

The American Economy: Policy Options

Statement of

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Our message today is quite straightforward, namely, that it would be very unwise to return to an activist short-run contra-cyclical macroeconomic policy. A more detailed argument for this position is provided in a set of extended remarks that we ask to have incorporated in the hearing record.

For now, we will provide a summary description of the behavior of the American unemployment rate beginning with 1948. For this purpose, we call your attention to the graphic appended to this statement. It describes the ten-year average unemployment rate for six decades, beginning with 1948-1957 and concluding with 1998-2007. In the initial decade, unemployment averaged 4.3 percent, while the most recent period shows an average unemployment rate of 4.9 percent. Thus, there is only a modest difference between the early and late years.

Far more interesting, though, is what happened in the intervening decades. Over the period 1958-1967, the average unemployment rate increased to 5.3 percent. In the years starting with 1968 and concluding with 1977, it increased to an average of 5.7 percent. Next, in the interval 1978-1987, it further increased to an average of 7.4 percent.

These three decades span a period in which the basic philosophy of policy makers was an activist one. Perhaps the quintessential statement of the attitudes of the time was provided by John Kenneth Galbraith, in 1982 testimony before this committee, when he remarked as follows:

“Persistent in the belief of the present administration is the notion that economic recovery and improving unemployment are an autonomous tendency of the system ... (T)here is ... no such autonomous tendency. Recovery is not the work of kindly gods with a special commitment to the free enterprise system. It is, alas, the affirmative accomplishment of man – and woman.”

In the years that followed, disenchantment with the activist approach became widespread and, in the years 1988-1997, the average unemployment rate fell to 6.0 percent, presaging a further decline to the most recent decade's 4.9 percent.

Obviously, we are implying that the recent declines in the ten-year average of unemployment rates are a product of a turning away from an activist policy approach. Is this, perhaps, too simplistic? We think not. Our view is based on the extended remarks that we have asked to be included in the hearing record. Specifically, we refer you to a technical appendix to those remarks which consists of extracts from an article published in a refereed academic journal. This article concludes, among other things, that:

- (1) Cycles in the unemployment rate are the result of shocks in the labor market that produce discoordination;
- (2) These shocks are random, in a statistical sense, and , therefore, cannot be successfully forecast;
- (3) About forty percent of the effects of the random shocks are eliminated by an endogenous correction mechanism;
- (4) Assuming that economic policy makers recognized the shocks immediately and were able to exactly compensate for them, the result would be a less stable labor market and higher average unemployment rates;
- (5) Therefore, short-term macroeconomic contra-cyclical policy is counter-productive.

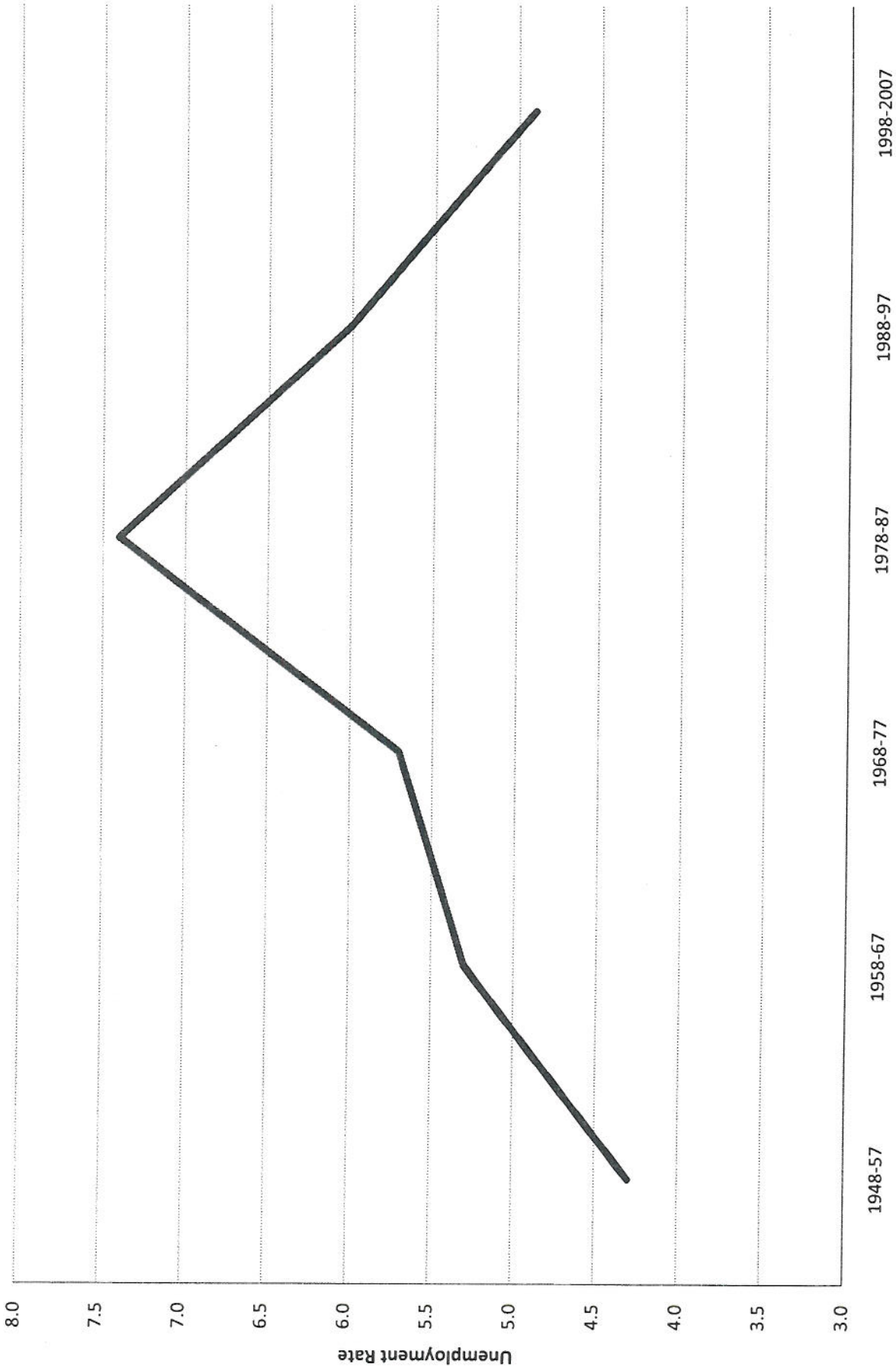
Based on these premises, we find it disturbing that there is much talk of a return to a philosophy that deliberately accepts higher inflation in an attempt to stimulate the economy. This is the language of the late 1950's and the 1960's, which ultimately led to eleven consecutive years of increase in the ten-year moving average of the unemployment rate. In the last 100 years, this is surpassed only by the thirteen year run-up of the average unemployment rate that embraces the Great Depression of the 1930's.

Contrast that with what happened when we turned away from emphasizing short-run contra-cyclical policy in the early 1980s. We have just now (in 2007) concluded the twenty-third consecutive year of decline in the ten-year moving average of the unemployment rate. That is almost twice the length of the second-longest period of decline, twelve years, which accompanied the recovery from the Great Depression and World War II.

To conclude our testimony, we offer two bits of advice to the formulators of national policy. First, do not repeat the errors of the past. Second, do not destroy the good that has emerged in the last quarter century in a futile pursuit of an unattainable perfection. We thank you.

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National Unemployment Rate: Ten Year Average (1957-2007)



Source: Economic Report of the President: 2008