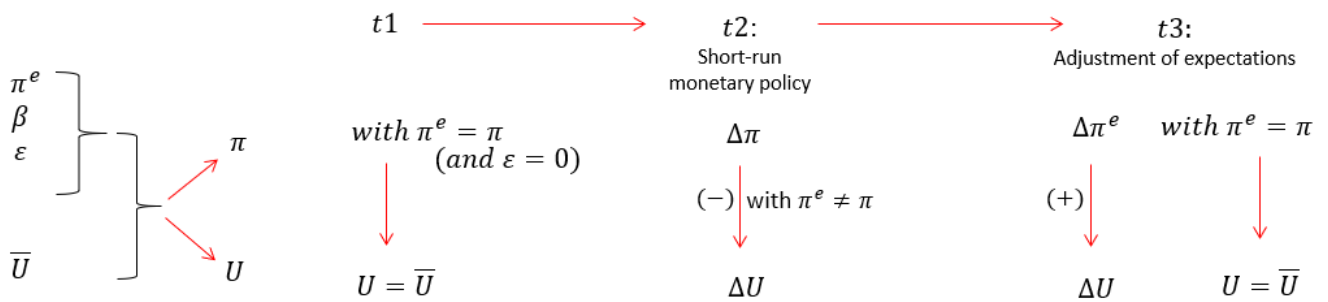


Friedman-Phelps Model

Operating Mode



Core Functions

Short-run Phillips curve:

$$\pi = \pi^e - \beta(U - \bar{U}) + \varepsilon$$

Long-run Phillips curve:

$$\bar{U} = \text{const.}$$

Variables and Symbols

π	Inflation rate	β	Cyclical sensitivity
π^e	Expected inflation rate	ε	Shock parameter
U	Unemployment rate		
\bar{U}	Natural rate of unemployment		

Relevance

The model offers a lot. With a focus on adjustable expectations, it explains why the short-run Phillips curve is unstable, how countries can escalate to high inflation rates (the usual suspects), and why it can lead to unpleasant adjustment costs when combating inflation (e.g. Volcker shock).

The limited effect of monetary policy impulses on the real economy is emphasized and the importance of structural factors (which are reflected here in natural unemployment) for the long-run situation of a country is highlighted (important e.g. for the euro area).

Finally, it becomes clear why central banks have an interest in the "anchoring of inflation expectations" (e.g. ECB).

Limitations

Manageable. The actual causal direction of the Phillips curve ($U \rightarrow \pi$) is reversed to ($\pi \rightarrow U$).

The effects of monetary policy are basically asymmetric. Expansionary monetary policy (in contrast to the contractive) has only an "inviting" character, so that the desired effect ($\pi \uparrow$ and $U \downarrow$) does not have to materialize in reality (e.g. euro area).

Finally, it should be noted that the natural unemployment rate is an exogenous variable here.