

MACROECONOMICS

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PowerPoint® Slides by Ron Cronovich

SEVENTH EDITION

CHAPTER 14

A Dynamic Model of Aggregate Demand and Aggregate Supply

In this chapter, you will learn:

- Taylor rule. (Please only read page 414-416 of this Chapter)

The Nominal Interest Rate: The Monetary-Policy Rule

$$i_t = \pi_t + \rho + \theta_\pi (\pi_t - \pi_t^*) + \theta_Y (Y_t - \bar{Y}_t)$$

*nominal
interest rate,
set each period
by the central
bank*

*natural
rate of
interest*

*central
bank's
inflation
target*

$$\theta_\pi > 0, \theta_Y > 0$$

The Nominal Interest Rate: The Monetary-Policy Rule

$$i_t = \pi_t + \rho + \theta_\pi (\pi_t - \pi_t^*) + \theta_Y (Y_t - \bar{Y}_t)$$

*measures how much
the central bank
adjusts the interest
rate when inflation
deviates from its target*

*measures how much the
central bank adjusts the
interest rate when
output deviates from
its natural rate*

CASE STUDY

The Taylor Rule

- Economist John Taylor proposed a monetary policy rule very similar to ours:

$$i_{ff} = \pi + 2 + 0.5(\pi - 2) - 0.5(\text{GDP gap})$$

where

- i_{ff} = nominal federal funds rate target
- $\text{GDP gap} = 100 \times \frac{\bar{Y} - Y}{\bar{Y}}$
= percent by which real GDP is below its natural rate
- The Taylor Rule matches Fed policy fairly well....

CASE STUDY

The Taylor Rule

