LECTURE FIVE – PART FIVE

The Core or Inertial Rate of Inflation

- Tends to persist at the same rate until a demand or supply side shock changes things.
- Key Concepts: "Inflationary expectations" and a behavioral model known as adaptive expectations.

Inflationary Expectations

- The expectation of inflation can significantly contribute to actual inflation.
- Inflationary expectations strongly influence the behavior of businesses, investors, workers, and consumers!

Adaptive Expectations

- We assume people believe *next* year's rate of inflation will be the same as *last* year's.
- Historical example: During 1990s, prices rose 3% per year, and most people came to expect that inflation rate.
- This expected rate was built into the core rate through institutional arrangements like labor contracts.

How Inflation Becomes Expected

- Suppose you are a labor negotiator and you believe your auto workers will achieve a 1% productivity increase.
- You will negotiate for at least a 1% increase in real, inflation adjusted wages.

QUESTION

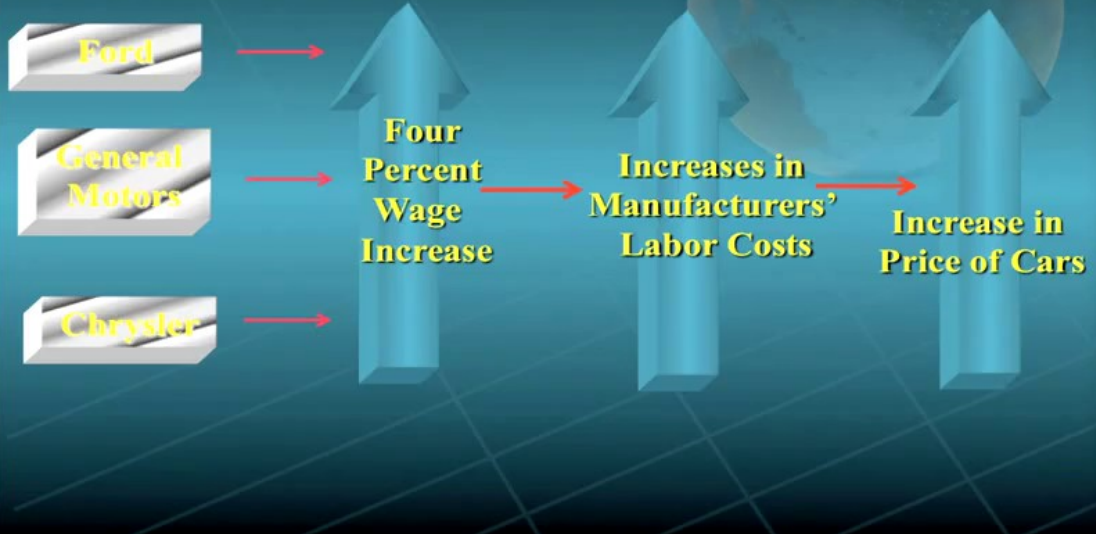
Assuming last year's inflation rate was 3%, what is the percentage increase in nominal wages that you will demand?

How Inflation Becomes Expected

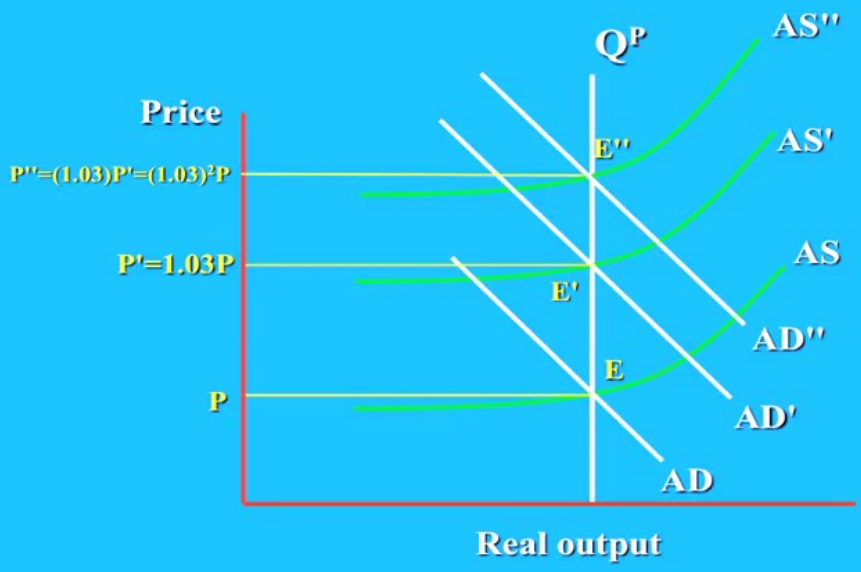
ANSWER

- You will demand a *4%* increase in the nominal wage!
- 1% for productivity gains. 3% to adjust for expected inflation.
- This shows how inflationary expectations get built into an economy!

Expectations Become Reality



An Inflationary Spiral



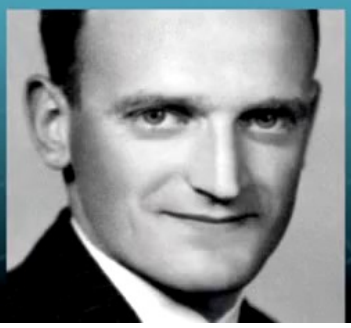
Our Next Questions

1. Why does the core inflation rate change?
2. How can it spiral out of control?

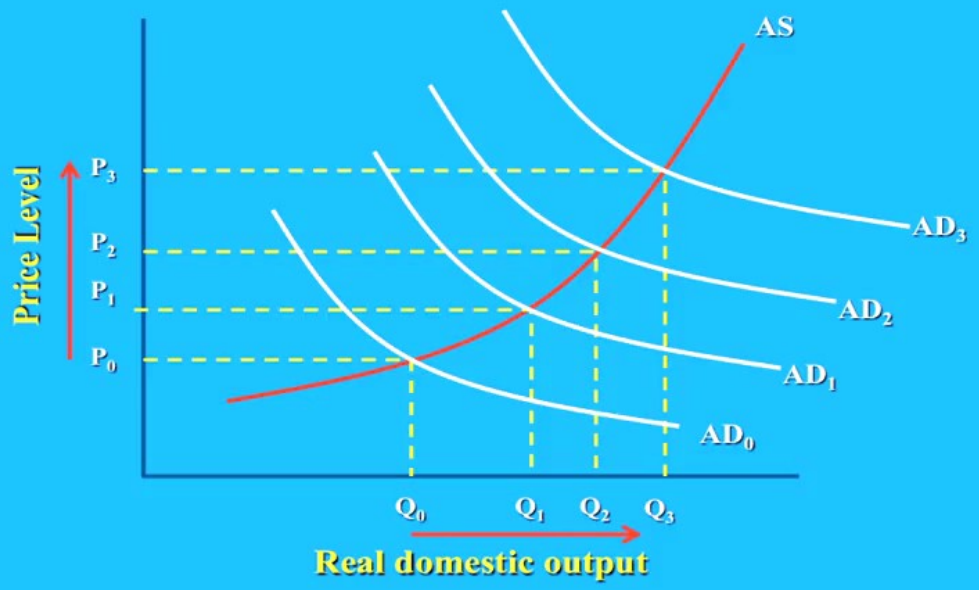
To answer these questions, we have to introduce the Phillips Curve.

Origins of the Phillips Curve

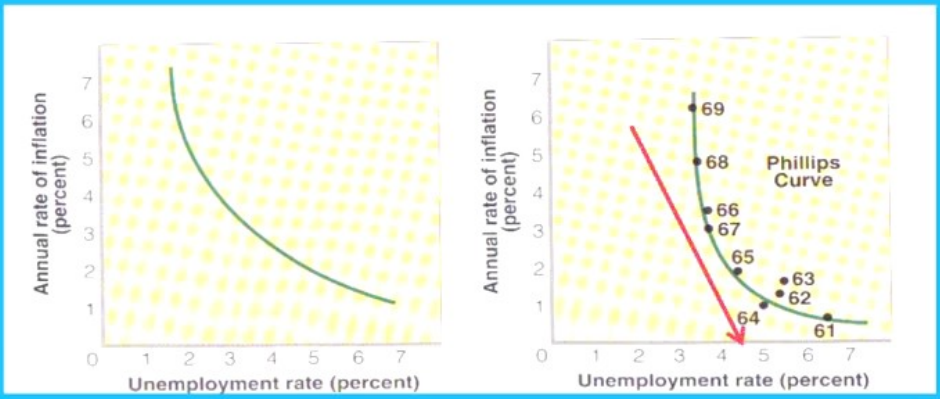
- A.W. Phillips studied data on unemployment and money wages in the United Kingdom.
- He found wages rose when unemployment was low but fell when unemployment was high.



Question: What happens to unemployment rate as output rises?

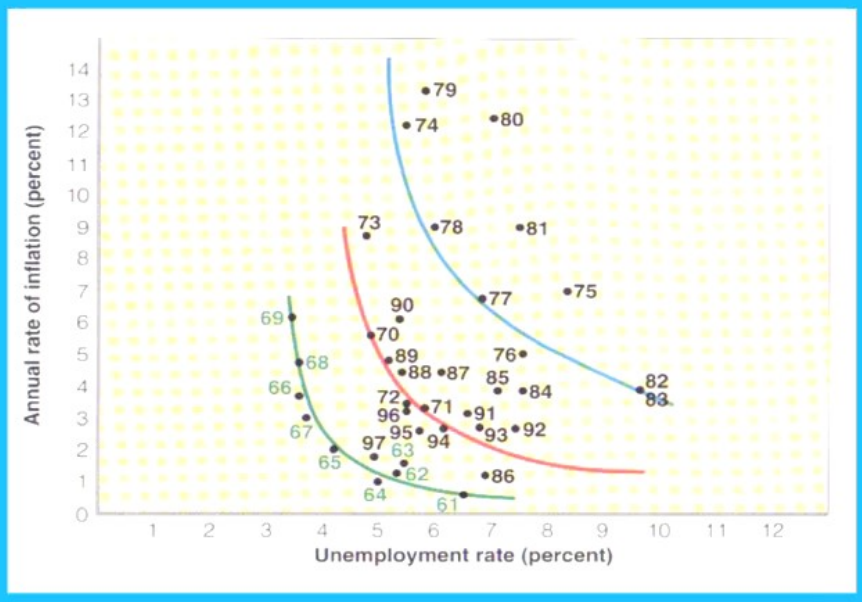


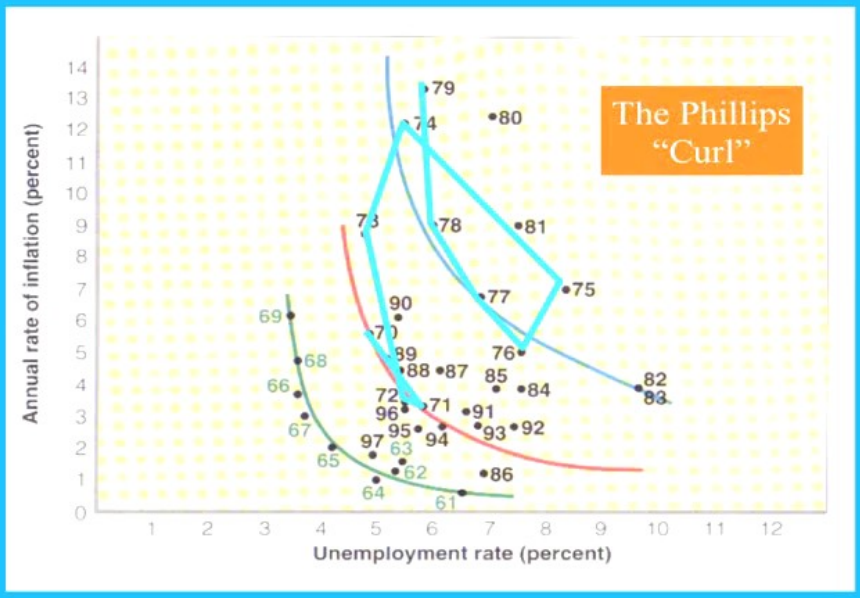
Answer:
Increase in real output leads to fall in unemployment as prices rise.

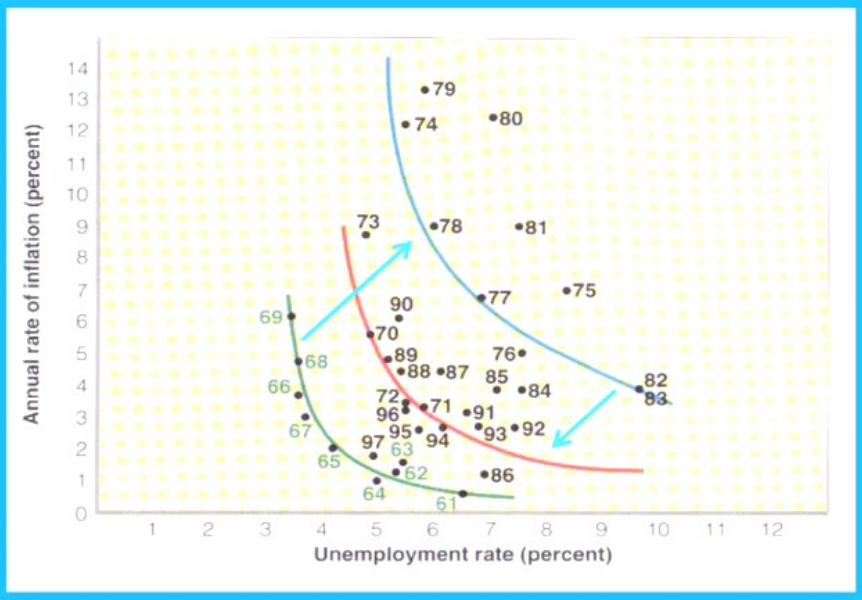


The Phillips Curve Becomes Conventional Wisdom

- Most economists came to believe that a stable, predictable tradeoff exists between unemployment and inflation.
- Policy Implication: You can use expansionary policies to reduce unemployment and the only price will be a bit more inflation.


Annual rate of inflation (percent)
Unemployment rate (percent)
0 1 2 3 4 5 6 7 8 9 10 11 12 13 14
1 2 3 4 5 6 7 8 9 10 11 12
79 74 80 73 78 81 77 75 90 69 70 68 89 88 87 76 66 72 96 71 85 84 82 83 91 67 95 94 93 92 97 63 65 62 86 64 61


The Phillips "Curl"
Annual rate of inflation (percent)
Unemployment rate (percent)
0 1 2 3 4 5 6 7 8 9 10 11 12 13 14
1 2 3 4 5 6 7 8 9 10 11 12
79 74 80 73 78 81 77 75 90 69 68 89 88 87 76 66 72 96 71 85 84 82 83 91 67 95 94 93 92 97 63 65 62 86 64 61



From A Macro Policy Perspective

- This explanation preserves the Phillip's Curve relationship.
- Implication: Policymakers can still engage in expansionary policy with the only price paid being a little more inflation for a little more employment.

Monetarists Explain the Phillips Curve

- The disappearance of the Phillips Curve in the 1970s and the appearance of the Phillips Curl can be explained using the *natural rate of unemployment* concept.
- Monetarists also distinguish between a short run and a long run Phillips Curve.