

Economics Chapter 16 – Expectations Theory and the Economy

1. **Phillips Curve** – a curve that originally showed the relationship between wage inflation and unemployment. Now it more ten shows the relationship between price inflation and unemployment
2. **Stagflation** – the simultaneous occurrence of high rates of inflation and unemployment
3. **Friedman Natural Rate Theory** – the idea that in the long run, unemployment is at its natural rate. Within the Phillips curve framework, the natural rate theory specifies that there is a long run Phillips curve, which is vertical as the natural rate of unemployment
4. **Adaptive Expectations** – expectation that individuals form from past experience and modify slowly as the present and the future become the past (or as time passes)
5. **Rational Expectations** – expectations that individuals form based on past experience and also on their predictions about the effects of present and future policy actions and events
6. **Policy Ineffectiveness Proposition (PIP)** - If a policy change is correctly anticipated, individuals form their expectations rationally, and wages and prices are flexible, then neither fiscal policy nor monetary policy is effective at meeting macroeconomic goals
7. **New Keynesian Rational Expectations Theory** – assumes that rational expectations is a reasonable characterization of how expectations are formed, but drops the assumption of completed wage and price flexibility

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1. Suppose the government cuts military spending permanently
 - a. In the short run, the AD curve shifts left, but inflation cannot change, hence the GDP goes down
 - i. Income goes down since the GDP went down
 - ii. If income goes down, and consumption is based on income by the consumption function, then consumption goes down
 - iii. Investments don't change since interest rates haven't changed
 - iv. Net Exports goes up because people have less money, hence they import less
 - v. Government spending obviously goes down since they just cut spending
 - b. As the economy recovers, interest rates will drop, which will bring down inflation, and eventually the inflation line will cross the AD curve at the original GDP.
 - i. The Income, or GDP, is the same as before the government cut spending
 - ii. Consumption goes up because the interest rate is now lower than it was before the government cut spending, people have less reason to save, so they consume more
 - iii. Investments go up due to the lower interest rates
 - iv. Net Exports go up since the low interest rates devalue USD, and makes it cheaper for foreigners to buy US goods, and more expensive for the US to buy foreign goods
 - c. However, after the economy returns to normal, the interest rates and inflation rates are still low, hence it would be easier for investors to borrow money than before the government cut spending
 - d. Hence, the growth of potential GDP after the recession had ended will increase
2. Suppose the government increases spending
 - a. Short run – AD curve shifts right, inflation doesn't change, G increases, Y increases, so C increases. I doesn't change since interest rates didn't change, and X goes down since people have more money to buy foreign goods
 - b. Long Run – Inflation and interest rise, GDP back at what it was before
 - i. However, now, the interest rate will be higher, hence C, I, and X will be lower than their pre boom levels. It makes sense too, as the GDP is the same, but government spending went up, so the other three must come down to compensate
3. **Disinflation** – a reduction in the inflation rate – the Fed can get this to happen by raising the interest rate
 - a. This causes either a temporary flowing of real GDP (small amounts) or a recession (large amounts)
4. **Deflation** – a decrease in the overall price level – a negative inflation rate – almost never happens in the US. This actually lowers prices, while disinflation slows down the growth of prices, but never lowers it.
5. Suppose the Fed changes monetary policy to reduce inflation – they sell bonds and raise the interest rate
 - a. AD curve shifts left, but inflation in the short run stays the same
 - b. In the long run, the inflation rate will fall and continue to fall until GDP is back where at where it was
 - c. When it gets to its new level, inflation is low, hence potential GDP can grow rapidly
 - d. Doing this requires a period of recession (when the curve shifts left), and people don't like that
6. **Reinflation** – an increase in the inflation rate caused by a change in monetary policy
 - a. Higher target inflation rate, interest rates drop, GDP rises
 - b. Not too good for long run growth, but politics make it happen sometimes
7. **Demand Shocks** – fancy name for shifting the AD curve
8. **Price (supply) Shock** – a change in the price of a key commodity such as oil, shifts the inflation adjustment line
9. **Real Business Cycle Theory** – shifts in potential GDP are a primary cause of fluctuations in real GDP
 - a. Usually caused by changes in technology

10. When the price of oil rises, the inflation adjustment line shifts up
 - a. If oil costs more, everything that depends on oil costs more, so that's inflation
 - b. **Short run** – GDP goes down, since the Fed raises interest rates to curb the high level of inflation
 - c. Long run – GDP will eventually get back to it's original point, and the high interest rates drive down inflation
 - d. No interest rate gain here because the aggregate demand did not shift. Only interest changed
 - e. If the price of oil somehow drops, then GDP would rise sine the IA line shifts down
11. **Stagflation** – high inflation and high unemployment at the same time
 - a. Normally, as demand rises, inflation rises, but unemployment falls. This is the case w/ demand shocks
 - b. W/ price shocks, the material costs change, so inflation rises but demand falls since people can't afford many products anymore, hence unemployment rises also