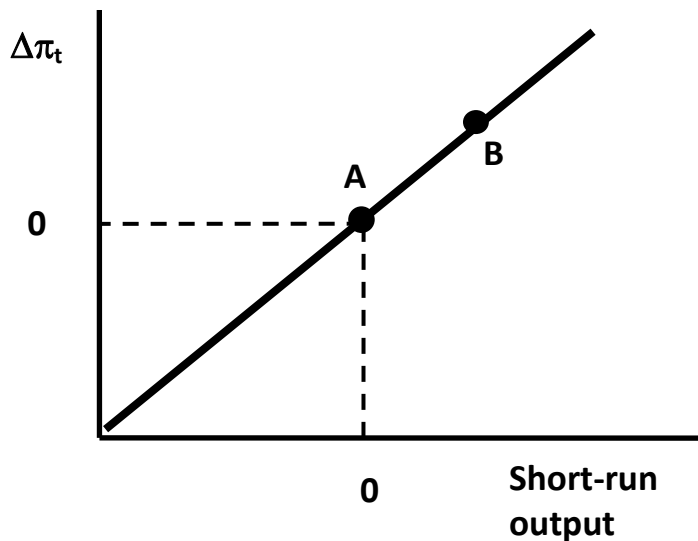


Econ 311
Professor Eschker
Phillips Curve

Suppose that people have adaptive expectations and that the Phillips Curve equation is:

$$\Delta\pi_t = 0.6\tilde{Y}_t + \bar{o}$$

1. Suppose that the economy's output is equal to its long run level of potential GDP with no aggregate demand shocks and no price shocks. Draw the Phillips Curve and indicate the point at which the economy is located.



Point A

2. Do we know the inflation rate?

No, we just know that it is constant from one year to the next in the long run.

3. Suppose that there is an aggregate demand shock in the form of an increase in \bar{a} that increases short run output by 2%. By how much does the inflation rate change?

$$\Delta\pi_t = 0.6(0.02) = 0.012$$

Inflation rate rises by 1.2%

4. Draw the new location of the economy along the Phillips Curve after this rise in aggregate demand.

See B above.

5. If the Fed did not want the inflation rate to rise, what would it have to do? Does the Fed's action lead to a movement along or a shift in the Phillips Curve?

The Fed would have to raise the real interest rate in order for short run output to fall back to zero. This is a movement along the Phillips Curve from point B back to A.