

ECO 400: Monetary Theory and Policy

Instructor: Murray, James

Take Home Exam 3

Due Tuesday, December 22 at 11:00am. Late exams will earn zero credit.

Directions: Answer three (and only three) of the following six questions on separate sheets of paper. *Start each answer on its own sheet of paper.* Each question is worth 30 points and you will receive 10 points for successfully following directions. All answers must be very neat and very clearly legible. If it is difficult to read an answer, no credit will be given.

Rules: *You must not work together on this exam with any other person.* You may however, discuss this exam with others if nobody in the conversation has any class materials in front of them, and no one is writing anything down. That is, you may discuss the exam in casual conversations, but you must still work on the exam independently. Failure to comply with this condition is considered academic dishonesty and will result in the harshest penalty that the university will allow. You are allowed to use your notes, textbook, and computer.

1. What does Dornbusch (1976) mean by exchange rate overshooting. What does he suggest causes exchange rate overshooting. What is the implication for the monetary policy transmission?
2. According to Cecchitti and Ehrmann (1999) is there evidence that countries whose central banks explicitly target inflation exhibit monetary policy with a higher aversion to inflation volatility than countries that do not explicitly target inflation. Is there evidence that countries who explicitly target inflation have different levels of output volatility than other countries? Carefully explain their findings *in your own words*.
3. Anderson and Gascon (2009) describes three “Lender of Last Resort” programs initiated by the Federal Reserve in 2008 to rescue the commercial paper market. Describe each of these three programs and their relative success. What was the Fed’s response to the potential commercial paper crisis following the collapse of Penn Central Railroad in 1970? Why do you think the current situation demanded a different response.
4. Describe monetary policy behavior if a central bank followed a Taylor (1993) rule. Cite and explain three criticisms from Garrison (2009) for following such a policy.
5. Cite at least three criticisms of the classical IS/LM/AS model. Describe the structure of the New Keynesian model and suggest how this model addresses some of the criticisms you mention. See Kapinos (2009).
6. Cite and describe any other paper not mentioned on this exam or the previous exam that concerns monetary policy and was cited sometime during the semester either by your instructor or a student, or that appears on the syllabus. Describe the issue in the paper, the implications for monetary policy, and your opinion of the findings.

References

- ANDERSON, R. G., AND C. S. GASCON (2009): “The Commercial Paper Market, the Fed, and the 2007-2009 Financial Crisis,” Federal Reserve Bank of St. Louis Review, 91, 589–612.
- CECCHITTI, S. G., AND M. EHRMANN (1999): “Does Inflation Targeting Increase Output Volatility? An International Comparison of Policy Makers Preferences and Outcomes,” NBER Working Paper No. 7426.
- DORNBUSCH, R. (1976): “Expectations and Exchange Rate Dynamics,” Journal of Political Economy, 84, 1161–1176.
- GARRISON, R. W. (2009): “Interest Rate Targeting During the Great Moderation: A Re-appraisal,” Cato Journal.
- KAPINOS, P. S. (2009): “A New Keynesian Workbook,” Working Paper.
- TAYLOR, J. (1993): “Discretionary Versus Policy Rules in Practice,” Carnegie-Rochester Conference Series on Public Policy, 39, 195–214.