

Macroeconomics

9. Macroeconomic Stabilization Policy

Bachelor's Degrees in Management and in Finance and Accounting

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April 20-24, 2026

Stabilization policy

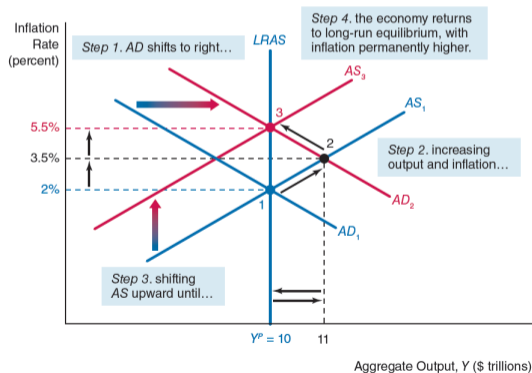
Definition and concept

- When short-run and long-run equilibria **do not coincide**, short-run equilibrium occurs **above or below** potential output ($Y - Y^P \neq 0$).
 - Causes we have analysed in class: demand shocks and supply shocks.
- **Stabilization policy**: a policy that, in the **short run**, eliminates the output gap and/or the inflation gap, that is, stabilizes output at its potential level ($Y = Y^P$) and/or inflation at its target level ($\pi = \pi^T$).
 - Unlike the self-correction mechanism, stabilization policy operates through aggregate demand (AD).
- There are 2 types of stabilization policy:
 - Fiscal policy - through G or T , which take more time to decide and implement.
 - Monetary policy - through r (specifically, \bar{r}).

Aggregate demand shocks without stabilization policy

Graphical representation

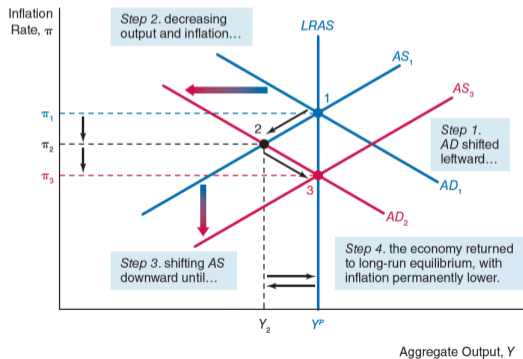
- Graphical representation of the self-correction mechanism after a **positive aggregate demand shock**. We have $\uparrow \pi$ and $Y = Y^P$:



Aggregate demand shocks without stabilization policy

Graphical representation

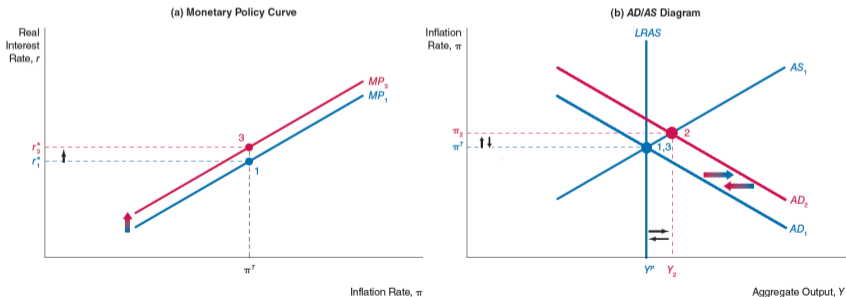
- Graphical representation of the self-correction mechanism after a **negative aggregate demand shock**. We have $\downarrow \pi$ and $Y = Y^P$:



Aggregate demand shocks with stabilization policy

Graphical representation | There is no *trade-off* between inflation stabilization and economic activity stabilization (divine coincidence)

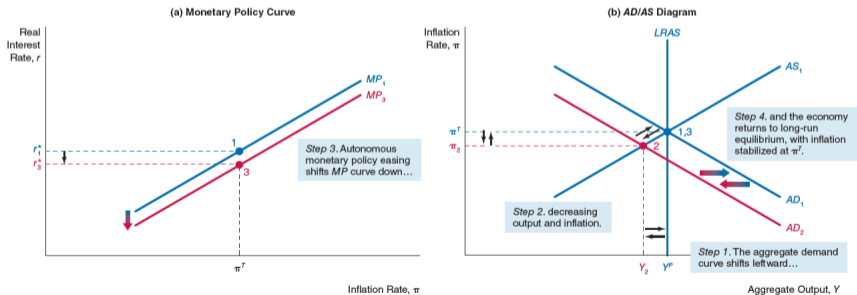
- Graphical representation of stabilization policy after a **positive aggregate demand shock**. We have $\pi = \pi^T$ and $Y = Y^P$:



Aggregate demand shocks with stabilization policy

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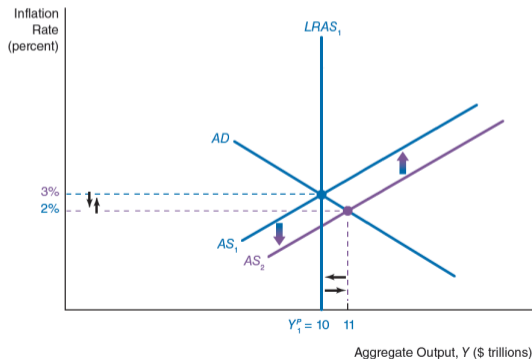
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Aggregate supply shocks without stabilization policy

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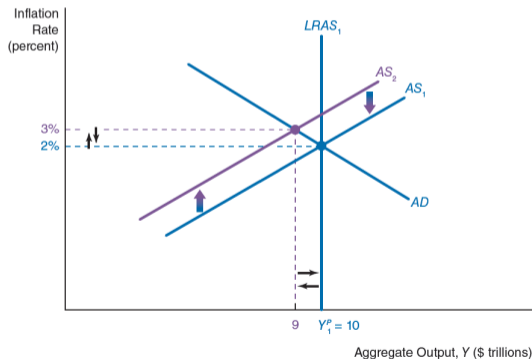
- Graphical representation of the self-correction mechanism after a **temporary negative price shock** ($\rho < 0$) in short-run aggregate supply. The final equilibrium is the same as the initial one:



Aggregate supply shocks without stabilization policy

Graphical representation

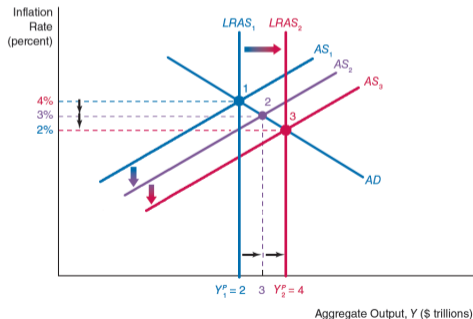
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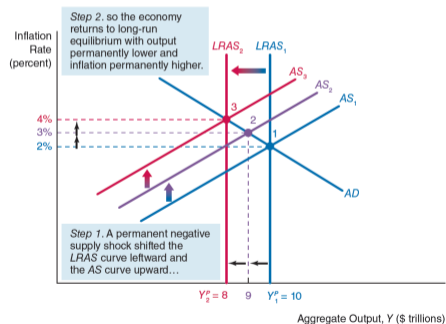
- Graphical representation of the self-correction mechanism after a **permanent positive supply shock**, that is, a **positive shock** to long-run aggregate supply. We have $\downarrow \pi$ and $Y = Y^P$:



Aggregate supply shocks without stabilization policy

Graphical representation

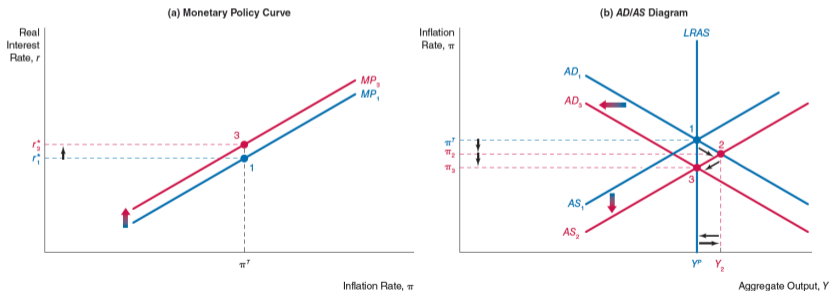
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Aggregate supply shocks with stabilization policy

Graphical representation | Objective after a temporary shock: stabilization of economic activity ($Y = Y^P$)

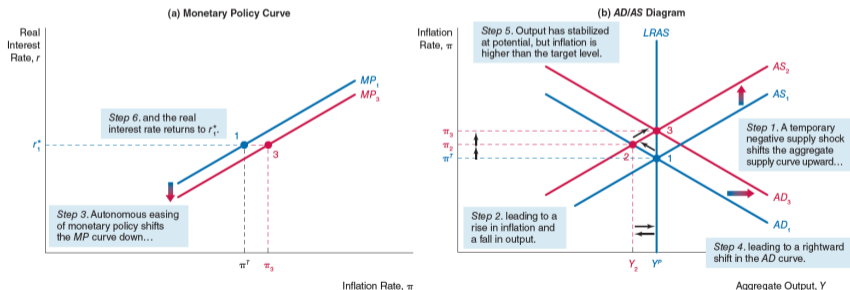
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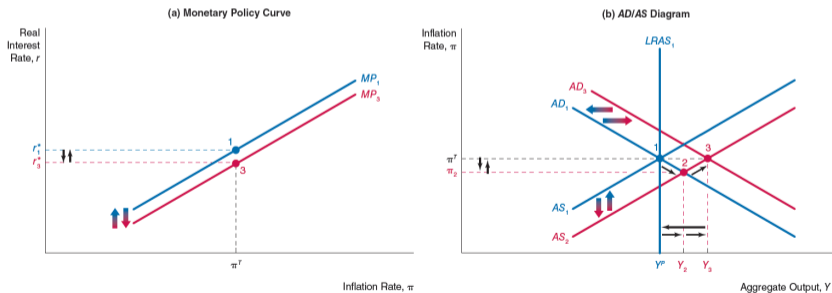
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Aggregate supply shocks with stabilization policy

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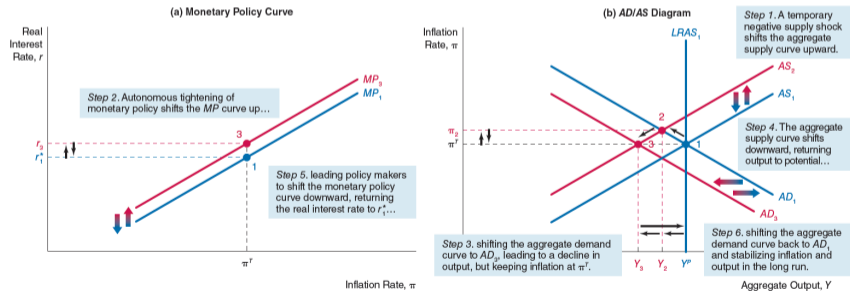
- Graphical representation of stabilization policy after a **temporary negative price shock** ($\rho < 0$) in short-run aggregate supply. We have $\pi = \pi^T$ and $\uparrow Y$ (point 3). Then, the self-correction mechanism takes place to eliminate the output gap, and stabilization policy has to be implemented again. In the end, the final equilibrium is the same as the initial one:



Aggregate supply shocks with stabilization policy

Graphical representation | Objective after a temporary shock: stabilize inflation ($\pi = \pi^T$)

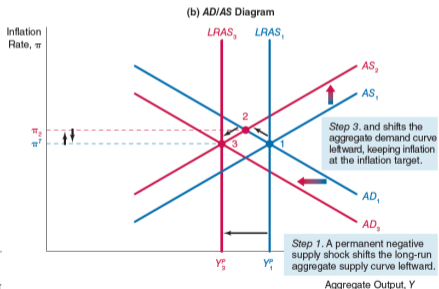
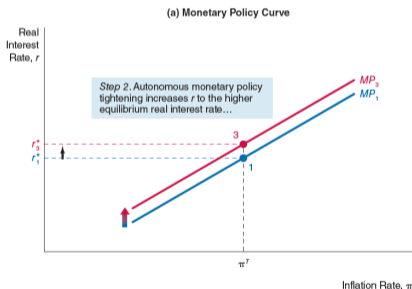
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Aggregate supply shocks with stabilization policy

Graphical representation | Objective after a permanent shock: stabilize inflation ($\pi = \pi^T$)

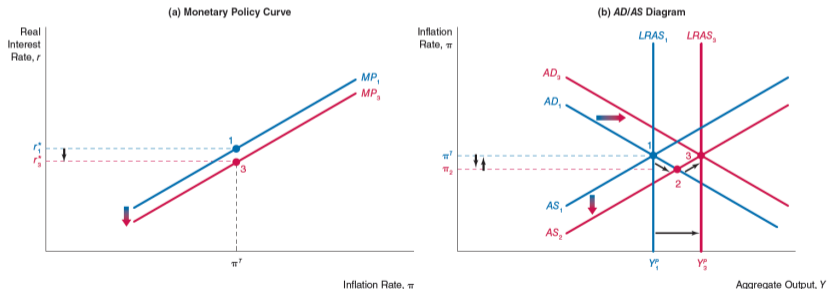
- Graphical representation of stabilization policy after a **permanent negative shock** to long-run aggregate supply. We have $\pi = \pi^T$ and $Y = Y^P$:



Aggregate supply shocks with stabilization policy

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References

- Mishkin, F. S. (2014), *Macroeconomics: Policy and Practice*, 2nd Edition, Pearson, Addison-Wesley, New York.