1. Suppose a lobster supper in Maine costs fewer dollars than a Lobster supper in Paris, France. Explain why this is inconsistent with purchasing-power parity and explain why the inconsistency may exist.

According to purchasing-power parity, a dollar should buy the same amount of goods everywhere in the world. The inconsistency may exist because lobsters have to be transported to Paris. Price differences can also persist because goods are not perfect substitutes. While eating lobster gazing at the Maine coastline may be a pleasurable experience, eating well-prepared lobster in a fancy French restaurant may be an experience people would be willing to pay more for.

2. What effect do protectionist policies have on the trade deficit?

Protectionist policies increase the demand for U.S. dollars, and so lead to an appreciation of the real exchange rate for U.S. dollars. However, the policies have no impact on either the supply of loanable funds or the demand for loanable funds, and so they have no effect on net capital outflow. Since net capital outflow must equal net exports, there is also no change in net exports. The appreciation of the dollar therefore leads to falling net exports which offsets the rise in net exports that protectionist policies would otherwise create.

3. Discuss what economists believe is different about the long and short run.

Most economists believe that in the long run, real variables are not affected by nominal variables. So, for example, changes in the money supply do not change real variables in the long run. However, most economists believe that nominal variables do change real variables in the short run. In the short-run prices and wages may be fixed based on the expected price level. If the actual price level differs from the expected price level, real variables are affected.

4. Explain the logic according to liquidity preference theory by which an increase in the money supply changes the aggregate demand curve.

When the money supply increases, the interest rate falls. As the interest rate falls people will want to spend more and firms will want to build more factories and other capital goods. This increase in aggregate demand happens for any given price level, so aggregate demand shifts right.
5. Suppose that the Fed unexpectedly pursues contractionary monetary policy. What will happen to unemployment in the short run? What will happen to unemployment in the long run? 

In the short run, unemployment will rise, because, contractionary policy reduces actual inflation and so moves the economy down along the Phillips curve. In the long run, the economy will return to its natural rate of unemployment as the short-run Philip curve shifts left as inflation expectations fall.

6. Suppose that the economy is at an inflation rate such that unemployment is above the natural rate. How does the economy return to the natural rate of unemployment if this lower inflation rate persists?

If unemployment is above its natural rate, then actual inflation is less than expected inflation. According to sticky-wage theory when inflation is less than expected, prices will have risen less than nominal wages which are based on expected inflation. Because prices have risen less than nominal wages, firms will choose to reduce production and lay off or fire workers. Eventually workers and firms will have lower inflation expectations and the nominal wage will adjust to a level consistent with lower inflation expectations which will encourage firms to raise production. This increase in production causes unemployment to fall and shifts the short-run Philips curve to the left and the unemployment rate will return to its natural rate.

7. Suppose that consumers become pessimistic about the future health of the economy. What will happen to aggregate demand and to output? What might the president and Congress have to do to keep output stable?

As consumers become pessimistic about the future of the economy, they cut their expenditures so that aggregate demand shifts left and output falls. The president and Congress could adjust fiscal policy to increase aggregate demand. They could either increase government spending, or cut taxes, or both.