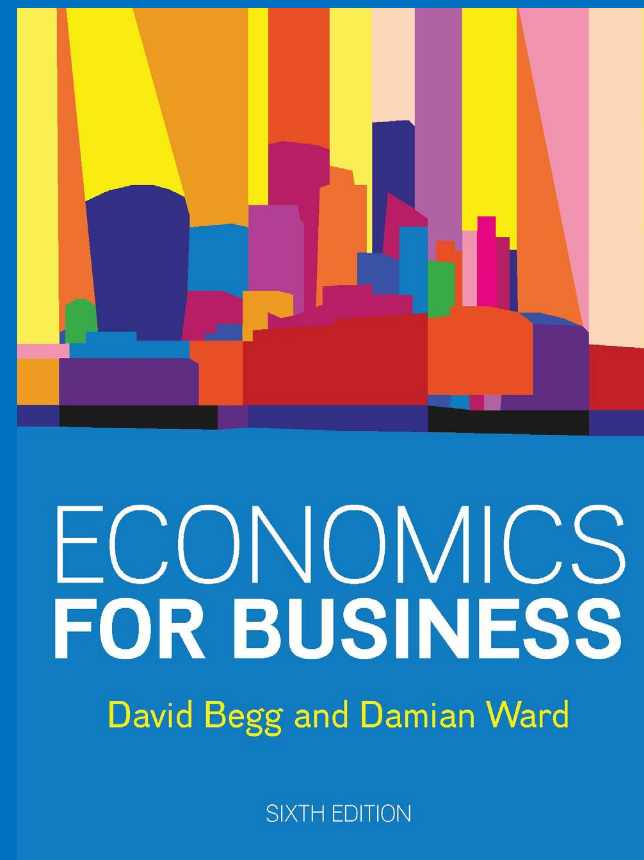
economics for business

Chapter 15
Inflation, output and economic policy



Learning Outcomes

Economic Theory

- The short- and long-run Phillips curve.
- The macroeconomic demand schedule.
- Short- and long-run aggregate supply.
- Macroeconomic equilibrium following demand and supply side shocks.
- Monetary responses to shocks.
- Taylor rule.
- Schools of thought and speeds of adjustment.

Learning Outcomes

Business Application

- The interest rate path.
- The importance of real business cycles.
- The formation of inflationary expectations in the long and short run.

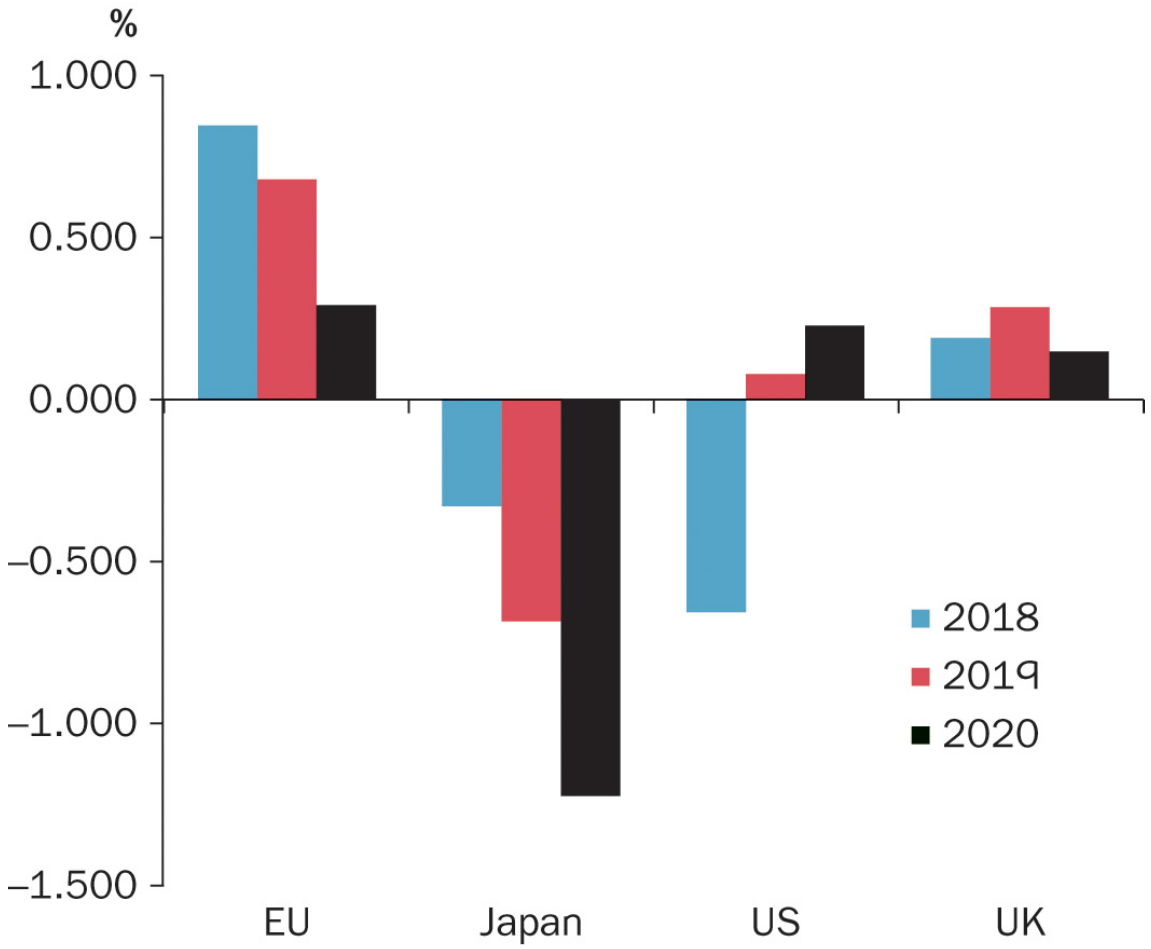
Business Problem

- How does the economy return to equilibrium after a severe crisis?

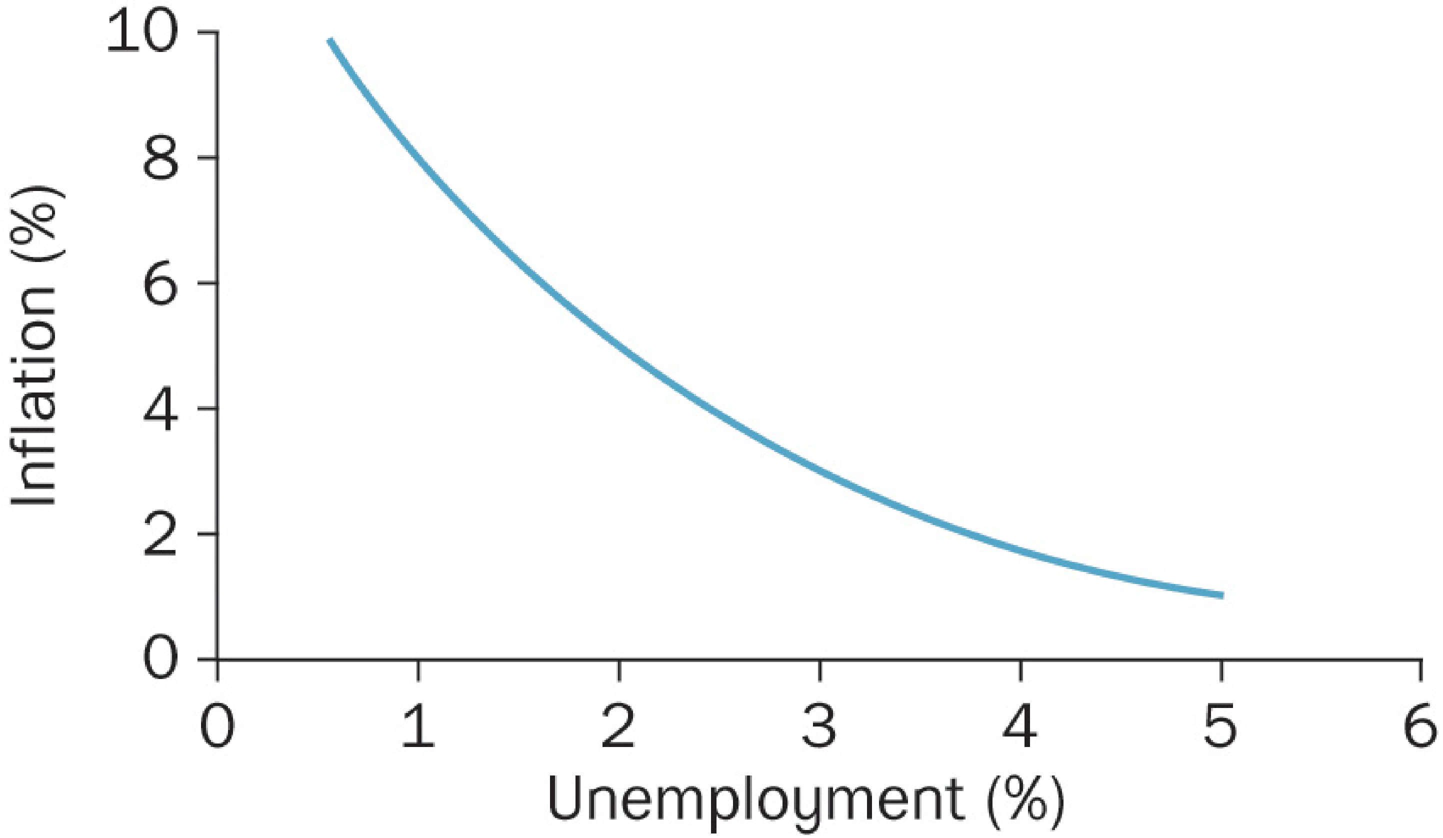
Short- and Long-Run Macroeconomic Equilibrium

- Full employment.
- Potential GDP.
- Actual GDP.
- Output gap.

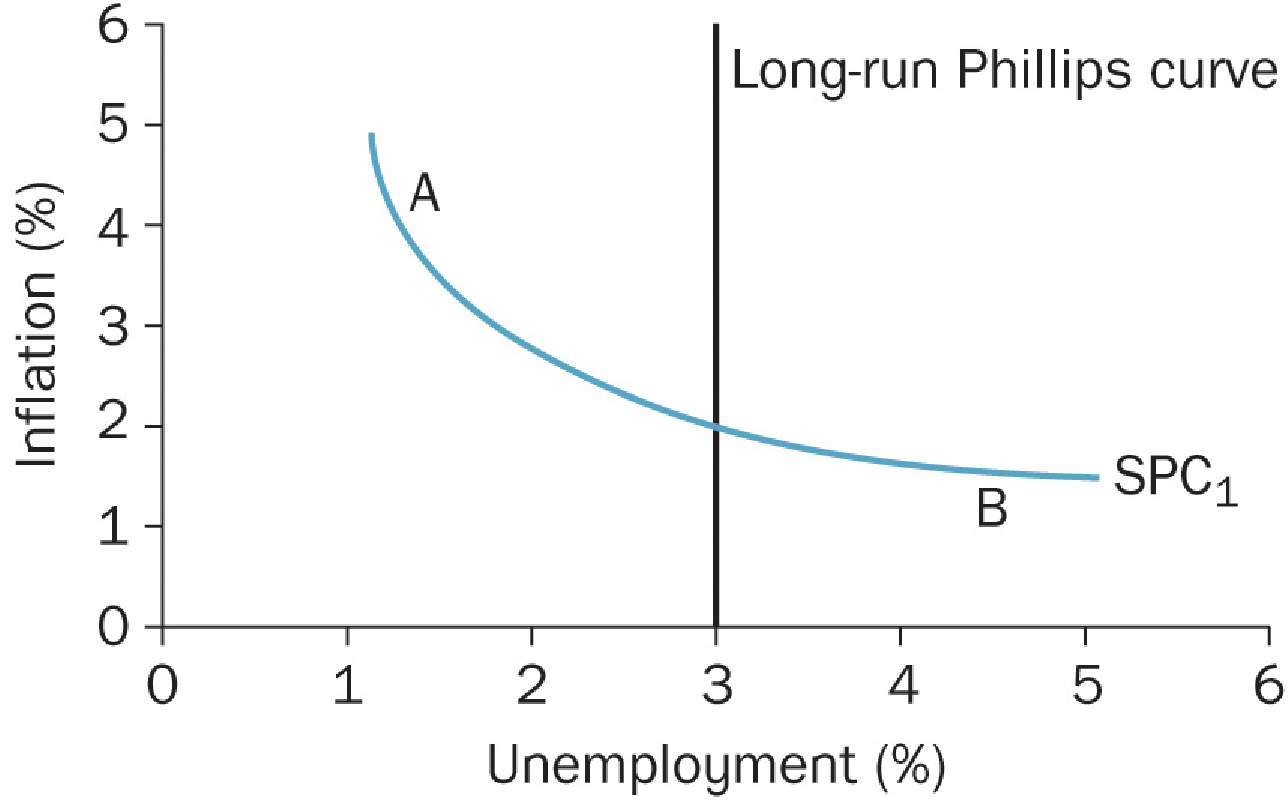
Output Gap



Short-Run Phillips Curve

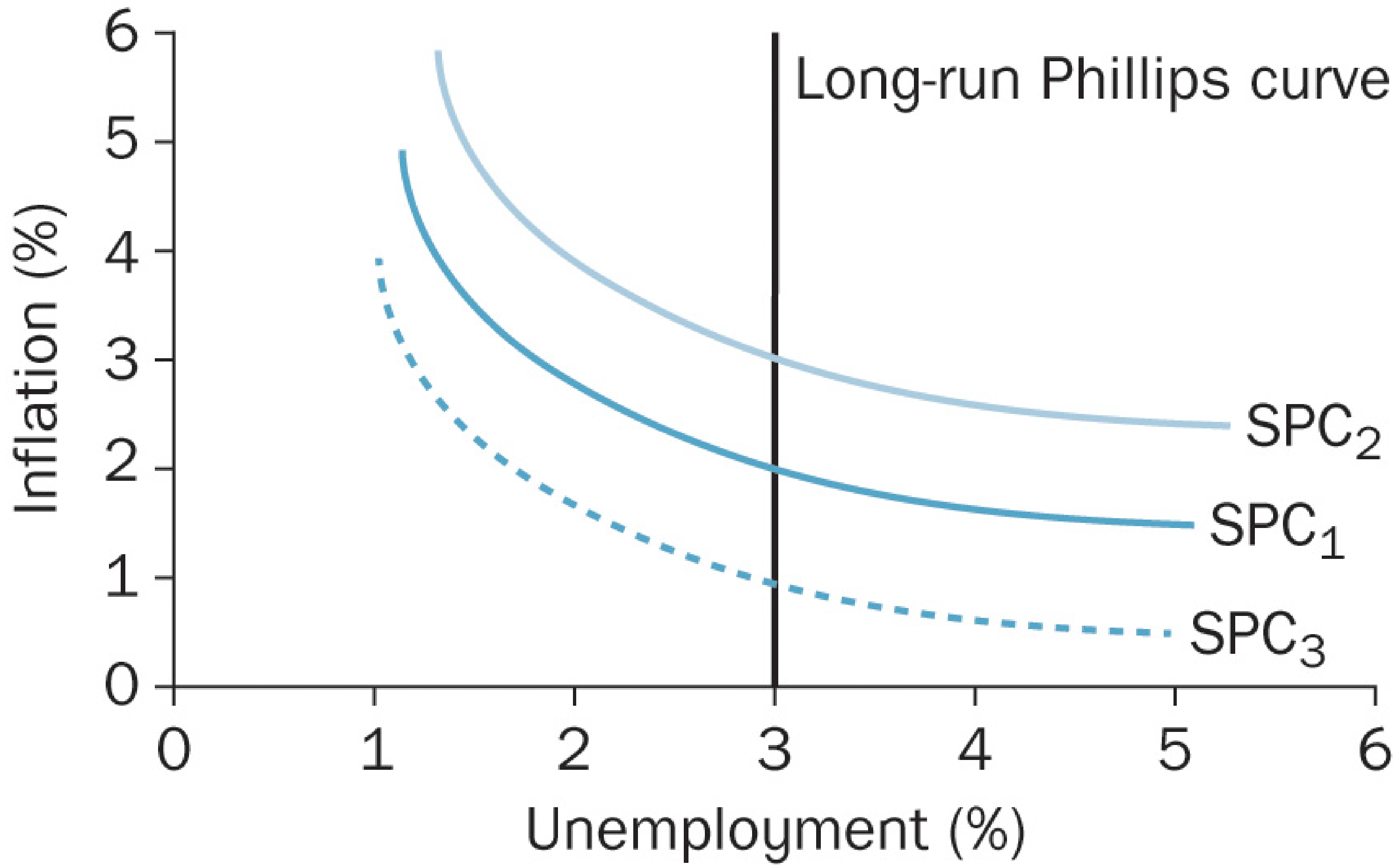


Long-Run Phillips Curve

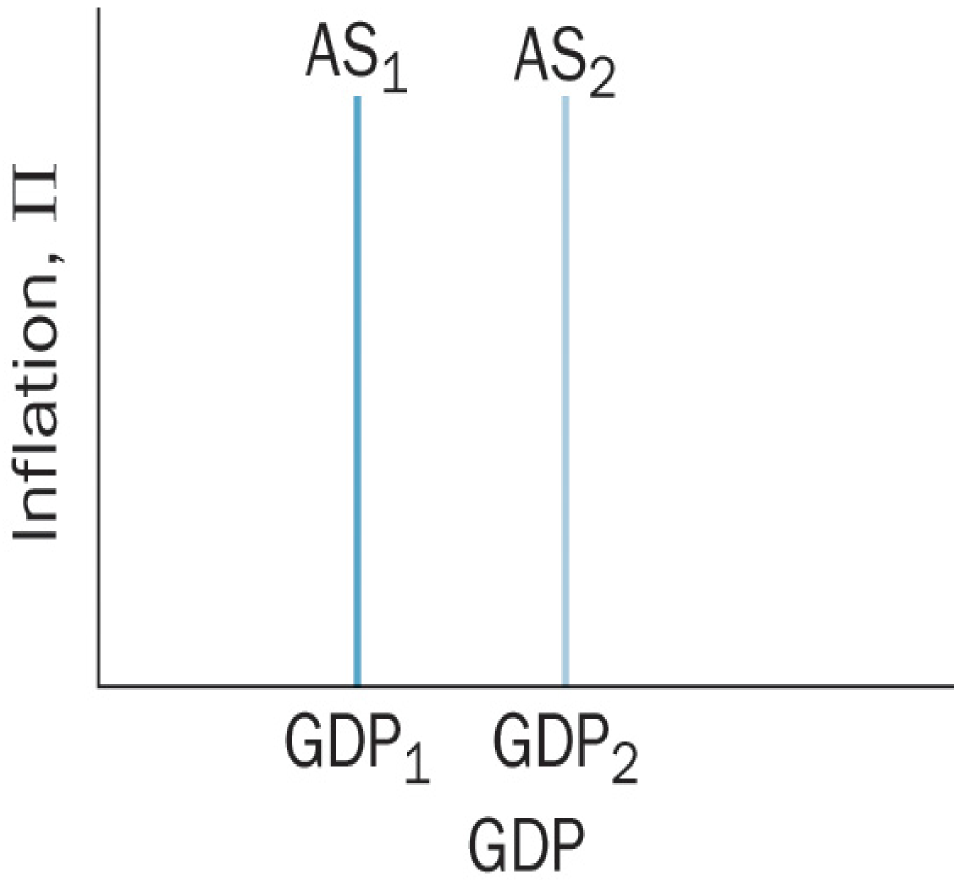


McGraw-Hill Education, 2016

Expectations-Augmented Phillips Curve



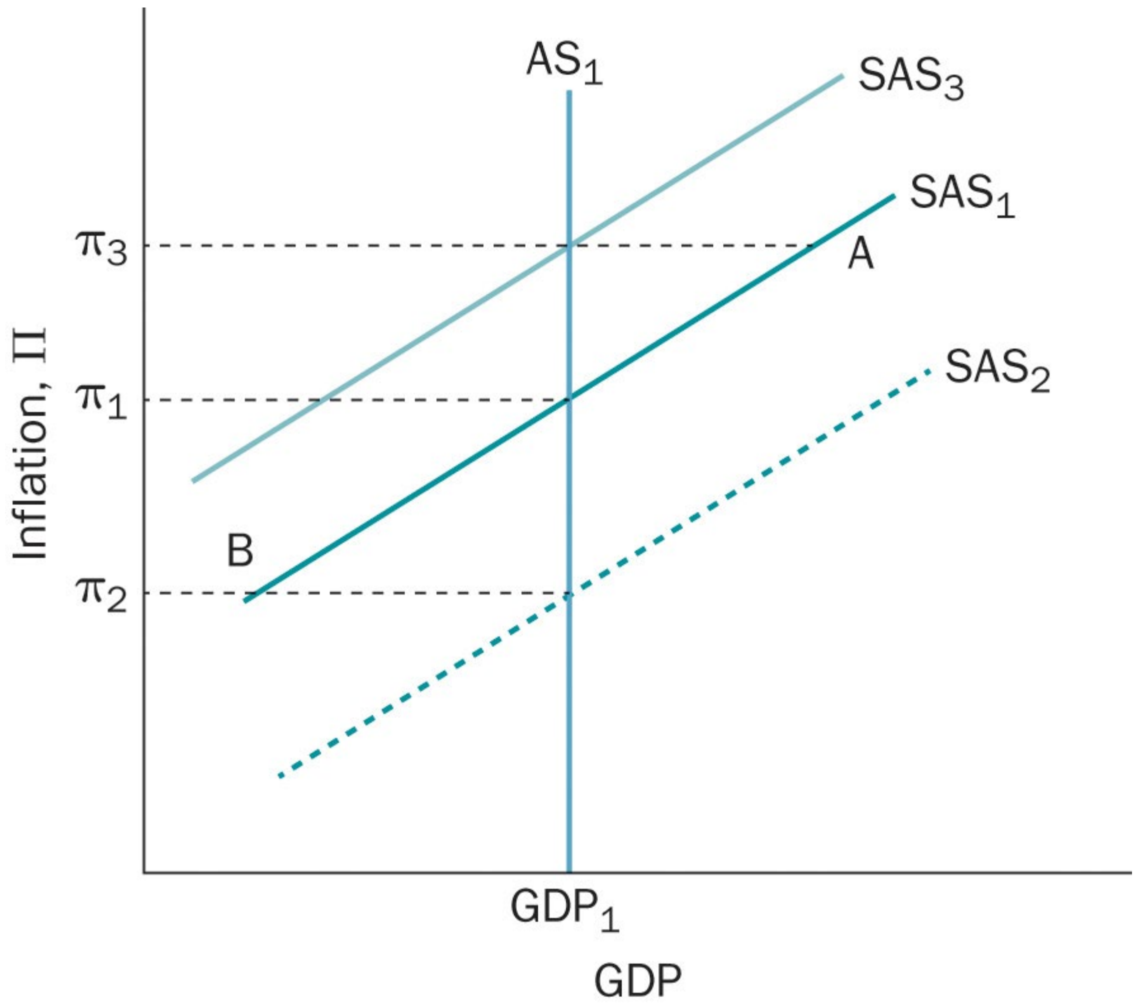
Long-Run Aggregate Supply



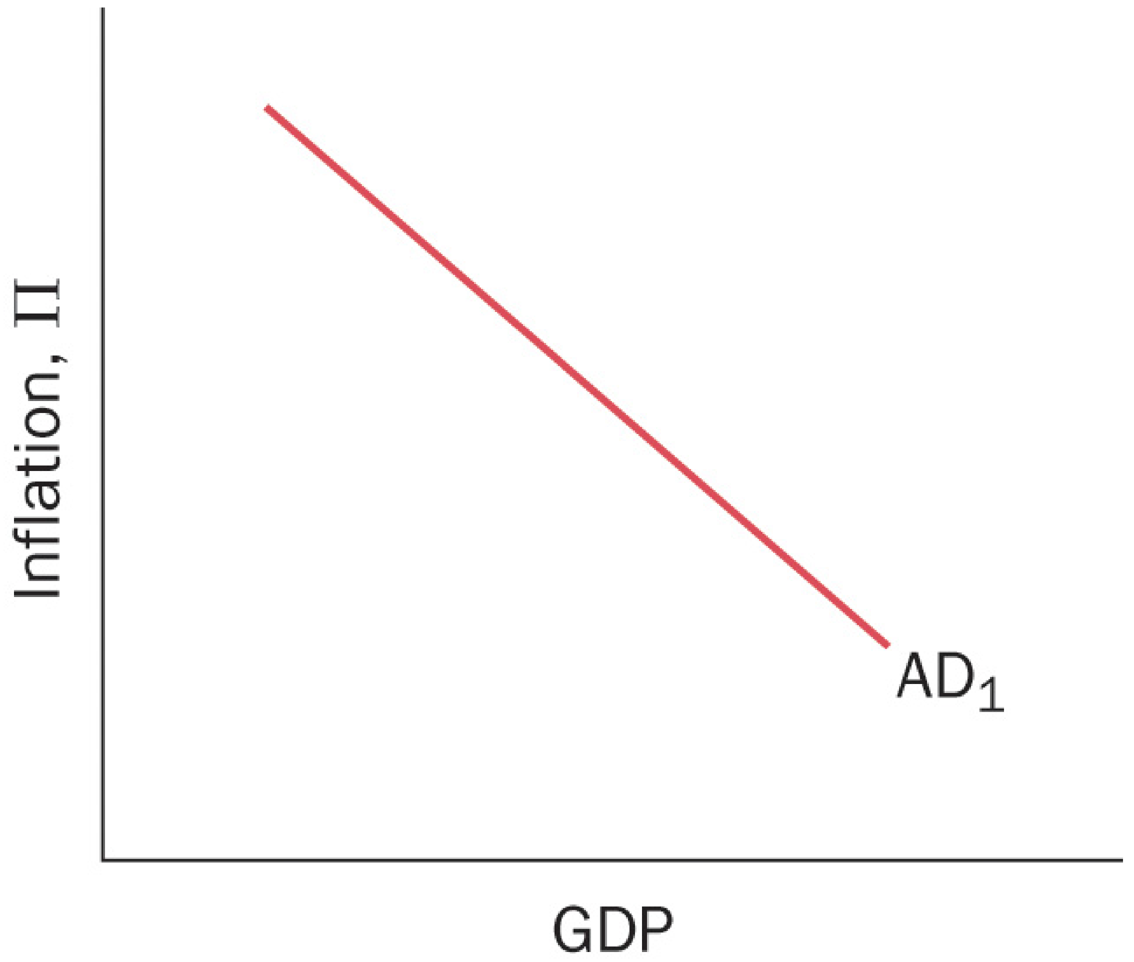
Long-run aggregate supply is constant and represents the full employment level of the economy.

Any change in long-run supply must reflect real changes in economic factor inputs, technology or productivity.

Short-Run Aggregate Supply

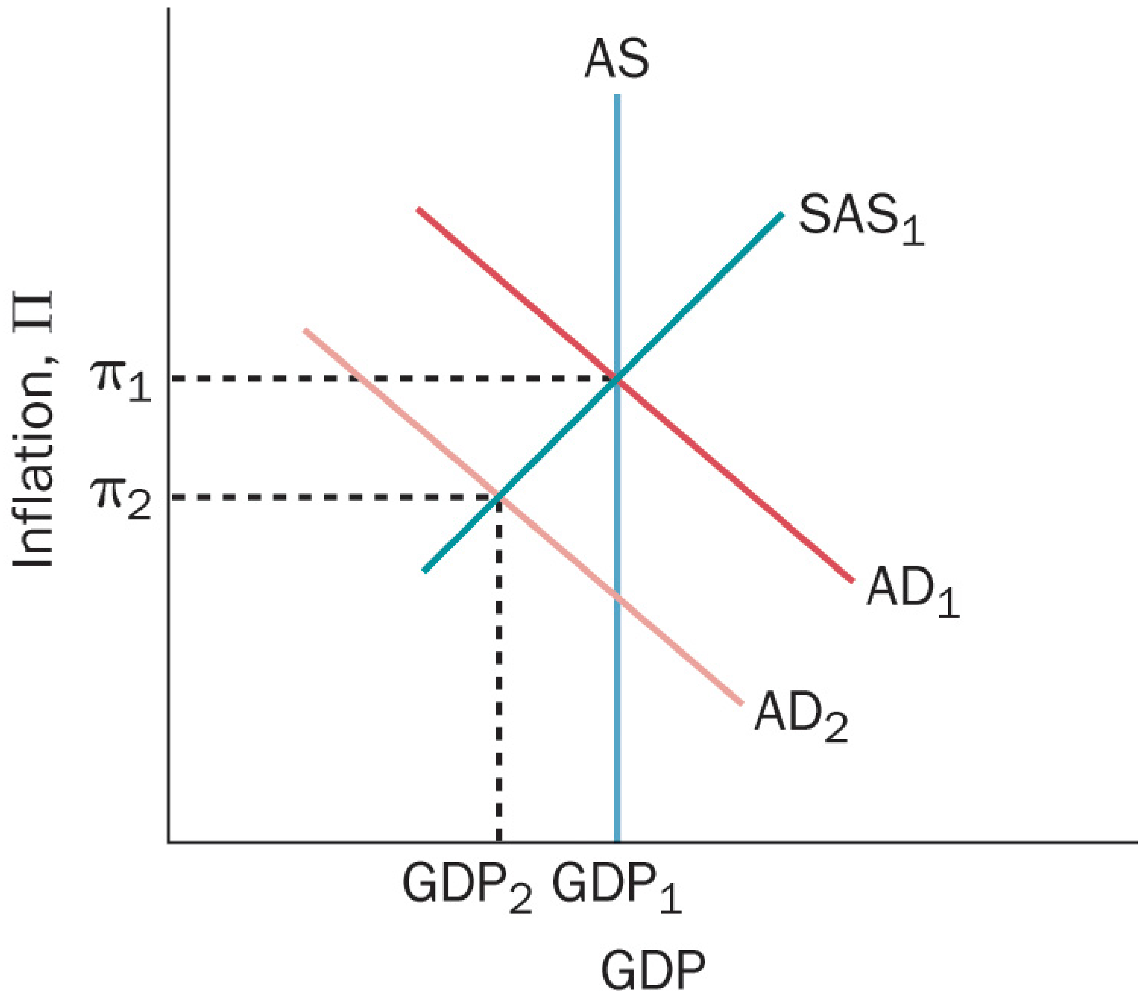


Aggregate Demand



Short- and Long-Run Equilibrium

Figure 15.9 Falling aggregate demand.

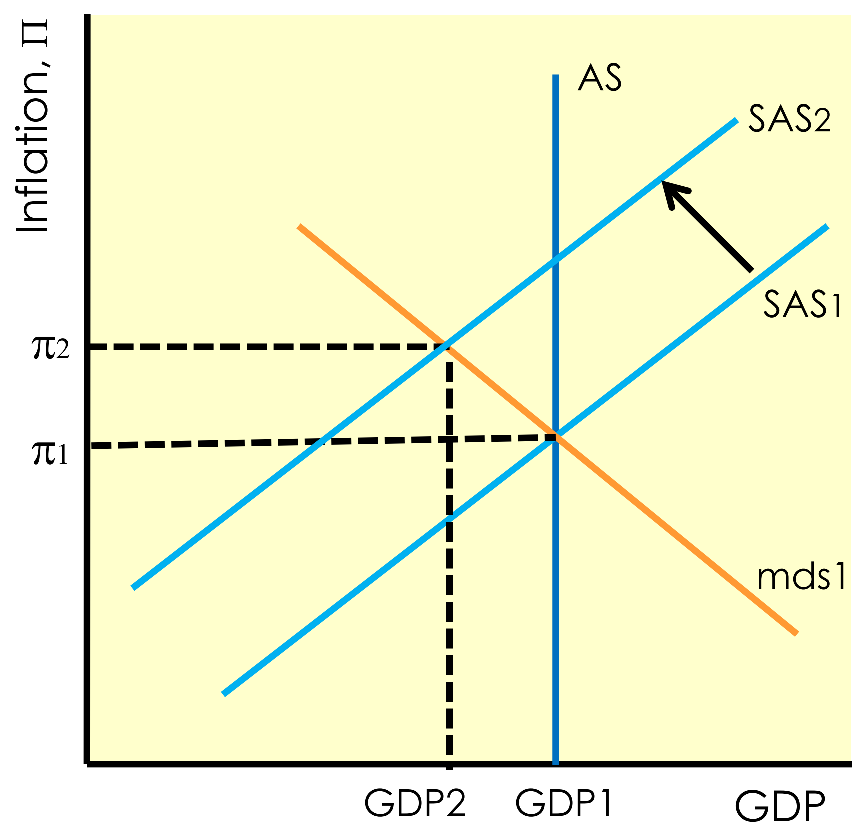


Deflation and the Credit Crisis

- Why avoid deflation?
- Temporary supply shock.

Temporary Supply Shock

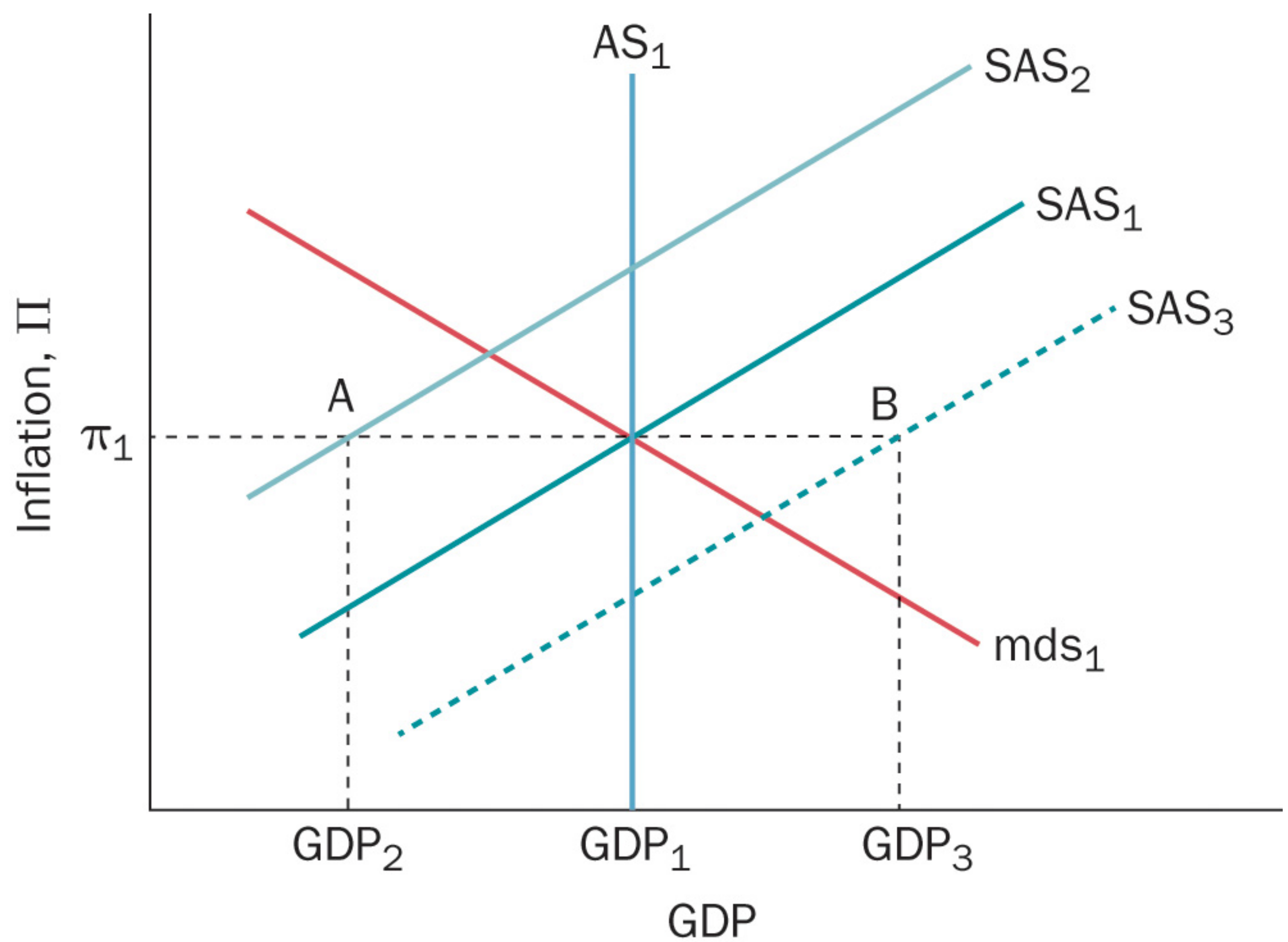
Figure 15.10 A temporary supply shock.



Monetary Policy Rules

- The Taylor Rule.
- $i = \pi + i^* + a(\pi - \pi^*) + b(GDP - GDP^*)$.
- Enables inflation and GDP to be targeted.

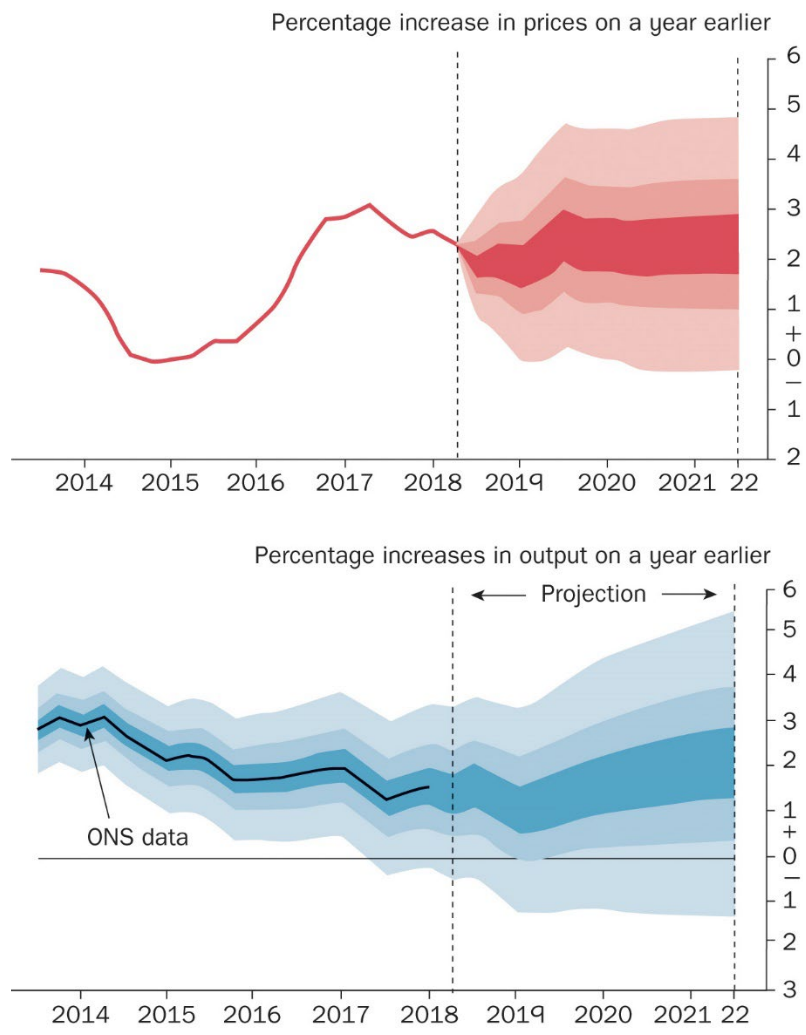
Targeting Inflation and Supply Shock



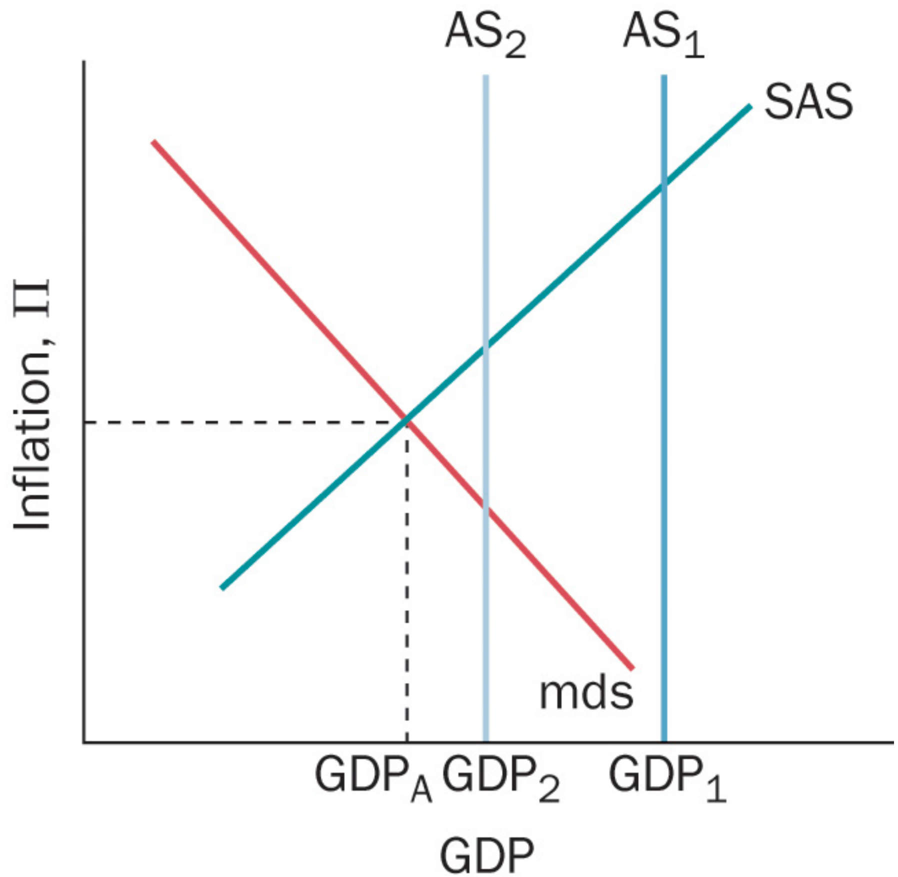
Adjustment Speeds and Schools of Thought

- New classical.
- Gradual monetarist.
- Moderate Keynesian.
- Extreme Keynesian.

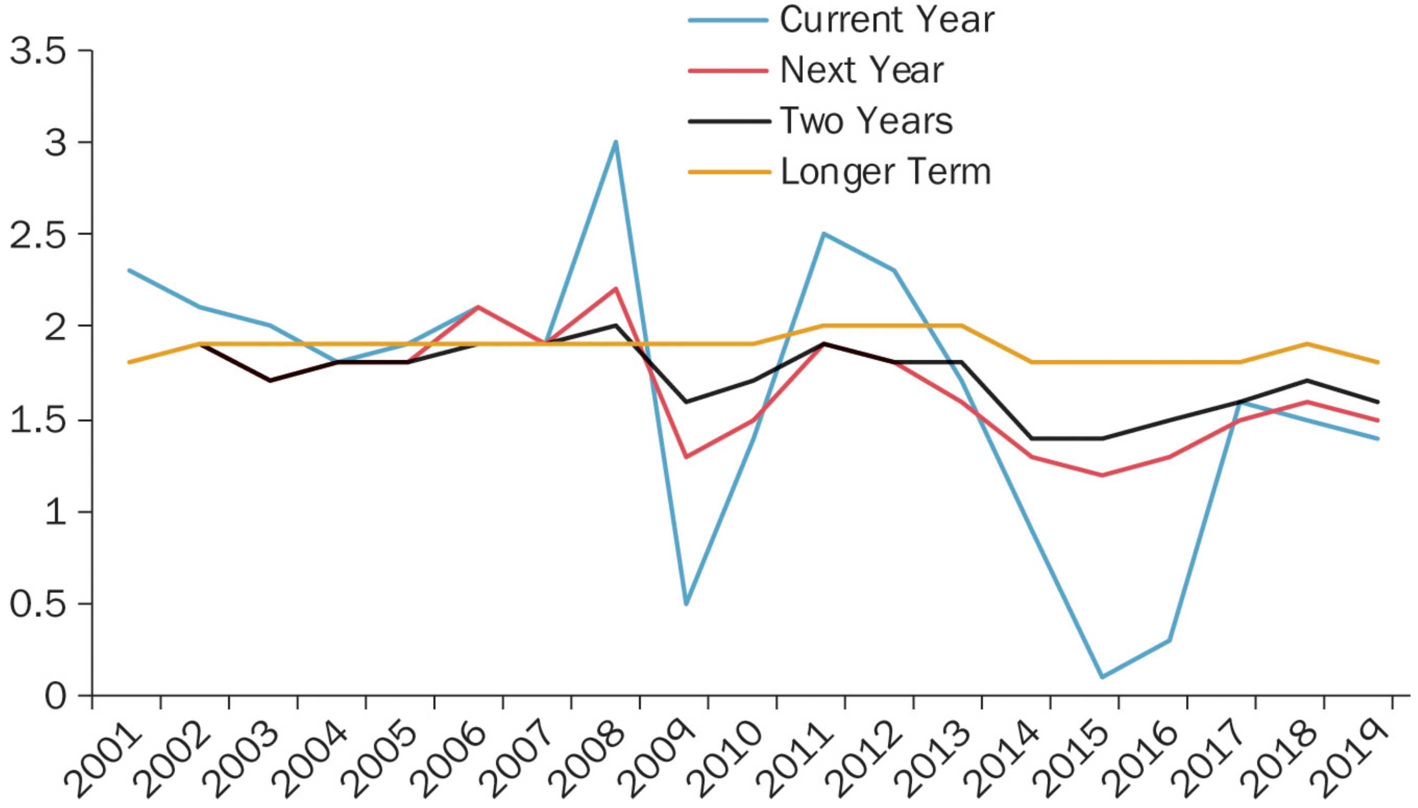
Business Applications: Interest Rates Paths



Business Application: the Importance of Real Business Cycles



Business Application: Formation of Inflationary Expectations



Exercise

1. Which of the following has caused the move from SPC_1 to SPC_2 in Figure 15.15?
   (a) A rise in the full employment rate.
   (b) An increase in nominal wages.
   (c) An increased expectation of higher unemployment.
   (d) An increased expectation of higher inflation.

Summary

You should now be able to:

- Explain the relationship described by the Phillips curve.
- Understand the key differences between the short- and long-run Phillips curves.
- Link the short- and long-run Phillips curves and short- and long-run aggregate supplies.
- Identify the short- and long-run macroeconomic equilibria.
- Explain the adjustment to long-run equilibrium.
- Assess monetary policy responses to demand and supply shocks in the economy.
- Understand the different views among economists regarding the speed of adjustment to long-run equilibrium.