Answers to practice quiz 6:
(Blackboard will net let me change to “display answers” while quiz is in use. . will keep trying)

MC 6-1 The misery index is calculated as the

- inflation rate plus the unemployment rate.

unemployment rate minus the Fed's target unemployment rate (6.5%).
actual inflation rate minus the Fed's target inflation rate (2%).
the natural unemployment rate plus the expected inflation rate as measured by TIPS.

Comment: Look at the answers, think about current Federal Reserve Policy (Bernanke to Yellen) and the Taylor rule.

MC 6-2 According to the Taylor rule, Central banks use monetary policy (set interest rates) in order to .

- Minimize the misery index over time, subject to their targets for inflation and unemployment.

reduce inflation to their target rate only, fiscal policy targets unemployment
protect investors in the bond market against unexpected inflation.
Minimize the tradeoff between output and inflation (the so called "sacrifice ratio" on p 503)

MA 6-3 Inflation is not theft (in the legal sense) because (recall Lydia's question for PK-- this is a MA or LATA question)

- *Investors can use TIPS for example, to protect themselves against inflation.*
- *Standard treasury Bills are not guaranteed against unexpected inflation, which may be lower or higher than expected.*
- *Fiat currencies are nominal assets, gold is a good inflation hedge, Euro or dollar notes rise in value with deflation and are widely accepted mediums of exchange.*
- *It is understood that Central Banks have an obligation to protect bond holders against inflation*

MC 6-4 One determinant of LRAS and the natural rate of unemployment (Chaper 15) is

- *the prevailing minimum wage rate*

the Expected inflation rate
the nominal interest rate set by the monetary authorities
All of these answers are correct

6-4 explanation and hint: only real variables affect LRAS, but all else equal, raising the minimum wage raises real wages, reduces profits (a little) and reduces LRAS. Economists see a tradeoff between wages and employment (See Christine Romer Op Ed posted on calendar) With efficiency wages employers choose to pay workers more so they work harder and fear being laid off (it is not easy to find a high wage job). A higher minimum wage can also increase real wages, but it also reduces the cost of being fired, so productivity may not go up. Firms response to higher minimum wages may be to replace workers with machines (ATMs, self-serve soda machines, self checkout, etc.). Either way higher wages tend reduce employment and raise productivity which is a good thing unless you are looking for an entry level or part time "low wage' job. There a "new economics of the minimum wage" literature due to Alan Krueger and David Card who find minimal or even positive employment impacts of higher minimum wages (in New Jersey for example) but labor substituting tecnologies and lower cost computers make many low wage workers vulnerable to being replaced with machines over the longer term (the ATM is a good example). Krugman, Robert Reich ("inequality for all") stress the importance of a larger middle class for increasing consumer demand, but higher wages may reduce opportunity and mobility for lower skilled and younger workers, even as it expands the middle class.

MC 6-5 The short-run relationship between inflation and unemployment is often called

✔ *the Phillips curve*

the sacrifice ratio

the misery index

none of these answers is correct

MC 6-6 As the AD curve shifts right along the SRAS (short-run aggregate supply curve)

✔ *inflation increases and unemployment falls*

inflation and unemployment rise

inflation and unemployment fall

unemployment rises and inflation falls

Feedback Note that you are tracing out a Phillips curve, if the LRAS holds in the L-R, what shape is the Phillips curve (assuming unemployment is on the X axis)

6.7 In 2009 Congress and President Obama approved tax cuts and increased government spending. As predicted by the short-run Phillips curve these policies should have and did (by 2010-2011)

✔ reduced unemployment and raised inflation

raised unemployment and inflation (unemployment lower, inflation higher than in 2009)

had no effect on inflation and unemployment in the long run (5 years later)

Raised inflation but did not reduce unemployment (as of 2013 unemployment is lower)

MC 6.8 If efficiency wages become the norm and/or the average national minimum wage increases,

✅ the long-run Phillips curve would shift rightward, and the LRAS curve would shift left.

(no) both the long-run Phillips curve and the long-run aggregate supply curve would shift right.
(no) the long-run Phillips curve would shift left, and the LRAS supply curve would shift right.
(no) the Phillips curve and the SRAS would shift to the left

Feedback: What happens to the Phillips curve when wages become less flexible? If wages are fixed in nominal terms (minimum wages) then inflation becomes more helpful in reducing wages (the Phillips curve gets flatter) if efficiency wages fix real wages, then inflation becomes less effective in reducing unemployment (the Phillips curve gets steeper). In Greece and Spain unemployment reached very high levels before prices and wages started to fall (too much "sacrifice"). Minimum wages and efficiency wages are part of the problem, but the flat Phillips curve (high sacrifice ratio) is a bit of a mystery....

MC 6-9 An event that directly and dramatically raises firms' costs of production is called

✅ A supply shock

A demand shock (not correct firms costs shift the supply at any given price, the demand curve stays the same)

A cost of living adjustment (COLA)

Inflation indexation (as with Social security payments)

MA 6-10 Suppose there a favorable supply shock, natural gas prices the cost of computers fall, then

✅ the SRAS shifts to the right and the Phillips curve shifts to the left
✅ At any given level of output or unemployment, there will be downward pressure prices and wages will
✅ If favorable supply shocks persist, there could be deflation which would affect HH spending and saving decisions,
the LRAS will shift to left and the Phillips curve will shift to the right...
