I’d been teaching since 1974, first on the frozen plains of the St. Lawrence at Clarkson College of Technology in upstate New York, and then at the University of Utah in Salt Lake City. I enjoyed teaching then, as I do now, especially the introductory course. No matter where you teach, you always have students who like a good economics story, one about how the world works. But in the late 1970s, teaching the principles of macroeconomics became downright unpleasant. We didn’t have a very good story about how the macroeconomic world worked anymore. I’m not sure whether economics was suffering what Thomas Kuhn called a paradigm shift, but some of our theories didn’t predict or explain economic events very well, especially our theory of the relationship between inflation and unemployment.

I was no more than four or five years out of graduate school. At normal rates of decay my intellectual economic capital should not have depreciated so rapidly. As in all disciplines, one of the purposes of economics graduate training is to teach the new generation the standard theory, the received doctrine. There’s an old saying, if you want to know something about standard theory ask a graduate student studying for Ph.D. qualifying exams. I’d been trained well, but certain macroeconomic anomalies perplexed me. In the U.S. economy, we were having high and increasing inflation and high and increasing unemployment, at the same time. Herb Stein, the Chairman of President Ford’s Council of Economic Advisers had developed what he called the Misery Index,
the sum of the inflation rate and the unemployment rate. In the late 1970s, this index read about 18 to 20%.

This wasn’t supposed to happen. In 1958, British economist A.W. Phillips had examined inflation and unemployment data from the first half of the 20th century and concluded that when the unemployment rate rose the rate of inflation fell. U.S. economists Paul Samuelson and Robert Solow, both later Nobel laureates, showed the same thing with U.S. data two years later. This statistical relationship, called the Phillips Curve, confirmed the reigning theory of inflation and unemployment at the time. Before the 1970s all had been well in macroeconomic science, as theory was confirmed by the facts of the world.

We had learned from Keynes that higher demand in the economy sooner or later caused inflation, as well. If the economy was not in a recession, if the unemployment rate was not high, more total spending meant we would have too many dollars chasing too few goods, and the lid would lift off the economy’s teapot. Inflation could be thought of as the economy letting off steam as it overheated. Macroeconomic policy was merely an exercise in choosing the combination of inflation and unemployment we wanted, and using government fiscal policy to maintain the right level of spending in the economy. Too little total spending? Increases the budget deficit. Too much spending? Reduce the budget deficit, or run the opposite of a deficit, a surplus.

The policy had worked in the 1960s. Following the Kennedy/Johnson cut in tax rates in the early 1960s, and increased government spending on the war against the Viet Cong in Vietnam, and the war against poverty at home, the 1960s economy expanded for the rest of the decade. All the while, however, inflation was always with us, and it crept
up ever so gently over the decade. We came to expect inflation, but many economists thought it was just the cost of having unemployment low. After all, Phillips, Samuelson and Solow had showed us this years ago.

Then came the 1970s. Two things had changed. First, after a decade and a half of rising prices every year, people now expected inflation all the time and they wanted to be protected from its erosive power on their purchasing power. We protected social security recipients every year by increasing their monthly checks according to changes in the consumer price index. Unions bargained for cost of living adjustments in their wage contracts. Even nonunion workers demanded cost of living increases in wages and salaries during their less formal annual bargaining with employers. I can remember helping out my noneconomist university colleagues who made presentations to the legislature in Utah about cost of living adjustments in faculty salaries.

Employers generally obliged. If inflation rose, we expected inflation next year to be higher as well. Employers passed on the wage increases in the form of higher prices. The average price level rose, almost a self-fulfilling prophecy. This type of inflation came to be called cost-push inflation, to contrast it with the demand-pull Keynesian variety. Economists talked about a wage and price spiral.

Then we had the Yom Kippur war in the Middle East, a disruption of oil supplies and the consequent increase in oil prices. The Organization of Petroleum Exporting Countries (OPEC), previously ineffective as a sellers cartel in oil, raised prices even further. This raised production costs and companies passed these costs along in the form of higher prices. Inflation was now even higher, and now, when the economy went into a
recession, inflation remained high. We had inflation and recession at the same time.

Some called this stagflation.

The macroeconomic models of the 1970s could not explain stagflation. The Phillips Curve was no longer a stable relationship of data on inflation and unemployment. Like the 1960s antiwar song, “Where Have All the Flowers Gone?” economists wondered where all the Phillips Curves had gone. Our favorite story we had told college freshmen and sophomores was no longer true. I opted out of teaching macroeconomic principles for a few years. As an untenured assistant professor trying to publish and not perish, and with what I considered to be more fruitful research outlets, I decided to wait for others to develop new theories to explain the new macroeconomic facts, and then for those who write textbooks to distill this down to something I could understand, and then relate it to my students.

I remember at the time that I was confident, as were most economists, that this theoretical realignment would occur. We had faith in the discipline. In fact, economists were well on their way to coming up with a theory to explain the new facts. In graduate school in 1973, I had taken a special summer seminar in which we studied the work of Edmund Phelps, Milton Friedman and others, whose work in the late 1960s on the effect of inflation expectations in labor markets suggested why the Phillips Curve might not work as we had thought. This was part of something called the expectations revolution in macroeconomics for which Robert Lucas of the University of Chicago won the Nobel Prize a few years later. Friedman also won the Nobel Prize.

By the time I came to the University of Idaho in 1989, the scientific process had worked itself out. Standard theory had been challenged by the facts. Economists had
checked the facts, and they seemed correct. The problem had to be with the theory.

Economists came up with a new theory about inflation and unemployment that explained the facts, and talented textbook writers found ways to cut through the thickets of algebra and substitute graphical models approachable by college students. I consider it one of the finest moments in economics. Of course, the moment lasted a decade or two, and had me sitting on the sideline of macroeconomics education longer than I wanted to, but we did it. We have a good macroeconomic story once again.