Additional Media Exercises

(Answers to even-numbered questions are provided at the end of this file.)

1. **Alan Blinder, the Fed's newish vice-chairman, insisted that central banks could use interest rates to reduce unemployment, at least for a few years. "Sell dollars" said a former European finance minister, summing up many economists' feelings.**

   a. Explain how the Fed could use interest rates to reduce unemployment.

   b. Under what circumstances would this practice be appropriate, and under what circumstances would it not be appropriate?

   c. Why might the reaction of many economists be to "sell dollars"?

   d. If this policy were undertaken appropriately, following your answer to part b, would the policy's effectiveness be enhanced or curtailed by the "sell dollars" reaction of part c?

2. **Consumer prices rose just 0.1 percent in July from June. While the increase from a year earlier is 2.8 percent, inflation in the last three months is a mere 0.8 percent annualized. As a result, the long bond plunged to a new low of 5.63 percent from 6.33 percent a week earlier.**

   Explain why the long bond plunged.

3. **The reason for Clinton's caution is obvious: the bond market sent him a signal a month ago that big spending is just not acceptable. In anticipation of Clinton's victory, coupled with talk from the Clinton camp about fresh spending, the selloff of treasury bonds boosted long-term interest rates to about 7.7 percent from 7.3 percent.**

   Explain why interest rates rose.

4. **Analysts are wondering if Canadian yields can fall while U.S. yields are rising.**

   Can they? If so, how? If not, why not?

5. **The two-year-old recession appears to have deepened in the past two months, paving the way for steep cuts in interest rates and a steady depreciation of the dollar in coming months, economists say.**

   Explain the logic behind this prediction.

6. **Bonds were at the mercy of the dollar this week as a midweek currency slump sent . . .**

   Complete this clipping, and explain your reasoning.

7. **That is why the jump in May's unemployment rate—from 7.2 percent to 7.5 percent, the highest during this business cycle—caused dismay. Yet this may be missing the point. The number of people in the labor force in the month of May jumped by 330,000.**

Of what relevance is the jump in the labor force?

8. **Monetary policy, by winning on inflation, is about to confer to the federal government an enormous fiscal dividend.**

   Explain what is meant here.

9. **Democratic presidential nominee Bill Clinton yesterday won the endorsement of nearly 600 economists who said they like his plan to revitalize the economy through government spending and tax breaks for business investment.**

   Explain how this policy would work to revitalize the economy.

10. **She said that there is no evidence we are suffering from either high inventory stocks or a sharp inflationary spike, the two factors that typically cause a major recession.**

    Explain how these two factors could cause a recession.

11. **Economists claim that a strong dollar is a result of the Fed's pitched battle against inflation.**

    Explain the logic of this claim.

12. **One way to alleviate inflationary pressure is to engineer an upward valuation of your currency against that of your major trading partners. A higher dollar means that imports are cheaper and prices should move lower.**

    How would a rise in the dollar be engineered? Is this compatible with a move to a lower inflation rate?

13. **Nevertheless the finance minister has taken a preemptive strike in recent weeks against any pressure on his currency by cutting government spending to slow domestic consumption. That should reduce the trade deficit, but will also slow the economy.**

    a. How will cutting government spending slow domestic consumption?

    b. How will these spending cuts reduce the trade deficit?

14. **The dilemma facing the Fed is whether to cut the discount rate charged to commercial banks—now at 3 percent—to rejuvenate the stalled economy and risk undermining an already weak dollar.**

    a. How would cutting the discount rate rejuvenate the economy?

    b. How would it undermine the dollar?

    c. Would undermining the dollar be good or bad for the economy now?

15. **Economists who a week ago were talking about economic sluggishness now fear a strong recovery that, coupled with an expansive fiscal package, will strengthen the dollar, hurt T-bills, and drive market yields .**

    a. Why should the dollar be strengthened?

    b. Why will T-bills be hurt?

c. Fill in the blank and explain your reasoning.

16. But she warns that any major attempt to reduce rates for the sole purpose of cutting the federal government's huge interest payments on the public debt would likely backfire and drive rates higher.

Explain what logic might lie behind the "backfire and drive rates higher" statement.

17. Economists and important figures in the U.S. government have been debating whether it is government spending deficits, restrictive monetary policy, capital inflows, or anticipated inflation that is the real culprit for interest-rate increases in the U.S.

a. Which of these four possible reasons could definitely not have caused high interest rates? Why?

b. Explain how the other three could have led to higher interest rates.

18. U.S. money supply in the October-to-March period grew at a 10 percent annual rate, compared with growth of less than 1 percent between June and October last year. This behavior tends to weaken the U.S. dollar, as it becomes progressively less profitable to invest in U.S. dollar-denominated, short-term investments.

a. Why does it become less profitable to invest in U.S. bonds?

b. Why should this effect weaken the U.S. dollar?

19. The central bank isn't ready to lay down its main weapon—high interest rates—in the fight against inflation despite signs that prices have stabilized and that exporters are being hurt by this policy.

a. How are high interest rates a weapon in the fight against inflation?

b. Why are exporters hurt by this policy?

20. Our trade account has remained in a deep deficit even though the dollar has fallen sharply over the past four years, a development that normally would have led to an improvement in trade figures. Now economists and others say that only a cut in our growth rate will bring the trade deficit down.

a. Why would a fall in the dollar normally lead to an improvement in the trade deficit?

b. What might be happening to prevent this from happening?

c. How would a cut in our growth rate influence the trade deficit?

21. The central bank can defend the long-term external value of our currency only by defending its internal value.

Explain the rationale behind this statement.

22. There is no historical evidence of countries finding enduring prosperity in a strategy of currency devaluation: We cannot devalue our way to the kind of competitive, high-performance economy we want.

What logic lies behind this view?

23. **Helping to spark yesterday's bond rally was a major drop in oil prices.**

    Explain what oil prices have to do with bond rallies.

24. **Most economists say that one crucial way to lift savings and investment would be to slash the federal budget deficit.**

    Explain how slashing the deficit would lift national savings and investment.

25. **The drop in sales provided a boost to the credit market where many analysts believe a slowing economy would relieve upward pressure on interest rates.**

    How would you explain why a slowing economy would lower interest rates?

26. **She noted that estimates of multipliers tend to reach a peak after 2 or 3 years and decline thereafter, sometimes being negative.**

    Why might this be the case?

27. **Comments by Alan Greenspan, chairman of the Federal Reserve Board, have intensified speculation that inflation will remain subdued and prompted some investment managers to predict even further declines in ________ . Prices of some actively traded 30-year Treasury bonds wound up the day with _______ of about three-quarters of a point, or about $7.50 per $1,000 face amount.**

    Fill in the blanks.

28. **The French economy took a nosedive after the Socialist government was elected in 1981. In reaction, Mr. Mitterrand's government shortened the workweek, raised the minimum wage, and increased various social benefits, whereupon unemployment actually increased further.**

    How would economists refer to this extra unemployment?

29. **He pays particular attention to the "yield curve"—the spread between long-term and short-term interest rates. Many economists believe that rising long-term rates signal financial-market expectations that . . .**

    Complete this clipping.

30. **Greenspan stated that what we have seen in the past is that the willingness of foreigners to hold dollars is closely related to their sense of soundness of our economic policies.**

    Just what would be meant by "soundness" in this context, and why?

31. **So it will be impossible for monetary authorities to get long-term interest rates down unless they can convince lenders they can hold down the rate of inflation.**

    Explain the logic of this comment.

32. **Bond prices sank on news that the unemployment rate fell to its lowest point in January in a year, to 7.1 percent, but then strengthened after the numbers**

proved too good to be true. On closer examination, most of the decline was caused by reductions in the labor force.

a. Why would bond prices sink on news of lower unemployment?

b. How are reductions in the labor force relevant here?

c. What name do economists often give such reductions?

33. Fed chairman Alan Greenspan worries that new Treasury borrowings could cause some crowding out and keep long rates _______ and economic growth _________ than normal.

a. Why would new Treasury borrowings cause crowding out?

b. Fill in the blanks.

34. The recent surge in the money supply must be contained, and in very short order, if the hope for a viable long-term bond market is to be sustained.

What has the money-supply surge got to do with the viability of the long-term bond market?

35. Many countries, such as the United States, do not include mortgage rates in their CPI measure, but for those countries which do, such as New Zealand, monetary authorities must focus on the underlying inflation rate, not the "headline" rate.

How would the inclusion of mortgage rates in the CPI measure complicate monetary policy?

36. Another criticism of defense spending is that it promotes inflation by adding to total demand in the economy without increasing the supply of new goods available to meet it, because a soldier spends his pay on things he has not helped produce and the munitions worker does not go out and buy a tank.

Comment on this argument.

37. The evidence has been available for some time that real multipliers have fallen and may now be below one. This means that government deficits are no longer stimulative: an increased deficit of $1 billion will yield less than a $1-billion increase in real output and will accelerate inflation.

a. What is the difference between a regular multiplier and a "real" multiplier?

b. Which would you expect to be larger? Why?

c. What does a multiplier less than one mean? Does this mean that the policy is not stimulative, as the clipping states? Explain why or why not.

d. Is the acceleration mentioned at the end of the clipping a long-run or short-run phenomenon? Explain why.

38. Higher rates of interest must boost the cost of all sorts of things for businessmen, whether they need loans to finance inventories or because the nature of their business entails time lags between delivering the goods and getting paid. How can higher interest rates be anti-inflationary?

How would you answer this question?

39. **The Fed based its monetary policy in the 1980s on the assumption that velocity would continue its upward trend. Had they assumed a constant velocity, inflation would have been ________ than what we actually experienced.**

    Fill in the blank and explain your reasoning.

40. **Indexing of personal income taxes was intended to take inflationary gains out of tax revenues. It was also intended to be a discipline on governments.**

    Explain how indexing was supposed to act as a discipline on governments.

41. **A $10 billion tax cut to ease the bite of inflation was urged yesterday by the Democratic majority of the Congressional Joint Economic Committee. Sen. William Proxmire, D-Wis., the committee's vice chairman, said in a separate statement that he thinks austerity, not stimulation, is the correct economic prescription.**

    With which opinion do you agree? Why?

42. **Inflation results when the quantity of money and credit is increased, on a sustained basis, at a rate that is . . .**

    Complete this statement.

43. **But don't expect any easing of interest rates yet, said analysts, who added that rates will probably remain at their current levels or possibly rise somewhat until there is clear evidence of an easing of inflation.**

    Why would clear evidence of an easing of inflation lead to a fall in interest rates?

44. **As someone who has been a proponent of low inflation, I am often asked how I can support a policy that seems to penalize those, like seniors, who live off the interest from their savings. Low inflation means lower interest rates, the argument goes, so seniors lucky enough to have savings have to live on less. The person posing the question often illustrates it with the plight of a parent, uncle, or aunt now forced to draw on capital to make ends meet.**

    a. Does low inflation mean lower interest rates? Why or why not?

    b. How would you respond to this criticism?

45. **Not only were both sets of headline data stronger than analysts had expected, but the "core" measures of producer and consumer price inflation, which exclude the volatile food and energy components, were also above Wall Street's estimates. The figures sparked heavy selling in the bond market, where the 30-year bond yield jumped from 6.81 percent to 6.97 percent in just two days.**

    a. Explain why these figures sparked bond selling.

    b. Is the yield jump consistent with this selling? Explain why or why not.

46. **There aren't a lot of disadvantages to low inflation, but there is one. High inflation reduces the value of debts, making them easier to pay off.**

    Evaluate this advantage of high inflation.

47. **The Bank of Canada began easing monetary conditions during the summer of 1990 in response to the recession and the resulting substantial reduction in inflationary pressures. The prime rate fell from 14.7 percent to 9.5 percent currently. While the U.S. Federal Reserve was also easing, the pace of easing in Canada exceeded that in the United States, resulting in a 300 basis point narrowing in the Canada-U.S. short-term interest rate spread. Surprisingly, this did not result in a decline in the value of the Canadian dollar; in fact, it strengthened.**

    a. Why might one normally expect a fall in the Canadian dollar when the interest rate spread narrows by three percentage points?

    b. Explain why this did not happen in this case.

48. **Lawson, the British Chancellor of the Exchequer, made the logical mistake of trying to track the deutschemark without also tracking German monetary policy. The British money supply was allowed to increase three times as fast as the German money supply. That difference doomed the policy of aligning the pound to the deutschemark.**

    Explain the logic of this observation.

49. **Because Canadian inflation will continue to accelerate while inflation in the U.S. starts to decline, the Canadian dollar will probably come under pressure this year. This will force the Bank of Canada to keep interest rates up, and with inflation accelerating you have to be very careful about bonds.**

    a. What kind of pressure will the Canadian dollar experience? Explain why.

    b. Would it be appropriate for the Bank of Canada to raise the Canadian interest rate? Explain why or why not.

    c. Why does one have to be careful about bonds, as suggested at the end of this clipping?

50. **What would happen, for example, if Canada adopted a deliberate policy of budget deficit reduction and lowering interest rates? Listen to the market through the voice of Richard Kapsche, a futures floor manager at Chicago's International Monetary Market: We would read that as an inflationary policy and start selling off Canadian dollars.**

    a. Would this policy be inflationary? Why or why not?

    b. Why would the market start selling Canadian dollars if it thought Canada was adopting an inflationary policy?

51. **While reiterating there is no target for the Canadian dollar, Bank of Canada governor John Crow said demands for it to be devalued to help the trade sector amounted to asking the bank "to print more money." A devaluation seen as deliberate and inflationary would probably force up interest rates, he said.**

a. How would a devalued dollar help the trade sector?

b. Under what circumstance would it not help the trade sector?

c. Why would devaluation involve printing more money?

d. What is the main drawback of printing more money?

e. Why would interest rates be forced up?

52. Winning the battle but losing the war? That seems to be the situation of the central bank in its fifth year of trying to apply the monetarist prescription to defeat inflation by squeezing the money supply.

a. What exactly is the monetarist prescription?

b. What do you think is the battle here, and what is the war?

c. What could be causing the central bank to be winning the battle but losing the war?

53. When assessing the effect of the U.S. growth slowdown on Canadian exports, it is important to bear in mind that much of the U.S. slowdown is due to the diversion of U.S. demand abroad.

a. What would cause a diversion of U.S. demand abroad?

b. Why would this cause a U.S. growth slowdown?

c. What impact would a U.S. growth slowdown have on the Canadian economy, and how?

54. Secondly, if we can't borrow all of the funds we need from abroad to finance expenditures which we are going to make in any event, we should at least look at the advisability of the central bank itself financing some of those expenditures simply by creating the money. That might be no more inflationary than borrowing the same amount of money abroad to finance the same expenditures.

Comment on this view.

55. Is the Fed tightening or easing? Analysts approach it in different ways. Some focus on interest rates while others focus on the growth in reserves. And, as is so often the case in economics, these two approaches can give different answers.

Explain a circumstance in which these two approaches could give different answers.

56. However, Friedman said, if politicians and the Fed overreact to the current recession, the roller-coaster pattern of the past 20 years could continue, with ever-higher inflation-deflation peaks and troughs.

a. Explain how this roller-coaster pattern would come about, and why the peaks and troughs would become ever higher.

b. What kind of policy does this argument support?

57. **These politicians talk as though they expect a Third World nation to be able to attract large inflows of capital and at the same time have large trade surpluses.**

    Comment on the feasibility of a country having large capital inflows in conjunction with trade surpluses.

58. **People widely believe that there is a correlation between higher interest rates and capital inflows, but this belief is as false as the once accepted belief that there is a correlation between unemployment and inflation, causing the one to go up when the other goes down. These correlations don't stand up to scientific research.**

    Explain why both these correlations will not stand up to scientific research.

59. **High interest rates are unquestionably anti-inflationary. Despite this, people no longer believe an increase in interest rates is a sign that inflation is about to be beaten. Quite the opposite. People now take a jump in interest rates as a sign that inflation is about to get worse.**

    a. How are high interest rates anti-inflationary?

    b. Why would people view a rise in interest rates as a sign that inflation is about to get worse?

60. **It was claimed that the extent to which we can get them down and keep them down depends mainly on getting the inflation rate down.**

    What does "them" refer to in this clipping?

61. **Investors again chewed their nails over fears that a strong economy could force up interest rates.**

    a. Why would a strong economy force up interest rates?

    b. Why would this worry investors?

62. **Years of high growth generally _______ inflation, which in turn prompts the Federal Reserve to ________ interest rates, a step that runs the risk of triggering _________ .**

    Fill in the blanks.

63. **Treasuries fell sharply for the second day, sending prices to their worst levels since Jan.11, as climbing bond yields in Japan, a spate of corporate-bond sales, and more signs of strength in the U.S. economy caused nervousness among investors.**

    Explain how each of these three factors would cause the price of Treasury bonds to fall.

64. **The Federal Reserve chairman told Congress that "the Fed is unlikely to raise interest rates in the near future." He also stated that "a strong signal of inflation pressures has not yet clearly emerged."**

    Are these two statements consistent or inconsistent with one another? Explain your reasoning.

65. **Higher interest rates must boost the cost of all sorts of things for business. How can higher interest rates be anti-inflationary?**

    Answer this clipping's question.

66. **Fans of the new-economy theory say U.S. businesses have become so efficient, and the world so open and competitive, that workers deserve ______ and businesses can't get away with _______ . The fluke school argues that temporary factors—low energy prices, a strong dollar, and weak demand in Asia—will eventually go away, causing ________ .**

    Fill in the blanks.

67. **The depression in Asia and the fall in Asian exchange rates acts as a coolant to keep the U.S. engine of growth from overheating.**

    a. Explain how the depression in Asia acts as a coolant.

    b. Explain how the fall in Asian exchange rates acts as a coolant.

68. **When the yen went through the roof early in the year, we all expected it to produce bad news later on. Well, surprise surprise, here it is.**

    Why would the yen going through the roof produce bad news later for Japan?

69. **The latest readings on the economy are a mixed bag: factory orders flagged in July, personal income perked up, and consumer spending stalled.**

    Why is this a mixed bag as opposed to an unequivocal signal?

70. **The problem is that economists have been underestimating the impact of rising asset values on consumer behavior.**

    In what way does this clipping suggest that the traditional Keynesian consumption function specification be changed?

71. **Economists say unexpectedly large individual tax refunds this year helped bolster the economy during the first quarter. As of April 24, the IRS had approved $89.8 billion in refunds, up 8% from a year earlier.**

    Explain how these refunds would bolster the economy.

72. **The fact that economic performance strengthened as inflation subsided should not have been surprising, given that risk premiums and economic disincentives to _______ diminish as product prices become more stable.**

    Fill in the blank.

73. **A February employment report that wasn't particularly weak—there were 275,000 new payroll jobs—sparked a major rally Friday because it didn't point to the blockbuster growth that many investors and traders had expected. It was a "relief rally," said one analyst. The unemployment rate ticked up to 4.4 percent from 4.3 percent, but the most soothing news was a small 0.1 percent increase in average hourly earnings. That suggested that strong growth still isn't sparking more inflation, and therefore the Federal Reserve can remain on hold, a number of analysts said.**

a. If there were so many new payroll jobs, why did the unemployment rate increase?

b. Explain the nature of the “relief rally” and why it came about. Why might it be called a “relief rally”?

c. What would the Federal Reserve do if it didn’t remain “on hold”?

74. A couple of years ago, economists would have considered such low unemployment a sure sign that prices were about to rise. Today they point to productivity as the reason why that might not happen.

How could productivity play this role?

75. A chorus of inflation-related worries pushed down stocks, bonds, and the dollar. The bellwether 30-year Treasury bond, for example, ______ $12.50 per $1,000 bond. Traders blamed the broad-based change on worries that the Federal Reserve might be preparing to . . .

Fill in the blank, and complete this clipping.

76. As he has in the past, the Fed chairman noted that there is some level of joblessness that will result in inflationary wage increases. “The robust increase of production has been using up our nation’s spare labor resources, suggesting that recent strong growth in spending cannot continue without a pickup in inflation unless . . .”

Complete this clipping.

77. Bond prices edged lower as investors trimmed holdings ahead of today’s monthly U.S. jobs report.

What do investors expect will be the nature of the monthly jobs report?

78. Traders said the dollar will probably fall if nonfarm payrolls rose in August by anything less than 110,000, but if the gain was between 140,000 and 200,000 traders might expect a mild reaction. If the figure comes in above 200,000, it may reassure the market that the Fed won’t need to cut rates.

a. In what units of measure are these numbers (i.e., miles, dollars, percentages, etc.)?

b. Why is this clipping expressed in the past tense (i.e., why use “rose” in the first sentence instead of “rise”)?

c. Explain in your own words why the dollar would be expected to fall if nonfarm payrolls rose by less than 110,000.

d. What might be expected to happen to bond prices in this circumstance? Explain your reasoning.

79. The snag is that governments, like voters, are naturally more interested in short-term than long-term growth. Inflationary policies can spur growth for a time, which is why politicians have often found them so tempting. This is the best argument for making central banks . . .

a. Complete this clipping.

b. Explain how inflationary policies can spur growth for a time, but not in the long term.

80. Indeed, higher Japanese rates helped the yen advance against the dollar.

Explain why the value of yen rose against the dollar.

81. The dollar was granted a reprieve yesterday from its recent slide against the mark as talk of a rise in German interest rates cooled. But market participants were jittery because a key piece of U.S. economic data was coming their way today: the Labor Department's report on nonfarm payrolls for April.

a. Explain why the dollar was granted a reprieve.

b. What would, say, an unexpectedly large increase in nonfarm payrolls do to the U.S. dollar? Explain why.

82. U.S. exports rose a huge 18.8% in the fourth quarter, spurred by a relative ________ of the U.S. dollar.

Fill in the blank.

83. The validity of his contention that Canada must match U.S. interest rates or else risk a declining exchange rate has been substantiated by the recent 3-cents U.S. fall in the value of the Canadian dollar.

Under what circumstances would Canada need to match U.S. interest rates to avoid a declining exchange rate?

84. The majority view on fixed exchange rates is that they aren't worth the cost for most countries because they can require painful actions in the domestic economy, such as . . .

Complete this clipping.

85. Japan's bond traders panicked this morning upon learning that GDP had grown in the last quarter by 4.5% at an adjusted annual rate. Their big fear was that the Bank of Japan would reverse its policy of _______ that it had undertaken to move Japan ________ .

Fill in the blanks.

86. The problem first appeared in the 1920s after Britain instituted the "dole," or unemployment benefit. Prices fell after a tremendous wartime inflation. But the dole, which was fixed in nominal terms, stopped money wages from adjusting. For the first time, Britain suffered permanent and high unemployment.

How could the dole be responsible for unemployment?

87. In advocating expanded unemployment benefits, President Clinton observed that "all the European countries have higher unemployment rates than we do, but also stronger support systems for the unemployed."

Comment on the strength of this reason for why the United States should have a more generous unemployment benefit.

88. **Not all economists buy the Keynesian story that a cut in government spending reduces income, claiming that the multiplier is in effect zero, thanks to falling interest rates and a falling dollar.**

    a. How would falling interest rates come about?

    b. How would a falling dollar come about?

    c. How could this cause the multiplier to be zero?

89. **She produced evidence showing that as the economy moved out of a recession the interest rate usually rose, and when the economy crashed into a recession the interest rate usually fell.**

    Explain why this observation would be accurate.

90. **Surges in economic growth are not necessarily unsustainable—provided they do not exceed the sum of the rate of growth in the labor force and productivity for a protracted period. However, when productivity is accelerating, it is very difficult to gauge when an economy is in the process of overheating.**

    a. What would happen if a surge in economic growth exceeded the sum of the rate of growth in the labor force and productivity?

    b. When productivity is accelerating, why is it difficult to gauge when an economy is overheating?

    c. What policy dilemma does this comment by the Fed chairman highlight?

91. **On a net basis, foreigners sold a record $22 billion of long-term Treasury debt in November. A repeat performance would fuel market nightmares about soaring Treasury rates and a sinking dollar.**

    a. Why would Treasury rates soar?

    b. Why would the dollar sink?

92. **The White House budget director said that the $787 billion economic stimulus package (increasing the 2009 estimated deficit to $1.84 trillion, at 12.9% of GDP the largest since 1945), combined with the Fed cutting the target interest rate for overnight loans between banks, will help …..**

    a. What name is given to this economic stimulus package?

    b. What name is given to the interest rate referred to in the clip?

    c. Complete this clipping and explain your reasoning.

93. **To stimulate the economy the government could give money away. The danger here is that it could trigger a bond market crash.**

    a. How would giving money away stimulate the economy?

    b. Why would this create a danger of a bond market crash?

94. **On the face of it, Zimbabwe's finance minister should be the envy of his counterparts around the world. How many of them could virtually double**

public spending without raising taxes, and simultaneously reduce the budget deficit from 11.5 per cent to 7.3 per cent of GDP?

a. How could this feat have been accomplished?

b. Why wouldn't all countries employ this policy?

95. The European Central Bank is becoming increasingly anxious about persistently strong money supply growth; dynamic growth in M3, a broad measure of money supply, is being seen at the ECB as ________ and is strengthening arguments against __________ despite concern over the fragility of the recovery in the eurozone.

Fill in these blanks.

96. The central bank has been arguing for some time that money growth has been distorted by portfolio shifts into cash. It expects people to put their cash into other assets once economic uncertainty fades, and so is not concerned about the inflationary outlook.

What other assets are likely meant here? What alternative would cause the central bank to be concerned about the inflationary outlook?

97. Business organizations are more optimistic, saying the job market is so tight employers will not part with workers for fear …….

Complete this statement.

98. The Fed's latest policy statement made it clear that an accommodative monetary policy will remain in effect until a full-fledged economic recovery arrives.

What is meant by an "accommodative" policy here?

99. When the U.S. Federal Reserve Board cuts its interest rates, the stock market typically goes up.

What logic lies behind this observation?

100. A Bank of Canada report suggested that wage inflation pressures are increasing, further reducing the odds that the Bank of Canada will follow the lead of the U.S. Federal Reserve and start ……..

Complete this clipping.

101. Softer commodity prices, a firmer greenback, and weak demand will likely drive inflation lower in the months ahead. This opens the door a crack for renewed Fed easing if the economy takes a turn for the worse.

a. Explain how each of these will "drive inflation lower."

b. What is meant here by Fed easing?

c. Why would the Fed want to ease if the economy takes a turn for the worse?

d. What has inflation got to do with this?

102. You can't be the head of the world's most powerful central bank and appear wishy-washy on interest rate policy, even if you really don't know where that

policy is going. You have to project confidence and certainty or the market will get 'you and your little dog, too!' by ……….. if it perceives you are behind the curve on inflation.

Fill in the missing part of this clipping.

103. The Fed next meets on Oct.28 and 29. Between now and then, officials will consider whether additional cuts are likely to have their desired effect of ……

a. What kind of cuts are being discussed here?

b. Complete this statement.

104. Identifying bubbles is a thorny problem. Sharp price rises that appear irrational might in fact turn out to be justified. Policy makers need to be careful of trusting their judgment over the collective judgment of the market because efforts to restrain prices could interfere with the crucial role markets play in ………

Complete this clip. (allocating capital)

105. But the stimulus package under discussion would bring no more than $150 billion in new government spending. The difference between a good year for consumer spending and a really bad one is about $400 billion.

What is being suggested about economic policy here?

106. Doubt we could have devastating bank runs? Doubters must explain why people who could get 3% interest at their bank instead bought 90-day T-bills yesterday yielding 0.14%.

Why were people doing this in 2009?

107. Just this July financial markets were anticipating a series of interest rate hikes by the Bank of Canada after an initial increase to 4.5%. But the credit market blow-up, on top of the U.S. housing slump, darkened the outlook.

Why would a credit market blow-up and a U.S. housing slump suggest that interest rates will not be hiked?

108. So it looks like the U.S. economy is in the not-too-hot, not-too-cold sweet spot: it expanded at an estimated 3.4 percent annualized rate, and the core inflation measure eased to 1.8 percent. But check the details: A reduction in inventories in the quarter sliced 2.3 percentage points off the GDP growth number.

a. Explain how a reduction in inventories could slice the GDP growth number.

b. What does this suggest should be done policywise?

109. Economic growth is supposed to be a good thing, right? Not always. If it gets too strong …..

Complete this statement.

110. If bond yields go higher, you'll have a big tug-of-war between the bond yields and strong profits. That will limit the upside of the stock market.

Explain the logic of this.

111. Canada's job creation machine churned out 34,300 positions in October, far surpassing expectations, and increasing the odds that the Bank of Canada will __________. The unemployment rate held steady at 7.1 per cent.

a. Fill in the blank.

b. How would you explain why the unemployment rate did not fall with so many new jobs created?

112. In October 1979, Mr. Volker launched one of modern history's riskiest inflation fights. With consumer prices surging 14% and the bond yield at 15% he ….

Complete this clipping.

113. China's central bank, the People's Bank of China, has raised the deposit reserve ratio requirement for financial institutions from 6 percent to 7 percent to stem rapid lending growth. An analyst said the central bank had few options because recent verbal admonishments against excessive lending had proved ineffective and raising interest rates would have increased already growing speculative purchases of the Chinese currency.

a. How would raising the deposit reserve ratio stem rapid lending growth?

b. What impact should this have on the interest rate? Why?

c. Why would a rising interest rate increase speculative purchases of the Chinese currency?

114. Central banking is as much about winning the trust of markets as adjusting interest rates.

Explain the logic of this statement.

115. As interest rates rose by record leaps this week, the dollar continued its slide.

Which of the following two explanations for this is more reasonable? Explain your thinking.

a) The dollar is falling and the central bank is trying to prevent it by increasing the interest rate.

b) Inflation expectations are rising, increasing the interest rate and decreasing the dollar.

116. Canada's interest rates are too low to bring inflation under control. The interest rate that matters for fighting inflation is _____. The contrast between Canada and other countries is revealing. The U.S. has a federal funds rate of 5.25% and inflation of 2.4%; the UK has a bank rate of 5.75 and inflation of 2%; and Australia has its overnight rate at 6.5% and inflation of 2.1%.

a. Fill in the blank.

b. How would you calculate what must be the Canadian interest rate being referred to here?

117. The U.S. bond market sold off in overnight trading on a report of Chinese selling of treasuries. The China Business News reported that China has started reducing its massive holdings of U.S. treasuries because the dollar's decline is causing them to lose value.

a. Explain in one sentence how this action by China would affect the interest rate.

b. Would this action by China reduce or accelerate the dollar's decline? Explain your logic.

c. This report of China's selling turned out to be false. Does your answer to part b) explain why China is continuing to hold on to its U.S. treasury bills? Why or why not?

118. Every time you say that you want to "stimulate" the economy, or get it going again, or whatever words you use, what you actually are doing is urging more expenditure without regard to what that expenditure is and what it might accomplish and without regard to what it might crowd out or displace in the process.

What is the main message of this clipping?

119. Higher interest rates would boost the dollar, but everyone agrees they would be economically disastrous.

a. Explain how higher interest rates would boost the dollar.

b. Explain how higher interest rates would be economically disastrous.

c. Present a counterargument claiming higher interest rates would be advantageous.

Hint: What is the current state of the economy?

120. Aside from the much-needed interest rate relief, the U.S. economy will continue to benefit from significantly improved terms of trade.

a. What is meant by "significantly improved terms of trade"? How would the economy "benefit" from this? In what respect would it not benefit?

b. From the information in this clip why has the U.S. interest rate fallen?

121. But in a sign some investors fear that the Fed's interest rate cut could also foster inflationary pressures, the dollar fell sharply, long-term Treasury-bond yields rose, and oil prices jumped.

Explain how the interest rate cut could lead to these market reactions.

122. The twin deficits are being financed by Asian central banks.

a. What are the twin deficits?

b. How are the Asian central banks financing them?

c. Why would they do this?

123. The dollar's decline cuts two ways for Americans.

What are these two ways?

124. High savings rates have been a hallmark of Asia's economic development, helping the region's economies _________. Now they have come to be seen as a handicap _________.

a. Fill in these blanks.

b. What assumption about the state of the economy did you need to make to fill in the second blank?

125. George W. Bush's $168 billion tax rebate plan of February of 2008 was designed to stimulate the U.S. economy, but it didn't work, and so instead ….

a. How is a tax cut supposed to work to stimulate the economy?

b. Why didn't the tax cut work in 2008?

c. Complete this statement.

126. I wouldn't say that a lower dollar is inflationary. A lower dollar means you're paying more for your imports. In other words, it adds to your cost of living, and it can become inflationary if . . .

Complete this statement to explain how a lower dollar can become inflationary.

127. A second flaw in economic policy lay in the contradiction between price stability and the pledge to maintain full employment. Why? Because firms and workers took the full-employment pledge seriously.

Explain how this flaw ruined economic policy.

128. Ordinarily, an increase in the budget deficit raises interest rates, but this does not always happen.

Describe a scenario in which an increase in the budget deficit is accompanied by a lower interest rate.

129. From their perspective, the only other way to lower interest rates is for the Fed to increase the supply of funds by continuously pumping more money into the economy. But they argue against such a loose monetary policy, claiming it would not be tolerated for long by the financial markets, since it would lead to a further fall in the value of the dollar and renewed . . .

a. Complete this clipping.

b. Explain why the dollar would fall.

130. High interest rates, not the deficit, are the country's major problem. It is high interest rates that have caused unemployment, which in turn has cut into government revenues and forced up spending, adding to the deficit.

a. How do high interest rates cause unemployment?

b. How does unemployment add to the deficit?

c. Evaluate the argument in this clip.

131. All China and other countries would have to do to start the switch away from the U.S. currency as the world's reserve currency is to stop trying to manage their own currencies lower, he said.

a. How would a country “manage their own currency lower”?

b. Why would they want to do this?

132. In May (2009) Americans saved seven percent of their after-tax income, in dramatic contrast to zero percent last year and a negative saving rate in 2007. In the long term this change isn’t such a bad thing. Spending will once again be a function of incomes rather than assets and the U.S. economy will be less vulnerable to the kind of credit-fuelled crisis we are dealing with now.

a. How could we have a negative saving rate?

b. What does spending being a function of assets mean?

133. Named after the writings of David Ricardo in the early 1820s, the theory suggests that stimulus spending is doomed to failure because …….

Complete this clipping.

134. Last year U.S. taxpayers saved virtually all the money they got through a federal tax cut. And the recent (2008-9) spike in the personal savings rate supports Ricardo’s theory.

What does this behavior do to the multiplier?

135. The White House is in a tough spot. Officials want to give the $787 billion stimulus package passed in February time to work – only 10 percent of the spending is out the door to date (July) – so they are resisting calls for a second round of stimulus.

a. What name is given to this policy?

b. Is this lag a good or a bad thing for this policy? Explain why.

Suggested answers to even-numbered questions

2.Lower inflation means lower expected inflation and thus a lower interest rate.

4. If Canadian inflation is falling relative to U.S. inflation and if the exchange rate is allowed to flex, it is possible for the Canadian interest rate to fall below the U.S. rate.

6. . . . interest rates higher. Presumably the central bank is cushioning exchange rate movements with interest-rate changes.

8. If inflation is lowered, the interest rate will fall, meaning that the government will have lower interest payments on the national debt. Therefore, its budget deficit should fall, creating some room for spending on other things, a fiscal dividend.

10. High inventory stocks mean that firms will cut back production to get rid of the high inventories, creating a recession. A sharp inflationary spike will cause the central bank to cut back on the money supply and raise interest rates to attack the inflation by lowering aggregate demand, pushing the economy into a recession.

12. A higher dollar could be engineered by raising the interest rate to increase capital inflows. The higher interest rate lowers aggregate demand, an effect which is consistent with fighting inflation. A higher dollar could also be engineered by buying dollars on the foreign exchange market. This would decrease the money supply, which is also consistent with fighting inflation.

14a. Cutting the discount rate encourages banks to borrow from the Fed to increase reserves to make loans, resulting in an increase in the money supply. This lowers the interest rate and increases aggregate demand, stimulating the economy.

14b. The lower interest rate lowers capital inflows, creating a balance of payments deficit and causing the exchange rate to fall.

14c. A lower dollar would be good for the economy because it will stimulate aggregate demand for domestically produced goods and services by making exports cheaper and imports more expensive.

16. Lowering rates below their market-determined level will require increasing the money supply, which may raise inflation expectations. This action will cause the interest rate to rise, eliciting further money-supply increases. This vicious circle could continue, resulting in high inflation and a consequent high nominal interest rate.

18a. The high U.S. money-supply growth foretells high U.S. inflation, which by PPP leads to a fall in the value of the U.S. dollar. Foreign investors will experience a loss if their bonds are denominated in U.S. dollars.

18b. The U.S. dollar is weakened because of the PPP result noted in part a, and because investors sell their U.S. dollar assets, creating capital outflows that bid down the exchange rate.

20a. The fall in the dollar should make exports cheaper and imports more expensive, increasing exports and decreasing imports, both of which decrease the balance of trade deficit.

20b. The dollar may be falling because our inflation exceeds that of our trading partners, so there is no fall in the real exchange rate.

20c. If our growth falls, our demand for imports slows.

22. Currency devaluation does not create prosperity—high productivity does. Historically, currency devaluations usually occur because of high inflation, with no change in the real exchange rate.

24. A smaller deficit leaves more financing available for private investment; the interest rate should fall, and private investment should increase. Furthermore, by “national savings” economists mean funds left over after the government has financed its deficit.

26. Crowding-out forces may take some time to offset the initial multiplier effect.

28. As an increase in the natural rate of unemployment.

30. Low inflation is what is meant by soundness. If we keep our inflation low, holders of our currency will not experience a fall in the value of these currency holdings.

32a. Lower unemployment suggests that higher income would increase the demand for money, that inflation may arise, and that the Fed may tighten monetary policy to prevent unemployment from going too low, all of which spell higher interest rates and consequently lower bond prices.

32b. Reductions in the labor force cause the unemployment rate to fall; if this is the reason for the fall in the unemployment rate, the factors described in part a are not relevant.

32c. Discouraged worker effect, or, more generically, a fall in the participation rate.

34. Surging money-supply growth causes high inflation, which pushes up interest rates, causing major falls in the price of long-term bonds. If such an unpredictable inflationary environment were to appear, nobody would want to invest in long-term bonds.

36. The government is buying these military items, and is taxing people (or selling bonds to these people) to reduce their demand for other things, to free up resources to produce these items. Further, higher interest rates also reduce aggregate demand for goods and services. Crowding out should come to mind, but nonetheless there will be some inflationary pressure if the economy is at full employment.

38. Although higher interest rates do raise costs, these are one-time increases in costs. The major role of interest rates is to attack inflation by decreasing aggregate demand.

40. Without indexing, governments could increase real taxes surreptitiously by creating inflation.

42. . . . greater than the economy’s rate of growth of real income.

44a. Low inflation should lower inflation expectations and cause the nominal interest rate to fall.

44b. When interest rates are high because of high inflation, by spending the high interest payments people are allowing the real value of their interest-earning assets to be eroded by inflation, so they are in effect drawing on capital in this case also.

46. This statement is only true of unexpected inflation. If the high inflation is expected, the interest payments on the debt will account for the erosion in the value of the debt.

48. By increasing the money supply faster than the increase in the German money supply, Britain was bound to experience a higher inflation, which makes it impossible to have a fixed exchange rate.

50a. If the government were truly successful in reducing its budget deficit, the decreased government demand for financing should lead to a lower interest rate without inflation. Probably the market does not believe that the government would actually be able to reduce its deficit, implying that lower interest rates would be achieved by increasing the money supply, an inflationary scenario.

50b. Purchasing power parity suggests that higher inflation in Canada will lower its exchange rate. To avoid this loss, people start selling Canadian dollars.

52a. Increase the money supply at a rate approximately equal to the real rate of growth of the economy.

52b. The battle is lowering inflation; the war is getting employment back down to its natural rate.

52c. Expectations of inflation have not yet fallen to the point where the economy can be pushed to a higher income level.

54. If we are near full employment, increasing the money supply will increase inflation. If we borrow from abroad, we can use the foreign currency to buy the needed goods from abroad. If not, the foreign borrowing should increase the demand for the dollar, raising its value. This rise of the dollar cuts down on domestic demand for goods and services because demand for exports falls and demand for import-competing goods and services falls. These effects offset the inflationary pressure of the additional spending financed by the extra borrowing.

56a. By overreacting to the current recession policymakers will stimulate the economy too much, pushing it below the NRU and accelerating inflation. To deal with this problem policymakers will overreact in the opposite direction, pushing the economy back into recession. The peaks and troughs become ever higher because of the asymmetry of the Phillips curve.

56b. It is an argument for a policy rule to prevent the overreactions.

58. Higher nominal interest rates cause capital inflows only if the real interest rate increases. Higher inflation causes a fall in unemployment only if that inflation is unexpected.

60. Interest rates.

62. First blank: raise; second blank: increase; third blank: a recession.

64. Consistent—if inflation looked imminent, the Fed would raise interest rates to cool the economy and dampen inflationary pressures.

66. First blank: real wage increases; second blank: increasing prices; third blank: inflation to develop.

68. The rise in the value of the yen would cause Japanese exports to fall and demand for import-competing goods to fall; both effects would decrease aggregate demand for Japanese output.

70. Consumption should be a function of wealth as well as of disposable income.

72. Invest in productive capital and new businesses.

74. With higher productivity, wage increases can be granted without requiring price increases.

76. . . . labor productivity growth increases significantly.

78a. People.

78b. The figures soon to be announced measure what happened the previous month.

78c. The Fed might be expected to lower interest rates to stimulate the economy; this action would lower demand for the dollar and cause it to fall.

78d. Bond prices would increase if the interest rate fell.

80. The higher Japanese interest rates must have been viewed as higher real rates, causing people to sell U.S. dollars to buy Japanese bonds. This selling decreases the value of the U.S. dollar.

82. Weakening.

84. . . . raising interest rates when recession looms, to attract investors and keep the currency from falling.

86. In this case the dole became very generous in real terms, causing people to delay finding jobs to enjoy living off the dole. The existence of the generous dole inhibited wages from falling to reduce unemployment.

88a. The reduction in income reduces the demand for money, causing its price, the interest rate, to fall.

88b. The lower interest rate decreases capital inflows, creating a balance of payments deficit. This lowers the exchange rate.

88c. The lower interest rate and the lower exchange rate increase aggregate demand. This offsets the original decrease in aggregate demand, perhaps causing the net change in aggregate demand to be zero, implying a multiplier of zero.

90a. Inflation would result.

90b. It is very difficult to measure productivity growth after the fact, let alone at the time it is happening.

90c.The Fed needs to guard against inflation, but does not want to dampen an expansion if inflation is in fact not imminent.

92a. Fiscal policy

92b. Federal funds rate

92c…the economy recover from the recession.

94a. The higher government spending must have been financed by printing money rather than by raising taxes. The claim that the deficit has been reduced is a puzzle. Probably what is happening is that the government spending financed by printing money has not been included in the deficit calculation.

94b. This policy of printing money creates inflation.

96. Likely thinking of bonds. If the cash is used to buy goods and services inflation could be created.

98. Accommodative means that the Fed will increase the money supply to meet increases in money demand as the economy recovers. In effect it will be holding the interest rate steady.

100….lowering interest rates.

102…pushing up interest rates

104….allocating capital.

106. They were afraid of bank failures.

108a. By looking at aggregate demand it appears that a lot of goods were bought. But if inventories were reduced, this means that some of this demand did not correspond to current production (GDP) – the aggregate demand figure exaggerates current output.

108b. It looks like the economy may be slowing, so policy stimulus may be appropriate soon.

110. Higher profits mean people should want to buy stocks. But higher bond yields mean that people will want to buy bonds.

112…..reduced the rate of growth of the money supply and thereby pushed interest rates up even higher.

114. If the markets trust the central bank to keep inflation under control, the central bank is free to make discretionary adjustments in interest rates to meet short-term goals. If the markets don't trust the central bank, any interest rate reductions the central bank makes could be interpreted as inflationary and so these interest rate reductions would quickly be offset by higher inflation expectations.

116a. The real interest rate.

116b. Subtract the Canadian inflation rate from the Canadian central bank nominal interest rate. If the real interest rate in Canada is comparable to the real rate in other countries this calculation should produce a number in line with what this calculation produces for these other countries, in the order of 4 percent.

118. Government spending has a tendency to be wasteful spending compared to market-directed spending.

120a. The exchange rate must have risen, implying that the U.S. receives more imports for a dollar of exports than before. The economy benefits from having cheaper imports; it does not benefit in that demand for some U.S. exports should fall.

120b. What must be happening here is that some structural change has increased U.S. exports relative to imports, implying that other things equal the interest rate no longer needs to be as high because less capital inflows are needed to maintain balance in the international accounts.

122a. A deficit on the current account and a government budget deficit.

122b. By buying U.S. government bonds and so financing the U.S. budget deficit. This prevents the U.S. exchange rate from falling and so maintains the current account deficit.

122c. To enhance their exports to the U.S. by keeping their exchange rate low.

124a. First blank: finance investment and so growth. Second blank: as the their economies are lacking aggregate demand.

124b. That their economy has fallen into recession.

126…... the central bank accommodates this increase in cost by increasing the money supply.

128. Suppose the economy moves into a recession. This lowers income, thereby lowering tax revenues and creating a budget deficit. The Fed may likely react to lower interest rates to fight the recession.

130a. High interest rate lower spending on goods and services and so initiate a multiplier process lowering income and employment.

130b. Unemployment means fewer taxes paid, and more transfer payments paid out to the unemployed, both of which add to the deficit.

130c. This argument is not very convincing because it is likely that the high interest rates were caused by the deficit. Furthermore, we are not told about the level of inflation - this high interest rate may be a result of high inflation, so that it is not a high real interest rate and so does not affect spending.

132a. By borrowing we can spend more than our income.

132b. Basing spending behavior on one’s total wealth position rather than just on one’s income level.

134. It lowers the multiplier. If people save more to prepare for higher future taxes this fall in spending offsets deficit spending somewhat and so lowers the multiplier value.