

LECTURE FIVE – PART SEVEN



An Obvious Policy Question

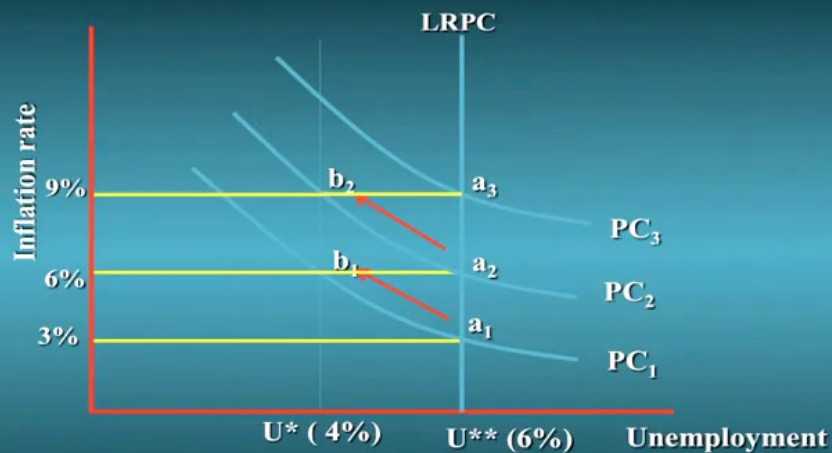
- This Monetarist-inspired story raises an obvious policy question: How do you stop such an inflationary spiral?

The Monetarist Solution

- Stop using expansionary Keynesian policies.
- Allow the economy to return to the natural rate of unemployment.

THE BIG PROBLEM

Even if we stop an upward inflationary spiral, we still have significant inflation because a higher core rate of inflation has been built into the economy!!!!



EXAMPLE

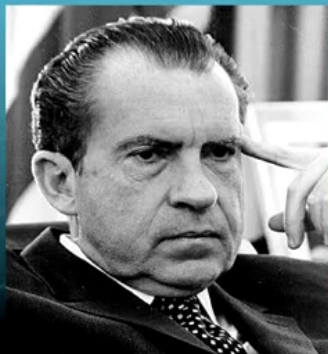
If we stop inflation's upward spiral, we may be stuck at Point a_3 with a core inflation rate of 9%.

The Traditional Keynesian Solution

- An “incomes policy”
- Impose wage and price controls until the inflation dissipates.

An Incomes Policy May Not Work

- President Nixon learned this in the 1970s.
- He watched helplessly as inflation jumped back up to double digits once controls were lifted.



An Incomes Policy is Ideologically Contrary

- Businesses don't want government holding down their prices.
- Workers don't want government holding down their wages.

The Monetarists' Bad Politics

- It is equally politically unpalatable.



The Monetarists' Recession Solution

- To wring inflation out of the economy, the actual inflation rate must be below the expected inflation rate.
- To achieve this, the actual unemployment rate must be above the natural rate.
- That means inducing a recession!!



The Federal Reserve's 1979 Gambit

- Under Chairman Paul Volcker, the Federal Reserve adopted a sharply contractionary monetary policy.
- Incredibly, interest rates soared to over 20%.



Effective But Costly

- The resulting recession was the worst since the Great Depression
- It probably cost President Jimmy Carter re-election



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- BUT between 1979 and 1984, inflation fell dramatically.

The Cost of Disinflation, 1980-1984

Initial Rate of Inflation:

1979	9%
1984	4%
Change	-5 percentage point

Difference between potential and actual GDP (1996 prices)

1980	\$150 billion
1981	210
1982	470
1983	470
1984	200

Total: \$1,500 billion

Cost of disinflation= \$1.5 trillion

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The Coming of Ronald Reagan

- The hard economic times left a bitter taste in the mouths of the American people.
- Enter stage right: Supply Side economics.

