

Lesson 6 Philips Curve

Unemployment and Inflation

- ◆ Society faces a short-run tradeoff between unemployment and inflation.
- ◆ If policymakers expand aggregate demand, they can lower unemployment, but only at the cost of higher inflation.
- ◆ If they contract aggregate demand, they can lower inflation, but at the cost of temporarily higher unemployment.

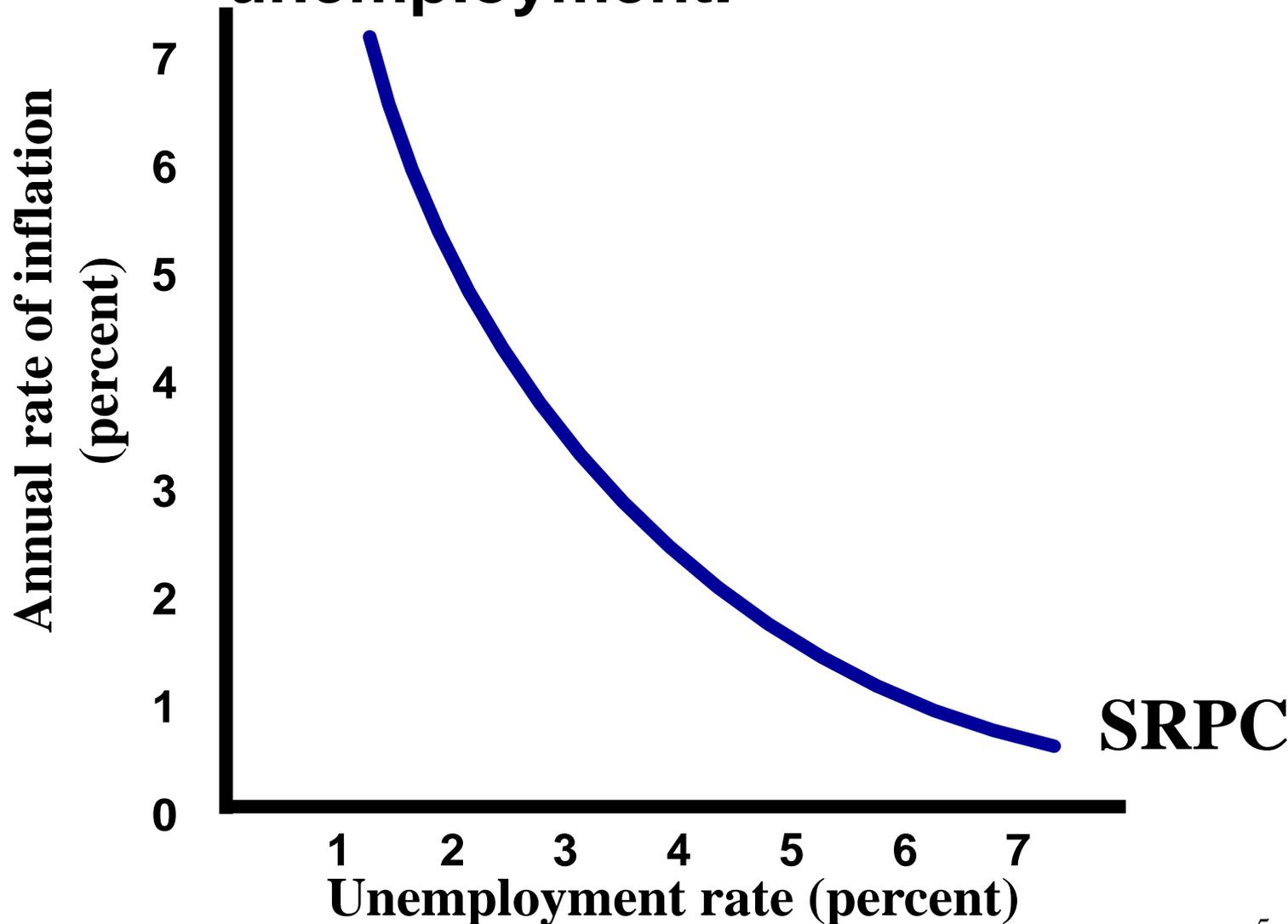
The Phillips Curve

The **Phillips curve** illustrates the relationship between inflation and unemployment.

Short-run Philips curve

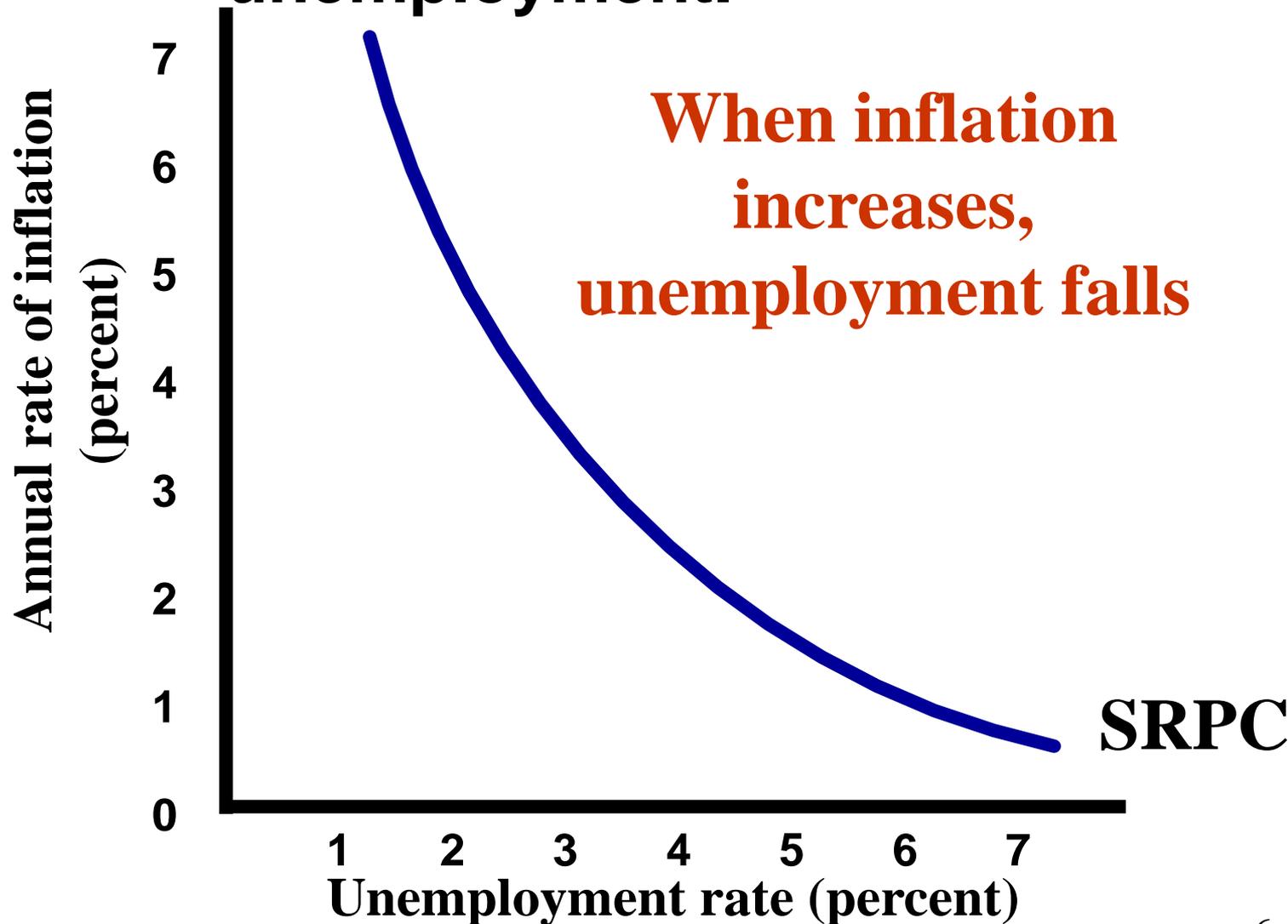
THE SHORT-RUN PHILLIPS CURVE

Inverse relationship between inflation and unemployment.

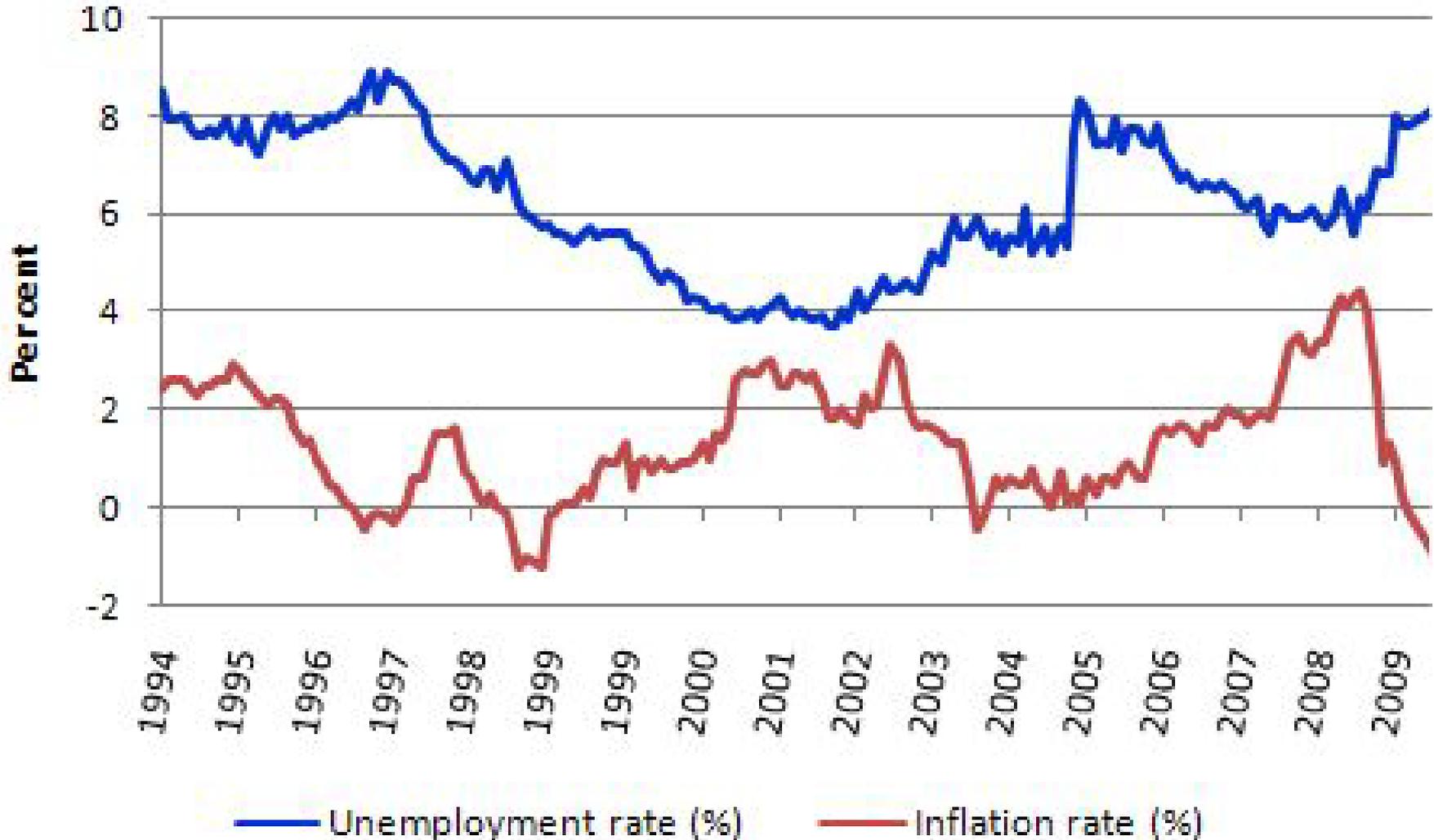


THE SHORT-RUN PHILLIPS CURVE

Inverse relationship between inflation and unemployment.



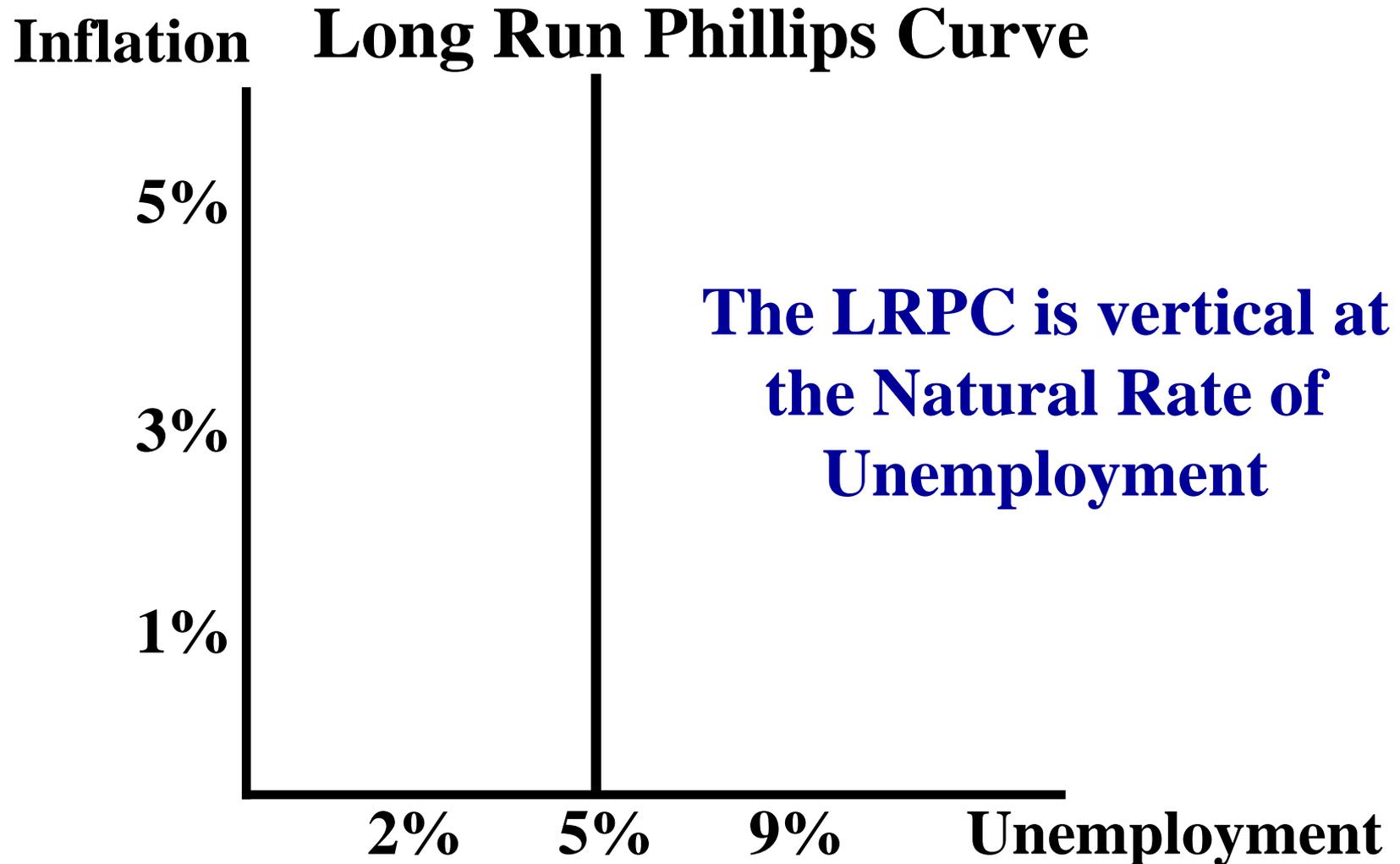
In general, there is an inverse relationship between unemployment and inflation



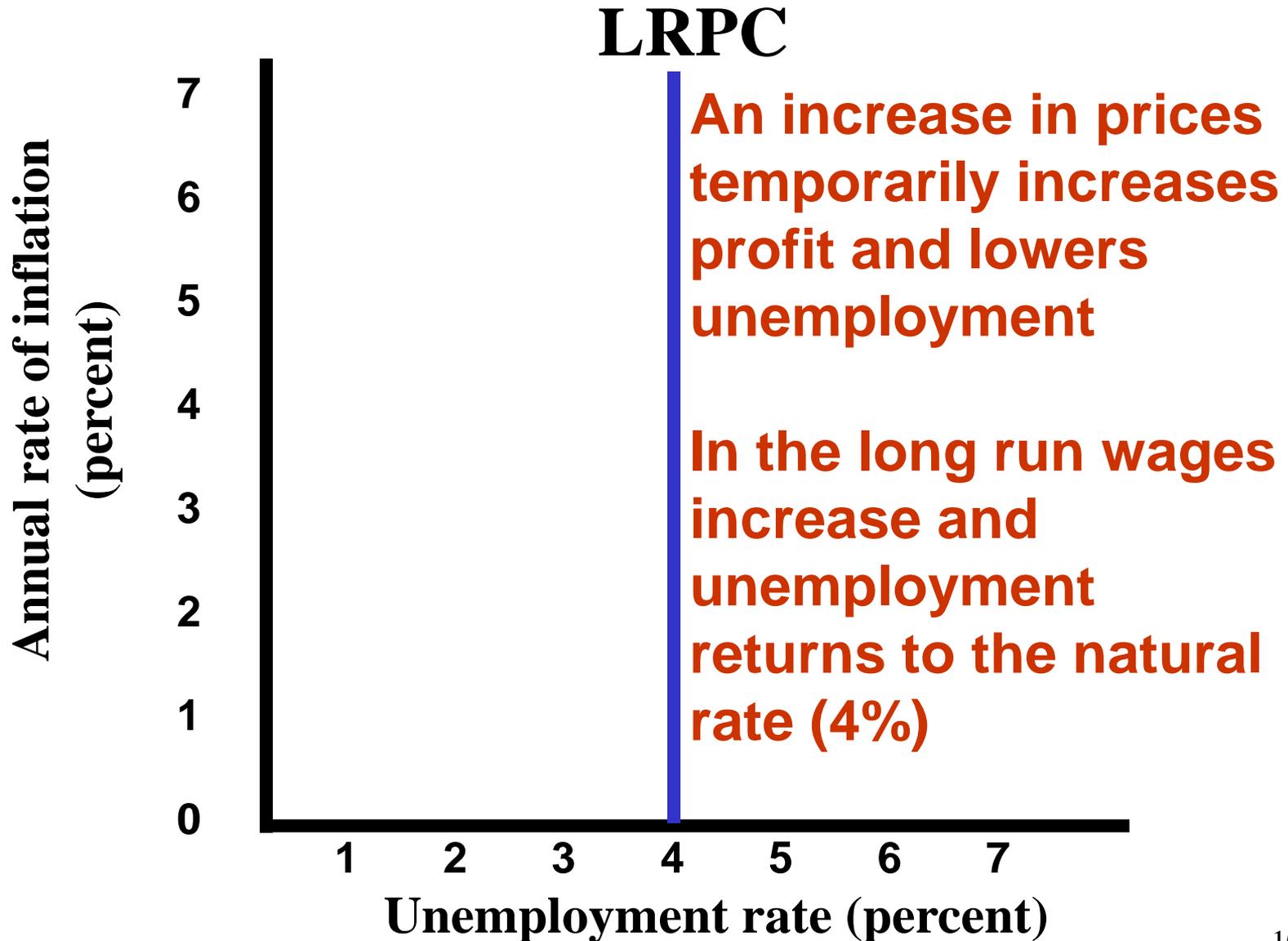
Long-run Philips curve

THE LONG-RUN PHILLIPS CURVE

In the long run there is no tradeoff between inflation and unemployment



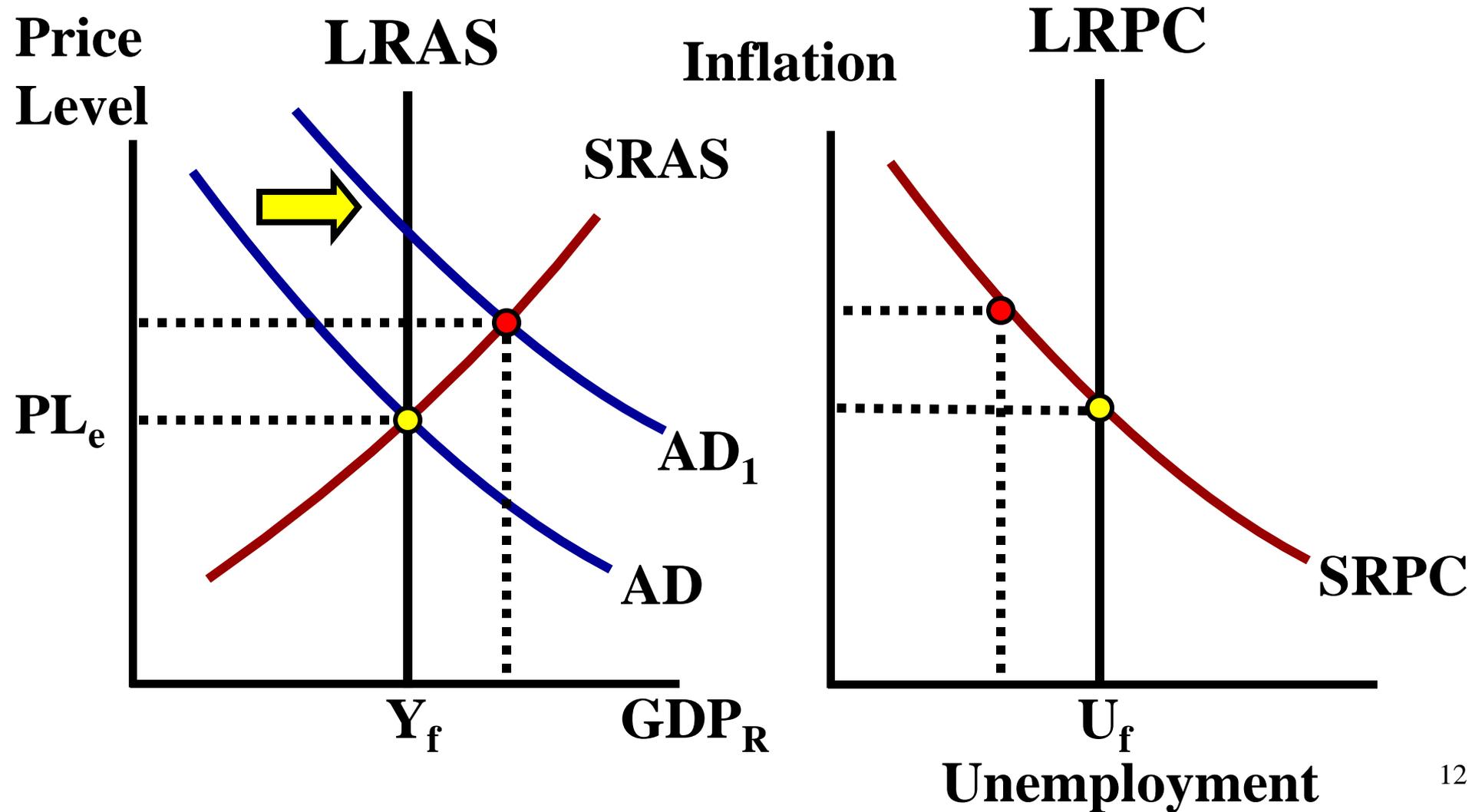
THE LONG-RUN PHILLIPS CURVE



AD/AS and the Phillips Curve

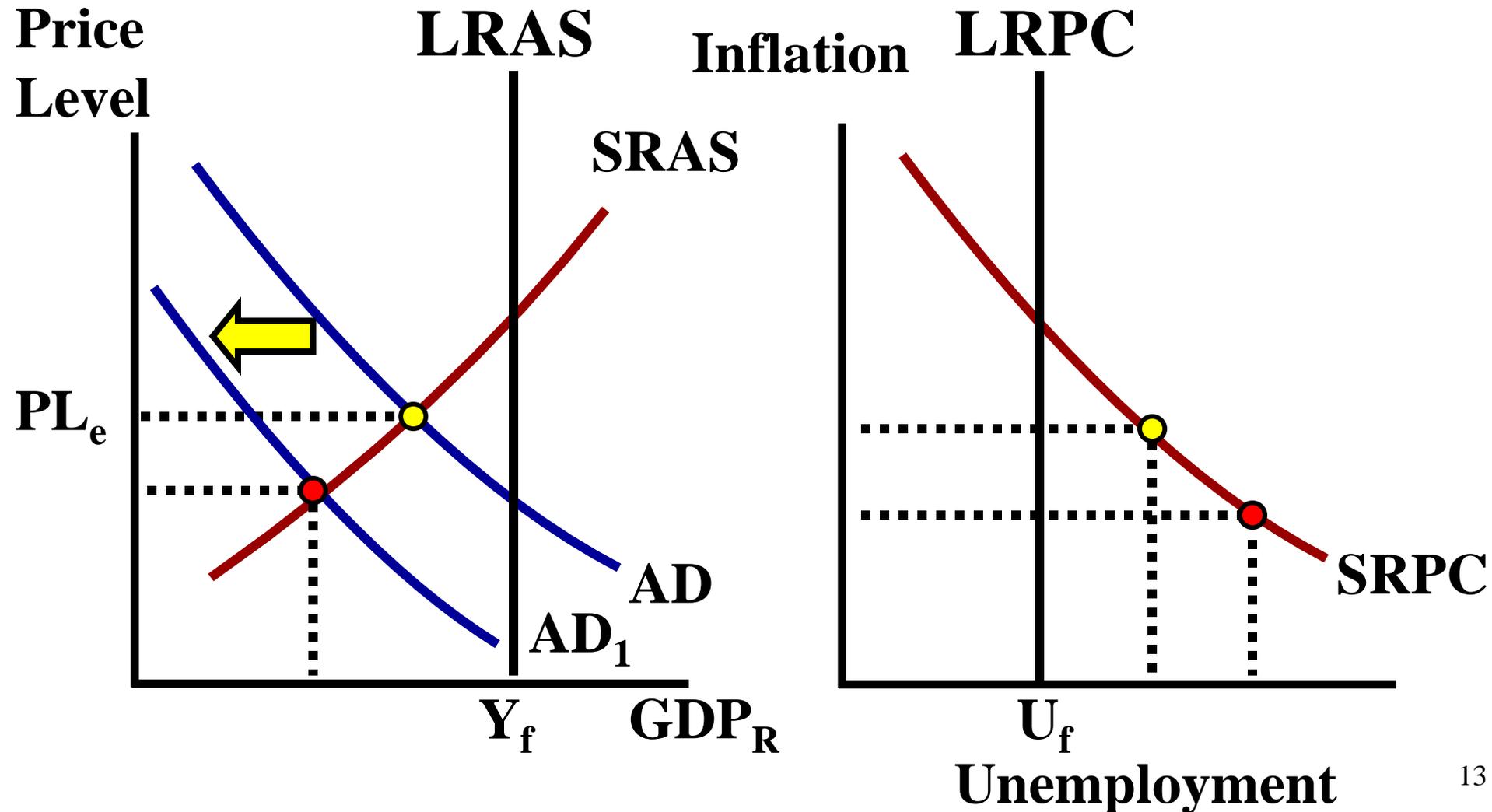
AD/AS and the Phillips Curve

Show what happens on both graphs if AD increase



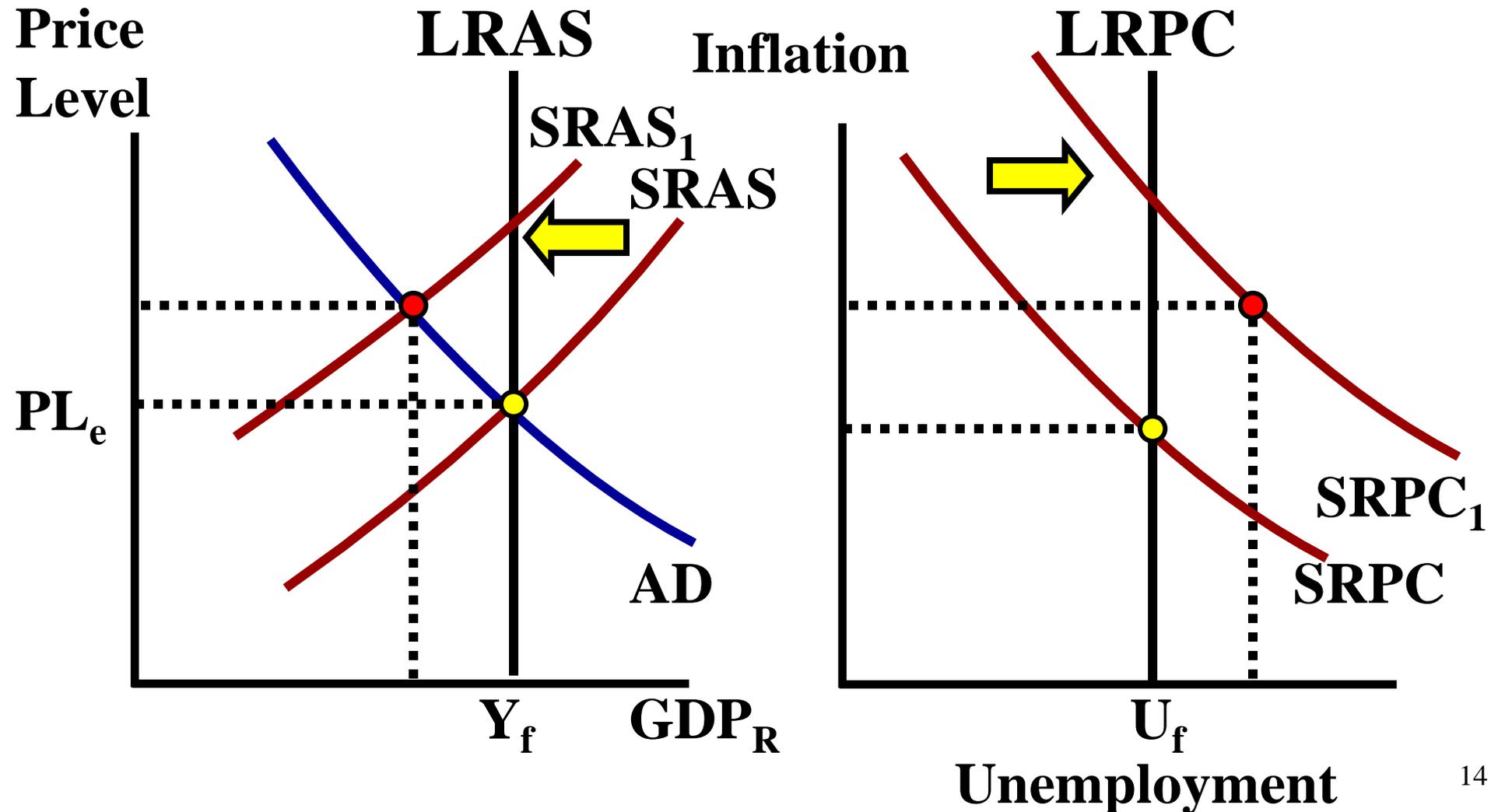
AD/AS and the Phillips Curve

Correctly draw the LRPC and SRPC with the recessionary gap. What happens when AD falls?



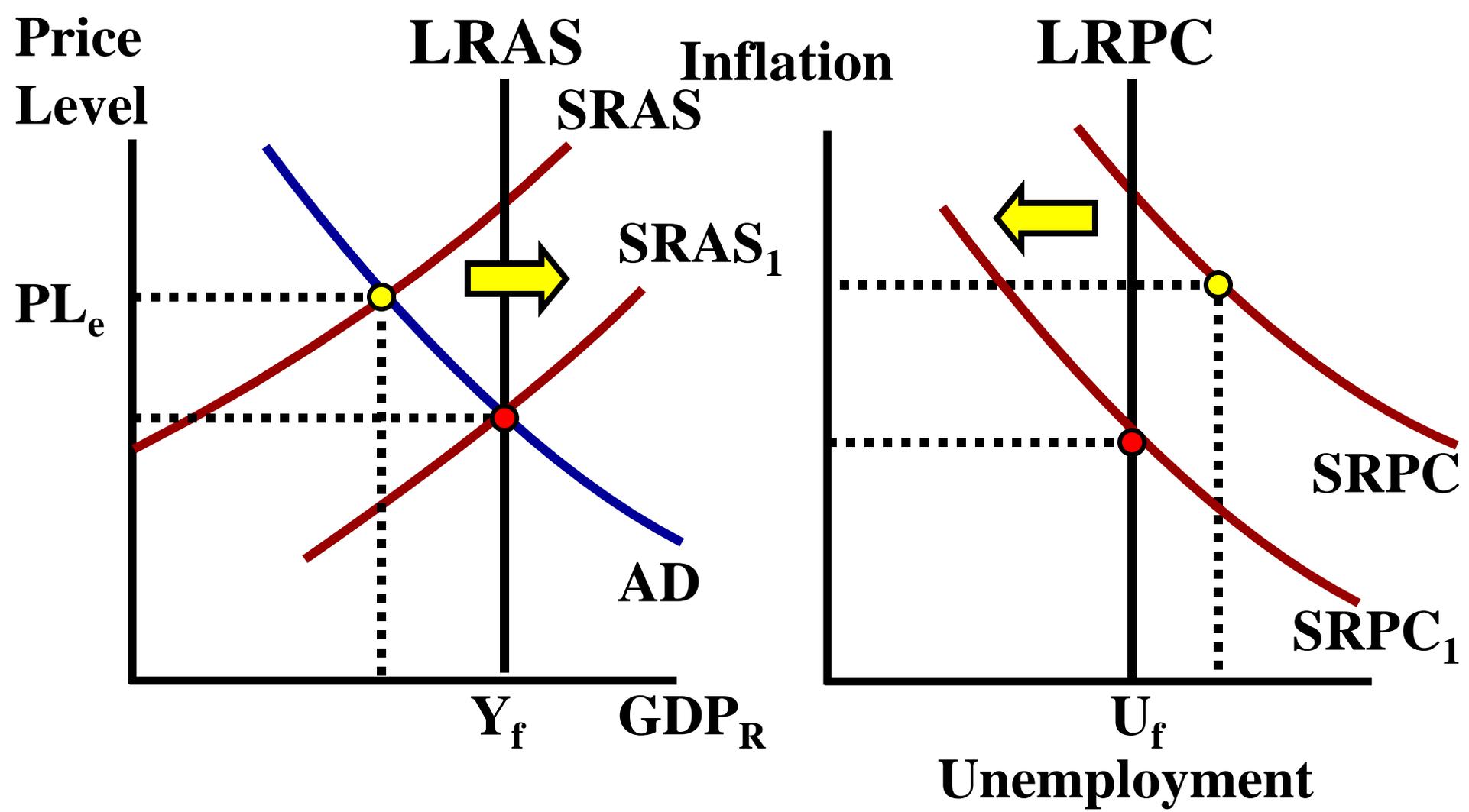
AD/AS and the Phillips Curve

Correctly draw the LRPC and SRPC at full employment. What happens when AS falls?

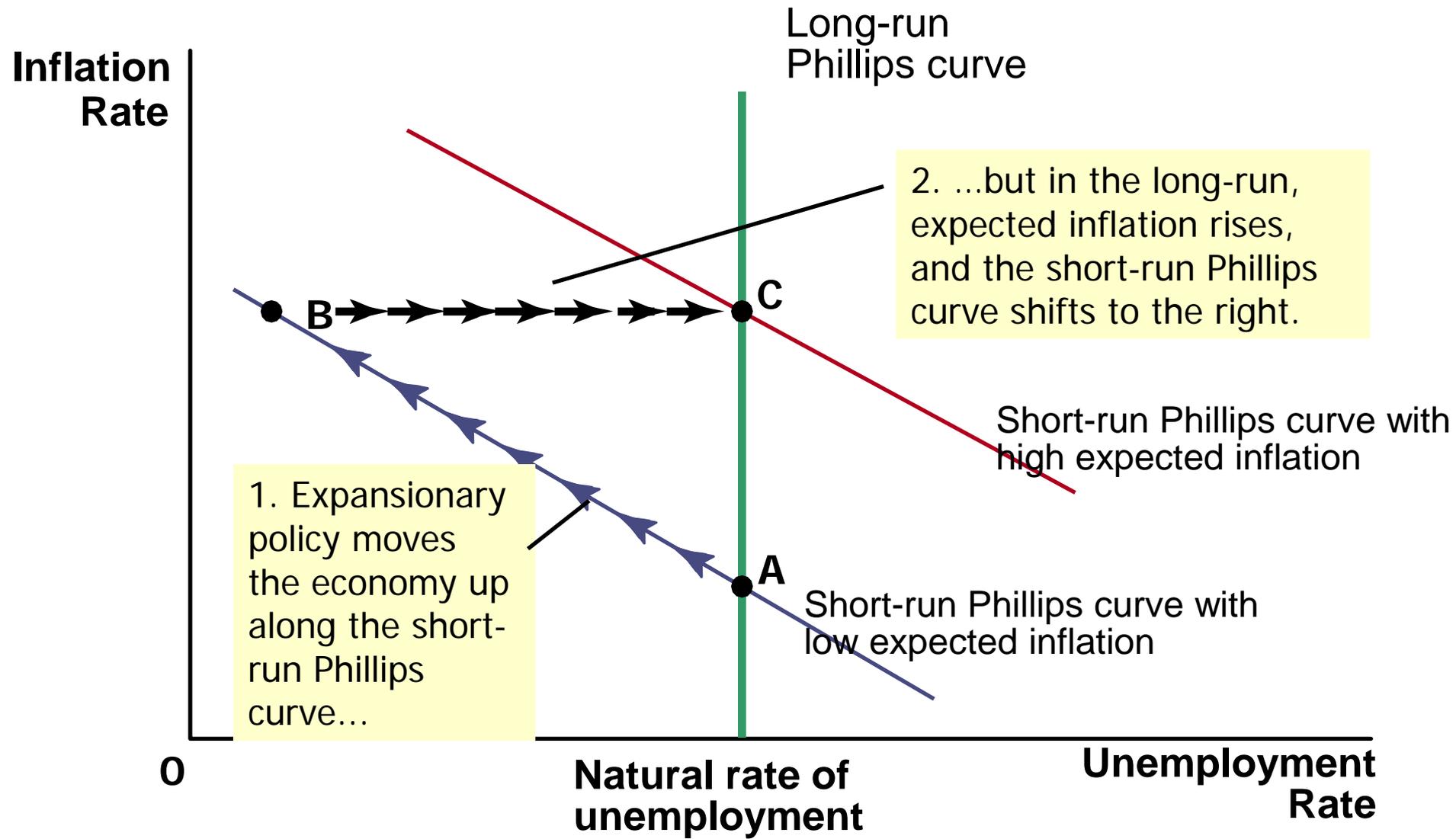


AD/AS and the Phillips Curve

Correctly draw the LRPC and SRPC with an recessionary gap. What happens when AS goes up?



How Expected Inflation Shifts the Short-Run Phillips Curve...



The Car Analogy



The economy is like a car...

- You can drive 120mph but it is not sustainable.
(Extremely Low unemployment, inflationary gap)
- Driving 20mph is too slow. The car can easily go faster.
(High unemployment, recessionary gap)
- 70mph is sustainable. (Full employment, equilibrium)
- If the engine (technology) increase then the car can drive at even higher speeds. (Increase LRAS/PPC)

The government's job is to brake or speed up when needed
(Fix the gaps)

as well as promote things that will improve the engine.
(Shift the LRAS/PPC outward)

How does the Government Stabilizes the Economy?

The Government has two different tool boxes it can use:

1. Fiscal Policy-

Actions by Congress to stabilize the economy.

OR

2. Monetary Policy-

Actions by the Federal Reserve Bank to stabilize the economy.

