BB Chapter 15: Inflation or Unemployment, What’ll you have?

The authors take far too long to get to the main point of this chapter.

If fluctuations in the economy are primarily driven by changes in aggregate demand and not changes in aggregate supply, then the most rapid inflation will occur when the growth rate is high and unemployment is low. The slowest inflation will occur when the growth rate is low and unemployment is high.

Put more directly, there is often a short term tradeoff between inflation and unemployment.

This is generally only true when supply shocks are dominated by demand shocks.

The relationship between inflation and unemployment can be graphed and is called the Phillips Curve.
The data from the U.S. economy fit a downward sloping Phillips curve from 1954 to 1969.

In the 1970s, a series of supply shocks upset the relationship. Reductions in aggregate supply (due to crop failures or rising oil prices, perhaps) shift the Phillips curve up. In the 1970s, the U.S. economy suffered high unemployment and high inflation.

Increases in aggregate supply shift the Phillips curve down.

In the 1990s, increases in productivity and low real oil prices increased aggregate supply and shifted the Phillips curve down, so the U.S. economy enjoyed low unemployment and low inflation for a time.

The important insight provided by the Phillips curve is that from a policy point of view there is an inflation-unemployment tradeoff. If an economy is in a recession, taking activist expansionary steps to correct it will probably eliminate unemployment more quickly than waiting for the self-correcting mechanism will, but will result in higher long term inflation. Whether or not it is worth it is a matter of opinion.

In the case of the Volcker Fed, unemployment was used to get inflation under control. In this case, it seems that the opinion was that inflation was worse than some temporary unemployment.

*In reading Chapter 15, please don’t bother wrestling with the material from the middle of page 290 through to the middle of page 295.*
Indexing

*Indexing* refers to the practice of adjusting payments for inflation. In terms of wages, these adjustments might be called cost of living allowances (COLAs). The usual form of the contract is that a payment will be increased by the percentage increase of the consumer price index (CPI) or some other measure of the price level.

Indexing of payments might be done for prices, wages or rental payments in a contract. There are bonds that are indexed for inflation as well, guaranteeing some real rate of return.

Tax brackets are also indexed, adjusted upward for inflation, because people should fall into a tax bracket based on their real rather than nominal income. Otherwise, inflation would push people into higher and higher tax rates when in fact their real incomes have not increased.

It has been argued that taxes on interest income and capital gains should be based on real gains rather than nominal gains. That is, if you buy an asset in one year and sell it in another year, you should be able to deduct the gain that was simply compensation for inflation before paying taxes on the income.

Here’s an example.

Imagine that you buy an asset for $100 when the price level is 100 and sell it some years later for $200 when the price level is 200. The real value of the asset will not have changed, but you will pay capital gains taxes on $200-$100=$100.

It is worth noting that this seemingly reasonable tax change would make the tax system more complex and would also benefit rich people more than it would poor people.

Chapter 16: International Trade and Comparative Advantage

The book starts out by talking about, “President’ Bush’s decision to protect the steel industry in March 2002.” However, they don’t mention the fact that large imports of cheap foreign steel were important for a lot of jobs in industries that use steel as an input, and restricting these imports hurt other, steel using, industries.

Comparative Advantage

The basic argument for trade goes back to the concept of comparative advantage, which we discussed earlier in the course. When trading partners, either individuals or countries, specialize and trade, there can be more of all goods than if they don’t trade.

As I may have said in class, imagine if Minnesota didn’t trade with the rest of the world. Orange juice and pineapples would be pretty pricey.
High Cost Labor versus Low Cost Labor
Further, relatively expensive U.S. labor is expensive because the opportunity cost of that labor, the value of what it could produce in some other activity, is high. That is, labor in the U.S. is expensive to hire because workers in the U.S. are very productive, in part due to relatively high levels of education compared with workers in much of the world, but also because of large amounts of capital per worker that exist in the U.S. Both of these factors make U.S. workers more productive than workers elsewhere.

In fact, it is not output per worker or wage per hour that matters, but rather output per dollar of labor, and more expensive workers are more expensive because they are more productive.

Special Considerations and Risks in International Trade
1. Risk of foreign political changes
2. Potential for changing tariffs
3. Risk of changes in exchange rates
4. Risk of restriction on capital mobility
5. Restrictions on labor mobility can preserve wage differences

For example, you might imagine a company locating a new production facility overseas only to find that a few years later a tariff is imposed on imports from that nation.

You might spend billions of dollars developing a new plant in a foreign country only to have the country nationalize the industry and seize all of your capital.

Wage differences can’t really persist in the U.S., as high wages will attract labor, increasing its supply and driving wages down. However, if workers aren’t allowed to cross national borders, then this response will be limited on internationally.

Supply, Demand and Pricing in World Trade
When considering trade of one good between two countries, the keys to understanding equilibrium are:
1. The price of the good has to be the same in the two countries (except for taxes).
2. The excess supply in the exporting country has to equal the excess demand in the importing country.
The value of this model is in predicting how prices will change when conditions in either country change. Consider each of the following:

1. Increased demand in the exporting country
2. Increased supply in the exporting country
3. Increased demand in the importing country
4. Increased supply in the importing country

Silly Ideas and Practices Relating to Foreign Trade

1. Gold!
   When European countries began operations in the Americas, the thing they seemed to desire most was gold. A number of countries extracted large amounts of gold from the Americas and brought it back to their countries. The really silly part of this is that it only lead to inflation in those countries and no real increase in wealth. Basically, because gold was mainly used as money, this was equivalent to increasing the money supply.

2. Mercantilism
   Mercantilism is the idea that exports are good for a country and imports are harmful. The same European countries that foolishly sought only gold from America also sought to force their American colonies to purchase goods only from them. In fact, all voluntary trade benefits both partners and when you import goods, you do so because you can get them more cheaply (in terms of the resources that go into production) from abroad than you can get them domestically.

3. Tariffs
   Tariffs are taxes on imports, and they were an important part of the U.S. government’s revenues for a long time. Tariffs protect domestic producers at the expense of foreign producers and domestic consumers. For example, a tariff on steel imports would help the domestic steel industry but would hurt all the industries that use steel as an input.

4. Quotas
Quotas are numerical limits on imports. They protect domestic producers at the expense of foreign producers (except those who get part of the quota) and domestic consumers. A fun issue with a quota is determining who gets to import how much, or indeed, who gets to import at all.

5. Export Subsidies
Export subsidies are subsidies given to certain producers to allow them to export their products to foreign countries. This is done as a result of the mistaken belief that exports are good and imports are bad (see #2 above). Export subsidies hurt taxpayers, domestic consumers and foreign producers and benefit domestic producers and foreign consumers. For example, I would love it if Scotland instituted huge export subsidies for whisky producers, as it would let me get good Scotch whisky more cheaply at the expense of Scottish taxpayers.

Silly Excuses for Inhibiting Trade
The authors of the book are too polite to call these ideas silly, so I will have to do it for them.

1. Protect certain industries
You might put tariffs or quotas on imports of particular goods to protect a certain industry, or to protect jobs in that industry. However, the trade restrictions are likely to lead to retaliation, which can cause international trade to break down. Also, the cost to consumers is generally high, meaning that the cost per job saved is usually well in excess of what people in the industry earn. The book gives the example of sugar quotas protecting jobs in the U.S. sugar industry at a cost to sugar consumers (in terms of higher prices for sugar) of about $600,000 per job. This is silly.

2. For national defense
Arguments are often put forth to protect an industry that is vital to national defense. This is fairly silly as it is likely to be much less costly for the government to make regular purchases to keep a defense industry going than it is to ban imports of civilian items that that industry produces. Banning domestic purchase of foreign airplanes, for example, would be silly when ongoing military purchases can keep domestic producers of military hardware going. Further, when certain products cease to be of military importance, their protections may not go away. We are still subsidizing the production of mohair (extra points if you know what mohair is) because it was a vital defense commodity in World War I.

3. To protect infant industries
This is silly. If a new industry is sufficiently promising that people believe it will be profitable some time down the road, private capital markets should be willing to provide it with the capital necessary to develop, grow and become profitable. It is too often the
case that the protections afforded infant industries never go away, as the wealth that they redistribute to the firms in the industry is used in part to preserve the protections.

The thing you really need to remember is that foreign competition does a lot to discipline a domestic industry. Insulated domestic industries with a small number of large firms and no exterior threats have a record of poor service to their customers. This was the case with the automobile industry in the U.S. in the 1960s and 1970s. They failed to improve technology, including safety advances, until they faced a real foreign threat. Without a foreign threat, insulated domestic industries will abuse their customers.

Mmmmmmmmm…. Dumping.

Dumping is the practice of selling large amounts of a product at a price that is below cost in hopes of driving foreign competitors out of business so that you can take over their market. Consumers do very well when dumping occurs. Think of your favorite product and imagine how you would feel if foreign producers suddenly flooded the market with huge quantities of it sold at cheap prices. The fearful story is that once domestic producers are driven out of business, mean foreigners will jack up the price and stick it to the consumer. The problem with this argument is that for this to happen there has to be really compelling reason why new firms won’t spring up when the price rises again, and there is rarely such a compelling reason.

Fight Silliness with Silliness

If imports from other states could be limited, there might well be Minnesota orange growers complaining about unfair competition from Florida and California and the need for protection.

An excellent example of silliness to combat silliness is the fictitious petition of French candlemakers to prohibit unfair competition from the sun….

“We are subject to the intolerable competition of a foreign rival, who enjoys, it would seem, such superior facilities for the production of light, that he is enabled to inundate our national market at so exceedingly reduced a price, that, the moment he makes his appearance, he draws off all custom for us; and thus an important branch of French industry, with all its innumerable ramifications, is suddenly reduced to a state of complete stagnation. This rival is no other than the sun.

“Our petition is, that it would please your honorable body to pass a law whereby shall be directed the shutting up of all windows, dormers, skylights, shutters, curtains, in a word, all openings, holes, chinks, and fissures through which the light of the sun is used to
penetrate out dwellings, to the prejudice of the profitable manufactures which we flatter ourselves we have been enabled to bestow upon the country…”