

The Adjustment Process

ECON 3133

Dr. Keen

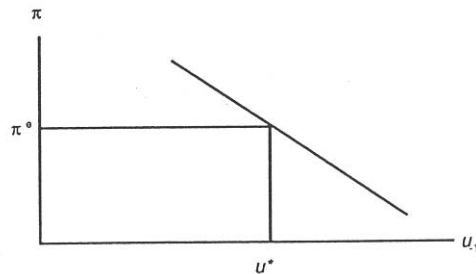
Answers

1. This period's inflation rate is a function only of last period's output and last period's inflation rate both of which are predetermined variables (as of this period).
2. When there is a decline in potential output, then output is above potential. Initially nothing happens. Then as prices start to rise, interest rates rise, while investment, consumption, and output fall. The effect on net exports is ambiguous. The economy may proceed directly to a new equilibrium, or it may overshoot equilibrium, depending on the behavior of expected inflation. In equilibrium, output is equal to the new lower level of potential, and consumption, investment, and net exports fall by the decline in output.

3.

- a. Substituting Okun's law, $\frac{(Y - Y^*)}{Y^*} = -2 \times (U - U^*)$, into the Phillips curve,

$$\pi = \pi^e + f \left[\frac{(Y_{-1} - Y^*)}{Y^*} \right], \text{ we get } \pi = \pi^e - f [2 \times (U_{-1} - U^*)].$$
 Inflation depends on last period's value of unemployment.

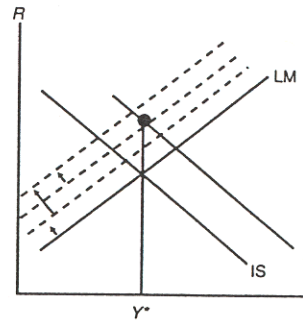
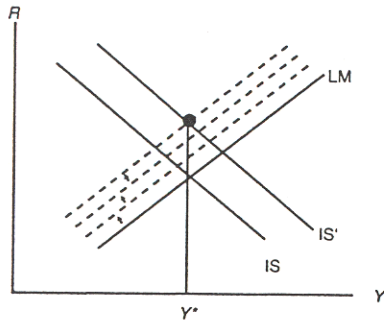


- b. A fall in potential output or a rise in the natural rate of unemployment would shift the curve outward.
- c. A shift in π^e would shift the curve outward.
- d. Inflation rose in the seventies due to expansionary fiscal policy during the end of the sixties and the oil price shocks. As inflation rose, expected inflation rose. This shifted the curve outward. Also, the changing nature of the labor (e.g., more younger workers who switch jobs more often) and of the available employment opportunities (some industries grew very fast while others shrank) has seemed to increase the natural rate of unemployment.

4.

a. During the adjustment process it is the LM curve that moves. As prices change, the real money supply changes. This shifts the LM curve.

b.



c.

