Portfolio Manager van Skagen Tellus

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19 augustus 2015

Dead Economists' Law

One of the main principles of conventional economic thinking doesn't seem to hold true. SKAGEN Tellus portfolio manager explains why the belief that inflation increases as unemployment drops might be misleading for our current predicament.

Paul Samuelson is arguably one of the captains of modern economics. Among a mile-long list of achievements he authored the best-selling economics text books of all time and was the first American to receive the Nobel Prize in Economics. One of the main principles in his text book from the mid 1950s is that falling unemployment will lead to higher inflation. Why? Very simply put, if the demand for goods and services is strong and more or less everyone is working, companies can charge more for their products, employees will ask for higher salaries and before long, the economy will overheat and we will get inflation. I will not reiterate the full argument; for that you'll have to pick up your own copy of the book, or one of its many clones.

Economic theory has moved on, but current introductory text books basically still proclaim this inverse relationship between unemployment and inflation. Thus, the conventional wisdom that falling unemployment will lead to high inflation is repeated in the financial press and by various analysts on a daily basis.

The problem with this story is simply that it doesn't have a lot of empirical support. What might have been the case in the 50s and 60s hasn't held up since the 70s. Since then, it has typically not been the case in advanced economies that unemployment and inflation move according to the conventional view as you can see in a number of charts in the latest status report for SKAGEN Tellus.

Or look at the evidence since the financial crisis. During the recovery over the last six years, while all the major central banks have held their policy rates close to zero, many countries have had both decent growth and a substantial decline in the unemployment rate, and yet inflation has not increased. It has in fact been falling in most of the major advanced economies.

What's going to happen to policy rates going forward?

The answer to this question depends on whether central bankers stick to the conventional view, which says that you should raise the policy rate as unemployment rate falls in order to limit the increase in inflation, or whether they will reconsider their view in the light of what has been the observed relation between unemployment and inflation.

While there might be a small uptick in some policy rates, probably first in the US, I think it's unlikely that we will see a string of interest-rate hikes in the foreseeable future. Why? With low inflation, and low expected inflation, it's hard to see how a significant tightening of monetary policy can be justified given the standard central bank view of how policy rates influence inflation. A hike in the policy rate is supposed to have a negative effect on inflation. And there is good evidence that this is also the case now – in the short term, I should add. Since central bankers will be hit by inflation numbers that fall further below their target, they are unlikely to keep lifting the policy rate – and central banks which will have lifted it might very well end up reversing their tightening.

Thus, close to zero policy rates might linger on much longer than the conventional view would have it. We might witness the "Japanification" of monetary policy in many other advanced economies.

You may remember the professor played by Robin Williams in the film Dead Poets Society telling his students to rip out the pages of their text books. Personally I have too much respect for old books to advocate tearing them up. However, I think it would be a good idea to skip some of the pages the next time you read a standard introductory economics text book.

About Paul A. Samuelson, 1915-2009:

- Professor at Massachusetts Institute of Technology, MIT
- Nobel prize winner
- Author of Foundations of Economic Analysis (1947), Economics: An introductory Analysis (1948), and a large number of important academic papers

Hoien is a portfolio manager with Skagen Funds in Stavanger, Norway and was on the executive board of the Norwegian central bank from 1998-2002.