Econ 102
Alan Deardorff
Quiz 3A - *Answers*
April 13, 2007

1. When 2007 began, the U.S. economy was in Long Run equilibrium. While studying for your Econ 102 final, you receive a call from Hillary Clinton. She tells you these 2 Short-Run facts about the U.S. economy so far in 2007:

i) An increase in unemployment, ii) An increase in the rate of inflation

Explain to Hillary (by saying YES or NO) whether the situations below would cause i) and ii) to occur in the Short Run. Use an appropriate AD-AS diagram and a Phillips curve to justify your YES or NO answer.

a. Ben Bernanke directed the Fed to **increase** its purchases of government bonds on the open market.
NO.
Increasing purchases of bonds would push down the interest rate, leading to an increase in AD (shift to the right). This increases output, increases the price level, and decreases unemployment. The decrease in unemployment and increase in inflation is a movement up and to the left on a short run Phillips curve.

b. Stories about both reduced production of oil in the Middle East and increasing world demand for oil are published in the Wall Street Journal.
YES
The stories tell people that the price of oil is expected to increase. This shifts the Short Run AS curve left. This increases prices, reduces output, and increases unemployment. As people adjust their expectation of inflation upward while unemployment increases, the short run Phillips curve shifts to the right. The economy moves to a point on the new Phillips curve with both higher inflation and higher unemployment then we started with.

2. Just after you get off the phone with Hillary, Jennifer Granholm calls. She tells you she plans to increase state government spending in Michigan by $500 million. Assume that everything we learned in Econ 102 applies to the economy of Michigan.

a. Assuming the Marginal Propensity to consume in Michigan is 0.80, use the spending multiplier to calculate by how much the demand for goods and services in Michigan will increase as a result of the new government spending.
Total demand increases by 500(1/0.2) = 2,500 million.*

b. As an expert on the effects of government policies, you advise Jennifer that the _______ ______ effect may cause the actual increase in demand to be (greater than, less than) the answer to part a. *Crowding out, less than*