Week 2 Homework: Macroeconomic Dynamics and Monetary Policy

ECO 301: Money and Banking

1. Suppose the economy is at the long-run equilibrium when the Federal Reserve takes actions to decrease interest rates in the economy. Describe and illustrate the short-run macroeconomic impacts on real GDP, price level, employment, and unemployment (remember to use sticky-wages for the short-run effect).

2. Suppose an economy is originally at the long run equilibrium when a drop in businesses' economic outlook leads to a decrease in investment spending.

   a) Describe and illustrate the impact the short-run macroeconomic impacts on real GDP, price level, employment, and unemployment.

   b) Suggest a change in interest rates that can remedy the effect of the recessionary shock that you illustrated in the previous question. Describe and illustrate the impact of your policy on real GDP, price level, employment, and unemployment. Start your market for aggregate goods and services in the situation from the previous answer (i.e. redraw the answer from the previous problem and then show the impact of your policy on these markets).

Stagflation Shock

3. Suppose the economy is originally at the long run equilibrium when an increase in global energy costs cause a widespread increase in the costs of production.

   a) Describe and illustrate the short-run macroeconomic impacts on real GDP, price level, employment, and unemployment (remember to use sticky-wages for the short-run effect).

   b) Suppose the Federal Reserve responds by decreasing interest rates. Describe and illustrate the impact of this policy on real GDP, price level, employment, and unemployment. Start your market for aggregate goods and services in the situation from the previous answer (i.e. redraw the answer from the previous problem). Does the recession get worse or better? Does this put upward or downward pressure on inflation?

   c) Suppose the Federal Reserve responds by increasing interest rates. Describe and illustrate the impact of this policy on real GDP, price level, employment, and unemployment. Start your market for aggregate goods and services in the situation from the previous answer (i.e. redraw the answer from part (a)). Does the recession get worse or better? Does this put upward or downward pressure on inflation?