

CONCEPT: SACRIFICE RATIO

- **Expectations** about inflation rates are a determinant of the position of the short-run Phillips Curve

☐ If expected inflation increases → Shift _____

☐ If expected inflation decreases → Shift _____

- The expected inflation in the economy has implications throughout:

☐ *Nominal Interest Rate vs. Real Interest Rate*

- If expected inflation increases, nominal interest rates will also increase to stabilize the real interest rate

Assume the real interest rate a bank wants to earn is 5% on a loan. If expected inflation is equal to 2%, then:

Now assume that expected inflation increases to 4%. To maintain the same *real interest rate* the bank would:

- If the Fed wishes to reduce the inflation rate, they must pursue _____ monetary policy

☐ Money Supply ____ → Interest Rates ____ → Aggregate Demand ____ → Price Level ____ and GDP ____

☐ **Sacrifice Ratio** – percentage of GDP lost in the process of lowering inflation by 1%

$$\text{Sacrifice Ratio} = \frac{\% \Delta \text{GDP}}{\% \Delta \text{Inflation}}$$

Sacrifice Ratio

1. Contractionary policy moves economy down the SR Phillips Curve

2. In the LR, expected inflation decreases, and SR Phillips Curve shifts left

