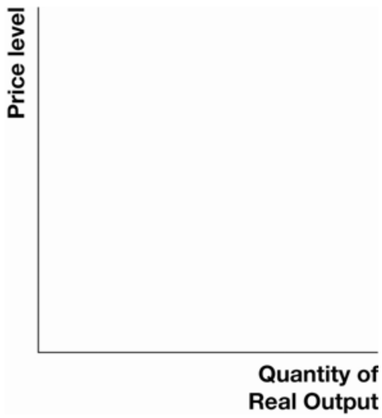
Chapter 39

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.

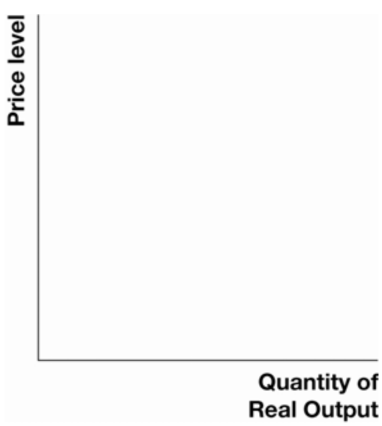
Exhibit 1



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

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



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

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

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?

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?

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