

Chapter 26

Macroeconomic Policy

Learning Objectives

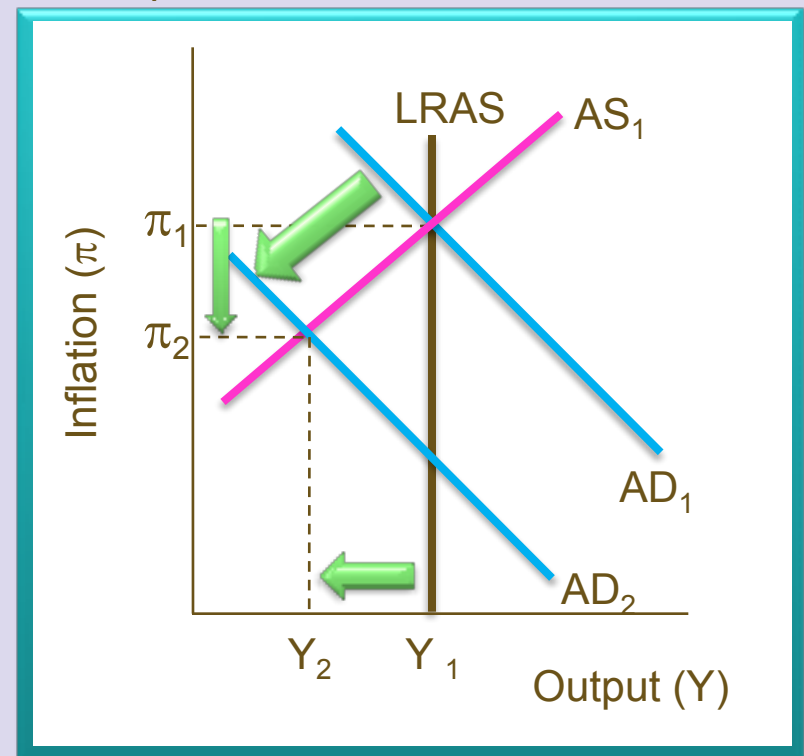
1. Analyze the effects of anti-inflationary monetary policy
2. Discuss the policy options available to the Fed in response to an aggregate demand shock
3. Discuss the policy options available to the Fed in response to an aggregate supply shock
4. Explain the roles of core rate of inflation, anchored inflationary expectation, and central bank credibility in keeping inflation low
5. Describe how fiscal policy can affect both AD and AS
6. Why is macroeconomic policy as much art as science

Enter Paul Volker

- President Carter appointed Volker in August 1979
- Volker's challenge: stabilize the economy and bring inflation down
 - Oil prices doubled after Iran revolution
 - Slowdown in productivity growth
 - CPI inflation was over 13% and increasing
- Volker plans "shock treatment"
 - Sharply reduce the growth of the money supply
 - Real interest rates would rise
 - Aggregate spending would fall
 - Recession, lost output, and lost jobs would follow

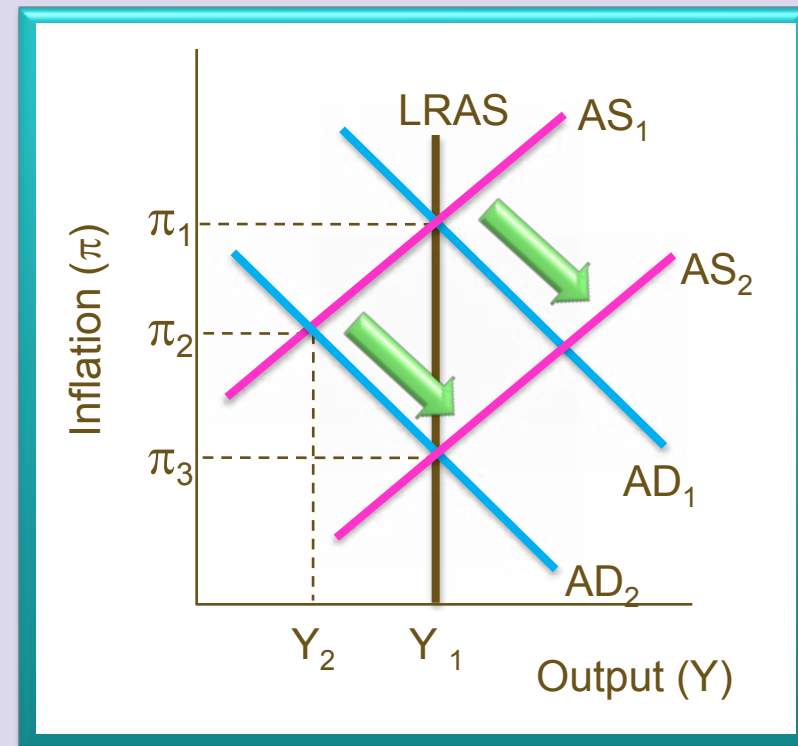
Monetary Policy v. Inflation: The Short Run

- Monetary policy can be used to reduce short-run and long-run inflation
- Start at potential output, Y_1 , and π_1
 - Increase the interest rate at each level of inflation
 - Shifts AD left to AD_2
 - Recessionary gap and short-run equilibrium at Y_2, π_2
 - Cyclical unemployment occurs



Monetary Policy v. Inflation: The Long Run

- Start at short-run equilibrium with a recessionary gap at Y_2 , and π_2
 - Actual inflation, π_2 , is below expected inflation of π_1
 - Expected inflation decreases
 - Lower expected inflation shifts AS to AS_2
 - Economy moves down AD_2
 - New equilibrium at Y_1 , π_3
- Short-term pain gets long-term gain



US Economy, 1978-1985

Year	Real GDP Growth (%)	Unemployment Rate (%)	Inflation Rate (%)	Interest Rate (%)	
				Nominal	Real
1978	5.5%	6.1%	7.6%	8.3%	0.7%
1979	3.2	5.8	11.4	9.7	-1.7
1980	-0.2	7.1	13.5	11.6	-1.9
1981	2.5	7.6	10.3	14.4	4.1
1982	-2.0	9.7	6.2	12.9	6.7
1983	4.3	9.6	3.2	10.5	7.3
1984	7.3	7.5	4.3	11.9	7.6
1985	3.8	7.2	3.6	9.6	6.0

1980s Inflation – Act 1

- Inflation was 13.5% in 1980
 - 3.2% by 1983; stayed 2 – 5% for rest of the decade
 - 2 – 3% in the 1990s
- Monetary policy defeated inflation
 - Short recession in 1980
 - Deeper recession 1981 – 1982
 - Negative GDP growth in 1980 and 1982
 - Unemployment peaked at 9.7% in 1982
 - Inflation unresponsive 1979 – 1981

1980s Inflation – Act 2

- The economy "got it" in 1983
 - Strong growth 1983 – 1985
 - Unemployment started to decline in 1984
 - Unemployment lags a recovery
 - Inflation stabilized at a lower level
 - Remained low since
- **Disinflation** is a substantial reduction in the rate of inflation
 - The cost was high unemployment and low growth
 - Central Banks target low inflation because the costs of disinflation are high

Keep Inflation Low

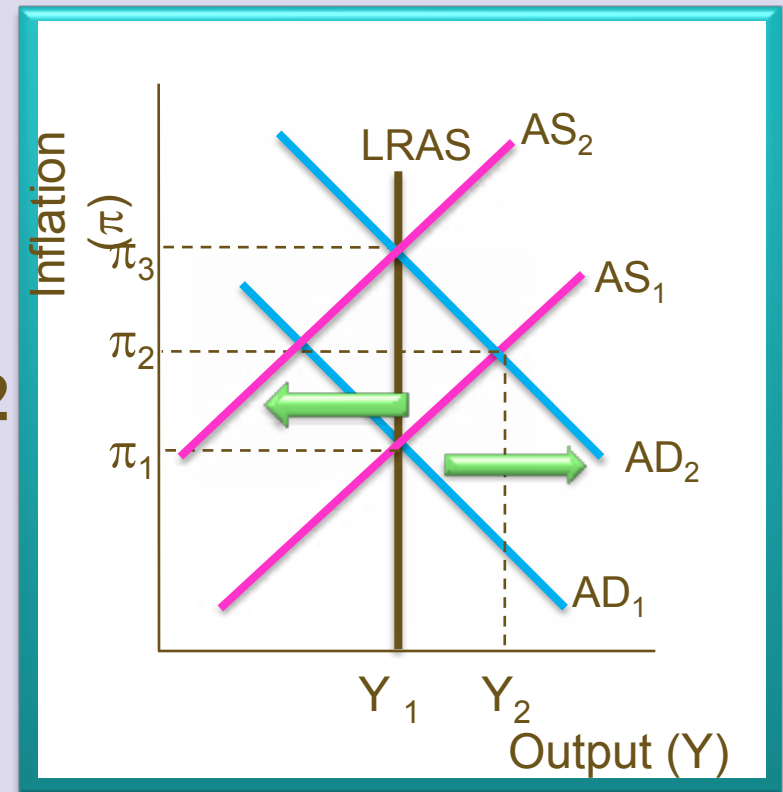
- Inflation has stayed low since the 1980s
 - Below 3.6% except for three years
- The benefits of low inflation include
 - A higher rate of economic growth
 - Average growth has been 3.2%
 - Greater economic stability
- Fed policy aims to avoid disinflation

The Fed and Spending Shocks

- Aggregate demand shifts from either an increase in government spending or other exogenous changes
 - Suppose changes are permanent
 - To maintain expected rate of inflation, Fed tightens monetary policy
- Suppose military spending increases sharply
 - Aggregate demand increases, opening an expansionary gap
 - Inflation exceeds expectations
 - Fed must decide whether to maintain monetary policy or fight inflation

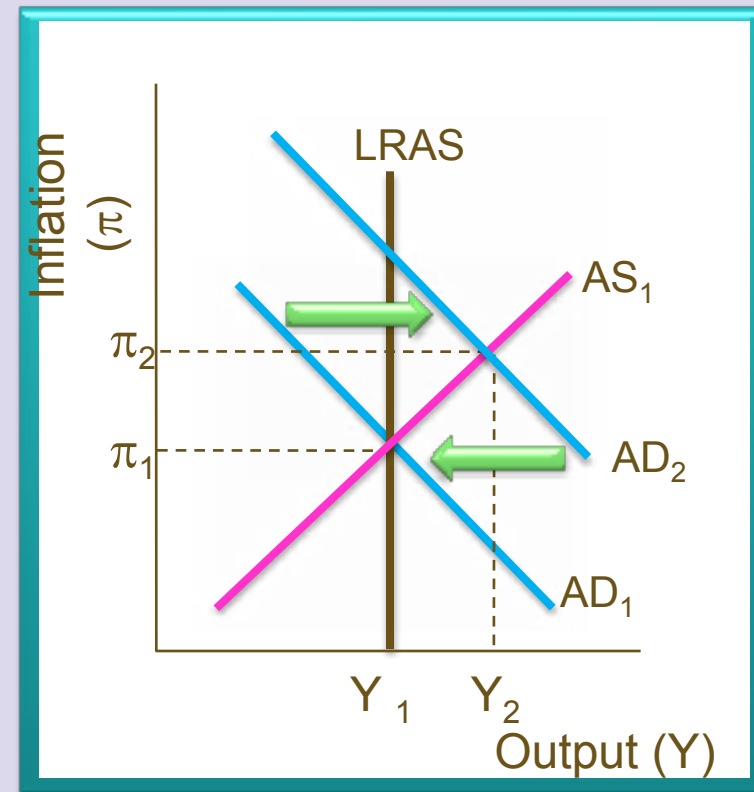
modating Monetary Policy

- modating monetary policy allows the effects of a shock to occur
- When exogenous spending goes up, the Fed does not change monetary policy
- AD shift to AD_2 and the economy moves to an expansionary gap at Y_2 , \square_2
- The Fed holds it MPR and AS shifts to AS_2
- Economy settles at Y_1 , \square_3



Fed Maintains Low Inflation

- The Fed can choose to enforce its inflation target, π_1
- Fed tightens monetary policy, shifting MPR left
- AD shift to AD2 and the economy moves to an expansionary gap at Y_2 , π_2
- Fed tightens monetary policy
- Interest rates increase more than if the Fed had modated the change
- AD shifts back to AD1
- Economy returns to Y_1 , π_1



Defending Target Inflation Rate

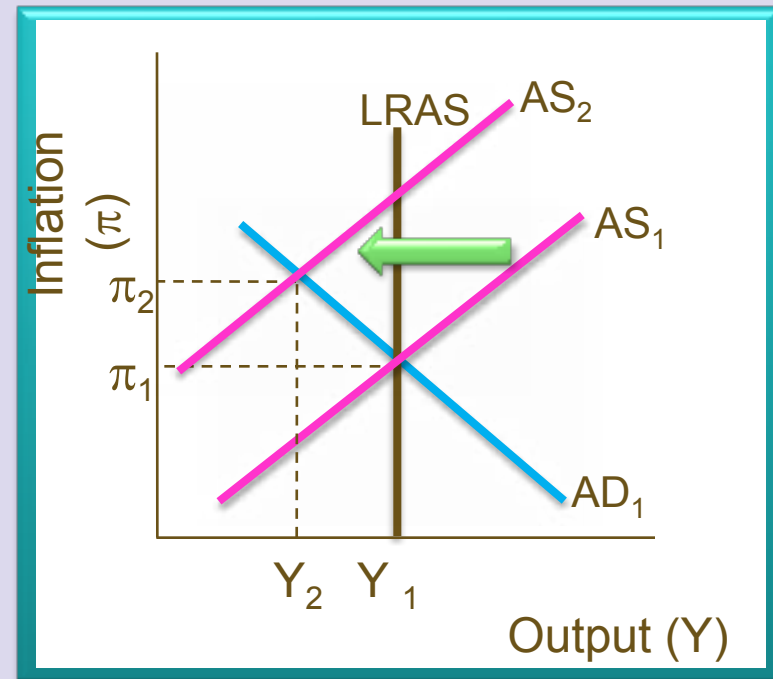
- When aggregate demand increases, the Fed shifts its MPR
 - Each inflation rate is now associated with a higher interest rate
 - Increase in spending reduces spending and increases interest rates in the long run
 - To fight inflation, the Fed raises its interest rates to the new, long-run level

Fed Lowered Interest rates in 2003

- Fed funds rate went from 6.5% January, 2001, to 1.75% in December, 2001
 - 1.25% in November 2002
 - 1.0% in June 2003
- The Fed was aggressive with interest rate reductions
 - Growth during the recovery was slower than in previous recoveries
 - Job growth was sluggish due to increases in productivity
 - Investment slowed as businesses became cautious
- The Fed avoided a recession

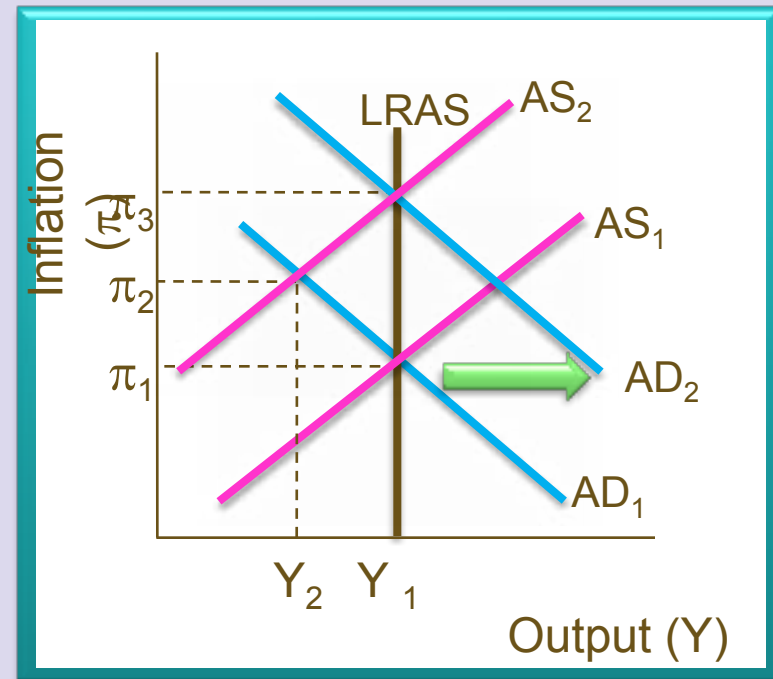
Responding to Aggregate Supply Shocks

- The economy begins in long-run equilibrium at Y_1, π_1
- Adverse supply shock shifts aggregate supply to AS_2
 - Fed follows its monetary policy rule and raises interest rates
 - Recessionary gap at Y_2 with higher inflation, π_2
- The Fed must choose
 - Close the recessionary gap
 - Restore target inflation rate



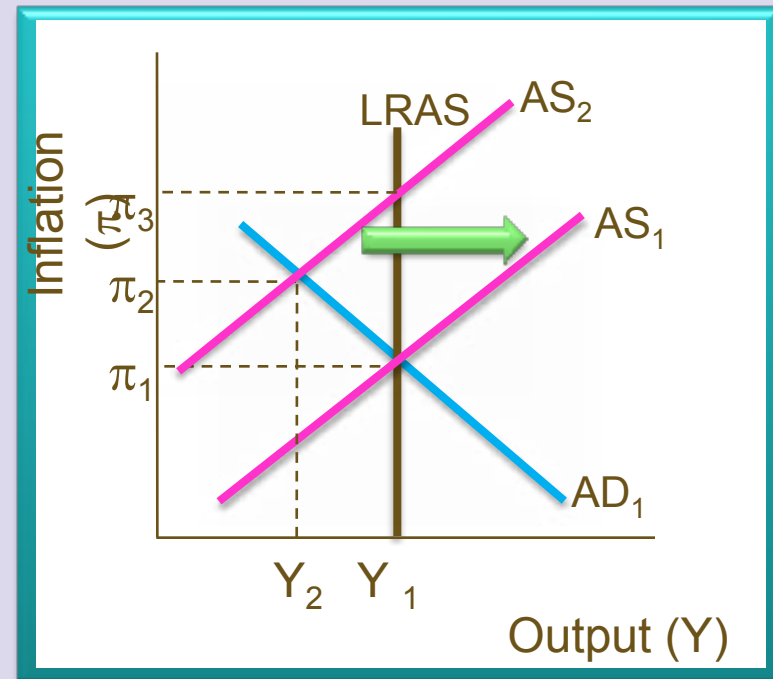
modating an Aggregate Supply Shock

- Suppose the Fed moves to close the recessionary gap
 - Eases monetary policy, lowering interest rates at π_2
 - Resets target inflation rate to π_3
 - Lower interest rates stimulate consumption and investment spending
 - AD shifts to AD_2
 - Long-run equilibrium is now at Y_1 and π_3
- Aggregate supply shock leads to higher long-run inflation



Responding to An Aggregate Supply Shock

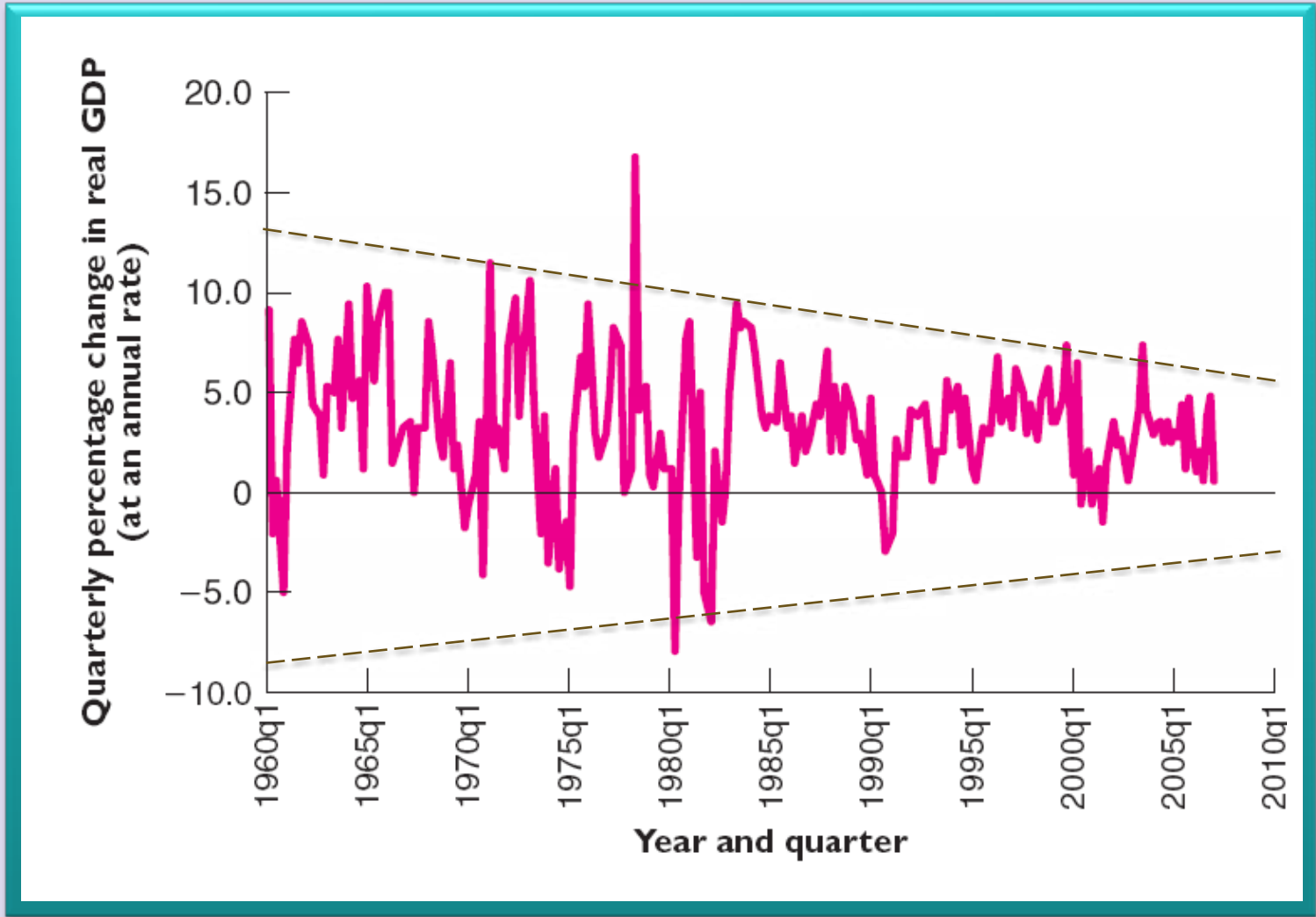
- Suppose the Fed decides to maintain inflation at π_1
 - Inflation is π_2 , above expected inflation of π_1
 - The Fed raises interest rates
 - Along AS_2 , expected inflation is π_3
 - When the Fed fails to respond with looser monetary policy, expected inflation decreases
 - AS_2 shifts back to AS_1
 - Original long-run equilibrium is restored



Anchored Inflation

- **Anchored inflationary expectations** means people's expectations of future inflation do not change even if inflation rises temporarily
 - Inflation anchoring dampens response to an aggregate supply shock
 - Businesses and consumers believe the Fed will reestablish its target inflation rate
 - Shortens the time required to close the recessionary gap from the shock
 - Encourages Fed to maintain its original inflation target

The Changing Volatility of Real GDP



Declining Macroeconomic Variability

- Variation in the growth rate down by half since 1960
 - Inflation declined by two-thirds
- Relative stability has benefits
 - Business and economic planning easier
 - Markets function better
 - Fewer resources devoted to adjusting to inflation and other economic instabilities
- Fed is usually credited with causing the increased stability by its consistent actions

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