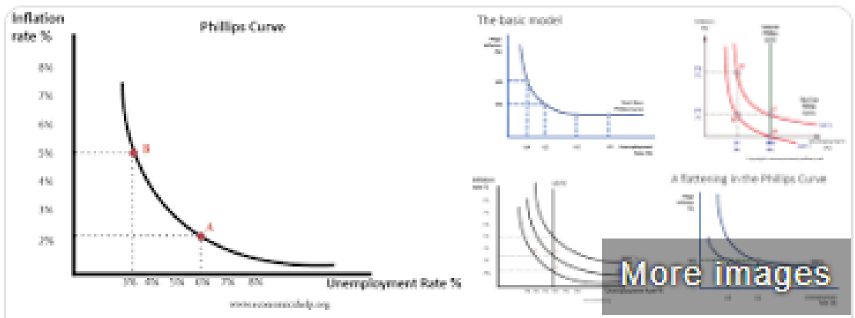
The Phillips Curve

Another way (in addition to AS/AD model) economists show the tradeoff between inflation and unemployment.

3 Minutes video
by Mr. Clifford
Explaining the
Phillips Curve

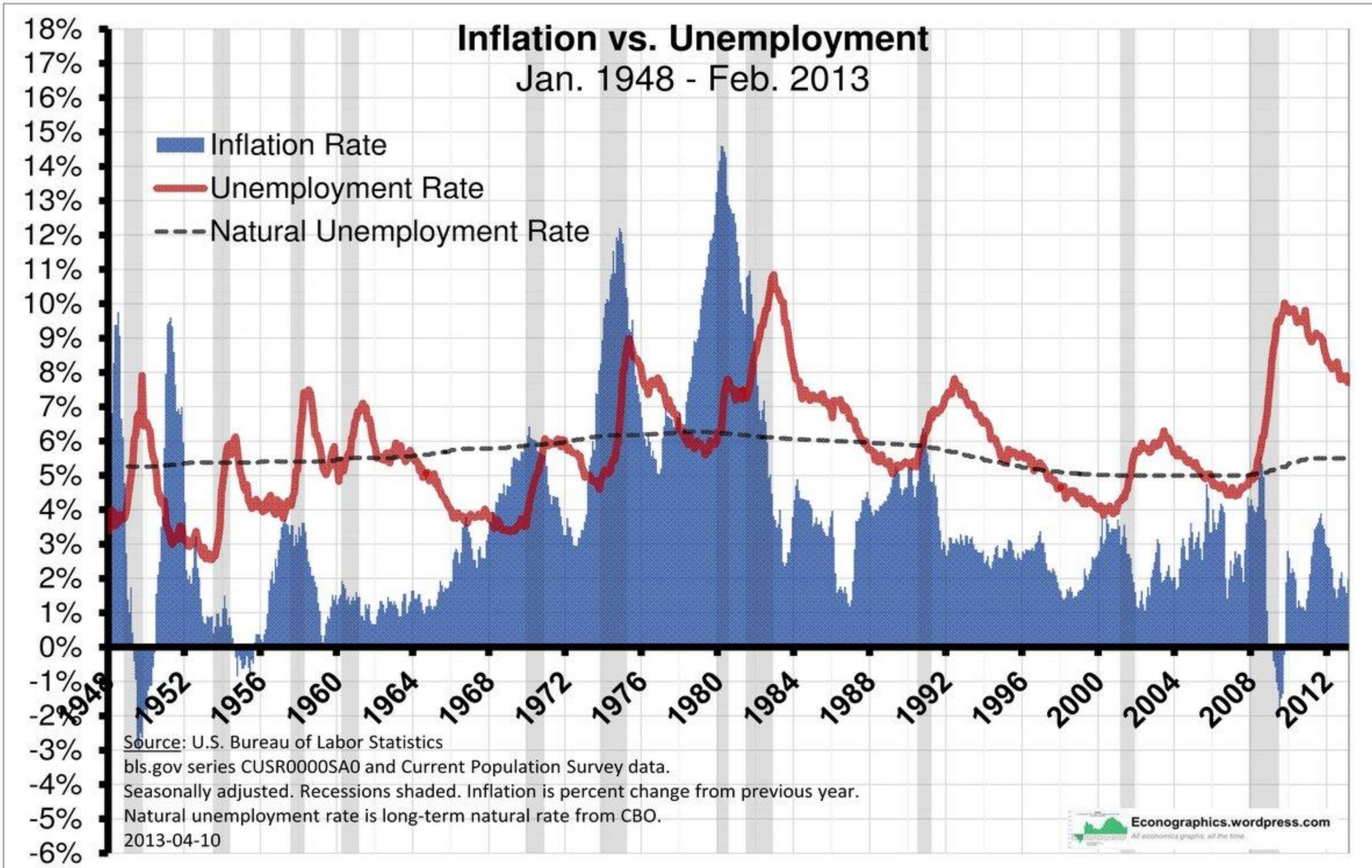


Phillips curve

The Phillips curve is a single-equation economic model, named after William Phillips, describing an inverse relationship between rates of unemployment and corresponding rates of rises in wages that result within an economy. Wikipedia

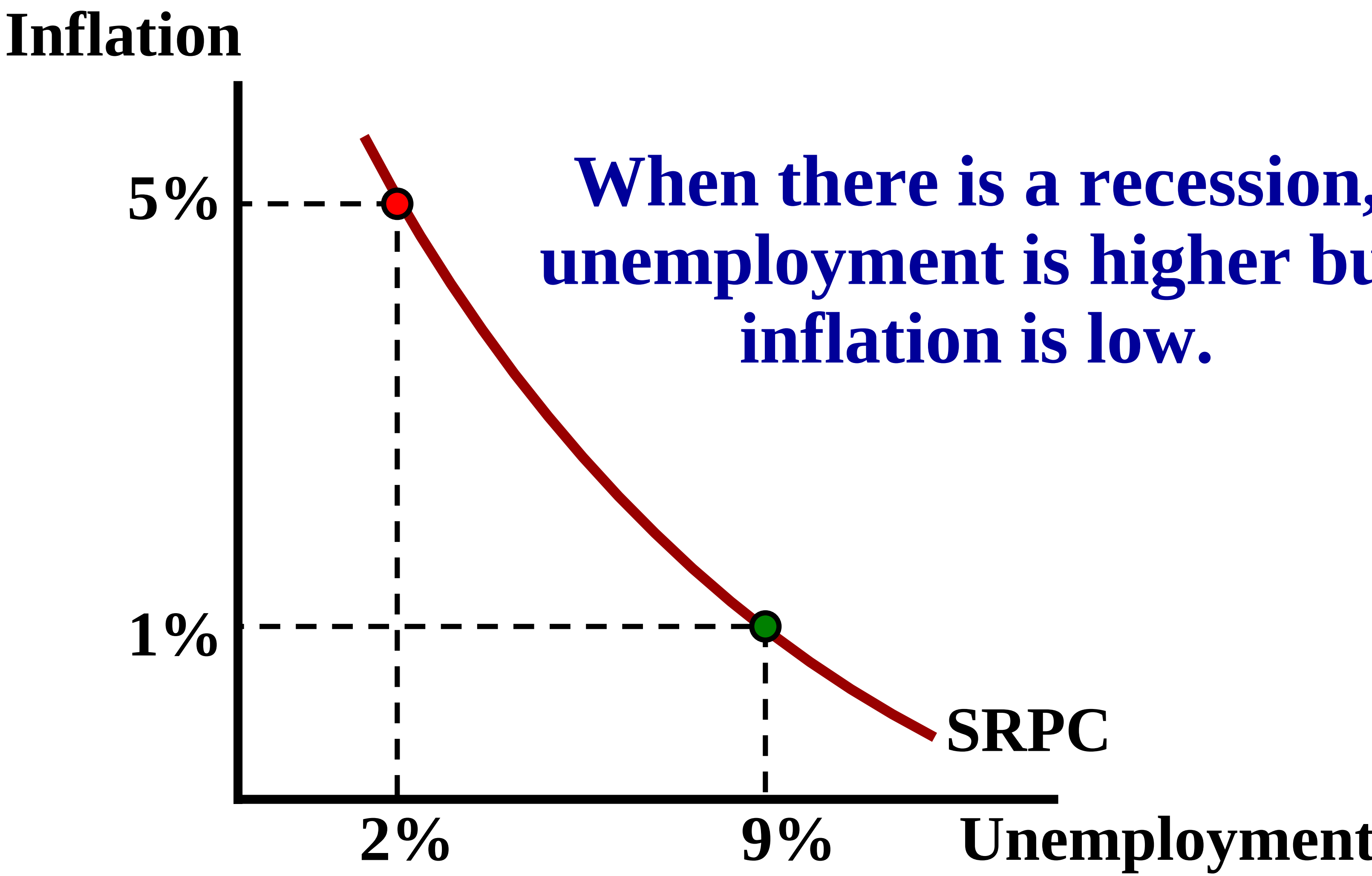
8 Minute
Khan
Academy
Video
Explaining
the Phillips
Curve

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



Short Run Phillips Curve

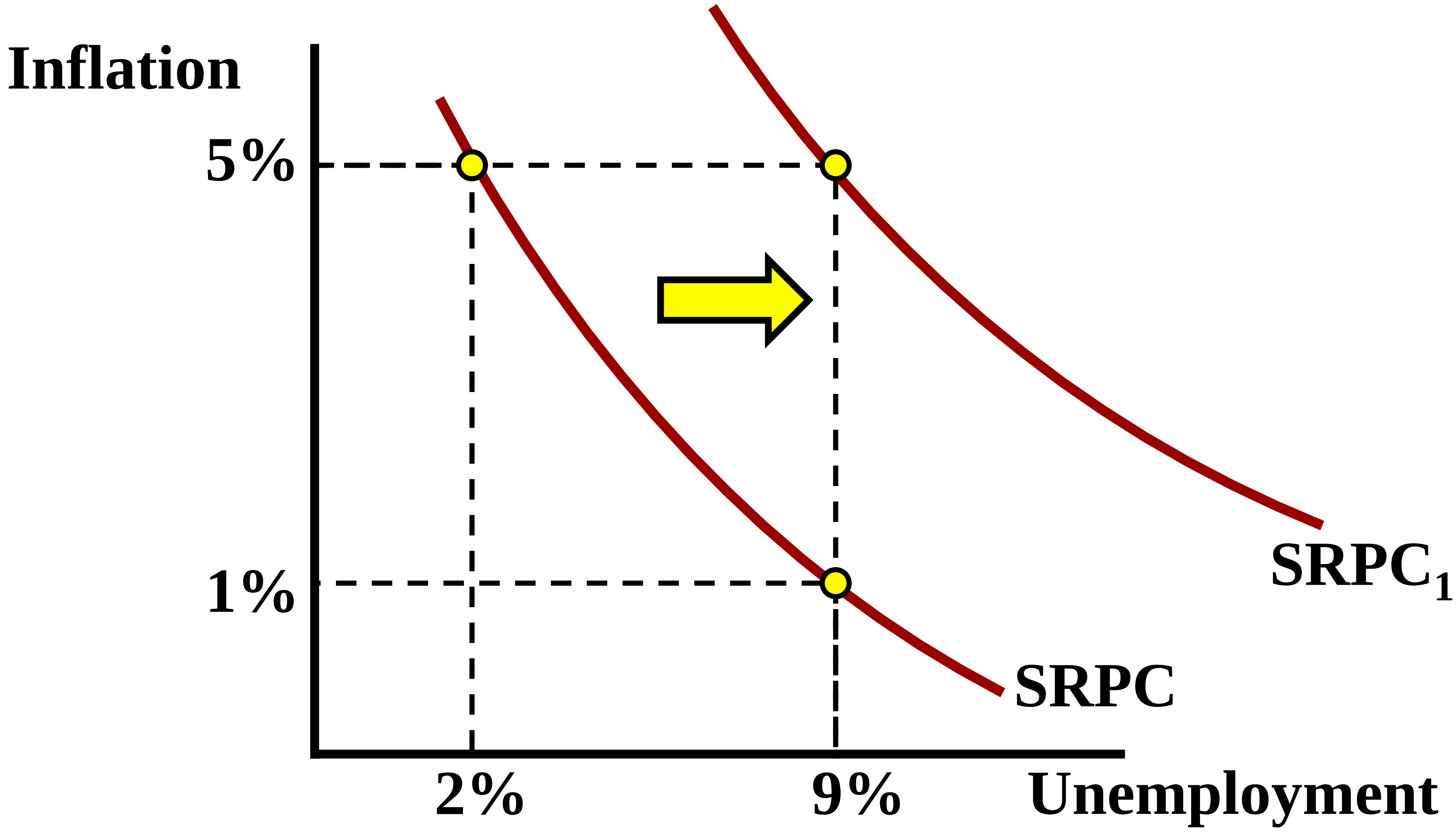
When the economy is overheating, there is low unemployment but higher inflation.



When there is a recession, unemployment is higher but inflation is low.

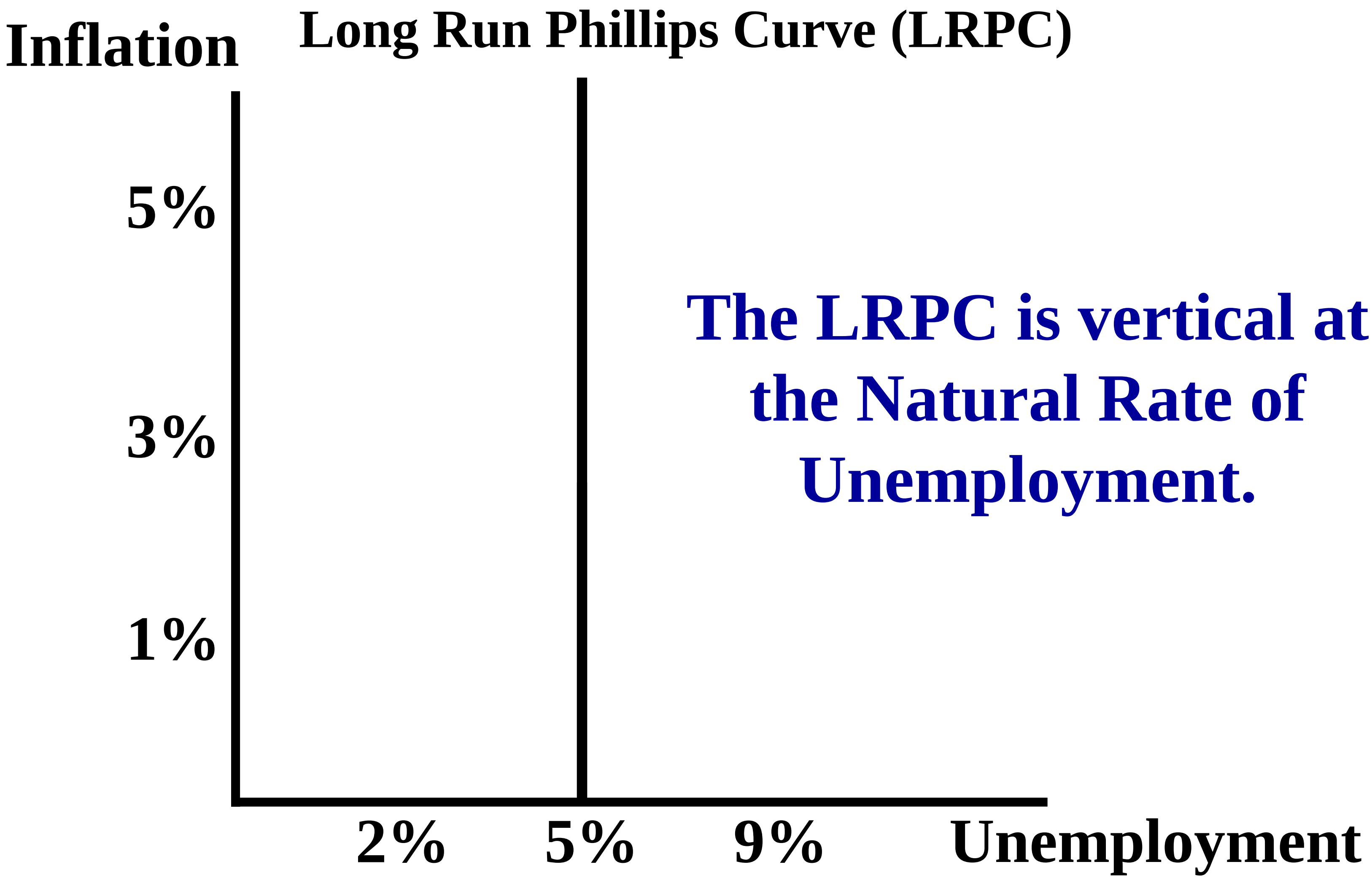
Short Run Phillips Curve (SRPC)

Q: What happens when AS falls causing *stagflation*?
A: Increase in unemployment AND inflation which shifts Short Run Phillips Curve (SRPC) to the right.



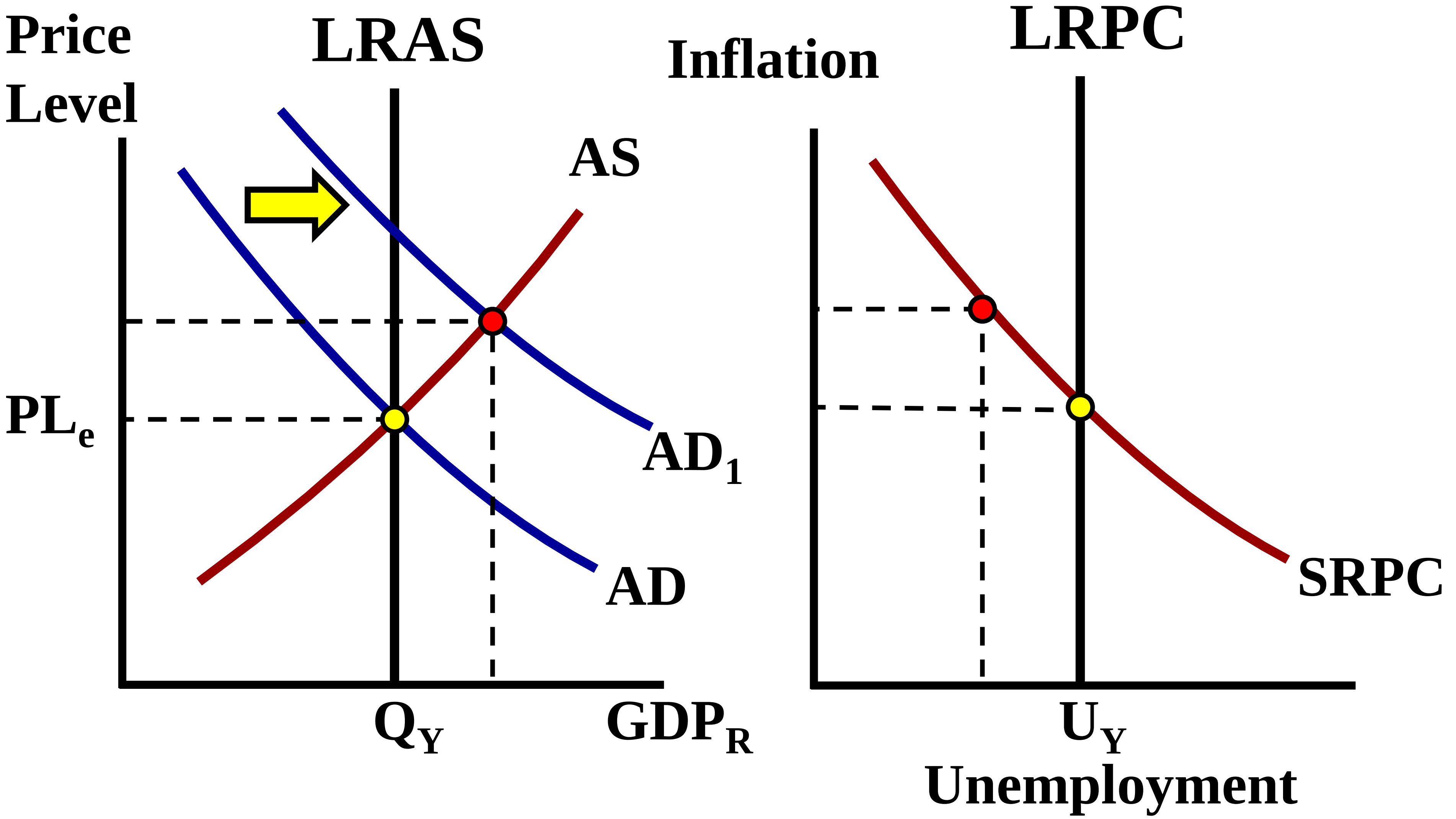
Short Run Phillips Curve vs. Long Run Phillips Curve

In the <u>long run</u> there is <u>NOT</u> a tradeoff between inflation and unemployment.



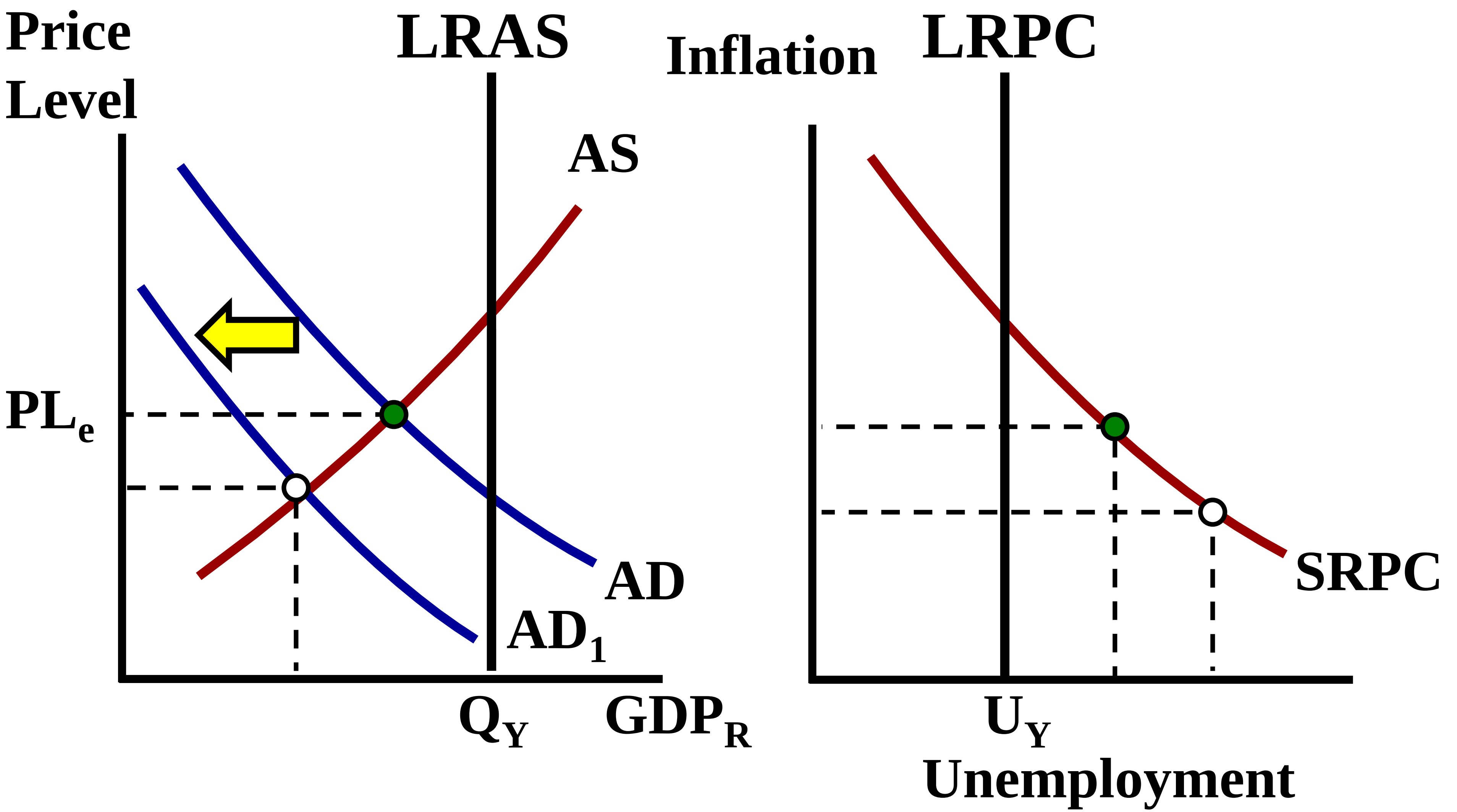
AD/AS Model and the Phillips Curve

Show what happens on both graphs if AD increases.



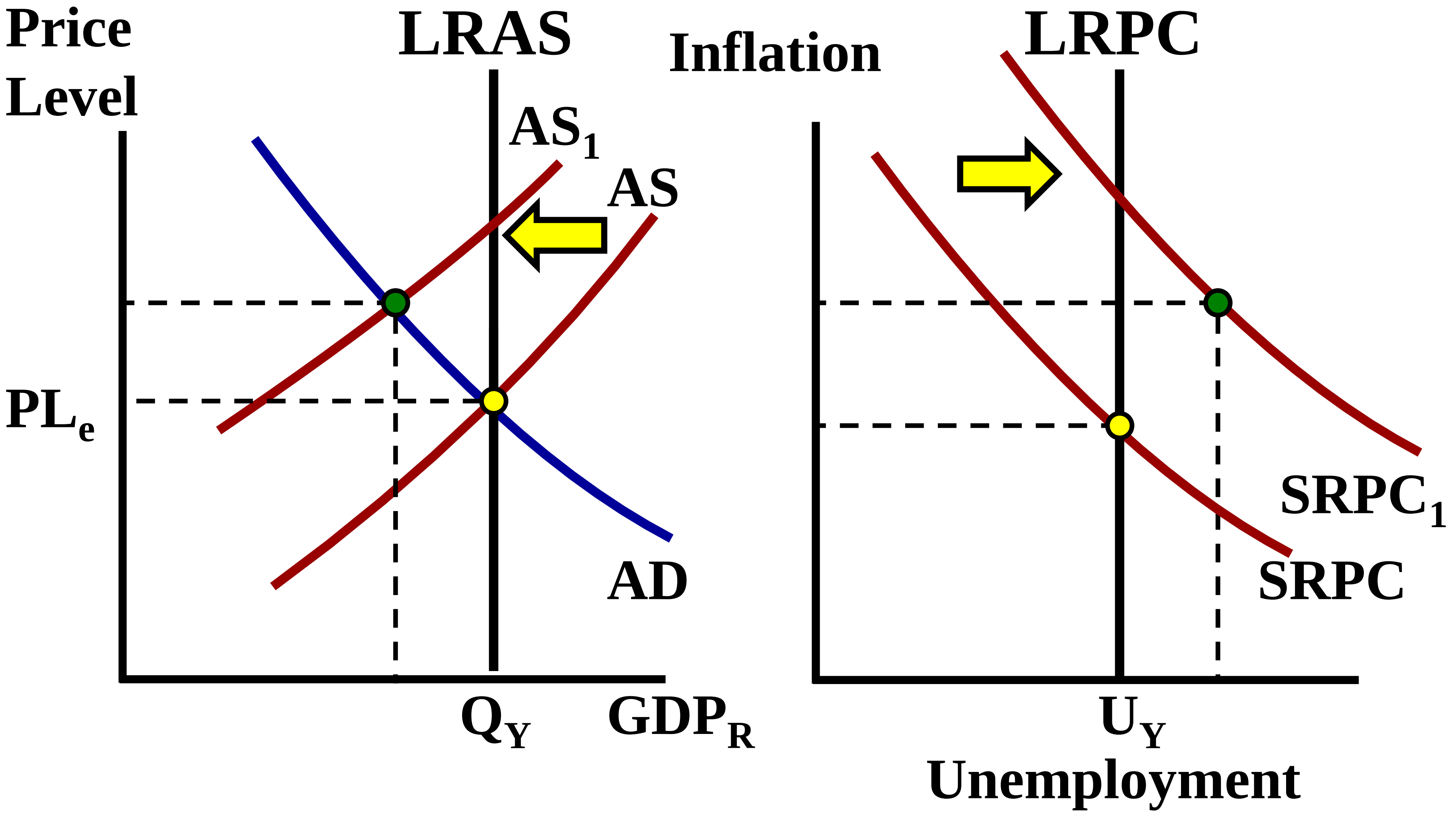
AD/AS Model and the Phillips Curve

Correctly draw the LRPC and SRPC with a <u>recessionary gap</u>. What happens when AD falls?



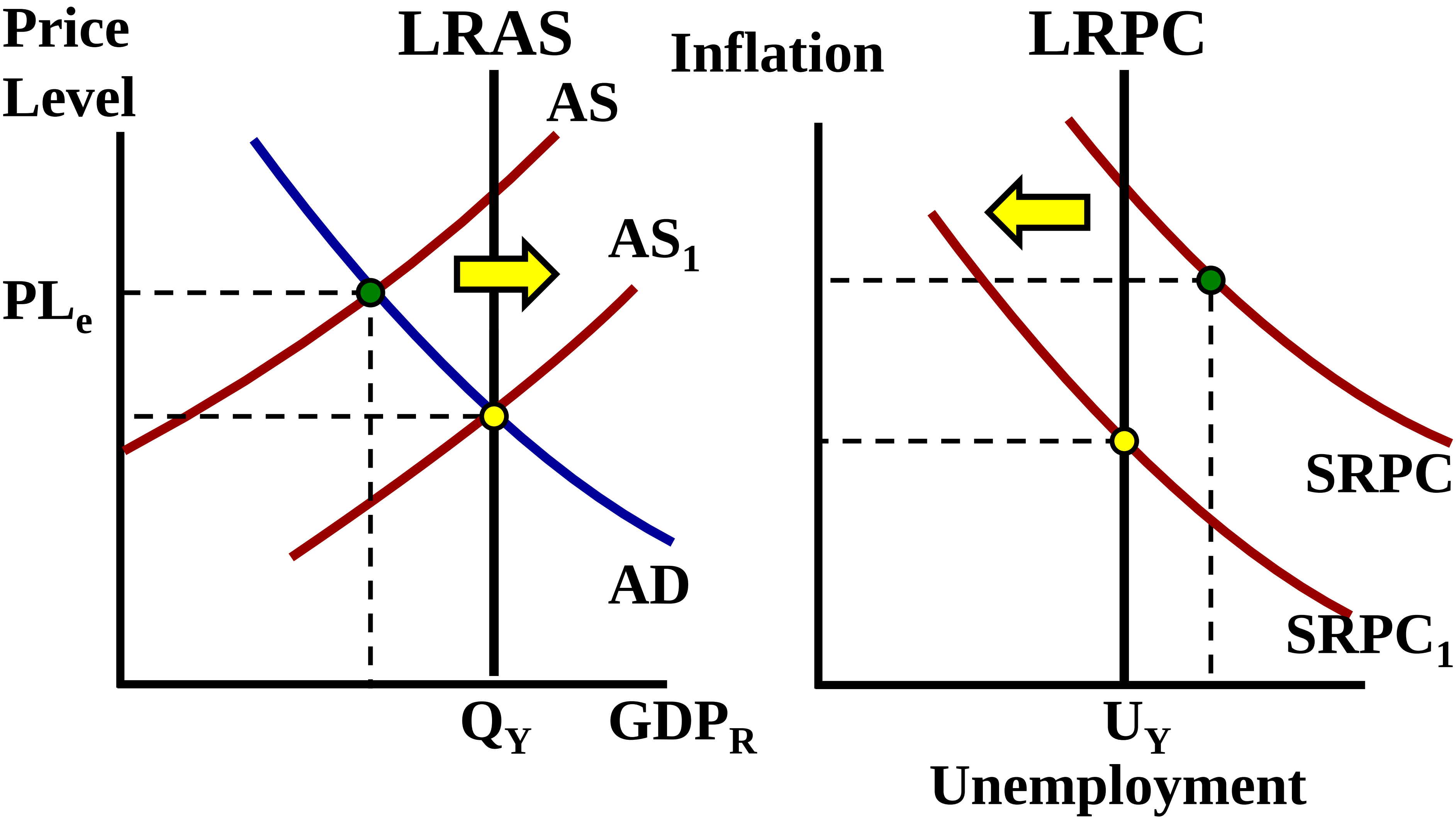
AD/AS Model and the Phillips Curve

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

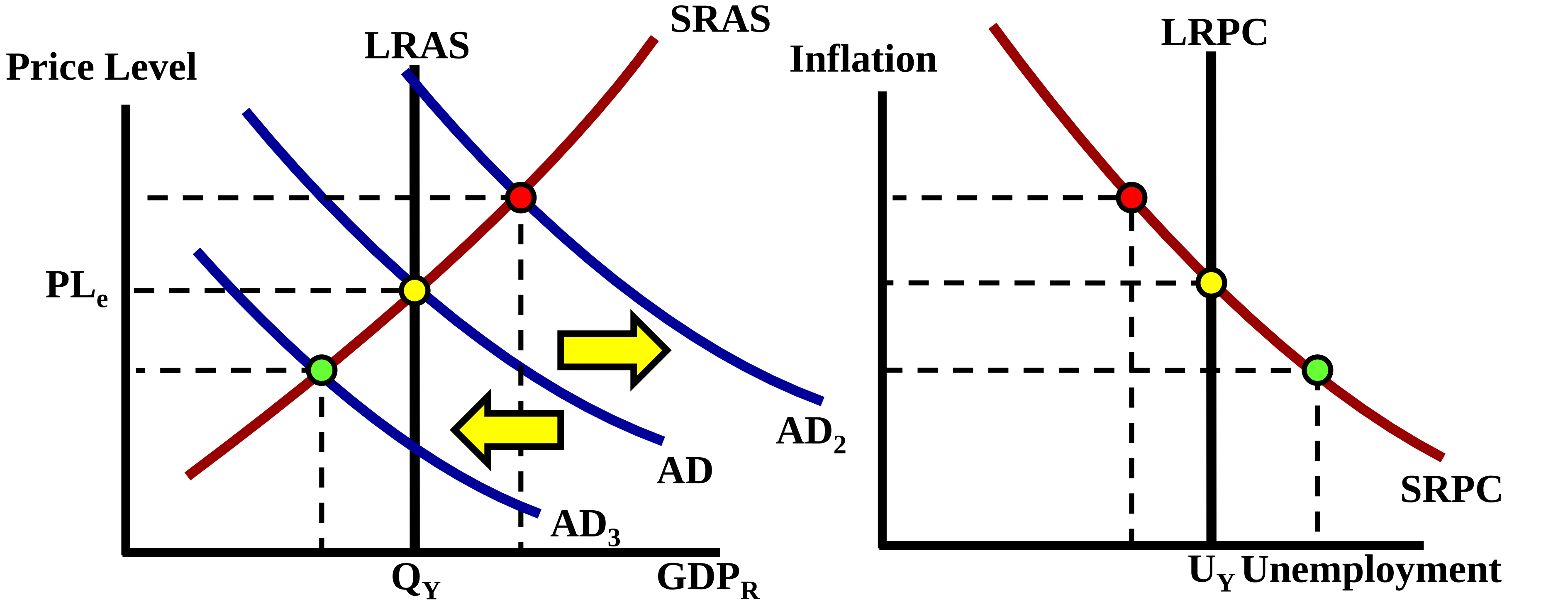


AD/AS Model and the Phillips Curve

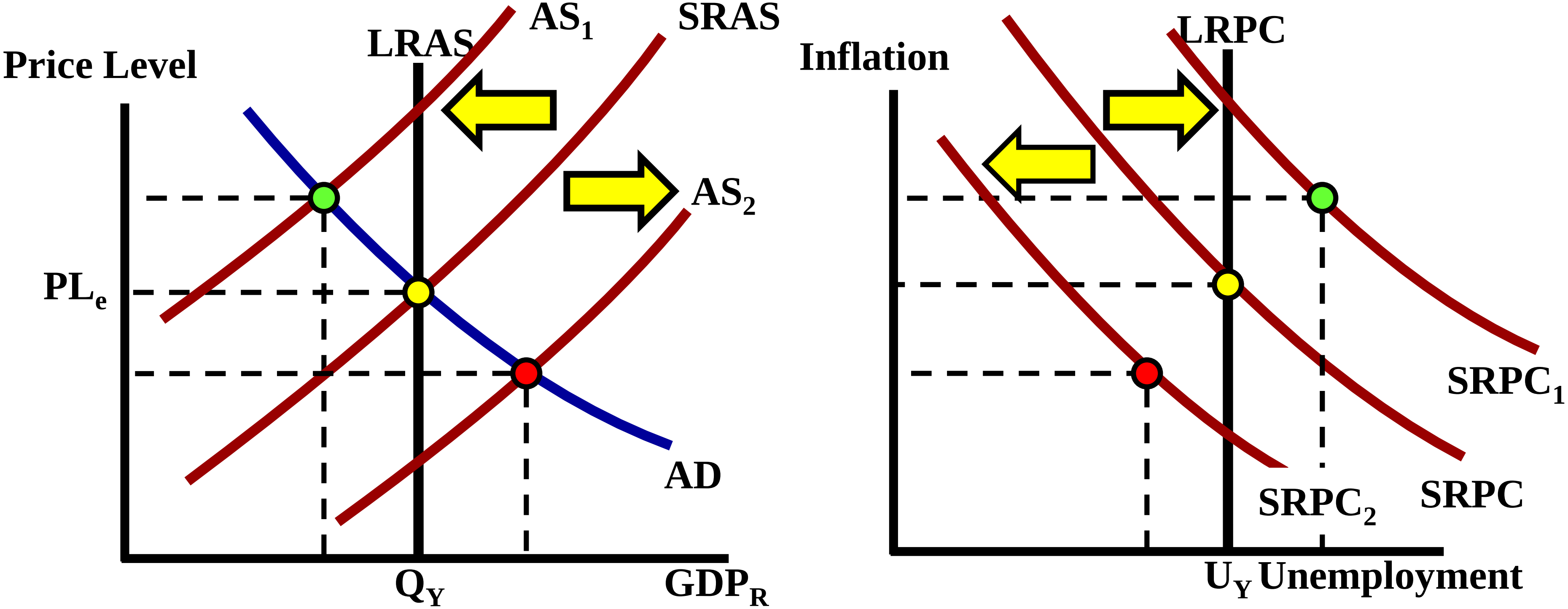
Correctly draw the LRPC and SRPC with an <u>recessionary gap</u>. What happens when AS goes up?



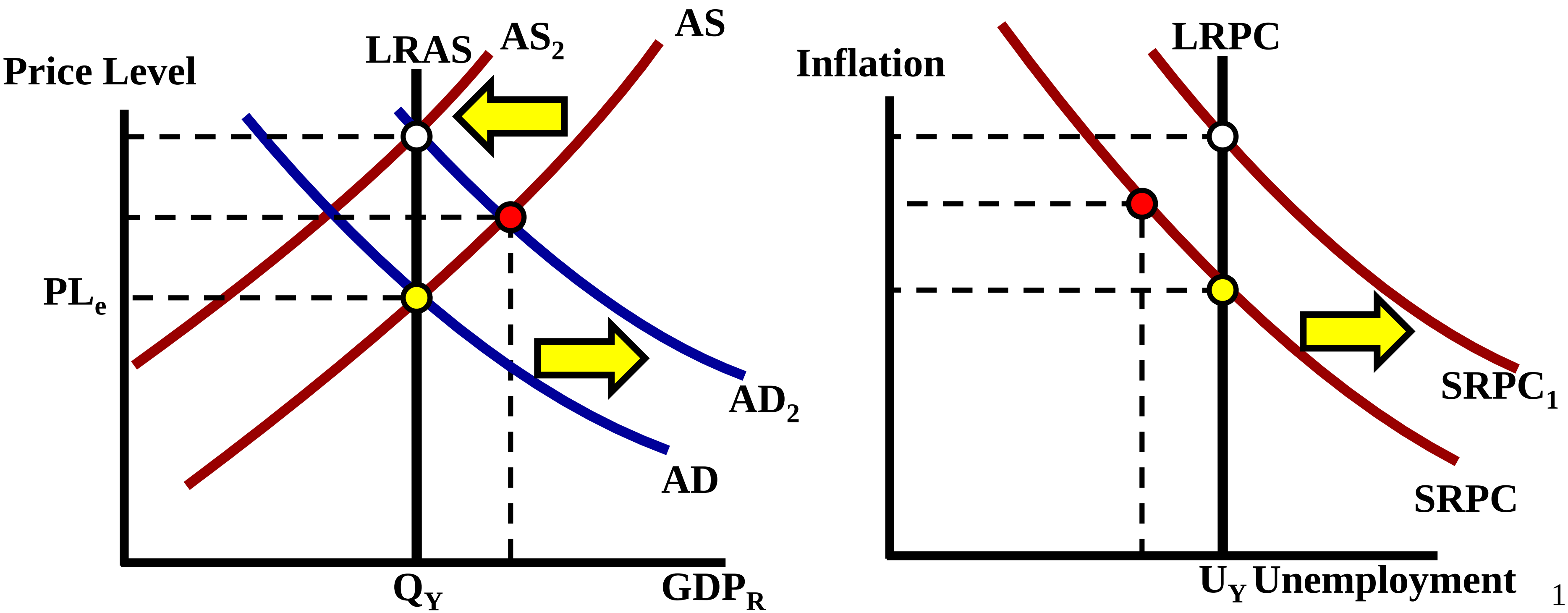
Aggregate Demand Shifts Shown on BOTH the AS/AD Model and the Phillips Curve Model



Aggregate Supply Shifts Shown on BOTH the AS/AD Model and the Phillips Curve Model



SIMULTANEOUS
Aggregate Supply & Aggregate Demand Shifts
Shown on
BOTH
the AS/AD Model and the Phillips Curve Model



1. According to the short-run Phillips Curve, there is a trade-off between
   a. interest rates and inflation.
   b. the growth of the money supply and interest rates.
   c. unemployment and economic growth.
   d. inflation and unemployment.
   e. economic growth and interest rates.

2. According to the long-run Phillips Curve, which of the following is true?
   a. Unemployment increases with an increase in inflation.
   b. Unemployment decreases with an increase in inflation.
   c. Increased automation will lead to lower levels of structural unemployment in the long run.
   d. Changes in the composition of the overall demand for labor tend to be deflationary in the long run.
   e. The natural rate of unemployment is independent of monetary and fiscal policy changes that affect aggregate demand.

3. An increase in which of the following will lead to lower inflation and lower unemployment?
   a. Exports
   b. Aggregate Demand
   c. Labor Productivity
   d. Government Spending
   e. The international value of domestic currency.

4. Which of the following best explains how an economy could simultaneously experience high inflation and high unemployment?

a. The government increases spending without increasing taxes.
b. The government increases taxes without increasing spending.
c. Inflationary expectations decline.
d. Women and teenagers stay out of the labor force.
e Negative supply shocks cause factor prices to increase.

Practice Phillips Curve FRQ

Assume that the United States economy is currently in a recession in a short-run equilibrium.

(a) Draw a correctly labeled graph of the short-run and long-run Phillips curves. Use the letter A to label a point that could represent the current state of the economy in recession.

(b) Draw a correctly labeled graph of aggregate demand and aggregate supply in the recession and show each of the following.

(i) The long-run equilibrium output, labeled Y_f

(ii) The current equilibrium output and price levels, labeled Y_e and PL_e, respectively

(c) To balance the federal budget, suppose that the government decides to raise income taxes while maintaining the current level of government spending. On the graph drawn in part (b), show the effect of the increase in taxes. Label the new equilibrium output and price levels Y_2 and PL_2, respectively.

4 Minutes of Graphing Practice AD/AS and the Phillips Curve With Mr. Clifford

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A)

B)