231025 – A Monetary Policy Rule and the AD Curve

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| Assume the central bank follows a monetary policy rule: | | |
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| Taylor rule: =\_\_\_\_\_\_\_\_\_\_\_\_ | | |
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| **Find the AD curve by combining the monetary policy rule with the IS curve** | | |
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| **The AS curve comes from the Phillips Curve with shocks** | | |
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231025 – Using the AS/AD Model

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| In the steady state, |
| During an oil shock (increase in ):   * AS shifts left * AS shifts slowly back to the right as the economy cools |
| During an AD shock (increase in AD):   * AD shifts right and stays there * AS shifts left * After a few shifts, stays high at * Eventually the AD shock wears off, AD curve shifts back to its starting point * Recession and high inflation until AS shifts right |
| Usually a counterclockwise pattern in output deviations and inflation |
| Modern MP:   * Rules v Discretion   + Rules might make inflation more strong. Why?   + Or rules can weaken inflation. Why? |
| Rational Expectation: |