

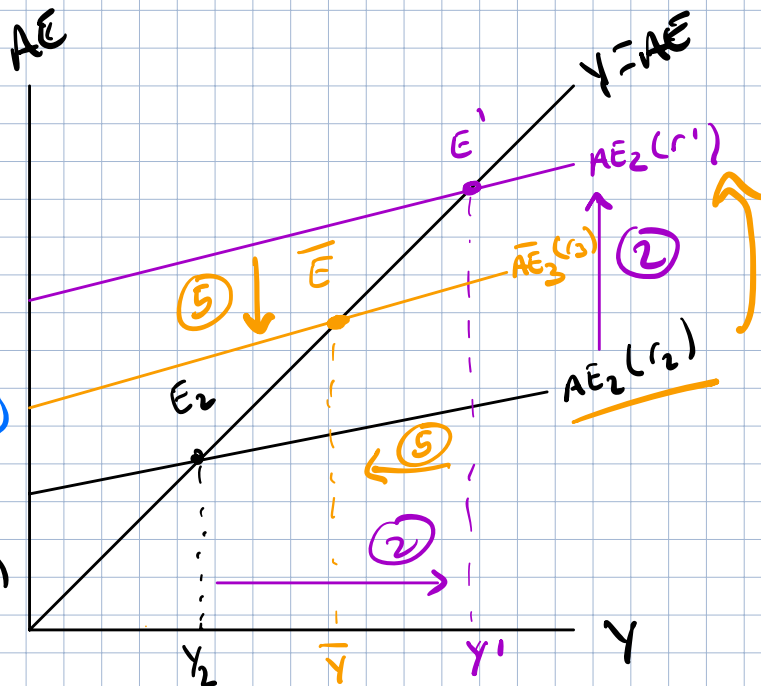
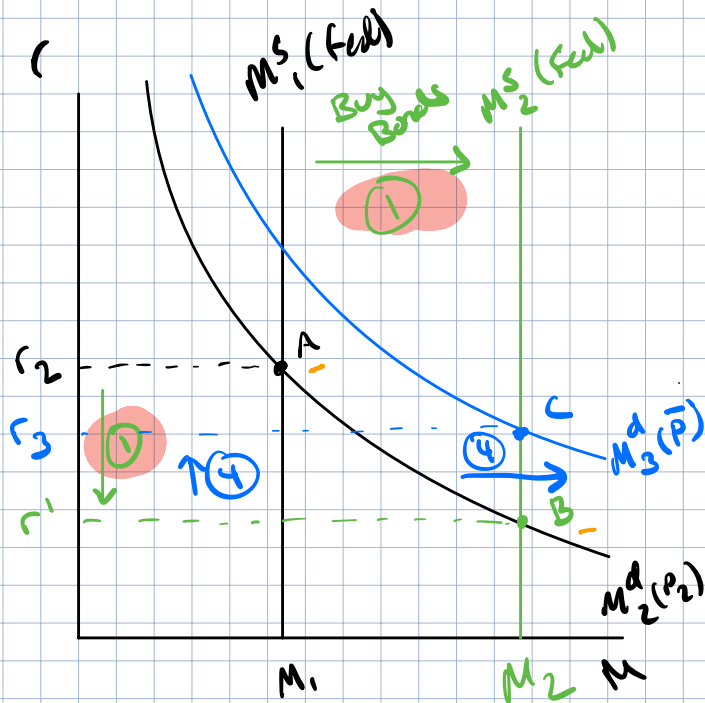
Econ 2 - Lecture 18 - 6/4/25 \Rightarrow Last Day of Lecture!

Lecture 9 Quiz Released Today, Due 12:00^{PM} on Tuesday, 6/10

Final Exam: 40 MC Questions, 2.5 Hours

\Rightarrow Distribution of questions on exam \Rightarrow align with time in lecture

Today: Simplifying Economic Shocks & Policy Analysis



$$r=r_2, M^s=M_1, Y_2 < \bar{Y}, P_2 < \bar{P}$$

Feed reaction?

1) Buy bonds, $\uparrow M^s$ to M_2^s , $\downarrow r_2$ to r_1

2) $\downarrow r \Rightarrow \uparrow AC, \uparrow IP \Rightarrow \uparrow AE, \uparrow Y$

3) $\uparrow Y_2$ to Y' , Prices at P_2

$AD_2 \rightarrow \bar{AD}_3$ must contain Y', P_2

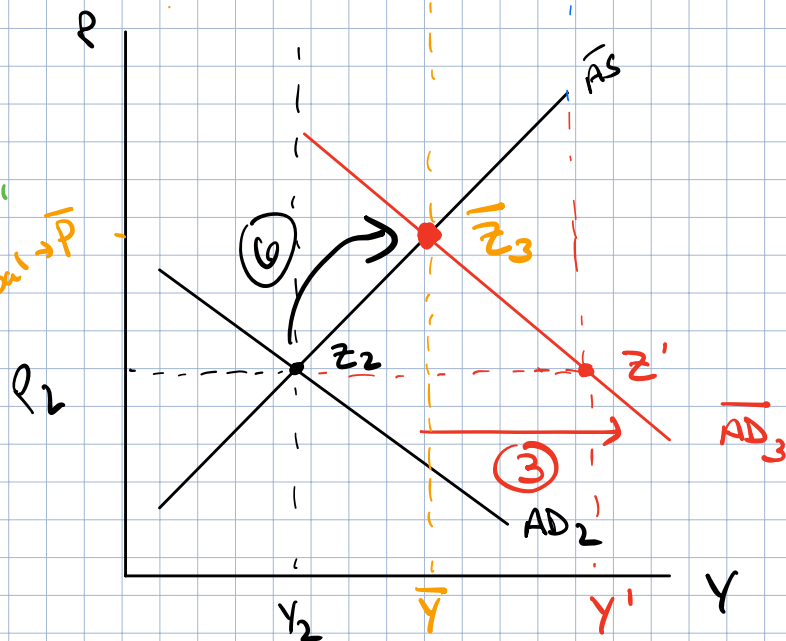
4) Upward pressure on prices

$P_2 \rightarrow \bar{P}, \uparrow M^d, \uparrow r$

5) $\uparrow r \Rightarrow \downarrow AC, \downarrow IP \Rightarrow \downarrow AE, \downarrow Y$

6) Increase P_2 to $\bar{P} \Rightarrow$

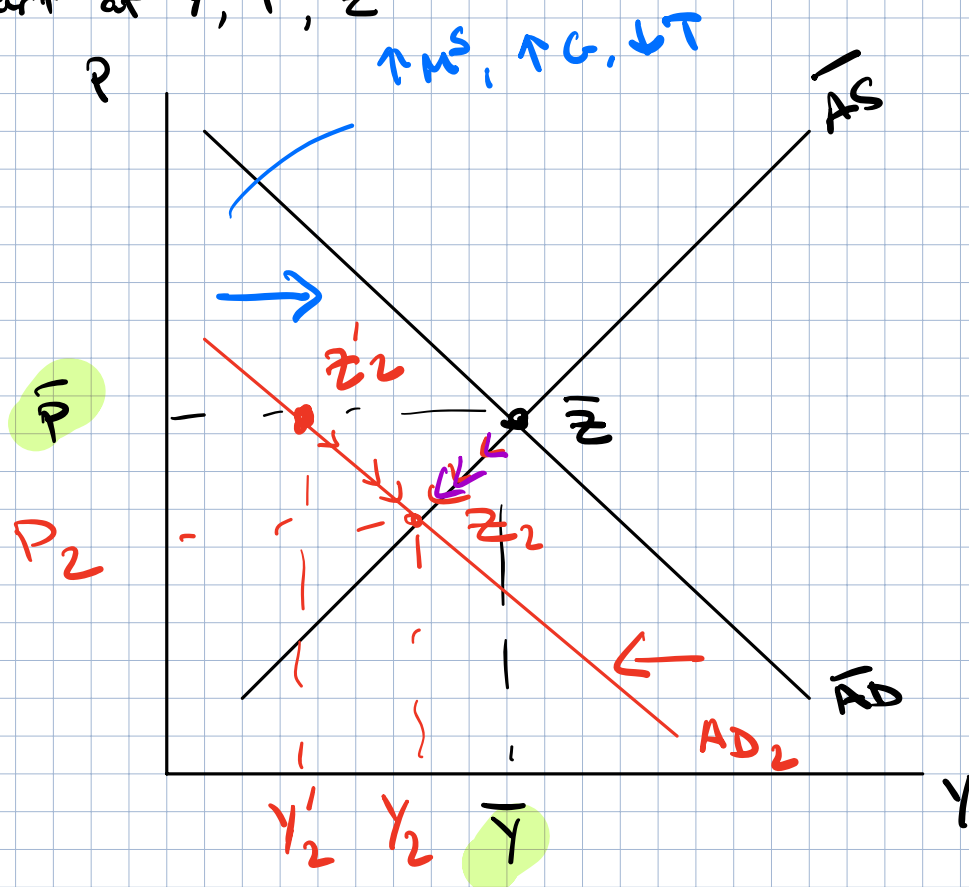
move along AS, Z_2 to Z_3



Goal
cyclical UE

Simplify Analysis: Focus on AS/AD

Start at \bar{Y} , \bar{P} , \bar{Z}



Apply analysis
 → Covid-19 Pandemic
 ↳ What happens to AS/AD model?

Pandemic → initial shock

↳ $\downarrow AC, \downarrow I^P \Rightarrow \downarrow AE$, Prices initially unchanged

↳ Decrease Y , $P = \bar{P} \Rightarrow \downarrow$ in AD

At Z_2 , Prices fall, output decrease!

How should policy makers respond?

Federal Reserve → influence AD } Buy bonds, $\uparrow M^S, \uparrow AD$
 Government → influence AD } $\Delta G > 0, \Delta T < 0, \uparrow AD$

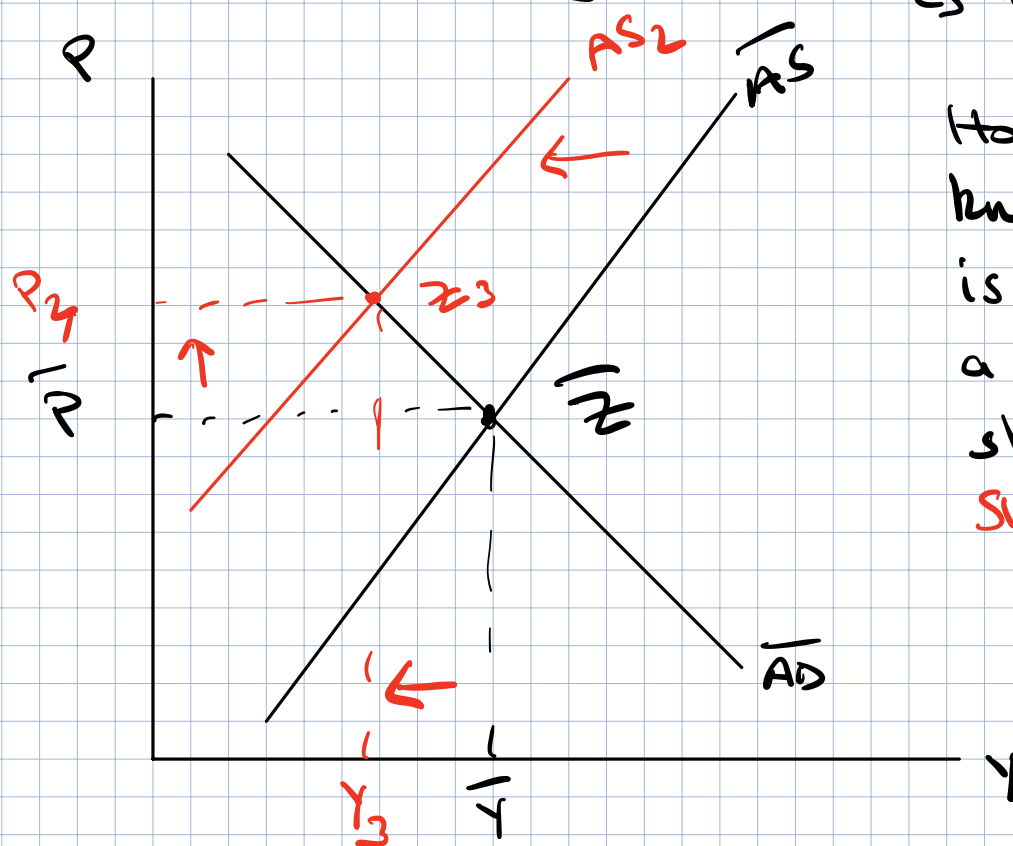
Negative AD Shock → Shifts AD left → $Y < \bar{Y}$ (cyclical UE)

Response by policymakers

↳ $P < \bar{P}$

↳ Counter the AD shock → Shift AD right, return to \bar{Y} & \bar{P}

New Setting: Economy is in a recession
 $\hookrightarrow Y < \bar{Y}$



How do we know recession is caused by a negative AS shock?

Shift AS left

AS decreases to AS_2 , \bar{Z} to Z_3

Y decreases to $Y_3 \rightarrow$ unemployment, stagnant economy

P increase to $P_3 \rightarrow$ inflation

\Rightarrow Stagflation

How should Fed respond? Influence AD!

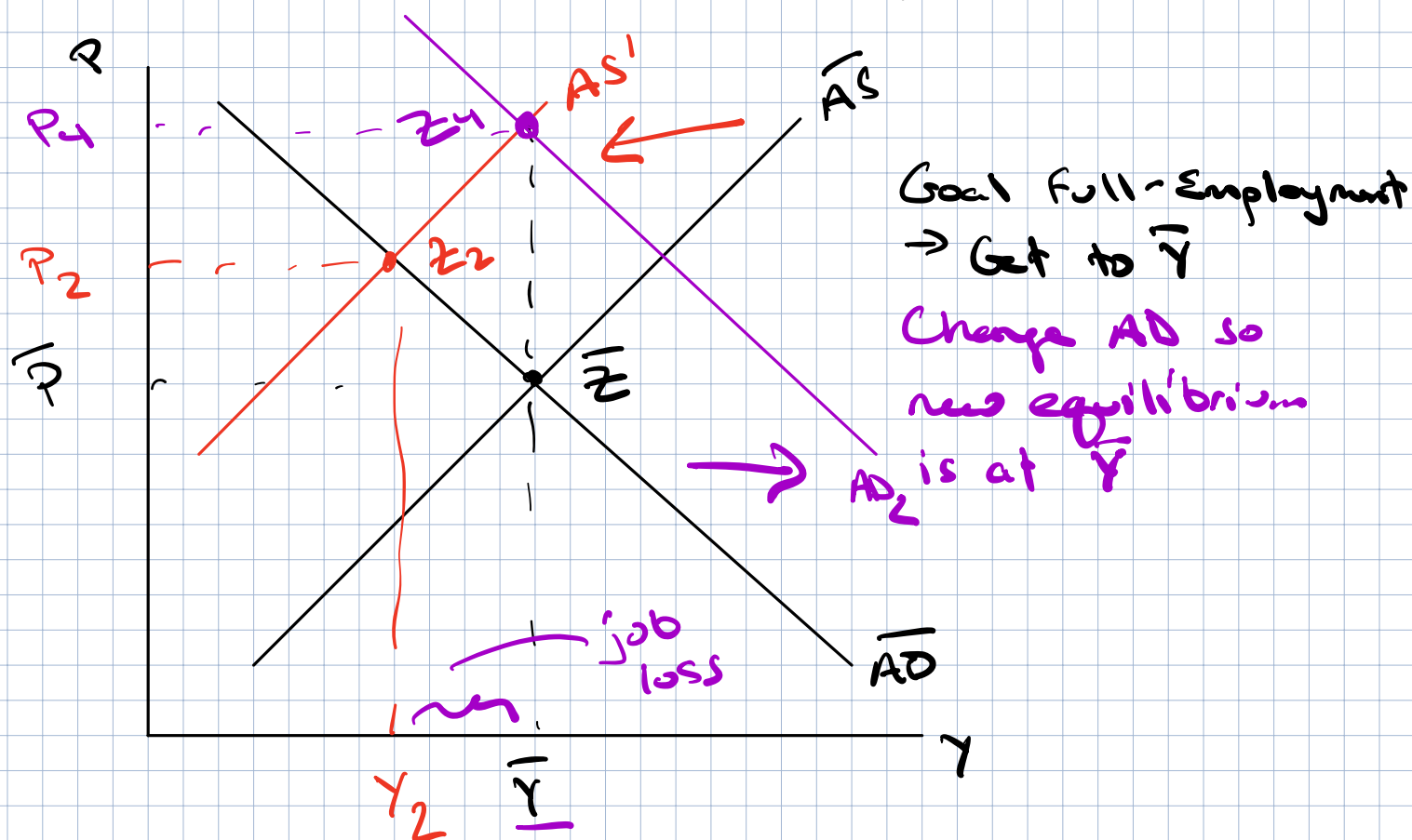
Dual Mandate

1) Maximum Employment $\rightarrow \bar{Y}$

2) Price Stability $\rightarrow \bar{P}$

Assume that Fed prioritizes employment over inflation

What action does the Fed take?



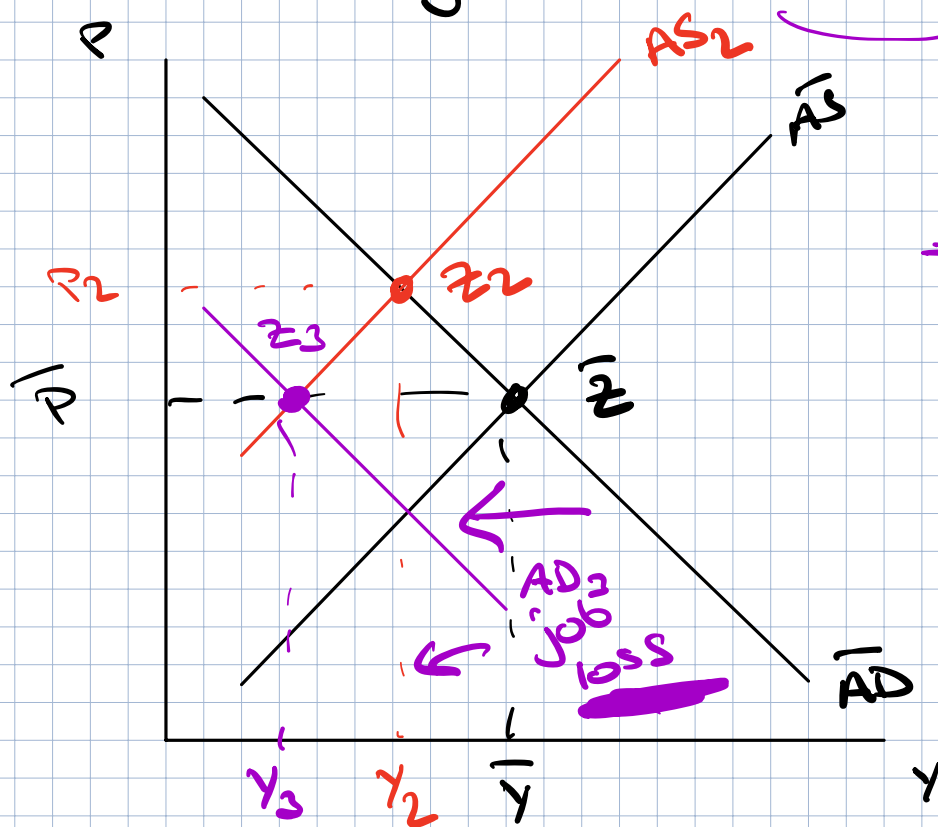
Fed influences AD \rightarrow right to $AD_2 \rightarrow$ return to \overline{Y}
Cost \rightarrow higher prices, $P_1 > P_2 > \overline{P}$

Non-aggressive Policy \Rightarrow Down Policy

Jobs are recovered for some workers

All of society pays higher prices

Return to Stagflation \rightarrow Prioritize Price Stability



Fed can influence AD
 \rightarrow What action should the Fed take?

Target $\bar{P} \rightarrow$ Shift AD left (sell bonds)
 Return to \bar{P} , move to $Y_3 < Y_2 < \bar{Y}$
 more job loss

Tradeoff: prices & jobs
 Sacrifice jobs for some, stable prices for all
 Hawk Policy \rightarrow Prioritizing prices over jobs

Summary of Policy Responses

<u>Event</u>	<u>Outcome</u>	<u>Fed Policy</u>	<u>Fiscal Policy</u>
Negative AD Shock	$P \downarrow, Y \downarrow$	$\uparrow M^S \Rightarrow \uparrow AD$ Buy bonds	$\uparrow G, \downarrow T \Rightarrow \uparrow AD$
Positive AD Shock	$P \uparrow, Y \uparrow$	$\downarrow M^S \Rightarrow \downarrow AD$ Sell Bonds	$\downarrow G, \uparrow T \Rightarrow \downarrow AD$

Negative AS Shock	$P \uparrow, Y \downarrow$ Stagflation	Dove: $\uparrow M^S \Rightarrow \uparrow AD$ Return to \bar{Y} $P_2 > P_1 > \bar{P}$ more inflation	$\uparrow G, \downarrow T$
		Hawk: $\downarrow M^S \Rightarrow \downarrow AD$ Return to \bar{P} $Y_2 < Y_1 < \bar{Y}$ more unemployment	$\downarrow G, \uparrow T$

What is the ideal response to stagflation?

→ Examine size of tradeoff between
UE → inflation

→ Extremes: Large job loss + moderate inflation
25% UE 3% inflation

High inflation + limited job loss → Hawk
10% inflation 5% UE

Dove
→

Hawk

What is going on today?

Weak job numbers today
+

Stable Prices
+

Rising Debt Costs (high interest payments)