Chapter 14 problems

1. The five equations that make up the dynamic aggregate demand–aggregate supply model can be manipulated to derive long-run values for the variables. In this problem, it is assumed that there are no shocks to demand or supply and inflation has stabilized.

Since inflation has stabilized, it must be true that inflation in time $t$ is equal to inflation in time $t-1$ ($\pi_t = \pi_{t-1}$). We also know that expected inflation is equal to last period’s inflation, or $E_{t-1}\pi_t = \pi_{t-1}$. Start with the Phillips curve equation below and use these two facts to find the following:

$$\pi_t = E_{t-1}\pi_t + \phi^*(Y_t - Y^p_t) + v_t$$
$$\pi_t = \pi_{t-1} + \phi^*(Y_t - Y^p_t) + v_t$$
$$\pi_t = \pi_t + \phi^*(Y_t - Y^p_t) + v_t$$

From here, it follows that output must equal natural output since the supply shock parameter $\nu_t$ equals zero. Moving to the demand for goods and services equation below, it now follows that the real interest rate equals the natural rate of interest since the demand shock parameter $\epsilon_t$ equals zero and $Y_t = Y^p_t$.

$$Y_t = Y^p_t - \alpha(r_t - \rho) + \epsilon_t$$

Turning to the Fisher equation, we can show the nominal interest rate is equal to the natural interest rate plus the current inflation rate. Since inflation has stabilized, expected inflation equals current inflation ($E_t\pi = \pi_t$) and we have just demonstrated that the real interest rate is equal to the natural rate of interest ($r_t = \rho$): $i_t = \rho + \pi_t$

Moving now to the monetary policy rule equation below, it must be true that current inflation equals the target inflation rate so that the third term on the right zeros out. Likewise, the fourth term on the right side will zero out since output is at the natural level:

$$i_t = \rho + \pi_t + \theta_{\pi^*}(\pi_t - \pi^*_t) + \theta_y^*(Y_t - Y^p_t)$$

The final values are as follows: $Y_t = Y^p_t$; $r_t = \rho$; $\pi_t = \pi^*_t$; $E_{t-1}\pi = \pi^*_t$; $i_t = \rho + \pi_t$

3. “If a central bank wants to achieve lower nominal interest rates, it has to raise the nominal interest rate.” In long-run equilibrium, the nominal rate of interest is equal to the natural rate of interest plus the target inflation rate. To lower the long-run nominal interest rate, the central bank must lower the target inflation rate and, ultimately, the actual inflation rate. In the short run, the central bank must increase the nominal interest rate in order to reduce spending and output in the economy. This will reduce inflation and, ultimately, expected inflation. The economy will adjust to a new long-run equilibrium in which the nominal interest rate, the target inflation rate, and the actual inflation rate are all lower. Graphically, lowering the target inflation rate will shift the dynamic aggregate demand curve down and to the left, forcing the economy through a recessionary cycle, and in the short run, output and inflation will be lower. As
expected inflation adjusts over the long run, the dynamic aggregate supply curve will shift down and to the right. In the long run, output is equal to the natural level and inflation is lower.

5. Follow the hint given in the problem and solve for the long-run equilibrium with the new assumption that the demand shock parameter $\varepsilon_t$ is not zero. Since inflation has stabilized, it must be true that inflation in time $t$ is equal to inflation in time $t-1 (\pi_t = \pi_{t-1})$. We also know that expected inflation is equal to last period’s inflation, or $E_{t-1}\pi_t = \pi_{t-1}$. Start with the Phillips curve below and use these two facts to find the following:

$$
\begin{align*}
\pi_t &= E_{t-1}\pi_t + \phi^*(Y_t - Y^p_t) + \nu_t, \text{ so } \pi_t &= \pi_{t-1} + \phi^*(Y_t - Y^p_t) + \nu_t \text{ and} \\
\pi_t &= \pi_t + \phi^*(Y_t - Y^p_t) + \nu_t
\end{align*}
$$

From here, it follows that output must equal natural output since the supply shock parameter $\nu_t$ equals zero. From the demand for goods and services equation below, it now follows that the real interest rate equals the natural rate of interest plus a new term:

$$
Y_t = Y^p_t - \alpha(r_t - \rho) + \varepsilon_t.
$$

0 = -\alpha(r_t - \rho) + \varepsilon_t, \text{ so } -\alpha r_t = \alpha \rho + \varepsilon_t, \text{ therefore } r_t = \rho + \varepsilon_t / \alpha
$$

Turning to the Fisher equation below, we can show the nominal interest rate is equal to the natural interest rate plus the current inflation rate plus a new term. Since inflation has stabilized, expected inflation equals current inflation ($E_t\pi_{t+1} = \pi_t$), and we have just demonstrated that the real interest rate is equal to the natural rate of interest plus a new term $r_t = \rho + \varepsilon_t / \alpha$

$$
\begin{align*}
r_t &= i_t - E_{t-1}\pi_t \text{ which implies } r_t = i_t - \pi_{t-1} \text{ which implies that } r_t = i_t - \pi_t. \text{ So } i_t = \pi_t + r_t \\
\text{finally, } i_t &= \rho + \pi_t + \varepsilon_t / \alpha
\end{align*}
$$

Moving now to the monetary policy rule equation below, substitute in for the nominal rate of interest from the rewritten Fisher equation above, and then note that the fourth term on the right side will zero out since output is at the natural level:

$$
\begin{align*}
\pi_t &= \pi_t + \theta_{\pi} \pi^* (\pi_t - \pi^*) + \theta_{\gamma} (Y_t - Y^p_t) \text{ therefore } \rho + \pi_t + \varepsilon_t / \alpha = \rho + \pi_t + \theta_{\pi} \pi^* (\pi_t - \pi^*) \text{ so } \\
\varepsilon_t / \alpha &= \theta_{\pi} \pi^* (\pi_t - \pi^*) \text{ which means that } \pi_t = \pi_t^* + \varepsilon_t / \theta_{\pi} \alpha
\end{align*}
$$

The final values are as follows:

$$
\begin{align*}
Y_t &= Y^p_t; \quad r_t = \rho + \varepsilon_t / \alpha; \quad \pi_t = \pi_t^* + \varepsilon_t / \theta_{\pi} \alpha; \quad E_{t-1}\pi_t = \pi_t^* + \varepsilon_t / \theta_{\pi} \alpha; \quad i_t = \rho + \pi_t^* + \varepsilon_t / \alpha
\end{align*}
$$

If the demand shock parameter $\varepsilon_t$ were to increase permanently, such that it remained a constant positive number, the dynamic aggregate demand curve would shift to the right permanently. This would cause a short-run increase in output and inflation and a long-run increase in the inflation rate as the economy adjusted to its new long run equilibrium. This is consistent with the newly derived long-run values above, where the inflation rate is higher than the target inflation rate. Note that expected inflation is also higher, as is the nominal and the real interest rate. To deal with this issue, the central bank could decrease its target inflation rate. This would effectively offset the permanent increase in the demand shock parameter $\varepsilon_t$ and shift the dynamic aggregate demand curve back to its original position.
7. Suppose that the natural rate of interest is not a constant parameter but varies over time so that it is now written as \( \rho_t \).

a. The equation for dynamic aggregate supply is not affected by this change because its derivation does not involve the natural rate of interest. The equation for dynamic aggregate demand is not affected by this change either because, although the variable \( \rho_t \) is involved in the derivation of the dynamic aggregate demand curve, it cancels out and does not end up as part of the final equation.

b. A shock to \( \rho_t \) would not cause a shift to either dynamic aggregate demand or dynamic aggregate supply because the variable does not appear in either equation. Output and inflation would not be affected. However, the real and nominal interest rates would both change by the amount of the change in \( \rho_t \).

c. If the natural rate of interest varied over time, it would make the setting of monetary policy more difficult. If the central bank knows that the natural rate of interest is 4 percent, for example, and it is aiming for target inflation rate of 2 percent, then a nominal interest rate of 6 percent will be the long-run target. If, on the other hand, the natural rate of interest varies over time, then the target long-run interest rate will also vary over time. It is more difficult to hit a moving target than a target that is standing still. In particular, in contrast to what is implicitly assumed above, if the natural rate of interest is always moving, the central bank might have trouble knowing the natural rate of interest at every point in time.

9. Use the dynamic AD–AS model to solve for inflation as a function of only lagged inflation and the two shocks. Start with the dynamic aggregate supply curve and substitute in for \( Y_t \) using the dynamic aggregate demand curve equation as is done below. Now, solve for inflation through a few algebraic manipulations:

\[
\pi_t = \pi_{t-1} + \phi[ Y^p_t - (\theta \pi/ (1 + \theta \alpha))(\pi_t - \pi^*_t) + [ 1/(1 + \theta \alpha)]e_t - Y^p_t] + v_t
\]

which can be solved for \( \pi_t \)

\[
\pi_t = (1 + \theta \alpha)\pi_{t-1} + \phi \theta \alpha \pi^*_t + \phi \epsilon_t + (1 + \theta \alpha) v_t
\]

\[
1 + \theta \alpha + \phi \theta \alpha
\]

a. A supply or demand shock will lead to an increase in current inflation. As the economy adjusts and returns to long-run equilibrium, the inflation rate will return to its target level. Note that the coefficient on the lagged inflation variable in the equation above is positive but less than 1. This means that inflation in time \( t + 1 \) will be less than inflation in time \( t \), and that inflation will eventually return to its target rate.

b. If the central bank does not respond to changes in output so that \( \theta_y \) is zero, then the economy will still return to its target inflation rate after a supply or demand shock because the coefficient on the lagged inflation variable in the equation above is still positive but less than 1. In this case, inflation should return more quickly to its target rate. This is because the coefficient on lagged inflation has become smaller (the change in the numerator is large in comparison to the change in the denominator). The dynamic aggregate demand curve is relatively flat when the central bank only cares about inflation.
c. If the central bank does not respond to changes in inflation so that \( \theta \pi \) is zero, then the coefficient on lagged inflation in the above inflation equation equals 1. In this case, the economy will not return to its target inflation rate after a demand or supply shock. The demand or supply shock will increase inflation in time \( t \). When \( \theta \pi \) is zero, inflation in time \( t + 1 \) is equal to inflation in time \( t \).

d. The Taylor rule says that a one-percentage-point increase in inflation will increase the nominal interest rate by \( 1 + \theta \pi \) percentage points. If the central bank increases the nominal interest rate by only 0.8 percentage points for each one-percentage-point increase in the nominal interest rate, then this means \( \theta \pi \) is equal to \(-0.2\). When \( \theta \pi \) is negative, the dynamic aggregate demand curve is upward sloping. A shock to demand or supply will set the economy on a path of ever-increasing inflation. This path of ever-increasing inflation will occur because real interest rates will continue to fall and output will remain above the natural level. You can see this phenomenon in the above equation for inflation: If \( \theta \pi \) is negative, the coefficient on lagged inflation is greater than 1. That larger than-one coefficient is the mathematical manifestation of explosive inflation.

Chapter 15 problems

1. Suppose the economy has a Phillips curve \( u = u_n - \alpha(\pi - \pi^e) \).

As usual, this implies that if inflation is lower than expected, then unemployment rises above its natural rate, and there is a recession. Similarly, if inflation is higher than expected, then unemployment falls below its natural rate, and there is a boom. Also, suppose that the Democratic party always follows a policy of high money growth and high inflation (call it \( \pi_D \)), whereas the Republican party always follows a policy of low money growth and low inflation (call it \( \pi_R \)).

a. The pattern of the political business cycle we observe depends on the inflation rate people expect at the beginning of each term. If expectations are perfectly rational and contracts can be adjusted immediately when a new party comes into power, then there will be no political business cycle pattern to unemployment. For example, if the Democrats win the coin flip, people immediately expect high inflation. Because \( \pi = \pi_D = E\pi \), the Democrats’ monetary policy will have no effect on the real economy. We do observe a political business cycle pattern to inflation, in which Democrats have high inflation and Republicans have low inflation.

Now suppose that contracts are long enough that nominal wages and prices cannot be adjusted immediately. Before the result of the coin flip is known, there is a 50-percent chance that inflation will be high and a 50-percent chance that inflation will be low. Thus, at the beginning of each term, if people’s expectations are rational, they expect an inflation rate of \( \pi^e = 0.5\pi_D + 0.5\pi_R \). If Democrats win the coin toss, then \( \pi > \pi^e \) initially, and unemployment falls below its natural rate. Hence, there is a boom at the beginning of Democratic terms. Over time, inflation rises to \( \pi_D \), and unemployment returns to its natural rate. If Republicans win, then inflation is lower than expected, and unemployment rises above its natural rate. Hence,
there is a recession at the beginning of Republican terms. Over time, inflation falls to \( \pi_R \), and unemployment returns to its natural rate.

b. If the two parties take turns, then there will be no political business cycle to unemployment, since everyone knows which party will be in office, so everyone knows whether inflation will be high or low. Even long-lasting contracts will take the actual inflation rate into account, since all future inflation rates are known with certainty. Inflation will alternate between a high level and a low level, depending on which party is in power.

2. There is a time-inconsistency problem with an announcement that new buildings will be exempt from rent-control laws. Before new housing is built, a city has an incentive to promise this exemption: landlords then expect to receive high rents from the new housing they provide. Once the new housing has been built, however, a city has an incentive to renege on its promise not to extend rent control. That way, many tenants gain while a few landlords lose. The problem is that builders might expect the city to renege on its promise; as a result, they may not build new buildings.

Appendix Chapter 15 problem
1. a. In the model so far, nothing happens to the inflation rate when the natural rate of unemployment changes.

b. The new loss function is  
\[
L(u, \pi) = u^2 + \gamma \pi^2.
\]

The first step is to solve for the Fed’s choice of inflation, for any given inflationary expectations. Substituting the Phillips curve into the loss function, we find:  
\[
L(u, \pi) = [u_n - \alpha(\pi - E\pi)]^2 + \gamma \pi^2.
\]

We now differentiate with respect to inflation \( \pi \), and set this first-order condition equal to zero:

\[
dL/d\pi = 2\alpha^2(\pi - E\pi) - 2\alpha u_n + 2 \gamma \pi = 0 \quad \text{or} \quad \pi = (\alpha^2 E\pi + \alpha u_n)/(-\gamma).
\]

Of course, rational agents understand that the Fed will choose this level of inflation. Expected inflation equals actual inflation, so the above equation simplifies to:  
\[
\pi = \alpha u_n/\gamma.
\]

c. When the natural rate of unemployment rises, the inflation rate also rises. Why? The Fed’s dislike for a marginal increase in unemployment now rises as unemployment rises. Hence, private agents know that the Fed has a greater incentive to inflate when the natural rate is higher. Hence, the equilibrium inflation rate also rises.

d. Appointing a conservative central banker means that \( \gamma \) rises. Hence, the equilibrium inflation rate falls. What happens to unemployment depends on how quickly inflationary expectations adjust. If they adjust immediately, then there is no change in unemployment, which remains at the natural rate. If expectations adjust slowly, however, then, from the Phillips curve, the fall in inflation causes unemployment to rise above the natural rate.

Chapter 16
1. The budget deficit is defined as government purchases minus government revenues.
Selling the Liberty Bell to Taco Bell would raise revenue for the U.S. government and, hence, reduce the deficit. A smaller budget deficit would lead the government to borrow less, and as a result the measured national debt would fall.

If the United States adopted capital budgeting, the net national debt would be defined as the assets of the government (its schools, armies, parks, and so forth) minus the liabilities of the government (principally outstanding public debt). By selling the Liberty Bell the government would be reducing its assets by the value of the Liberty Bell and reducing its liabilities by its purchase price. Assuming Taco Bell paid a fair price, these reductions would be the same amount and the net national debt would be unchanged.

Before you worry too much about the Taco Liberty Bell, you might want to notice that this ad appeared on April Fools’ Day.

3. a. We will assume that the life-cycle model of Chapter 16 holds and that people want to keep consumption as smooth as possible. This implies that the effect on consumption of a temporary change in income will be spread out over a person’s entire remaining life. We will also assume for simplicity that the interest rate is zero.

Consider a simple example. Let $T$ be the amount of the one-time, temporary tax levied on the young, and let $B$ be the amount of the one-time benefit paid to the old, where $B = T$. If a typical elderly person has 10 years left to live, then the temporary benefit increases the present consumption of the elderly by $B/10$. If a typical worker has 30 years left to live, then the increase in taxes decreases their present consumption by $T/30$. Aggregate consumption changes by an amount $\Delta C = B/10 - T/30 = B/15$.

The transfer of wealth to the elderly causes a net increase in consumption and, therefore, a decrease in saving. This happens because the elderly increase consumption by more than the workers decrease it, because the elderly have fewer years left to live and thus have a higher marginal propensity to consume.

b. The answer to part (a) does depend on whether generations are altruistically linked. If generations are altruistically linked, then the elderly may not feel any better off because of the Social Security benefit, since the tax and benefit increase has no effect on a typical family’s permanent income; it simply transfers resources from one generation of the family to another. If the elderly do not want to take advantage of this opportunity to consume at their children’s expense, they may try to offset the effect of the tax increase on the young by giving them a gift or leaving a bequest. To the extent that this takes place, it mitigates the impact of the tax change on consumption and saving.

4. A rule requiring a cyclically adjusted balanced budget has the potential to overcome, at least partially, the first two objections to a balanced-budget rule that were raised in this chapter. First, this rule allows the government to run countercyclical fiscal policy in order to stabilize the economy. That is, the government can run deficits during recessions, when taxes automatically fall and expenditures automatically rise. These automatic stabilizers affect the deficit but not the cyclically adjusted deficit. Second, this rule allows the government to smooth tax rates across
years when income is especially low or high—it is not necessary to raise tax rates in recessions or to cut them in booms.

On the other hand, this rule only partially overcomes these two objections, since the government can only run a deficit of a certain size, which might not be big enough. Also, a cyclically adjusted balanced budget does not allow the government to smooth tax rates across years when expenditure is especially high or low, as in times of war or peace. (We might take account of this by allowing an exemption from the balanced budget rule in special circumstances such as war.) This rule does not allow the government to overcome the third objection raised in the chapter, since the government cannot shift the burden of expenditure from one generation to another when this is warranted.

Finally, a serious problem with a rule requiring a balanced cyclically adjusted budget is that we do not directly observe this budget. That is, we need to estimate how far we are from full employment; then we need to estimate how expenditures and taxes would differ if we were at this full-employment level. None of these estimates can be made precisely.

5. The Phillips Curve characterizes the relationship between inflation and unemployment. Studies of the United Kingdom and the United States showed a stable relationship between these two variables until the mid-1960s. These results suggested that there might be a tradeoff between unemployment and inflation. When policy makers attempt to exploit such a tradeoff by inducing higher inflation in order to achieve lower unemployment, the Phillips curve becomes unstable. Contemporary analysis of the Phillips curve suggests that a change in expectations of inflation, or in any other variable that would shift the Aggregate Supply curve, also changes the position of the Phillips curve. Thus, the Phillips curve tradeoff can be exploited only if such supply shift factors, especially expected inflation, do not exist.

6. Inflation has been and remains of interest to economists for at least eight reasons:

a. Inflation is impure - there exist winners and losers.
b. Anticipated inflation has different effects than unanticipated inflation.
c. Inflation has been asked to reconcile competing claims on income when there is insufficient income to satisfy all such claims.
d. Inflation causes people to devote resources to protecting their incomes and assets. The higher the inflation rate the more critical this becomes.
e. Anticipated inflation is not neutral. For example, holders of money are not compensated for inflation, and the income tax structure does not distinguish between nominal and real increases in asset value (since capital gains, when cashed, are treated as taxable income).
f. Menu and shoe leather costs rise with the inflation rate.
g. The variability of the inflation rate, and thus uncertainty, rises with the level of inflation.
h. The rich have more ways to protect themselves against inflation than the poor have.

7. Assume Model 4 for this question. Large budget deficits may arise from two sources:
intentional increases in G or decreases in T (fiscal policy) or endogenous increases in G or decreases in T. For the first source, budget deficits correspond to outward shifts in the IS and AD curves with short term increases in Y, L, and r. If money expansion accompanies the surplus, the P and Y effects will be magnified and the upward pressure on r will be reduced.

The more open the economy, the more important the discussion of net export behavior becomes. For example, increases in r and Y would lead to decreased net exports that would reduce the size of the AD increase.

If a recession-related increase in the deficit arises, a change in some exogenous variable must have set the process in motion; thus, one must analyze the implications of that variable to understand the implications for the economy.

8. Policy credibility means that the public believes the policy will be implemented, and, furthermore, acts on such beliefs even with occasional evidence to the contrary. Rules refer to formulas or equations. A monetary policy rule means an explicit equation that one might employ to predict the rate of growth of money. In models with rational expectations, credible policy rules are used to predict the amount of anticipated inflation. If policy makers follow such rules, disinflationary rules in particular, then the cost of disinflating the economy will be minimized. In graphical terms, a monetary deflation policy would shift the AD curve toward the origin. If such a policy followed a credible rule, then the AS curve would shift down sufficiently to yield a drop in price level without a change in output growth.