

Phillips Curve and Stagflation

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Meaning and Explanation of PC

- **Phillips curve:** shows the short-run trade-off between inflation and unemployment
- 1958: A.W. Phillips showed that nominal wage growth was negatively correlated with unemployment in the U.K.
- 1960: Paul Samuelson & Robert Solow found a negative correlation between U.S. inflation & unemployment, named it “the Phillips Curve.”
- Lipsey’s in 1960 provided a sound theoretical and statistical relation observed by Phillips.

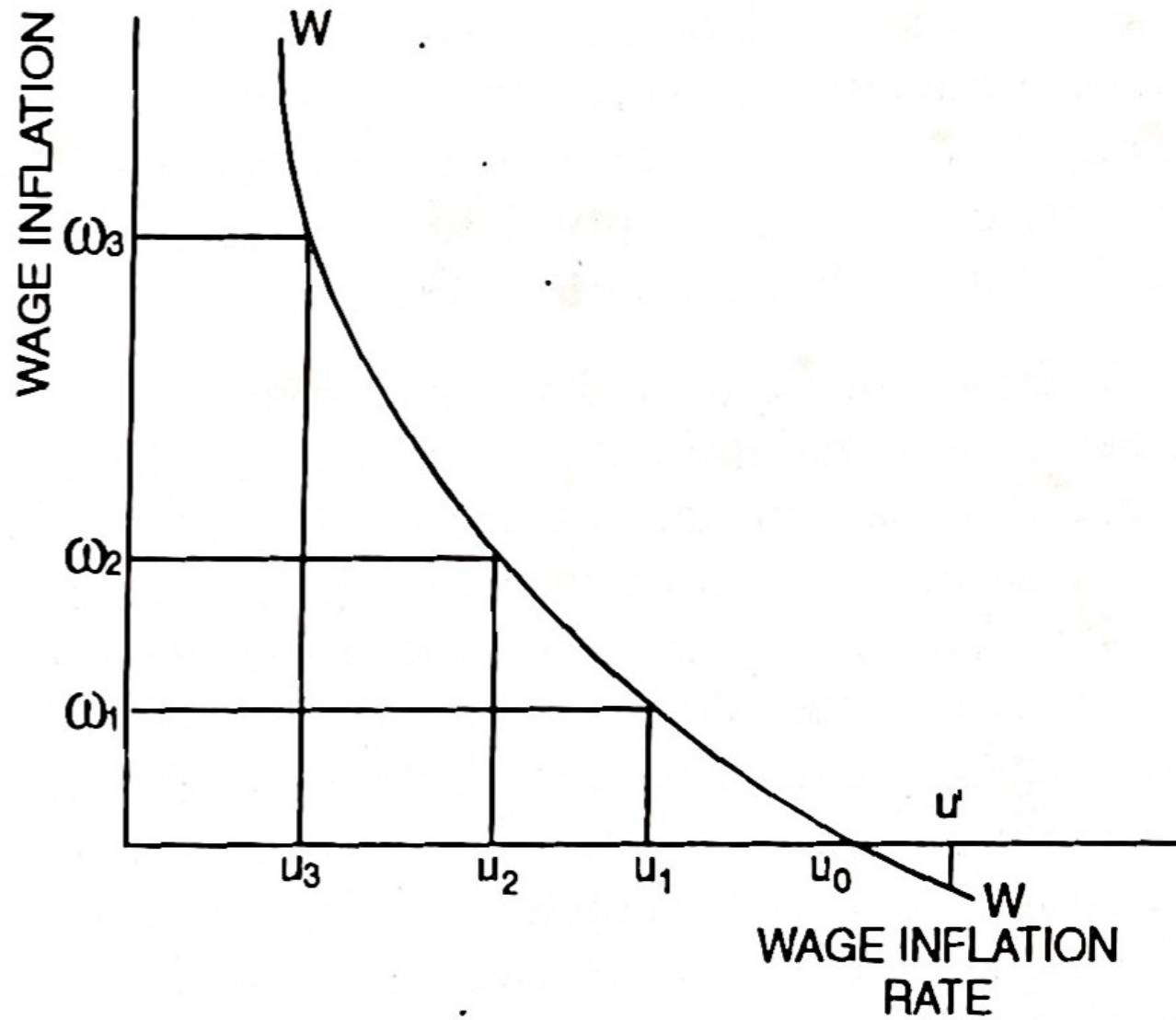
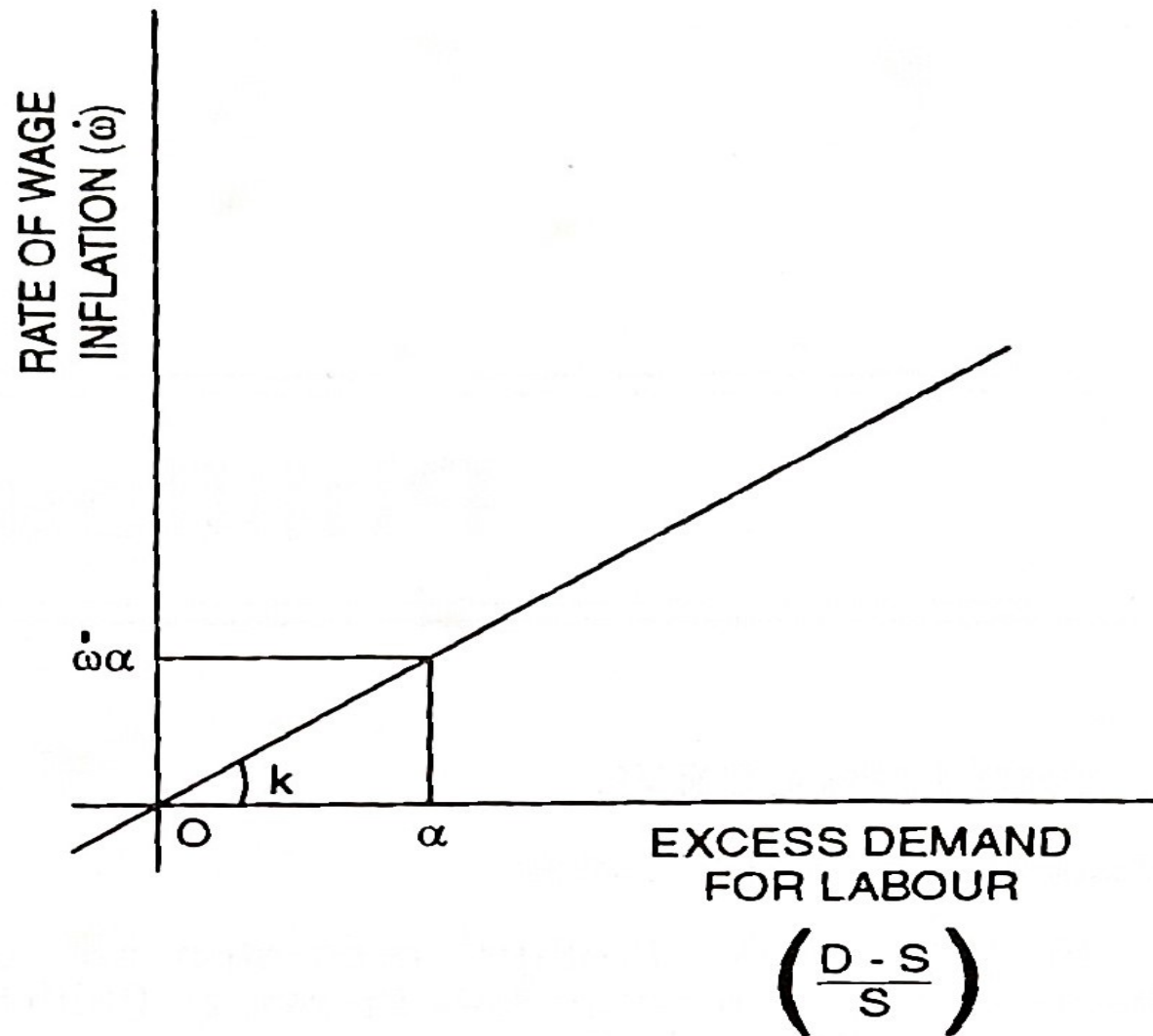


Fig. 1

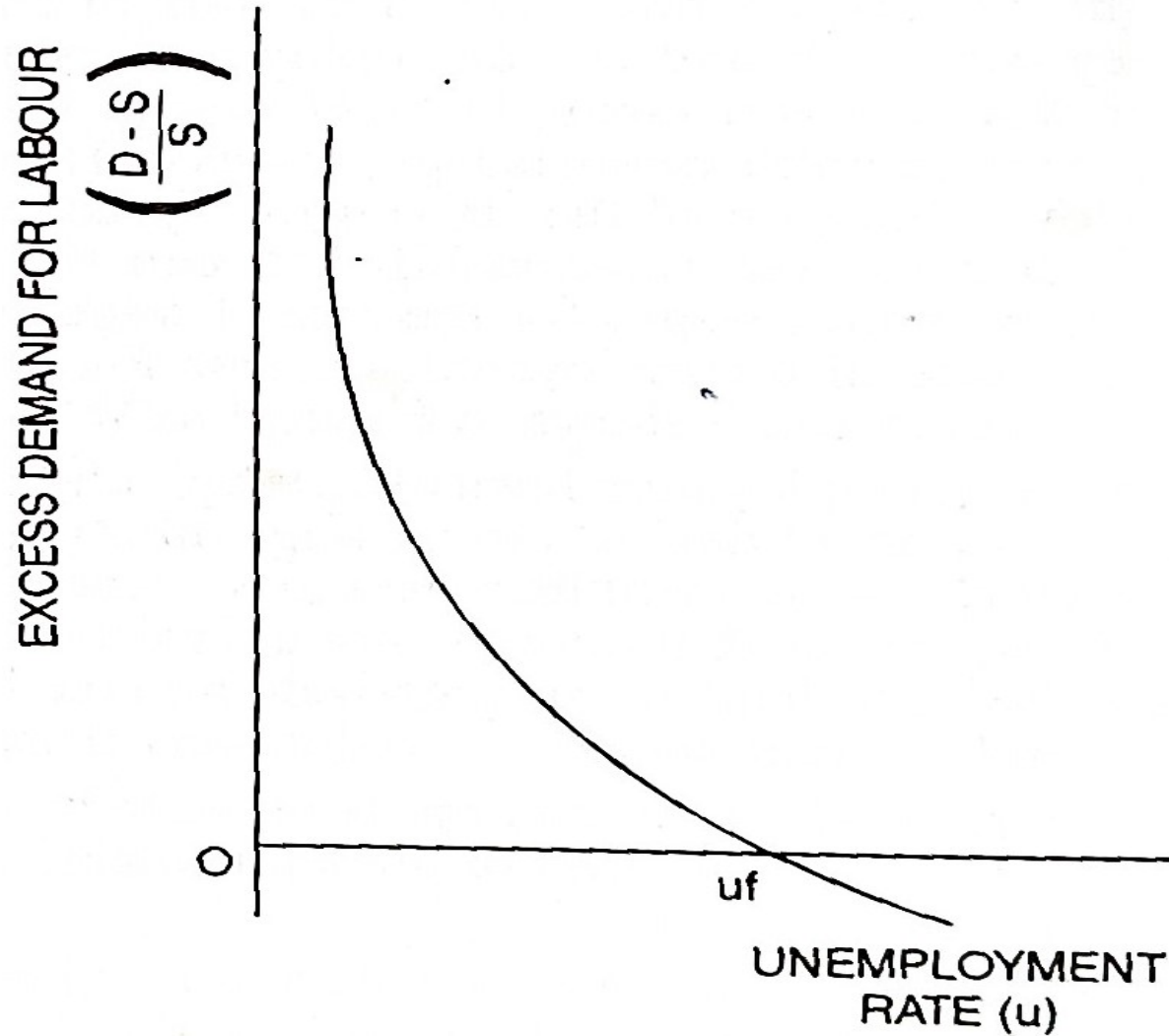
Lipsey's Theory of PC

- Inverse relationship between wage inflation and unemployment can be derived from:
 - (a) a positive relationship between the rate of money wages change and the magnitude for excess demand for labour and
 - (b) An inverse non-linear relationship between excess labour demand and unemployment

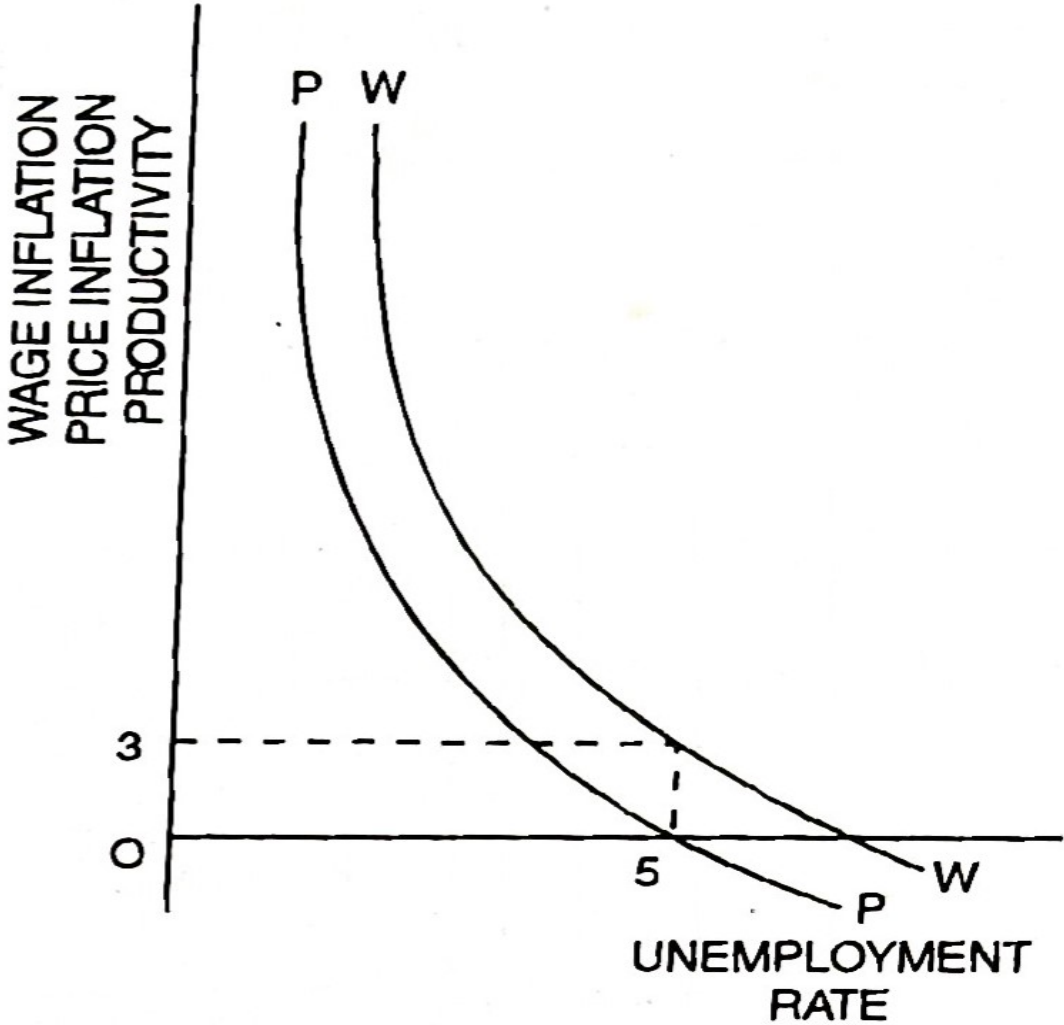
Relationship between wage inflation and excess demand



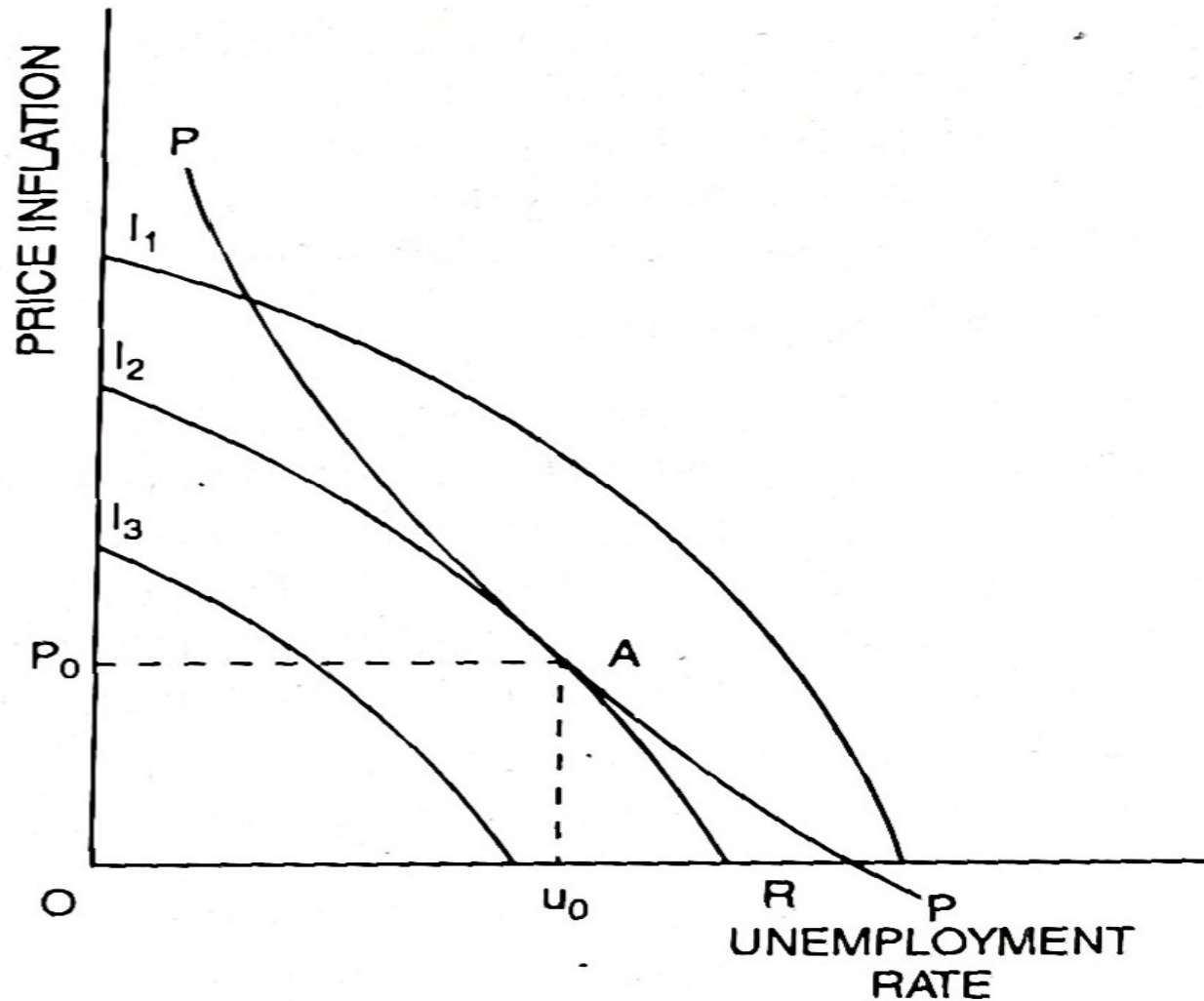
Relationship between excess demand and inflation



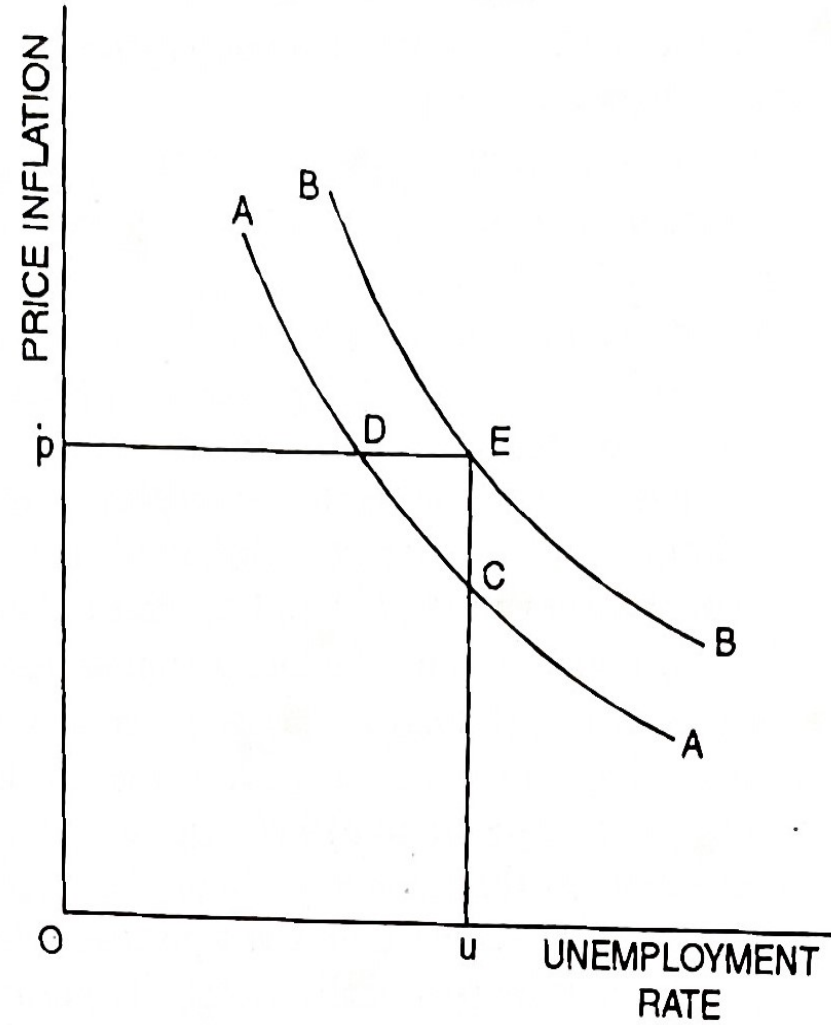
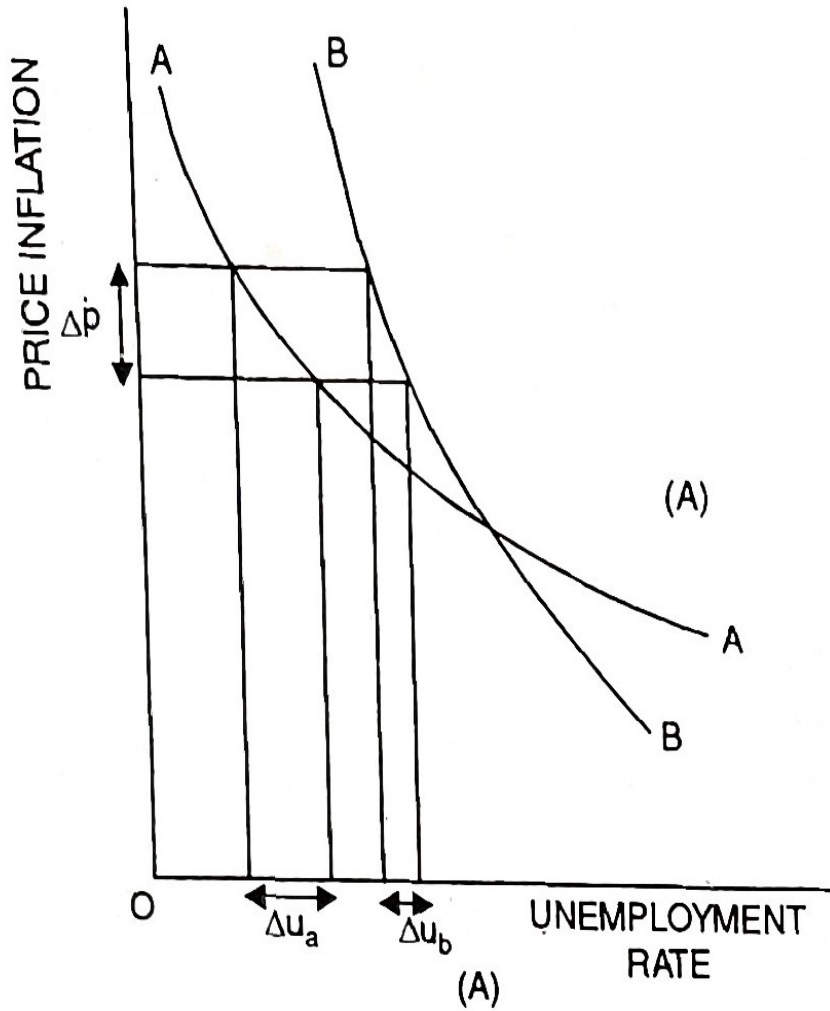
Policy implications of Phillips Curve



Policy maker will maximise their utility by selecting the inflation-unemployment combination at point A where trade off curve PP is tangential to an indifference curve I



Slope and position of Phillips Curve



Criticism of Phillips Curve

- Unstable trade off
- Role of trade union ignored
- Influence of cost of living ignored
- The problem of stagflation
- Inflation an international phenomenon
- Neglect of Macro issues

Thank You