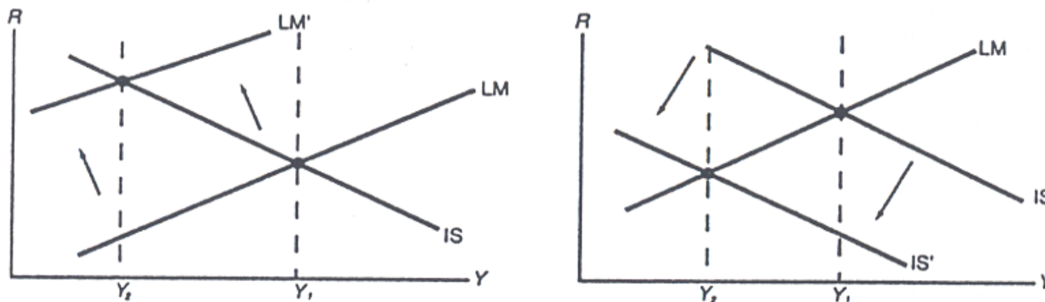
The New Normative Macroeconomics
Additional Homework Problems
ECON 3133
Dr. Keen

Answers

1. A sharp rise in the nominal interest rate (i.e., the federal funds rate) in response to the late 1970s inflation represents a policy with large coefficient on β_π in the monetary policy rule designed to reduce inflation rapidly.

2. The principle disadvantages for both money supply and interest rate policy rules revolve around measurement issues. Money demand and money supply can be difficult to measure and interpret. If money demand is volatile and unpredictable, then targeting the money supply can generate unnecessary and destabilizing interest rate and output fluctuations. Thus, when the primary source of uncertainty arises from the money market, an interest rate rule provides a superior monetary policy. On the other hand, the goods market responds to movements in real interest rates and monitoring them requires knowledge of inflation expectations. The expected inflation rate is more difficult to measure as inflation becomes more volatile. That can cause unintended shifts in real interest rates (and output) if the central bank incorrectly measures expected inflation when setting its nominal interest rate target. Thus, if the primary source of uncertainty comes from the goods market, then a money supply rule provides a superior monetary policy.

3.



Using fiscal policy to restrict aggregate demand leads to lower interest rates and thus higher investment and growth. A mix of monetary and fiscal policy may be best because of the effect of interest rates.