Final Exam

Directions: Answer all questions. Point totals for each are given in parentheses. Remember, to receive full credit you must provide explanations for your answers. Relax and Good Luck. And, most important, enjoy your summer — after exams are over.

1. (20) Contrast Ricardian Equivalence and the Tax Smoothing Hypotheses. In particular, discuss how it is possible for economists to reach such different conclusions in the analysis of fiscal policy? In your answer, be sure to identify the thought experiment associated with both theories.

2. (14) Blinder quotes a former Canadian central banker as saying, “We didn’t abandon the monetary aggregates, they abandoned us!” Why would a central bank want to abandon the monetary aggregates in the first place?

3. (12) Suppose that you are considering buying a car next year and, because of your lack of savings, plan on financing the purchase with a loan. How would you forecast the interest rate on the loan? Give a numerical example.

4. (20) In his paper on inflation targeting, Carl Walsh discusses the “New Policy Trade-off” (attributing this term to John Taylor). What does this refer to? In your answer, discuss why the adjective “New” is included in the term.

5. (20) Canada and the United Kingdom have both adopted a policy of inflation targeting. Why in heaven’s name would they do such a thing?
6. (16) Walsh’s analysis of inflation targeting employed two fundamental relationships: an expectations-augmented Phillips curve (PC) and a monetary policy rule (MPR). These are given below:

\[ \pi_t = \pi^e + ax_t + e_t \]  \hspace{1cm} (PC)

\[ \pi_t = \pi^T - \alpha (x_t - u_t) \]  \hspace{1cm} (MPR)

where \( \pi^e \) is expected inflation and \( \pi^T \) is the inflation target and \( e_t \) and \( u_t \) are the shocks to inflation and output (\( x_t \)) respectively. Express this model in reduced form. Prove that, in this economy, a positive inflation shock, i.e. \( e_t > 0 \), will cause output to fall - explain.

7. (24) While laying on the beach during the summer, an attractive acquaintance that you are desperately trying to impress asks the following question: “I am very puzzled about the Lucas Island model - the model states that there will be a positive relation in the data between inflation and output yet, at the same time, it says that monetary policy can not influence output. Since monetary policy affects inflation, doesn’t this imply that monetary policy is affecting output?” With your enthusiasm bolstered by the realization that you had not, after all, wasted your Spring Quarter, you begin your answer: “This is simple really - it is all about a signal extraction problem......”