Unit - 2

Inflation, Unemployment and Expectations :

Phillips Curve : (Inflation, unemployment trade off)

Inflation : Inflation is the rate of increase in price over a given period of time.

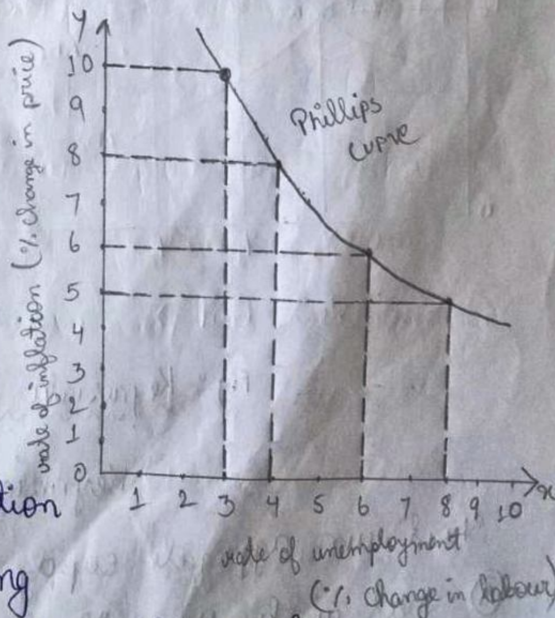
It is a persistant rise in price in general price level.

* Causes :

(i) Demand - pull inflation : Aggregate demand for goods and services exceeds the supply of output, Price level increases.

(ii) Cost - push inflation :

(a) When trade union pushes for higher wages
(b) Due to increase in profit margin, producer charges higher prices for consumer.
(c) Rise in prices of raw materials (oil prices)



A noted british economist A.W. Phillips published an artical in 1958 based on his research using historical data from the U.K and arrived at the conclusion that there existed an inverse relationship between rate of unemployment and rate of inflation. This inverse relation implies a trade off i.e for reducing unemployment, price in the form of a higher rate of inflation has to be paid and for reducing the rate of

inflation, price in terms of a higher rate of unemployment has to be born. Phillips curve is downward sloping showing, the inverse relation between rate of inflation and rate of unemployment and this curve is now named after his name as Phillips curve. It is seen that when rate of inflation is 10%, the unemployment rate is 3% and when rate of inflation is reduce to 5%, say by reducing aggregate demand, the rate of unemployment increase to 8% of labour force. on the basis of this, many economist came to belive that there existed a stable phillips curve, which depicted a product stable inverse relation between inflation and unemployment.