Chapter 14
Inflation and Monetary Policy

The Objectives of Monetary Policy
- Stability of the banking system
  - Alleviate financial panics
- Low and stable interest rate
- Low and stable rate of inflation
- Full employment of the labor force

Low, stable inflation
- A high inflation rate
  - Cost to society
  - Labor, time
- Unstable inflation
  - High risk of lending and borrowing
    - Redistribute real income
  - Interferes with long-run financial planning
- Inflation - unpopular with the public

Full employment
- Natural rate of unemployment
  - No cyclical unemployment
- Unemployment rate - below natural rate
  - GDP > potential output
  - Creates inflation
- Unemployment rate - above natural rate
  - GDP < potential output
  - Downward pressure on the price level
The Fed’s Performance

Figure 1 The Fed’s Performance Since 1950 to Mid-2006 (a)

In the 1970s and early 1980s there were periods of high inflation... but the inflation rate dropped during the 1980s... and it dropped again in the 1990s and early 2000s.

Figure 1 The Fed’s Performance Since 1950 to Mid-2006 (b)

The unemployment rate was particularly high during the early 1980s... but it fell dramatically during the 1990s... then rose again during the 2001 recession.

Federal Reserve Policy

- Goals:
  - Low inflation
  - Full employment
- In many cases
  - Trade-off
- Assumption
  - the Fed’s goal: zero inflation rate

Responding to Demand Shocks

- Positive demand shock
- The Fed’s possible responses:
  - Maintain the money supply
  - Maintain the interest rate
  - Neutralize the shock
Positive Demand Shock; Constant MS

- Potential output
- Positive demand shock
- The Fed: maintains the money supply
  - Output – overshoots potential
  - Rise in the price level - short run and long run

Positive Demand Shock; Constant r

- Potential output
- Positive demand shock
- The Fed: maintains the interest rate
  - Output – overshoots potential output (even more)
  - Greater rise in the price level
Positive Demand Shock: Neutralized

Potential output
Positive demand shock
The Fed: Neutralize the shock
- Raises interest rate target
- Creates complete crowding out
- Prevents any shift in the \( AD \) curve

Responding to Supply Shocks

Negative supply shock
- Short-run tradeoff
  - Limit the recession - more inflation, or
  - Limit inflation - deeper recession
- Hawk and Dove Policies
Expectations and Ongoing Inflation

- Ongoing inflation
  - Public – expects similar trend
- A continuing, stable rate of inflation
  - Built into the economy

Built-in Inflation

- Built-in inflation
  - AS curve shifts upward each year
  - Even when output = potential
  - And unemployment = natural rate
- Built-in inflation = upward shift AS curve
- The Fed – short run
  - Can reduce inflation below the built-in rate
  - Creates recession

Built-In Inflation

- Figure 6: Long-Run Equilibrium with Built-In Inflation

The Phillips Curve

- Phillips curve
  - Fed’s choices between inflation and unemployment
  - Short run