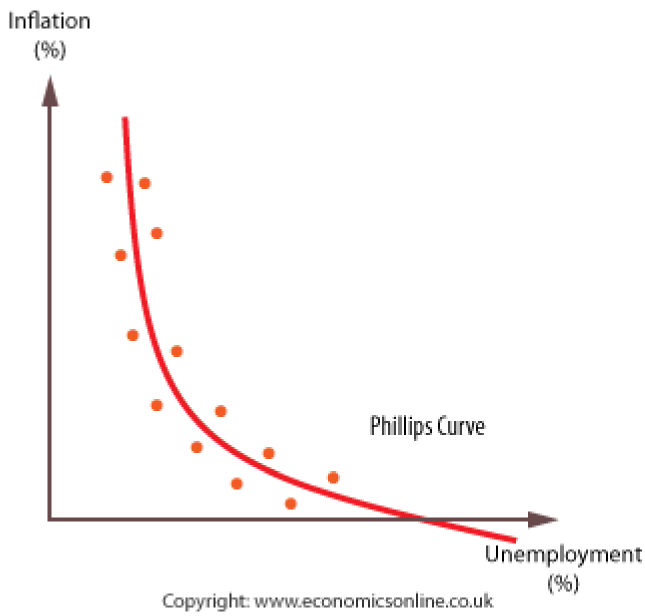
Question#26260

The Phillips curve shows the relationship between unemployment and inflation in an economy. Since its "discovery" by British economist A.W. Phillips, it has become an essential tool to analyze macro-economic policy.

a) Phillips analyzed annual wage inflation and unemployment rates in the UK for the period 1860 – 1957, and then plotted them on a scatter diagram.



The curve suggested that changes in the level of unemployment have a direct and predictable effect on the level of price inflation. The accepted explanation during the 1960's was that a fiscal stimulus, and increase in AD, would trigger the following sequence of responses:

- ✓ An increase in the demand for labor as government spending generates growth.
- ✓ The pool of unemployed will fall.
- ✓ Firms must compete for fewer workers by raising nominal wages.
- ✓ Workers have greater bargaining power to seek out increases in nominal wages.
- ✓ Wage costs will rise.
- ✓ Faced with rising wage costs, firms pass on these cost increases in higher prices.

b) In less-developed economies, the existence of an empirical Phillips curve is often evasive or absent. Many studies, specifically in India, have failed to find the conventional Phillips-curve pattern. In addition, most studies uncovered an unexpected negative relation between inflation and the output gap. The studies that suggest the nonexistence of the Phillips curve for India include Bhalla (1981), Chatterji (1989), Rangarajan (1983), Samanta (1986), Bhattacharya and Lodh (1990), Dholakia (1990), Rangarajan and Arif (1990) and Virmani (2004). In the case of most Phillips Curve models for developed countries, the output gap has been applied as an indicator of demand. The link between interest rate and excess demand is found to be strong in the case of developed economies because of which the transmission mechanism from monetary policy to the real economy (via the interest rate) is expected to be effective. It has therefore been argued that money should not be included in the Phillips curve along with output gap since the impact of money on aggregate demand is captured through its effect on the interest rate. Output gap models of inflation, however, have been less commonly applied in the case of developing countries. One explanation for this is that developing countries have relatively underdeveloped financial markets, and therefore a weak relationship exists between interest rates and aggregate demand. Hence, for developing countries, the real money gap can be taken as a potential determinant of inflation in addition or in lieu of the output gap.