

# Economics 442

## Macroeconomic Policy

Lecture 6

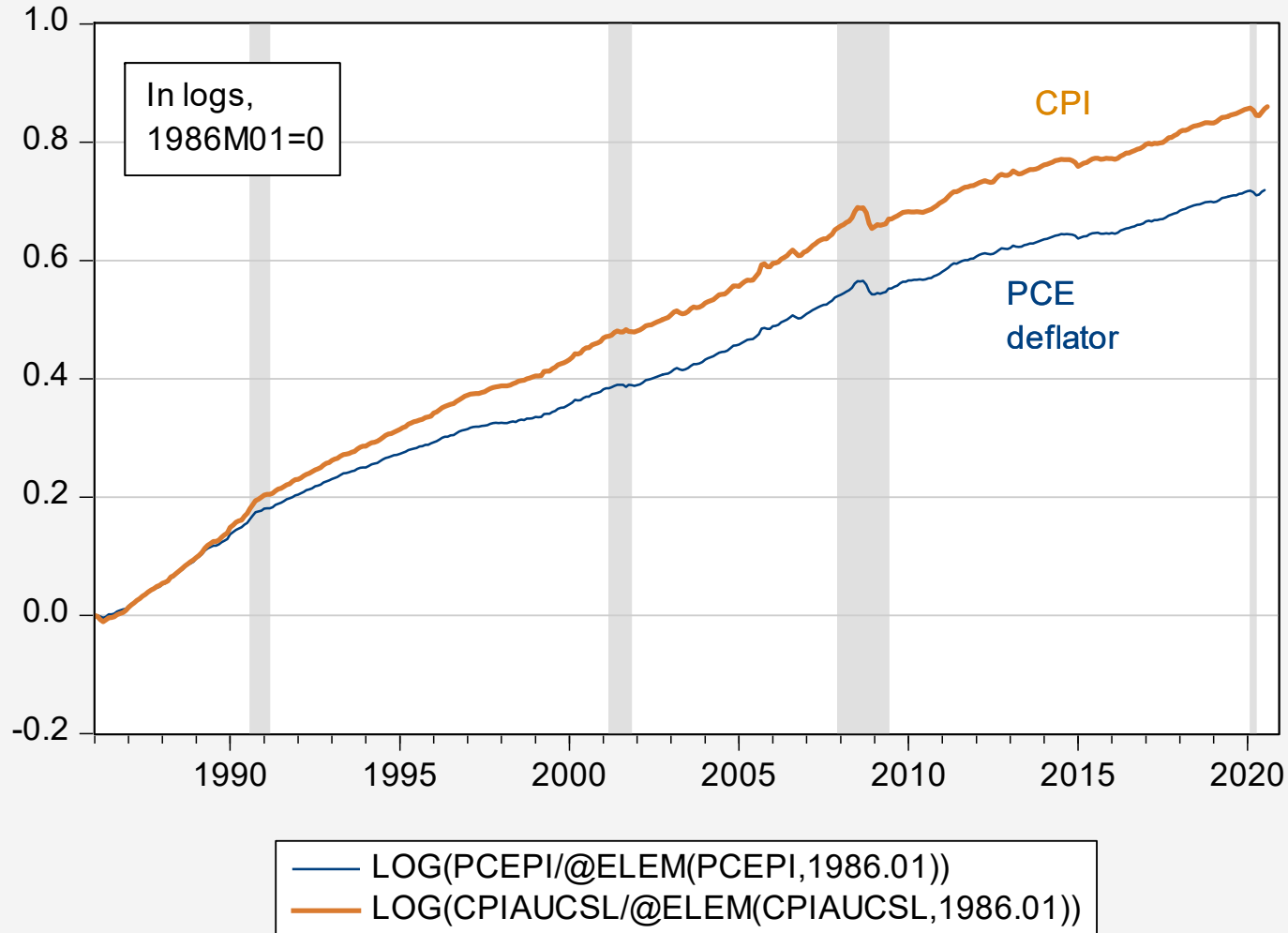
9/23/2020

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UW Madison  
Fall 2020

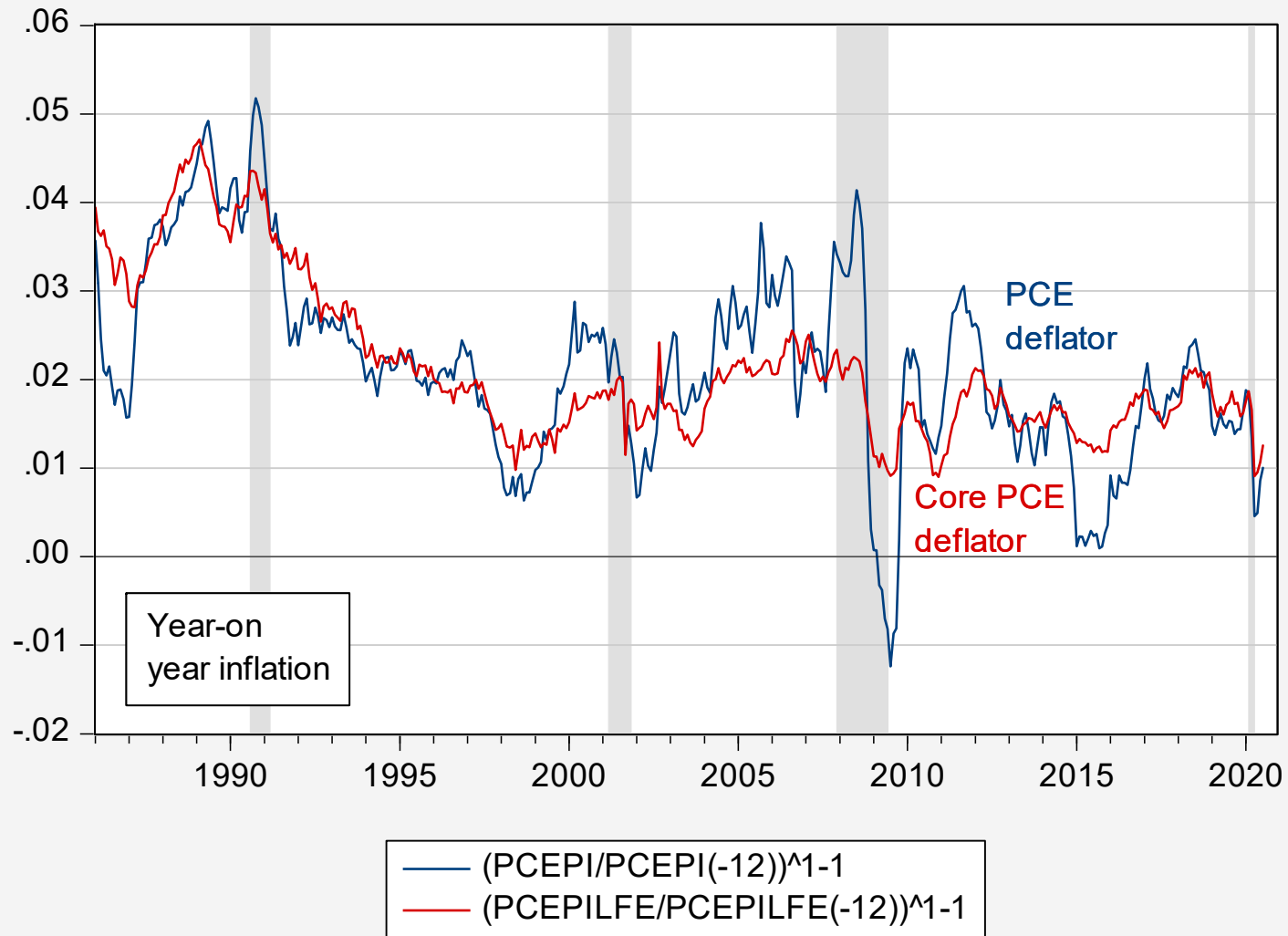
# Limitations of IS-LM

- “Old fashioned” “Keynesian” in that price level is fixed
- Supply passively responds to demand
- Can dichotomize economy into real and financial sides
- We can fix first two...

# Price Level *Does* Change



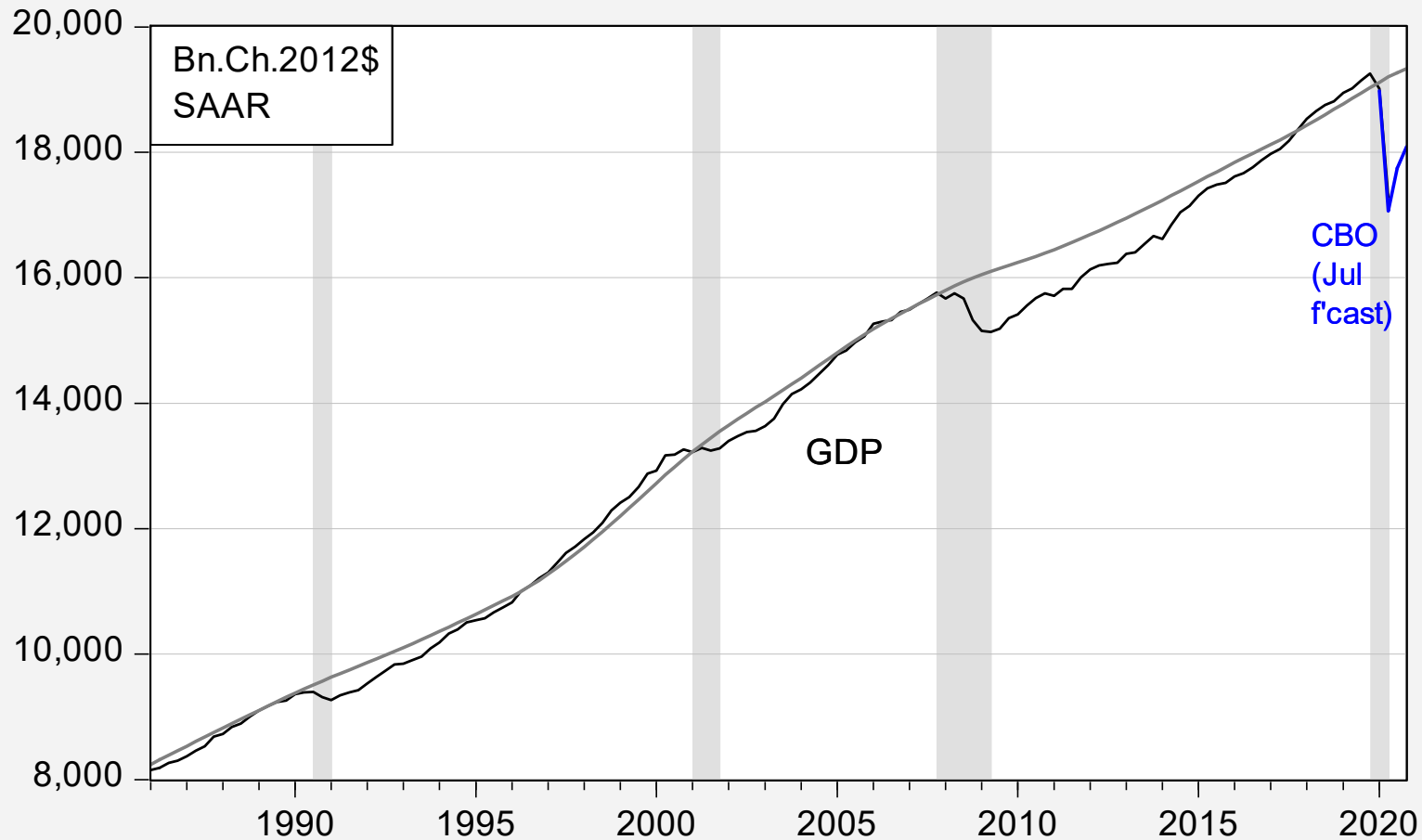
# But Pretty Slowly Recently (Low Inflation)



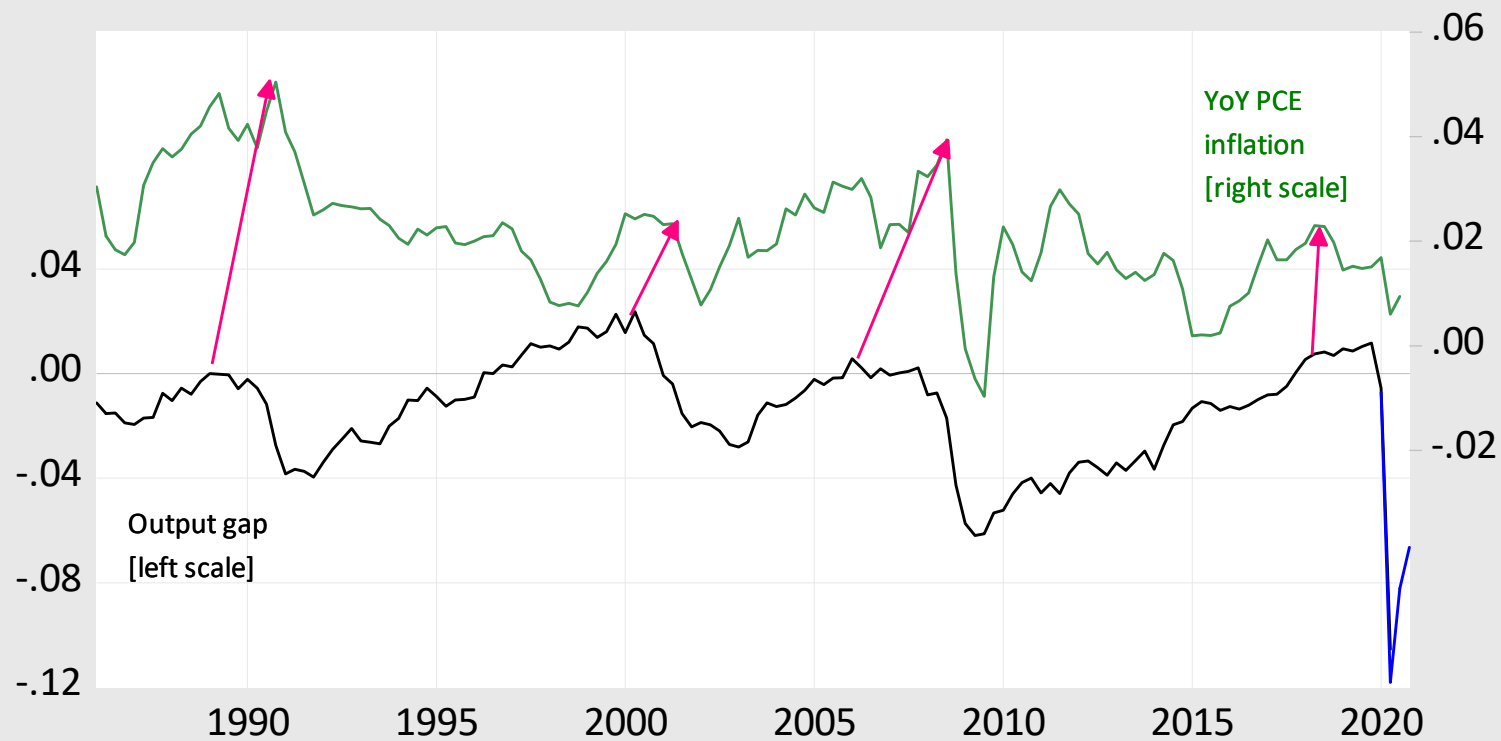
# Notable Features

- Inflation declines when economy is some way into a recession
- Suggests when economic activity is low relative to what the economy can produce, downward price pressure
- Average (over business cycle) inflation has been declining (true since late 1970s), so no-price-level change (IS-LM) has become more and more appropriate
- No guarantee this continues

# Aggregate Demand Is Sometimes Less That What Can Be Produced



# Systematic Movement in Price Level



— LOG(GDP12/GDP12\_POT\_CBOJUL20)  
— LOG(GDP12\_CBOJUL20/GDP12\_POT\_CBOJUL20)  
— (PCEPI/PCEPI(-4))^1-1

# What We Need

- A model that incorporates demand side
- But has price level rise faster when output exceeds what level the economy could produce utilizing factors of production at normal (“natural”) rates
- This level is called the natural rate of output ( $Y_n$ ) or potential GDP, and the corresponding unemployment rate, the natural rate of unemployment ( $u_n$ ).
- This is the AD-AS model