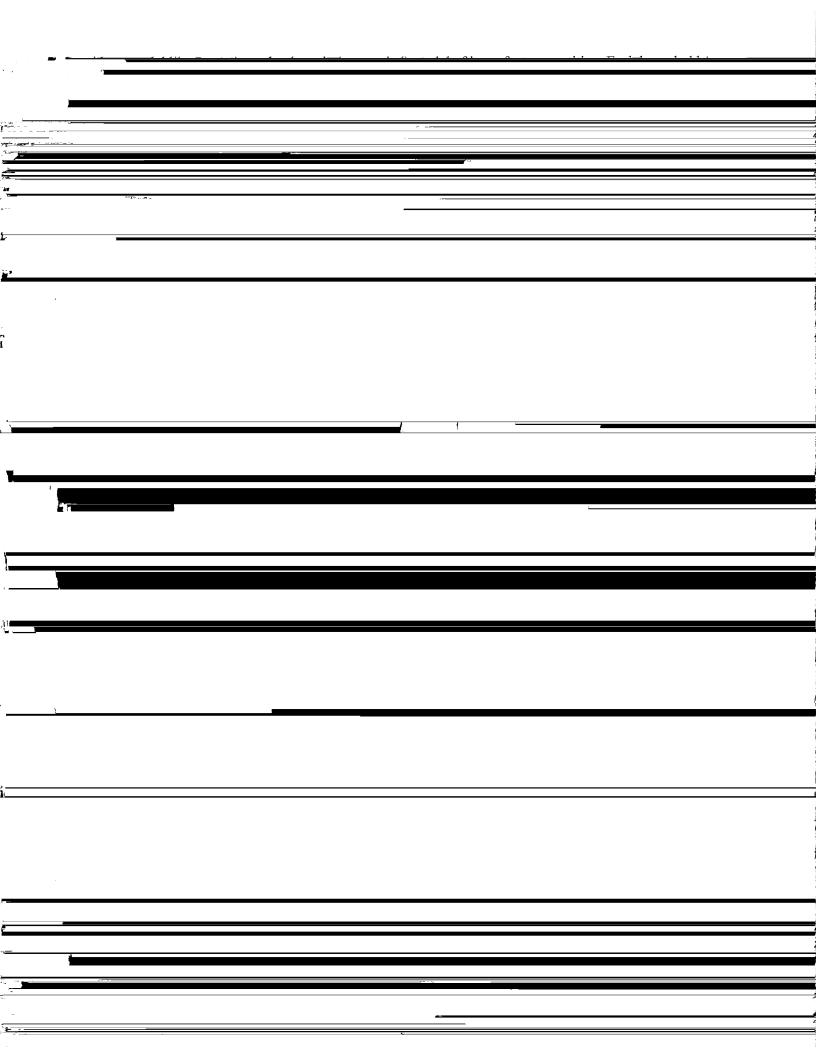
	real money balances is given by $(m-p)^d = y - bi$ where of output is fixed. The natural rate of interest is also	
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r	ational The output can is known to evolve in an AR(1) process: $v = av + \epsilon$, where ϵ follows a standard normal

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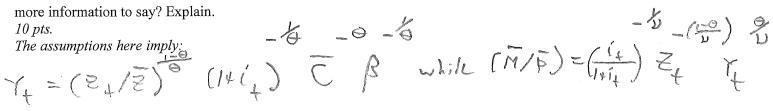
Since $0 < \alpha < 1$, $\partial u_t / \partial R_t < 0$. This is the opposite of the result in the CEE model.

b) Starting from the Bellman equation, derive an equation that gives demand for real money balance $(M/P)_i$ as a function of consumption C_i , the nominal interest rate i_i , and any other relevant variables. 5 pts $S_i = S_i = S_$

d) Now assume:

- Total output is equal to consumption (closed economy, no investment or government purchases).
- the central bank holds the money supply fixed.
- in every period t, $E_t C_{t+1}$ is equal to the long-run steady-state value \overline{C} , and the price level is fixed so $E_t \pi_{t+1}$ is always equal to zero (don't ask why).

What relationship would you expect to observe between the realized value of ϵ in a period and the nominal interest rate i in that period? That is, will a high realized value of ϵ_t tend to increase, decrease or have no effect on i_t ? Or do you need more information to say? Explain.



This corresponds to the IS/LM model. A high realized value of ϵ_t shifts the IS curve out/up. It shifts the LM curve back/down. So far the effect on i_t is ambiguous. You have to do the math, which shows that the effect on i_t necessarily nets