Ch 29 The Business Cycle, Inflation, and Deflation

Principles of Macroeconomics

Econ 102

Outline

- The Business Cycle
- Inflation Cycles
- Deflation
- The Phillips Curve

Business Cycle theory

- There are 2 different approach to understanding business cycle:
  - Mainstream business cycle theory
    - Focuses on the changes in aggregate demand and potential real GDP
    - Aggregate demand grows at a fluctuating rate
  - Real business cycle theory
    - Focuses on productivity as the main source of economic fluctuations

Mainstream Business Cycle

- Keynesian Cycle Theory → fluctuation in investment spending
  - Driven by business confidence (animal spirit) of the market players
- Monetarist cycle Theory → fluctuation in both investment and consumption expenditure
  - Driven by fluctuations in the growth rate of the quantity of money
- New Classical Cycle Theory → unexpected fluctuation in aggregate demand
  - People have rational expectation of the price level that is determined by potential GDP and expected aggregate demand. That dictates the money wage rate
- New Keynesian Cycle Theory → both unexpected and expected fluctuation in aggregate demand
  - Money wage rate is based on past expectations of the price level

Real Business Cycle Theory

- Business cycle happens due to productivity → fluctuation in short run aggregate supply
  - Fluctuations in the pace of technological change
  - International disturbances
  - Climate fluctuations
  - Natural disasters

Inflation Cycles (1)

- Based on AD-AS model, inflation can happen due to a shock to AD or a shock to AS
  - Demand-pull inflation → inflation due to an increase in AD
    - Anything that could increase AD can start a demand-pull inflation
    - In the long run, we expect that money wage rate to increase. Inducing a leftward shift on SRAS, moving the economy back to its potential GDP
    - If AD consistently increasing, then we have a persistent inflation. An example is when the government keep on growing the quantity of money in the economy

Inflation Cycles (2)

- Based on AD-AS model, inflation can happen due to a shock to AD or a shock to AS
  - Cost-push inflation → inflation due to a leftward shift of SRAS
    - Two main sources are : an increase in money wage rate and an increase in the money prices of raw materials
    - Stagflation
    - The government may respond to decreasing employment rate and real GDP. However, the government may only change AD. This causes even higher inflation rate

Deflation

- Deflation is when an economy has a persistently falling price level or inflation rate is negative
- Similar to inflation, deflation can happen to due to a shock in AD or a shock in AS
    - However, this is usually a one time fall in the price level
- Persistently falling price level can happen if aggregate demand persistently increases at slower rate than aggregate supply
    - In simpler terms, productivity growth is faster than AD growth
    - SRAS and LRAS shift rightwards at a higher magnitude compared to the rightward shift of AD

Solving Deflation

- The government can intervene to solve deflation
- The approach is to persistently increase the AD
  - Examples would be by persistently increasing the growth rate of quantity of money

The Phillips Curve (1)

- The Phillips curve tells us the relationship between inflation and unemployment
- In the short run, the relationship is negative
  - When the unemployment rate is high, we expect that the inflation rate to be low
    - When there are a lot of people who are unemployed, they tend to be willingly take a low-income job in order to have some sort of income. Since their money wage rate is low and disposable income is low, the inflation rate should be low.
  - When the unemployment rate is low, we expect that the inflation rate to be high
    - When there are only a few people who are unemployed, firms would have to offer a high salary for qualified potential workers (since the qualified workers probably already have a job). Since the money wage rate is high and disposable income is high as well, the inflation rate should be high

The Phillips Curve (2)

- In the long run, the Phillips curve is vertical
  - In the long run, we expect full employment in the economy
  - The unemployment rate will be equal to natural unemployment rate
  - At natural unemployment rate in the long run, the inflation rate can be any rate