Exercise Session 5

Monetary policy rules, the complete IS-MP-PC Model

TASK 1: Monetary policy rules

a) Explain the general intuition behind the Taylor Rule.
b) What arguments speak in favor of interest rate smoothing?
c) What is the challenge in estimating monetary policy rules?
d) How is econometrically still possible to estimate monetary policy rules?

TASK 2: Monetary policy rule in the IS-MP-PC model

a) Derive the IS-MP curve based on the IS curve and the simplified monetary policy rule.
b) Show algebraically that there is a negative relationship between output and inflation. What is the intuition behind this negative relationship?

TASK 3: Graphical representation and shocks

a) Draw the movements of/along the IS curve and the real interest rate following a temporary, positive demand shock assuming adaptive inflation expectations. Use the extended graphical representation of the IS-MP-PC model.
b) Redo exercise 3a) but assume anchored inflation expectations.
c) Draw the movements of/along the IS curve and the real interest rate following a temporary, negative supply shock assuming adaptive inflation expectations. Use the extended graphical representation of the IS-MP-PC model.
d) Redo exercise 3a) but assume anchored inflation expectations.