

Commentary: Past and Prospective Causes of High Unemployment

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I am delighted to see that Paul Krugman and I agree on the two most basic points to be made. First, there is a natural rate of unemployment. Second, the natural rate moves. The importance of natural rate doctrine, of course, lies in the property of its standard models that after a monetary disturbance has driven the unemployment rate away from the natural rate—or a real disturbance operating through the monetary mechanism discovered by Keynes—the *equilibrium* (that is, the surprise-free, correct-expectations) trajectory of the unemployment rate returns to the natural rate (Phelps, 1968). A soft landing is theoretically possible in the simplest models, while in realistic models exhibiting stickiness of wages or prices or of the interest rates set by the central bank, *overshooting* is to be expected. In any case, the average unemployment rate in a long period—a dozen years or more, say—is rarely far from the average value of the natural unemployment rate in that period.

On our approaches to unemployment, however, we are far apart. I feel compelled therefore to inject into the discussion my own perspective on the natural unemployment rate, since it differs from that of Krugman and several other economists here. Then I will come to his thoughts on the subject and try to give them their due.

Confidence in the essential rightness of natural rate doctrine has not always been as firm as it is now. As the 1980s unfolded it began to be felt that I and the other natural rate theorists, such as Stiglitz (1973),

Calvo (1979), and Salop (1979) had left the natural rate concept too feeble to live. In Western Europe, unemployment rates reached double-digit levels at mid-decade and seemed to hang there, motionless. Moreover, the inflation rate seemed to be barely falling. Several economists began to express doubts about the natural rate. Since the natural rate couldn't have jumped to double digits, they said, there must be something wrong with the natural rate concept.¹ (Some economists developed the concept of strong persistence, or strong hysteresis: A country's equilibrium unemployment rate is not some natural rate; it is whatever rate was experienced yesterday.)

Now I am coming off a six-year effort to fortify the natural rate concept against such doubts through a further development of the theory of the determination of the natural rate (Phelps, 1994a). The objective has been to find the mechanism governing how the natural rate moves in response to a nonmonetary macroeconomic shock or policy shift. The empirical conclusion is stronger than I anticipated: *Most of the long-term changes in the unemployment rate are the result of the movement in the natural rate rather than of deviations from an unchanging natural rate.* It is the persistence of the underlying forces driving the natural rate that accounts for the seeming "persistence" of the unemployment rate, not any tendency for unemployment to lock onto its current rate regardless of fundamentals.

The gist of the theory, as in my original 1968 formulation, is still the idea that costliness of employee behavior at low unemployment rates impels firms to drive the equilibrium wage level above the market-clearing level. (If across the economy the going wage starts out low enough to clear the market—a wage level so low that firms could afford to hire everyone wanting a job, leaving no pool of workers involuntarily unemployed—firms are beset by employee quitting, shirking, absenteeism, strikes, and the rest. Each firm then responds by raising its wage in the expectation that a favorable wage differential would provide its employees with an incentive to perform better—sufficiently better to repay the higher hourly wage.) The escalation of wage standards in turn forces each firm to economize more on labor.² Employment—the number of jobs available—is decreased; but the labor force is not or not by as much, if decreased at all. Thus a pool of involuntarily unemployed workers is created—the natural army of

