

100b  
Midterm #2 Review Questions  
Chapter 11  
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Question 1. In reaction to a growing debt, suppose the congress reduces government spending and raises taxes thereby generating a negative aggregate demand shock. Show what would happen to the IS curve. What monetary policy action would you expect the Fed to take and why?

Question 2. Explain the process by which central banks control nominal interest rates.

Question 3. What is wrong with the following student's response regarding an inflationary effect of an unexpected increase in oil prices on the output gap.

"Oil prices will cause inflation to rise and thus,  $\Delta\pi > 0$ . Furthermore, since the Phillips curve states that  $\Delta\pi = v\_bar * Gap$ ,  $\Delta\pi > 0$  translates into an increase in the output gap, which will raise actual output relative to potential and bring the economy into a boom."