

Chapter 17 - Stabilization in an integrated world economy

What type of policy should be followed?

Active(discretionary): All actions on the part of monetary and fiscal policymakers that are undertaken in _____ to or in anticipation of some _____ in the overall economy

People in favor of active policy believe that there exists a _____ between _____ and _____ due to _____.

Passive(Non-discretionary) Policymaking that is carried out in response to a _____, not in response to an actual or potential _____ in overall economic activity. For example: Rate of growth of money = _____ + _____

People in favor of Passive Policy believe that discretionary policies involve _____ and policy makers are _____ (ie they make _____ or are swayed by _____)

Also they believe that there is _____ trade-off between unemployment and inflation.

Review:

In the long run, inflation and unemployment are _____.

The inflation rate is determined by the _____, and the unemployment rate is determined by the _____ which depends on amount of _____ and _____ unemployment.

However, in the short-run there is normally a _____.

• Due to _____ $U_{actual} = \text{_____} + \text{_____}$.

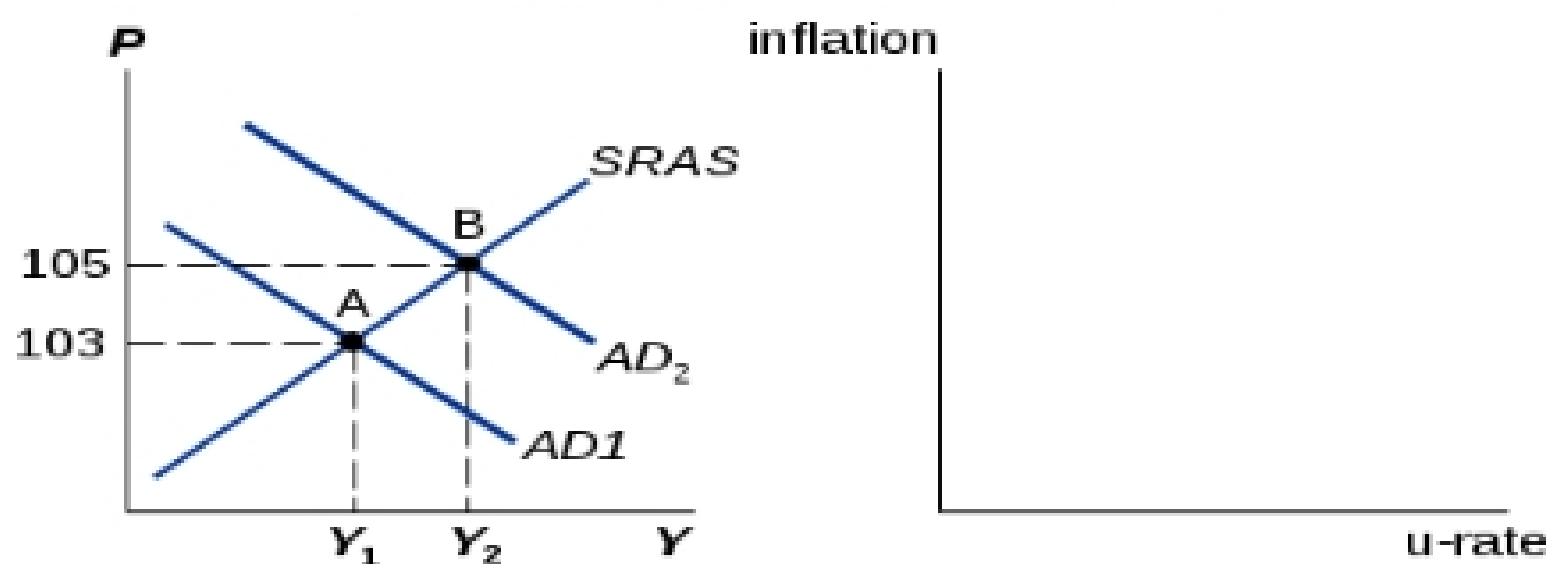
when $Y < Y_n$ $U > U_N$ $u_c > 0$ when $Y > Y_N$ $U < U_N$ $u_c < 0$

SRPC - Short-Run Phillips Curve - Shows the Short-run Trade-off between unemployment and inflation.

1958 - A.V. Phillips showed that nominal wage growth was _____ correlated with unemployment.

Deriving the Short-Run Phillips Curve - SRPC

A. Low agg demand, low inflation, high u-rate



B. High agg demand, high inflation, low u-rate

THE SHORT-RUN TRADE-OFF

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Assume we are currently at Z where $P = 100$ this year and $GDP = \underline{\hspace{2cm}}$.

Scenario 1. (low growth) AD only increases to AD1 reflecting, for example, slow money growth - then outcome A will occur next year. In outcome A, $P = 103$ next year, so the inflation rate from this year to next equals _____. Output (Y_1) is relatively low, so unemployment is relatively high at _____.

Scenario 2. (high growth) Instead, if aggregate demand increases to AD2- reflecting, for example, rapid money growth - then outcome B will occur next year. In outcome B, $P = 105$ next year, so the inflation rate from this year to next equals _____. Output (Y_2) is higher, so unemployment is _____.

Shifts in AD cause a _____ the SRPC.

Does this mean that Policy makers can pick and choose?

The Phillips Curve: A Policy Menu?

- Since fiscal and mon policy affects _____, the *PC* appeared to offer policymakers a menu of choices:
 - low unemployment with _____ inflation
 - low inflation with _____ unemployment
 - anything in between
- 1960s: U.S. data supported the Phillips curve. Many believed the *PC* was stable and reliable.

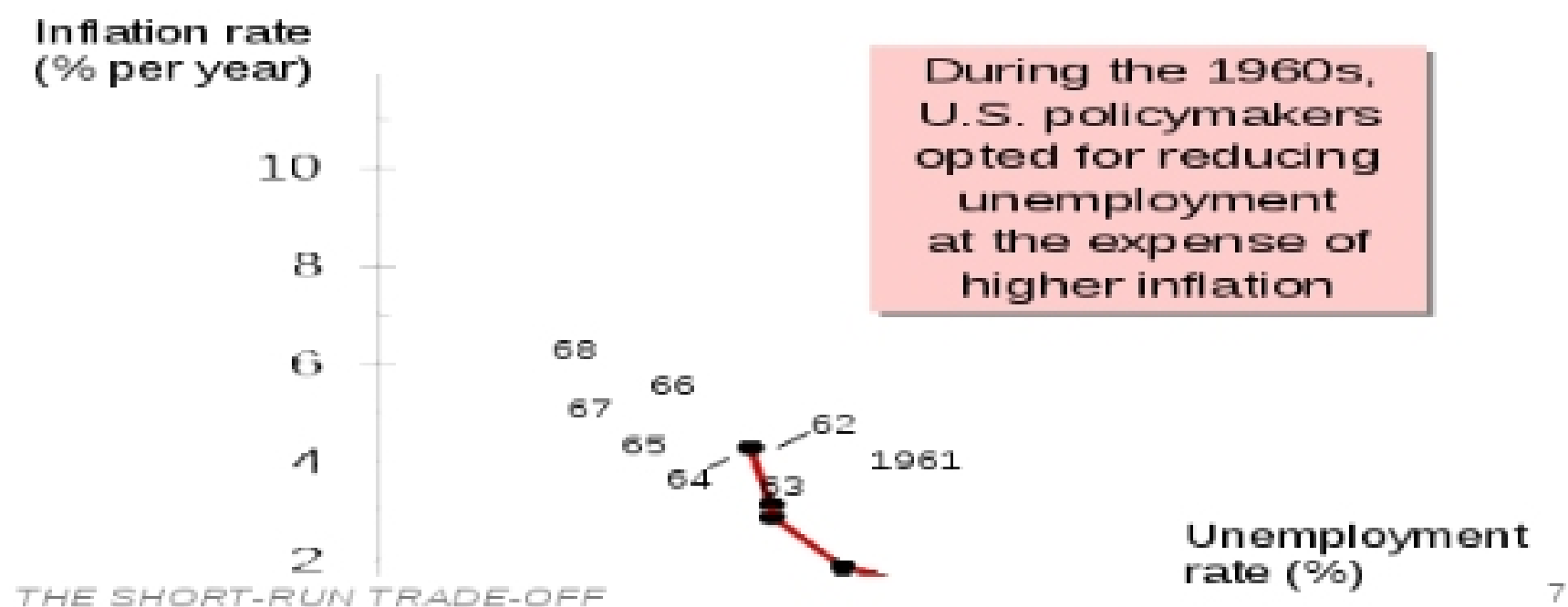
THE SHORT-RUN TRADE-OFF

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Suppose the Fed wanted to decrease unemployment from 6% (1963) (where inflation was _____) to 4%.

Fed could undertake an _____ monetary policy: _____ Bonds, MS _____, r _____, C and I _____, AD _____ unemployment _____ and inflation _____.

Evidence for the Phillips Curve?



IN 1968 unemployment was _____ while inflation was _____.

However,....