

The Dynamic AS/AD model is a good guide to understanding the economy over the last 25 years of low & stable inflation

Two charts

help to set the stage. To better understand them, the AD curve should be viewed

as a rectangular hyperbola. That means that the elasticity along the curve is

unity. In that case, along the curve, NGDP growth is constant, say 5%. In other

words, a fall in real growth is exactly offset by a rise in inflation. It also

means, from a monetary policy perspective, that velocity (or money demand)

changes are exactly offset by changes in money supply.

In Chart 1,

I illustrate the case of a (negative) demand shock. In that case, NGDP growth

falls (to 3% say). Both RGDP growth and inflation decrease. Chart 2 depicts the

case of a negative supply shock (an oil price rise, for example). If NGDP

growth (the AD curve) remains stable (at 5%), inflation rises and real growth

falls. However, if because of the rise in inflation (above target), the Fed

constrains aggregate demand (NGDP) growth, inflation could in principle be held

constant, but the fall in RGDP growth (which could even turn negative) is exacerbated.

That's one of the reasons that inflation targeting is, as suggested by [James Meade](#) in 1977, "dangerous".

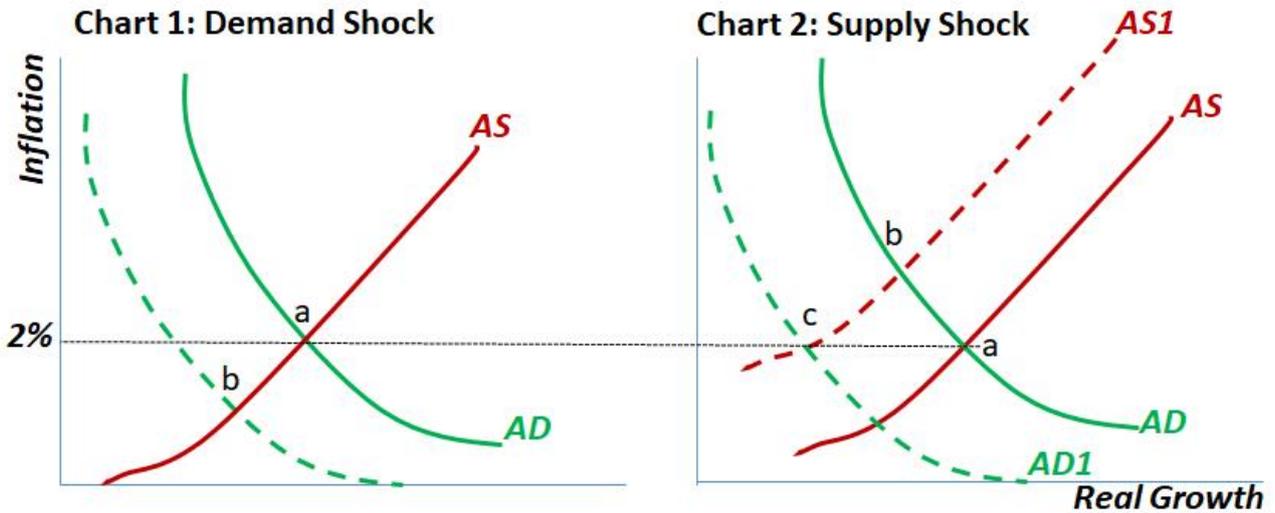
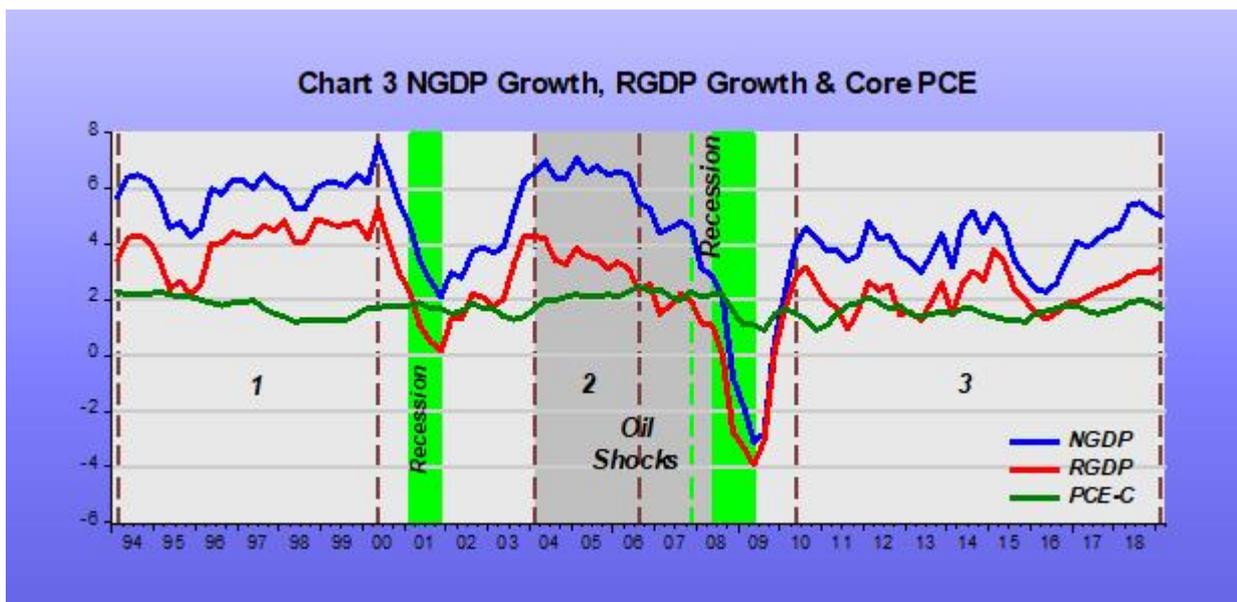


Chart 3 depicts the three variables of charts 1 & 2; NGDP growth, RGDP growth and inflation over the last 25 years with “landmarks”.



The periods delimited by the vertical dotted lines, periods 1, 2 and 3, are periods when NGDP growth was relatively stable. The green bars denote recession periods and the gray bar shows the period when oil shocks hit.

Interestingly, during the first leg of the oil shock, NGDP growth remains stable. As indicated

by Chart 2 above, RGDP growth falls somewhat and even core inflation increases a little.

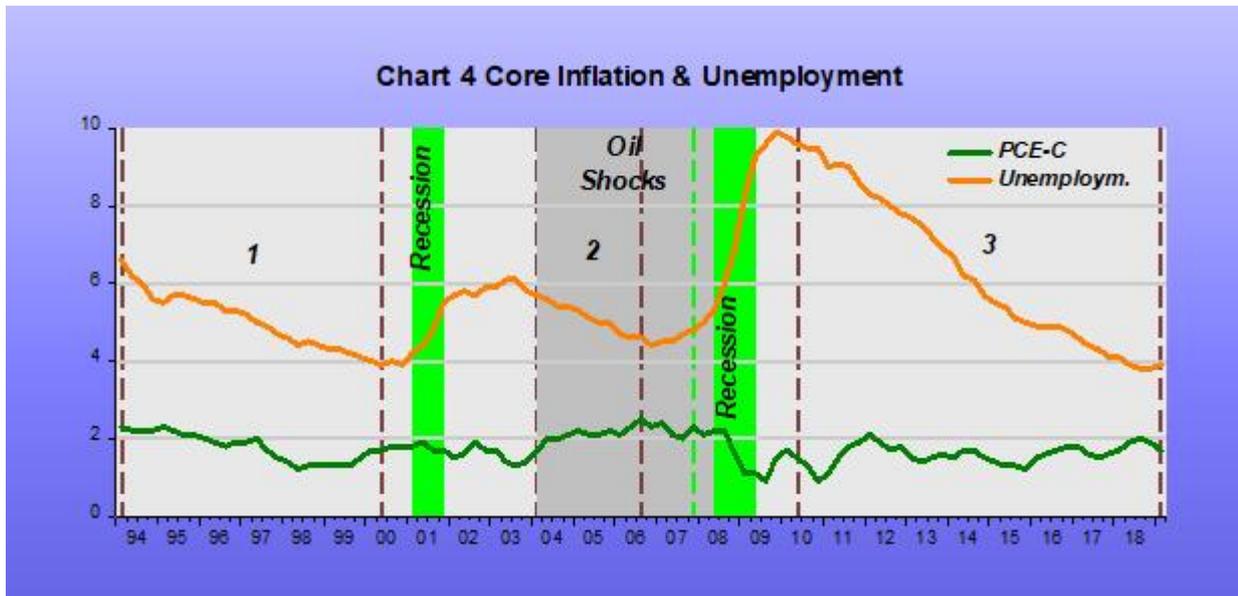
Shortly

after Bernanke took over at the Fed in January 2006, monetary policy begins to tighten (NGDP growth drops). Monetary policy continues to tighten and RGDP growth falls further, until monetary policy is “squeezed” and real growth tanks (Great Recession). At that point, core inflation drops to 1% (a 50% drop). That’s a clear indication (see Chart 1) of a (massive) demand shock.

The danger of inflation targeting alluded by Meade shows itself. At the time, as the 2008 [FOMC transcripts](#) show, the Fed was very worried about headline inflation, a result of oil shocks. As Chart 2 indicates, the result of monetary tightening to constrain inflation resulting from supply shocks will be a strong, in this case massive, fall in real output (and a fall in inflation).

Why, we can ask, did monetary policy tighten so much in 2000-01 and again, much more strongly in 2007-09, if core inflation was stable?

Chart 4 provides a possible answer. Monetary policy tightens (NGDP growth falls) when unemployment is considered “excessively” low.



Recently, [Antonio Fatas](#) wrote:

“What is interesting is the absence of a single episode of stable low unemployment (or full employment). It seems as if reaching a low level of unemployment always leads to **dynamics that soon generate a recession.**”

Chart 3 clearly points the finger at the “monetary dynamics”. That is likely the result of the “faith” policymakers put in the Phillips Curve model of inflation. As [Laurence Meyer](#) in one of his first speeches as Fed Governor put it in 1997:

“Despite the sharpness and force of the Phillips Curve/NAIRU model, it can be difficult to implement in practice. **Still, this relationship was about the most stable tool in the macroeconomists’ tool kit for most of the past 20 years; those who were willing to depend on it were likely to be very successful forecasters of inflation, and the record speaks for itself on this score.**”

If the last 25 years have shown anything, it is that the Phillips Curve model is deficient and grossly misleading. The cost paid in

terms of lost employment and income has been huge!
