**Chapter 7 Review Questions**
**Price Indexes and Inflation**
**Dr. McGahagan**

_____1. Inflation typically falls in recessions and increases in good times.

_____2. The GDP deflator is a price index which fixes quantities in the base year.

_____3. The CPI typically shows a higher rate of inflation than the GDP deflator.

_____4. If the GDP deflator were 150 in 2010 and goes up to 160 in 2011, the inflation rate calculated in 2011 would be 10 percent.

_____5. One problem with the GDP deflator is that it neglects the substitution effect.

_____6. The substitution effect is the tendency of people to buy relatively more of luxury goods when their income rises.

_____7. The core PCE deflator is the measure most closely watched by the Federal Reserve as an indicator of inflation.

_____8. The real interest rate is the nominal interest rate divided by a price index.

_____9. Unexpected inflation will benefit banks and other lenders.

_____10. Falling prices automatically benefit all sectors of an economy.

_____11. Sudden and unexpected deflation is more likely to be harmful to economic growth than sudden and unexpected inflation.

_____12. The United States has not seen deflation since the Great Depression.

_____13. Prices of goods and services which are labor-intensive tend to be sticky; prices of goods that are raw-materials intensive tend to be flexible.

_____14. The CPI was 215 in 2008 and 214 in 2009. The rate of inflation was about half a percent between 2008 and 2009.

Given the following data, answer the following questions. Show all your work, clearly indicating the operations you are conducting.

Assume that 2011 is the base year. Also assume that these are the only two goods produced, and that both are produced domestically, so that the coverage of the CPI and the GDP deflator is the same.

| | **PRICES** | | **QUANTITIES** | |
|---|---|---|---|---|
| | **Good X** | **Good Y** | **Good X** | **Good Y** |
| **2011** | **$ 50** | **$ 100** | **30** | **20** |
| **2012** | **$ 40** | **$ 110** | **20** | **30** |

__________15. Nominal GDP in 2011 is ---

__________16. Real GDP in 2011 is ---

__________17. Nominal GDP in 2012 is ----

__________18. Real GDP in 2012 is ---

__________20. The real GDP growth rate between 2011 and 2012 is ----

__________21. The rate of inflation between 2011 and 2012, as calculated by the GDP deflator, is –

__________22. The rate of inflation between 2011 and 2012, as calculated by the CPI, would be ---

__________23. It is normally the case that the GDP deflator shows a higher rate of inflation than the CPI.