

Macroeconomics problem set assignment

[Economics](#)



**ASSIGN
BUSTER**

However, if the more expansionary policy persists, the long-run impact will be inflation and higher nominal interest rates, without any positive impact on real output and employment. The more rapid the sustained growth rate of the money supply (relative to real output), the higher the expected rate of inflation. Thus, modern analysis indicates that the long-run implications of the earlier quantity theory of money are correct: Money growth and inflation are closely linked. ” (Economics: Private and Public Choice, p. 84) The money supply in an economy is the benchmark by which interest rates are determined. The supply of money is directly tied into the amount of money that can be loaned and borrowed in various capacities. The more money there is to loan, the less “expensive” it is to borrow that money. This is because when there is an increase in the money supply, the demand for that money fluctuates as well. This causes an increase in the overall amount of money being exchanged, and in turn, also causes a decrease in the real interest rate.

The decrease in the interest rate also affects the economic appeal of domestically produced goods and services. This causes increased economic activity and the increase of real output because of that activity. When output increases, economic theory says that employers will typically need to hire more workers in order to handle their increased sales and output. However, this may not be the case in today’s modern economy because modern businesses’ potential output are not directly proportional to their workforce.

The long run economic impact depends on whether or not the unexpected short run money supply increase is permanent or not. If the money supply increase is permanent, then the short run effects mentioned above will drive

<https://assignbuster.com/macroeconomics-problem-set-assignment-essay-samples/>

the output of the economy above where it naturally should be. If the Fed decided to implement an Expansionary monetary policy to counteract this increase in the money supply then it would most likely try to reduce interest rates. This type of monetary stimulus affects the interest rates in the short term.

This can eventually lead to long term economic change based on short term economic change being as the Fed intended. Expansionary policies are meant to push the economy towards full employment and spur economic growth. This means that if the policy is not loosely monitored, or not removed at the right time, it can cause inflation, and thereby increase interest rates in the long run.

2. How rapidly has the money supply (M1) grown during the past twelve months? State the rate of growth (use <http://whom.federalreserve.gov/releases/h1/>) and the most recent release, use the seasonally adjusted figures.

Calculate the rate of growth across the year by taking the (new amount of M1 - old amount of M1) / old amount of M1). Given the state of the economy, should monetary authorities increase or decrease the growth rate of money? Explain why. I feel the monetary authorities should increase the growth rate of money because increasing the money supply would help to decrease inflation.

Percent change at seasonally adjusted annual rates M1 12 Months from June 2013 TO June 2014

Date	M1 (Seasonally Adjusted)
1 Jan. 2014	672.6
6 June 2014	2,834.8

2834.8 - 672.6 = 2162.2 divided by 672.6 = 3.216

Is stability in the general level of prices through time important? Why or why not? Should price stability be the goal of monetary policy? Explain your

<https://assignbuster.com/macroeconomics-problem-set-assignment-essay-samples/>

responses. Yes, “ maintenance of price stability is the essence of sound monetary policy; price stability provides the foundation for both economic stability and the efficient operation of markets. ” Also, price stability is often a significant objective associated with monetary policy. When inflation is high, variable or the two, it interferes with all the efficient operation of the economy and can easily reduce economic progress.

In addition, once inflationary expectations are set, bringing inflation back down can be distressing. All this explains why stability is the goal of monetary policy. However, “ monetary policy cannot generate real economic growth. It can only create an environment conducive for such growth. If investors and other business decision makers can count on monetary policy-makers to maintain price stability, a potential source of uncertainty is reduced. ” For these reasons, I don't think price stability should be the goal of monetary policy. (Economics: Private and Public Choice, p. 87) 4. Compare and contrast the impact of an unexpected shift to a more expansionary monetary policy under rational and adaptive expectations. Are the implications of the two theories different in the short run? Are the long- run implications different? Explain. “ Adaptive expectations hypothesis, decision-makers believe that the best indicator of the future is what has happened in the recent past. For example, individuals would expect the price level to be stable next year if stable prices had been present during the past two or three years.

Similarly, if prices had risen at an annual rate of 4 or 5 percent during the past several years, people would expect similar increases next year.

According to rational-expectations hypothesis, rather than merely assuming that the future will be like the immediate past, people also consider the expected effects of changes in policy. Based on their understanding of economic policy, for example, people may alter their expectations regarding the future rate of inflation when the government runs a larger deficit or expands the supply of money more rapidly.

The adaptive- and rational-expectations theories differ in two major respects (1) how quickly people adjust to a change and (2) the likelihood of systematic forecasting errors. If the adaptive-expectations theory is correct, people will adjust more slowly. When a more expansionary policy leads to inflation, for example, there will be a significant time lag perhaps two or three years, before people come to expect the inflation and incorporate it into their decision making.

In contrast, the rational- expectations theory implies that people will begin to anticipate more inflation as soon as they observe a move toward a more expansionary policy-?? perhaps even before there is an actual increase in the rate of inflation. Therefore, the time lag between a shift in policy and a change in expectations will be shorter under rational than under adaptive expectations. Second, systematic errors will cur under adaptive but not under rational expectations.