

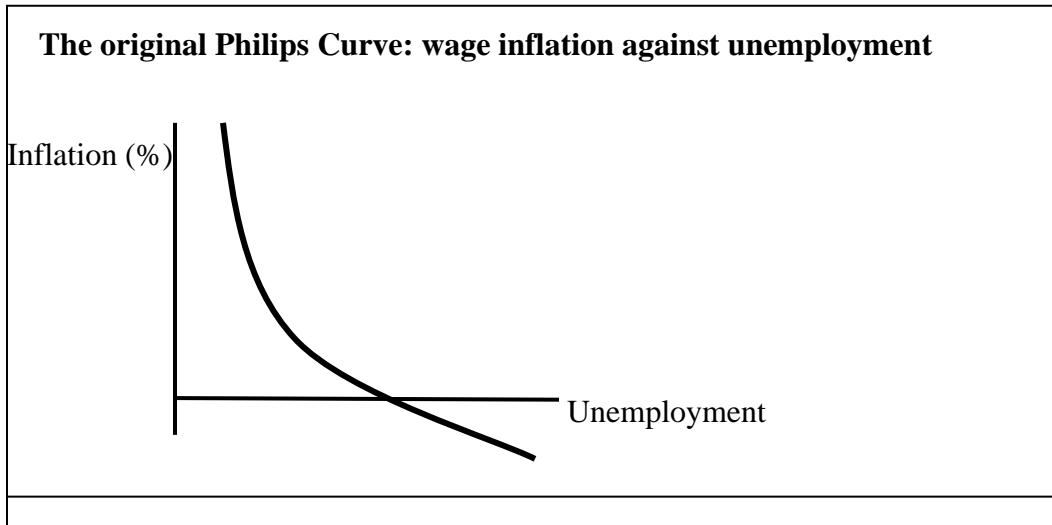
A SHORT NOTE ON
INFLATION, UNEMPLOYMENT AND PHILIPS CURVE

- Macroeconomic policies are implemented in order to achieve government's main objectives of full employment and stable economy through low inflation. We can use Philips Curve as a tool to explain the trade-off between these two objectives.

- Philips Curve describes the relationship between **inflation** and **unemployment** in an economy.
- You already know that the Inflation is defined by increase in the average price level of goods and services over time.
- When there is inflation, value of money falls. A low inflation rate indicates that average price of goods would not rise as high.
- Unemployment exist when someone is actively seeking for job but unable to find any despite their willingness to accept the going market wage rate (we discussed it many times right? See Ch5)

New Zealand-born economist A.W Philips first put this theory forward in 1958 gathered the data of unemployment and changes in wage levels in the UK from 1861 to 1957.

He observed that one stable curve represents the trade-off between inflation and unemployment and they are inversely/negatively related. In other words, if unemployment decreases, inflation will increase, and vice versa.



- For example, after the economy has just been in recession, the unemployment level will be fairly high. This will mean that there is a labor surplus.
- As the economy has just started growing, the aggregate demand (AD) will increase and therefore leading to an increase in employment. In the beginning, there will be little pressure for a raise in wages. However, as the economy grows faster and more people are employed, wages will start rising slowly.
- This will increase the firm's cost of production and the high costs are usually passed on to the customers in the form of higher prices. **Therefore a decrease in unemployment has led to an increase in inflation and vice versa.**
- Not only that, unemployed might suffer from money illusion as they thought the increase in wages offered to them represented a real wage (Sloman 2000). They underestimate inflation by not realizing that higher wages will be eaten up by higher prices. Thus they will accept job more readily and this will reduce the *frictional unemployment* (we discussed this in Ch5.. right??.) in the short run.

The relationship we discussed above is a phenomenon in the **short-run**. But in the **long run**, since unemployment always returns to its *natural rate* (unemployment rate at which GDP is at its full-employment level that is, with no cyclical unemployment.... we discussed this in Ch5...right??), there is no such trade-off.

[Remember that

- When unemployment rate is below natural rate, GDP is greater than potential output
 - Economy's self-correcting mechanism will then create inflation
- When unemployment rate is above natural rate, GDP is below potential output
 - Self-correcting mechanism will then put downward pressure on price level]

Using the data from the 1950s and 1960s where the world economy tended to be stable, the Philips Curve relationship proved to be true for many economies such as the United States and UK (Griffiths and Wall, 1999). However, during 1967-1970 most countries such as the US, Britain and France had doubled their inflation (Ormerod, 1995). This was the first sign that the downward relationship in the Philips Curve was not always true. In the 70's the concept of a stable Philips Curve shows a break down as the economy suffered from both high inflation and high unemployment simultaneously. Economists refer to this kind of situation as stagflation where stagnant economies and rising inflation occur together.