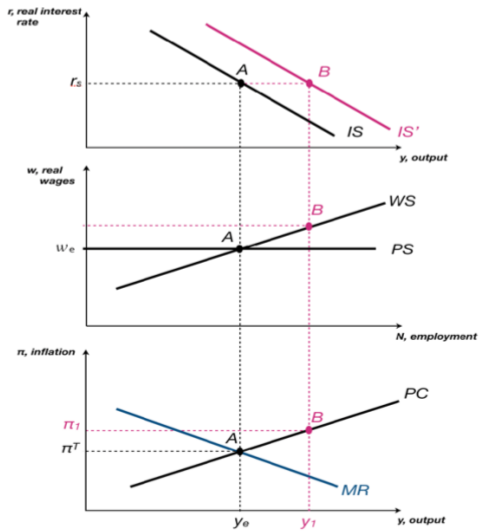
Figure 1: Example of questions for two students

STUDENT A: Question 1

Consider the economy represented in the graph below. This economy has been hit by a positive demand shock (represented by point B). Before the shock the economy was at equilibrium (point A). The top graph represents the equilibrium in the goods market, the labour market is depicted in the middle graph, and the bottom graph shows the central bank's monetary rule.



Given this information, which of the following statements are CORRECT:

- In the model, the change in interest rate by the central bank will make the Monetary Rule curve (MR) shift upwards to cross the Phillips Curve (PC) at point B in order to bring the economy back to equilibrium.
- In order to bring inflation back to target, unemployment will have to increase above the equilibrium level during the adjustment process led by the central bank.
- If the demand shock is permanent, once the adjustment process guided by the central bank finishes, the economy will be at a new equilibrium point with higher potential output and higher interest rate.
- The responsiveness of investments to interest rates matter for central bank's response to shocks.

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STUDENT A: Question 7

Which of the following statements regarding stabilisation policy are CORRECT?

- “While inflation lets firms cut real wages by freezing pay in nominal terms, deflation increases rigidity in the labour market. Workers are resistant to wage cuts in nominal terms."
- “A large negative demand shock will always cause the economy to fall into a deflation trap."
- “Fiscal policy is only used as policy instrument when the economy is in a deep recession and monetary policy are limited by the zero-lower bound."
- “Inflation bias can only be caused by central banks trying to achieve an output level above equilibrium output."

STUDENT B: Question 2

Which of the following statements regarding stabilisation policy are **CORRECT**?

- “If inflation is low and real interest rates can't fall far enough to boost demand and push prices up, demand will weaken even further."
- “Fiscal policy is only used as policy instrument when the economy is in a deep recession and monetary policy is limited by the zero-lower bound."
- “A large negative demand shock will always cause the economy to fall into a deflation trap.”
- “In an economy with output at its equilibrium level, if the government increases government expenditure in order to decrease unemployment below its equilibrium, it may cause inflation bias if central banks maintain interest rates unchanged."

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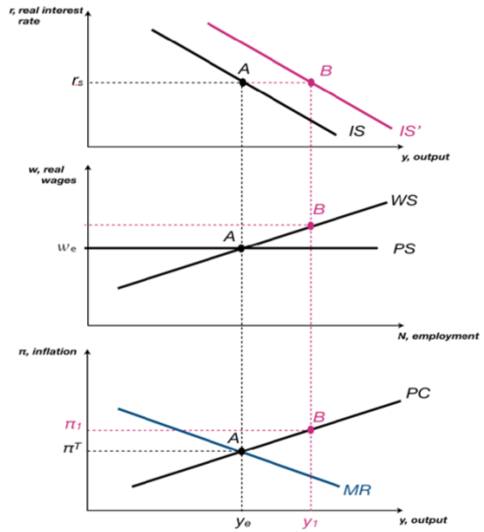
STUDENT B: Question 9

Consider the economy represented in the graph below. This economy has been hit by a positive demand shock (represented by point B). Before the shock the economy was at equilibrium (point A). The top graph represents the equilibrium in the goods market, the labour market is depicted in the middle graph, and the bottom graph shows the central bank's monetary rule.



- In the period after the shock, the Phillips Curve (PC) will shift upwards reflecting the higher expected inflation in that period.
- The higher inflation due to the demand shock means that, in the WS-PS graph, there is a gap between the prevailing real wage and the real wage consistent with the tighter labour market.
- If the demand shock is temporary, once the adjustment process guided by the central bank finishes, the economy will be at a new equilibrium point with a higher interest rate.
- The slope of the Phillips curve (PC) does not matter for the central bank's decision of how much to change interest rate.