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.

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

c. OPEC raises the price of crude oil.

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

e. The stock market falls.

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.

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

c. OPEC raises the price of crude oil.

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

e. The stock market falls.

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

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.

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

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

d. OPEC raises the price of crude oil.

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?

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?

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?

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?

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?

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

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

c. Are these results inconsistent? Explain.