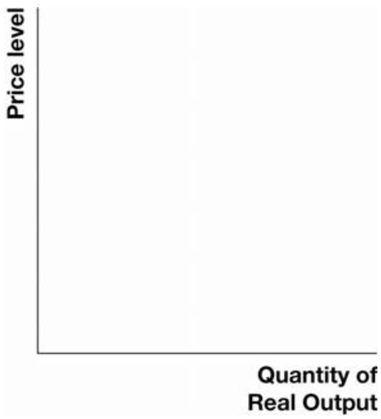
Chapter 39

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

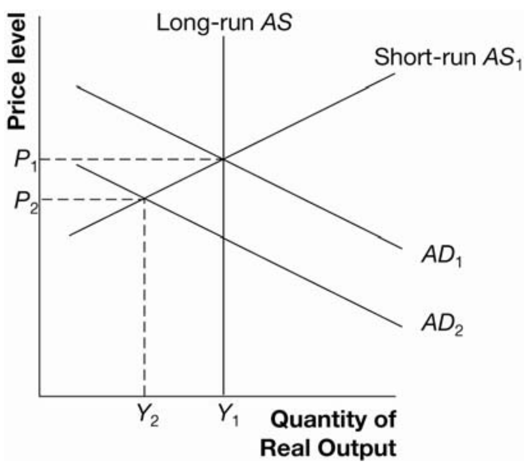
a. Demonstrate this event in Exhibit 1 using the model of aggregate demand and aggregate supply and assuming that the economy was originally in long-run equilibrium.

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.

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

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.

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.

3. Why is high quality information so important to the efficient working of markets?

Answer: Decisions of both buyers and sellers rely on high quality accurate information. If information is inaccurate or unreliable then risks assessed would also be inaccurate and decisions would be made based on incorrect information. Resources would not, as a result, be diverted to their most useful purpose and so the market would be inefficient, by definition.

4. Should economics base more of its assumptions on behavioural psychology rather than on rational behaviour?

Answer: In order to carry out any economic analysis some assumptions have to be made. What may be dangerous is relying on only one type of assumption which may be too far from reality and making economic policy on this type of assumption alone. Assumptions of rationality may have some relevance in certain situations but in others a behavioural approach may be more relevant. The future for economics is to find a way of rationalising our understanding of human behaviour and building these into models that will help better reflect the real world. This is one of the benefits of neuroeconomics, using advances in the understanding of how the brain works to help inform theory and the reasons for the behaviour of 'homoeconomicus'.

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