

Chapter 24 – Monetary Policy Theory

Response of Monetary Policy to Shocks

- Monetary policy should try to minimize the difference between inflation and the inflation target
- In the case of both demand shocks and permanent supply shocks, policy makers can simultaneously pursue price stability and stability in economic activity
- Following a temporary supply shock, however, policy makers can achieve either price stability or economic activity stability, but not both. This tradeoff poses a dilemma for central banks with dual mandates

Response to an Aggregate Demand Shock

- Policy makers can respond to this shock in two possible ways:
 - No policy response
 - Policy stabilizes economic activity and inflation in the short run
- In the case of aggregate demand shocks, there is no tradeoff between the pursuit of price stability and economic activity stability

Figure 1 Aggregate Demand Shock: No Policy Response

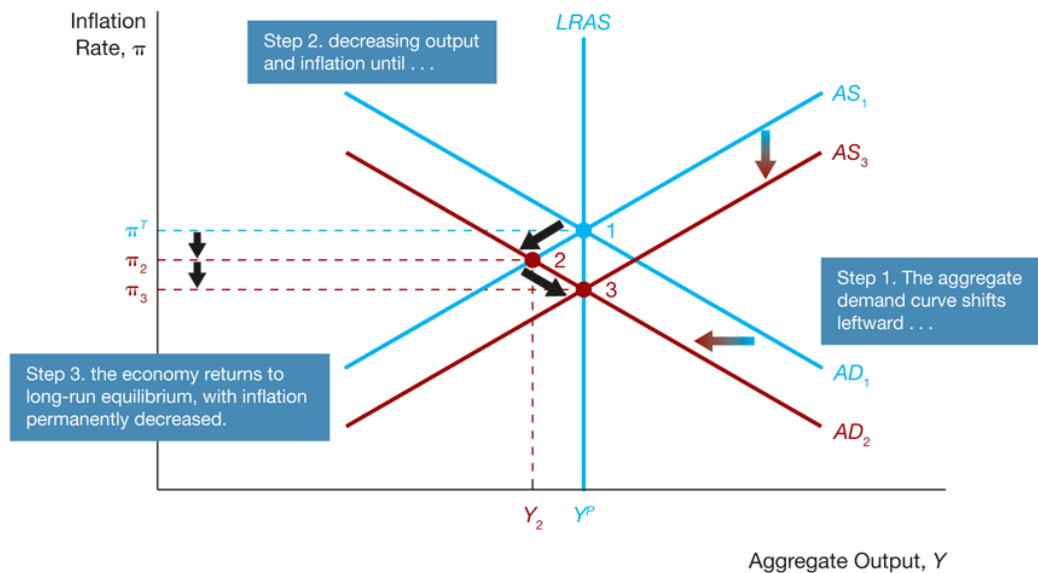
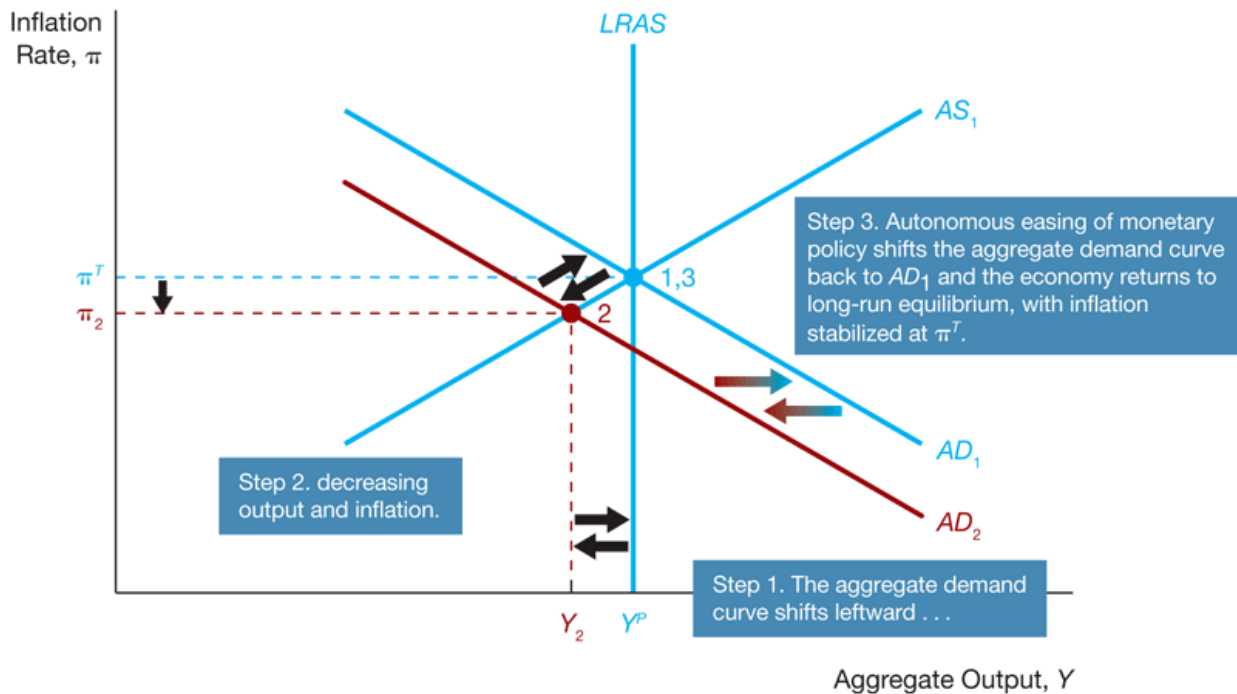


Figure 2 Aggregate Demand Shock: Policy Stabilizes Output and Inflation in the Short Run



APPLICATION Quantitative (Credit) Easing to Respond to the Global Financial Crisis

- Sometimes the negative aggregate demand shock is so large that at some point the central bank cannot lower the real interest rate further because the nominal interest rate hits a floor of zero, as occurred after the Lehman Brothers bankruptcy in late 2008
- In this situation when the zero-lower-bound problem arises, the central bank must turn to nonconventional monetary policy
- Though the Fed took action, the negative aggregate demand shock to the economy from the global financial crisis was so great that the Fed's quantitative (credit) easing was insufficient to overcome it, and the Fed was unable to shift the aggregate demand curve all the way back and the economy still suffered a severe recession

Response to a Permanent Supply Shock

- There are two possible policy responses to a permanent supply shock:
 - No policy response
 - Policy stabilizes inflation

Figure 3 Permanent Supply Shock: No Policy Response

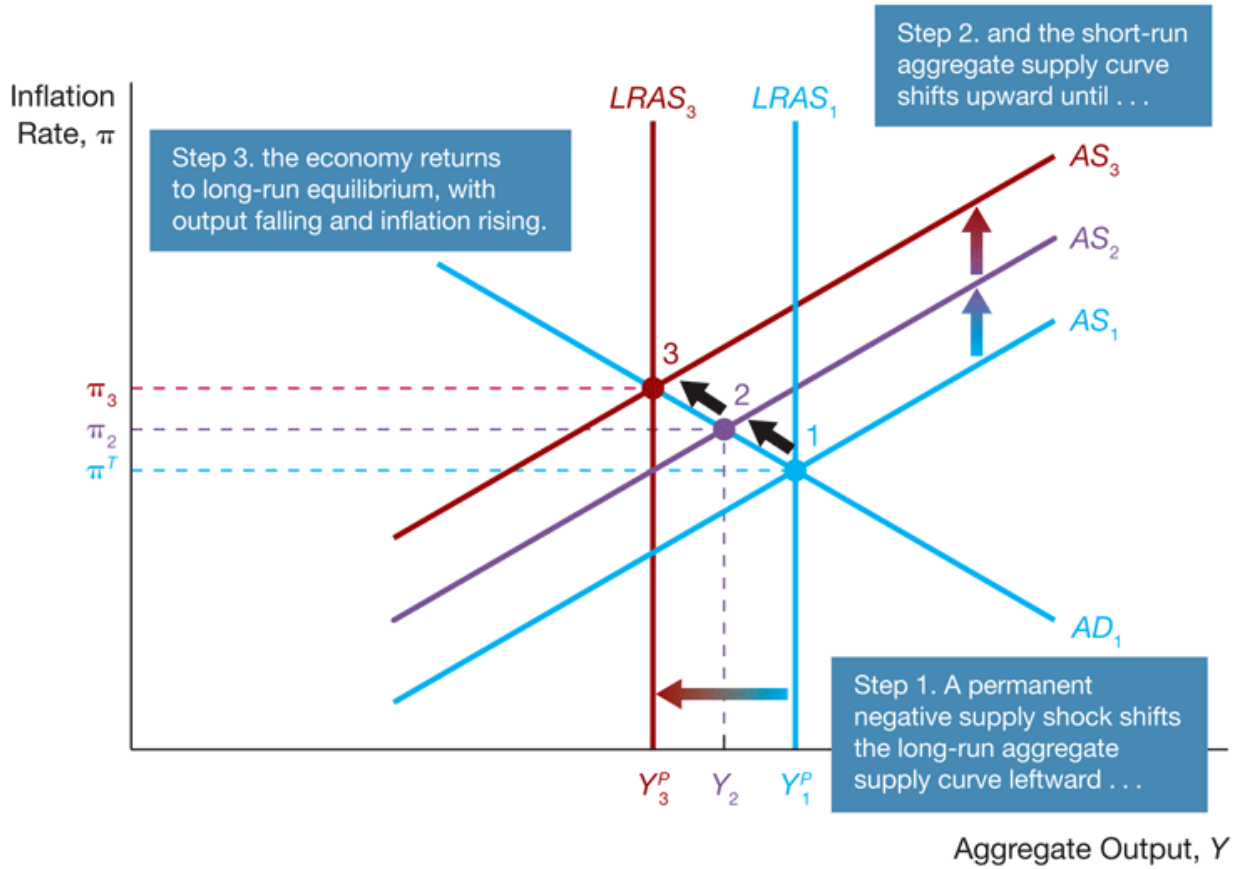
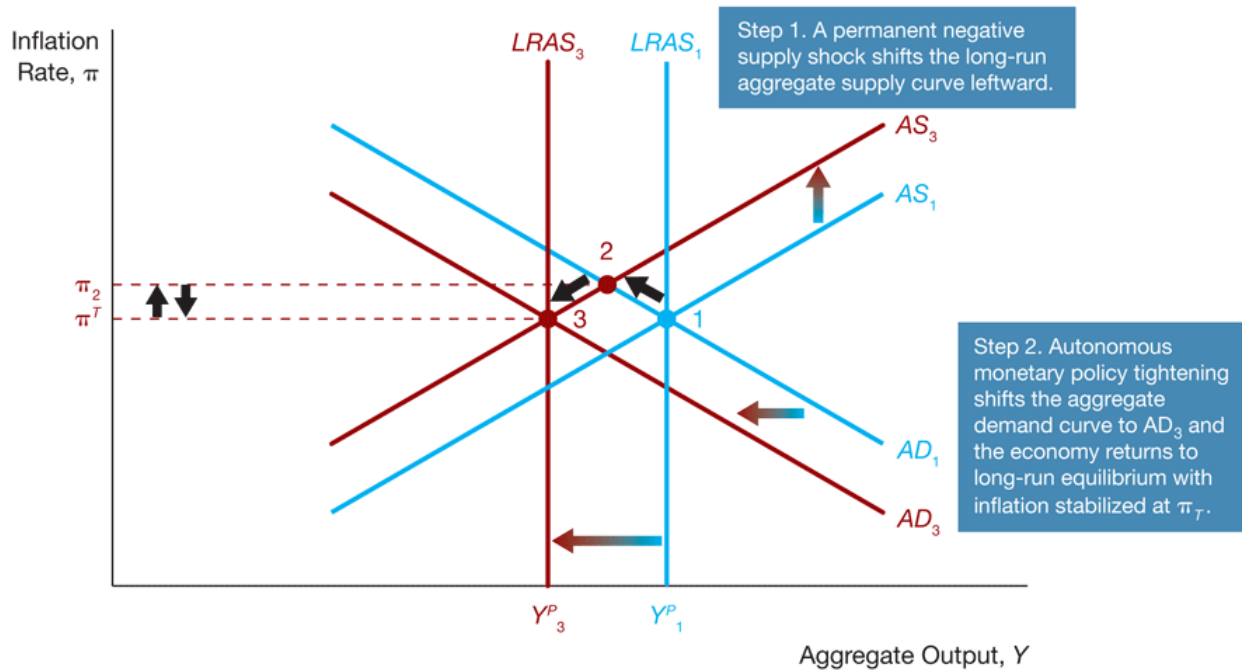


Figure 4 Permanent Supply Shock: Policy Stabilizes Inflation



Response to a Temporary Supply Shock

- When a supply shock is temporary, policymakers face a short-run tradeoff between stabilizing inflation and economic activity
- Policymakers can respond to the temporary supply shock in three possible ways:
 - No policy response
 - Policy stabilizes inflation in the short run
 - Policy stabilizes economic activity in the short run

Figure 5 Response to a Temporary Aggregate Supply Shock: No Policy Response

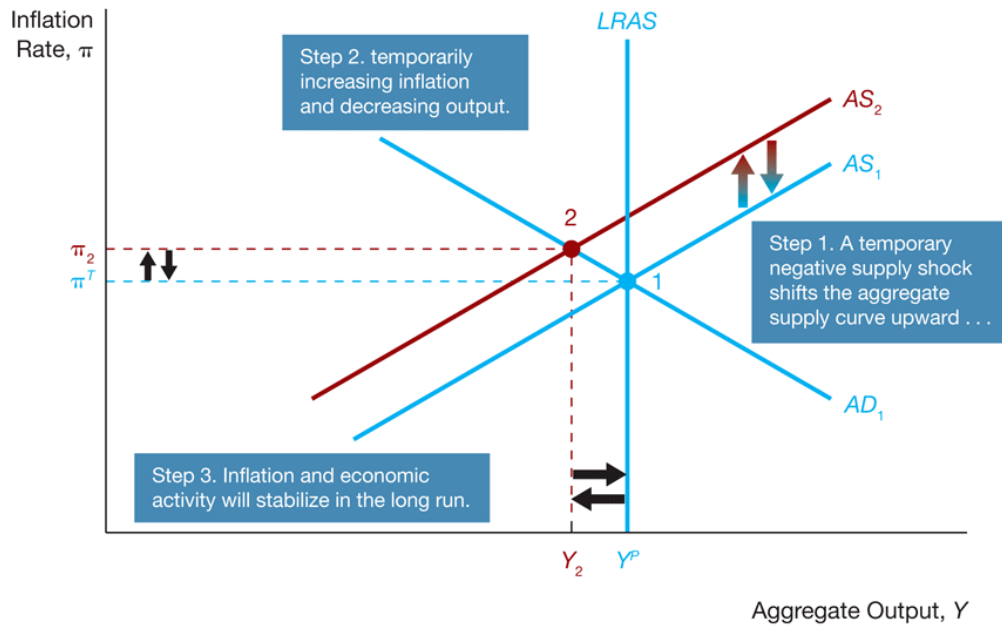


Figure 6 Response to a Temporary Aggregate Supply Shock: Short-Run Inflation Stabilization

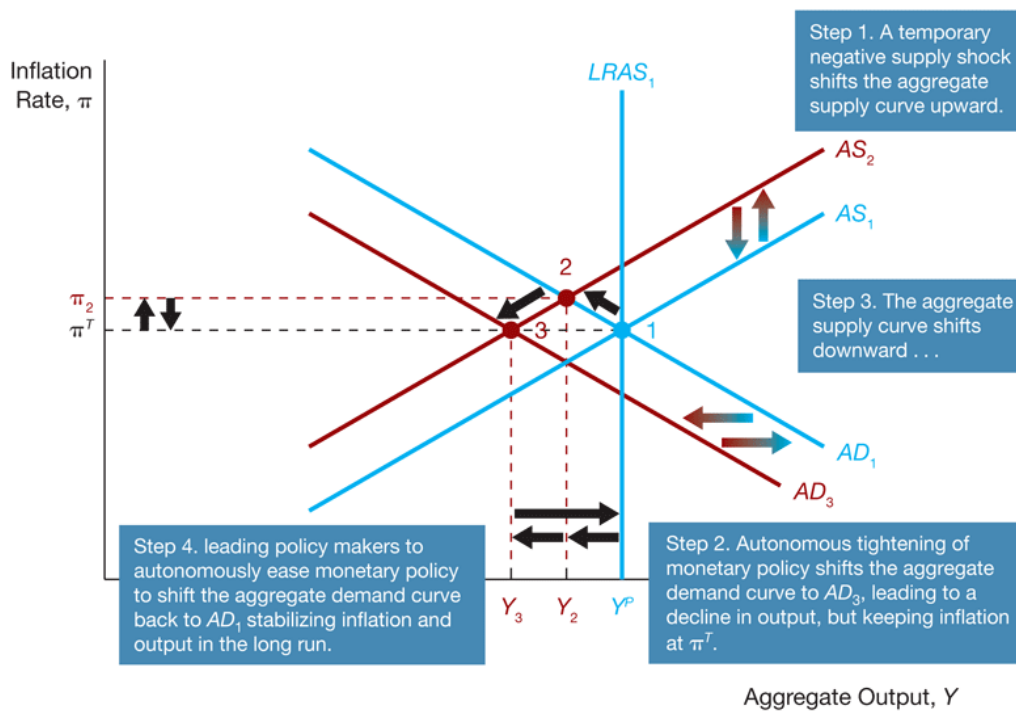
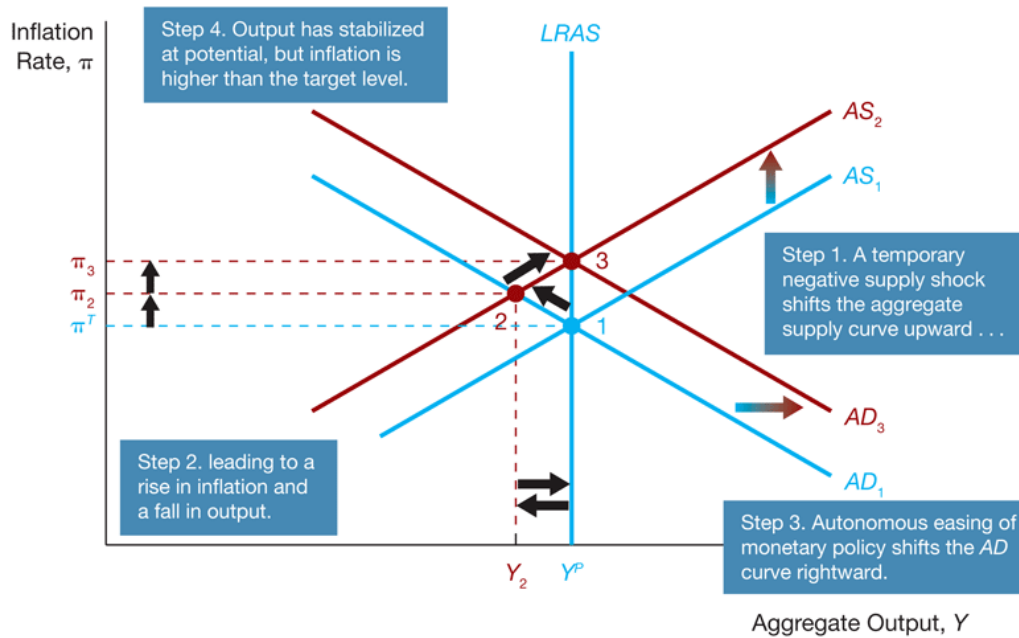


Figure 7 Response to a Temporary Aggregate Supply Shock: Short-Run Output Stabilization



The Bottom Line: The Relationship Between Stabilizing Inflation and Stabilizing Economic Activity

- We can draw the following conclusions from this analysis:
 1. If most shocks to the economy are aggregate demand shocks or permanent aggregate supply shocks, then policy that stabilizes inflation will also stabilize economic activity, even in the short run.
 2. If temporary supply shocks are more common, then a central bank must choose between the two stabilization objectives in the short run.
 3. In the long run there is no conflict between stabilizing inflation and economic activity in response to shocks.

How Actively Should Policy Makers Try to Stabilize Economic Activity?

- All economists have similar policy goals (to promote high employment and price stability), yet they often disagree on the best approach to achieve those goals
- **Nonactivists** believe government action is unnecessary to eliminate unemployment
- **Activists** see the need for the government to pursue active policy to eliminate high unemployment when it develops

Lags and Policy Implementation

- Several types of lags prevent policymakers from shifting the aggregate demand curve instantaneously

FYI The Activist/Nonactivist Debate Over the Obama Fiscal Stimulus Package

- Many activists argued that the government needed to do more by implementing a massive fiscal stimulus package
- On the other hand, nonactivists opposed the fiscal stimulus package, arguing that fiscal stimulus would take too long to work because of long implementation lags
- The Obama administration came down squarely on the side of the activists and proposed the American Recovery and Reinvestment Act of 2009, a \$787 billion fiscal stimulus package that Congress passed on February 13, 2009

Inflation: Always and Everywhere a Monetary Phenomenon

- This adage is supported by our aggregate demand and supply analysis because it shows that monetary policy makers can target any inflation rate in the long run by shifting the aggregate demand curve with autonomous monetary policy

Figure 8 A Rise in the Inflation Target

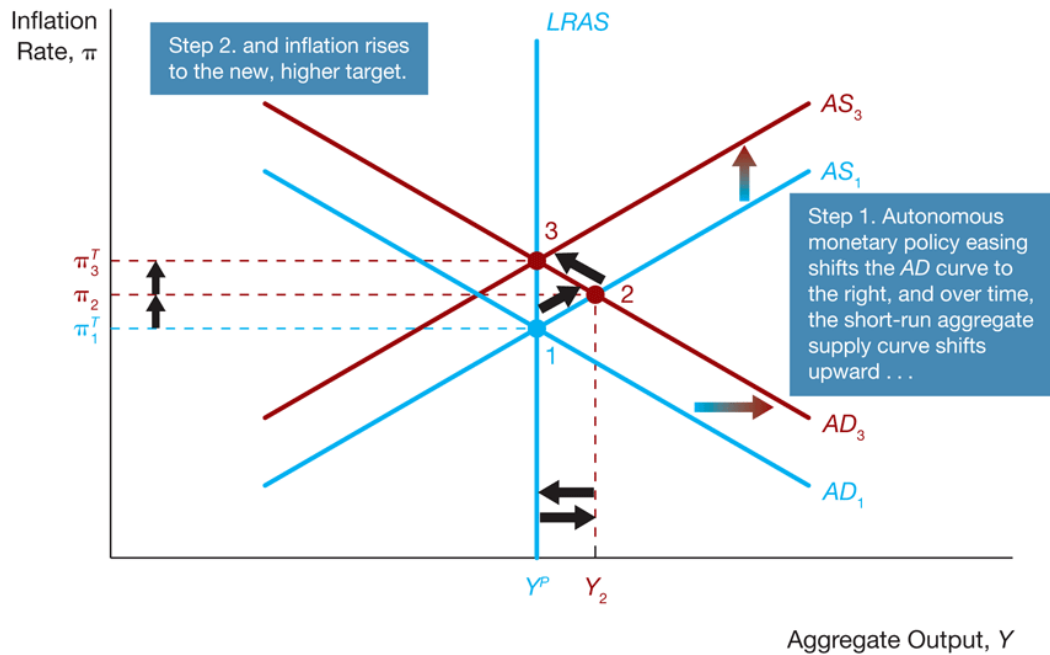
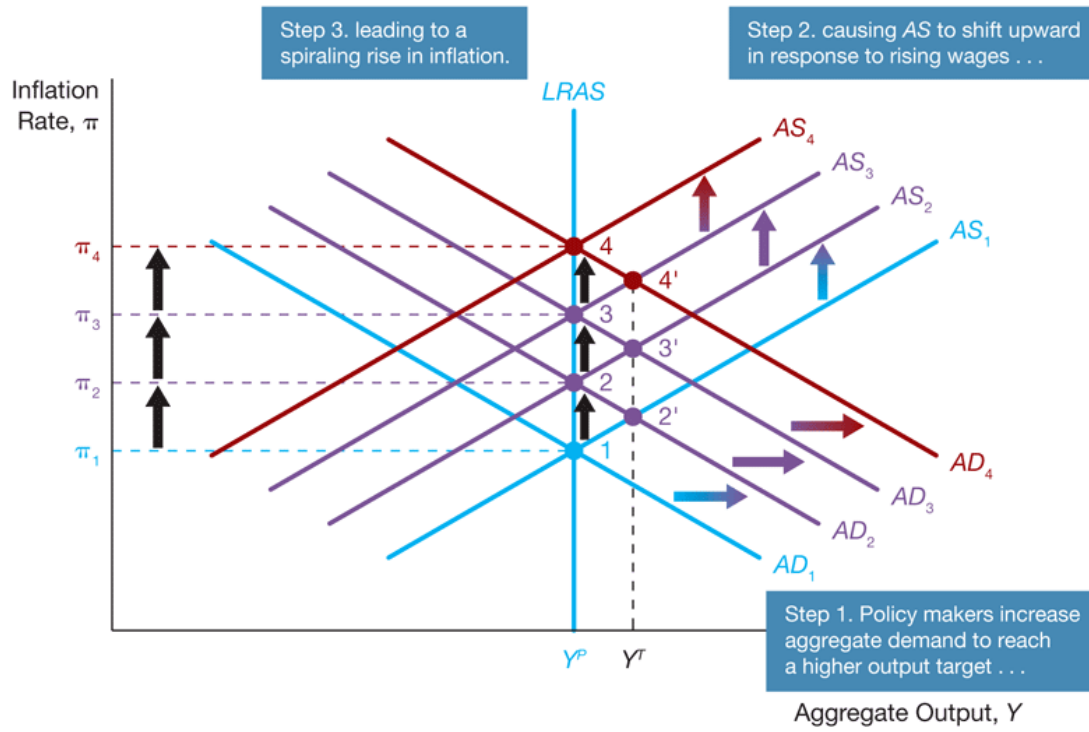


Figure 10 Demand-Pull Inflation



APPLICATION The Great Inflation

Figure 11 Inflation and Unemployment, 1965-1982

