Lecture 19: Inflation and Unemployment

- The dollar rose to a three- month high against the yen and gained against the euro amid optimism the U.S. economy will recover soon. Bloomberg, 11/19/01
- ….the government earlier this month admitted that Japan was probably in its worse economic condition in more than 20 years and forecast recession this year and possibly the next. FT 11/19/01

- Review
  - The Phillips Curve
- Nominal and real interest rates

The Phillips Curve

* The price level vs The inflation rate

$$P(t) = P^{e}(t)\ (1+\mu)\ F(u(t), z)$$

$$\approx>$$

$$\pi(t) = \pi^{e}(t) + (\mu+z) - \alpha\, u(t)$$

* original Phillips curve; Figures: 8-1/8-2/8-3/8-4/8-5

The Phillips Curve and The Natural Rate of Unemployment

$$\pi^{e}(t) = \pi(t)$$

$$\Rightarrow$$

$$u_n = \frac{(\mu + z)}{\alpha}$$

$$\pi(t) = \pi^{e}(t) - \alpha\,(u(t) - u_n)$$

Inflation and Disinflation

* In the long run $\pi = g_m - g_y$

* Disinflation and credibility

$$\pi(t) = \pi^e(t) - \alpha\,(u(t) - u_n)$$

Real and Nominal Interest Rates

IS: $Y = C(Y-T) + I(Y,r) + G$

LM: $\frac{M}{P} = YL(i)$

$$\mathbf{r = i - \pi^e}$$

The Long Run: $\pi^e = \pi = g_m - g_y$

Changes are relatively small; a "constant."

Dynamics: Figure 14-6 / Evidence: Figure 14-7