Macroeconomics Unit 5

- **Stagflation** will SHIFT the Phillips Curve to the right

Differentiating between the **Short Run Phillips Curve** and the **Long Run Phillips Curve**

Natural- Rate Hypothesis (p. 339)

- A series of supply shocks shift AS to the left

This result questions the inverse relationship of Unemployment & the Price Level (inflation)

One view is that the economy is stable at a natural rate of unemployment (also the FE of output)
(this is determined by the gov't.)

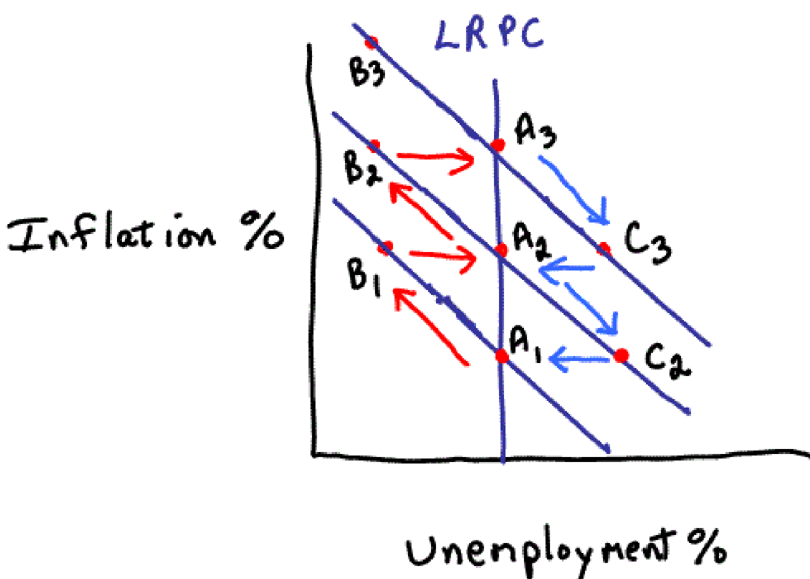
There are 2 Variations of the Natural Rate Hypothesis:

1. **Adaptive Expectations theory**

- People form expectations of future inflation based on previous & present rates & gradually change their expectations as experience unfolds
    - When actual rate of inflation is greater than expected, profits temporarily rise and the unemployment rate temporarily falls (p. 340-341)
- As nominal wages begin to rise, business profits will fall to earlier levels…..leading to a rise in unemployment levels

2. **Rational Expectations Theory**

- Businesses consumers, and workers understand how government policies will affect the economy and anticipate the impacts in their own decision making
- **The Policy Implication**………… is that Fiscal and Monetary Policy designed to push Unemployment below its natural rate will increase the rate of inflation.



Adaptive Expectations

- Ppl. gradually change their expectations as experience unfolds.

Rational Expectations

- Ppl. understand how gov't. policies will affect the economy & anticipate impacts in their own decision making