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THE INFLATION-UNEMPLOYMENT TRADE-OFF AT LOW INFLATION

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Working Paper 13986
<http://www.nber.org/papers/w13986>

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
May 2008

We are grateful to conference and seminar participants at CEPR-ESSIM, NBER Monetary Economics Summer Institute, Graduate Institute of International and Development Studies, University of Tor Vergata, as well as Florin Bilbiie, Giancarlo Gandolfo, and Alberto Petrucci for helpful suggestions, Mary Yang and Hermes Morgavi for excellent research assistance, and Thomas Walter for editorial assistance. The views expressed herein are those of the authors and should not be attributed to the IMF, its Executive Board, its management, or the National Bureau of Economic Research.

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NBER Working Paper No. 13986
May 2008, Revised August 2008
JEL No. E0,E24,E30

ABSTRACT

Wage setters take into account the future consequences of their current wage choices in the presence of downward nominal wage rigidities. Several interesting implications arise. First, a closed-form solution for a long-run Phillips curve relates average unemployment to average wage inflation; the curve is virtually vertical for high inflation rates but becomes flatter as inflation declines. Second, macroeconomic volatility shifts the Phillips curve outward, implying that stabilization policies can play an important role in shaping the trade-off. Third, nominal wages tend to be endogenously rigid also upward, at low inflation. Fourth, when inflation decreases, volatility of unemployment increases whereas the volatility of inflation decreases: this implies a long-run trade-off also between the volatility of unemployment and that of wage inflation.

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