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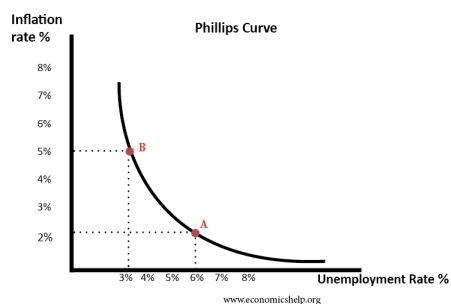
Paper - MIC 6

Topic- The Phillips Curve: An Overview

The Phillips Curve: An Overview

1. Introduction

The Phillips Curve is a fundamental concept in macroeconomics that describes the inverse relationship between unemployment and inflation. Named after economist A.W. Phillips, this theory suggests that when unemployment is low, inflation tends to be high, and vice versa. Policymakers and economists have used this relationship to understand and manage economic fluctuations, particularly in setting monetary and fiscal policies.



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2. Historical Background

A.W. Phillips first introduced the concept in his 1958 paper, "The Relation Between Unemployment and the Rate of Change of Money Wages in the United Kingdom, 1861–1957." He observed that when unemployment was low, wages increased rapidly,

leading to higher inflation. This empirical observation was later extended to price inflation, forming the basis of the modern Phillips Curve.

During the 1960s, economists such as Paul Samuelson and Robert Solow applied Phillips' findings to the U.S. economy, suggesting a stable trade-off between inflation and unemployment. This provided policymakers with a framework to target lower unemployment at the cost of higher inflation or vice versa.

3. Theoretical Foundations

The Phillips Curve is based on the idea that labor markets adjust slowly, and wage-setting behavior responds to changes in unemployment. The core theoretical underpinning includes:

- **Demand-Pull Inflation:** Lower unemployment increases demand for goods and services, pushing prices up.
- **Cost-Push Inflation:** When unemployment is low, firms must offer higher wages to attract workers, leading to higher production costs and, consequently, inflation.
- **Expectations-Augmented Phillips Curve:** Introduced by Milton Friedman and Edmund Phelps in the late 1960s, this version argues that inflation expectations influence wage-setting behavior. If workers expect higher inflation, they demand higher wages, making inflation persistent.

4. Empirical Evidence and Criticisms

In the 1970s, the traditional Phillips Curve relationship broke down as many economies experienced “stagflation”—high inflation and high unemployment simultaneously. This challenged the notion of a stable trade-off and led to new theories:

- **Rational Expectations Theory:** Robert Lucas and Thomas Sargent argued that if workers and firms anticipate inflation correctly, monetary policy has little impact on reducing unemployment in the long run.
- **Long-Run Phillips Curve (Vertical Curve):** Friedman and Phelps suggested that in the long run, the Phillips Curve becomes vertical at the **natural rate of**

unemployment (or Non-Accelerating Inflation Rate of Unemployment - NAIRU), meaning there is no trade-off between inflation and unemployment.

- **New Keynesian View:** While the long-run trade-off may not exist, in the short run, market frictions, price stickiness, and imperfect information can still create a temporary relationship between inflation and unemployment.

5. Policy Implications

The Phillips Curve has significant implications for economic policy:

- **Monetary Policy:** Central banks use inflation-unemployment dynamics to set interest rates. If inflation is high, they may raise rates to cool the economy, while during high unemployment, they may lower rates to stimulate demand.
- **Fiscal Policy:** Governments may use expansionary fiscal policies (e.g., increased spending or tax cuts) to reduce unemployment but must be cautious about inflationary pressures.
- **Inflation Targeting:** Modern central banks focus on keeping inflation expectations stable, recognizing that a short-term trade-off exists but aiming for long-term stability.

6. Conclusion

The Phillips Curve remains a cornerstone of macroeconomic analysis, though its applicability has evolved over time. While its simple trade-off view has been challenged, its insights continue to shape monetary and fiscal policies worldwide. The key lesson from the Phillips Curve debate is that understanding inflation, unemployment, and expectations is crucial for effective economic management.