

Chapter 33 The Phillips curve and policy conflicts

Answers to Knowledge checks

- 33.1** A government might want to increase a feeling of wellbeing among the electorate by lowering unemployment, knowing that the effect on inflation would not be immediate. This could give rise to what became known as the ‘political business cycle’. The problem with such an approach is that eventually inflation has to be brought back under control, so unemployment would rise again.
- 33.2** An increase in structural unemployment would mean that the natural rate of unemployment would also increase.
- 33.3** An acceleration in economic growth is likely to lead to an increase in imports, so pushing the current account of the balance of payments into deficit. The authorities then need to intervene to cover the deficit by supporting the exchange rate. This entails reducing domestic money supply, which in turn affects aggregate demand. Economic growth therefore slows down.
- 33.4** Rapid economic growth could increase inequality in the distribution of income if the benefits of growth mainly go to those who are already well-off. This could well be the case, if the increased income flows to the entrepreneurs or to the owners of the production process.
- 33.5** If the national debt becomes unsustainable this could become a major problem, so the government budget deficit needs to be controlled, as was explained in Chapter 30.

Answers to Exercises and Case studies

Exercise 33.1

Let’s look at each country in turn, starting with France. Figure A33.1 shows the scatter plot of inflation against unemployment. Notice that I have restricted the x -axis to show only the range of unemployment above 7% to make it easier to discern the patterns. When you come to look at the graphs for Italy and Germany, you will see that the range I have plotted is slightly different in each case, reflecting the variation in unemployment rates between the three countries.



Figure A33.1 Inflation and unemployment in France, 2006–17

When looking at the graph, it is important to remember that the financial crisis affected all of the countries in 2008–9, so we might expect to see some shift in the relationship as the economies adjusted to new conditions. This is clear in the graph for France, where the relationship appears to shift between 2009 and 2010 (as it did in the case of the UK (*see* Figure 33.3, page 453 of the book)). However, there is a generally negative relationship between these variables between 2006 and 2009 and between 2010 and 2017. Notice that the pattern differs from that shown for the UK, where unemployment fell more strongly after 2013.

I will look at Italy next, shown in Figure A33.2.

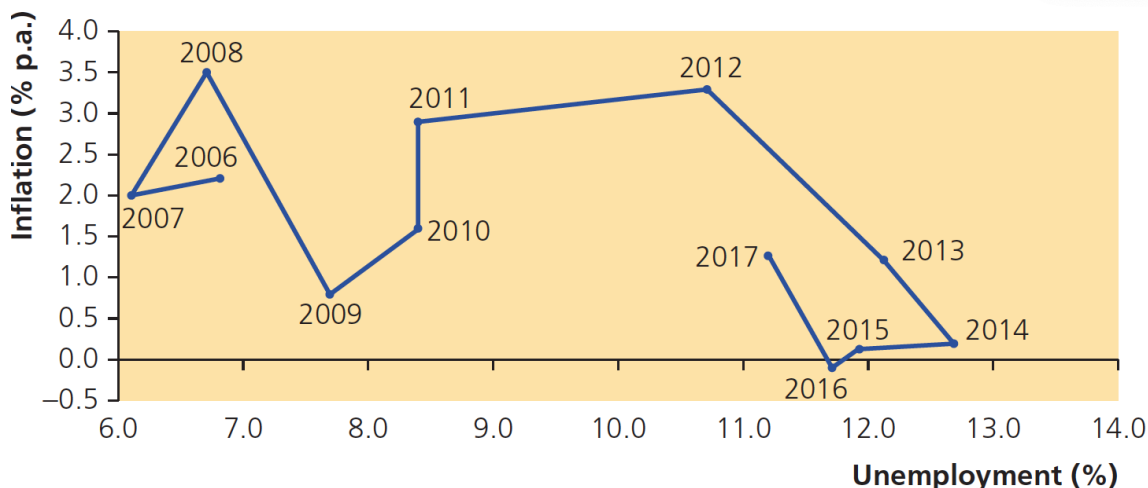


Figure A33.2 Inflation and unemployment in Italy, 2006–17

In some ways the graph for Italy shows some similarity to that for France, in that there is a negative relationship between inflation and unemployment between 2006 and 2009, which could be said to resemble a Phillips curve. There is then a shift in the relationship, but a longer transition, so that the relationship does not seem to settle until about 2012, and there seems to have been a much larger increase in unemployment. This reflects the way that the crisis affected the Italian economy.

Finally, let's look at Germany, shown in Figure A33.3.

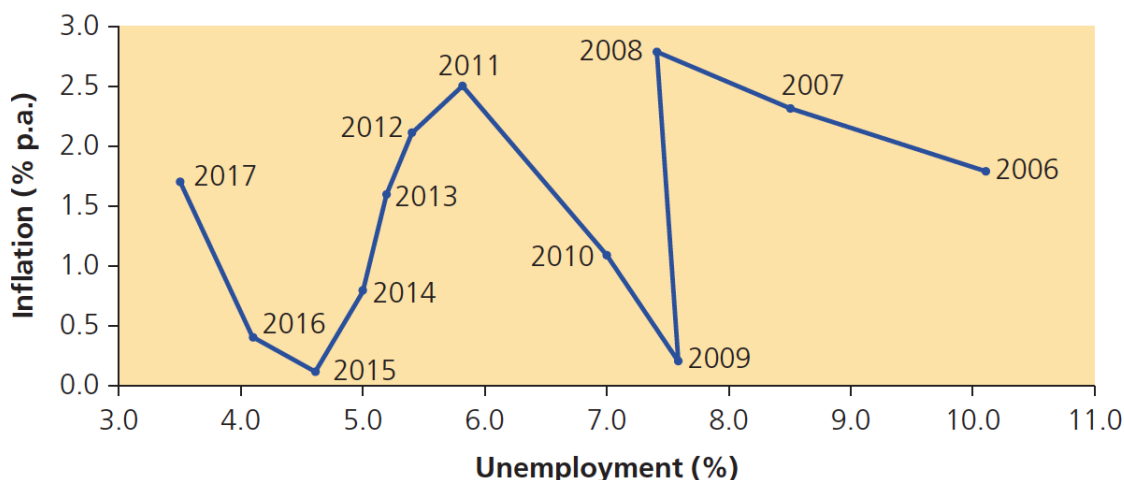


Figure A33.3 Inflation and unemployment in Germany, 2006–17

The pattern here is quite different. The pre-crisis period from 2006 to 2008 shows a clear negative pattern, but inflation fell abruptly in 2009 without much change in the rate of unemployment.

Inflation then accelerated between 2009 and 2011, with unemployment falling, but between 2011 and 2015 both unemployment and inflation fell, before the negative relationship seemed to be re-established in the last years shown. Notice that the UK also showed a negative relationship in these last three years.

Exercise 33.2

A key argument in support of granting independence to the Bank of England in the use of monetary policy to meet an inflation target is that this raises the credibility of policy. The government can no longer court popularity in the run-up to an election by exploiting the Phillips curve relationship, gaining lower unemployment in the short run at the expense of inflation in the longer term.

If economic agents believe that the inflation target will be met, their expectations will adjust more rapidly to a changing economic environment, so in theory the economy should return to equilibrium more rapidly after an external shock. This could also help to explain why the Phillips curve may have become flatter in recent years.

Case study 33.1

Macroeconomic policy conflicts

- a** It seems quite a challenge to be faced with all these competing demands, but there are strong arguments in favour of each of them, so we can regard all of them as valid objectives.

The problem is there are conflicts that arise between many of the various objectives, as has been explained in the chapter. These arise because of trade-offs in the macroeconomy. For example, given the Phillips curve relationship, the simultaneous achievement of low inflation and low unemployment may not always be feasible. Depending on the policy context, high economic growth may not be compatible with a low deficit on the current account of the balance of payments. High economic growth may not be consistent with the maintenance of high environmental quality. This has been seen in China in recent years, where the pursuit of economic growth has led to increasing problems with environmental pollution.

An overarching issue is that resources are scarce (which of course is the fundamental economic problem). Given high levels of national debt, there will not be sufficient funds to meet all the competing demands for government expenditure.

No doubt you can identify other potential conflicts that can arise here.

- b** Can there be a policy package that could deliver on all of these objectives? Probably not. What is needed is to set priorities that are acceptable to as many people as possible, and to create a long-term strategy that will eventually allow targets to be achieved. Trying to do this while coping with the uncertainties of Brexit makes this an even greater challenge...

Answers to end-of-chapter questions

A Multiple-choice questions

- 1 b. Non-accelerating inflation rate of unemployment
- 2 d. Unemployment and the rate of inflation

B Knowledge and understanding questions

- 3 The natural rate of unemployment is the rate of unemployment in which there is only frictional and structural unemployment, as real wages will have adjusted to the equilibrium level.

A full explanation of the natural rate of unemployment	2 marks
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A vague or partial explanation of the natural rate of unemployment	1 mark
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- 4 When the demand for labour is high, firms will be prepared to bid up wages in order to attract labour. To the extent that higher wages are then passed on in the form of higher prices, this would imply a relationship between unemployment and inflation: when unemployment is low, inflation will tend to be higher, and vice versa.

An explanation of the relationship between unemployment and inflation in the long run	up to 2 marks
A diagram showing the relationship between unemployment and inflation in the long run (the Phillips curve)	up to 2 marks

C Stimulus response question

- 5 a Objectives may include:

- Low unemployment
- A sustainable balance of payments position

Two macroeconomic objectives of government, apart from economic growth and low and stable inflation, identified	2 marks
One macroeconomic objective of government, apart from economic growth and low and stable inflation, identified	1 mark

b

AO1 Knowledge	1 mark
AO2 Application	1 mark
AO3 Analysis	5 marks
AO4 Evaluation	5 marks

Knowledge (1 mark) is likely to include:

- Macroeconomics objectives of government

Application (1 mark) is likely to include:

- Application of the conflict between economic growth and low and stable inflation

Analysis (5 marks) is likely to include:

Analysis of possible consequences of a conflict between economic growth and low and stable inflation, for example:

- Increased short-run economic growth leading to an increase in *AD* and an increase in inflation (classical *LRAS* model or section of Keynesian model)
- Monetary policy to reduce inflation leading to a reduction in *AD* and a reduction in short-run economic growth

Evaluation (5 marks) is likely to include:

Evaluation that is not a conflict between economic growth and inflation, for example:

- Long-run economic growth may lead to a decrease in inflationary pressure
- Depends upon the state of the economy
- Depends upon the timescale
- Depends upon the type of economic growth

A judgement of whether there is always a conflict between the macroeconomic objectives of government for economic growth and low and stable inflation

D Essay question

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AO1 Knowledge	6 marks
AO2 Application	6 marks
AO3 Analysis	6 marks
AO4 Evaluation	7 marks

Knowledge (6 marks) likely to include:

- The Phillips curve
- Inflation
- Unemployment

Application (6 marks) is likely to include:

- Application of the Phillips curve for macroeconomic policy-makers

Analysis (6 marks) is likely to include:

Analysis of the usefulness of the Phillips curve, for example:

- Understanding the relationship between inflation and unemployment
- Understanding of the natural rate of unemployment and implications of being above or below this point
- Impact on setting targets for inflation and unemployment

Evaluation (7 marks) is likely to include:

- Evaluation of why the Phillips curve may not be useful
- Evaluation of other, more useful techniques for managing the macroeconomy

A judgement of the usefulness of the Phillips curve for macroeconomic policy-makers