**Short run Phillips curve**

**Explanation**

**Long run Phillips Curve**

**Explanation (what is the rate of unemployment where the LRPC intersects the SRPC?, what happens if government acts to increase AD to reduce unemployment below this level?, how might they act? What would happen to unemployment in the long run?)**

Draw a short run and a long run Phillips curve.

The point at which the long run Phillips curve intersects the short run Phillips curve is known as the Natural Rate of Unemployment ( or Nairu). What does this mean?

Mark a point Un on your diagram showing unemployment at the natural rate and inflation at zero. Label this point A. At this point inflation is zero and workers expect future inflation to be at zero. Now the government increases AD (consider how it might do this) to trade off along the short run Phillips curve to a point B on the SRPC. Label the new level of unemployment U1. At point B what is the rate of unemployment in relation to the natural rate? What has happened to the rate of inflation? If workers suffer from money illusion (i.e. they believe prices are stable when they might not actually be) the economy would eventually return to point A. However, if they expect inflation to continue what would they do in negotiations with employers? What effect would this have on SRAS? What effect would this have on prices? What will happen to real wages? Will workers stay in or leave the labour market? What will happen to the SRPC? (draw it in labelling it SRPC2). What will the economy always come back to? What is the difference between your original SRPC and your new one at SRPC2?

Now show the analysis above using a classical diagram.

Explanation

Policies to tackle inflation (in explaining each policy consider the advantages and drawbacks of its use (in doing so also consider the other macro economic objectives that the government is trying to achieve)

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