Closing the Output Gap

Class Activity

THE FED CLOSES THE OUTPUT GAP

Between 2001 and 2009, the Federal Reserve responded to two output gaps. For each one, identify which type of gap existed, ascertain which type of monetary policy was enacted, and indicate whether each variable increased or decreased as a result. Illustrate how monetary policy affected aggregate demand on each graph.

1) The Housing Boom/Bubble, 2001 - 2007

This economic expansion was fueled by a massive boom in the housing market. Financial institutions made excessive and increasingly risky loans, causing the value of real estate to become inflated. In an effort to control these upward inflationary pressures, the Federal Reserve chose to continually raise the federal funds rate from 2004 - 2007.

Type of Gap: ______________________

Monetary Policy: ______________________

Money Supply: ______________________

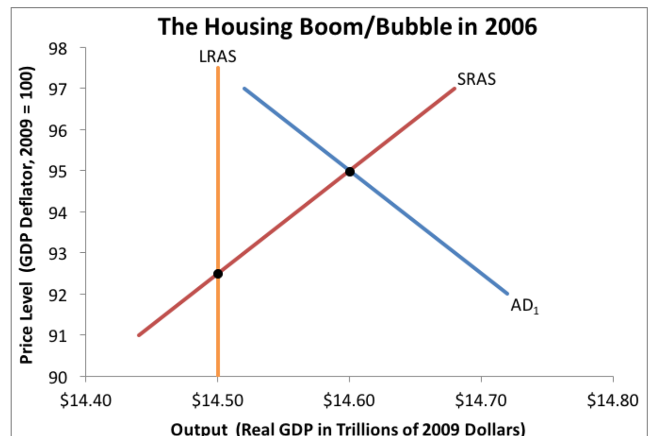
Interest Rate: ______________________

Aggregate Demand: ______________________

Real GDP (Output): ______________________

Price Level (Inflation): ______________________

Unemployment: ______________________



2) The Great Recession, 2007 - 2009

When the housing bubble finally burst, the value of real estate and related assets quickly declined. This created a global financial crisis as lending institutions lost liquidity or went bankrupt. In an effort to offset these massive decreases in investment spending, the Federal Reserve responded by reducing the federal funds rate down to just above 0%.

Type of Gap: ______________________

Monetary Policy: ______________________

Money Supply: ______________________

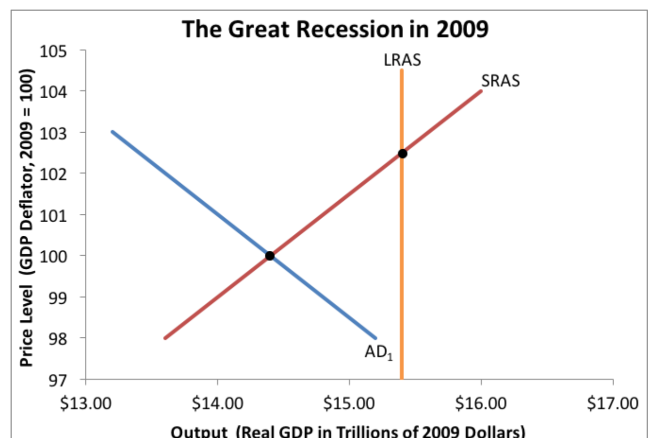
Interest Rate: ______________________

Aggregate Demand: ______________________

Real GDP (Output): ______________________

Price Level (Inflation): ______________________

Unemployment: ______________________



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YOU CLOSE THE OUTPUT GAP

For each output gap, identify which type of gap existed, decide which type of monetary policy you think the Fed should have adopted, and indicate whether each variable would have increased or decreased as a result of this policy. Use the money market graphs to illustrate how this monetary policy would have affected that market, and use the AS-AD graphs to illustrate the change in AD before and after the adoption of a monetary policy.

3) The Great Depression, 1929 - 1933

The 1929 stock market crash precipitated the worst economic disaster in U.S. history. Characterized by an initial reduction in investment spending, the Great Depression was caused by a negative demand shock. In the following years, the government did little to fix the situation, causing a full-blown financial crisis.

Type of Gap: ____________________

Monetary Policy: ____________________

Money Supply: ____________________

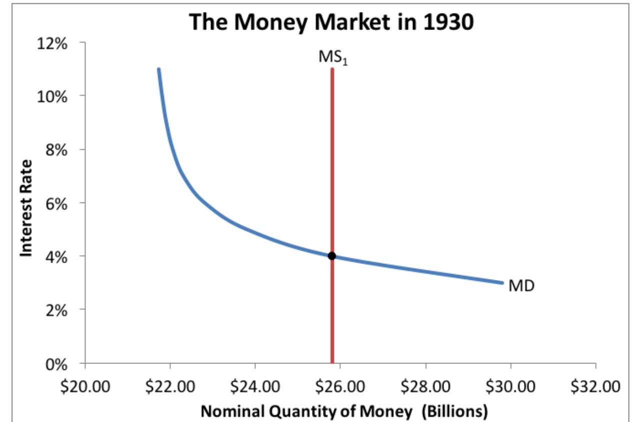
Interest Rate: ____________________

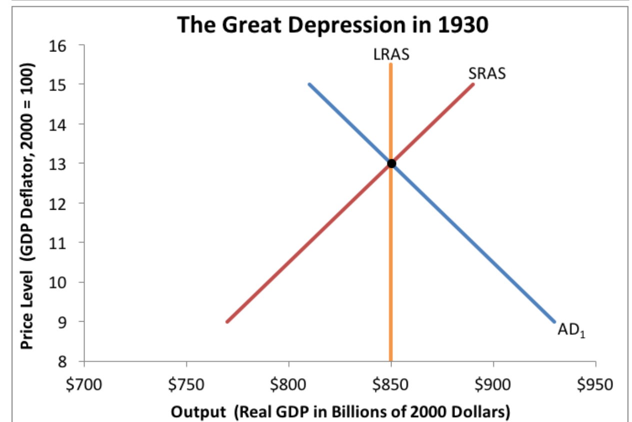
Aggregate Demand: ____________________

Real GDP (Output): ____________________

Price Level (Inflation): ____________________

Unemployment: ____________________





4) The Energy Crisis Recession, 1979 - 1982

The 1979 Iranian revolution triggered a global recession with serious effects in the United States. Characterized by severe increases in oil prices, the recession was caused by a negative supply shock. The subsequent decrease in output and increase in prices, known as stagflation, created a particularly bitter recession.

Type of Gap: ____________________

Monetary Policy: ____________________

Money Supply: ____________________

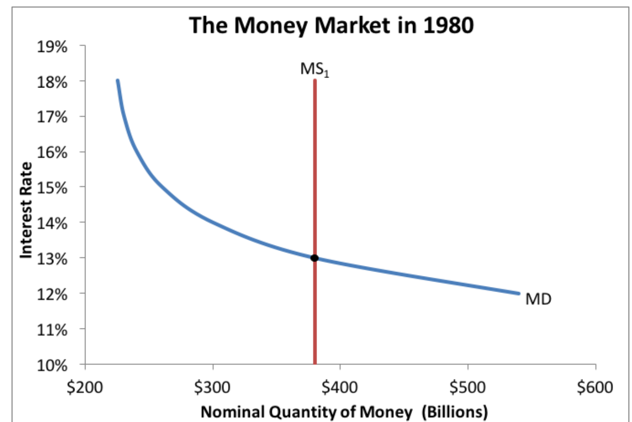
Interest Rate: ____________________

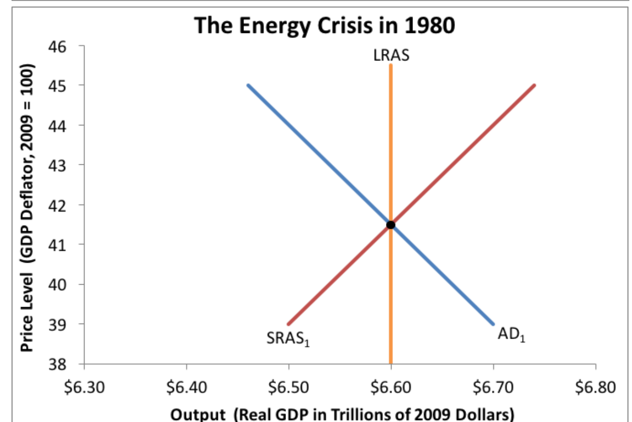
Aggregate Demand: ____________________

Real GDP (Output): ____________________

Price Level (Inflation): ____________________

Unemployment: ____________________





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