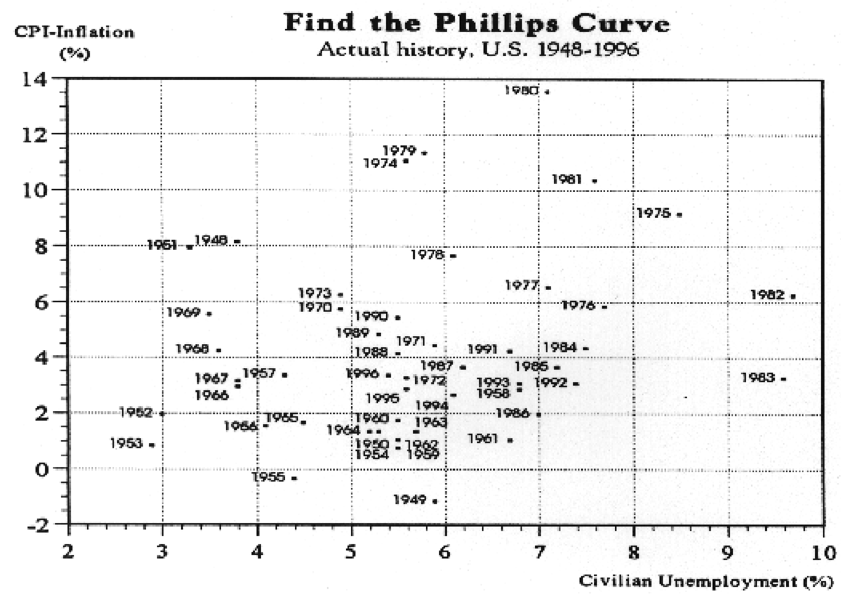


Figure 3



living standards *every* generation. Today's growth limit means such a doubling must take two generations. This absurd policy of ensuring economic stagnation is even codified into law, in the Humphrey-Hawkins Act of 1978.

How do these theories correspond to the facts? Those wishing to locate a Phillips curve in the actual data of the post-war US may try their hand at Figure 3. There is no obvious pattern, let alone a textbook curve. And there exist such "impossible" combinations as high inflation with high unemployment (the "stagflation" of the late 1970s and early 1980s) and low inflation with low unemployment (the low-inflation growth of the 1950s and early 1960s). No arbitrary rationalizations can make a Phillips curve appear.

There is no curve because paper money is not wealth, jobs cannot be printed, inflation is not a "wage-push" phenomenon, and unemployment does not result from stable money. For those baffled by today's Keynesian confusions, it pays to recall the true nature of inflation, interest rates, and unemployment—and how they influence financial markets.

Inflation is a decline in the purchasing power of money caused by an excess of its supply relative to demand. The excess is caused by central banks, which issue paper money undefined by any objective standard, with the primary aim of financing government debt. Inflation is reflected in higher prices paid for goods and services. A free-market banking system does not generate inflation because it operates on a gold standard; it defines the monetary unit of account (the dollar) objectively, as a specific weight of gold. The last quarter century has exhibited unprecedented world-wide inflation precisely because, since 1971, no currency has retained any link to gold.

Headlines aside, inflation is not caused by hiring workers or producing goods. All else equal, a greater supply of goods lowers prices. For this reason, there is no such thing as "cost-push" inflation caused by higher wage demands (or by any other cost). Any worker who demands more than the market-clearing wage only dooms himself to unemployment. If firms are forced to pay above-market wages due to pro-union laws, unemployment is merely shifted to non-unionized workers. If wages rise generally, firms are able to pay such wages only because they spend less on other factors (in which case there is no general rise in prices) or because excess money is created. In either case, the fact remains that the only cause of inflation is excessive money creation, not excessive wage demands.

Economic growth does not cause inflation—and neither does inflation spur economic growth. In fact, inflation undermines economic growth by, among other ways, raising interest rates.

Consider the role of interest rates in the production process. Interest rates are the prices paid (as a borrower) or received (as a lender or investor) when people exchange goods available in the present for goods available in the future. Interest rates balance the supply (savings) and demand (investment) for wealth. Normally a man prefers present goods to future goods, because he must sustain his life now if he is to have a future. But a society whose members are relatively more future-oriented—i.e., more civilized and more conceptual—saves more of its present goods, invests more in future goods, and grows more quickly. It experiences lower interest rates, by virtue of the lower discount it places on obtaining future goods versus present goods. A society whose members are more present-oriented—i.e., less civilized and less conceptual—saves and invests relatively less, grows more slowly, and experiences higher interest rates, reflecting the higher discount it places on future goods versus present goods.

Inflation raises interest rates. One obvious way is that lenders demand compensation for being repaid in cheaper money. Borrowers willingly pay higher rates for the same reason. Thus, higher interest rates do not "fight inflation"—they reflect it. That is why interest rates are much higher when paper, not gold, is the prevailing money.

At the deepest level, however, inflation raises interest rates because it compels people to live short-range. The faster money loses its value, the more preoccupied people become to rid themselves of it. For the same reasons, inflation also distorts price signals and makes it difficult to plan long-range. It raises the cost of capital and increases risk, thereby scuttling investment projects. This is why, historically, higher interest rates have accompanied slower rates of economic growth.

What about Friedman's "critique" of the Phillips curve which says that it works (i.e., that inflation creates jobs), but only in the short run? Inflation cannot stimulate genuine production under any time horizon, any more than a "mind-expanding" drug can stimulate one's power to reason. From the time it is injected into an economy, inflation diverts resources from productive uses to less productive or unproductive uses. New jobs, seeming to result from an initial inflationary deception, are gained only at the expense of real, productive jobs that would have been created elsewhere. But inflation is worse than a zero-sum game; it destroys an economy's efficiency, productivity, and job-creating capacity. Inflation is a stealth tax, a form of robbery, not a job-making machine or stimulus to output.

Because a monetary unit with stable purchasing power fosters saving, investment, and long-range planning, sound money is no impediment to job creation. Thus, in a free society, unemployment is a status chosen voluntarily, usually reflecting the desire for leisure or the temporary process of searching for a new job. A statist society, on the other hand, with its favored labor unions, occupational licensing rules, minimum wage laws, and unemployment insurance, makes work illegal for those who wish to work and subsidizes greater and more prolonged joblessness. Unemployment above negligible levels is the result of monetary manipulations or of wage demands that are kept above market-clearing levels by statist means.

So much for Main Street. How about Wall Street? Stocks and bonds are a legal claim to the future dividends and interest payments of productive and profitable enterprises. Thus, a growing economy (higher dividend payments) and lower interest rates (at which future payments are discounted) tend to raise the market value of such assets. There is nothing "irrational" about paying for such prosperity with higher stock market valuations. There is no inherent conflict between the performance of an economy and that of the financial assets which are claims upon it.

Why, then, do financial markets react so badly to good news? If prosperity is seen as inflationary, as the Phillips curve implies, and the Fed then raises interest rates, the result will be a slowing of future growth and falling financial markets. Such was the result when the Fed raised rates prior to the recessions of 1981–82 and 1990–91, again in 1994, and recently. Markets are not irrational when they react badly to good news; they react rationally to an irrational Fed policy.

In the absence of Fed interevention, however, no such reaction would occur. Consider the evidence of history. The 19th Century, largely characterized by free banking and the gold-coin standard, provides substantial evidence that non-inflationary economic prosperity and job creation are possible. The gold standard brought gently falling prices but imposed no brake on prosperity. Costs fell along with selling prices, so profit margins—the main spur to production—were sustained. As a result, growth in output, jobs, productivity, and real wages was rapid. Living standards skyrocketed. Significantly, the few episodes of low-inflation growth experienced in the post-war US came when the dollar retained some tenuous link to gold (under the Bretton Woods gold-exchange standard, 1948–71). Episodes of "stagflation" came in the decade after that link was broken. The low-inflation prosperity seen since 1991, though not as favorable as that of the 1950s, reflects a relatively stable gold price, which itself suggests confidence in the dollar. But in the absence of a formal gold standard, with a free banking system committed to maintaining it, inflation remains a threat. Central banking is the source of that threat. That is why interest rates are twice as high, and growth rates half as fast, as in the 1950s.

Unfortunately, among modern economists, only the supply-siders and the New Classical economists reject the Phillips curve entirely,[15] arguing that wage earners form forward-looking "rational expectations" about government policy, acting swiftly to adjust their wages and work effort to reflect inflation. These economists advise central banks to forswear policy deception and eclecticism in favor of fixed rules, such as the gold standard.[16] The implementation of supply-side policies in the 1980s showed that the jobless rate and inflation rate could decline together.

But the influence of such policies has faded. Deeper premises always prevail. Despite overwhelming evidence against the curve, it persists because it is fully in accord with statism and its underlying premise of class warfare. That is why the Fed, a statist organ, believes in the curve (albeit in its short-run version)[17]; why it alternates absurdly between attempts to "create jobs" through inflation and to "fight inflation" through stagnation; why it treats good news as bad news and pits Main Street against Wall Street.

More fundamentally, the curve persists because it fits with today's predominant philosophic ideal. By its nature it codifies *sacrifice,* whether by crucifying the beneficiaries of sound money for the alleged sake of prosperity, or by crucifying the beneficiaries of a prosperous, job-creating economy for the alleged sake of sound money.

In place of the alleged "cross of gold" the Phillips curve substitutes a "sacrifice ratio." In place of monetary objectivity it invites the arbitrary and subjective feelings of Fed officials. In place of solid prosperity it brings prolonged economic stagnation.

If you hear any variant of the claim that "good news is bad news," remind yourself that contradictions pertain only to a man's thinking, not to reality itself. The thinking behind the Phillips curve is false; its proponents are pernicious; its consequences are destructive of our prosperity. Only an objective monetary system—consisting of free banking and the gold standard[18]—can deliver America from such evil.

REFERENCES

[1]For two typical accounts, see Louis Uchitelle, "Growth of Jobs May Be a Casualty in Inflation Fight," *New York Times,* April 24, 1994, p. A1; and Sylvia Nasar, "Why Wall St. Investors Cheer as the U.S. Economy Slows," *New York Times*, February 25, 1995, p. D1. [2]"Fed Chief on 'Irrational Exuberance,'" *Investor's Business Daily*, December 9, 1996, p. A2. [3]*A Documentary History of American Economic Policy Since 1789*, Edited by William Letwin (Doubleday & Co., 1961, pp. 255–256). [4]Richard M. Salsman, "The Gold Standard: Scapegoat for the Great Depression," *The Intellectual Activist*, January 1995. [5]A.W. Phillips, "The Relation Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861–1957," *Economica,* November 1958, pp. 283–299. Other economists had anticipated Phillips' work to some extent, but none had drawn the eye-catching curve as he did (see Thomas M. Humphrey, *A History of the Phillips Curve*, Federal Reserve Bank of Richmond, October 1986). [6]For an account of Phillips' statistical sleights-of-hand and professional reactions, see Nancy Wulwick,

"The Phillips Curve: Which? Whose? To Do What? How?" *Southern Economic Journal*, April 1987, pp. 834–857. [7]Cited in Wulwick, pp. 841-842. [8]Paul A. Samuelson and Robert M. Solow, "Analytical Aspects of Anti-Inflation Policy," *American Economic Review*, May 1960, pp. 177–194. [9]Laurence Ball, "What Determines the Sacrifice Ratio?" in *Monetary Policy*, edited by Gregory Mankiw, University of Chicago Press, 1994, pp. 155–193. [10]Lawrence Klein and R.J. Ball, "Some Econometrics of the Determination of Absolute Prices and Wages," *Economic Journal*, June 1959, p. 469. [11]Paul A. Samuelson, *Economics* (McGraw Hill & Co., 1973), p. 836–837. [12]Ibid., p. 837. [13]Milton Friedman, "The Role of Monetary Policy," *American Economic Review*, March 1968, pp. 1–17 and "Nobel Lecture: Inflation and Unemployment," *Journal of Political Economy*, June 1977, pp. 451–472. Equal credit for these insights is due to Edmund S. Phelps, Ed., *Microeconomic Foundations of Employment and Inflation Theory* (W.W. Norton, 1970). [14]According to Harvard professor Martin Feldstein, "Economists are puzzled because decades of experience indicate that unemployment below about 6% leads to demand pressures that fuel inflation." See Feldstein, "Unsolved Mystery," *Financial Times* (London), January 6, 1997, p. 16. [15]For the supply-side view see Robert A. Mundell, "The Dollar and the Policy Mix: 1971," *Essays in International Finance #85*, Princeton University, May 1971; for the New Classicals' critique of the Phillips curve see Robert E. Lucas, Jr., "Nobel Lecture: Monetary Neutrality," *Journal of Political Economy*, 1996, pp. 661–682. [16]See Robert J. Barro, "Money and the Price Level Under the Gold Standard," *Economic Journal*, March 1979, pp. 13–27; and Robert A. Mundell, "Gold Would Serve Into the 21st Century," *Wall Street Journal*, September 30, 1981. [17]Jeffrey C. Fuhrer, "The Phillips Curve Is Alive and Well," *New England Economic Review*, Federal Reserve Bank of Boston, March / April 1995, pp. 42–56. [18]Richard M. Salsman, *Gold and Liberty* (American Institute for Economic Research, 1995).