Short Run:
Understanding Policy and Reality

T. Kam

File: 05-cycles_ispcmp_apps.tex
Read: Mishkin, Ch. 12

Australian National University

Outline of Talk

Learning Objectives

- To test our understanding of how the IS-PC-MP model works
  - "If you know how to apply it, then you know how it works".
- We use IS-PC-MP to study two historical episodes in the data:
  - A disinflation monetary policy experiment
  - Interpreting the 1970's episode of "stagflation"

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Monetary Policy 1970s style

- Two major oil shocks in the 1970s coupled with slowdown/stagnation in productivity
  - led perception that there was recession
- Policymakers engaged in *loose (or expansionary)* monetary and fiscal policy:
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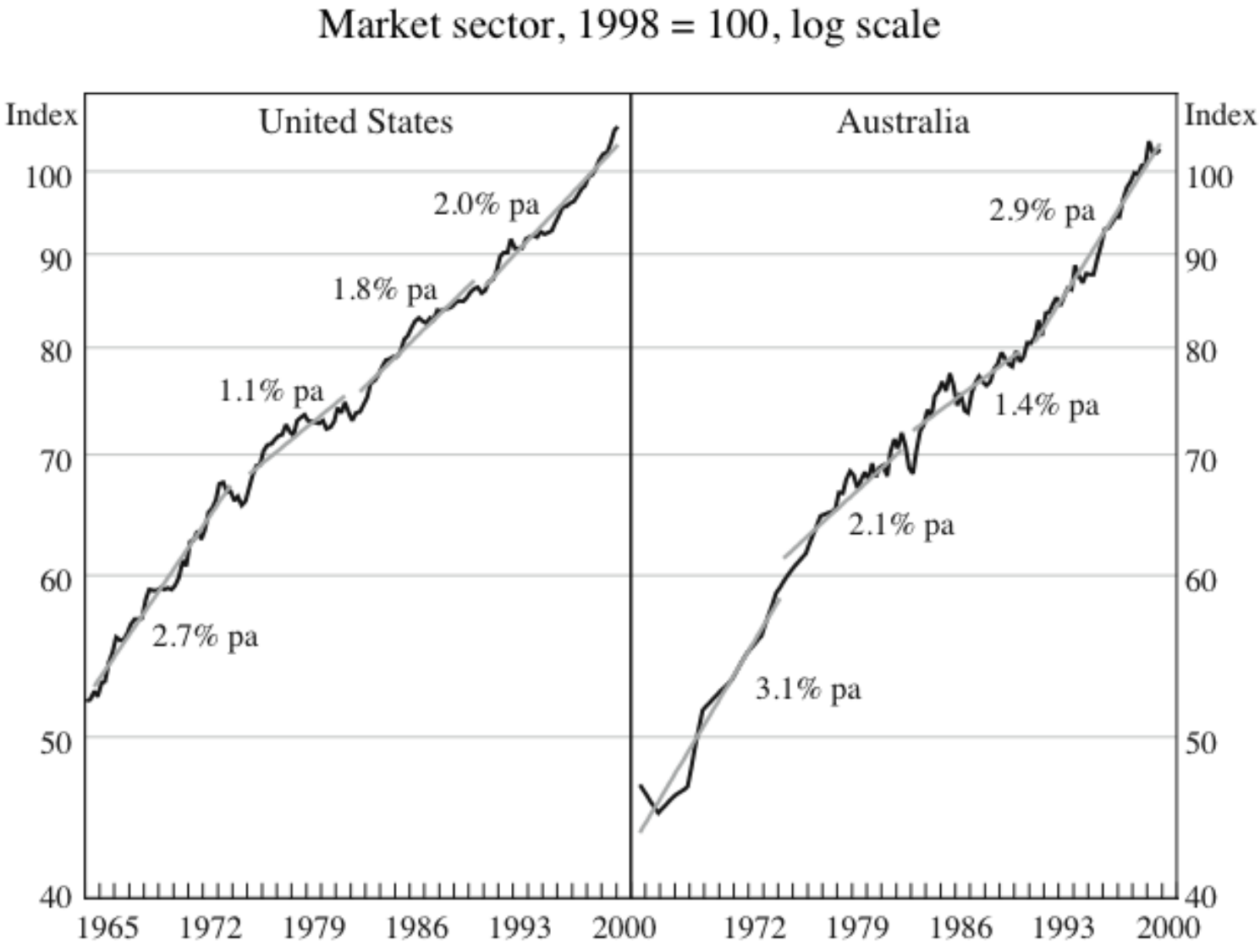

Labour Productivity (Y/L) slowdown: U.S. (left) and Australia (right)

Australian National University

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- By end of the 1970s high inflation and high unemployment
  - Phillips curve inflation-unemployment empirical fact and trade-off disappeared!
  - an era that coined the new phrase "stagflation"

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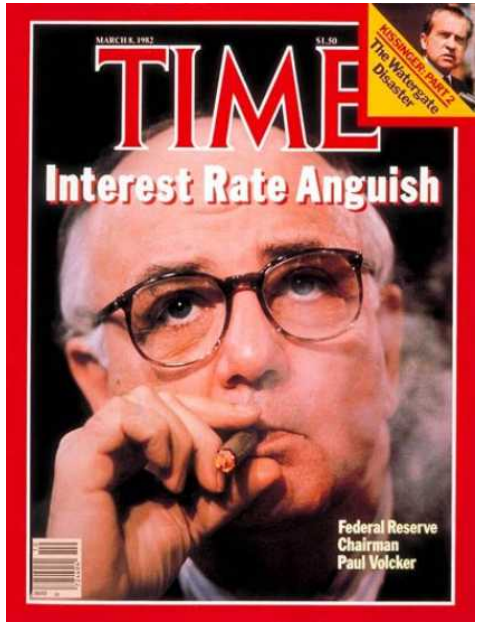

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- Entrusted with job of bringing inflation back down.
- Implemented a tight monetary policy.
  - reduced money supply; raised interest rate
  - by mid-1980s, inflation had gone down
  - average unemployment rate around 7.5%

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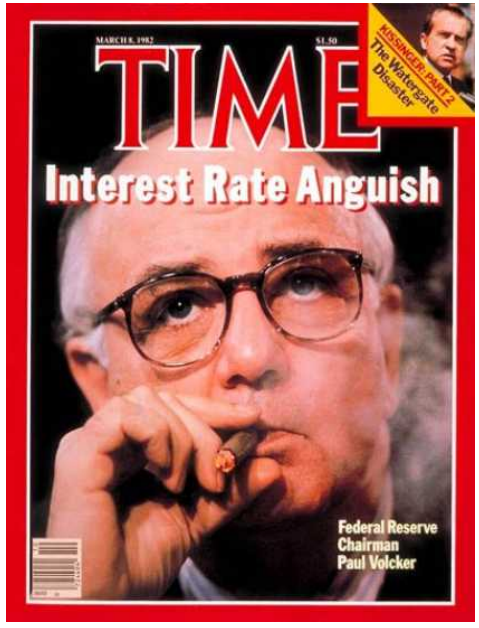

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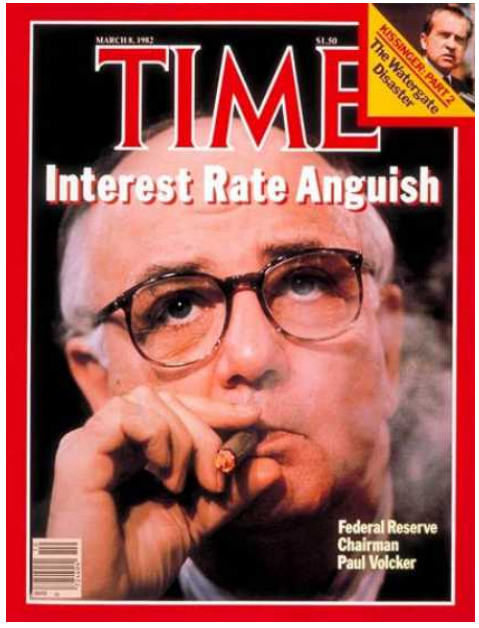

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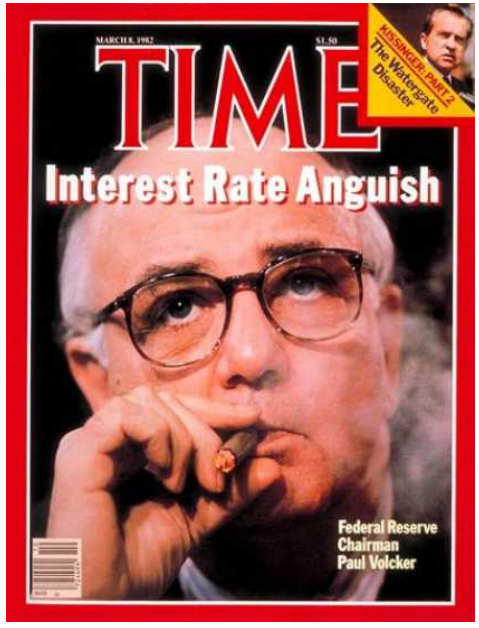

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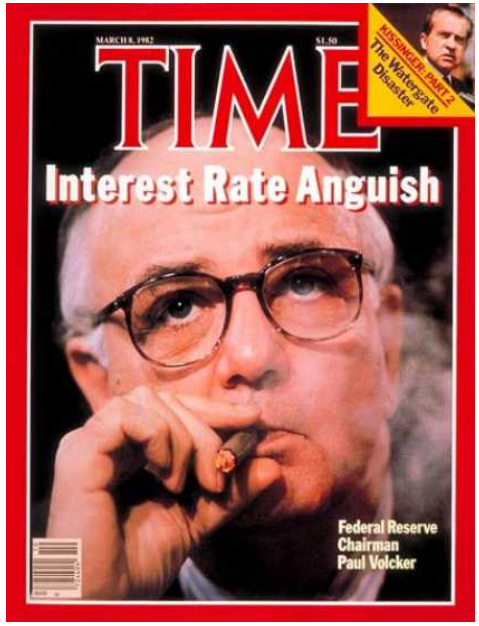

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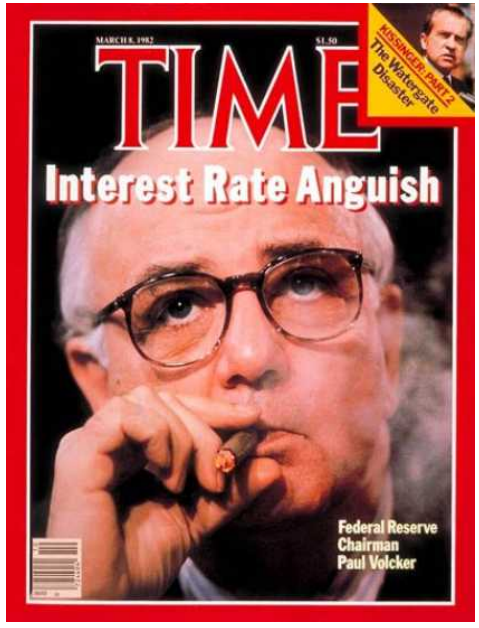

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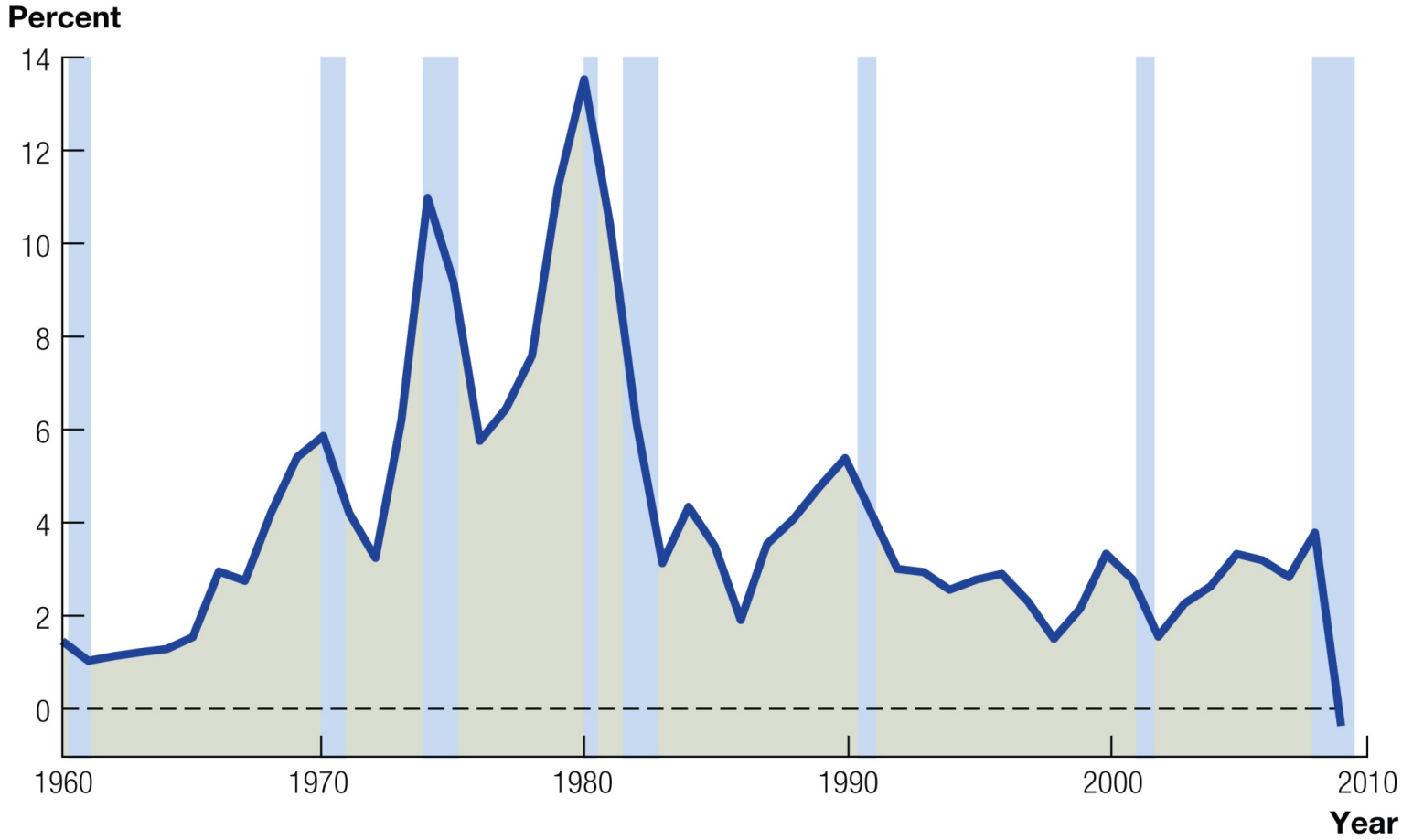

Two episodes in U.S. Inflation: Oil crises 1974 and 1979. Volcker disinflation, early 1980s.

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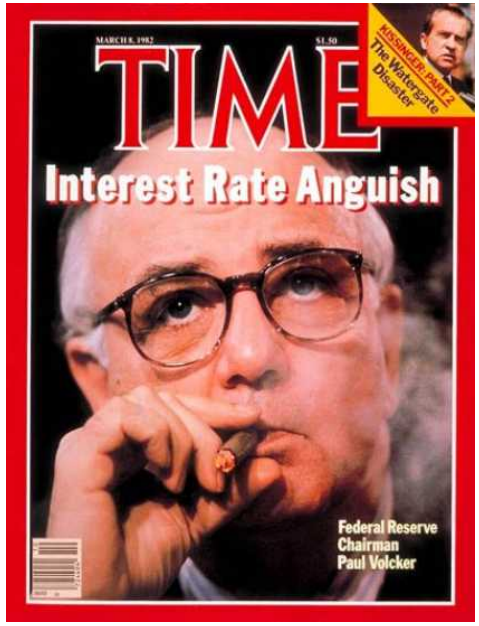
IS-PC-MP: Understanding 1980s disinflation



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  - how that resulted in terms of short run outcomes

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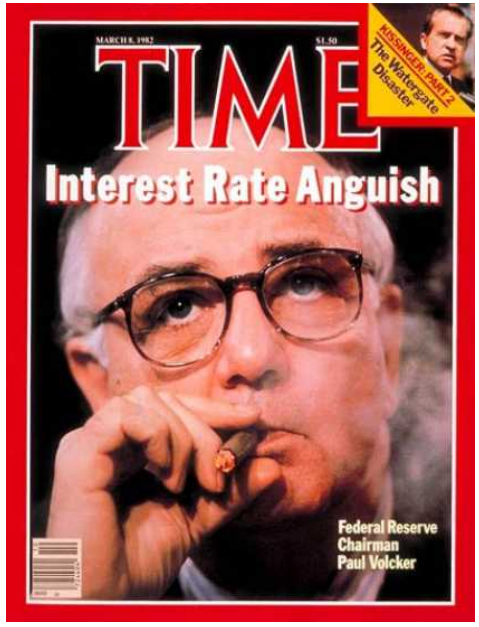

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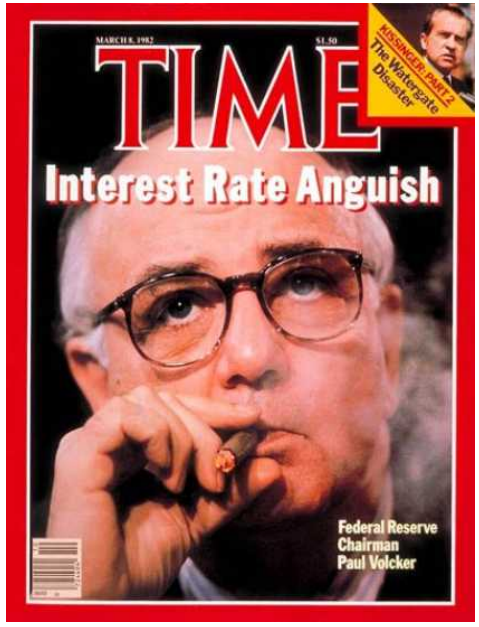

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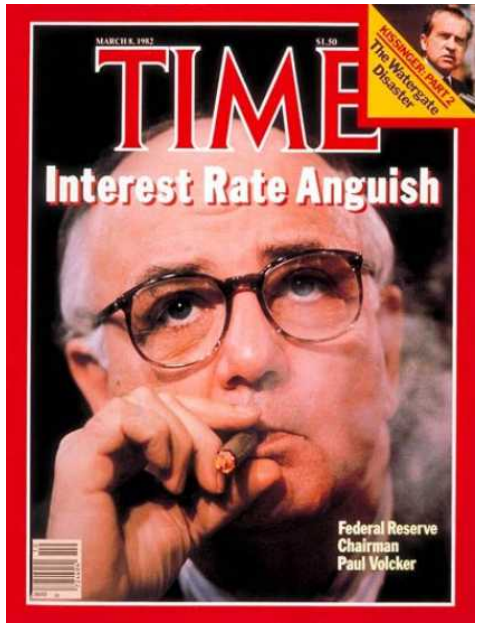
IS-MP-PC: Two Applications

Application 1

1980s Volcker disinflation



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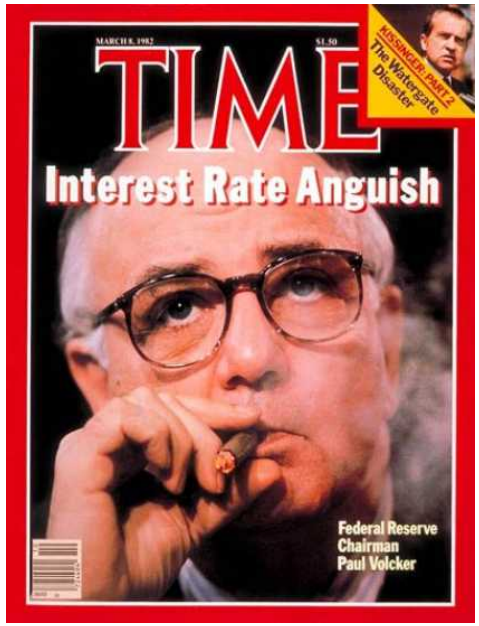

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- Because of the stickiness of inflation
  - The *classical dichotomy* is unlikely to hold exactly in the short run—i.e. *short-run monetary non-neutrality*
  - Just a reduction in the rate of money growth may not slow inflation immediately.
- Thus, the real interest rate must increase to induce a recession.
  - This is exacted through the **MP curve** and adaptive-expectation-Fisher equation: $r_t = i_t - \pi_{t-1}$, and
  - the **IS curve** via the investment demand response: $Y_t = \bar{a} - \bar{b} \cdot r_t$.

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  - As demand falls firms raise their prices less aggressively to sell more.
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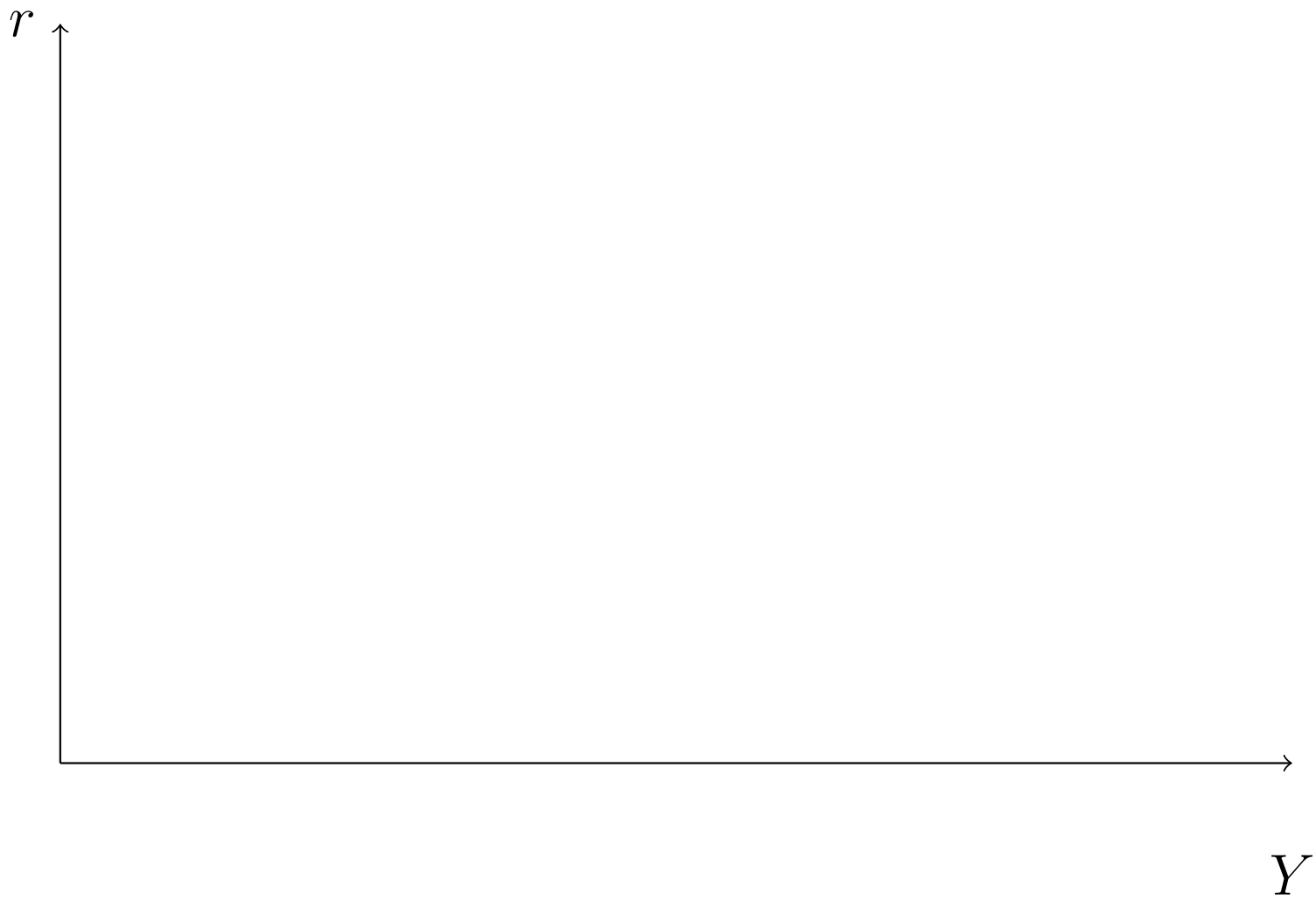

IS shifts left, MP shifts down. Why?

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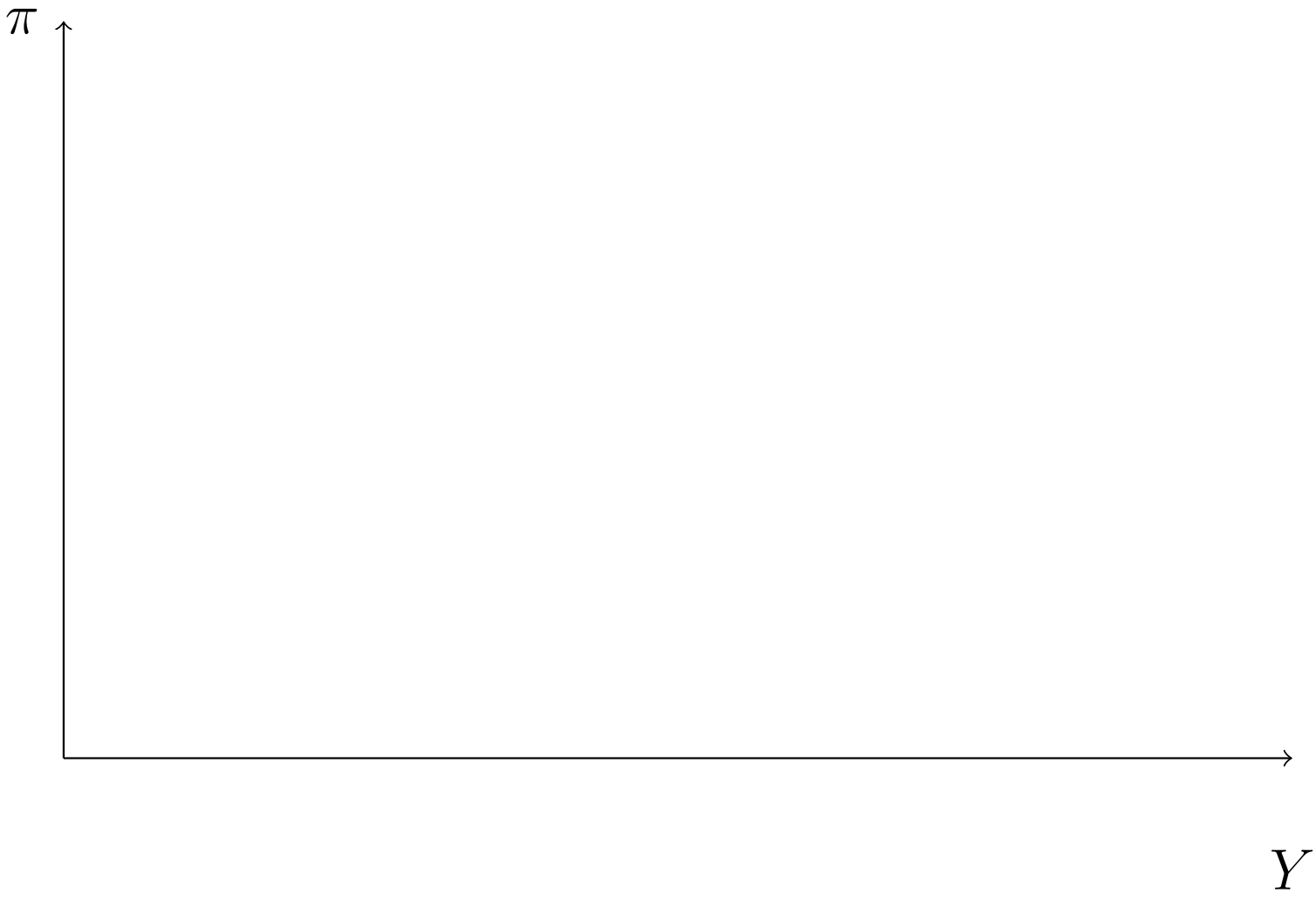

What happened to PC or AS? How?

Application 1

Checkpoint!

In a nutshell, what we just said using the IS-PC-MP to interpret the Volcker disinflation effect:

$$\begin{aligned} \text{MP:} \quad & \uparrow i_t \Longrightarrow \uparrow r_t \\ \text{IS:} \quad & \uparrow r_t \Longrightarrow \downarrow \tilde{Y}_t \\ \text{PC:} \quad & \downarrow \tilde{Y}_t \Longrightarrow \downarrow \Delta\pi_t \end{aligned}$$

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So a Volcker-style disinflation policy can

- keep the real interest rate high
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- The IS-PC-MP diagrams display a static snapshot of the dynamic short run economy.
- We can try to visualise how our Volcker disinflation policy and resulting economic outcomes look like dynamically.
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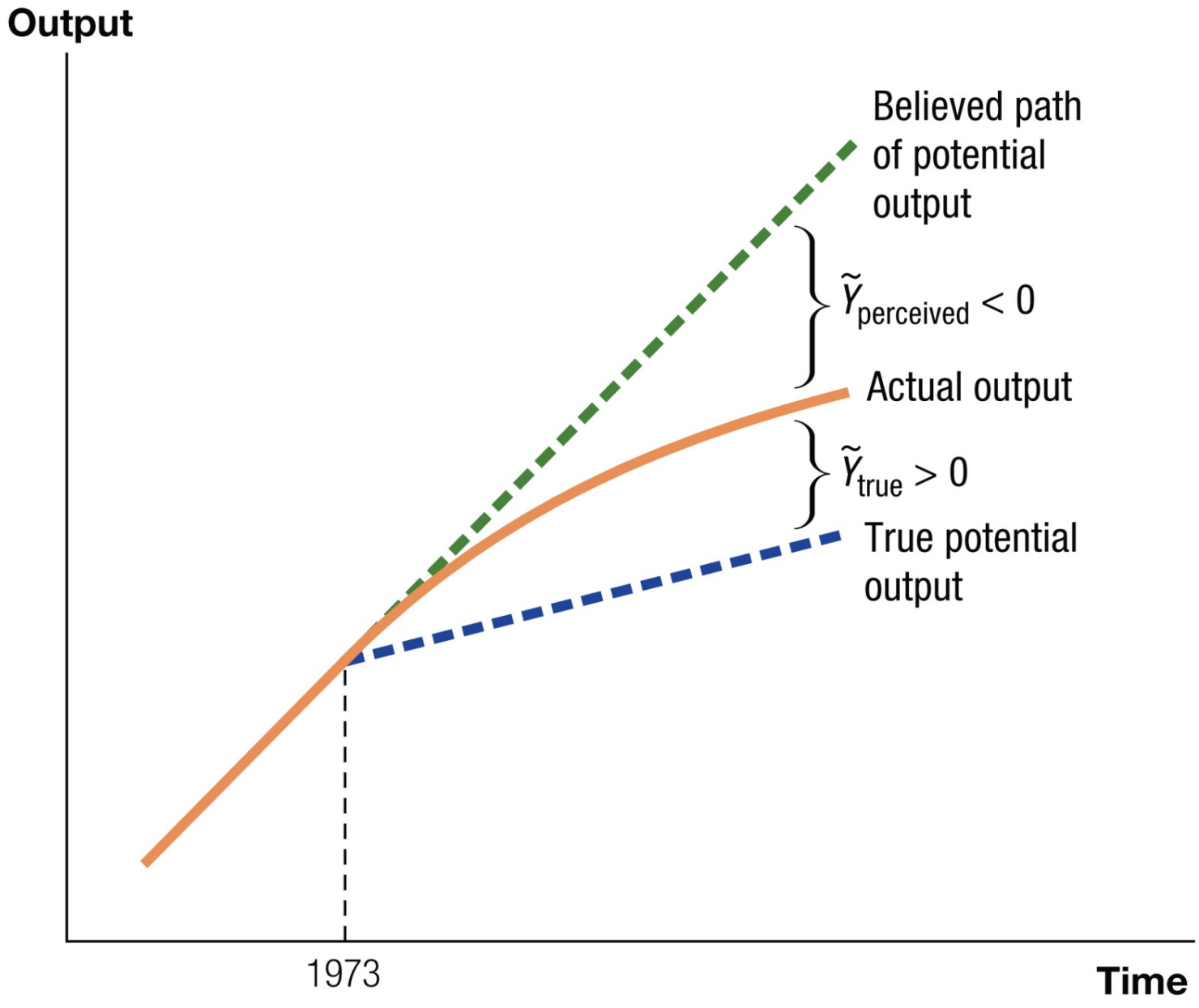
    - ⋆ Which increased output above potential, generating more inflation. Why? (See AS!)



Australian National University

Application 2

1970s stagflation

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Explain the 1970s stagflation story and its resulting loose monetary policy response using the IS-PC-MP framework.

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Application 2

1970s stagflation: what the Fed thought and how they reacted (IS-MP)

Application 2

1970s stagflation: what actually happened (IS-MP)

Application 2

1970s stagflation: how this affects inflation (AS or PC)

Summary

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  - Phillips Curve
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We looked at two famous case studies from two distinct decades

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- PC as an AS curve
- AD-AS representation of the same IS-PC-MP model
- Understanding recent Great Recession and financial factors in the IS-PC-MP or AD-AS framework

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Conversation Pieces

... with your loved ones over dinner tonight

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