

# Responding to Economic Fluctuations

This lecture discusses the effects of monetary and fiscal policy on the economy.

- A. Economic shocks or disturbances to the economy might call for a policy response.
  - 1. Aggregate demand disturbances.
  - 2. Price disturbances.
- B. Potential policy responses
  - 1. Adjusting the money supply.
  - 2. Changing government spending or taxes.

# Shocks and Disturbances to the Economy

## A. Shocks to aggregate demand

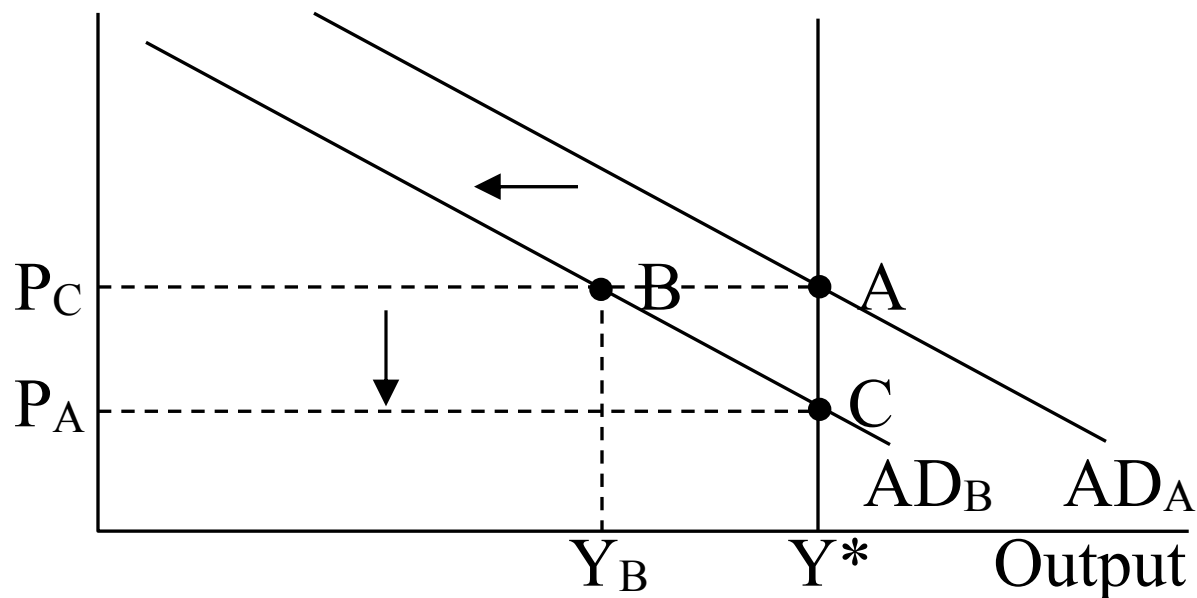
1. Factors that shift the spending line. Ex. increases in  $a$ ,  $e$ ,  $g_X$  or a decrease in  $g_{IM}$  shifts the spending line upward, which causes the AD curve to shift rightward.
2. Factors that shift the money demand line. Ex. An increase in  $h$  or a decrease in  $k$  shifts the money demand line leftward, which results in a lower  $R$  and rightward shift in the AD curve. [Recall:  $M^D = (k \times Y - h \times R) \times P$ ]

## B. Analyzing the effects of an aggregate demand shock when monetary and fiscal policy do not change.

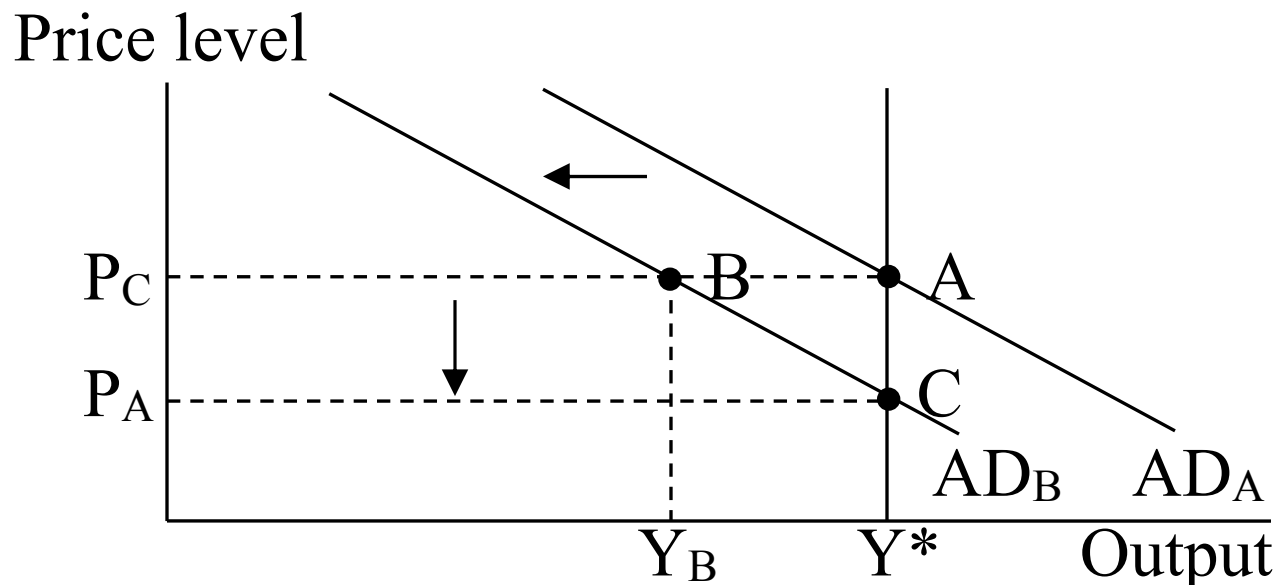
1. Suppose  $Y$  starts at its potential ( $Y^*$ ) and a shock shifts the spending line downward.

- a. In the short run, the shock pushes down  $Y$  to  $Y_B$ , which causes the IS curve to shift leftward and  $R$  to fall. Since  $P$  is unchanged at  $P_A$ , the AD curve shifts leftward from  $AD_A$  to  $AD_B$ . [point B]
- b. In the long run,  $P$  falls from  $P_A$  to  $P_C$ , which causes  $M^D$  and  $R$  to decline. A lower  $R$  leads to increases in  $I$  and  $(X - IM)$ , which causes  $Y$  to return to  $Y^*$ . [point C]
- c. Graph of the effects of a decline in AD.

Price level



2. Suppose  $Y = Y^*$  and a shock shifts the  $M^D$  line rightward.
- In the short run, the rise in  $M^D$  pushes up  $R$ . That decline pushes down  $I$  and  $(X - IM)$ , which causes  $Y$  to fall to  $Y_B$ . Since  $P$  remains at  $P_A$ , the  $AD$  curve must shift leftward from  $AD_A$  to  $AD_B$ . [point B]
  - In the long run,  $P$  falls from  $P_A$  to  $P_C$ , which causes  $M^D$  and  $R$  to fall. A lower  $R$  leads to increases in  $I$  and  $(X - IM)$ , which causes  $Y$  to return to  $Y^*$ . [point C]
  - Graph of the effects of a decline in  $AD$ .



## C. Shocks to the price level.

### 1. Potential sources of a price shock.

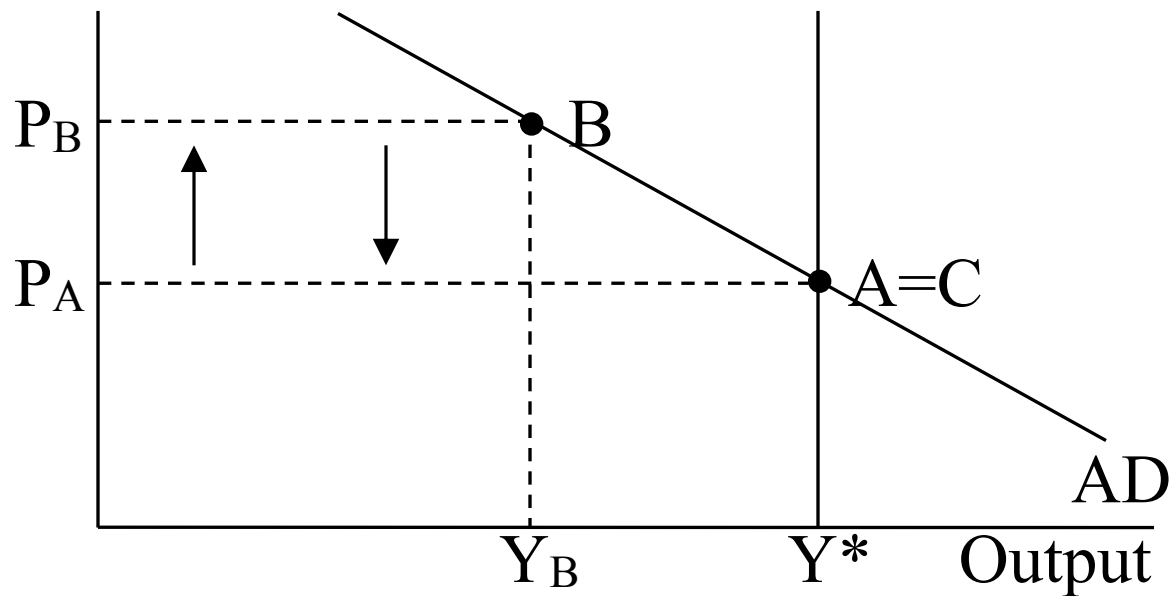
- a. The price of an economy wide input, such as oil, rises.
- b. A large group of workers get an abnormally high wage increase. (Ex. a dramatic increase in the minimum wage)
- c. Firms mistakenly raise their prices too much. (Ex. firms expect an increase in inflation, wages or input prices that does not happen)

### 2. Suppose output starts at $Y^*$ and a price shock increases $P$ from $P_A$ to $P_B$ .

- a. In the short run, the rise in  $P$  pushes up  $M^D$ , which elevates  $R$ . The higher  $R$  leads to decreases in  $I$  and  $(X - IM)$ , which causes  $Y$  to fall to  $Y_B$ . [point B]

- b. In the long run,  $P$  falls from  $P_B$  to  $P_A$ , which causes  $M^D$  and  $R$  to fall. A lower  $R$  leads to increases in  $I$  and  $(X - IM)$ , which causes  $Y$  to return to  $Y^*$ . [point C]
- c. Graph of the effects of a positive price shock.

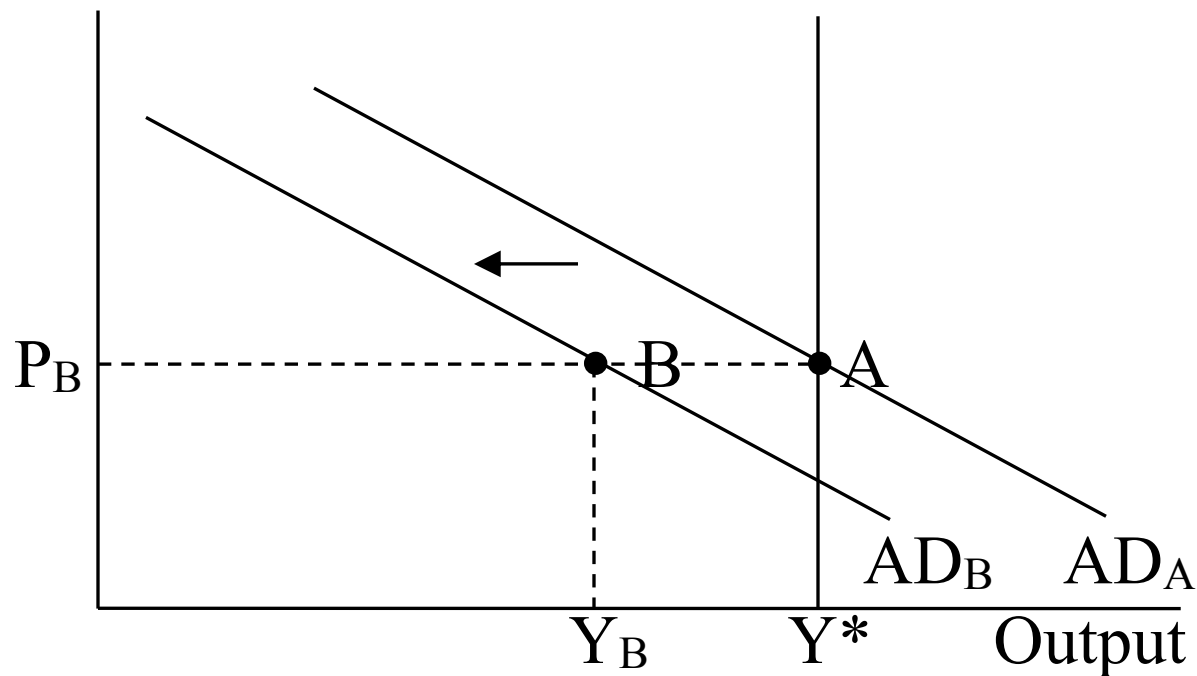
Price level



## Responding to Aggregate Demand Shocks: Stabilization Policy

- A. To counter shocks to the AD curve, policymakers can implement offsetting monetary or fiscal policy. This is referred to as stabilization policy.
- B. Using stabilization policy to counteract a decline in AD from  $AD_A$  to  $AD_B$ .

Price level



## 1. Active monetary policy

- a. The Federal Reserve can shift the AD curve back to  $AD'$  by increasing  $M^S$ .
- b. The result is that  $Y$  returns to  $Y^*$ ,  $R$  declines and  $I$  and  $(X - IM)$  rise.

## 2. Active fiscal policy

- a. The President and Congress can shift the AD curve back to  $AD'$  by increasing  $G$  or decreasing taxes.
- b. If  $G$  increases, the result is that  $Y$  returns to  $Y^*$  and  $R$  rises.
- c. If taxes decrease, the result is that  $Y$  returns to  $Y^*$  while  $C$  and  $R$  rise.



## C. Problems with stabilization policy

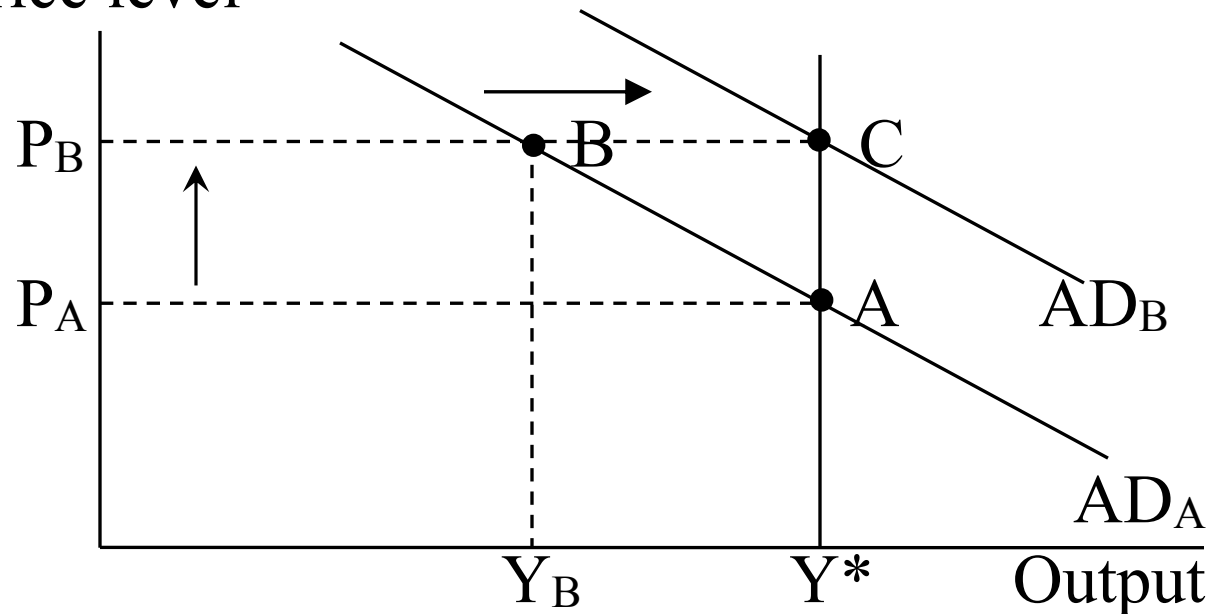
1. Policymakers have trouble identifying the level of potential output.
2. Policymakers lack detailed knowledge of current and future economic conditions.
3. There are a variety of lags that prevent the economy from immediately adjusting.
  - a. Recognition lag is the time it takes to identify an economic problem.
  - b. Decision-making lag is the time it takes to identify a solution to the problem.
  - c. Implementation lag is the time it takes to introduce a policy change.
  - d. Effectiveness lag is the time it takes monetary or fiscal policy to have an effect on the economy.

# The Response of Monetary Policy to a Price Shock: Two Options

## A. Accommodative monetary policy (in response to a rise in $P$ )

1. The Federal Reserve increases  $M^S$  in order to shift the AD curve rightward and push  $Y$  back to  $Y^*$ . [point C]
2. The result is that  $Y$  returns to  $Y^*$ ,  $R$  declines,  $I$  and  $(X - IM)$  increase, and  $P$  permanently rises.

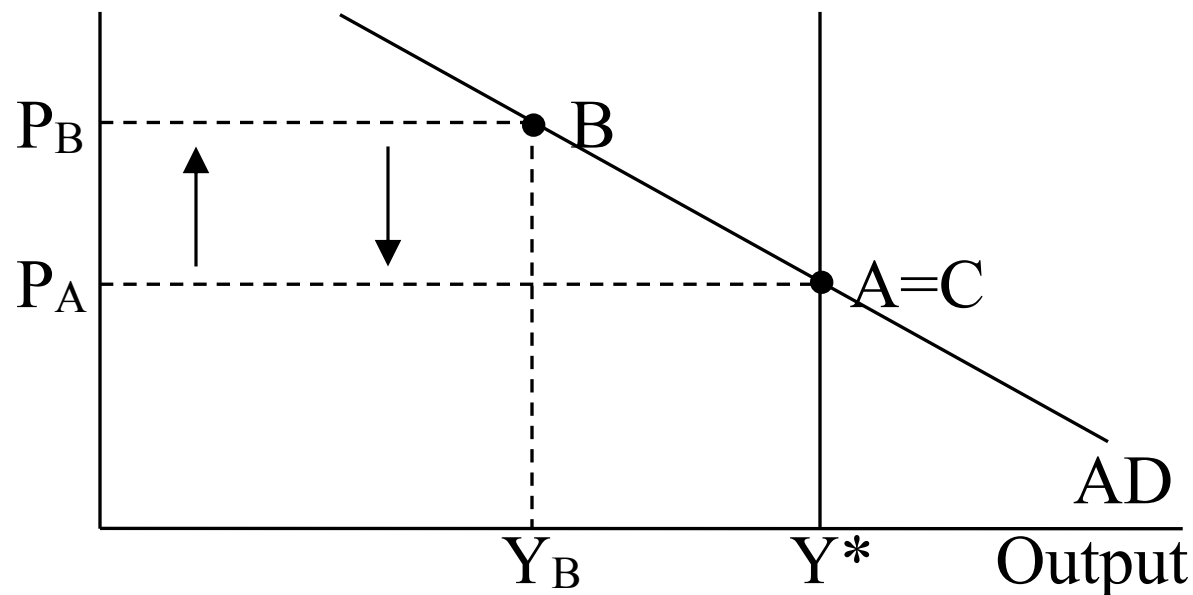
Price level



B. Nonaccommodative monetary policy (in response to a rise in  $P$ )

1. The Federal Reserve does not shift the AD curve.
2. In the short run,  $Y$  will be below  $Y^*$  and  $P$  will be temporarily high. [point B]
3. In the long run,  $Y$  returns to  $Y^*$  and  $P$  returns to its pre-shock level. [point C]

Price level



# Disinflation

A. Disinflation occurs when the inflation rate is falling.

B. The impact of disinflation

1. Recall, the Phillips curve relationship

$$\pi = \pi^e + f[(Y_{-1} - Y^*)/Y^*]$$

2. Disinflation is problematic when  $\pi^e = \pi_{-1}$  because  $\pi$  can only be reduced by letting  $Y_{-1}$  fall below  $Y^*$ .

3. If inflation is too high and needs to be reduced, then a recession and unemployment are inevitable.

C. Alternative disinflation paths

1. Rapid disinflation causes the drop in output and the rise in unemployment to be large but short.

2. Slow disinflation causes the drop in output and the rise in unemployment to be small but persistent.