

Instituto Universitário de Lisboa (ISCTE-IUL) - Economics Department

Course: Macroeconomics | Program: Management

Week IX: Macroeconomic stabilization policy

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These slides do not cover all the contents of the theoretical classes. They only provide a summary of the subjects which will be used in the practical exercises. This means you should attend theoretical classes as well.

Stabilization policy

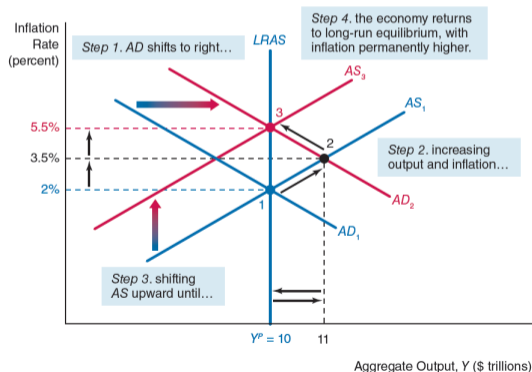
Definition and concept

- When the short-term and long-term equilibria **do not match**, the short-term equilibrium occurs **above or below** the potential output ($Y - Y^p \neq 0$).
 - Causes that we analyze in class: demand shocks and supply shocks.
- **Stabilisation policy**: policy that, in the **short term**, eliminates the output gap and/or the inflation gap, ie, stabilizes output at its potential level ($Y = Y^p$) and/or inflation at its target level ($\pi = \pi^T$).
 - Unlike the self-correcting mechanism, the stabilization policy takes place through the aggregate demand (AD).
- There are 2 types of stabilization policy:
 - Fiscal policy – via G or T but that takes time to decide and implement.
 - Monetary policy – through r , using an aggressive MP (\bar{r}).

Aggregate demand shocks with no stabilization policy

Graphical representation

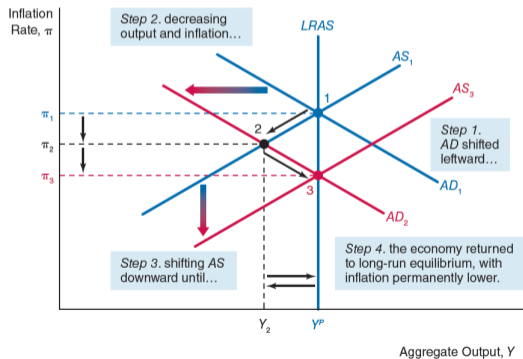
- Graphical representation of the self-correcting mechanism after a **positive shock** in the aggregate demand. We have that $\uparrow \pi$ and that $Y = Y^P$:



Aggregate demand shocks with no stabilization policy

Graphical representation

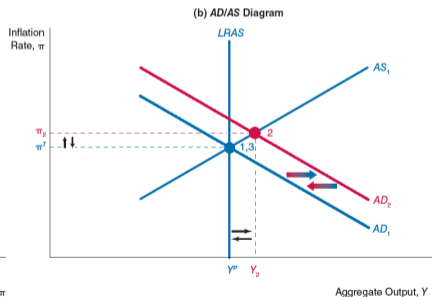
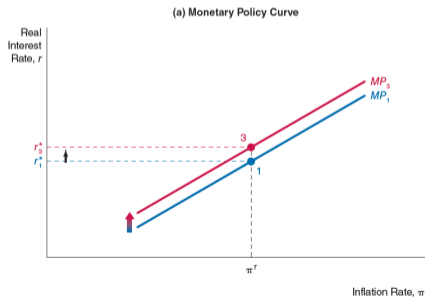
- Graphical representation of the self-correction mechanism after a **negative shock** in the aggregate demand. We have that $\downarrow \pi$ and that $Y = Y^P$:



Aggregate demand shocks with stabilization policy

Graphical representation | There is no trade-off between the pursuit of price stability and the pursuit of economic activity stability (divine coincidence)

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

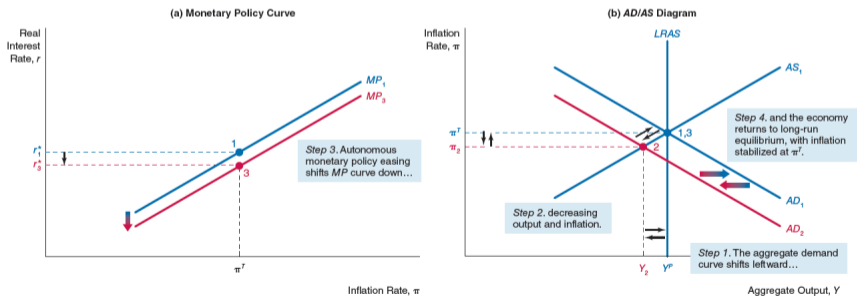


Aggregate demand shocks with stabilization policy

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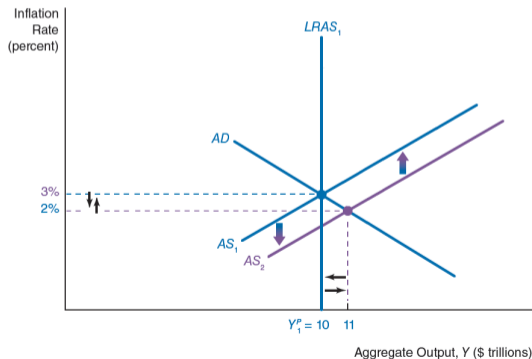
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Aggregate supply shocks with no stabilization policy

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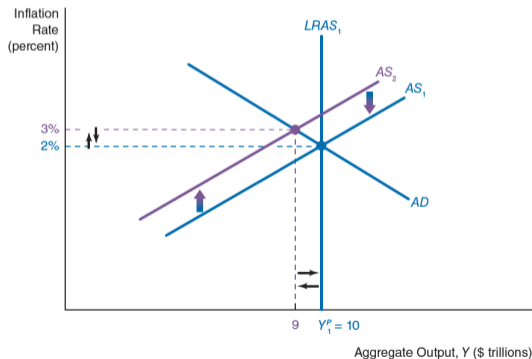
- Graphical representation of the self-correcting mechanism after a **negative temporary shock in prices** ($\rho < 0$) in the short-term supply. The final equilibrium is the same as the initial one:



Aggregate supply shocks with no stabilization policy

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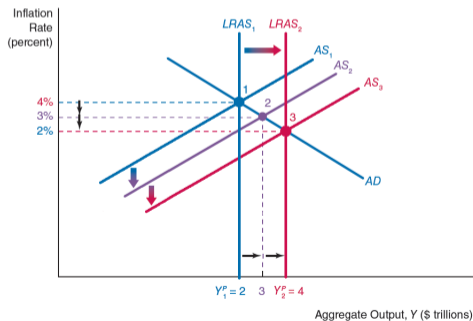
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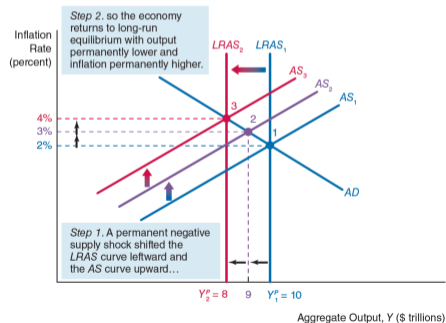
- Graphical representation of the self-correcting mechanism after a **positive permanent shock** in the supply, i.e., a **positive shock** in the long-term aggregate supply. We have that $\downarrow \pi$ and that $Y = Y^P$:



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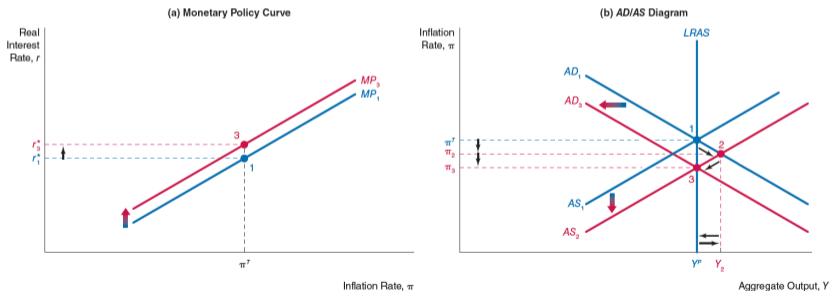
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Aggregate supply shocks with stabilization policy

Graphical representation | Goal after temporary shock: stabilize economic activity ($Y = Y^P$)

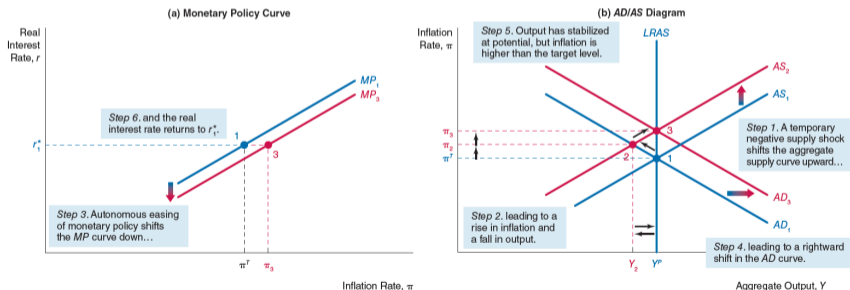
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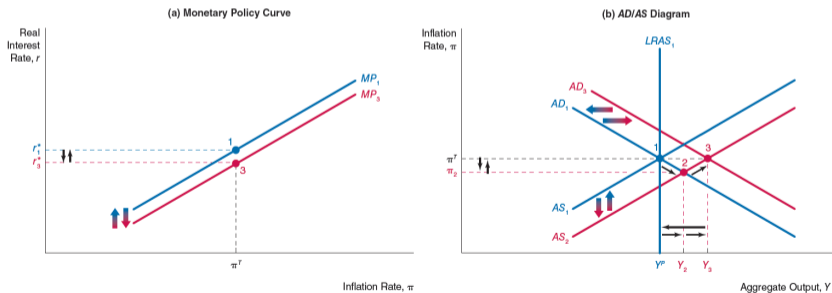
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Aggregate supply shocks with stabilization policy

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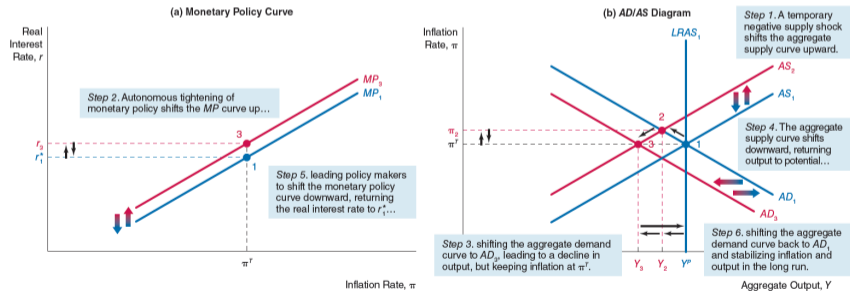
- Graphical representation of the stabilization policy after a **negative temporary shock in prices** ($\rho < 0$) in short-term aggregate supply. We have that $\pi = \pi^T$ and that $\uparrow Y$ (point 3). Afterwards, self-correcting mechanism takes place to eliminate the output-gap and stabilization policy has to occur again. In the end, the final equilibrium is equal to the first one:



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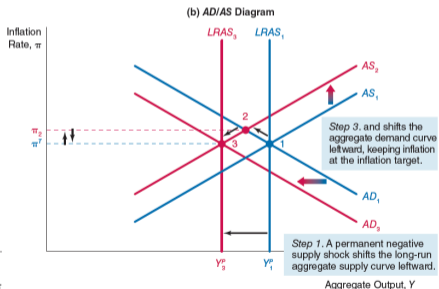
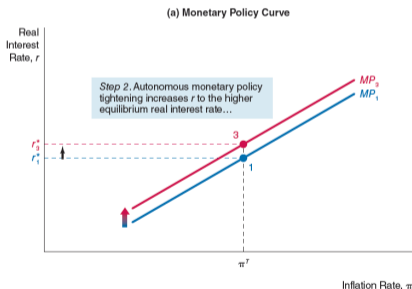
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Aggregate supply shocks with stabilization policy

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

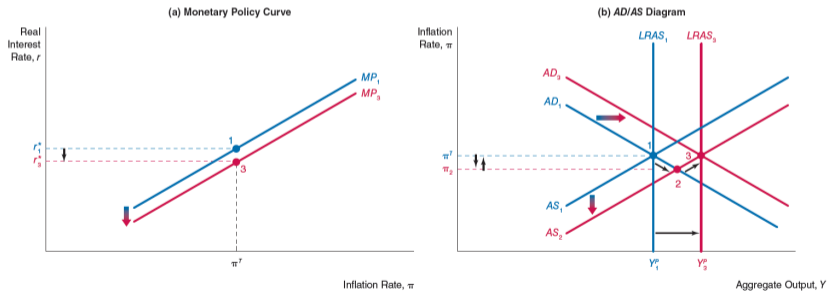
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References

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