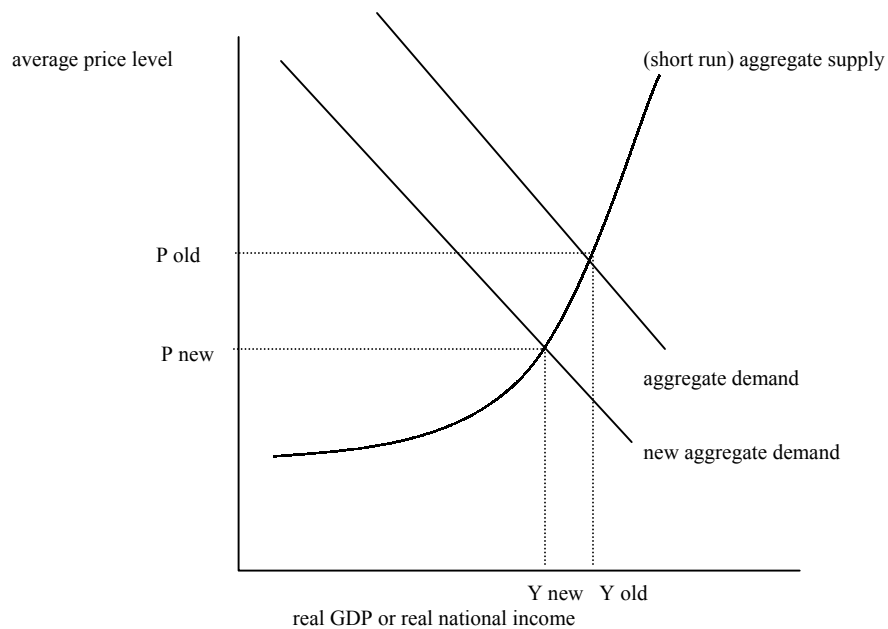


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**Principles of Economics**

**Another Model 4 Study Question**

1. Suppose the government wants to reduce inflation.
  - a) Name 1 monetary policy that would possibly reduce inflation. Explain how it works. Illustrate its effects on an AD/AS graph (model #4) of the economy.
  - b) Indicate how the policy above would affect
    - unemployment      --disposable income      --consumption
    - savings              --investment              --the budget deficit
    - net exportsAlso, fully explain why each changes.
  - c) Name 1 fiscal policy that would possibly reduce inflation. Explain how it works. Illustrate its effects on an AD/AS graph (model #4) of the economy.
  - d) Indicate how the policy above would affect
    - unemployment      --disposable income      --consumption
    - savings              --investment              --the budget deficit
    - the living standards of future generations      --net exportsAlso, fully explain why each changes.
2. Suppose an oil embargo drastically increases production costs.
  - a) Illustrate the macroeconomic effects of this on an AD/AS graph (model #4).
  - b) Indicate how the embargo would affect
    - unemployment      --disposable income      --consumption
    - savings              --investment              --the budget deficit
    - the living standards of future generations
    - net exportsAlso, fully explain why each changes.

1a) To reduce inflation the Fed needs to reduce aggregate demand. They do this by reducing the money supply (which increases interest rates). This is accomplished by raising the discount rate or selling used government securities or raising the required reserve ratio.

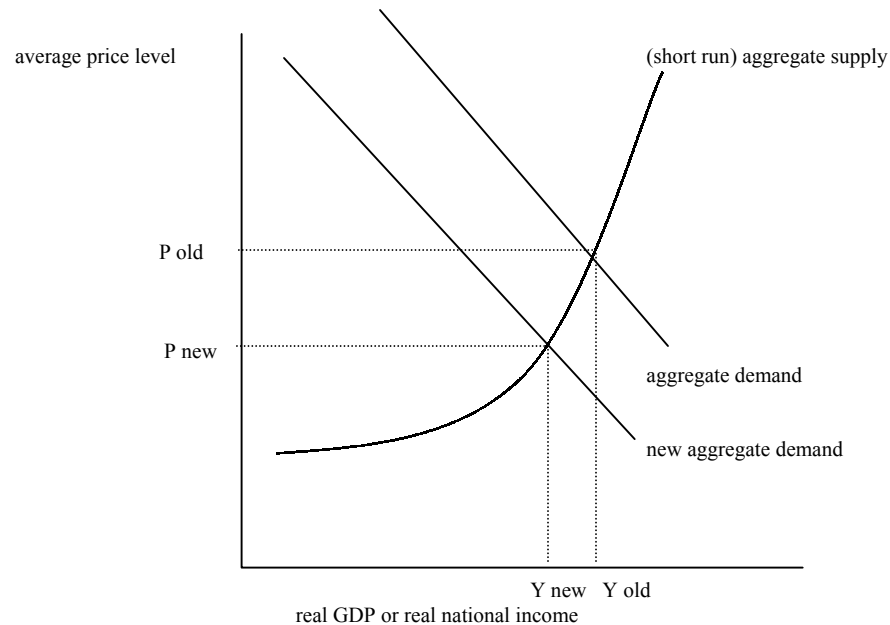


1 b)

- unemployment is higher because real GDP is lower
- disposable income is lower because real national income is lower
- consumption is lower because disposable income is lower
- savings is lower because disposable income is lower
- investment is lower because interest rates are higher
- the budget deficit is higher because tax revenue has fallen (due to the lower real national income) while government spending has remained constant
- net exports are lower because the higher interest rates have caused the dollar to appreciate

1 c) To reduce inflation the government needs to reduce aggregate demand. They can do this by reducing  $G$  (which directly reduces  $AD$ ), or by raising tax rates or cutting transfer payments (either of which reduces consumption).

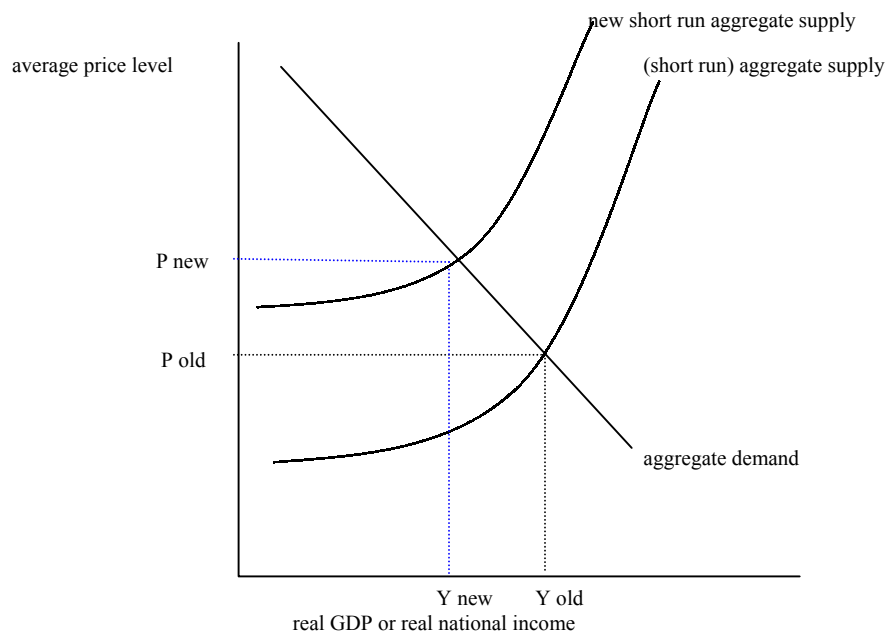
Let's assume that the government raises tax rates.



1 d)

- unemployment is higher because real GDP is lower
- disposable income is lower because government is taking more in taxes away from people's earned income
- consumption is lower because disposable income is lower
- savings is lower because disposable income is lower
- investment is higher because interest rates are lower. (Interest rates are lower because lower prices reduce money demand.)
- the budget deficit is lower because tax revenue has risen (due to the higher tax rates) while government spending has remained constant
- net exports are higher because the lower interest rates have caused the dollar to depreciate
- If the higher investment persists for many many years then future generations will enjoy higher living standards, because investment spurs long term economic growth over many many years.

2.a)



2 b)

- unemployment is higher because real GDP is lower
- disposable income is lower because real national income is lower
- consumption is lower because disposable income is lower
- savings is lower because disposable income is lower
- investment is lower because interest rates are higher. (Interest rates are higher because higher prices increase money demand.)
- the budget deficit is higher because tax revenue has fallen (due to the lower real national income) while government spending has remained constant
- net exports are lower because the higher interest rates have caused the dollar to appreciate
- If the lower investment persists for many many years then future generations will have lower living standards, because low investment means little or no long term economic growth over many many years.