THE RELATIONSHIP BETWEEN INFLATION AND UNEMPLOYMENT: A STUDY BASED ON SRI LANKAN ECONOMY

S.A.U. Niranjala

Deptartment of Social Sciences, Rajarata University of Sri Lanka, Mihintale, Sri Lanka
Corresponding author: niranjalaamuktuwa@yahoo.com

One of the key objectives of macroeconomics is to sustain high economic growth through maintaining low rate of unemployment and low rate of inflation. Traditional Phillips Curve provided evidence of negative relationship between the level of unemployment and the rate of change of wage inflation. On the other hand, Monetarists argue that in the long run there is no trade-off between inflation and unemployment. But some economists have argued that unemployment and inflation are endemic nature of poverty in developing countries. The significance of this study is that, if the inverse relationship between prices and unemployment were true, economic policy making would be trouble-free for a country. Objective of this study is to identify the nature of relationship between unemployment and inflation in Sri Lanka and provide suggestions based on the results obtained. A sample of 35 years for rate of inflation and unemployment has been taken from the year 1977 to 2012. The Ordinary Least Square (OLS) techniques employed to obtain the numerical estimates of the coefficients of the equation and Augmented Dickey Fuller test of stationary is adopted along with the Granger Causality test to determine the causation between unemployment and inflation. The results of the statistical analysis show that there is no trade-off between inflation and unemployment in Sri Lanka. Policy makers should clearly identify the situation when it is fit for the policy instruments, because only the inflation cannot be fully responsible for unemployment.

Keywords: Inflation, Phillips curve, Unemployment