

## Chapter 27 Objectives, Targets, and Instruments

### Question 27.4

Economists have made many recommendations in order to avoid the rational expectations equilibrium with its relatively large welfare loss. Below we have listed a number of these recommendations. Explain for each of them why these proposals may convince the general public that the authorities will pursue a low inflation target.

27.4A The Central Bank should have an inflation target

27.4B The Central Bank should be independent

27.4C Appoint conservative central bankers

27.4D The wage of central bankers should depend negatively on inflation

### Question 27.5

The [data file of question 27.5](#) offers data on the federal funds rate, inflation, GDP and unemployment of the United States. Develop and estimate your own Taylor rule with this data and evaluate in class which student has made the best rule. Compare the different Taylor rules both on goodness of fit and their usefulness in policy making.

### Question 27.6

The [simulation file of question 27.6](#) gives the Barro-Gordon model as shown in figure 27.9 in the main text. The simulation allows you to analyze the consequences of changes in the target inflation rate, target unemployment rate, expected inflation, natural rate of unemployment and the parameters. In this question we will analyze the consequences of changes in exogenous variables in the case of surprise inflation. Rational expectations will be introduced in question 27.7.

27.6A Explain the difference in the loss function between the simulation and figure 27.9 in the main text.

- 27.6B What happens to the actual inflation and unemployment rate when a government becomes less ambitious in reducing unemployment? Explain why this happens.
- 27.6C Why is it unlikely that a government targets an unemployment rate above the natural rate of unemployment?
- 27.6D What happens to the actual inflation and unemployment rate when a government becomes less ambitious in curbing inflation?

**Question 27.7**

Rational expectations can easily be added to the simulation of question 27.6 by realizing that not only the government but also economic agents (like you and me) can predict what the inflation rate will be with the Barro-Gordon model. It is therefore rational to assume that the expected inflation rate will be equal to the outcome of the model.

- 27.7A What is the rational expectations inflation rate in the simulation of question 27.6?
- 27.7B Does the loss of the government increase with the introduction of rational expectations? Why is this the case?