Economics 104B, Section 1 – Spring, 2013
Prof. Steve Fazzari
Homework Problems: Part 6

Due In Class: Wednesday, April 17

1. For each part below draw a Phillips Curve diagram consistent with the situation described. Label the initial point A and the final point B. (Note that you *might* need to shift the Phillips Curve.) Briefly explain what causes *movements along or shifts* of the Phillips Curve.

   a) The Fed raises interest rates and unemployment increases.

   b) Unemployment is unchanged, but some major oil exporting countries raise crude oil production in an attempt to gain market share.

   c) A new person is appointed to lead the Fed who has a reputation for not worrying too much about inflation.

2. Some analysts worried that high energy prices caused by Hurricanes Katrina and Rita in 2005 would cause stagflation in the U.S. economy. Part of the concern was that high energy prices would increase spending on imported oil and reduce the amount that consumers spend on domestically produced products.

   a) Show the initial effects of this scenario in the Phillips Curve and Keynesian Cross diagrams; explain shifts or movements along the relevant curves.

   b) Suppose that the oil price increases stop after a period of time. What might cause the change of inflation caused by the hurricanes to be persistent nonetheless?

3. In the early 1980s, monetary policy was extremely restrictive and interest rates rose dramatically. The U.S. economy entered a deep recession with a large rise in unemployment from about 7 percent in 1980 to above 10 percent in 1982. Inflation fell significantly during the recession from about 10 percent in 1980 to 5 percent in 1982. In the middle 1980s, unemployment and output recovered due to looser monetary policy and massive tax cuts. Inflation continued to decline, however, to about 3 percent in 1986 while unemployment returned to about 7 percent. Answer the questions below about these events.

   a) Depict the events from 1980 to 1982 described using both a Keynesian Cross diagram and a Phillips Curve diagram. Use point “A” to label 1980 and point “B” to label 1982 on both diagrams. Explain what causes the changes in the diagrams.

   b) On the same diagrams used above for part a), label 1986 as point “C.” Explain what happened to the Phillips Curve between 1982 and 1986 in terms of inflation expectations and their effect on wage bargaining.

4. Some time ago, an article in the *St. Louis Post Dispatch* stated: "The Fed cares so much about inflation because when it starts spiraling it can be hard – and painful – to control." Answer the questions below about this statement.

a) What kind of open market operation will the Fed take if it wants to "control," that is, reduce, inflation? How does this action affect bank reserves and the federal funds interest rate?

b) Describe one "transmission mechanism" that causes this Fed policy to affect the broader economy and explain why this policy will reduce inflation." Be specific about each step in the process.

c) Use the theory discussed in class to explain why inflation, once it gets going, can be persistent.

d) Describe the most obvious event from U.S. economic history over the past 50 years during which the Fed pursued a policy specifically to reduce inflation. In what sense was this event "painful?"

5. Many monetary economists argue that the Fed should announce an explicit target for inflation. Evaluate this policy by answering the questions below.

a) Explain how such a policy "anchors" inflation expectations.

b) If the policy provides an effective inflation expectation anchor, describe how it would likely improve the performance of the economy after an unfavorable supply shock like a rise in energy prices.

c) Explain why an inflation target policy might have some costs for society.