Why the Phillips Curve

\[ LS^{SR} = \Phi(\eta - \eta_e) \]

Conclusion

- No Long Run Phillips Curve
- Apparently a Short Run Phillips Curve, when inflation rate differs from expected rate.

Our Task

- How do we Explain these findings?
- And how do we incorporate them into the model?

Long Run and Short Run LS

You are currently making $10 an hour, and are suddenly offered $15 an hour. If it is a temporary wage increase, move along the short run LS curve. If it is simply due to inflation, ignore it.

So which is it?
Imperfect Information

\[ \Delta w_R = \omega \Delta w \]

\[ 0 \leq \omega \leq 1 \]

History will be the guide to the value of \( \omega \).

If you expect a lot of variability in inflation rates and little variability in real wage rates, set \( \omega \) very low.

If you expect little variability in inflation rates but a lot of variability in real wage rates, set \( \omega \) high.

The Response

The Equation

\[ LS^{SR} = \Phi(\eta - \eta_e) \]
Why the Phillips Curve

The Waste

Can You be Consistently Fooled?

Lincoln’s law says you can be fooled some of the time.

Ex post – yes
Ex ante - no

Implications

More inflation than expected means an increase in output

Less inflation than expected means a decline in output

Can We Exploit This?

Any boost will be temporary.
Why the Phillips Curve

Can We Exploit This?

So why not constantly create surprise inflation and get boost after boost.

Can We Exploit This?

Dream on. why not constantly create surprise inflation and get boost after boost.

Can We Mismanage This

• In Pleasantville, the inflation rate is always as expected. Information is always perfect

Can We Mismanage This

• In Pleasantville, the inflation rate is always as expected. Information is always perfect
  – No waste

Can We Mismanage This

• In Pleasantville, the inflation rate is always as expected. Information is always perfect
• In Mudville, monetary policies are quixotic, and the inflation rate is highly uncertain.
  – A lot of business cycles due to a lot of imperfect information.
Can We Mismanage This

- In Pleasantville, the inflation rate is always as expected. Information is always perfect.
- In Mudville, policies are quixotic, and the inflation rate is highly uncertain.

Moral: Mudville should do a better job of monetary policy so as to reduce inflationary surprises.

An Important Caveat

- We tell the story in terms of workers getting surprised.
- We could just as well tell it from the perspective of firms getting surprised.

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Surprising Firms

- You are selling your product for $10 but the price jumps to $15.
- If it is a price jump, take advantage of it.
- If it is simply due to inflation, ignore it.

So which is it?

Implications

More inflation than expected means an increase in output
Less inflation than expected means a decline in output
End