Responses to Unanswered Questions

1. Please clarify the difference between nominal and real GDP with an example.

Suppose I run a bakery and want to create a measure of the bakery’s output. I make cakes and donuts in different amounts on different days. It seems wrong to simply count the bakery items since cakes have much higher prices than donuts. So I decide that my measure should be the value of what my bakery sells. Put another way, my measure is the dollar value of what my bakery produces. Now I need to choose prices. If I use current quarter prices, my measure of bakery output is just like nominal GDP: current price of cakes*number of cakes + current price of donuts*number of donuts. If I use some reference year prices, my measure of bakery output will be just like real GDP: base year price of cakes*number of cakes + base year price of donuts*number of donuts.

2. How does the Federal Reserve alter the unemployment rate?

The Federal Reserve cannot directly alter the unemployment rate. What is can do, and what it does during normal business cycles, is to change interest rates to either stimulate or de-stimulate the economy as conditions suggest. For example, in a recession the unemployment rate rises and output falls below potential output. The Fed lowers interest rates in order to stimulate “interest-sensitive spenders” to increase their spending. This offsets the decrease of output and the increase in the unemployment rate and makes a recession milder than it would otherwise have been.

3. How can the Fed make money out of thin air?

Go back and take a look at the T-accounts that show how an open market operation works. When the Fed buys government bonds, it pays for those bonds by “creating” federal funds—that is by creating funds that commercial banks can use as reserves. Because the law says that a commercial banks deposits at the Federal Reserve count as legal reserves, the Fed by creating those reserves allows banks to increase their deposits which are part of the money supply.

4. How does lowering and raising the federal funds rate affect commercial banks willingness to lend?

In normal times, both during expansions and normal recessions, commercial banks do not choose to hold more reserves that required by law. Thus, open market operations change the amount of lending that banks can do. In normal times, banks are willing to lend to any credit worthy customer who is willing to pay the market rate of interest and who has sufficient collateral and/or a credit history that indicates that repayment is likely. In the Great Contraction, banks feared that they would be repaid. That fear curtailed lending and was a more powerful force than the interest rate that banks could earn by lending. To the extent that the Fed helped end the Financial Crisis, it did so more by taking actions that made lenders believe that they would be repaid and less by
lowering the federal funds rate. Changes in the federal funds rate are meant to change the demand for credit—they do not have their primary effect on bank willingness to lend.

5. What macroeconomic models are important for this course?

The only macro model you will be tested on is the one covered during classes 28 and the beginning of 29.

6. What is the correlation between monetary policy differences and variability in house appreciation?

I am afraid that I do not understand what is being asked. Perhaps you are asking whether Taylor or Bernanke is correct. Personally, I do not believe that the decision to keep the federal funds rate low after 2002 was responsible for inflating the housing bubble although I do agree it contributed to the inflation.