OCR Economics A-level

Macroeconomics

Topic 2: Economic Policy Objectives

2.8 The Phillips Curve

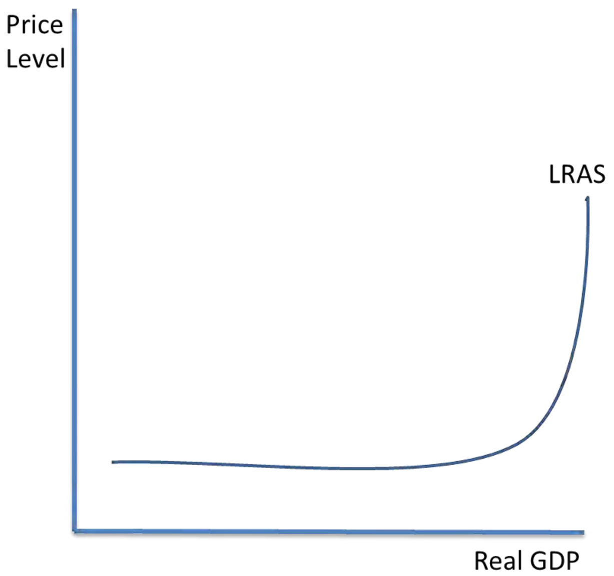
Note

The natural rate of unemployment

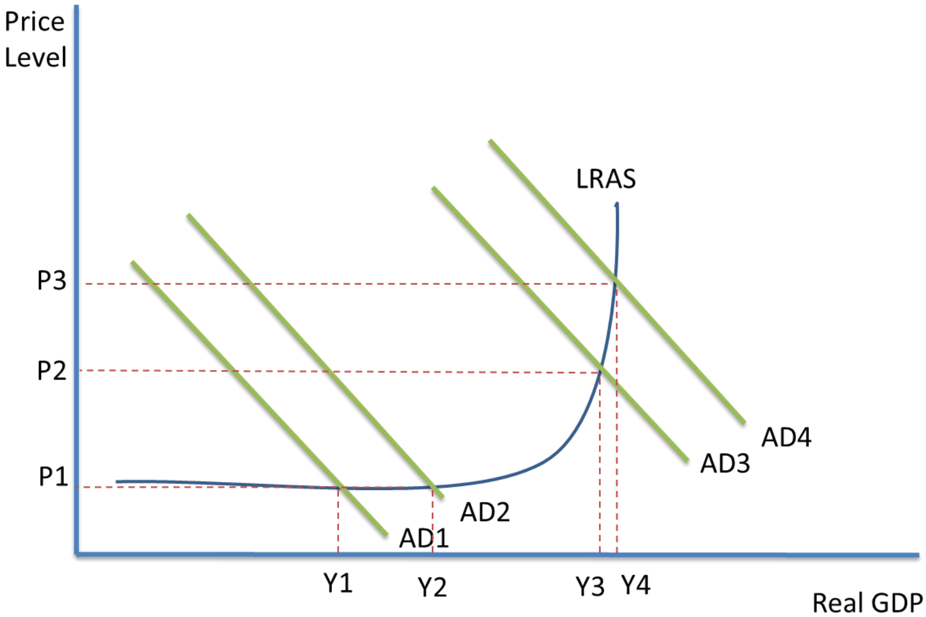
- The unemployment rate when the labour market is at equilibrium is called the natural rate of unemployment. It is a concept developed by Milton Friedman and Edmund Phelps.
- This type of unemployment is the difference between those who are willing to have a job at the current market wage level, and those who are willing and able to have a job. It is caused by supply-side factors.

- It includes the frictional level of unemployment, structural unemployment and workers who do not have the necessary skills for a job.
- It is also called the NAIRU: non-accelerating inflation rate of unemployment. It means that inflation does not have a tendency to increase at this unemployment rate. Sometimes, it is also referred to as the full level of employment, since there is no demand-deficient unemployment.
- In the long run, the unemployment rate reverts to the natural rate of unemployment. However, it can fluctuate around this rate due to economic variables.

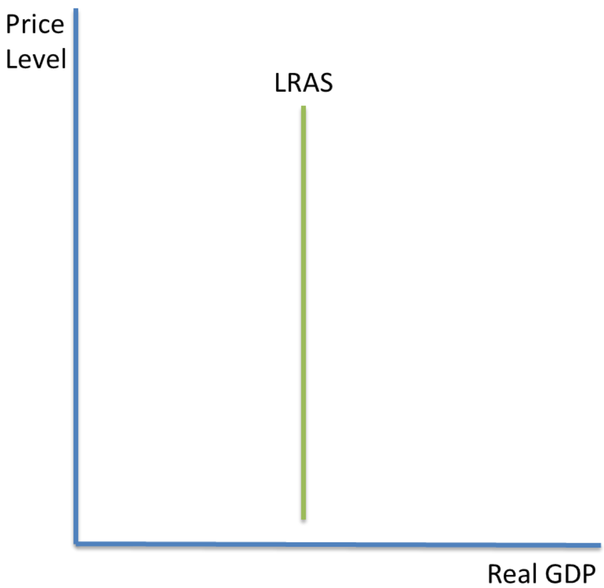
Keynesian long run AS:



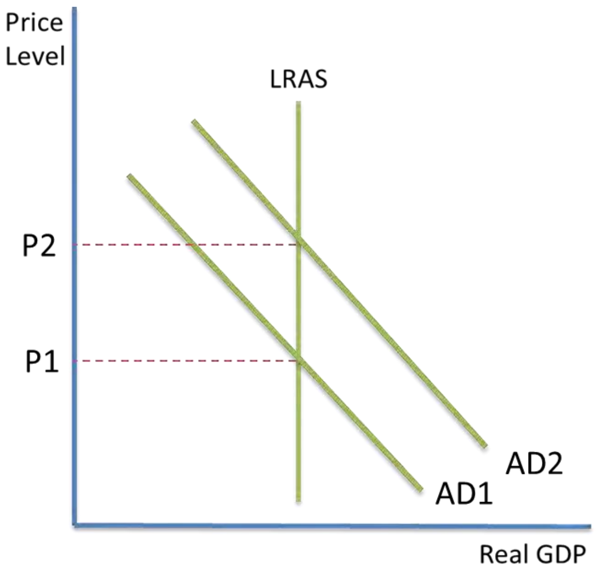
- The Keynesian view suggests that the price level in the economy is fixed until resources are fully employed. The horizontal section shows the output and price level when resources are not fully employed; there is spare capacity in the economy. The vertical section is when resources are fully employed.
  - Over the spare capacity section, output can be increased (AD1 to AD2) without affecting the price level (stays at P1). In other words, output changes are not inflationary.
  - Once resources are fully employed, an increase in output (AD3 to AD4) will be inflationary (price level increases from P2 to P3).



Neoclassical Aggregate Supply:



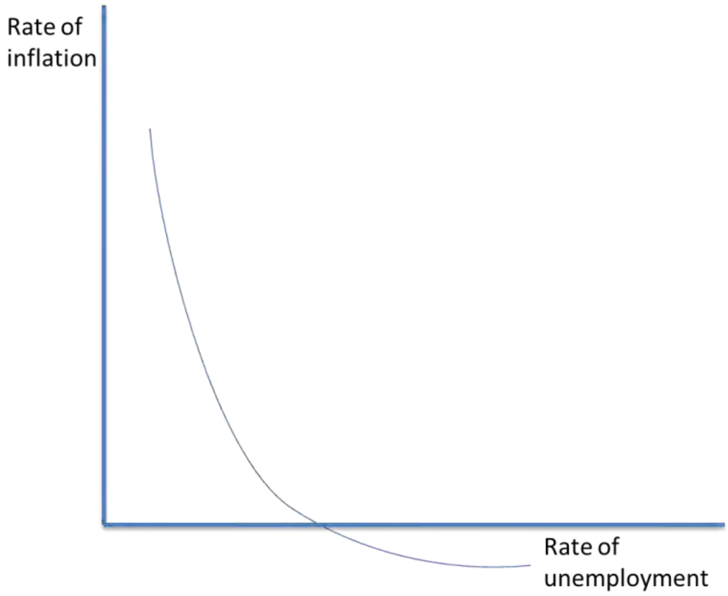
- In the long run, output is fixed at each level and all factors of production in the economy are fully employed.
- This means that changing AD, such as from AD1 to AD2, only makes a change in the price level (P1 to P2), and it will not change national output (real GDP).
- The position of the vertical LRAS curve represents the normal capacity level of output of the economy.



Unemployment vs inflation:

In the short run, there is a trade-off between the level of unemployment and the inflation rate. This is illustrated with a **Phillips curve.**

As economic growth increases, unemployment falls due to more jobs being created. However, this causes wages to increase, which can lead to more consumer spending and an increase in the average price level.

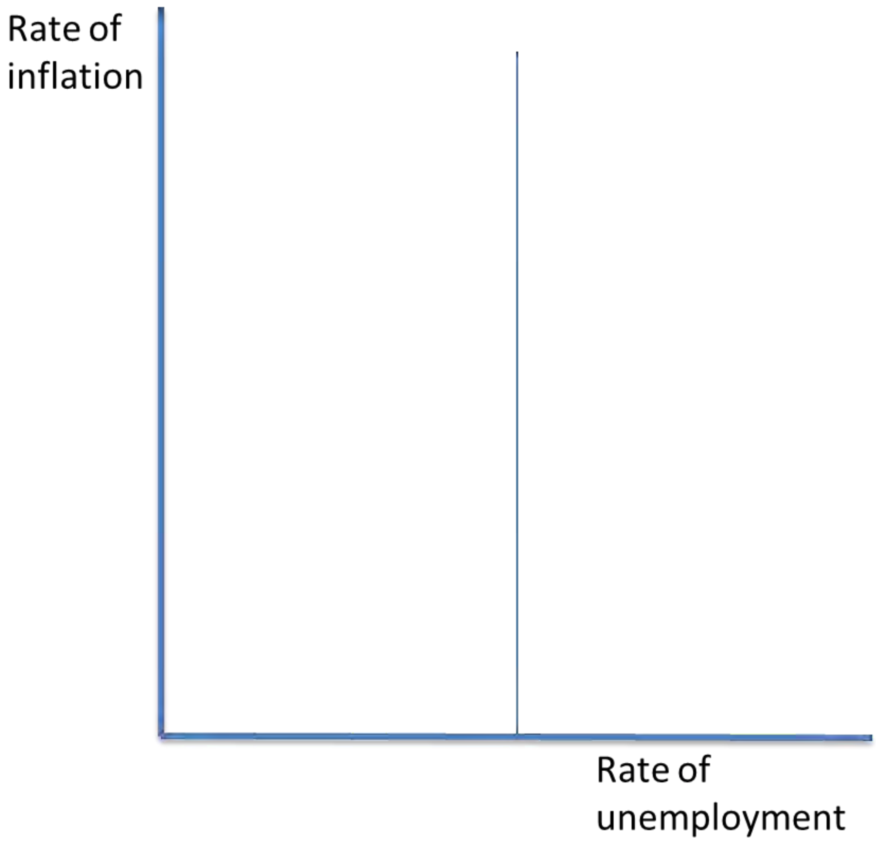


The extent of this trade off can be limited if supply side policies are used to reduce structural unemployment, which will not increase average wages.

The long run Phillips curve

The short-run Phillips curve represents the trade-off between unemployment and inflation. In the short run, the Phillips curve is roughly L-shaped, which shows how as unemployment increases, inflation decreases. The above Phillips curve is for the short run.

The long run Phillips curve is also known as the vertical long-run Phillips curve (shown below). It is at the natural rate of unemployment, and there is no trade-off between unemployment and inflation. The two variables are unrelated.



The implications of the short-run Phillips curve and the long-run, L-shaped Phillips curve for economic policy

If the government tries to lower unemployment in the short run, there could be inflationary pressure on the price level. In the short run, the economy suffers from demand-deficient unemployment. This might encourage the use of demand-side policies to tackle unemployment.

In the long run, changes in the unemployment rate do not affect the inflation rate. Therefore, policies can be more flexible. Since there is no demand-deficient unemployment in the long run, supply-side policies are more likely to be used.

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