Final Exam

Directions: Answer all questions. Point totals for each are given in parentheses. Remember, to receive full credit you must provide complete 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. (25) My elderly next door neighbor, Mr. Kelly, admonished me once for teaching “that Keynesian crap.” Since the modern models of monetary policy include a version of the IS curve, should I be wary of telling this to Mr. Kelly? Carefully and thoroughly explain your answer.

3. (20) In Euroland, financial markets are prone to waves of skepticism and optimism which translates into changes in the demand for money. Based upon Poole’s analysis, should the European Central Bank target the money supply, inflation, nominal GDP, or interest rates?

4. (25) Analyze the following quote about the Taylor rule (identified as the “monetary policy rule approach”). What is the significance of the change in the coefficient mentioned in the quote?

An unexpected benefit of the monetary policy rule approach is that it has revealed changes in the decisionmaking processes at central banks. One important change is in how the federal funds rate has responded to events in the economy. The response can be measured by the coefficient in the policy rule. John Judd and Glenn Rudebusch discovered such a change for Federal Reserve policy by empirically estimating a policy rule for the federal funds rate. They found that the response of the federal funds rate to the inflation rate has increased over time. During the late 1960s and 1970s the coefficient was less than one; during the period since the mid 1980s the coefficient has been greater than one.
5. (25) Consider the following simple structural macroeconomic model:

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\begin{align*}
\text{consumption} & : \ c = a + b(y - t) \\
\text{investment} & : \ i = i_0 - dr \\
\text{money demand} & : \ m^d = e_y - fr \\
\text{government} & : \ g = g_0 \\
\text{taxes} & : \ t = t_0 \\
\text{moneysupply} & : \ m^s = m_0 \\
\text{goods market eq} & : \ y = c + i + g \\
\text{money market eq} & : \ m^s = m^d 
\end{align*}
\]

The terms \((a, b, d, e, f)\) are positive coefficients while the following are exogenous \((t_0, g_0, m_0, i_0)\). Represent the model in reduced form.

6. (25) An implication of optimal monetary policy (as described by Clarida, Gali, and Gertler) is the new policy tradeoff between output and inflation variability. Using graphical analysis, illustrate this tradeoff and demonstrate how policymakers’ preferences toward output and inflation volatility influence the economy.