

Exercise 3

The data in INTDEF come from the **2004 Economic Report of the President** (Tables B-73 and B-79) and span the years 1948 through 2003. The variable $i3$ is the three-month T-bill rate, inf is the annual inflation rate based on the consumer price index (CPI), and def is the federal budget deficit as a percentage of GDP. Use the data to estimate the following model:

$$i3_t = \beta_0 + \beta_1 * inf_t + \beta_2 * def_t + u_t$$

Interpret the coefficients. Argue whether all assumptions of TS model are satisfied.

In October 1979, the Federal Reserve changed its policy of using finely tuned interest rate adjustments and instead began targeting the money supply. Define a dummy variable equal to 1 for years after 1979. Include this dummy in equation above to see if there is a shift in the interest rate equation after 1979. What do you conclude?