Practice Problems: Expectations and Monetary Policy

Econ520. Spring 2016. Prof. Lutz Hendricks. April 26, 2016

Blanchard / Johnson, Macroeconomics, 6th ed., ch. 14

1 Shocks

Derive the effects of the following shocks on short-run and medium-run Y, i, r:

1. A rise in inflation expectations.
2. An increase in money growth accompanied by an increase in inflation expectations, such that the short-run π^e equals medium run π.
3. An adverse supply shock that reduces Y_n.

2 Miscellaneous

1. Why is the distinction between nominal and real interest rates important?

   A: Spending decisions are affected by the real interest rate. The Fed controls the nominal interest rate. The difference is inflation expectations. The effect of a Fed action that changes i can be undone by changes in π^e (and this happens reliably in the medium run).

2. Does lose monetary policy raise or lower interest rates?

   A: Both interest rates initially fall, but the nominal rate eventually rises due to higher inflation expectations.
