Answer on Question #73732 - Economics / Macroeconomics

Explain how the theory of the Phillips curve can be used to explain why it is often thought that a low level of unemployment makes an inflationary outburst inevitable.

ANSWER

By modifying the curve of aggregate supply (AS), which describes relations between real output and level of prices we can get a curve named Phillips. Phillips curve shows how the inflation and unemployment rates are linked.

The modified curve of Phillips can be represented by the following formula - $\pi = \pi^e - \beta \cdot (u - u^*) + \varepsilon$, where π *and* π^e represent actual and expected rates of inflation, u *and* u^* describe actual and natural rates of unemployment, $\beta > 0$ is a coefficient and ε indicates the supply shocks.

So the above represented Phillips curve serves as a new expression of the aggregate supply curve and shows short run relation between inflation and unemployment. The changes in expected inflation and supply shocks will be reason for shifts in the Phillips curve. This curve cannot be used for the estimation of changes in long run period. The economic policy aimed to cut unemployment rate by motivating aggregate demand can be efficiently only in case if economic agents change their inflationary expectations. For instance, they do not insist on increasing nominal wages in response to higher prices.

Now let's consider the economy is in the point A. The situation when the economy is in the natural level of unemployment. The high level of demand will lead to the extension of output and employment. After these changes the price will start to grow, but the wages will stay in the same level, as the contracts are for a long period with the fixed level of expected inflation rate - π^{e1}. The high level prices will cause in an increase of output. In this case now the economy will move to the point B. However, in close future in response to the increase of inflation rate the economic agents will change their expectations. In fact the nominal wages will increase and there will be no stimulus for extension of the production, the unemployment rate will return to the same position and the economy will move to the new point C, where we will have higher level of inflation rate - π^{e2}. Above described process can be shown in the following picture.