1. Long-term interest rates will fall. Theories of the term structure suggest that long-term interest rates are related to the expected average of future short-term interest rates. When the public expects the Central Bank to raise short-term interest rates permanently, they raise their expectations of future short-term rates and long rates are higher. Then, when the Central Bank does not go through with the expected policy of raising short-term rates, the public will realize that their expectations were mistaken and will revise their expectations of short-term rates downward. The result is that the Central Bank’s decision not to go through with the policy change causes long-term interest rates to fall.

3. In the new classical model, the Central Bank’s chairman plan might work if the public believes his announcement. When the public expects the 10 percent money growth rate the Central Bank does implement this change, suppose the aggregate demand and supply curves both move up by 10 percent per year and the price level increases at a 10 percent rate. When the public lowering its expectations of money growth, the aggregate supply curve does not move up the full 10 percent. Then when the aggregate demand curve is shifted up by the full 10 percent, the intersection of the aggregate demand and supply curves is at a higher level of output and a lower rate of increase of the price level than 10 percent. Thus, if the chairman is believed, his plan will help to lower inflation and unemployment. However, why should public believe the chairman if they suspect that he might renege on his promises? If he is not believed (a likely possibility, since the public will try to figure out if the chairman plans to mislead them), then his plan will not work. In the traditional model, the chairman’s announcement has no effect on the aggregate supply curve. Thus, the outcome of his policy will be the same, whether he tries to fool the public or not.

5. The similarity between monetarist and new classical view of the aggregate supply is that they both assume that wages and prices are set flexible and that expectations about policy affect the position of the aggregate supply curve. The monetarist view of the aggregate supply, however, does not make the strong assumption that wages and prices are completely flexible with regard to expected changes in the price level. As a result, some monetarist does not accept the policy ineffectiveness proposition.

7. The principle that the forecast errors of expectations cannot be predictable, which implies that unanticipated policy must be unpredictable. Since only unanticipated policy affects aggregate output in the new classical model, stabilization policy can have no predictable effect on the aggregate output.

9. True, if expectations about policy affect the wage and the price setting process. In models in which expectations about policy are relevant (such as the
new classical and new Keynesian model), Figure 6 shows that a credible anti-inflation policy reduces inflation faster and at a lower costs than anti-inflation policy that is not believed (and hence expected) by the public.

11. In this situation, the aggregate demand curve shifts to the left. But because this shift is expected, the aggregate supply curve shifts out, so there is no change in aggregate output. The intersection of the new aggregate demand and supply curves is at a lower price level but at the same level of aggregate output.

12. In the new Keynesian model and the tradition model, both the price level and aggregate output would fall. In the traditional model, the aggregate demand curve shifts to the left, but the aggregate supply curve is unaffected. The result is that both output and the price level fall. In the new Keynesian model, because the leftward shift in the aggregate demand is expected, the aggregate supply curve shifts out; however, it shifts out by less than in the new classical model, so aggregate output falls at the same time that price level falls.

15. The traditional model does not allow for substantial shifts in the aggregate supply curve because of new events, so it would predict no change in inflation or output. In both the new classical and new Keynesian models, the rise in expected inflation as a result of the election would shift the aggregate supply curve upward which would lead to a rise in inflation and a fall in output. However, in the new classical model, the shift in the aggregate supply curve would be greater so the rise in inflation and fall in output would be larger than in the new Keynesian model.