ANALYZE: DECREASE IN GOVERNMENT SPENDING

Assume that Econoland is currently in long-run equilibrium, where the unemployment rate is 5% and the inflation rate is 2%. Illustrate this in the AD/AS model, and also label this as point A on a short-run Phillips curve. Now suppose that the government decreases expenditures. BUILD YOUR GRAPH &

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ANALYZE: LOWER INFLATIONARY EXPECTATIONS

Assume that the unemployment rate increases to 6% and inflation decreases to 1%. Illustrate this in the AD/AS model, and also label this as point B in your Phillips curve model. Eventually, inflation expectations fall. Wages adjust downward, employment increases and unemployment returns to the natural rate. Illustrate this new equilibrium on your AS/AD. Now create a new short-run Phillips curve to reflect the new lower inflation expectations on your Phillips curve model. Connect these points of long-run equilibrium at the natural rate of unemployment from your two short-run Phillips curves. You have now created Econoland’s long-run Phillips curve.