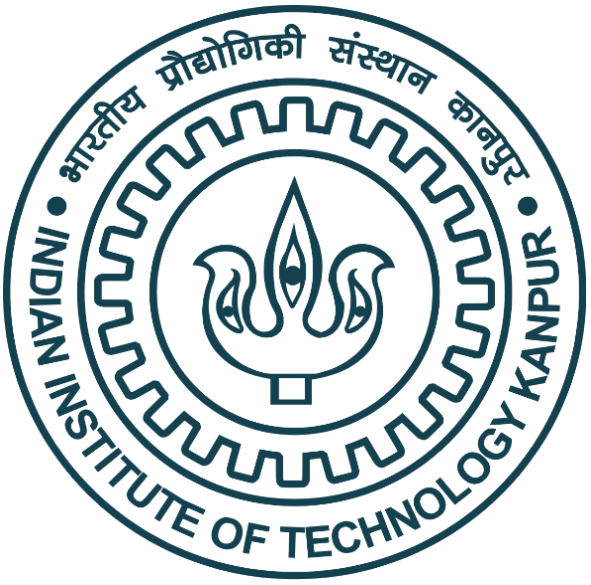
A Critical Macroeconomic Analysis of the Causes of the 1981-1982 Recession, its Propagation Mechanism, and the Effectiveness of the Policy Interventions



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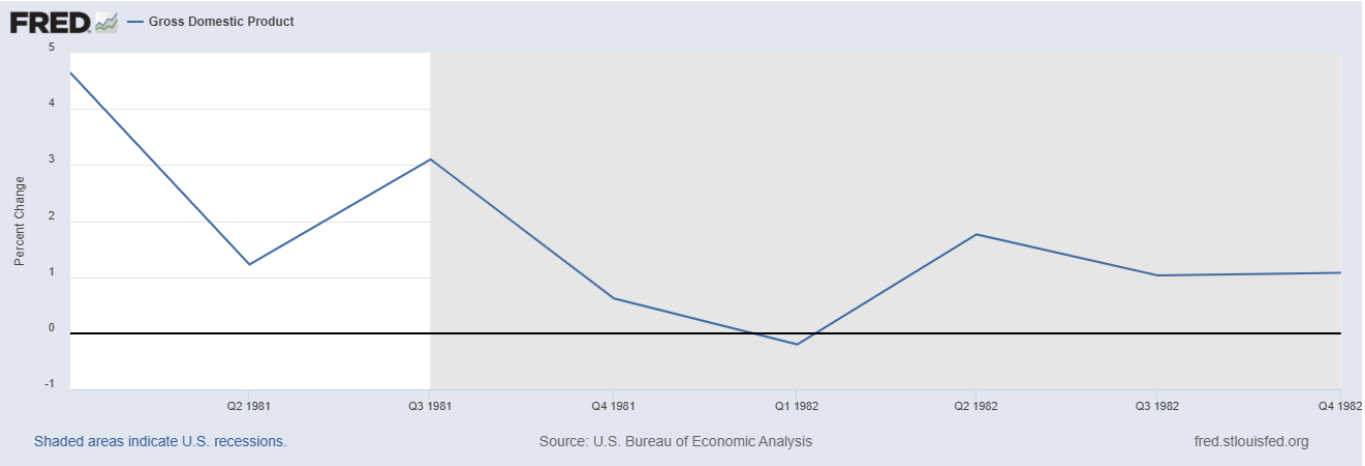
INTRODUCTION-

Recession refers to a period of general economic decline, typically characterized by a fall in GDP, higher unemployment rates, and a reduction in business activity. The recession of 1981-82 in the United States was a significant economic event that had lasting impacts on the economy. This essay aims to delve into the causes and propagation mechanisms of the 1981-82 recession, focusing on both demand-side and supply-side shocks. Additionally, an evaluation of the policy interventions employed during this period will be discussed in terms of their effectiveness in mitigating the recessionary effects. Lasting from July 1981 to November 1982, this economic downturn was triggered by tight monetary policy in an effort to fight mounting inflation.



Depth of the recession:

During the early stages of the recession, the economy experienced a sharp and sustained decline in economic activity, reflected in metrics such as GDP contraction, soaring unemployment rates, and reduced consumer spending and business investment. This period represented the downward slope of the **“U”**

Following the trough of the recession, which occurred around November 1982, the economy began to gradually recover. While the recovery was slow and uneven, economic indicators such as GDP and employment started to improve over time. This period represented the upward slope of the **"U"** reflecting the gradual turnaround and eventual recovery of the economy.

Gross Domestic Product (GDP) Decline:

- Real GDP declined sharply during the recession, with the economy contracting for several consecutive quarters.
- GDP fell by approximately 2.7% in 1980, followed by a further decline of around 1.9% in 1982.

Unemployment:

- Unemployment rates soared to levels not seen since the Great Depression.
- The unemployment rate peaked at around 10.7% in late 1982, reflecting widespread job losses and labor market distress.

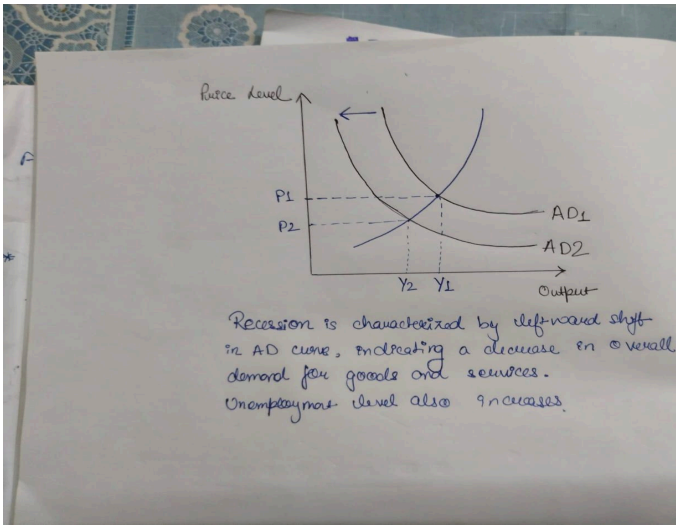
Industrial Production:

- Industrial production, a key measure of manufacturing activity, also experienced significant declines.

- Manufacturing output fell by over 2.75% during the recession, reflecting reduced demand and capacity utilization across industries.

Consumer Spending and Business Investment:

- Consumer spending and business investment contracted sharply as high interest rates and economic uncertainty dampened confidence and spending.
- Consumer spending declined by approximately 1.5% in 1982, while business investment fell by over 6% during the same period



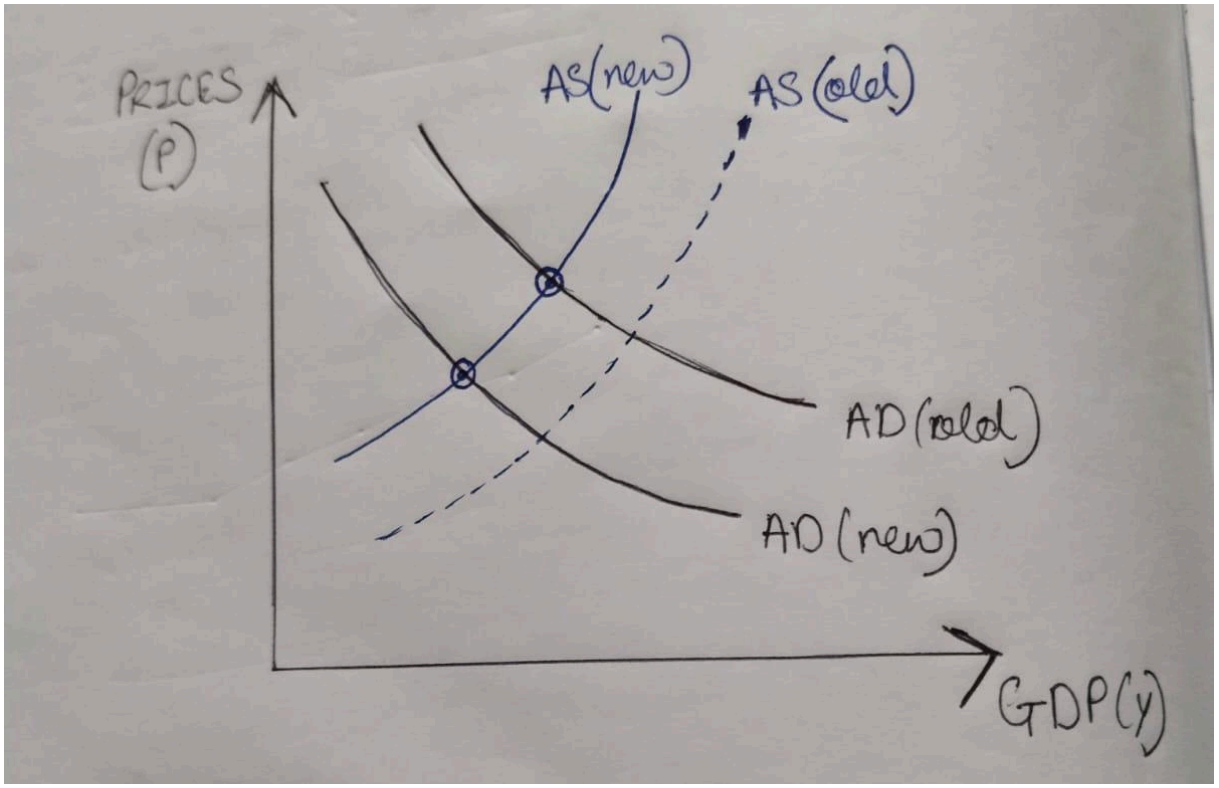
During Recession GDP declined shifting the Agreggate Demand Curve leftwards as a result total output decreases. Price level decreases from P1 to P2 and total output decreases from Y1 to Y2.

Causes of the Recession:

The recession of 1981-82 was precipitated by a combination of demand and supply-side shocks, which exerted significant downward pressure on the economy.

1. Demand-side Shocks:

- Demand shock - On the demand side, higher prices and diminishing disposable income, prevented consumers from buying as much as they used to usually, when the prices were comparatively low, this means demand for goods decreases and Aggregate demand (AD) curve shifts leftward. In order to lower production costs, the businesses also let go of employees. This led to a surge in unemployment, which in turn also contributed to decreasing aggregate demand. Additionally, this combined impact led to a drop in net production, which brought on a recession. Oil was becoming increasingly expensive to import, so the Government had to redirect spending to Oil imports, causing a drop in Govt spending for the public. This further decreased aggregate demand and worsened the recession.

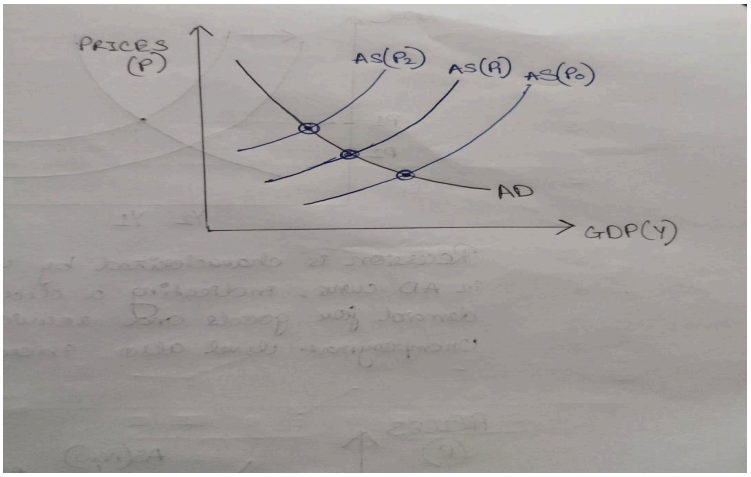


As aggregate demand decreased, increased costs of production and decreased output meant that firms had to lay off workers in order to remain profitable. This caused a massive dip in employment, leading to high unemployment and high inflation. Keynesian theory could not adequately explain this novel situation, also known as stagflation.

2. **Supply-side Shocks:**

a) **Oil Price Shocks:** Supply Shock – Oil demand is usually highly inelastic, i.e. a change in price doesn't change demand much. So when the oil prices hiked due to the oil embargo, the cost of industrial production increased drastically, hence also hiking the price of various goods and services. This meant a heavy reduction in the production of goods and services by firms at the same price level, so the Aggregate supply (AS) curve shifted leftward. This also meant firms will raise prices to maintain their profit margins, contributing to inflation. Because costs of production increased, firms' profits dipped. This caused a decrease in net investment. Decreased investment would mean that firms reduce their spending on capital goods, which in turn causes their net production to decrease, shifting the AS curve further to the left.

b) **Structural Changes in the Economy:** The 1981-82 recession occurred amidst significant structural changes in the U.S. economy. Industries such as manufacturing were undergoing transformations due to technological advancements and increased globalization. Automation and outsourcing led to job displacement in traditional manufacturing sectors, contributing to rising unemployment levels.



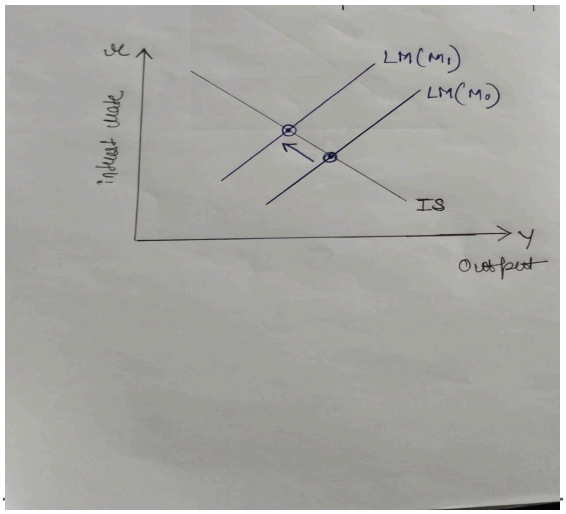
THE IMPULSE AND THE PROPAGATION MECHANISM OF THE SHOCKS-

Impulse and propagation mechanisms of shocks during the 1981-82 recession can be understood through both theoretical frameworks and empirical evidence.

IMPULSE:

a) Tightening of Monetary Policy (M):

1. The Federal Reserve implemented contractionary monetary policy, leading to higher interest rates and reduced money supply growth. This is represented by a leftward shift in the LM curve, indicating higher interest rates at each level of income.



b) Contractionary Fiscal Policy (F):

The government pursued fiscal policies aimed at reducing budget deficits, involving cuts in spending and, in some cases, increases in taxes. This is illustrated by a leftward shift in the IS curve, indicating lower levels of aggregate demand at each interest rate.

c) Oil Price Shocks (OP):

While oil price volatility primarily impacted supply, it also had demand-side effects. Increases in oil prices reduced consumers' purchasing power, leading to decreased spending on energy-using goods such as

automobiles and home heating. Additionally, higher production costs for businesses led to reduced profitability, limiting their ability to invest and expand.

Propagation Mechanisms:

a) Wealth Effect and Expectations (M):

The tightening of monetary policy led to decreases in household wealth and business profitability, dampening consumer spending and investment. This further shifts the LM curve to the left due to lower demand for money at each level of income.

b) Credit Crunch (M):

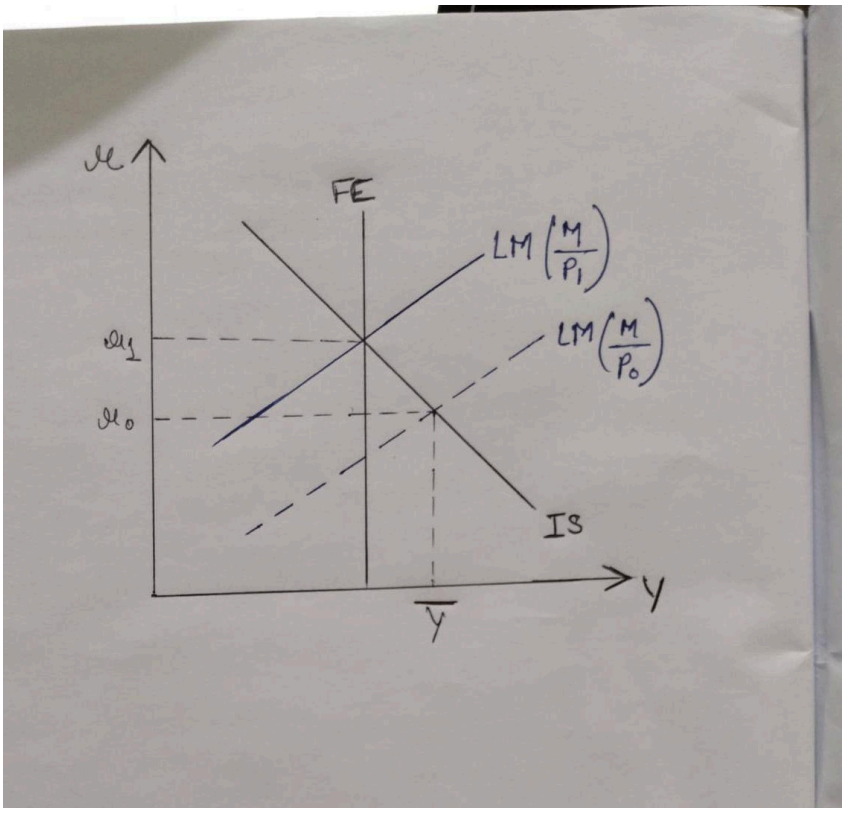
Higher interest rates and tighter monetary conditions led to reduced borrowing and investment, represented by a further leftward shift in the LM curve.

c) Cost-push Inflation (OP):

The oil price shocks increased production costs and reduced aggregate supply, leading to a decrease in potential output. This can be represented by a leftward shift in the production function in the IS-LM framework.

d) Supply-side Constraints (OP):

Structural changes in the economy and higher production costs constrained the ability of businesses to increase output, leading to a decrease in potential output and further shifting the IS curve to the left.



UNDERSTANDING THIS USING IS-LM-FE MODEL-

The IS-LM-FE model could also be used to describe the inflation and the recession. The point of general equilibrium moved to a lower input and higher interest rate as a result of the output decline, which caused the FE line to shift leftward. The real money supply would need to fall in order for the LM line to reach this position, which can happen by either raising prices or lowering nominal money. In our case, the earlier was accurate.

Theoretical Analysis:

The propagation mechanism of shocks during the 1981-82 recession can be understood through the lens of the IS-LM model. The initial shock of the contractionary monetary policy shifted the LM curve upward, leading to higher interest rates and a decrease in investment and consumption. This, in turn, caused the IS curve to shift to the left as aggregate demand contracted, resulting in a decline in output and employment levels.

Empirical Analysis:

Empirical evidence from the 1981-82 recession supports the theoretical framework, with data showing a sharp decline in real GDP, a spike in unemployment rates, and a contraction in industrial production. The negative feedback loop created by the initial shock further amplified the recessionary impacts, leading to a prolonged period of economic downturn.

POLICY INTERVENTIONS AND THEIR EFFECTIVENESS

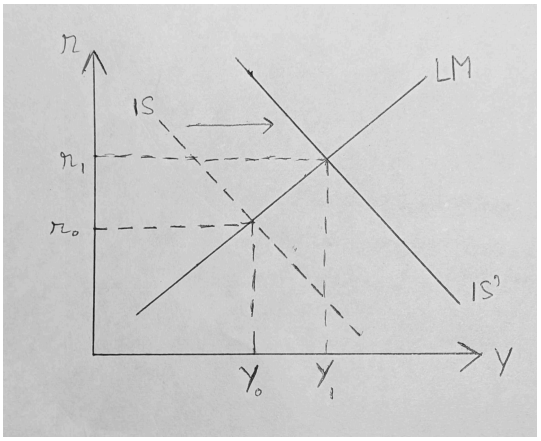
Policymakers implemented various policy interventions to address the economic downturn. These interventions included both monetary and fiscal measures aimed at stimulating economic activity and mitigating the effects of the recession.

The policy intervention happened in four major ways.

- Fiscal subsidies
- Monetary expansion
- Tighter monetary policy
- Oil conservation

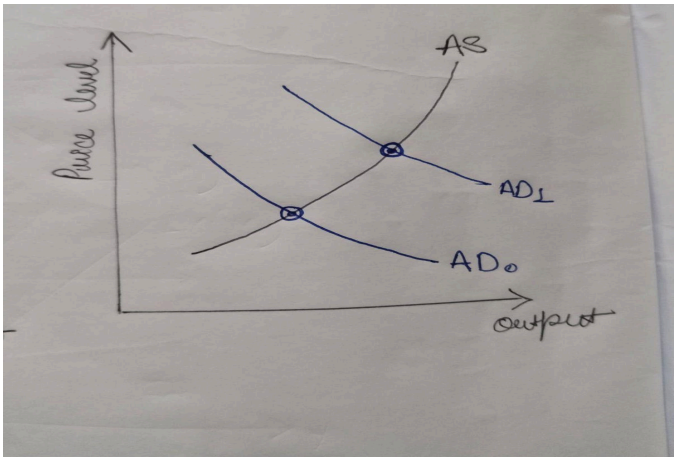
Fiscal Subsidies-

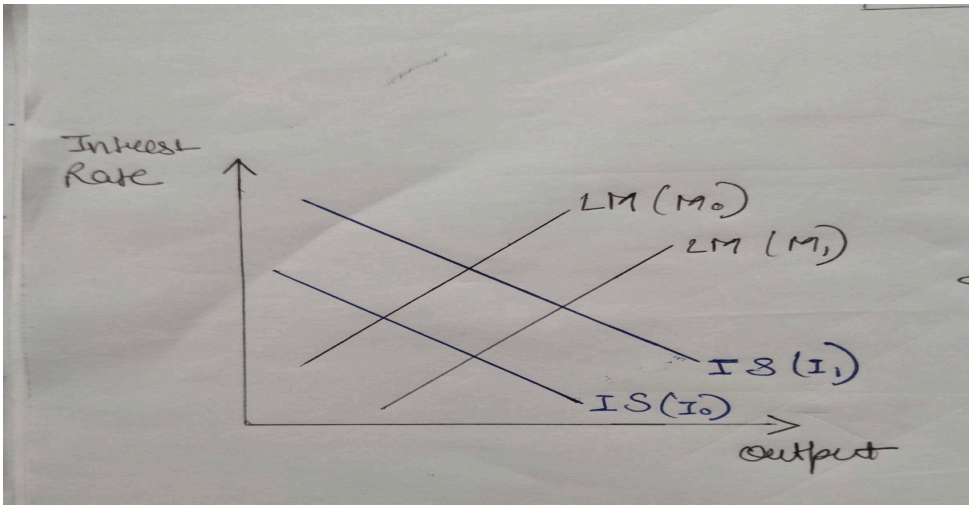
The government reduced taxes, to force more spending (investing). They hence tried to increase Y (output) by attempting to shift the IS schedule rightwards. They could not do so by increasing government expenditure because most of the government money was spent to procure more oil. The shifting of the IS schedule also caused an increase in interest.



Expansionary Monetary Policy-

To combat the recessionary effects of the oil crisis, the Fed initially maintained a lax monetary policy by allowing interest rates to decline and expanding the money supply. Increasing the amount of money in circulation and hence attempting to lower the interest rates, the FED therefore shifted LM schedule rightwards. However, this resulted in more inflation, which ultimately helped further drive up the price of gasoline.





Tighter monetary policy-

In order to fight inflation, the Fed then switched to a tighter implementation of monetary policy, raising interest rates and decreasing the money supply. The US economy was significantly impacted by this policy response, which helped to prolong a time of high unemployment and slow economic growth.
When the Federal Reserve raises interest rates, it becomes more costly for banks to borrow money from the government-run institution. As a result, the LM curve would shift upward. Consequently, the amount of available money in the economy declines, as lending becomes comparatively difficult. When the Federal Reserve raises interest rates, it makes it more costly for people to borrow money from banks, causing the IS curve to shift to the left. This implies that they may opt to reduce their spending, or their investment. Less consumer spending indicates a decline in the economy's overall demand. As a result, the IS curve moves to the left, lowering the level of economic production at any given interest rate. Next step would be that the equilibrium output would fall: The equilibrium interest rate and amount of economic output are determined by the intersection of the IS and LM curves. The equilibrium point shifts to a higher interest rate and lower level of production as a result of the LM curve shifting upward and the IS curve shifting to the left. Hence reducing economic activity, which causes the economy to contract.

Oil Conservation-

To cut down on spending on oil, the government adopted some policies. Some of these involved odd-even rationing, which restricted the ability of certain vehicles to refuel on specific days. These regulations served as a means of price regulation. Until the embargo was lifted, these measures prevented the situation from getting worse.

Short-run and Medium/long-run Effects

In the short run, the intersection of the new IS' and LM' curves (point E') represents a new equilibrium with higher interest rates and lower output. This corresponds to the intended effect of contractionary fiscal policy to dampen economic activity, reduce inflationary pressure, and stabilize the economy. The immediate impact is often a decrease in investment due to higher interest rates and a reduction in consumption due to lower disposable income, leading to a recessionary gap.

In the medium to long run, the expectations of firms and consumers adjust. As inflation slows down, the Federal Reserve may lower interest rates, which would shift the LM curve back down. This can potentially move the economy to a new equilibrium with lower interest rates and a gradual recovery in output. However, this assumes that the contractionary policy does not lead to a prolonged recession.

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