Recession of 1981-82

Introduction

In 1981-82 US. Recession prevailed from July 1981 to November 1982. The Recession coincided with major monetary and fiscal changes under the Reagan Regime which started from Jan 1981. Reagan promised to bring down inflation rates and boost production and GNP during his presidency.

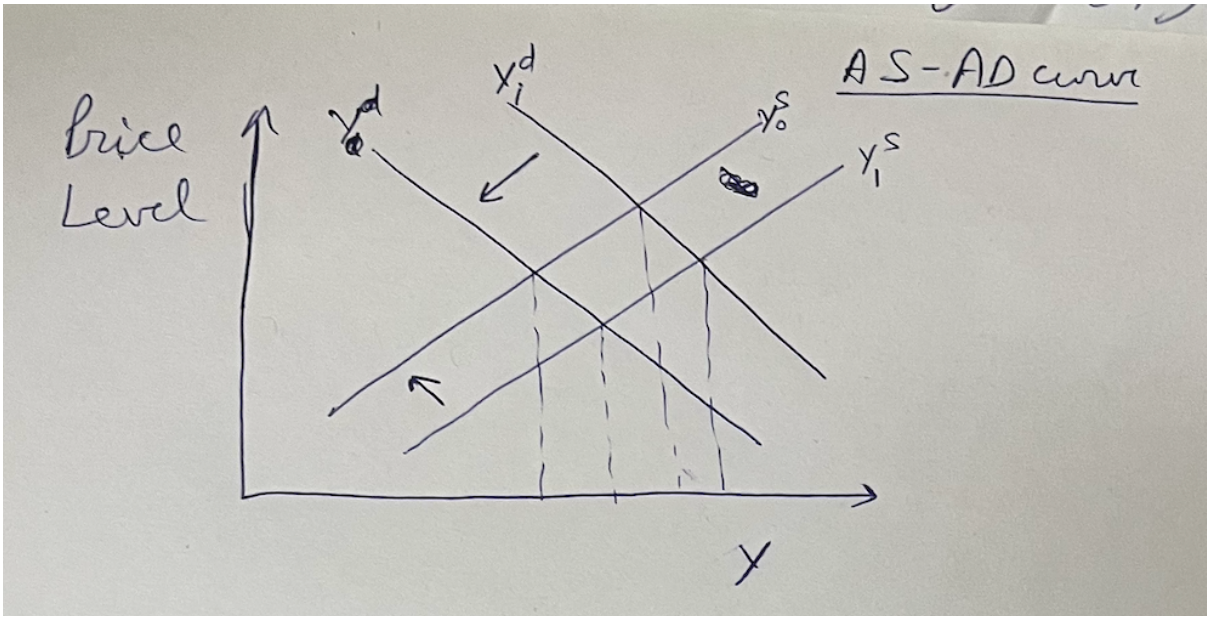
We majorly focus on interpreting AS-AD curve model and IS-LM model to study and elaborate the recession. We also analyze how the recession impacted and propagated. At the end we discuss what major monetary and fiscal policy changes resulted in overcoming recession.

Depth of the Recession-

- Unemployment grew from 7.4% at start of recession to nearly 10% a year later.
- Federal Funds Rate approached a high of 19% in July 1981 which resulted in high interest rate in the market and high cost of borrowing, limiting money supply.
- Inflation rate in the economy was brought down from double digits in Carter period to 5% in Jan 1982 and to 4% till the end of recession.
- Growth rate of money supply decreased to 5.4% in between second quarter of 1981 to third quarter of 1982.

Causes of the recession-

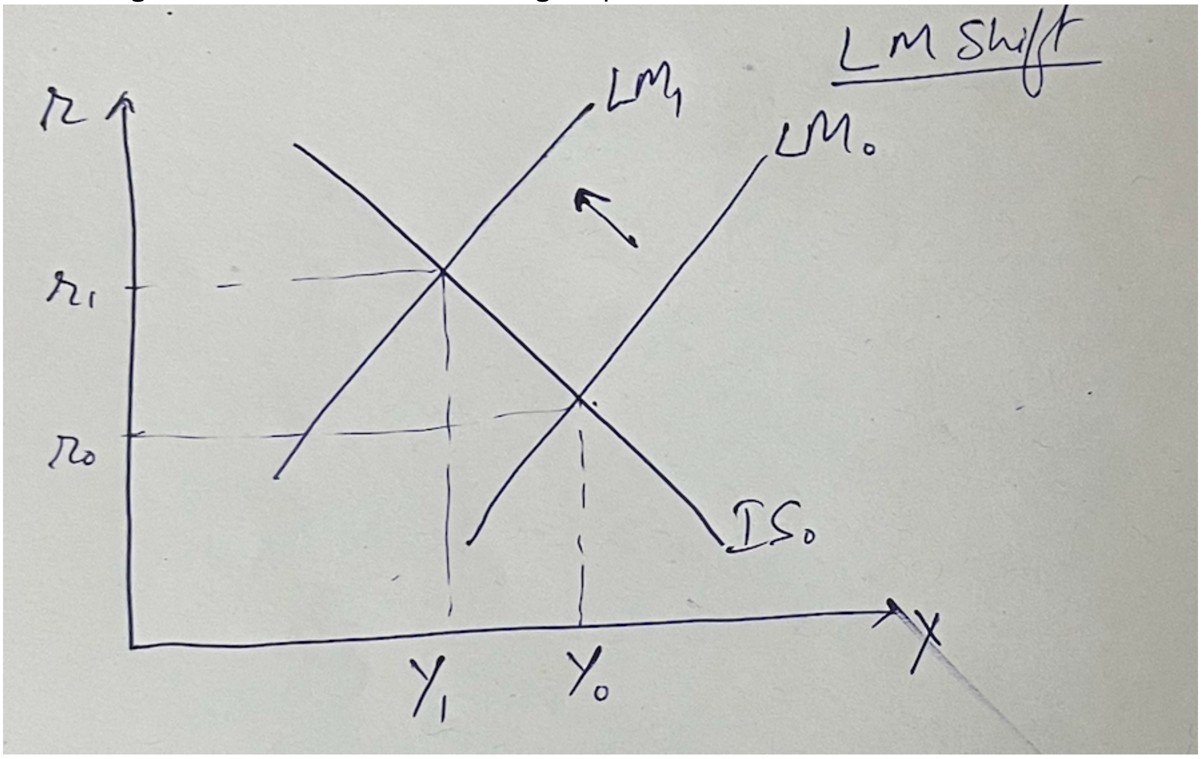
- The recession was major caused by supply side shock.
- Federal policy at the time targeted money supply rather than interest rates to bring down inflation.
- Money supply was very restricted and interest rates continued to soar high which resulted in low income and less output.



The Impulse and the Propagation mechanism of the Shocks

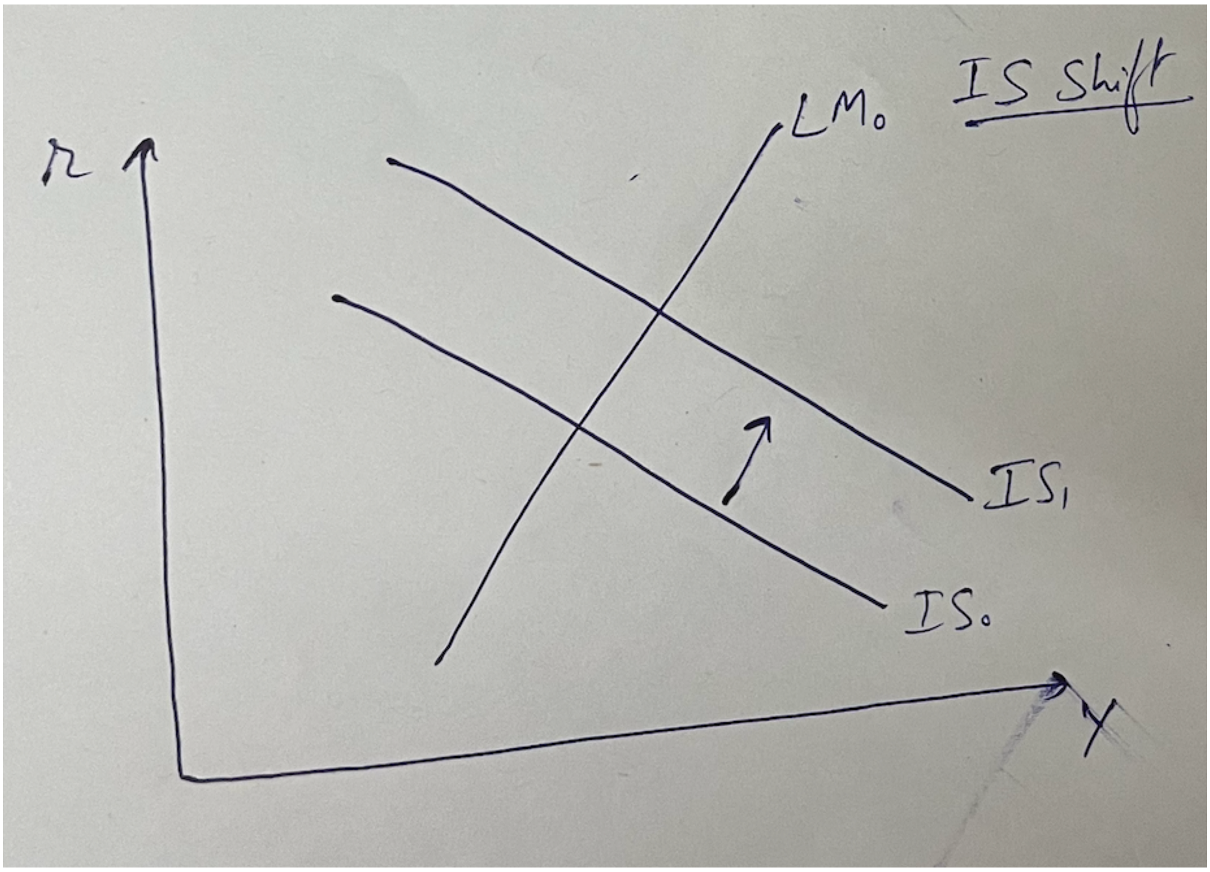
Impact -

The immediate effect of Fed announcing contractionary monetary policy to reduce inflation was steep increase in interest rates. Fed also restricted money supply to a large extent and as money supply being one of the exogenously fixed policy variable, it shifted LM curve. As a result there was a leftward and upward shift of LM curve, increasing interest rates and decreasing output.



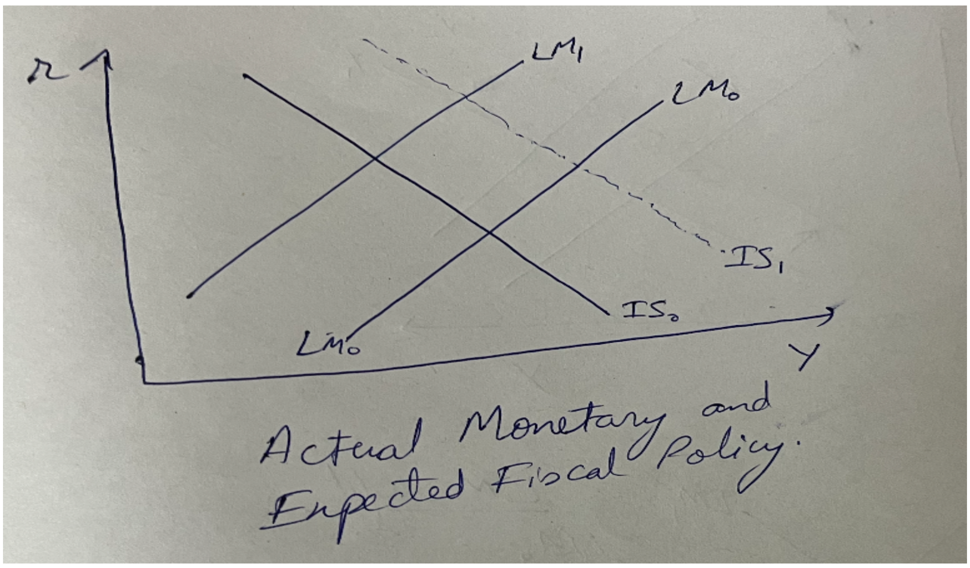
Regan Administration with its start in Jan 1981 announced a fiscal expansion in the future. This means that the financial markets were expecting a rise in output and jump in the interest rates. The future expectation of interest rates were high.

Due to high long interest rates, investments slowed down and output substantially decreased. Also money supply was held tight by the Fed to curb inflation which targeted an anticipatory recession. Recession can only be curbed when there is true expansion in the economy and output increases. This resulted in **expectation** of shift of IS curve upward and to the right.



Propagation Mechanism –

- Expectations Formation – People expected a growth in economy and expansionary fiscal policy which resulted in expected shift of IS. But shift in IS or rather say expansion in fiscal policy wasn't immediate.
- Investment – Investment declined as a result of high expectation of long term interest rates.
- Inflation, wages and prices – Inflation was at peak before Reagan administration but he tightened monetary policy to curb in the inflation which resulted in low inflation, lower wage and high prices.



Effectiveness of Policy Interventions

Monetary Policy:

- The Federal Reserve maintained a tight monetary policy, giving precedence to controlling inflation over addressing immediate growth concerns. This strategy underscores a commitment to long-term stability and averting the risk of inflation spiralling out of control.
- The decision to uphold high interest rates reflects the Fed's determination to curb inflationary expectations within the economy, aiming to stabilize prices and preserve the purchasing power of the currency.

Fiscal Policy:

- The fiscal policy pursued by the US government was contractionary, marked by restrained efforts to stimulate the economy through increased spending or tax cuts. This cautious approach indicates a reluctance to engage in significant fiscal intervention.
- The government's hesitancy to implement expansionary fiscal measures likely stems from concerns about exacerbating inflationary pressures. By refraining from actions that could fuel demand, policymakers seek to mitigate the risk of further inflation.

The effectiveness of the policy interventions remains a topic of debate:

Short-Run:

- While the tight monetary policy succeeded in curbing inflation, it probably extended the recession. The Fed's dedication to combatting inflation ultimately disrupted the cycle of inflationary expectations but at the expense of exacerbating economic downturn.

Medium/Long-Run:

- Volcker's persistence bore fruit by late 1982 when inflation retreated to 5%, removing the threat of double-digit inflation rates. Unemployment and interest rates also saw declines.

Alternative Approaches:

- Some economists contend that a more balanced strategy, combining tighter monetary policy with targeted fiscal stimulus, could have achieved similar inflation reduction with less severe recession. This approach might have entailed tax cuts or increased government spending on infrastructure or social programs to bolster short-term aggregate demand while the Fed addressed inflation.

References

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