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THE RELATIONSHIP BETWEEN DYNAMIC PRICE AND DYNAMIC UNEMPLOYMENT: THE CASE OF THE CE-3 AND THE BALTIC TIGERS

Abstract:

Convention specifies the relationship between price and unemployment in terms of the Phillips curve (PC) where inflation and the rate of unemployment are correlated. This paper argues that the relationship is ambiguous. In the aggregate supply (AS) curve, price and output are both in levels at a given time. But in the PC, price represented by inflation is its change through time while unemployment represented by its rate is frozen at a given time. This paper uses a variant of the PC that is more consistent with the relationship between price and output as depicted in the AS curve. In the variant specification, price as represented by inflation and unemployment as represented by the rate of change in the level of unemployment net of employment are both changes through time. The relationship between price and unemployment using convention and its variant is tested on Poland, the Czech Republic, Hungary, Estonia, Latvia, Lithuania and the pooled data. The Expectations Augmented (EA) is able to track a negative relation between inflation and unemployment better than the New Keynesian (NK) is able. Within the EA runs, the convention is able to track the same negative relation better than the variant, but one has to be cautious given the implied results.

Keywords:

Employment, Unemployment, Inflation, Central Europe

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