

Homework 5 - Economics 101

Chapter 13

Due 12-4-09 in class

- 1) Suppose that the president of Colombia wants to improve his chances for re-election by making the economy look strong: high GDP figures and low inflation. Suppose he has the central bank increase the money supply, hoping to make GDP statistics rise in the period prior to the election. He knows this can lead to higher inflation, but he hopes this policy will affect inflation statistics (CPI) mainly after the election is over.
 - a) Discuss the short-run and long-run implications of this monetary policy on output and the price level. Use the AS-AD graph where the short-run aggregate supply (SRAS) assumes that output is some positive function of price surprises.
 - b) How does the success of the president's strategy depend on how flat or steep the short-run aggregate supply curve is? Thinking of our stories of aggregated supply, what are two things that would make this curve steep?

- 2) Suppose that an economy has the following Phillips curve: $\pi = \pi^e - 2(u - u^n)$. Suppose the natural rate of unemployment is 5 percent (0.05), and that expectations about inflation are adaptive. Suppose the central bank targets inflation to be 2 percent (0.02) in the coming year.
 - a) If inflation over the past year has been 4 percent, what will total actual unemployment have to be in the coming year for the central bank to achieve its inflation target?
 - b) If the central bank plans to keep inflation at 2 percent again the following year, what must total actual unemployment be in that following year? Explain why your answer is different from part (a) above.

- 3) Short essay: Read the following opinion column by Nobel Prize winner Paul Krugman, which appeared in the New York Times November 2:

http://www.nytimes.com/2009/11/02/opinion/02krugman.html?_r=1

In a short essay of 200-300 words (one page) formulate an argument to either support or critique his main claim that the fiscal stimulus package should be continued longer and expanded. Please include a discussion of the tradeoffs between the benefits and costs of a fiscal stimulus; consider the long run as well as short run implications. According to our theories, can a fiscal stimulus be used indefinitely to reduce employment in the long run?