

# Quiz 7

## Question 1

- a. Write down Okun's law.
- b. The following equation characterizes an economy's Phillips curve.

$$\pi = \pi_{-1} - .75(u - 4)$$

What is this economy's natural rate of unemployment?

- c. Suppose that inflation the previous period was 8 percent. Additionally cyclical unemployment is 4 percent. What is current inflation?

For part d, assume cyclical unemployment is zero.

- d. If this economy wants to reduce inflation by 6 percentage points, it will need to raise unemployment to 8 percentage points above the natural level. Using Okun's law, calculate the sacrifice ratio for this economy to cut inflation by 6 percentage points.

## Question 2

If the government increases spending, how does it affect inflationary expectations? Explain using an aggregate demand and aggregate supply graph. Properly label your curves.

## Question 3

What will happen to the actual rate of inflation if people expect a higher inflation rate in the future? What will happen to the actual rate of inflation if people expect a lower inflation rate in the future? Describe the differences, if any, between the rational expectations model and the adaptive expectations model.