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# **Is Jamaica Caught in A Structural Unemployment Policy Trap?**

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## **Is Jamaica Caught in A Structural Unemployment Policy Trap?**

For the last seventeen years in Jamaica, the theory of the natural rate of unemployment has dominated Jamaican Government macroeconomic policy making. Attention has predominantly focused on its implications for the inflation - unemployment trade-off as a result of the complete embracing of the Euro-American economic theory in comparison to say “neo-south-south economic thinking” as has happened in Brazil on this matter . However, another implication concerns the possibility that Jamaican Government policy makers may have gotten caught in a **structural unemployment policy trap**. Natural rate theory decomposes unemployment into structural and cyclical components, and it is claimed that **the structural component predominates**. As a result, counter-cyclical macroeconomic policy is diminished, and policy makers are led to focus on policies of labor market flexibility (we note with concern that over the last 17 years the government has primarily promoted Passive labour market polices instead of active labour market policies). This policy stance has resulted in Jamaica in permanently higher aggregate unemployment (if we include the so called unemployable which the methodology does not speak to and does not include; which when totally ignored creates serious social problems as occurs in Jamaica), and promotes the remaking of labor markets in a fashion that increases worker economic insecurity and lowers wages. Moreover, to the extent that monetary authorities adopt a pre-emptive approach to inflation, they risk making high structural

unemployment self-fulfilling. This is because they slow the economy whenever it approaches their point estimate of the natural rate, thereby making that point estimate self-fulfilling.

### **NAIRU or Non-Accelerating Inflation Rate of Unemployment**

The concept of the NAIRU derives from a perfectly competitive general equilibrium approach to thinking about the economy. The claim is that there exists a unique rate of equilibrium unemployment which is determined by structural conditions within an economy, and that competitive economies like Jamaica adjust to this rate of unemployment fairly quickly. Moreover, Government monetary policy and aggregate demand management policies can do little to affect this equilibrium natural rate of unemployment because it is essentially determined by supply-side conditions.

Normal unemployment in Jamaica is determined by the objective conditions governing labor exchange in labor markets. These objective conditions refer to the number of workers looking for jobs and the terms on which they are willing to work (i.e. labor supply), the productivity of labor once employed by firms (i.e. labor demand), firms' costs and ease of access to information about which workers want jobs, and workers' costs and ease of access to information about which firms have job vacancies. Given these objective conditions, workers and firms try to match up with one another, with labor productivity determining what firms are willing to pay workers. Owing to imperfect information amongst firms in Jamaica as to who job-

seekers are and amongst workers as to where jobs are, some firms and workers inevitably fail to match up. As a result there are some unfilled vacancies and some unemployment.

### **Jamaica and the structural unemployment policy trap**

Following the emergence of NAIRU in Jamaica, the main focus of Government policy discussions has been on its implications for the trade-off between inflation and unemployment. Phillips curve analysis in Jamaica should emphasized the existence of a negative trade-off between inflation and unemployment that allowed policy makers to systematically purchase a little less unemployment at the cost of a little more inflation.

However, the theory of the natural rate denies this trade-off, and claims a complete separation between normal equilibrium unemployment and inflation. Equilibrium unemployment is determined by real forces and conditions governing labor markets, and these conditions are independent of aggregate demand, the money supply, and the rate of inflation. Neither aggregate demand, the money supply nor inflation affect worker productivity or firms' and workers' information about who wants jobs and where jobs are. As a result, they have no effect on equilibrium unemployment, and the Phillips curve is therefore vertical.

In reviewing the body of research in this area we in particular highlight Palley (1998):

1. Though attention has tended to focus on the implications of natural rate theory for the inflation - unemployment policy trade-off, there is a more dangerous policy implication that can be termed the "structural unemployment policy trap"(as applied to the Jamaican Unemployment situation). This trap has policy makers abandoning macroeconomic policy as a means of lowering unemployment, and shifting to policies of labor market flexibility. The result is higher unemployment and increased economic insecurity.
2. The foundation of the Jamaican structural unemployment trap lies in natural rate theory's creation of an artifactual separation between structural and cyclical unemployment. Structural unemployment is identified with natural unemployment, while cyclical unemployment is identified with unemployment resulting from normal business cycle fluctuations. It is then argued that macroeconomic policy can lower cyclical unemployment, but it can do nothing about structural unemployment. Addressing the latter can only be done through structural adjustment programs designed to create "labor market flexibility" through weakening of unions, elimination of minimum wage laws, and stripping away of worker employment protections.

3. The natural rate's construction of policy in terms of a divide between structural and cyclical unemployment becomes critical when empirical estimates of the natural rate lead to the conclusion that almost all unemployment is structural in character. **It is for this reason that not only is the underlying theory of the natural rate an issue of contention, but so too is the econometric methodology that underlies empirical estimates of the natural rate( the point the former Opposition was trying to make but poorly articulated it, due to there being insufficient research done because of time limitations).**
4. If structural unemployment were restricted to just one or two percent, the policy significance of the natural rate would be greatly diminished. However, once the bulk of unemployment is identified as structural, the validity and plausibility of estimates of the natural rate become crucial.
5. A hallmark of the Jamaican structural unemployment trap is the tendency for empirical estimates of the natural rate to follow the actual unemployment rate, thereby making structural unemployment self-fulfilling.

## **How Can Jamaica escape the structural unemployment policy trap?**

1. The pre-emption approach to conduct of monetary policy in Jamaica risks making estimates of the natural rate self-fulfilling. This is because every time the economy approaches the central bank's point estimate of the natural rate, the central bank raises interest rates thereby putting the break on unemployment. This is particularly troubling given the enormous variation in estimates of the natural rate.
2. Financial market expectations can also make the natural rate self-fulfilling. Thus, to the extent that financial markets believe that the central bank is guided by natural rate theory, then market participants will expect the central bank to start raising interest rates as the economy approaches the central bank's point estimate of the natural rate. With market participants expecting the central bank to raise rates, there will be upward pressure on market interest rates that will serve to slow the economy. Once again, the economy can get trapped with high unemployment.

An alternative to pre-emptive Jamaican policy approach is one that can be labelled "testing the waters". This approach has been advocated by Galbraith (1997) as follows:

1. Natural rate thinking tends to represent the economy as a cliff, whereby pushing unemployment below the natural rate results in a catastrophic acceleration of inflation. However, the economy may be more akin to a gently sloped beach, with a lowering of unemployment producing a slow gentle increase in inflation. Rather than engaging in pre-emption, policy makers should instead adopt a testing the waters approach which has them gradually nudging unemployment downward until the economy reaches a level of inflation that is deemed unacceptable. At this stage, monetary authorities can then step on the break.
2. A testing the waters approach to monetary policy can provide a way out of the structural unemployment trap. Macroeconomic policy is used to nudge the economy forward, thereby preventing policy from generating self-fulfilling high unemployment. Even if policy makers believe in the theory of the natural rate, they are freed from being trapped by mistaken point estimates of the natural rate. This is particularly important given that these estimates are subject to large margins of error. If the economy is characterized by a negatively sloped Phillips curve which is horizontal over a significant range of unemployment, policy makers get to lower unemployment: if it is characterized by a natural rate, policy makers get to lower unemployment to the natural rate without stopping short. Though a



testing the waters approach to monetary policy does nothing to resolve the theoretical differences between natural rate and Keynesian Phillips curve theory, it does produce an operational procedure that avoids the structural unemployment policy trap.

## **Conclusion**

1. For the last 17 years the theory of the natural rate has dominated Jamaican macroeconomic policy making. Attention has predominantly focused on its implications for the inflation - unemployment trade-off. However, another ominous implication concerns the possibility that Jamaican policy makers may get caught in a structural unemployment policy trap.
2. Natural rate theory decomposes unemployment into structural and cyclical components, and estimates based on the theory have the structural component predominating (as occurs in Jamaica). As a result, countercyclical macroeconomic policy is diminished, and policy makers are led to focus on policies of labor market flexibility.
3. This policy stance results in permanently higher aggregate unemployment, and also promotes remaking of labor markets in a fashion that increases worker economic insecurity and lowers wages.
4. Moreover, to the extent that Jamaican monetary authorities adopt a pre-emptive approach to inflation, they risk making high structural

unemployment self-fulfilling. This is because they slow the economy whenever it approaches their point estimate of the natural rate, thereby making that point estimate self-fulfilling.

5. Finally, the natural rate's construction of policy in terms of a divide between structural and cyclical unemployment becomes critical when empirical estimates of the natural rate lead to the conclusion that almost all unemployment is structural in character. It is for this reason that not only is the underlying theory of the natural rate an issue of contention, but so too is the econometric methodology that underlies empirical estimates of the natural rate

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