Trade-off Between Inflation and Unemployment

Inflation: Meaning

- Inflation refers to a continuous rise in general price level which reduces the value of money or purchasing power over the period of time.
- “Inflation is a state in which the value of money is falling, i.e. the price is rising”(Crowther).
- Some economist consider inflation as a purely monetary phenomenon while others consider it as a post full employment phenomenon.
- Inflation rate depends primarily on the growth in money supply
- A situation where too much of money chases too few goods.

Full employment: Meaning

- A situation where all those willing and able to work at the existing rate of wages are employed.
- No involuntary unemployment
- It consists of a small percentage of unemployment exist for a short period of time like frictional unemployment, seasonal unemployment, structural unemployment.
- When the national income is at its potential level, unemployment is not zero, the situation is referred to as full employment.

Natural Rate of Unemployment

- The amount of frictional and structural unemployment that exists when national income is at its potential level is called **natural rate of unemployment**.
- Non-accelerating inflation rate of unemployment (NAIRU)—P.A.Samuelson and W.D. Nordhans
- The normal rate of unemployment around which the unemployment rate fluctuates is called the natural rate of unemployment. (Mankiw)
- Also expressed as the **lowest sustainable unemployment rate (LSUR)**.
  - upward and downward forces of price and wage rate inflation are in balance.
  - Lowest level of unemployment that can be sustained for long without upward pressure on inflation.

Short-run Phillips Curve

- Phillips Curve is a curve which shows the short-run trade-off between inflation and unemployment.
- Conducted a study using data on money wages, inflation and unemployment in U.K. for a period 1861 to 1957.
- Conclusion of his study showed that wages tend to rise when unemployment was low and vice-versa.
- Analyses the short-term relationship between unemployment and inflation and negative correlation between the two variables.
- Low unemployment →high AD →raise wages →price rise

Trade off theory

- Short-run phenomenon
- An economy prefers to have a very low percentage of unemployment, then it should be ready for high rate of inflation.
- Choice between unemployment and inflation
- E-zero inflation and unemployment=NAIRU

Long Run Phillips Curve

- No trade-off between inflation and unemployment in long run (Friedman and Phelps)
- Their theory is based on classical theory that money supply is the primary determinant of inflation.
- Money supply does not affect real variables such as output and employment.
- Thus long-run Phillips curve (LRPC) is vertical.
- In long run the real variables such as employment, potential output and real wages remain unaffected by inflation.

Stagflation

- Observed in 1970s and 1980s in western countries specially in USA.
- A situation where there is high inflation rate and high rate of unemployment. “(jobless growth)
- Economic growth is almost constant but inflation happens due to demand pull or cost push inflation.

Type of Inflation (Cause)

- Demand Pull Inflation

i. Population
ii. Increased Money Supply by Monetary Authority
iii. More Credit Creation by Commercial Banks
iv. Repayment of Public Debt
v. Existence of Black Money

- Cost Push Inflation

i. Wage-price Shock
ii. Material Cost- Farm Price Shock
iii. Increase in Profit Margin
iv. Natural Calamities
v. Oil Shocks
vi. Import Price Shock