Lecture 10

Chapter 12: Policy and Cost Effects in the AS/AD Model

- State of economy at the time of the policy change is important
- Effects of exogenous monetary policy (the Z factors)
- What if Fed cares more about inflation than output?
- What if there is a zero lower bound?
- Effects of cost shocks—stagflation
- Actual Fed policy since 1970

P

Fed hates inflation

$\alpha << \beta$

AD

Y

Zero interest rate bound

r

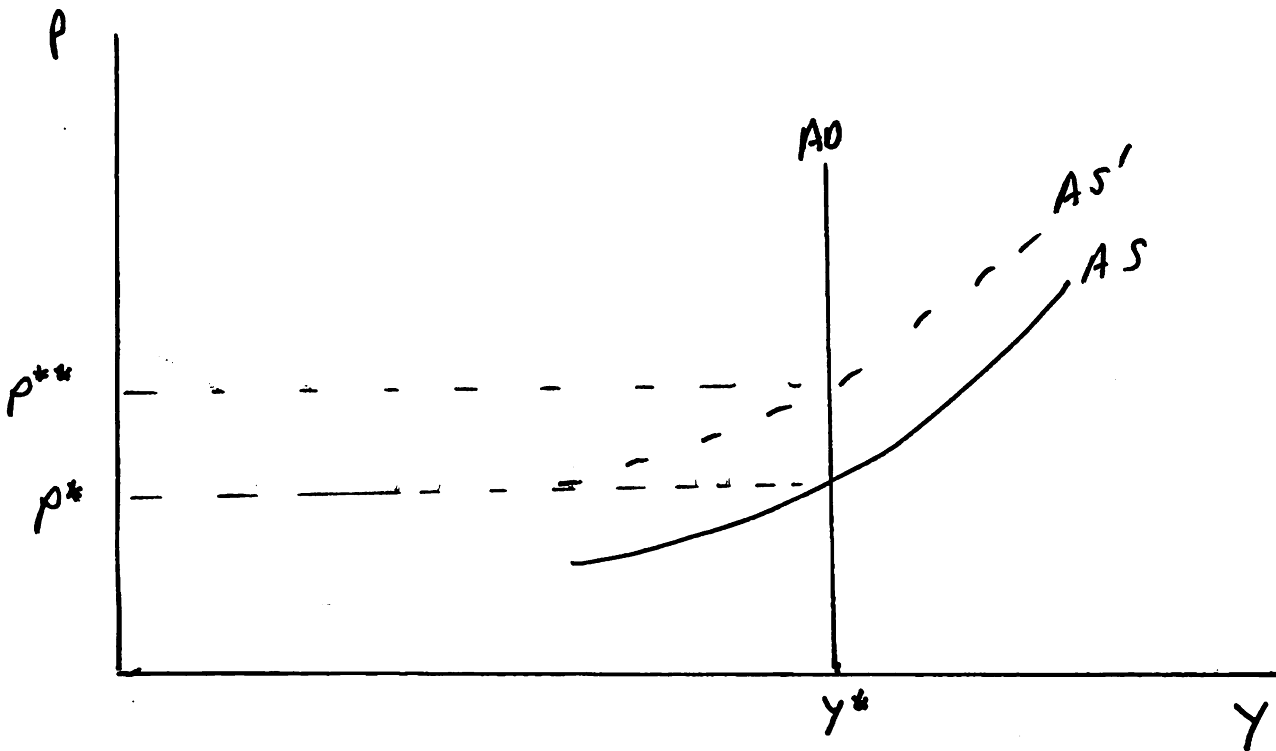
IS

replaces Fed rule

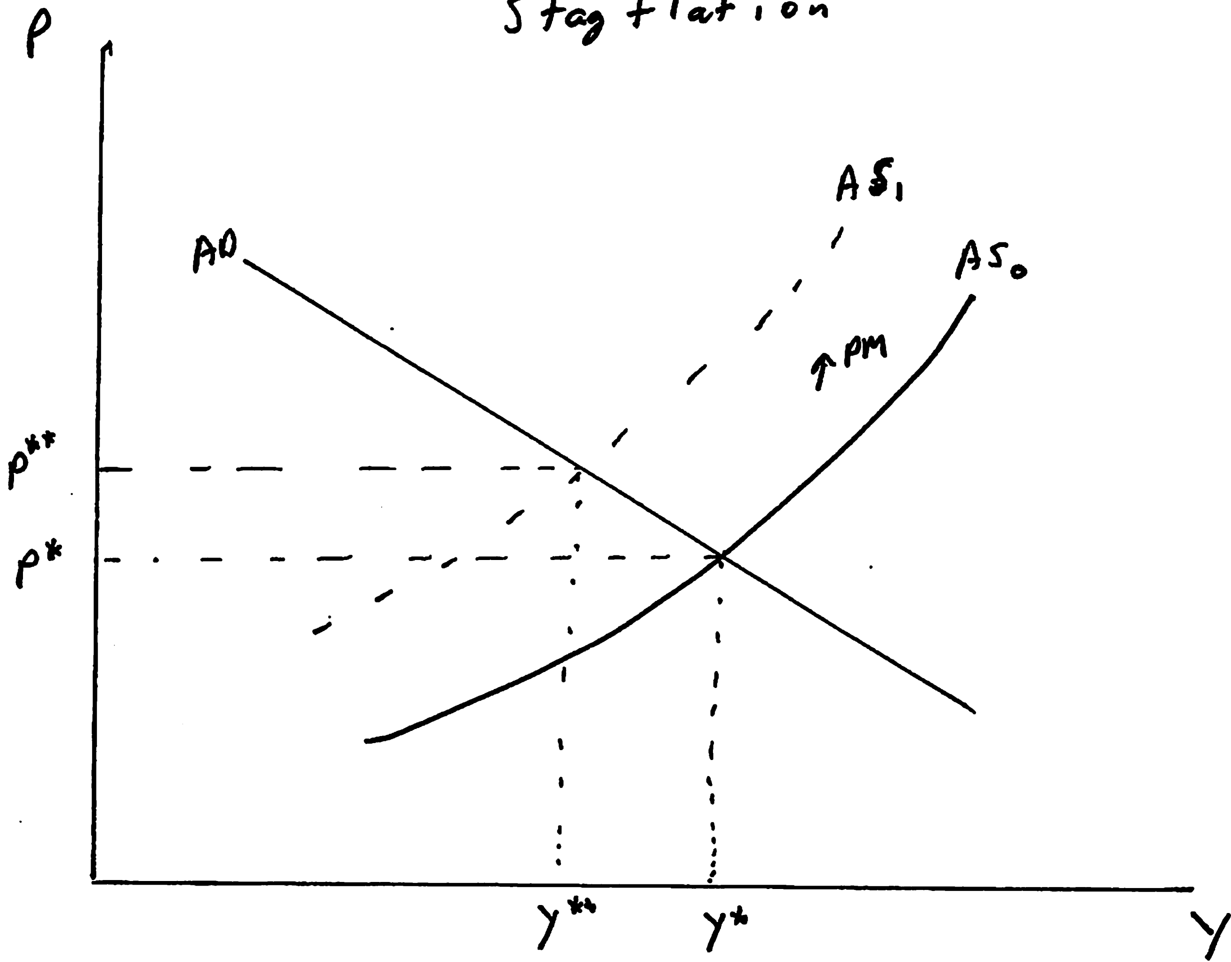
0

Y*

Y



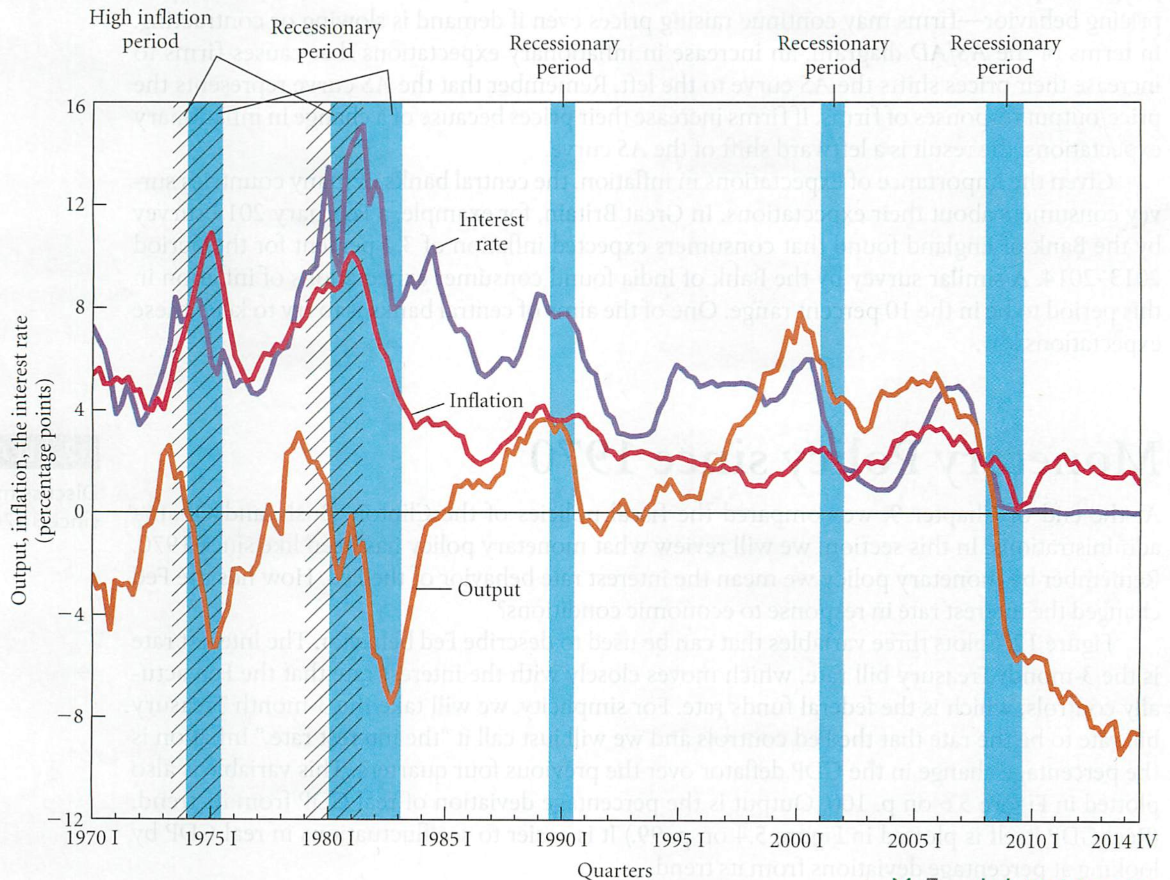
Stagflation



We know from earlier in this chapter that stagflation is bad news for policy makers. No matter what the Fed does, it will result in a worsening of either output or inflation. Should the Fed raise the interest rate to lessen inflation at a cost of making the output situation (and therefore unemployment) worse, or should it lower the interest rate to help output growth (which will lower unemployment) at a cost of making inflation worse? What did the Fed actually do? You can see from Figure 12.7 that the Fed generally raised the interest rate when inflation was high—even when output was low and unemployment was high. So, the Fed seems to have worried more in this period about inflation than unemployment. The interest rate was very high in the 1979–1983 period even though output was low. Had the Fed not had such high interest rates in this period, the recession would likely have been less severe, but inflation would have been even worse. Paul Volcker, Fed chair at that time, was both hailed as an inflation-fighting hero and pilloried for what was labeled the "Volcker recession."

After inflation got back down to about 4 percent in 1983, the Fed began lowering the interest rate, which helped to increase output. The Fed increased the interest rate in 1988 as inflation began to pick up a little and output was strong. The Fed acted aggressively in lowering the interest rate during the 1990–1991 recession and again in the 2001 recession. The Treasury bill rate got below 1 percent in 2003. The Fed then reversed course, and the interest rate rose to nearly 5 percent in 2006. The Fed then reversed course again near the end of 2007 and began lowering the interest rate in an effort to fight a recession that it expected was coming. The recession did come, and the Fed lowered the interest rate to near zero beginning in 2008 IV. The interest rate has remained at essentially zero since then. This is the zero interest rate bound discussed previously in this chapter. The period 2008 IV–2014 IV is a "binding situation" period.

Fed behavior in the period since 1970 is thus fairly easy to summarize. The Fed generally had high interest rates in the 1970s and early 1980s as it fought inflation. Since 1983,



▲ **FIGURE 12.7 Output, Inflation, and the Interest Rate 1970 I–2014 IV**
The Fed generally had high interest rates in the two inflationary periods and low interest rates from the mid-1980s on. It aggressively lowered interest rates in the 1990 III–1991 I, 2001 I–2001 III, and 2008 I–2009 II recessions. Output is the percentage deviation of real GDP from its trend. Inflation is the four-quarter average of the percentage change in the GDP deflator. The interest rate is the 3-month Treasury bill rate.