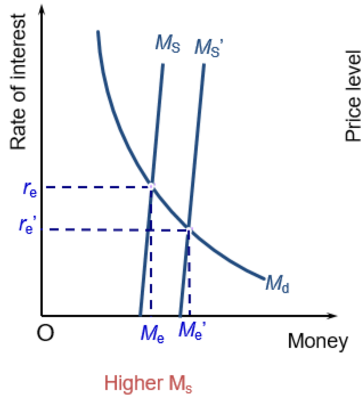
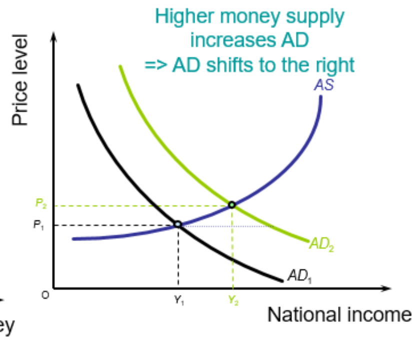
AD-AS Analysis

Effect of an expansionary monetary policy (IR down or credit creation):

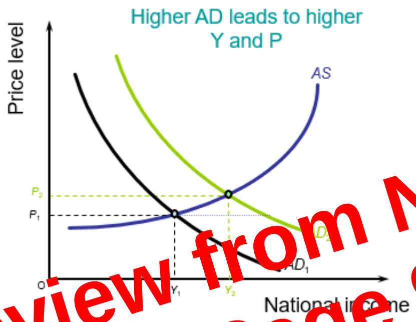
$$M_s\uparrow \rightarrow r\downarrow \rightarrow AD\uparrow \rightarrow Y\uparrow$$

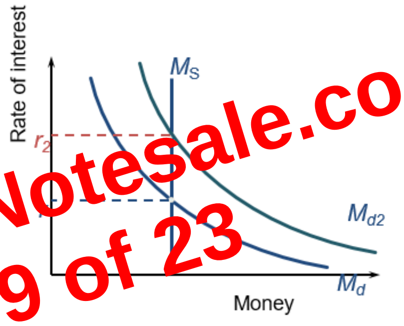




Effect of an increased aggregate demand on the money market:

$$AD\uparrow \rightarrow Y\uparrow \rightarrow M_d\uparrow \rightarrow r\uparrow$$



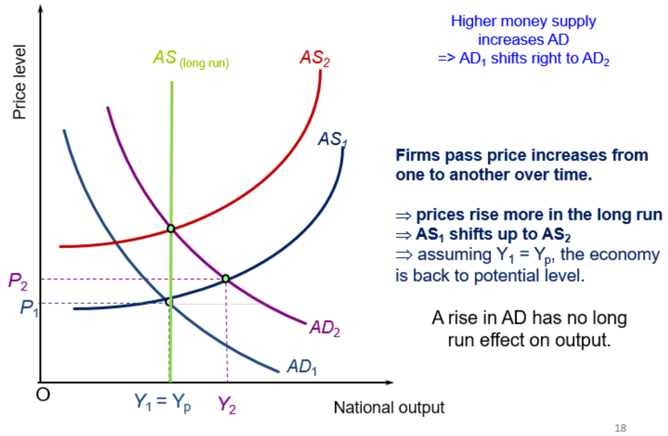


An expansionary monetary policy:

- Will lead to lower interest rates.
- Lower interest rates stimulate AD.
- National output increases.
- As income increases, the demand for money goes up.
- This will reduce the decline in interest rates.

The effectiveness of the monetary policy change depends on expectations.

Effect of an expansionary monetary policy in the *long-run*.



Inflation

Defined as the annual percentage increase in prices. Lower inflation means prices are growing slower, does not mean prices are declining.

Measured by the **CPI (Consumer Price Index)**: the percentage increase in the index over the previous 12 months.

Hyperinflation: very high and accelerating inflation rate.

Costs of inflation

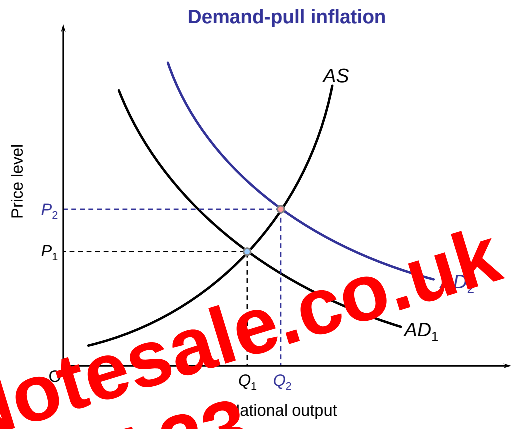
1. Hurts people on fixed incomes.
2. Uncertainty, which deters investment, less growth in economy?
3. Worsens balance of payments.

Demand-Pull Inflation

Caused by continuing rises in aggregate demand.

Firms respond to increasing demand by increasing prices and output. The increase in prices depends on the increase in firms' costs due to higher production.

This reduces unemployment also.

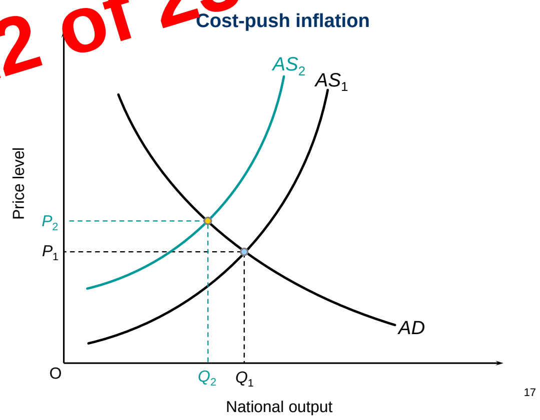


Cost-Push Inflation

Caused by continuing rises in costs independently of aggregate demand.

Firms respond to increasing costs by increasing prices and reducing output. How much firms increase prices and cut back output depends on the shape of the AD curve.

This increases unemployment also.



These two types of inflation can occur together. It's often difficult to separate the two.

> e.g. an initial cost push inflation makes the government expand AD to offset rises in unemployment.
>
> e.g. an initial demand pull inflation strengthens bargaining power of certain groups, who claim higher wages, increasing firms' costs.

Topic 6: Financial Crisis

Financial crisis' are major disruptions in financial markets characterised by sharp declines in asset prices and firm failures.

- Agency problems arise due to asymmetric information. Lenders do not have perfect information about potential borrowers.

What causes a Financial Crisis?

1. **Initiation:**

   A financial crisis can begin with mismanagement of financial liberalization or innovation.

   A financial crisis can begin with an asset price boom and bust – where a price bubble starts and asset values exceed their fundamental prices, then it bursts and prices fall.

   A financial crisis can begin with a spike in interest rates or an increase in uncertainty.

2. **Bank Panics:** Deteriorating balance sheets lead financial institutions into insolvency. If severe enough, these factors can lead to a bank panic.

3. **Debt Deflation:** If the crisis also leads to a sharp decline in prices, debt deflation can occur (where asset prices fall but debt levels do not adjust), increasing debt burdens.

2007 – 2009 Financial Crisis

- Low interest rates in early 2000s.
- Demand for loans was held back by firms' desire to rebuild balance sheets.
- Banks looked elsewhere for profit opportunities.
- Deregulation made it easier to borrow in countries where interest rates were low, and invest those funds in assets where IR's were higher.
- House prices rose.

Policy response in 2007-2009

- Expansionary monetary policy: reduction in short-term interest rates (nominal rates close to 0), and quantitative easing.
- Expansionary fiscal policy: bailout of banks and other firms by governments (government loans), and stimulus packages (increase in government spending and tax rate cuts).