ECON 1150 Money and Inflation Review Questions Fall 2013



Figure 2 from page 352 Chapter 17.

LDQ 17-1. Money supply and prices: (a) What does the vertical supply curve in Figures 1 & 2 (on page 351-25 and above) above suggest about the Federal Reserve’s control of the money supply? (b) If banks can create money, how can the Federal Reserve control the money supply so completely? Hint: new York Federal Reserve branch. (c) Discuss the difference between M1 and M2 (page 329). Is M2 always greater than M1? (d) How has electronic banking and the internet made M2 more like M1 (hint: Apps)? Credit cards not money but they can increase the \_\_\_\_\_\_\_\_\_ of money by allowing us to carry less cash, which is also safer (p. 328). Debit cards also allow us to hold less cash, but not less money. Explain. *Credit would be especially helpful for people who live from pay check to pay check, but they have a hard time getting credit (in fact, those that have credit are generally the ones who don’t need it, why?)*

LDQ 17-2 (a) Almost by definition, inflation reduces the purchasing power of \_\_\_\_\_\_\_ but not \_\_\_\_ even though people blame inflation for lowering their purchasing power. What basic principle is at work here? (hint: the Fisher effect is an example, also see page 361). (b) Suppose, however, there is zero percent floor on interest rates or wages are fixed by contracts, or you run a business which requires you to hold a lot of cash (a food stand for example). What does inflation do in each of these cases? (c) As Mankiw points out on page 361, inflation is a “tax on the holders of money.” When it useful to have a tax on money (or negative real interest rates)? How can people (even you or I) avoid this tax?

LDQ 17-3 Clearly high inflation and hyperinflation is costly and destabilizing. Right now inflation is a low 1.5% (September) and has been falling since mid-2011 (see Figure BLS-1 below, which shows core and actual inflation) inflation was actually even lower in September (see October 30, 2013 Reuters story below). (a) What is the difference between core and “headline” inflation? Which does the Fed watch, mainly? (b) Why do some economists think higher inflation might be a good thing right now? (Fed Chair Ben Bernanke unofficial, official target is 2%, Ken Rogoff things 4% would be even better). Create a Table (or answer) with three columns, give the pro and cons of 0% inflation (Milton Friedman) 2% inflation (Chairman Ben) and 4%+ inflation (Ken Rogoff, Abe and Helicopter Ben). What would be your choice next year? Why? *(d) After the BLS inflation report today, Fed failed to taper, again, holding their monthly asset purchases at $85 billion a month. Why was this result expected? (e) A few years ago BLS staff were caught calling people on Wall Street from the restroom on release days, what BLS information is valuable to traders? What happens to bond prices if we get an inflation or GDP surprise? How does this validate the Fisher effect, to some extent? (don’t worry, BLS staff are no longer allowed to go to the rest room alone on release day). What does this episode tell us about the efficient markets hypothesis?*

**QFR 17-4** (Mankiw p. 37) In what sense is inflation like a tax? How does thinking about inflation as a tax help explain hyperinflation? (b) During wars inflation may be very high, why? One of the things inflation does is raise interest rates which may lead to “crowding out” of private investment. Why is this the point from the point of view of the government?

**Problems & Applications P&A 17-1**: (copied fromMankiw, page 370)

**P&A 17-1** Suppose that this year’s money supply is $500 billion, nominal GDP is $10 trillion, and real GDP is $5 trillion. a. What is the price level? What is the velocity of money?

b. Suppose that velocity is constant and the economy’s output of goods and services rises by 5 percent each year. What will happen to nominal GDP and the price level next year if the Fed keeps the money supply constant?

c. What money supply should the Fed set next year if it wants to keep the price level stable?

d. What money supply should the Fed set next year if it wants inflation of 10 percent?

**Excerpts of a quick summary of today’s inflation report (**lots of people get paid to write these sorts of short news stories, they have to do it very quickly to beat their competitors to the internet…perhaps they have to story preformatted and then just update the numbers…)

Below is a quote from a CPI release story, Reuters if I recall,

<http://news.yahoo.com/u-private-sector-adds-130-000-jobs-october-122236098--business.html>

*In a separate report, the Labor Department said its Consumer Price Index increased 0.2 percent last month as energy prices rebounded, after edging up 0.1 percent in August.*

*In the 12 months through September, the CPI increased 1.2 percent, the smallest gain since April. It had advanced 1.5 percent in August. Economists polled by Reuters had expected consumer prices to rise 0.2 percent last month and increase 1.2 percent from a year ago. U.S. Treasury debt prices held gains after the data.*

*FED SEEN ON HOLD*

*The weak labor market picture and benign inflation environment should allow the Fed to stay the course on its monthly bond purchases as it tries to stimulate the economy through low interest rates.*

*The Fed targets 2 percent inflation, although it tracks a gauge that tends to run a bit below the CPI.*

*Officials from the central bank are expected to keep their monthly $85 billion bond purchasing program in place when they conclude a two-day meeting later on Wednesday.*

***Stripping*** *out the volatile energy and food components, the so-called core CPI nudged up 0.1 percent, rising by the same margin for a second consecutive month.*

*That took the increase over the past 12 months to 1.7 percent after rising 1.8 percent in August. This measure touched a two-year low of 1.6 percent in June and the slowdown last month could catch the attention of some Fed officials who are concerned about inflation being too low.*

*Last month, inflation was lifted by a 0.8 percent rise in energy, which accounted for about half of the rise in the CPI. Energy prices had dropped 0.3 percent in August. Food prices were flat in September. That was the weakest reading since May.*

*Within the core CPI, housing and medical care costs advanced, maintaining a recent trend. Owners' equivalent rent of primary residence rose 0.2 percent after rising 0.3 percent in August.*

<http://news.yahoo.com/u-private-sector-adds-130-000-jobs-october-122236098--business.html>

**Figure BLS-1**



Open Economy questions

LDQ 18-1 Apple recently overtook \_\_\_\_ as the most valuable brand in the World, according to [interbrand](http://www.bloomberg.com/news/2013-09-30/apple-overtakes-coca-cola-as-most-valuable-brand-study-finds.html) as reported by [Bloomberg.](http://www.bloomberg.com/news/2013-09-30/apple-overtakes-coca-cola-as-most-valuable-brand-study-finds.html) Before Iphones, there were iPods, both very profitable for Apple. Is the Iphone more profitable that the Iphone

Take a look at the Big Mac Index,