Section 11.8 Labour Supply, Hysteresis versus the Natural Rate (Added 2018/20)

At the heart of the Keynesian versus classical approach to whether credit financed investment (without prior savings) can generate savings to pay for it, and whether it is inflationary or not, lies the factual issue of labour supply. More generally is debt/credit financed spending – whether on consumption or investment -- inflationary? Some historical perspective is useful in discussing this.

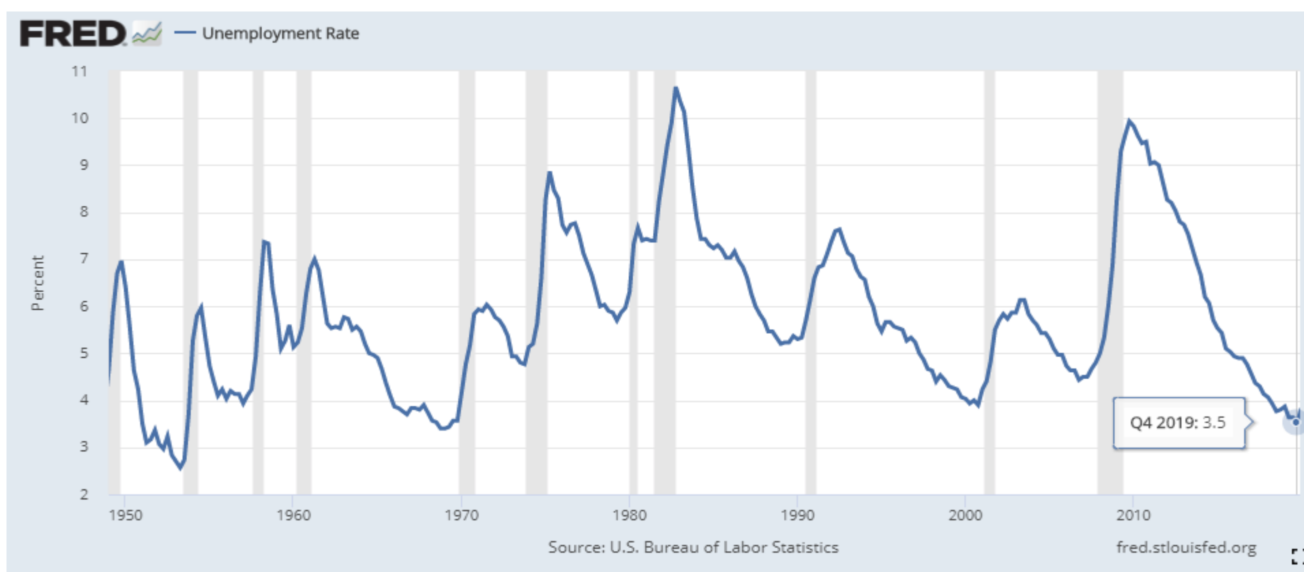
When production of automobiles (in particular Henry Ford's Model T) took off during the 1920s, about 75% of sales were financed by installment buying and not cash down. The newly formed (1913) Federal Reserve did not defend, and generally frowned upon, installment buying. George W Norman, the Governor of the Fed Reserve Bank of Philadelphia criticized in 1925 instalment buying because it was "*borne of the seller's passion for volumes, and the buyer's passion for indulgences.*" However he was forced in 1929 to admit that "*instalment buying had not yet had an adverse impact on saving*". He cited evidence compiled by Savings Bank Division of American Bankers Association that, "*revealed a very regular curve in the total of all savings and other time deposits in all banks for the last 25 years*". Thus the data at one level supported Keynes 1930 and 1936 view that you did not need prior saving to sustainably finance spending. Spending based on borrowing generates income and thus saving to pay abck debt

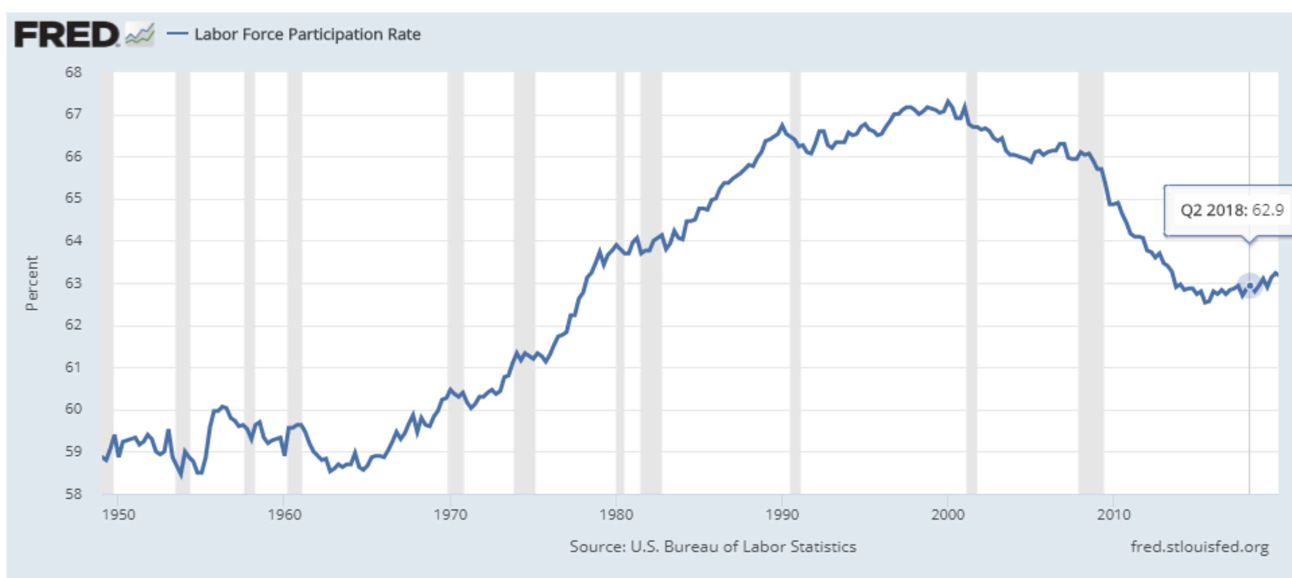
To go back to labour supply, if credit financed consumption is backed by an increase in labour supply to pay it off, then that need not lead to overheating and thus inflation. The bumper sticker "*I owe, I owe, so off to work I go"* on many cars in USA somewhat explains as to why the debt financed "shop until you drop" economy has continued for years, and even decades, without inflation.

The concept of hysteresis goes against the long run equilibrium natural rate approach taken in EGI. The term is derived from physics: loosely, if you give a system an electrical shock, some electrical current

remains permanently. Statistically if you regress variable X on X(t -1) and it is a random walk then that corresponds to hysteresis. But if the coefficient is less than one then X is stationary and reverts to its LRE value. Loosely, evidence shows that URATE has a strong cyclical pattern and tends to be stationary for annual or lower frequency data (e.g. two year averages), but the Labour Force Participation Rate is a random walk (Charts below). The NRU concept can partially holds. However, there may be no strict g(y*) corresponding to the natural rate U*, since LFPR can drift up or down in the long run.

Chart: Long-Term Comparison of Unemployment versus Labor Force Participation Rate





..continued

11.8.1 Sustained Low Recent Unemployment in US without Inflation: Credit Based Hypothesis

The drop in the URATE to below 4% without inflation has led the Federal Reserve itself to question the validity of the concept of the natural rate, and somewhat ignore the EAPC in its monetary policy decisions. When URATE was below 4% for fours years in the late 1960s, inflation went out of control. By contrast wage inflation and thus price inflation is remarkably subdued at present. The standard explanation offered is that workers in USA are very insecure due to competition due to globalization (manufacturing, China; IT Services, India etc). The fracking process in energy extraction and automation have also greatly contributed to low inflation by rising productivity and lowering costs. Further, the lack of health insurance has created a class of gig economy workers known as the *precariat.*

All these factors, essentially ex post rationalizations, have some validity. However, in my opinion, the drop in URATE in recent years, unlike the late 1960s has been accompanied by a rise in consumer debt leading to an increase in labour supply. This hypothesis can perhaps be tested by panel data on wages and labour supply decisions of individual workers with differing amounts of various types of debt. An drop in URATE based on credit financed spending is unlikely to be inflationary since it is backed by an increase in labour supply.