# The Phillips Curve at Fifty: Introduction

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To celebrate the 50th anniversary of the Phillips Curve in 2008, the Kiel Institute for World Economics organized a high-level symposium in Kiel in June 2007 seeking to improve our understanding of the relation between the real and monetary sides of the economy, to take stock of recent research advances, and to formulate a new assessment of the role of monetary policy. The *European Economic Review* decided to publish a special cluster of papers selected from those presented at the symposium. The *Review* wanted a balanced group of theoretical and empirical papers on different aspects and applications of Phillips's original contribution.

Research on the Phillips Curve and the natural rate of unemployment has boomed in recent years. This revived interest rests on several important current policy concerns: How important has expansionary monetary policy been in explaining the prolonged upswing of the United States economy since the early 1990s? To what extent can the sluggish performance of the large continental European economies be attributed to insufficient monetary expansion? How was the rise of European unemployment in the 1980s and the early 1990s related to the dramatic, sustained decline in inflation over this period?

These questions also highlight important theoretical concerns. To the extent that monetary policy contributes to prolonged expansions and contractions of macroeconomic activity, the mainstream theory of the Phillips Curve and the natural rate of unemployment may be called into question. According to this mainstream view, monetary shocks may generate a short-run tradeoff between inflation and economic activity, but after at most one or two years the effects fade away and unemployment returns to its natural rate: the long-run Phillips Curve is vertical. This view emerges from the traditional, expectations-augmented Phillips Curve as well as from the forward-looking New Keynesian Phillips Curve and the New Classical Synthesis.

This mainstream picture seems to be at odds with the way central bankers and dealers in financial markets think. In banking circles, monetary policy is considered important not mainly because it influences inflation, but because it is considered to have sustained effects of real macroeconomic activity. Besides, inflation also matters for growth. Moreover, the mainstream view has difficulty explaining several important empirical regularities, such as inflation inertia, the gradual effects of monetary policy on inflation and unemployment, and the absence of disinflationary booms. Both the traditional and new Phillips curves have a "knife-edge" property: when unemployment is above or below its natural rate, inflation falls or rises without limit. The empirical evidence for this property (particularly limitless deflation when unemployment is high) is, at best, thin.

Against this background, there has been an impressive resurgence of research in recent years on inflation persistence, the persistent effects of monetary policy on real variables, and the time profile of monetary policy effects. Clearly, the more prolonged are the effects of monetary policy on unemployment, the less important is the natural rate of unemployment for

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labor market activity. The same applies to other real macroeconomic variables. The recent research has focused on a variety of phenomena, including menu costs, temporary rigidities in wage and price setting, labor migration, behavioral macroeconomics, near rationality, learning, experimental economics, imperfect competition, risk, hysteresis, etc. These analyses have shed new light on the responses of inflation and real macroeconomic variables to monetary policy shocks as well as the interactions between the effects of monetary and fiscal policies.

Some recent writers argue that the Phillips Curve exhibits hysteresis, so that monetary policy has permanent real effects, while others consider the possibility that the natural rate of unemployment is affected by money growth, so that the long-run Phillips Curve is not vertical. The microfoundations of the New Keynesian Phillips Curve suggest that the long-run Phillips Curve is not vertical, but very steep (because the slope depends on the time discount factor). On this account, yet other writers view the vertical long-run Phillips Curve as a reasonable approximation, but monetary policy can have real effects in the short and medium run. Finally, there are those who maintain that monetary policy has at most transient real effects.

In short, recent macroeconomic research has come through a prolific and productive period, generating a variety of observationally distinct conceptions of the role of monetary policy. At the same time, the world economy has experienced profound monetary developments, such as the expansionary monetary policy of the United States in recent years, exported to the Far East, the more cautious monetary policy of the European Union, the rise and fall of house prices in various OECD countries, credit crunch, and the recent resurgence of inflation. Therefore, policy makers have a pressing need for insights into the macroeconomic implications of alternative monetary strategies. The time is now ripe to take stock and find our way toward a new assessment of the Phillips Curve and the natural rate of unemployment. This cluster of six papers from the Kiel symposium celebrating A. W. Phillips's seminal contribution aims to address this challenge.