

Economics 435

Macroeconomic Policy

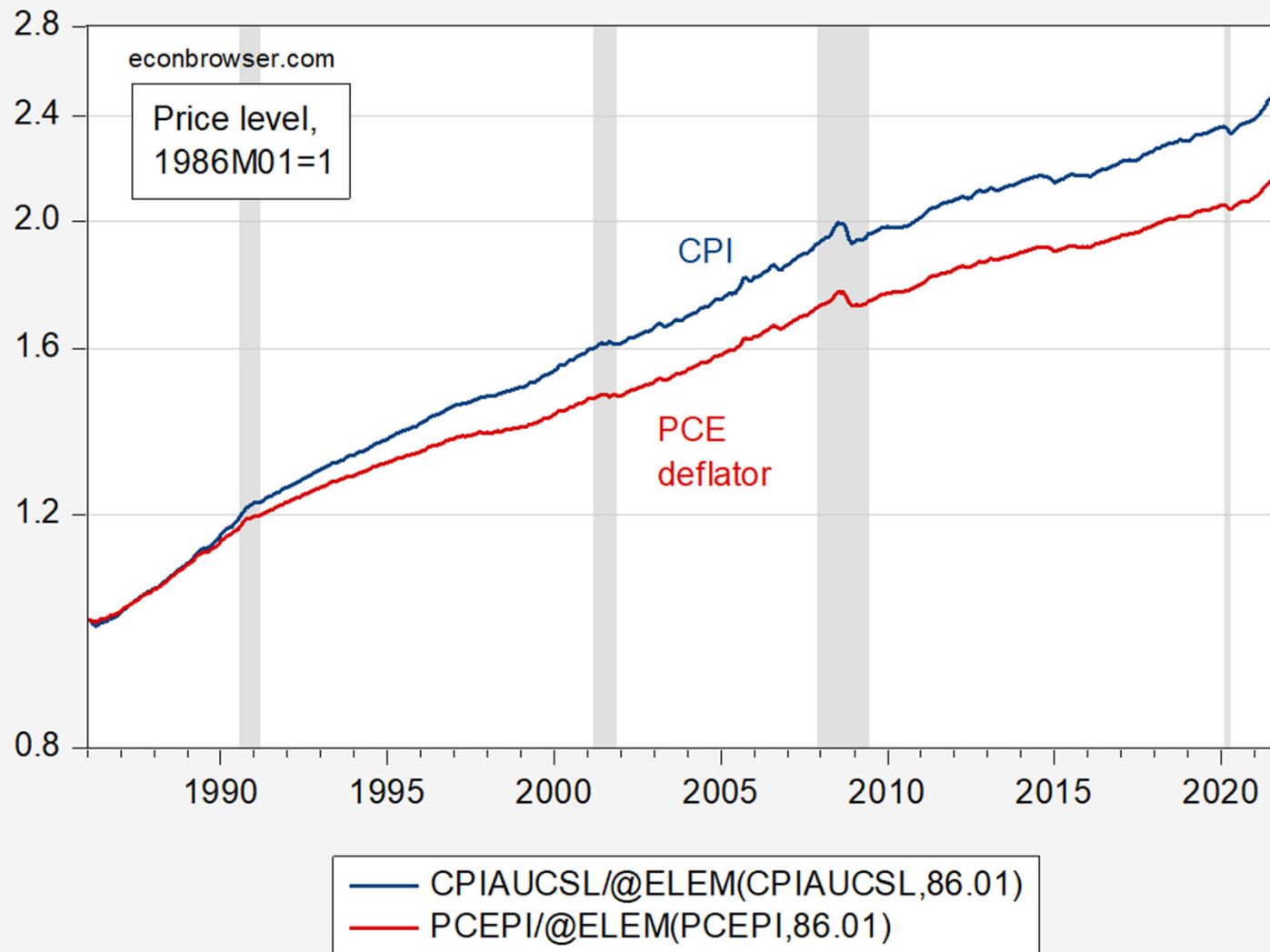
Lecture 6
9/28/2021

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UW Madison
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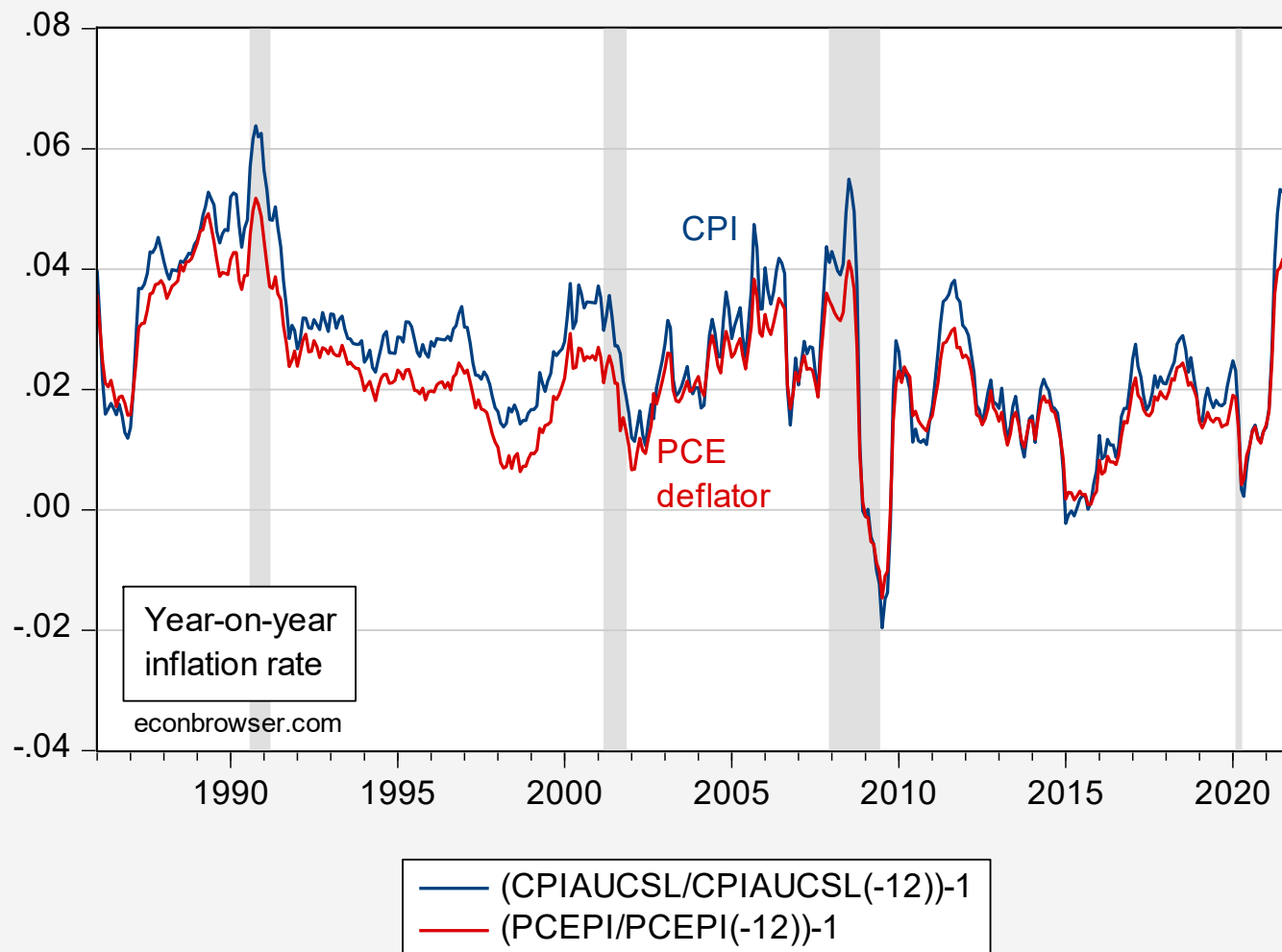
Limitations of IS-LM

- “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...

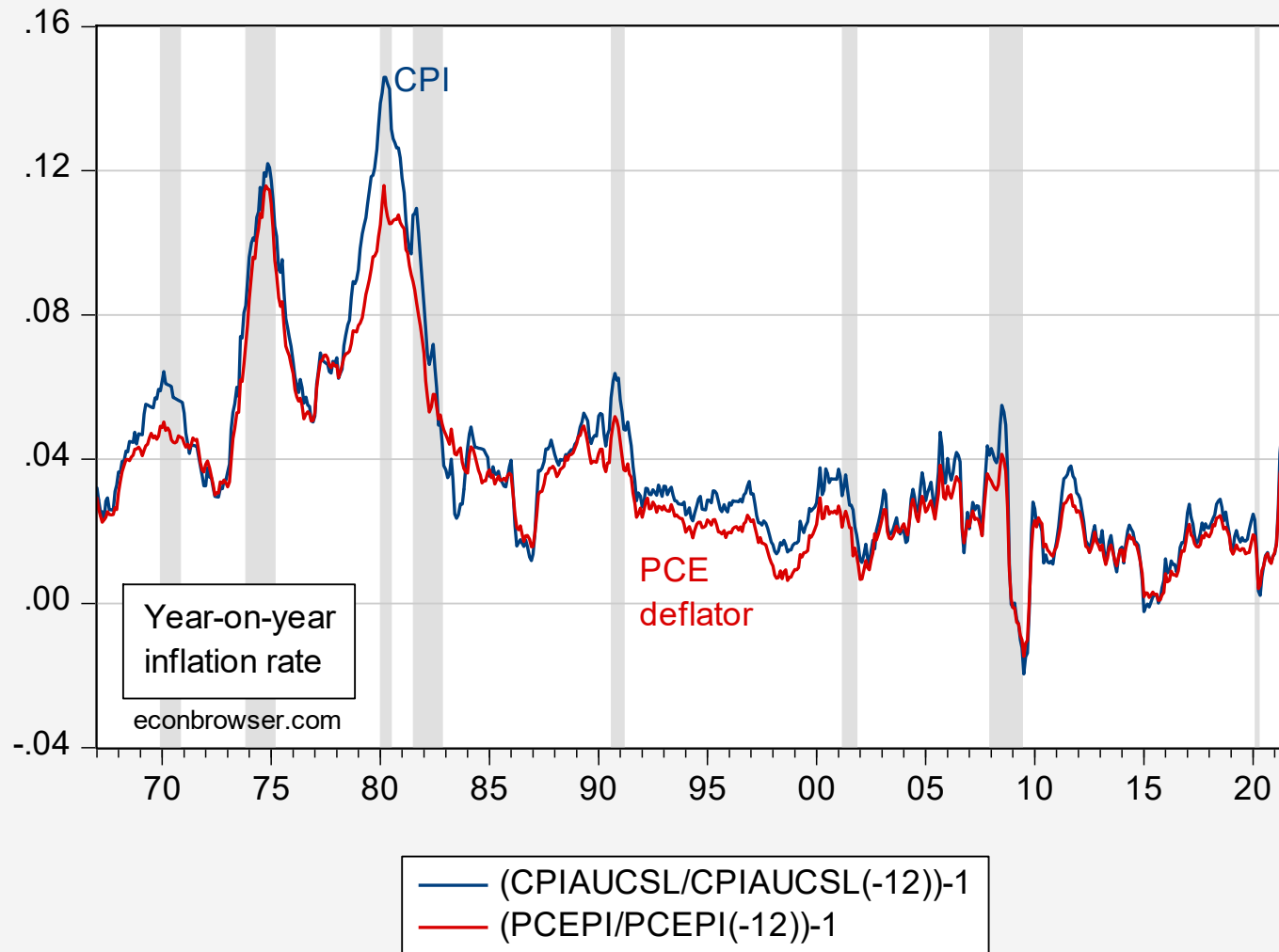
Price Level *Does* Change



But Pretty Slowly Until Recently



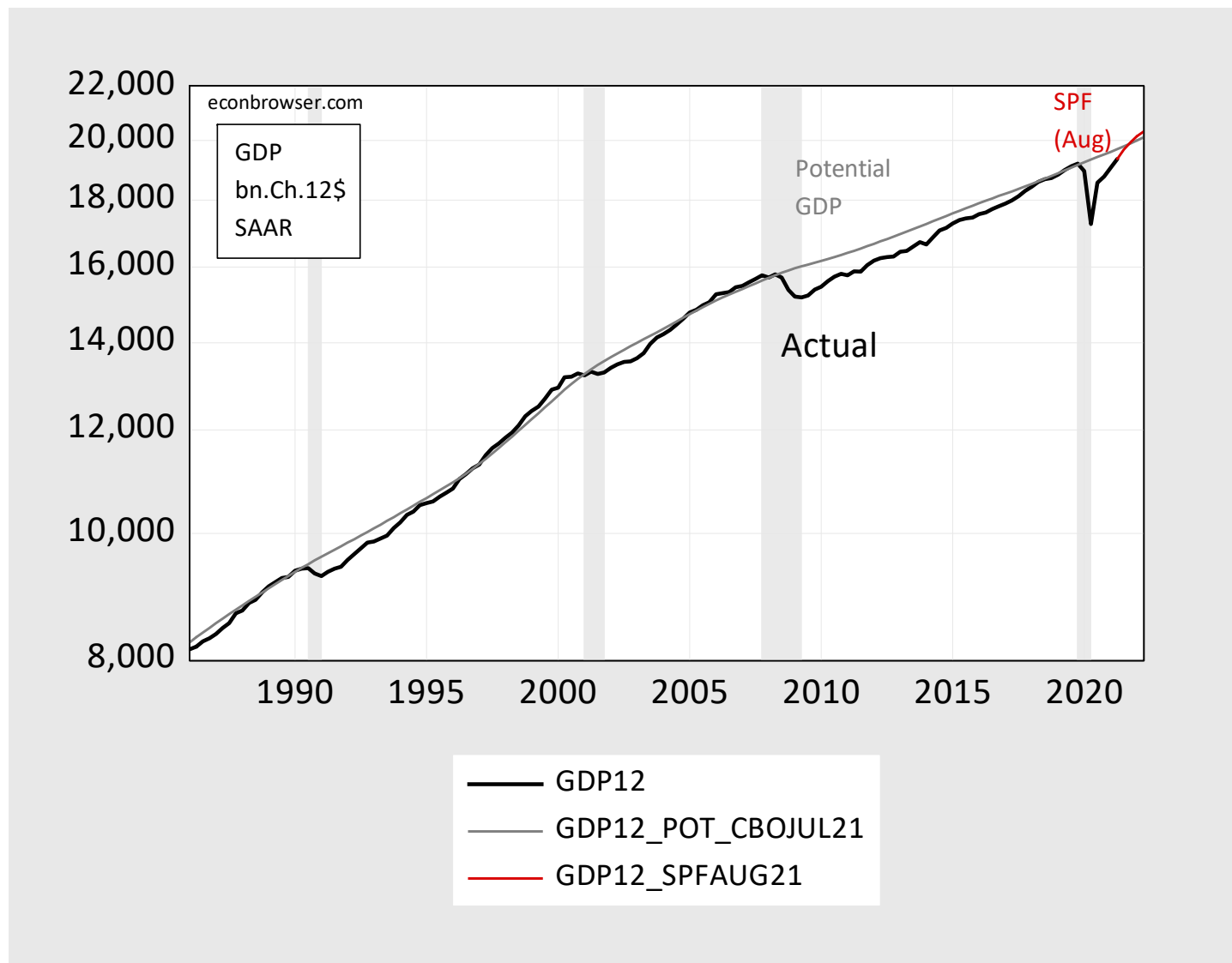
Inflation Rates over Longer Span



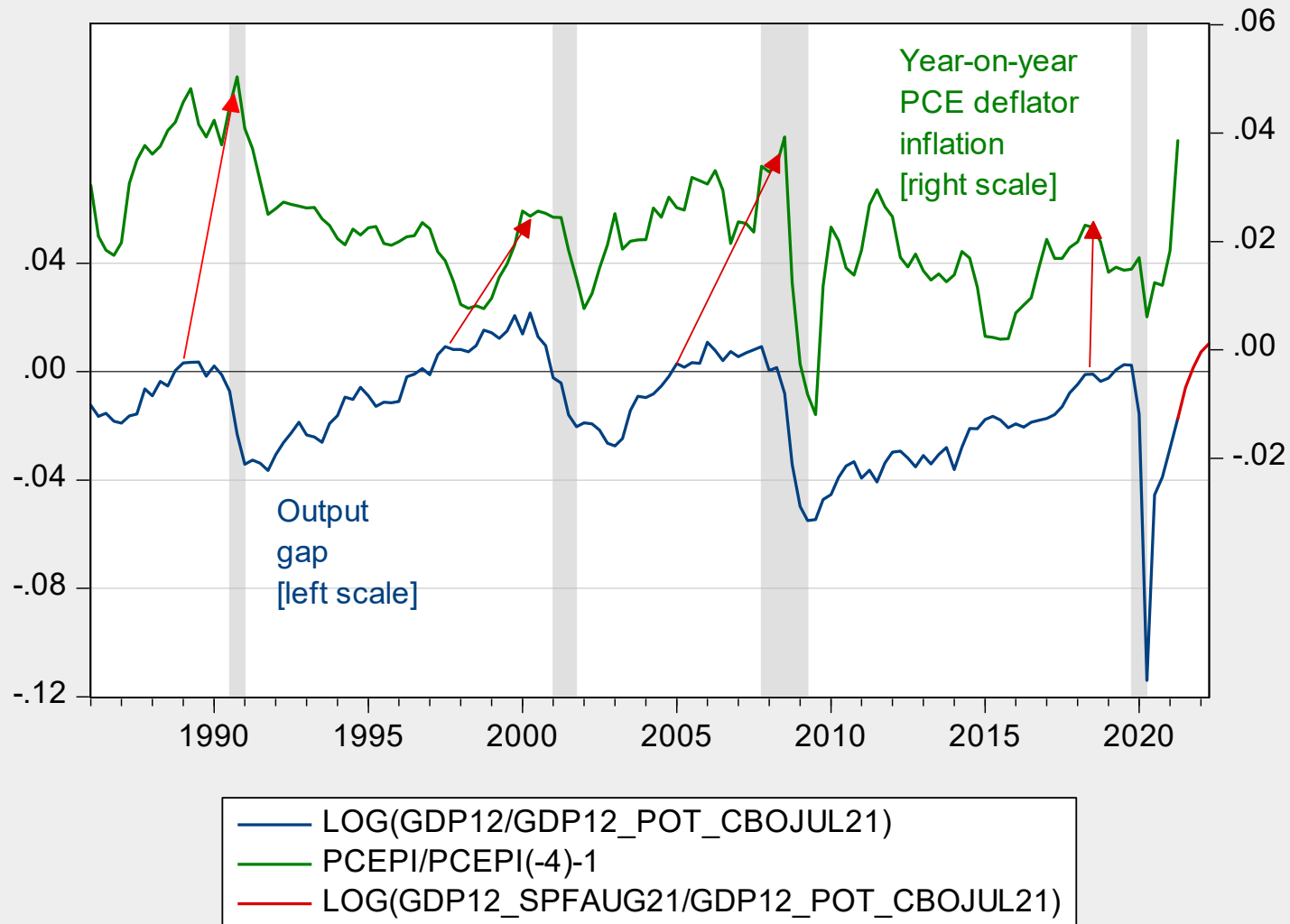
Notable Features

- 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 Than What Can Be Produced



Systematic Movement in Price Level



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