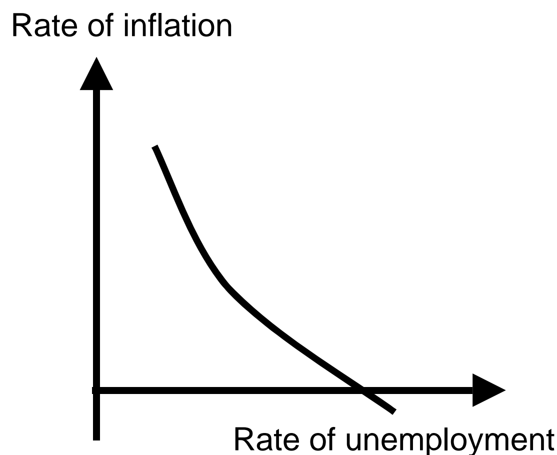
Phillips Curve

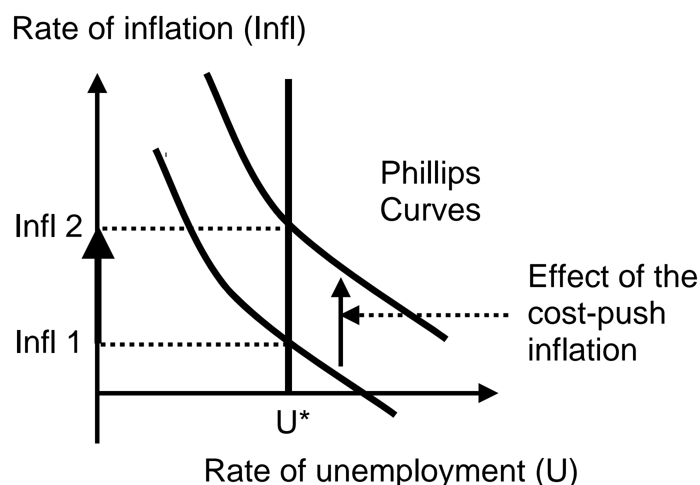
1 Inflation vs unemployment

The Phillips curve describes the negative relationship between inflation (originally: rate of change of money wages) and unemployment, that is, the trade-off between them. A government could choose less inflation at the price of a higher unemployment rate or a smaller unemployment rate at the price of more inflation.



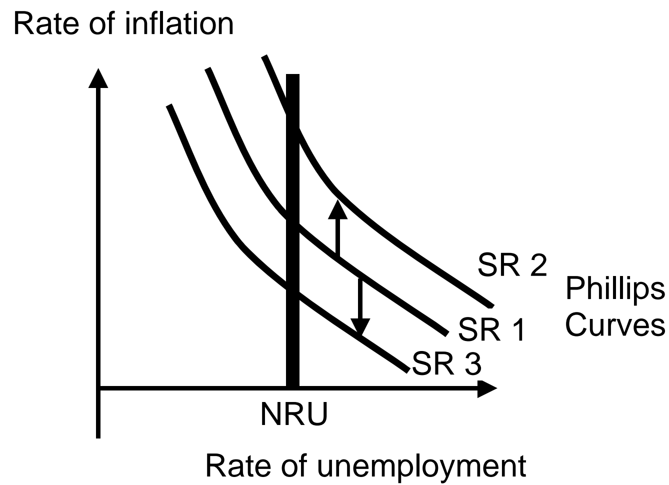
2 The instability of the short-run Phillips curve

In the 1970s the until then stable relationship between inflation and unemployment was not observed any more. There was inflation combined with unemployment (so-called stagflation). The Phillips curve changed its location. An important reason for such a change was the cost-push inflation due to the energy crisis.



3 The long-run Phillips curve

Economists like Milton Friedman have pointed out that the Phillips curve (as described in 1) is a short-run phenomenon and that the **long-run** equilibrium is represented by a **vertical line** showing the **natural rate of unemployment** (NRU). In this context, the short-run Phillips curve shifts according to **expectations** of inflation.



SR = Short-run

Shifts:
SR 1 $\rightarrow$ SR 2: higher inflation expected
SR 1 $\rightarrow$ SR 3: lower inflation expected