WJEC (Wales) Economics A-level

Macroeconomics

Topic 1: Macroeconomic Theory

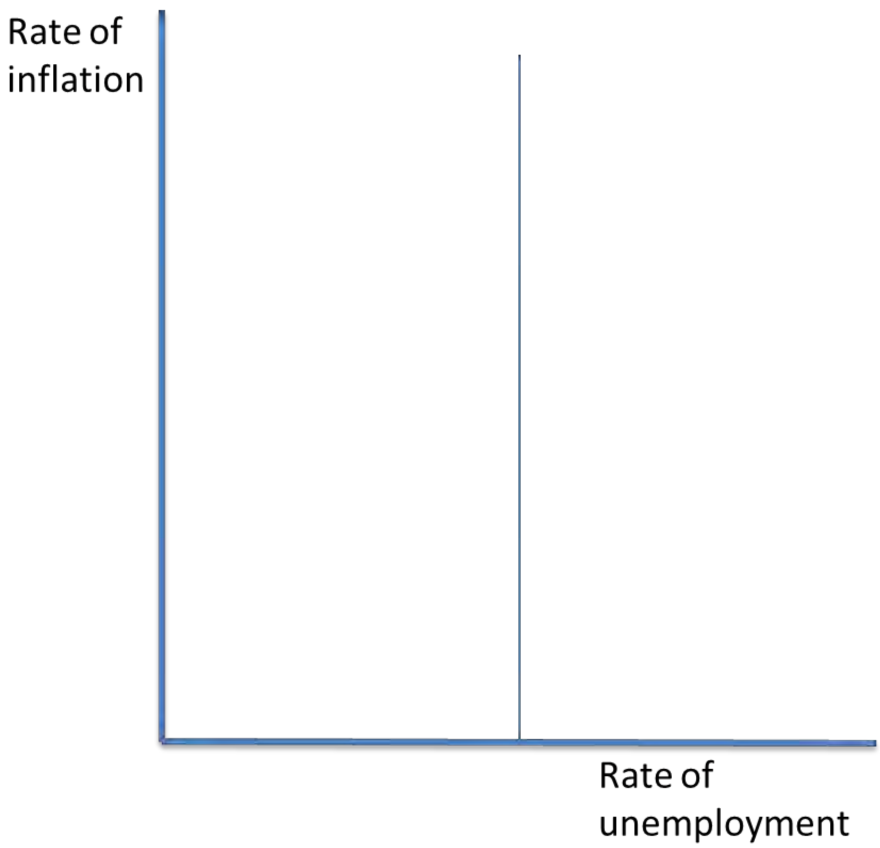
1.4 The long run Phillips curve

Notes

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 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. Supply-side changes cause the long run Phillips curve to shift.

Neo-Classical economists believe that the short run Phillips curve is not stable due to the role of long run expectations. In the long run, if unemployment is held below its natural rate, there will be inflation. When the economy returns to the natural rate, it will do so with a higher rate of inflation.

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.