

Midterm 2012

MCQ 8: e

- ▶ FE: $r = i + \pi$. Credibility.
- ▶ **Beveridge curve** – see diagram on board.
- ▶ **Nominal anchor**: ‘technique of fixing a nominal variable in an economy as a means of reducing inflation’ e.g.: peg nominal exchange rate so there is less ability to raise the money supply.
- ▶ **TIPS**: Treasury Inflation Protected Securities (indexed bonds). Real rate: 3%, nominal rate 5% so $E(\pi) = 5 - 3 = 3\%$ break even inflation.

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MCQ 9: d

- a) $\pi = g_p \stackrel{QT}{=} g_M - g_Y$. g_M falls so π increases. $i \stackrel{FE}{=} r + \pi$ so i falls. Permanent change implies i falls at all maturities.
- b) Fall in I demand reduces i (chapter 5, Mishkin) – less profitable opportunities to invest in so less demand for loanable funds so less i .
- c) Rise in precautionary saving so less need to incentivise saving.
- d) By elimination!
- e) Lower π target: $i \stackrel{FE}{=} r + \pi$ and π falls so i falls. Can see also by Taylor Rule: target π^* lower so target i^* is lower.

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MCQ 10: f

- ▶ Domestic currency appreciation makes domestic price of foreign currency more expensive so firms and banks find it harder to pay off debt. So, balance sheet effects affect firm (more difficult to get loans) and banks reduce lending.
- ▶ b is out since households are not directly involved here, which rules out d and e.
- ▶ a is correct, but c is correct too so it must be a & c, which is answer f.

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MCQ 3: d

- ▶ Quantitative Easing (QE) encourages investors to take on more risk, stimulates an economy (possibly through depreciating the nominal exchange rate), lowers interest rates on long-run bonds and other assets and encourages more lending by banks to the private sector.
- ▶ What is wrong with d? $r \stackrel{\text{FE}}{=} i - \pi^e$ and reducing π^e would only raise r , which is the opposite of what QE aims to do. After all, the problem of deflationary spirals at the zero lower bound of monetary policy motivates the use of QE in the first place.

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MCQ 5: c

- ▶ Creating inflationary expectations lowers r through the Fisher equation ($r = i - \pi^e$), stimulating the economy. This rules out a.
- ▶ Taylor Principle and divine coincidence don't enter the problem ruling out b & e.
- ▶ If consumption increases, why would the central bank create inflation? There is certainly the problem of dynamic inconsistency – smokers problem – 'I will quit. . . tomorrow'; then tomorrow comes and I don't quit but say the same thing again perhaps.
- ▶ **Divine coincidence**: with no real nominal wage rigidity, New Keynesian models predict that there is no trade-off between inflation stabilisation and output stabilisation.

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MCQ 7: c

- a) Declines in government expenditure tend to reduce likelihoods of fiscal crises, which could be economically costly, so long-run rates tend to fall. No.
- b) Quantity theory: $\pi = g_M - g_Y$. If g_M falls, π falls. Then by Fisher equation ($i = r + \pi$) i falls. No.
- c) β falls implies that we care less about the future so need to be incentivized to save. Yes (most correct).
- d) Raising short-term interest rates doesn't necessarily imply long-run rates also rise. Possible but no.
- e) Chapter 5 Mishkin – tends to raise interest rates so a possible contender, but no.

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MCQ 8: c

Suppose TIPS real was 3% and TIPS nominal was 5%. Suppose long-run was 4% and now is 3%. Gap was $5 - 4 = 1$. To keep gap same, nominal TIPS now must be 4. Breakeven inflation was $E(\pi) = 5 - 3 = 2\%$ and now is $E(\pi) = 4 - 3 = 1\%$. The answer is therefore c. Obviously, b, d and e are ruled out because they imply rising interest rates. c is more apt than a given the relation between TIPS and long-run bonds, i.e. we are talking about *inflation*-indexed bonds.

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MCQ 5: c

This is like the permanent lump sum tax each period of T . People will feel poorer so consume less, ruling out d. e is irrelevant. If each period they have T less euros to consume from, they will reduce their consumption by T , since each period they consume the average lifetime income (averaged over the length of time) and average lifetime income has been reduced by T . However, with more certainty (less uncertainty), precautionary savings motives will be reduced so they will not reduce consumption by as much as otherwise. The answer is therefore a.