

Practice Problems: Economics 105

Chapters 13, 5, and 12

These problems are not to be handed in. A solution key will be posted on the web the last day of class.

Do not hand in - Do not hand in - Do not hand in - Do not hand in - Do not hand in

- 1) An election year is coming up and President Bush wants to raise his chances of re-election. Suppose he increases government spending, 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.
- Discuss the short-run and long-run implications of this fiscal policy on output, the price level and real interest rate. Use the IS-LM & AS-AD graphs, where the short-run aggregate supply assumes that output is some positive function of price surprises.
 - 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 three stories of aggregated supply, what are some things that determine the steepness of this curve?
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- 2) Suppose that an economy has the following Phillips curve: $p = p^e - 3(u - u^n)$. 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.
- If inflation over the past year has been 5 percent, what will total actual unemployment have to be in the coming year for the central bank to achieve its inflation target?
 - 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?
 - What is the sacrifice ratio (in terms of output). Use Okun's law, which states that a fall in unemployment by 1 percentage point tends to raise output by 2 percentage points.
 - What would be the sacrifice ratio here if expectations were completely rational instead of adaptive?
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- 3) During the 1980s the U.S. had a large government budget deficit due to recent tax cuts. It also had a large trade deficit at about the same time. Use the open-economy classical theory from chapter 5 and the associated graph to show how these two different types of deficits could be related to each other.
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- 4) Use the Mundell-Fleming model of chapter 12 to predict what would happen to aggregate income, the exchange rate, and the trade balance under both floating and fixed exchange rates in response to each of the following shocks:
- A fall in consumer confidence about the future induces consumers to spend less and save more.
 - The introduction of a stylish line of Toyotas makes some consumers prefer foreign cars over domestic cars.
 - The introduction of automatic teller machines reduces the demand for money.
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