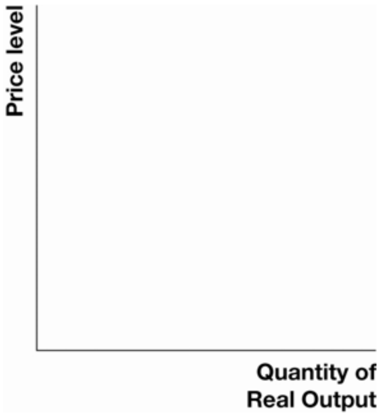
Chapter 37

1. Suppose a wave of pessimism engulfs consumers and firms, causing them to reduce their expenditures.

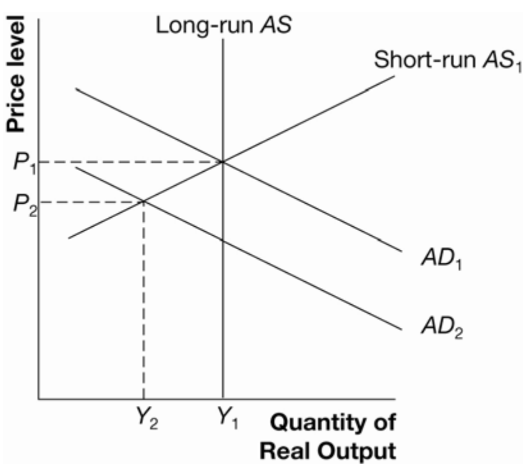
a. Demonstrate this event in Exhibit 1 using the model of aggregate demand and aggregate supply and assuming that the economy was originally in long-run equilibrium.

Exhibit 1



Answer:
See Exhibit 3.

Exhibit 3

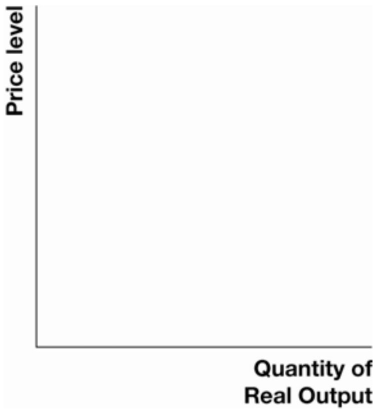


b. What is the appropriate activist policy response for monetary and fiscal policy? In which direction would the activist policy shift aggregate demand?

Answer:
Increase the money supply, increase government spending, decrease taxes. Shift aggregate demand to the right.

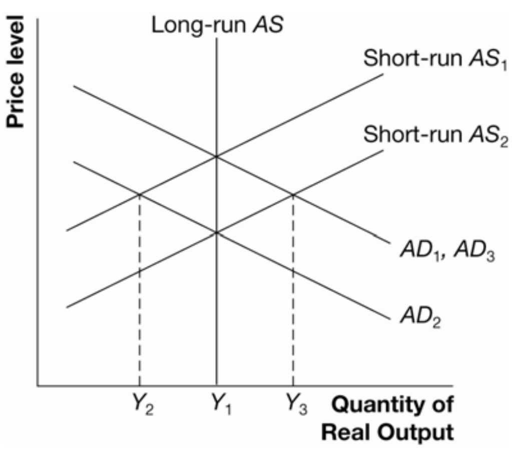
c. Suppose the economy can adjust on its own in two years from the recession described in part (a). Suppose policy makers choose to use fiscal policy to stabilize the economy but the political battle over taxes and spending takes more than two years. Demonstrate these events in Exhibit 2 using the model of aggregate demand and aggregate supply.

Exhibit 2



Answer:
See Exhibit 4.

Exhibit 4



d. Describe the sequence of events shown in the graph you created in part (c) above.

Answer:
Destabilize, because the economy had already adjusted back to the long-run natural rate so the increase in aggregate demand caused output to rise above the natural rate.

e. Did the activist fiscal policy stabilize or destabilize the economy? Explain.

Answer:
It destabilized the economy, because the economy had already adjusted back to the long-run natural rate so the increase in aggregate demand caused output to rise above the natural rate.

2. Suppose a country's central bank repeatedly announces that it desires price stability and that it is aiming for zero per cent inflation. However, it consistently generates 3 per cent inflation.

a. Will this type of behaviour on the part of the central bank reduce unemployment below the natural rate in the long run? Why?

Answer:
No. In the long run, people will grow to expect 3 per cent inflation and wages and prices will rise accordingly.

b. Once people have formed expectations of 3 per cent inflation, what would happen in the short-run if the central bank actually did target zero inflation?

Answer:
The economy would move down a short-run Phillips curve and inflation would fall while unemployment would rise above the natural rate.

c. Would it help if the country's government passed a law requiring the central bank to target zero inflation?

Answer:
Yes. The central bank's announcement of a zero inflation target would be more credible and the movement toward zero inflation would create a smaller increase in unemployment.