Monetary Policy Theory
ECON 4673
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Problems

1. Suppose the current administration decides to decrease government expenditures as a means of cutting the existing budget deficit.

    a. Using an aggregate demand and aggregate supply graph, show the effects of such a decision on the economy in the short run. Describe the effects on inflation and output.

    b. What will be the effect on the real interest rate, the inflation rate, and the output level if the Federal Reserve decides to stabilize the economy?

2. Why do temporary negative supply shocks pose a dilemma for policymakers?

3. In what way is a permanent negative supply shock worse than a temporary negative supply shock?

4. Suppose three economies are hit with the same temporary negative supply shock. In country A, inflation initially rises and output falls; then inflation rises more and output increases. In country B, inflation initially rises and output falls; then both inflation and output fall. In country C, inflation initially rises and output falls; then inflation falls and output eventually increases. What type of stabilization approach did each country take?

5. Is stabilization policy more likely to be conducted through monetary policy or fiscal policy? Why?