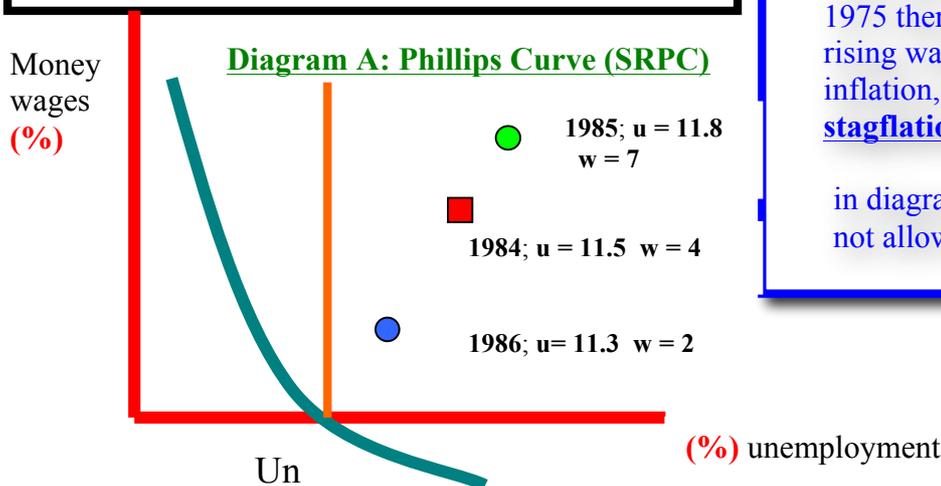


Syllabus Reference 3.5: The Phillips Curve (HL) The SRPC and the LRPC

- What is the relationship between inflation and unemployment¹?
- To what extent are inflation and employment interdependent?
- Is there a difference between the SR and the LR?

- Economies have a natural rate of unemployment- see webnote 316.
- How to tackle this rate of unemployment is the issue that divides economists
- Demand side or supply side policies?
- Is there a trade off between inflation and unemployment? The Phillips curve suggests such a trade off
- The Phillips curve appeared to show the impossibility of achieving 2 key government policy objectives simultaneously i.e. policy conflict
- Phillips curve works only in short run and will be vertical in long run as shown in diagram A



The simple Phillips Curve. (See diagram A)

- ✦ This shows a statistical inverse relationship between levels of unemployment and the rate of change of wages (wage inflation). Paper published in 1958 for years 1862 -1958.
- ✦ There appears to be simple trade-off between (less) inflation but (more) unemployment, and vice- versa.
- ✦ The Phillips Curve seemed to be successful in predicting combinations of unemployment and inflation until 1966. Thereafter the relationship was broken. Between 1969 and 1975 there was both rising unemployment and rising wage inflation, leading to what economists called **stagflation**. See   in diagram A. The original Phillips curve does not allow for this. See also diagram C.  

Note on diagram:

- Un is the natural rate of unemployment. (See diagram A) It has been estimated at 4-5 % for the United Kingdom.

Long run vs short run

Phillips empirical findings widely accepted until 1966. It showed stable 'trade off' for almost 100 years. This had obvious policy implications for government i.e. Unemployment or inflation. In the short run it appears a 'trade off' is valid but in the long run it appears less likely.

¹ See Anderton pp 125 and 126 for a better analysis

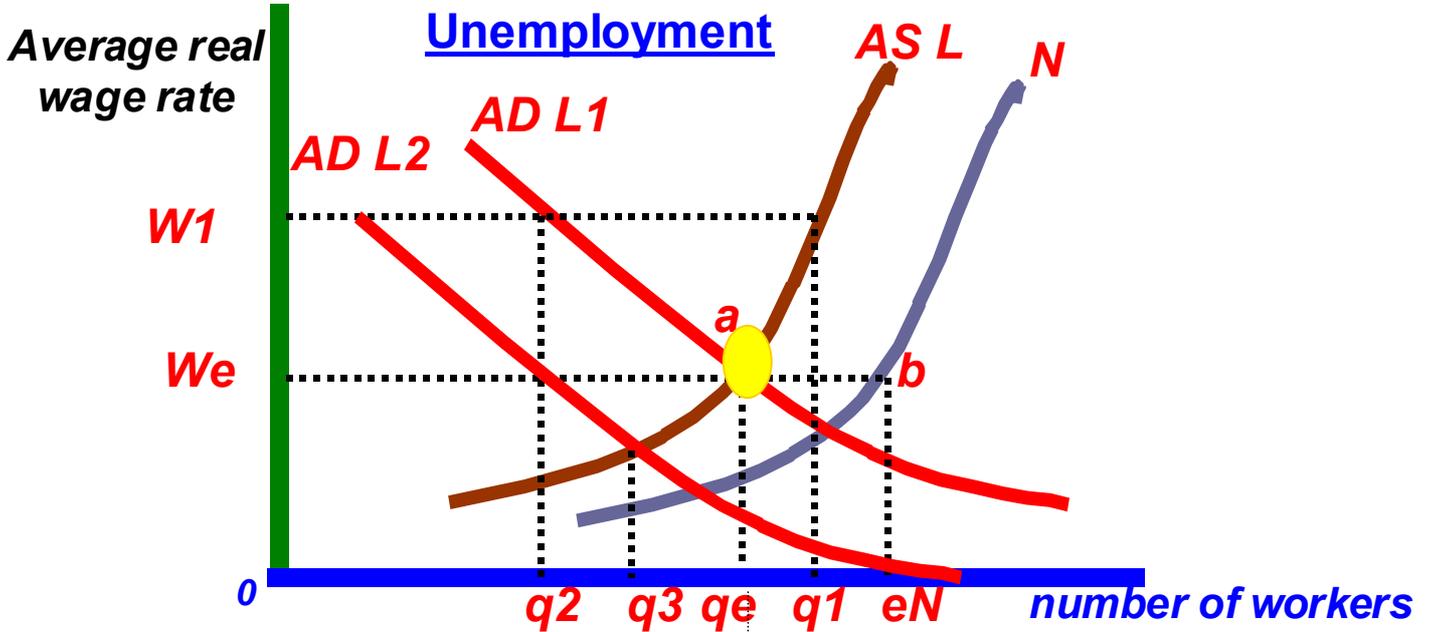
IB assessment:

Why might the goal of full employment conflict with the goal of economic growth?

IB HL 2 May 2003

Long Run Philips Curve (LRPC)

DIAGRAM B: Disequilibrium



Note: the key issue here is that the labour market is in equilibrium at W_e a q_e

