Third-best macro policy

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Nov. 2009
World industrial production
Long-term unemployment as % of labor force
Shaded areas indicate US recessions.
2009 research.stlouisfed.org
Figure 3

Past Unemployment Cycles and Banking Crises: Trough-to-peak
Percent Increase in the Unemployment Rate (left panel) and Years Duration of Downturn (right panel)
Thinking about policy: minimal NK framework

(1) \[ U = \sum_{t=0}^{\infty} \beta^t \left[ s_t \ln(C_t) + \chi \ln\left(\frac{M_t}{P_t}\right) + v(G_t) - \kappa \ell_t^2 \right] \]

where C is private consumption, G gov’t purchases.

“Fudge factor” to get shock to aggregate demand.

Sticky prices (one period) to get output fluctuations
Nominal interest rate

The normal case

Target rate

Full employment

C+G

AD
The current situation

Nominal interest rate

Full employment

Target rate

C+G

AD
What to do?

*First best*: Inflation targeting to reduce the real interest rate

Problem: Persuasion/credibility

*Second best*: Strong fiscal expansion/quantitative easing

Problem: Deficit/inflation fears

*Third best*: Job promotion/work sharing
10-Year Treasury Inflation-Indexed Security, Constant Maturity (DFII10)

Shaded areas indicate US recessions.
2009 research.stlouisfed.org
Net debt as % of GDP

Belgium | Italy | Japan | US

Yearly data from 1991 to 2014.