Deflation.

- The good kind=> supply side, prices fall due to oversupply, cost –cutting and productivity increases.

- The bad kind=> demand side, consumer spending and confidence decline, business investment suffers (Japan in the 2000s).

- Stagflation: slowing growth, higher inflation, high unemployment.

INTEREST RATES, DEMAND AND SUPPLY

- There are many interest rates, prime rates, treasury rates, mortgage rates, some are long-term some are short term, generally tend to move together locally and now globally. For now, focus on how policy affects these.
  - Supply of funds: savers will increase if real interest rates are higher, i.e. benefits to deferring consumption into the future. Implication of central bank liquidity and low rates on propensity of people to save.
  - Demand for funds from business - will borrow if real interest rates are lower.
  - Government : will affect both: higher budget deficits increase the demand for funds and therefore interest rates. Fed policy offsets these by increasing money supply which adjusts nominal rates.
  - Inflation increases if demand levels are beyond the productive capacity of the economy.
- Demand shocks are: reduced taxes, export demand, budget deficits.
- Supply shocks are: oil prices, commodity prices both reduce productive capacity.

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US Monetary policy (easy to implement/reverse, takes time).

- Increases (decrease) in growth of money supply.
- Adjust short-term rates via open market transactions in T-bonds.
- The US Fed has historically embarked on a gradual program of increasing (decreasing) rates. Evidence of the 1975, 1982, 1991, suggests this worked well, typically preceding business expansions (contractions) by 8 (20) months. In fact, it worked so well that growth/employment targets get ambitious, triggering possible inflation. So Fed became pro-active, raising rates to slow economy to head off inflation.
- 11 cuts in 2001-2002, from 6.5%. After Sep 11, Fed provided more liquidity via repos. Effective overnight rates were close to 0.
- Since then 12 hikes in the mid 2000s.
- Since the global financial crisis, rates have been kept low. The first hike of the current cycle started December 2015. Market participants are not convinced that the US economy can handle more of these.

Fiscal policy (hard to implement/reverse, works quickly).

- Tax relief (been there, done that).
- Deficit spending, keeps long-term interest rates high.

Supply side –policies

- Both above policies are demand-side to push economy to achieve full employment equilibrium.
- In contrast, supply side policies address the economy’s productive capacity and devise incentive schemes to encourage growth.

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