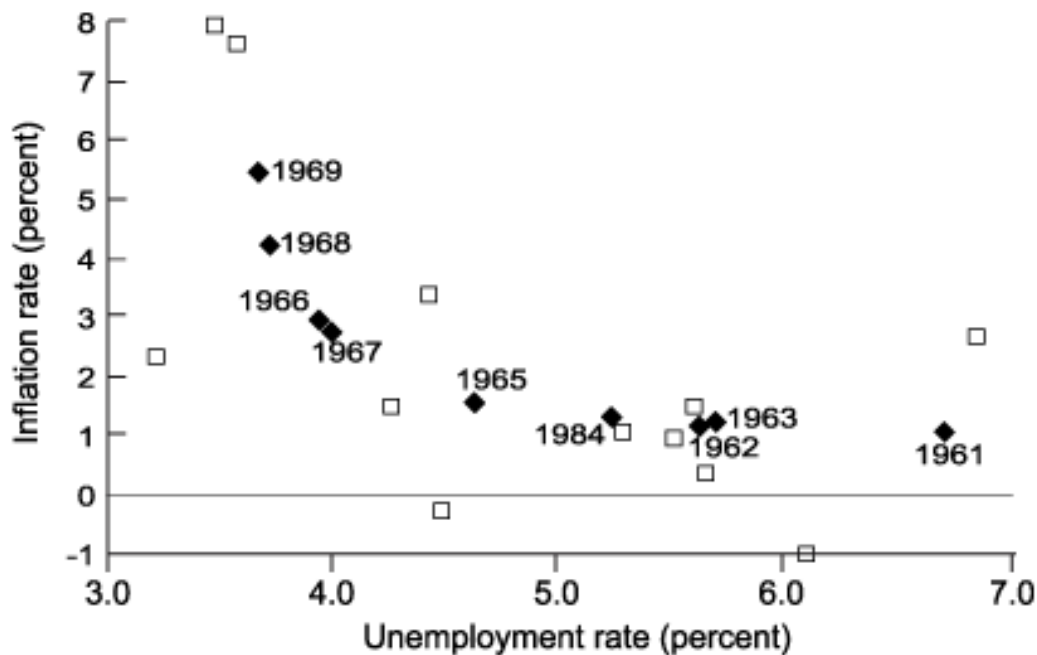




As we can see there is indeed a negative relationship arising from the data, as Phillips found for the UK.

The true importance of the Phillips curve is that it is consistent with the Keynesian economic theory. According to Keynes we cannot have high unemployment and high inflation at the same time. If what matters in the economy is the aggregate demand, then when aggregate demand is low unemployment should be high but inflation should be low (low demand puts downward pressure on prices that should decrease). The opposite will be true when aggregate demand is high.

The Phillips Curve and Economic Policy

If the Phillips curve is stable as Phillips believed and many economists in the 60's, then it provides a *trade-off* between inflation and unemployment rate.

Figure 1.

policymakers can contract aggregate demand, causing unemployment to rise above the natural rate.

The **sacrifice ratio** measures the percentage of a year's real GDP that must be foregone to reduce inflation by 1 percentage point. A typical estimate of the ratio is 5. This is an estimate that comes from a Phillips curve with inflation inertia (if expectations are calculated differently from the simplest adaptive expectations case then this number can be different). Example: To reduce inflation from 6 to 2 percent, we must sacrifice 20 percent of one year's GDP:

$$\text{GDP loss} = (\text{inflation reduction}) \times (\text{sacrifice ratio}) = 4 \times 5$$

This loss could be incurred in one year or spread over several, *e.g.*, 5% loss for each of four years. The cost of disinflation is lost GDP. One could use Okun's law to translate this cost into unemployment.

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