Chapter 15 Expectations Theory and the Economy

1. When economists speak of the Phillips Curve today they generally refer to the relationship that exits between
   a. the inflation rate and the unemployment rate.
   b. bond prices and bond yields.
   c. bond yields and the perceived default risk of bonds.
   d. Real GDP and the unemployment rate

ANS:
   a. Correct.
   b. Incorrect. The Phillips curve depicts an inverse relationship between the inflation rate and the unemployment rate.
   c. Incorrect. The Phillips curve depicts an inverse relationship between the inflation rate and the unemployment rate.
   d. Incorrect. The Phillips curve depicts an inverse relationship between the inflation rate and the unemployment rate.

2. New classical theory incorporates the assumption that expectations are formed
   a. according to the adaptive expectations model.
   b. by trial and error.
   c. solely on the basis of what policy makers say they plan to do.
   d. rationally by taking into account all sorts of information, not just past events.

ANS:
   a. Incorrect. New classical theorists incorporate the rational expectations model in their theory.
   b. Incorrect. New classical theorists incorporate the rational expectations view of how expectations are formed.
   c. Incorrect. New classical theory uses the rational expectations model and policy-makers statements would be only one of many bases on which inflation expectations are formed.
   d. Correct.

3. In his 1967 address to the American Economic Association, Milton Friedman argued that in the long-run there is
   a. a highly inverse relationship between the inflation rate and the unemployment rate.
   b. no relationship between the inflation rate and the unemployment rate.
   c. a strong positive relationship between the inflation rate and the unemployment rate.
   d. none of the above

ANS:
   a. Incorrect. He argued that there is virtually no relationship in the long run between the inflation and unemployment rates.
   b. Correct.
   c. Incorrect. Friedman believed that there is virtually no relationship in the long run.
d. Incorrect. Friedman argued that there is virtually no relationship in the long run.

4. Assume that the natural rate of unemployment is approximately 5 percent and that the actual unemployment rate is also 5 percent. Suppose that Congress pursues an expansionary fiscal policy and that the Fed embarks on an expansionary monetary policy and as a result aggregate demand increases sharply. According to the natural rate theory the
   a. unemployment rate would fall to a lower permanent level.
   b. inflation rate would drop dramatically.
   c. inflation rate would increase and any decrease in the unemployment rate would be only short-lived.
   d. none of the above

ANS:
   a. Incorrect. According to this view, any reduction in the unemployment rate would only be temporary.
   b. Incorrect. According to this view, the inflation rate would increase and any decrease in the unemployment rate would be only short-lived.
   c. Correct.
   d. Incorrect. According to this view, the inflation rate would increase and any decrease in the unemployment rate would be short-lived.

5. Assume that the inflation rate was 3 percent last year. According to the adaptive expectations theory you are likely to anticipate the inflation rate for next year to be:
   a. About 3 percent.
   b. Much lower than in the past.
   c. Much higher than in the past, say 8 percent.
   d. None of the above.

ANS:
   a. Correct.
   b. Incorrect. According to this theory, we base our forecast on recent experience.
   c. Incorrect. According to this theory, we base our forecast on recent experience.
   d. Incorrect. Answer A is correct. According to this theory, we base our forecast on recent experience.

6. New classical economists assume which of the following about wages and prices?
   a. Complete flexibility.
   b. Complete rigidity.
   c. Prices are completely flexible, but wages are not.
   d. Wages are completely flexible, but prices are completely rigid.

ANS:
   a. Correct.
   b. Incorrect. New Classical join their classical forbearers in assuming complete wage and price flexibility.
c. Incorrect. New Classical join their classical forbearers in assuming complete wage and price flexibility.
d. Incorrect. New Classical join their classical forbearers in assuming complete wage and price flexibility.

7. What is the major assumption that separates the New Keynesian view of macroeconomics from the New Classical view?
   a. New Keynesian economists believe that both wages and prices are inflexible even in the long run.
   b. New Classical followers believe in rationally formed expectations whereas New Keynesians believe in the adaptive expectations model.
   c. New Keynesians do not believe that wages are flexible in the short-run, whereas New Classical followers think wages are flexible in the short-run.
   d. None of the above.

ANS:
   a. Incorrect. Where the two groups differ is with respect to wage flexibility. New Classical followers believe in complete wage flexibility even in the short-run; New Keynesians believe that wages are not flexible in the short-run.
   b. Incorrect. Both groups accept the rational expectations hypothesis. They differ, however, with respect to wage flexibility. New Classical economists believe wages are flexible in the short-run, New Keynesians do not.
   c. Correct.
   d. Incorrect. The correct answer is C.

8. What happens if wages and prices are flexible, people form their expectations rationally, and they anticipate policy incorrectly?
   a. Real GDP will remain unchanged in the short run.
   b. Real GDP can be increased or decreased in the short run.
   c. Real GDP will not exist in the short run.
   d. None of the above.

ANS:
   a. Incorrect. If wages and prices are both flexible, people form their expectations rationally, and they anticipate policy incorrectly, then Real GDP can be increased or decreased in the short run. If people anticipate policy correctly, then the policy ineffectiveness proposition could come into play.
   b. Correct.
   c. Incorrect. If wages and prices are both flexible, people form their expectations rationally, and they anticipate policy incorrectly, then Real GDP can be increased or decreased in the short run. If people anticipate policy correctly, then the policy ineffectiveness proposition could come into play.
   d. Incorrect. Answer B is correct.

9. Suppose that OPEC severely restricts the amount of petroleum shipped to the
United States, and as a result of this adverse supply shock, the LRAS curve shifts to the left. According to the real business cycle theorists, all of the following would occur except the
a. demand for labor falls and the unemployment level increases.
b. level of natural real GDP falls.
c. demand for business loans rises because interest rates fall.
d. money supply falls.

ANS:
a. Incorrect. They believe that this will be one result of the leftward shift of the LRAS.
b. Incorrect. They believe that this will be one result of the leftward shift of the LRAS.
c. Correct.
d. Incorrect. They believe that this will be one of the results of the leftward shift of the LRAS.

10. True or False? According to the so-called real business cycle theory, all changes in Real GDP and the unemployment rate can be traced to changes in events that affect the economy’s LRAS curve.
a. True.
b. False.

ANS:
a. Correct.
b. Incorrect. This school of thought believes that supply-shocks such as war, terrorism, changes in worker productivity, technological advances, etc. are the fundamental causes of changes in real economic variables such as real GDP and the unemployment rate.