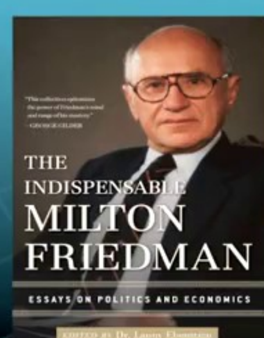
LECTURE FIVE – PART SIX

The Modified Phillips Curve

- The theory grew out of the work of Edmund Phelps and Milton Friedman
- There is a minimum unemployment rate consistent with steady inflation.



The Natural Rate of Unemployment

- A key concept of Monetarist inflation theory
- AKA the "lowest sustainable rate of unemployment" without causing inflation

MONETARISTS' MAJOR POINT

1. It is impossible to drive unemployment below the natural or lowest sustainable rate in the long run.
2. Implies long run Phillips Curve is <u>vertical</u> rather than downward sloping.

The Monetarists' Natural Rate Theory

- Strikes at the heart of Keynesian activism.
- Implication 1: Expansionary fiscal or monetary policy can drive unemployment below the natural rate temporarily
- Implication 2:This Keynesian "joy ride" along the short run Phillips Curve must inevitably come at the price of rising inflation.

A Deadly Inflationary Spiral

KEY POINT

If a nation repeatedly uses Keynesian policies to try and keep unemployment below the natural rate, an inflationary spiral will result in the long run.

How An Inflationary Spiral Happens

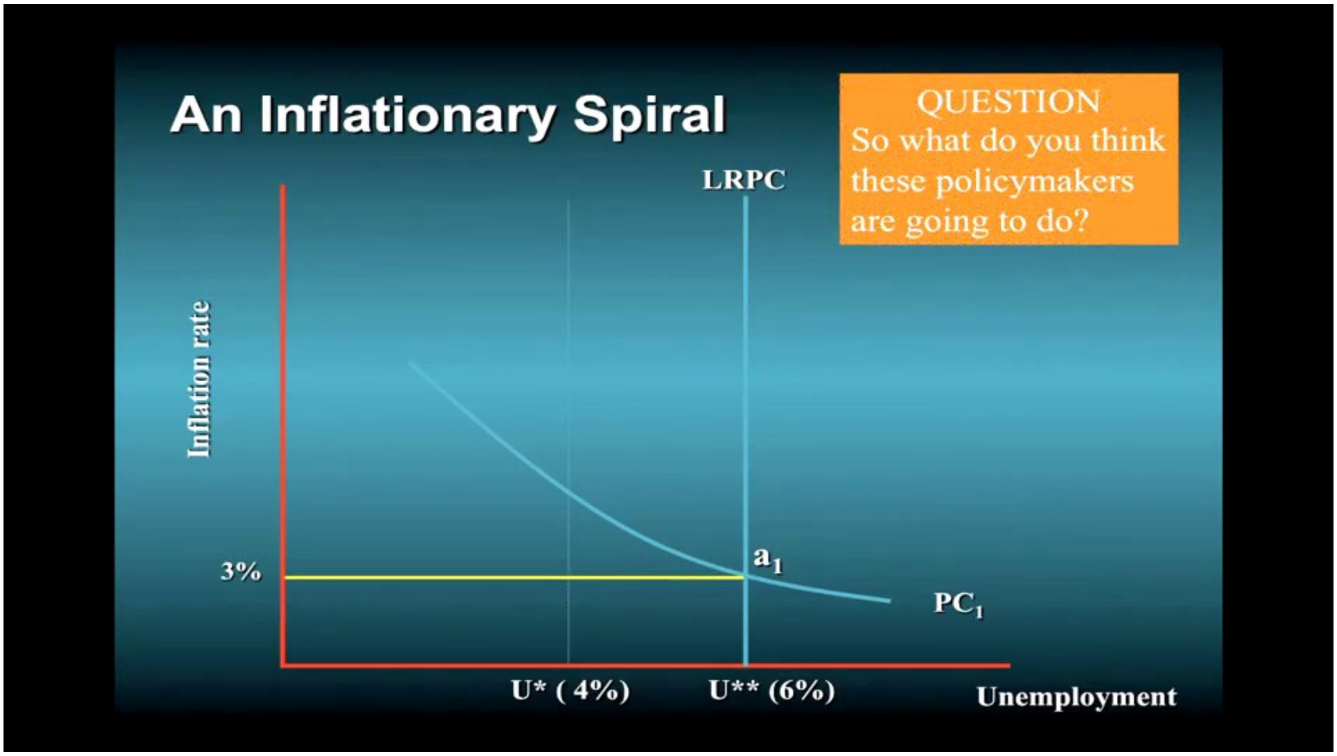
- The natural rate of unemployment is NOT a constant.
- The natural rate of unemployment CHANGES as the structure of an economy changes.
- Example: In the prosperous 1960s, the natural rate of unemployment ranged between 4% to 5% but rose in the 1970s.

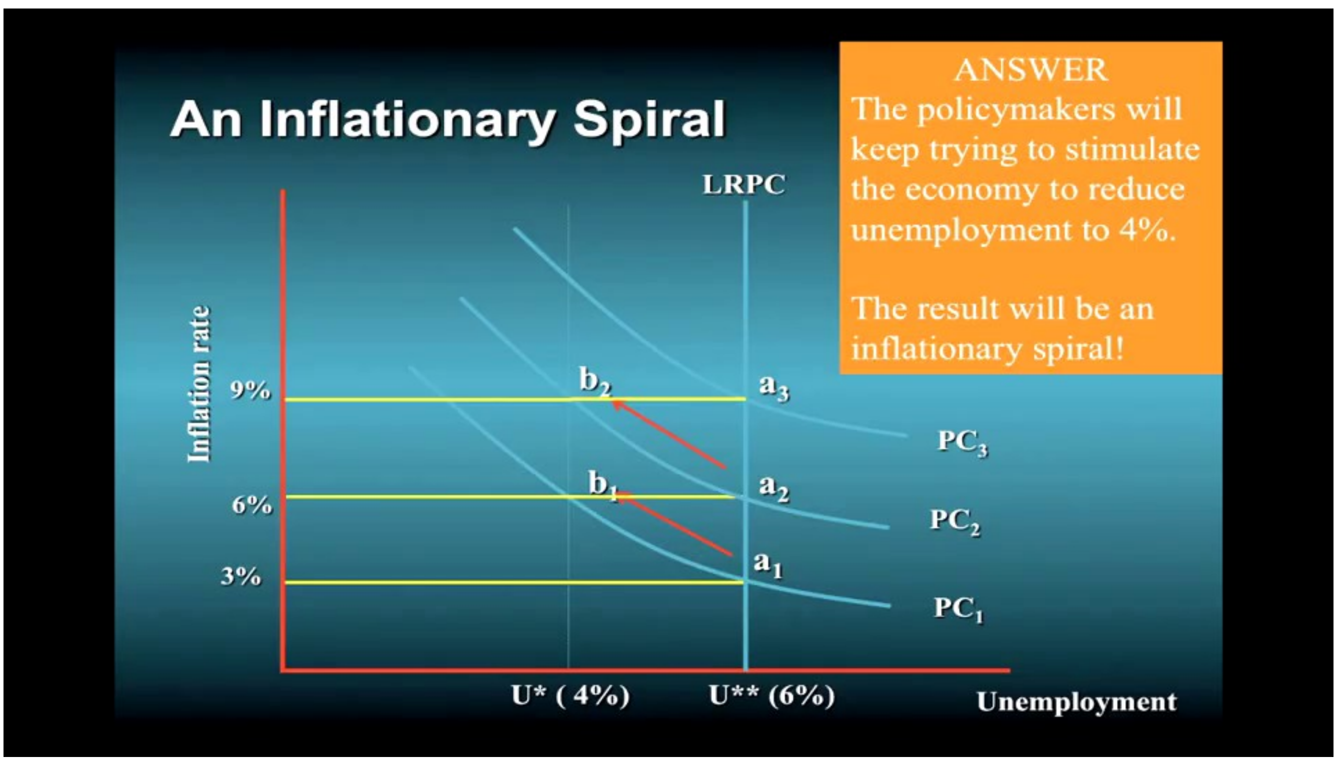
Supply Shocks Drive up the Rate

- The natural rate of unemployment climbed to 5% to 6% range in the 1970s because of supply side shocks.
- Shocks like energy price shocks raised the real costs of production.
- Higher costs, in turn, lowered potential output.

From The Monetarist's Perspective

- The Monetarist perspective on the Phillips Curve helps illustrate how inflation can spiral out of control.
- The trigger: Policy makers try to expand the economy below its natural rate of unemployment.


An Inflationary Spiral
QUESTION
So what do you think these policymakers are going to do?
LRPC
Inflation rate
3%
a1
PC1
U* (4%)
U** (6%)
Unemployment


An Inflationary Spiral
ANSWER
The policymakers will keep trying to stimulate the economy to reduce unemployment to 4%.
The result will be an inflationary spiral!
LRPC
Inflation rate
9%
6%
3%
b2
a3
b1
a2
a1
PC3
PC2
PC1
U* (4%)
U** (6%)
Unemployment