The phillips curve

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The short-run relationship between inflation and unemployment is often called the Phillips curve. In 1958, economist A. W. Phillips published an article in the British journal Economica that would make him famous. The article was titled “ The Relationship between Unemployment and the Rate of Change of Money Wages in the United Kingdom, 1861–1957. ” In it, Phillips showed a negative correlation between the rate of unemployment and the rate of inflation. That is, Phillips showed that years with low unemployment tend to have high inflation, and years with high unemployment tend to have low inflation.

Phillips examined inflation in nominal wages rather than inflation in prices, but for our purposes that distinction is not important. These two measures of inflation usually move together.) Phillips concluded that two important macroeconomic variables—inflation and unemployment— were linked in a way that economists had not previously appreciated. Although Phillips’s discovery was based on data for the United Kingdom, researchers quickly extended his finding to other countries.

Two years after Phillips published his article, economists Paul Samuelson and Robert Solow published an article in the American Economic Review called “ Analytics of Anti-Inflation Policy” in which they showed a similar negative correlation between inflation and unemployment in data for the United States. They reasoned that this correlation arose because low unemployment was associated with high aggregate demand, which in turn puts upward pressure on wages and prices throughout the economy.

Samuelson and Solow dubbed the negative association between inflation and unemployment the Phillips curve. The model of aggregate demand and

aggregate supply provides an easy explanation for the menu of possible outcomes described by the Phillips curve. The Phillips curve simply shows the combinations of inflation and unemployment that arise in the short run as shifts in the aggregate-demand curve move the economy along the short-run aggregate-supply curve.

An increase in the aggregate demand for goods and services leads, in the short run, to a larger output of goods and services and a higher price level. Larger output means greater employment and, thus, a lower rate of unemployment. In addition, whatever the previous year's price level happens to be, the higher the price level in the current year, the higher the rate of inflation. Thus, shifts in aggregate demand push inflation and unemployment in opposite directions in the short run—a relationship illustrated by the Phillips curve.

Monetary and fiscal policy can move the economy along the Phillips curve. Increases in the money supply, increases in government spending, or cuts in taxes expand aggregate demand and move the economy to a point on the Phillips curve with lower unemployment and higher inflation. Decreases in the money supply, cuts in government spending, or increases in taxes contract aggregate demand and move the economy to a point on the Phillips curve with lower inflation and higher unemployment. In this sense, the Phillips curve offers policymakers a menu of combinations of inflation and unemployment.