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 $\rightarrow$ high AD $\rightarrow$ raise wages $\rightarrow$ 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