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A REVIEW OF
JAMES FORDER'S *MACROECONOMICS AND THE PHILLIPS*
CURVE MYTH

BY
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CHOPE WORKING PAPER No. 2015-07

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CENTER FOR THE
HISTORY OF POLITICAL ECONOMY
AT DUKE UNIVERSITY

A Review of
James Forder's *Macroeconomics and the Phillips Curve Myth*
(Oxford University Press, 2014)*

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Abstract

A review of James Forder's important history of the Phillips Curve.

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At the end of John Ford's classic Western "The Man Who Shot Liberty Valance," a newspaper man says of Ranse Stoddard (Jimmy Stewart's character), "This is the West, sir. When the legend becomes fact, print the legend." Like a major part of the film, James Forder's book aims to establish the actual facts behind the role of the Phillips curve in modern macroeconomics and to expose the legend – or, as he puts it, the myth – of the Phillips curve for what it is. Here "myth" means falsehood. This is an important book because the Phillips curve myth has taken hold not only within academic economics, but more widely within the financial and economic press and policy circles.

What is the myth? First, in 1958 the New Zealand economist A.W. Phillips, then at the L.S.E., discovered an inverse relationship between the unemployment rate and the rate of wage inflation in the U.K. that was remarkably stable over nearly a century. Second, in 1960, the American economists Paul Samuelson and Robert Solow substituted prices for wages and applied the Phillips curve to the United States, interpreting it as a menu that would allow policymakers to purchase lower unemployment rates at a known cost of higher inflation rates. Third, the Phillips curve was rapidly welcomed by economists, since there was no good account of inflation in the canonical Keynesian model – there was a "missing equation." Fourth, in both the U.K. and the U.S., the Phillips curve was used to justify economic stimulus – "fine-tuning" the economy. Fifth, in 1967, Milton Friedman and Edmund Phelps independently pointed out a fatal flaw in the logic of the Phillips curve: a fall in unemployment results only when inflation is higher than what it was expected to be; but people could be counted on to adjust their expectations upward in the face of persistent inflation, so that stimulus to aggregate demand would lose its punch over time and the unemployment rate would return to an equilibrium level that was independent of the inflation rate (*a natural rate of unemployment*). The Phillips curve should not be stable if used to guide policy. Sixth, the stagflation of the early 1970s to 1980s gave dramatic empirical confirmation of Friedman's and Phelps's prognostications, and the natural rate hypothesis with its sister, the expectations-augmented Phillips curve, became the orthodox view, supporting the rise of monetarism and rule-based monetary policy in central banks round the world.

Virtually none of the story is true. Forder offers us the most detailed and well documented demolition job that I know of in the history of economics. Forder approaches the job with the zeal of a Crown Prosecutor and piles on the evidence with lawyerly thoroughness and precision, showing that each element of the myth is false or in need of careful and substantial qualification. Phillips by no means discovered the inverse relationship between unemployment and wage inflation. It had been observed – and even to some extent quantified – going back to Irving Fisher in the 1920s or even earlier. The general idea of an inverse relationship was a commonplace of Keynesian economics. Phillips was most notable in Forder’s view for documenting the quantitative stability of the relationship over a long period that included massive institutional changes in the British labor market. But even that result rested on inferior data and questionable statistical analysis. Despite applying the Phillips curve to price inflation in the American context, Samuelson and Solow in fact noted its actual historical instability and the possibility that it would shift bodily if used to guide policy. There was no hole to fill in the canonical Keynesian model. Postwar macroeconomic models had from the beginning included equations accounting for both wage and price inflation and related them to aggregate demand and unemployment. Improving these models was an active area of research, and in Forder’s view many other economists made more substantive and sophisticated contributions to it than did Phillips. Policymakers of the 1960s and 1970s never viewed inflation as a good thing nor consciously tried to exploit a stable tradeoff. One looks in vain, for example, for any reference to the Phillips curve in the reports of the President’s Council of Economic Advisers during the Keynesian ascendancy of the Kennedy administration. References to Phillips are few in academic circles (and nil outside them) until after 1970. Phelps saw his own work as a development of, and not a challenge to, the Phillips curve. Friedman’s accusations that Phillips and the Keynesians had made the elementary and fatal mistake in economic logic of confusing real and nominal quantities are simply not borne out by any fair reading of their actual articles. The stagflation of the 1970s provided no clean test of the natural rate hypothesis, as western economies were battered by supply shocks and, contrary to what might have surmised from Friedman’s account, as inflation rates rose, unemployment rates themselves rose substantially rather than stabilizing around a relatively constant rate.

On all of these points, Forder is absolutely convincing because he leaves no stone unturned. He has read everything and covered every angle. He demolishes the myth and also demonstrates when it first came to be widely accepted – in the middle 1970s. This solves a personal mystery for me. I recall in a revision class in Trinity term 1979 before my finals in Philosophy, Politics, and Economics being told by Andrew Oswald – now Professor at Warwick, but then a college lecturer at Balliol – that the *orthodox* understanding of inflation was essentially the myth that Forder exposes. But that was the first time that I had heard of such an orthodoxy. The explanation is that my Balliol tutor, Andrew Graham, was a little older and had not been inculcated with the myth that had only just been established in the leading textbooks. As happens not infrequently, the witnesses to an historical event are hardly aware of the moment it actually happens.

“Myth” is sometimes used, as Forder uses it, simply to denote falsehood. But myths, as any anthropologist knows, are not just falsehoods but are also socially functional. Part of Ford’s film tells the “real story” of the death of Liberty Valance. And Forder’s dissection is no doubt the real story of the Phillips curve and, as far as it goes, is a welcome corrective. But the more interesting part of Ford’s film explores the creation of the myth and its implication for Rance Stoddard’s career as a state governor, U.S. senator, Ambassador to the Court of St. James, and vice-presidential candidate. One wishes that Forder had done more in this line for the Phillips-curve myth. Why for instance did the profession light on Phillips’s article – an article that Forder denigrates as rather slipshod – as the *Urtext* of the myth? And why did Samuelson and Solow’s, Friedman’s, and Phelps’s articles join it to become the canon of the orthodox history of inflation theory? Why is the myth so entrenched and enduring when the facts speak loudly against it?

We learn the chronology of its creation from Forder’s book, but the deeper roots of its appeal and functionality remain mysterious. For my own part, I believe that Phillips’s article is not “unjustly famous,” as Forder puts it but was, in fact, a valuable empirical investigation by an insightful economist and that Samuelson and Solow recognized that and did help to canonize Phillips’s curve. Forder is, of course, correct that Phillips was neither the first nor the last word on the relationship of inflation to

aggregate demand and unemployment, but I wish that he had given a more detailed account and a constructive appreciation of Phillips's article. The absence of such an account in no way detracts from Forder's considerable achievement. While no doubt textbooks will continue to print the legend – after all, this is the West – after Forder's book no fair-minded observer will be able again to assert that the common story of the Phillips curve is what really happened. It is rare that a historical question is so decisively settled.