Review Problems: AS/AD Model
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Jones, Macroeconomics, problems 12.1, 12.3-12.7, 12.12, 12.14.

1 Basics

1. Why is it important to split monetary policy actions into rules and shocks?
2. Explain why a central bank that follows a strict rule without deviations would be irrelevant.
3. Which leading indicators can be used to forecast turning points / recessions? Explain why they make sense.
4. Explain the time consistency problem in monetary policy.
5. Why is it important for a central bank to have the reputation of being a tough inflation fighter?
6. How could a central bank, in principle, reduce inflation without causing a recession?

1.1 Answer: Basics

1. The predictable part, the rule, has no effect because these monetary policy actions are anticipated. The shocks are not anticipated and have real effects. The AS/AD model does not quite get that right. The reason is that expected inflation in the AS curve is set to π_{t-1}. Effectively, the private sector has less information than the central bank. That way, even rule based Fed actions have real effects.
2. Expectations would anticipate the rule based policy actions. Anticipated monetary policy is neutral.
3. See slides.
4. See slides.
5. See slides.
6. The CB would have to successfully manipulate inflation expectations. Historical examples: Germany after WW2, Argentina's currency board. Hard to do...

2 AS/AD Model

1. Why is the AD curve downward sloping (plotting π against $\tilde{Y}$)?
2. What shifts the AD curve?
3. You should able to work through the effects of shocks to supply or demand.
4. Why do temporary shocks have persistent effects on π and $\tilde{Y}$?
5. Why does disinflation lead to a recession?
6. How does the monetary policy rule (its slope m) affect its effectiveness for smoothing out supply and demand shocks?

2.1 Answer: AS/AD Model

1. The AD curve is downward sloping because the Fed responds to inflation above target by raising the interest rate, which reduces demand.
2. See slides.
3. See slides.
4. Because inflation expectations are sticky. When the economy is away from the steady state, it takes time for expectations to converge to $\bar{\pi}$. This would be different with rational expectations.
5. Lower $\bar{\pi}$ induces the Fed to raise R. That would not be necessary if the Fed could control π^e.
6. See slides.