Phillips Curve and Adaptive Expectations:

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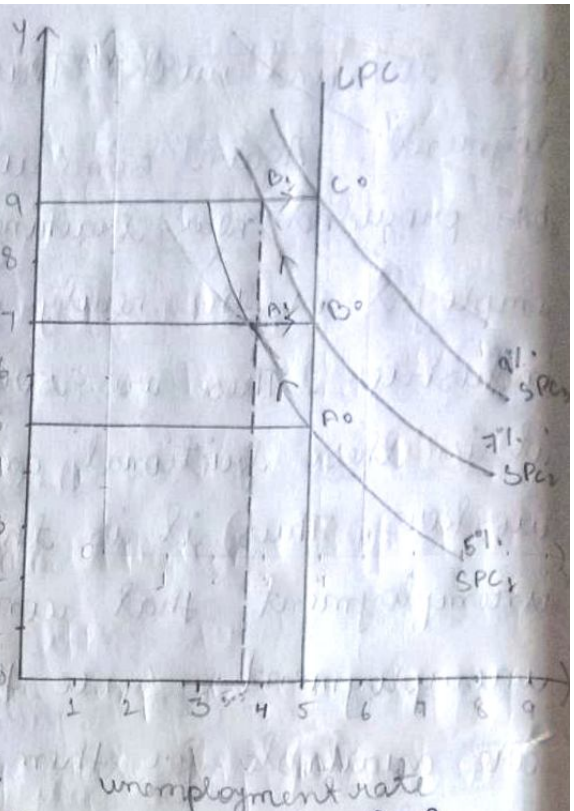
Expectations about the future rate of inflation play on important role. Friedmen put for ward a theory of adaptive expectation according to which people form their expectation on the basis of previous period rate of inflation and change or adopt their expectation only when the actual inflation turns out to be different from their expected rate. According to this Friedmen's theory or adaptive expectations, there may be a trade off between rate of inflation and unemployment in the short run, but there is no such trade off in the long run.



To begin with SPC_1 is the short run Phillips curve and the economy is at point A_0 corresponding to the natural rate of unemployment equal to 5% of labour force. Further we assume that the economy has been experiencing a rate of inflation equal to 5%. Now suppose the government adopts expantionary fiscal and monetary policies to raise aggregate demand. The increase in aggregate demand will cause the rate of inflation to rise, say to 7%. Given the level of money wage rate which was fixed on the basis that 5% rate of inflation would continue to occur, the higher price level would raise the profits of the firms. It leads to increase in output and will induce the firm to employ more labour. As a result of this, the economy will move to point A_1 on the short run Phillips Curve SPC_1 where unemployment has decreased to 3.5% and inflation rate has risen to 7%.

According to them, the economy will not remain at A_1. Because the workers will realise that due to higher rate of inflation than expected one their real wages and incomes have fallen. The workers will therefore demand higher nominal wages.

Profits of firms will fall to their earlier levels. This reduction in their profit, resulting in reduced employment till the unemployment rate rises to the natural level of 5%. The economy will move from A_1 to B_0 at a higher inflation rate of 7%.

Further at point B_0, the workers will now expect this 7% inflation rate to continue in future. As a result short run Phillips curve (SPC) shift upward from SPC_1 to SPC_2. The government may misjudge the situation and think that 7% rate of inflation is not too high and adopt expansionary fiscal and monetary policies to increase aggregate demand. The price level will rise further. The economy will move from B_0 to B_1 along SPC_2 curve. The workers will demand higher nominal wages to compensate for the higher rate of inflation than expected. The profits decline which will cause employment to fall and unemployment rate to return to the natural rate of 5%. The economy moves from point B_1 to C_0. The new short run Phillips curve will now shift to SPC_3. On joining point such as A_0, B_0 and C_0 corresponding to the natural rate of unemployment, we get a vertical long run Phillips curve (LPC).

Thus in the adaptive expectations theory of the natural rate hypothesis, while the short run Phillips Curve is downward sloping

indicating the trade off between inflation and unemployment rate in the short run, the long run Phillips Curve is a vertical straight line showing that no trade off exist between inflation and unemployment in the long run.