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INFLATION AND ITS RELATIONSHIP WITH UNEMPLOYMENT AND EXCHANGE RATE

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The relationship between inflation and unemployment has been a topic of much debate since the mid-20th century. It was initially thought that there was an inverse relationship between the two economic variables, this connection is known as the Phillips curve. The first widely-acknowledged research on inflation and unemployment rates was done by economist W. Phillips in 1958. He examined the economy of the United Kingdom from 1861 to 1957 and concluded that an inverse relationship existed between wage changes which signify inflation and the unemployment rate. In the 1960s, many economists believed the Phillips curve offered societies a trade off between inflation and unemployment. If a country was willing to tolerate moderate inflation, it could enjoy low unemployment. Likewise, if it desired low inflation, it would have to face higher unemployment. Economic statistics during the '60s seemed to confirm the theory. The 1970s, however, showed periods of both high inflation and high unemployment. Economists then largely abandoned the Phillips curve, believing there was no long-term link between the two factors. Despite this development, many economists continue to accept a short-term link between inflation and unemployment reminiscent of the Phillips curve. In 1968, American economist Milton Friedman suggested that there is no long-term link between inflation and unemployment. Three years later, both the inflation and unemployment rate began to rise in industrialised countries. The U.S. economy during 1975 had inflation at 9.3% and unemployment at 8.3%. This data contradicted the predictions of the Phillips curve, which suggested it was impossible to see both rates rise. The phenomenon of high inflation and high unemployment lasted from 1971 to 1984 and has been termed stagflation. After stagflation, most economists rejected the validity of the Phillips curve. An effect of this paradigm shift was that governments shifted away from directly intervening in their economies through fiscal policy. They now tended to prefer monetary policy to control inflation. The free market was left to adjust to economic disturbances. Around this time, the idea of a natural rate of unemployment was offered. A natural rate of unemployment essentially means that inflation has no long-term relation to unemployment. A number of reasons for natural unemployment exist, including technological change and voluntary unemployment. While the natural unemployment rate would return in the long-term, many economists continued to advocate the Phillips curve as a short-term economic trade off.

The relationship between exchange rate and inflation rate is not a one-to-one relation. However, sustained inflation induces depreciation of the exchange rate but not as much as the destabilising speculation's effect on exchange rate stability. Likewise, the currency value of a country would, therefore, be more responsive to the expected pattern of domestic and foreign interest rates than to the current short-term rates. This is because of the inverse relationship between inflation and real interest rates. A high and rising inflation rate reduces the domestic real rate of interest and currency value. Consequently, achieving a strong currency value and low interest rate in the country at the same time in the face of high and rising inflationary trend may, however, be untenable both in economic theory and practice in a fairly deregulated economy. This is because a high and rising inflation depicts hyperinflation which leads to soaring exchange and interest rates.