

Fiscal and Monetary Policies

The Nominal Anchor

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 - nominal rigidities may link changes in nominal and real GDP in the short run
 - but this does not interact in a fundamental way with our discussion of the nominal anchor

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 - According to these models, expected money growth and inflation affect the current price level

Expectations of Future Monetary Policy

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 - The right-hand side is the (logarithm of) demand for real money balances
- Expected inflation ($E_t \pi_{t+1}$) raises the nominal interest rate (i_t) via the (linearized) Fisher equation,

$$i_t = r_t + E_t \pi_{t+1},$$

(where r_t is the expected real interest rate); this reduces current demand for real money balances, which raises p_t

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- Since we have $\eta > 0$, we get a unique bounded solution for p_t , with bounded forcing variables– this solution is forward-looking, as you can show for HOMEWORK

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 - But in policy-oriented research, we usually set this aside, focusing on the unique suitably **bounded** solution for the price level and inflation (as we did in the preceding example)
- The prospect of nominal indeterminacy that does play a role in policy-oriented discussions pertains to interest-rate rules

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- The possibility of nominal indeterminacy under interest-rate targeting is an old topic in monetary theory, and in policy-oriented discussions

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- There is a general perception in this literature that avoiding nominal indeterminacy should be an important part of the central bank's mandate

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- Using the Fisher equation, the dynamics of inflation are governed by

$$E_t \pi_{t+1} = \phi_\pi \pi_t - (r_t - r)$$

which generates explosive dynamics if $\phi_\pi > 1$, unless inflation is at the target level $\pi_t = 0$

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- We will revisit these questions and alternative interpretations