

Long-Run Relationship and Structural Change between Inflation and Unemployment

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Abstract

This paper explores whether the characteristics of the long-run relationship between inflation and unemployment have changed since Paul Volcker's appointment as Chairman of the Fed. Analyses of VAR forecast errors at long horizons are used to obtain information regarding the long-run relationship. The results provide evidence of a positive long-run relationship for the period of rising inflation, the 1960s and 1970s, but no relationship in the long-run for the subsequent two decades of falling inflation. This suggests that the great inflation of the earlier period is a consequence of the combined effects of discretionary policymaking and increases in the natural rate of unemployment, but the driving force of the fall in inflation for the latter period is the Fed's conduct of monetary policy in a credible manner.

Keywords: Inflation; Unemployment; Monetary Policy; Long-Run Relationship; Structural Change

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