180.101 Elements of Macro - TA Section - Week 10

Qingyuan Fang

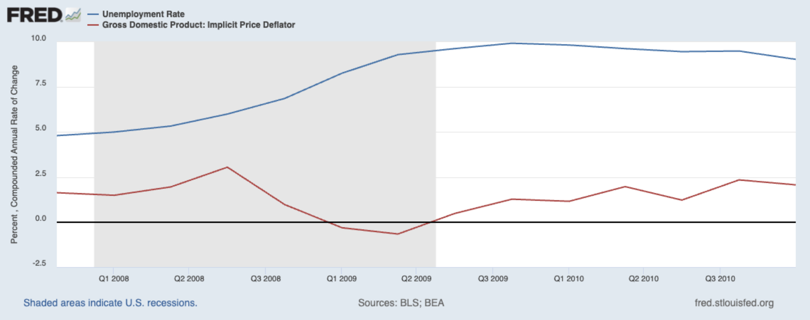
qfang6@jh.edu

Slides on https://github.com/QingyuanFang/TA_ElementsOfMacro

Oct 28th, 2024

"Missing Deflation"

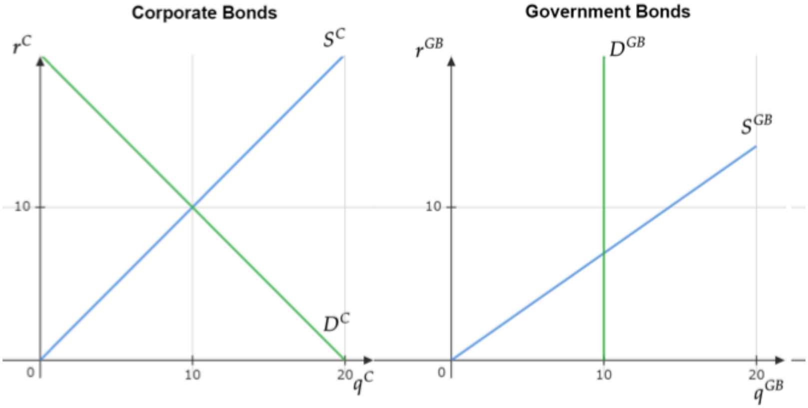
- In the aftermath of the financial crisis, the unemployment rate is so high that according to the Phillips Curve, there should have been negative inflation (deflation). But it was not the case.



- Why?

Loanable Fund Model

- Key assumption: Total available funds supplied by the households are constant



Consider the Following Cases

- **A natural disaster calls for an emergency government outlay.**

Consider the Following Cases

- **A natural disaster calls for an emergency government outlay.**
  - Demand for government bond $\rightarrow$, equilibrium rate $\uparrow$. Funds lent to the government $\uparrow$. Funds to the firms $\downarrow$ for a given real rate. Supply curve in the corporate bond market $\leftarrow$. Lending to firms $\downarrow$ and the rate $\uparrow$.
- **A nationwide increase in household risk appetite.**

Consider the Following Cases

- **A natural disaster calls for an emergency government outlay.**
  - Demand for government bond $\rightarrow$, equilibrium rate $\uparrow$. Funds lent to the government $\uparrow$. Funds to the firms $\downarrow$ for a given real rate. Supply curve in the corporate bond market $\leftarrow$. Lending to firms $\downarrow$ and the rate $\uparrow$.
- **A nationwide increase in household risk appetite.**
  - Given the same amount of funds households are willing to supply, some funds flow from government bonds to corporate bonds market. Supply curve $\leftarrow$ in G market and $\rightarrow$ in C market. Higher lending and lower rate in C and Lower lending and higher rate in G . The risk premium shrinks.

Consider the Following Cases

- **Weak economic confidence lowers household consumption.**

Consider the Following Cases

- **Weak economic confidence lowers household consumption.**
  - Supply curves $\rightarrow$ in both markets. Equilibrium rates are lower in both markets.
- **Firms suddenly take fewer investment projects due to the uncertainty associated with corporation tax reforms.**

Consider the Following Cases

- **Weak economic confidence lowers household consumption.**
  - Supply curves $\rightarrow$ in both markets. Equilibrium rates are lower in both markets.
- **Firms suddenly take fewer investment projects due to the uncertainty associated with corporation tax reforms.**
  - Demand for funds by corporations shift $\leftarrow$. Lower rate and lower lending in C. Supply for the funds to G shifts $\rightarrow$.
- **A suddent increase of inflation expectations of households.**

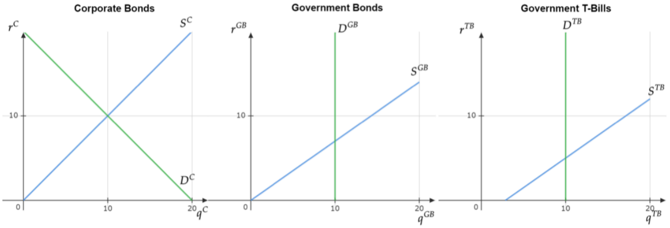
Consider the Following Cases

- **Weak economic confidence lowers household consumption.**
    - Supply curves $\rightarrow$ in both markets. Equilibrium rates are lower in both markets.
- **Firms suddenly take fewer investment projects due to the uncertainty associated with corporation tax reforms.**
    - Demand for funds by corporations shift $\leftarrow$. Lower rate and lower lending in C. Supply for the funds to G shifts $\rightarrow$.
- **A suddent increase of inflation expectations of households.**
    - There will be no changes in the graphs of the loanable fund model! Because the real rates that matter for household/firm decisions stay the same.

What's Next: Extended Loanable Fund Model

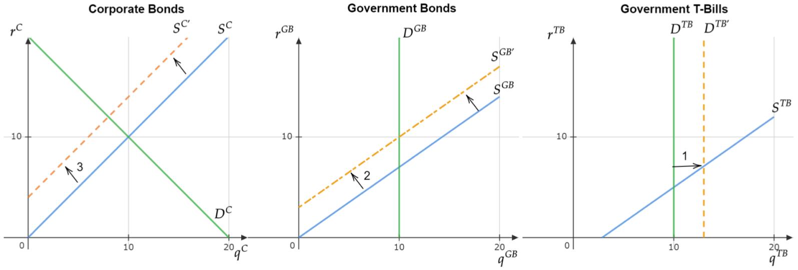
- Household, Firms, Government, **Fed**

	Risk	Duration	Interest rate
Corporate Bonds	**High**	Long Term	Highest
Government Bonds	Low	Long Term	Middle
Government T-Bills	Low	**Short Term**	Lowest



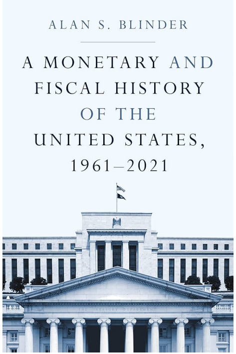
Effect of Monetary Tightening

- Fed sells T-Bills $\Rightarrow$ D^{TB} shifts to the right $\Rightarrow$ r^{TB} rises, S^{GB} and S^{C} shift leftwards $\Rightarrow$ r^{C} and r^{GB} rise
- Firms reduce investment, Output $\downarrow$, unemployment increases, inflation goes down



Monetary and Fiscal History of the US.

Blinder, Alan S. "A Monetary and Fiscal History of the United States, 1961-2021." (2022): 1-440.



Bernanke, Ben S. "21st century monetary policy: The Federal Reserve from the great inflation to COVID-19." (2022).