1 Monetary Policy by a Taylor Rule

Suppose that the Fed were committed to the following Taylor-style policy rule for the Federal Funds rate:

\[ i_{FF} = \pi + 0.02 + 0.5(\pi - \pi^*) + 0.5(Y - \bar{Y}) \]

where \( i_{FF} \) is the nominal Federal Funds rate, \( \pi \) is the annual inflation rate, \( \pi^* = 2\% \) is the target inflation rate, and \( Y \) is the deviation of output from potential (i.e., \( Y = Y - \bar{Y} \)).

For each of the following shocks, determine the effects of the policy prescribed by the Taylor Rule on the Federal Funds rate, output, and inflation. Would the policy reaction be stabilizing, destabilizing, or neutral relative to leaving the money supply unchanged after the shock?

a. A temporary boost in government purchases.

b. A negative technology shock.

c. An increase in money demand.

d. A drop in consumer confidence.

2 Contemporary Monetary Policy

Pick one of the following two short texts and analyze its discussion of contemporary monetary policy using the tools and framework of analysis covered in this course. How does the content relate to our discussion of monetary policy goals, strategies, and policy instruments? How does the discussion of monetary policy and the real interest rate map into our IS/LM-AS/AD framework? And where does it seem to most closely fit among the competing theories of the business cycle we have studied?


   http://www.brookings.edu/blogs/ben-bernanke/posts/2015/03/30-why-interest-rates-so-low

3 Shocks to the Money Supply

How would each of the following developments affect the U.S. monetary base, money multiplier, and money supply? Explain.

a. The Federal Open Market Committee decides to purchase $40 billion of mortgage-backed securities every month (like the third round of “quantitative easing” purchases initiated in 2012).

b. A financial crisis prompts households to sell off some of their stock market portfolio and deposit the proceeds into bank accounts covered by deposit insurance.

c. Higher expected inflation makes both households and banks less willing to hold cash.

d. Banks decide to hold more excess reserves.