Extra Questions: Monetary Policy

Intermediate Macroeconomics, Fall 2015
The University of Notre Dame
Professor Sims

Instructions: The following are extra questions for practice and review. The topic covered is monetary policy.

1. Explain in words why a central bank ought to implement monetary policy so as to support \( Y_t = Y_t^{f} \) – in other words, to make the equilibrium of the Keynesian model (whether it is Keynesian because of sticky prices, sticky wages or both) equal to the equilibrium of the neoclassical model.

2. In the context of the sticky price model, graphically work out how a central bank ought to adjust the money supply (and hence interest rates) so as to implement the neoclassical equilibrium in response to a productivity shock, a labor supply shock, and an IS/demand shock.

3. In the context of the sticky wage model, graphically work out how a central bank ought to adjust the money supply (and hence interest rates) so as to implement the neoclassical equilibrium in response to a productivity shock, a labor supply shock, and an IS/demand shock.

4. Is price stability a good goal in the sticky price model? Is it a good goal in the sticky wage model? Does the source of exogenous shocks matter for these answers? Explain.

5. Would a policy of trying to adjust the money supply so as to stabilize \( Y_t \) make sense in either model? Does the answer depend on the source of exogenous shocks? Explain.

6. Would a policy of trying to adjust the money supply so as to stabilize \( r_t \) make sense in either model? Does the answer depend on the source of exogenous shocks? Explain.

7. Write down the expression for the Taylor rule. Briefly explain the logic behind it. Does it make sense from a normative perspective? Does it provide a reasonable positive description of Fed policy in practice?

8. Explain why the nominal interest rate, \( i_t \), is bound from below by 0, but the real interest rate, \( r_t \), is not necessarily.

9. Graphically show a binding zero lower bound constraint affects the slope of the LM and AD curves.

10. Analyze the consequences of shocks to the IS curve and supply shocks with a binding zero lower bound. Does output respond more or less to these shocks than it would if the zero lower bound were not binding and the money supply was set exogenously.

11. Discuss the problem of the “deflationary spiral” and why that can be cause for concern if the zero lower bound is binding.
12. With a binding zero lower bound, graphically analyze the consequences of an increase in expected inflation.

13. Describe a policy proposal which ought to reduce the frequency of the zero lower bound binding.