

## SOLUTION TO QUIZ IV SHORT-ESSAY QUESTIONS

ECO 3223 – FALL 2005

The solution to the multiple-choice part of the quiz will be distributed in class.

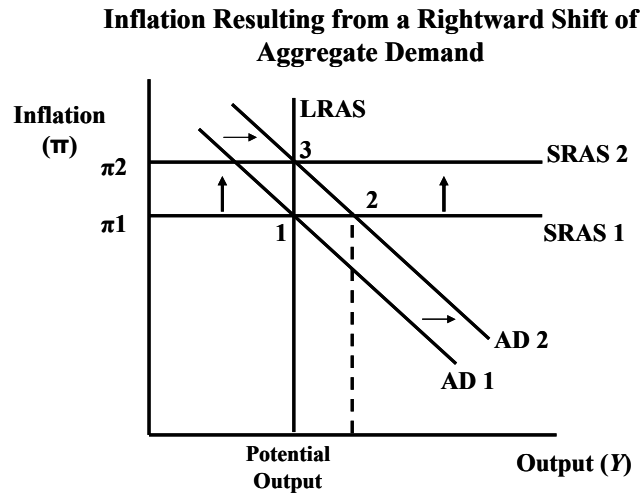
NAME: \_\_\_\_\_ Student ID: \_\_\_\_\_

### Short-Essay Questions (15 points)

#### Question I (10 points)

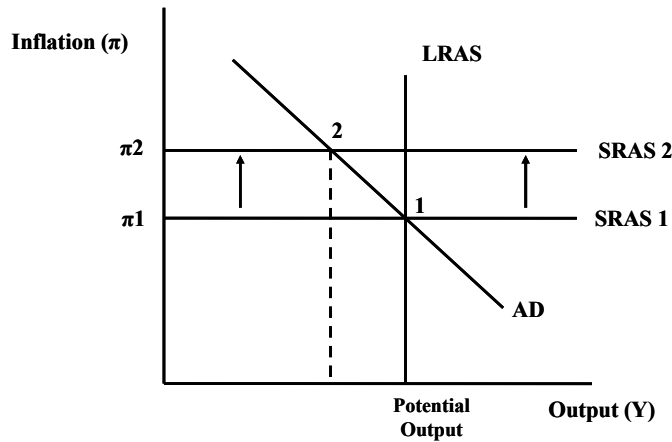
There are two possible sources of inflation: shifts in aggregate demand and inflation shocks. Describe each source in detail and illustrate how it influences inflation using the aggregate demand/aggregate supply diagram.

Answer:



Aggregate demand shifts from AD 1 to AD 2 and the economy moves from point 1 to point 2. Current output is above potential output and there is upward pressure on inflation. SRAS shifts up until it reaches point 3, where current output equals potential output. Inflation rises from  $\pi_1$  to  $\pi_2$ .

### Inflation Resulting from an Inflation Shock



An inflation shock shifts SRAS from SRAS 1 to SRAS 2. The economy moves from point 1 to point 2 and inflation rises from  $\pi_1$  to  $\pi_2$ . However, this creates a recessionary output gap, which puts downward pressure on inflation and will eventually cause SRAS 2 to shift downward all the way back to SRAS 1. The economy returns to point 1 and inflation falls back down to  $\pi_1$ .

#### Question II (5 points)

In the United States, inflation fell from 12 percent in 1980 to 4 percent in 1983. Describe the likely effect on the monetary policy reaction curve and the aggregate demand curve. What would you expect happened to output over the period? Can you find data to substantiate your answer?

Answer: Policymakers became more aggressive about targeting inflation; this increased the slope of the monetary policy reaction curve and the aggregate demand curve. In order to reduce inflation, the Fed had to raise interest rates, which reduced output growth. The data support this; during the 8 quarters of 1981 and 1982, average annual GDP growth was 0.26 percent.