Chapter 34

1. If a country's central bank were to engage in activist stabilization policy, in which direction should it move the money supply in response to the following events?

a. A wave of optimism boosts business investment and household consumption.

Answer:
Decrease the money supply

b. To balance its budget, the government raises taxes and reduces expenditures.

Answer:
Increase the money supply

c. OPEC raises the price of crude oil.

Answer:
Increase the money supply

d. The taste for the country's products amongst the residents of other countries declines.

Answer:
Increase the money supply

e. The stock market falls.

Answer:
Increase the money supply

2. If a country's central bank were to engage in activist stabilization policy, in which direction should it move interest rates in response to the same events listed in the previous question?

a. A wave of optimism boosts business investment and household consumption.

Answer:
Increase interest rates

b. To balance its budget, the government raises taxes and reduces expenditures.

Answer:
Decrease interest rates

c. OPEC raises the price of crude oil.

Answer:
Decrease interest rates

d. The taste for the country's products amongst the residents of other countries declines.

Answer:
Decrease interest rates

e. The stock market falls.

Answer:
Decrease interest rates

f. Explain the relationship between central bank policy in terms of the money supply and policy in terms of the interest rate.

Answer:
In the short run, with prices sticky or fixed, an increase in the money supply implies a reduction in interest rates and a decrease in the money supply implies an increase in interest rates.

3. If policy makers were to use fiscal policy to actively stabilize the economy, in which direction should they move government spending and taxes?

a. A wave of pessimism reduces business investment and household consumption.

Answer:
Increase spending, decrease taxes

b. An increase in price expectations causes unions to demand higher wages.

Answer:
Increase spending, decrease taxes

c. The taste for the country's products amongst the residents of other countries declines.

Answer:
Decrease spending, increase taxes

d. OPEC raises the price of crude oil.

Answer:
Increase spending, decrease taxes

4. Suppose the economy is in a recession. Policy makers estimate that aggregate demand is €100 billion short of the amount necessary to generate the long-run natural rate of output. That is, if aggregate demand were shifted to the right by €100 billion, the economy would be in long-run equilibrium.

a. If the government chooses to use fiscal policy to stabilize the economy, by how much should they increase government spending if the marginal propensity to consume (MPC) is 0.75 and there is no crowding out?

Answer:
Multiplier = 1/(1 – 0.75) = 4; €100/4 = €25 billion.

b. If the government chooses to use fiscal policy to stabilize the economy, by how much should they increase government spending if the marginal propensity to consume (MPC) is 0.80 and there is no crowding out?

Answer:
Multiplier = 1/(1 – 0.80) = 5; €100/5 = €20 billion.

c. If there is crowding out, will the government need to spend more or less than the amounts you found in (a) and (b) above? Why?

Answer:
More, because as the government spends more, investors spend less so aggregate demand won't increase by as much as the multiplier suggests.

d. If investment is very sensitive to changes in the interest rate, is crowding out more of a problem or less of a problem? Why?

Answer:
More of a problem. Government spending raises interest rates. The more sensitive investment is to the interest rate, the more it is reduced or crowded out by government spending.

e. If policy makers discover that the lag for fiscal policy is two years, should that make them more likely to employ fiscal policy as a stabilization tool or more likely to allow the economy to adjust on its own? Why?

Answer:
More likely to allow the economy to adjust on its own because if the economy adjusts before the impact of the fiscal policy is felt, the fiscal policy will be destabilizing.

5. a. What does an increase in the money supply do to interest rates in the short run? Explain.

Answer:
It lowers interest rates because, in the short run, with prices sticky or fixed, money demand is unchanging. Thus, an increase in the money supply requires a decrease in interest rates to induce people to hold the additional money.

b. What does an increase in the money supply do to interest rates in the long run? Explain.

Answer:
It has no effect because, in the long run, the increase in spending causes a proportional increase in prices, output is fixed at the natural rate, money is neutral, and interest rates are determined by the supply and demand for loanable funds which have not changed.

c. Are these results inconsistent? Explain.

Answer:
No. Prices are likely to be sticky in the short run and flexible in the long run.