Why the Phillips curve does not work

An economic concept that serves as the linchpin for central bankers across the world is the Phillips curve. Developed by New Zealand economist A.W.H. Phillips, it states that there is an inverse relationship between inflation and unemployment in any economy. Phillips studied price and employment data in the United Kingdom from 1861 to 1957 to arrive at this interesting conclusion.

The underlying logic behind the Phillips curve is that wages are quite “sticky”, or inflexible, in a market economy, so unemployment is bound to shoot up whenever workers refuse to accept lower wages. Inflation, which increases nominal but not real wages, is assumed to trick workers into accepting a lower remuneration for their services; it is thus an indirect wage cut that helps prevent an increase in unemployment.

Central bank chiefs thus keep a very close eye on inflation and unemployment data of the overall economy to plan monetary policy accordingly. They try to maintain the level of unemployment at the non-accelerating inflation rate of unemployment, which is the unemployment rate at which inflation too is just under control.

Whenever inflation is too low and unemployment too high, central banks increase the money supply to encourage greater employment. When this causes inflation to shoot up too high, they reduce the money supply, which results in lower inflation but also slightly higher unemployment.

“Do Phillips curves conditionally help to forecast inflation?”, a 2017 paper by Michael Dotsey, Shigeru Fujita and Tom Stark published by the Federal Reserve Bank of Philadelphia, however, argues that central bankers may be using the wrong economic model to frame policy. The authors argue that there is no real trade-off between inflation and unemployment, as assumed by generations of economists, as models based on the Phillips curve have a poor forecasting record. This should not be surprising. The stagflation of the 1970s proved quite convincingly that high unemployment and high inflation can very well co-exist. Also, wages may not be as rigid as many economists assume, which means that they could adjust downward quite comfortably in many cases. Lastly, loose monetary policy, apart from ramping up inflation, often also causes structural distortions in the economy which lead to higher unemployment. Given such complexity in an economy, any effort to micromanage it may well be a fool’s errand.

The new U.S. Fed Chairman is unlikely to opt for policies that might upset the President’s plan

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