Part I, Paper 2: Macroeconomic Principles I

Supervision 4:
Money Market and Economic Fluctuations

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Short Questions

1. Explain the effects of the following changes on the demand for real money and the price level in the long run:
   (a) a decrease in the real interest rate,
   (b) an increase in real income.

2. What is meant by 'Persistent high inflation is always and everywhere a fiscal phenomenon'? (*Hint: Read section 8.5 from Jones*)

Long Questions

1. Suppose that consumption depends on the level of real money balances (on the ground that real money balances are part of wealth). Show that if real money balances depend on nominal interest rate, then an increase in the rate of money growth affects consumption, investment and the real interest rate. Does the nominal interest rate adjust more than one-for-one or less than one for one to expected inflation? This deviation from the classical dichotomy and the Fisher effect is called the "Mundell-Tobin effect". How might you decide whether it is important in practice?

2. Can real and nominal interest rates be negative? If yes, under what circumstances?

3. Suppose that a new technology improves productivity permanently and increases the long run steady state output. During transition and as potential output increases, policy makers misinterpret the increase as a boom above potential. What policies (broadly) would they implement? What would the effect of such policies be to the economy?