

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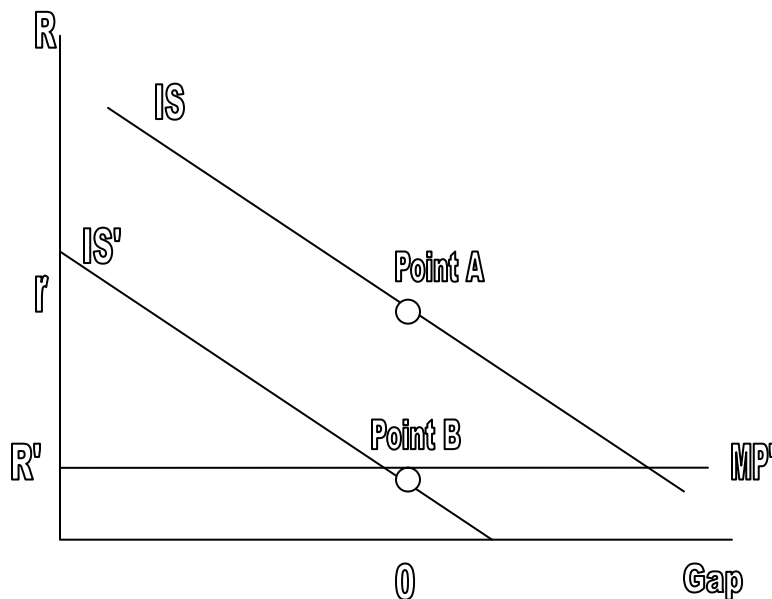
Question 1. In reaction to a growing debt, suppose the congress reduces government spending and raises taxes thereby generating a negative aggregate demand shock. Show what would happen to the IS curve. What monetary policy action would you expect the Fed to take and why?

Answer:

Aside: Although there is a strong case to be made for how contractionary fiscal policies may be lead to expansionary real effects (if interested, see for instance "Can severe fiscal contractions be expansionary? Tales of two small European countries" by Francesco Giavazzi at <http://www.nber.org/papers/W3372> or google "rubinomics,"), we will assume the conventional case whereby a decrease in government purchases and an increase in taxes lead to a negative aggregate demand shock.

The IS curve will shift down and we will have a negative output gap.

The Fed would then lower the nominal interest rate. Since the classical dichotomy will not hold in the short run, this reduction in the nominal interest rate leads to a reduction in the real interest rate and consequently, stimulates investment. If the real interest rate is reduced sufficiently enough, the central bank may be able to bring the output gap back up to zero.



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

Answer: Let's treat the case where the central bank wants to increase the nominal interest rate.

Through Open Market Operations, the central bank sells government bonds, and in effect, trades government securities in exchange for currency or

non-interest bearing reserves. This reduces the money supply. Nominal interest rates will rise so that the markets will accommodate these extra bonds

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."

Answer: The student mistakenly forgot to modify the Phillips curve to incorporate the oil price shock. When price shocks are involved, the new equation for the Phillips curve is $\Delta\pi = v_bar * Gap + o_bar$, where o_bar reflects the increase in inflation due to a price shock.