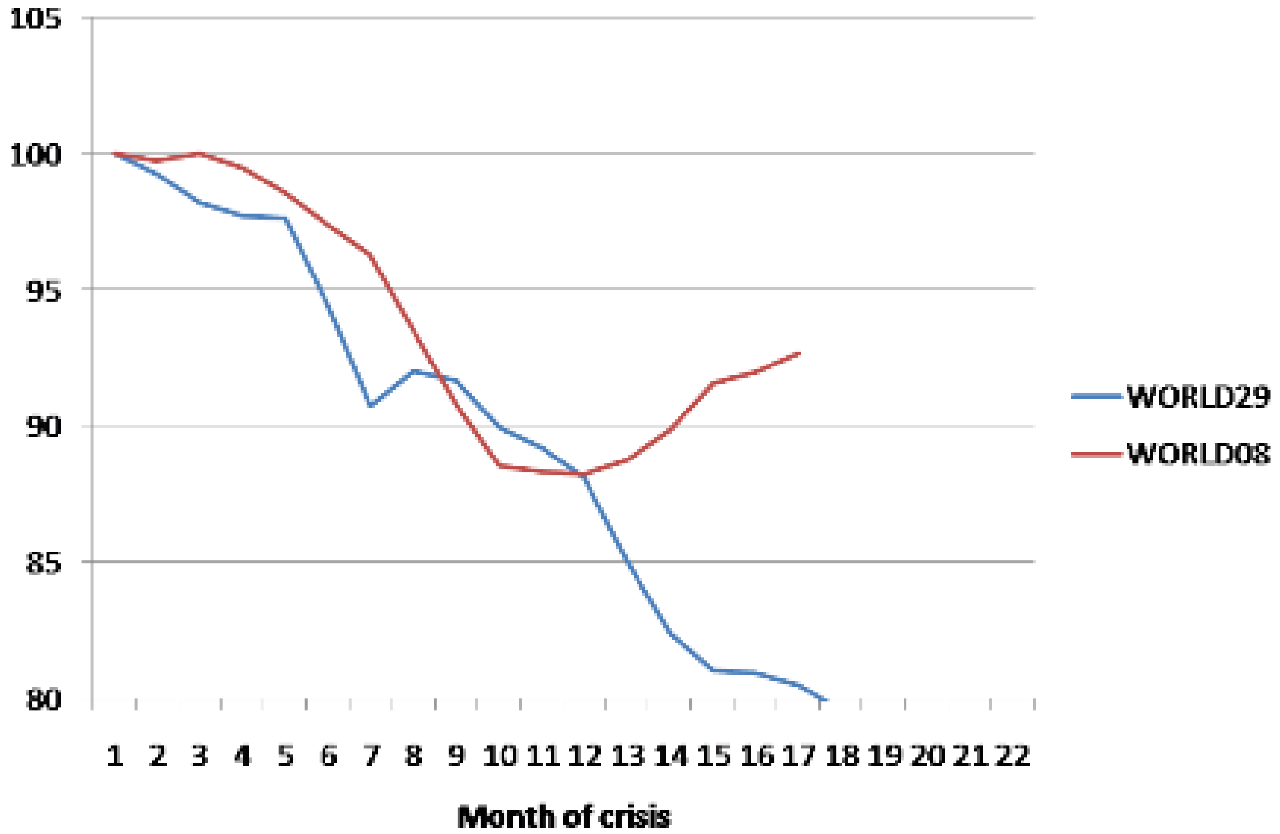
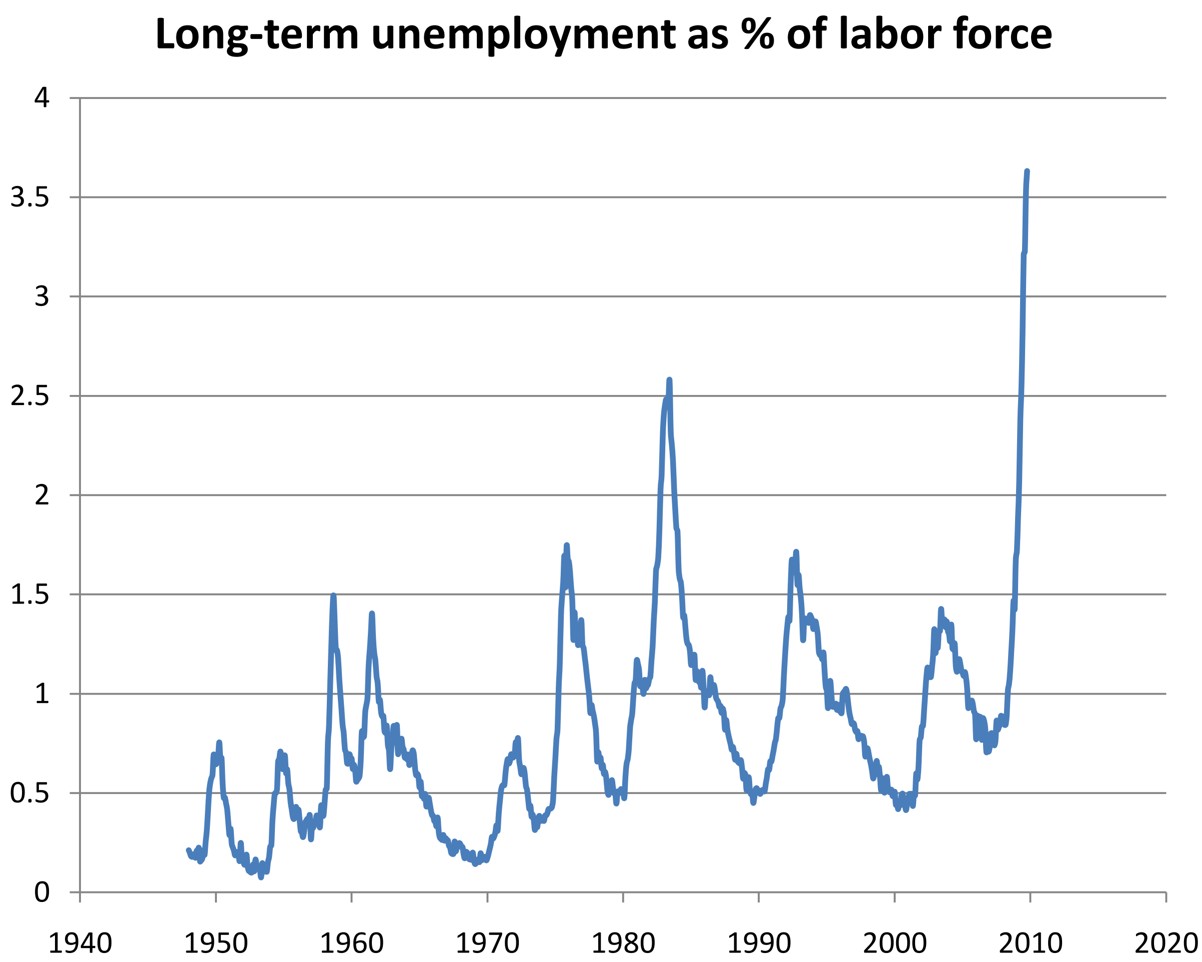
Third-best macro policy

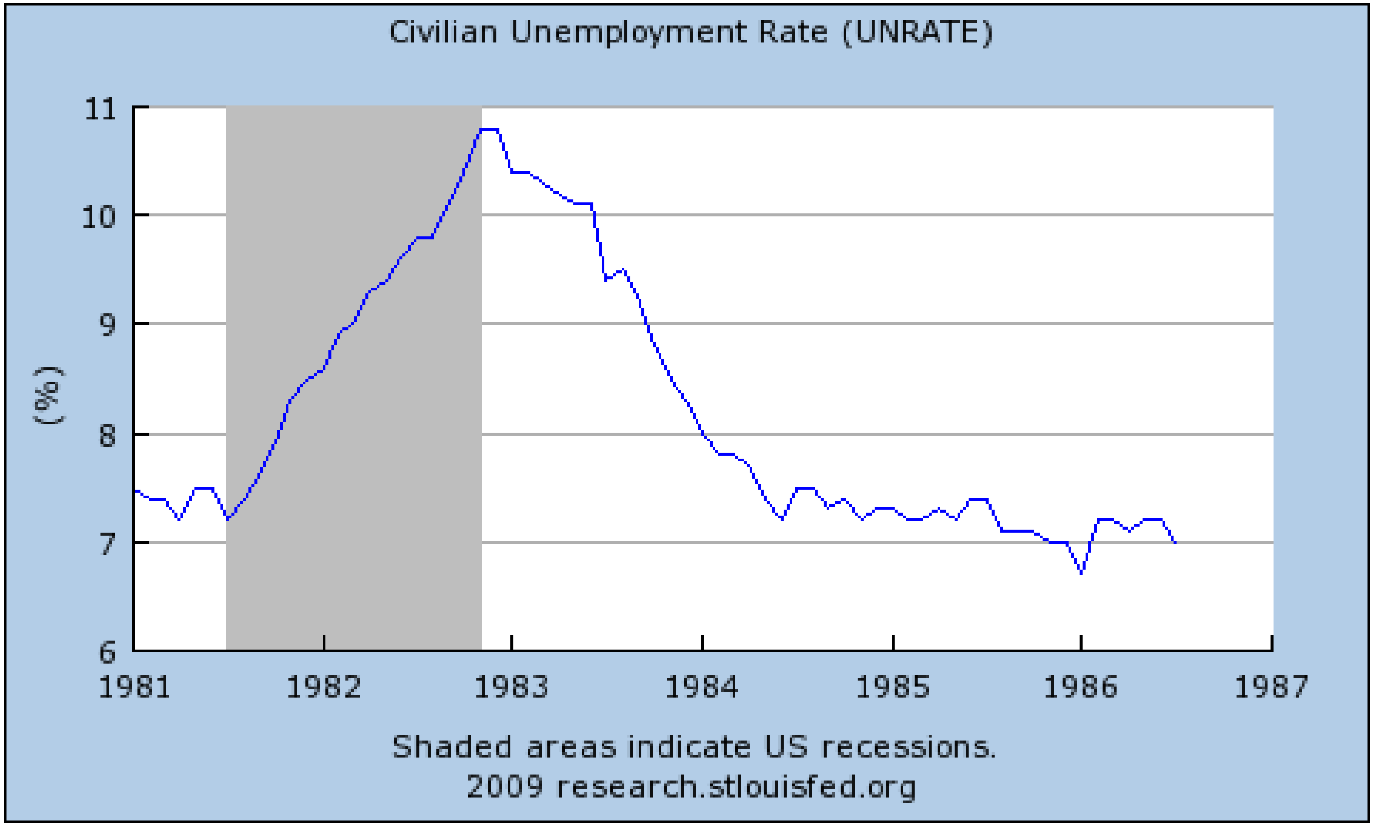
Paul Krugman

Nov. 2009

World industrial production




Long-term unemployment as % of labor force
4
3.5
3
2.5
2
1.5
1
0.5
0
1940
1950
1960
1970
1980
1990
2000
2010
2020


Civilian Unemployment Rate (UNRATE)
11
10
9
8
7
6
(%)
1981
1982
1983
1984
1985
1986
1987
Shaded areas indicate US recessions.
2009 research.stlouisfed.org

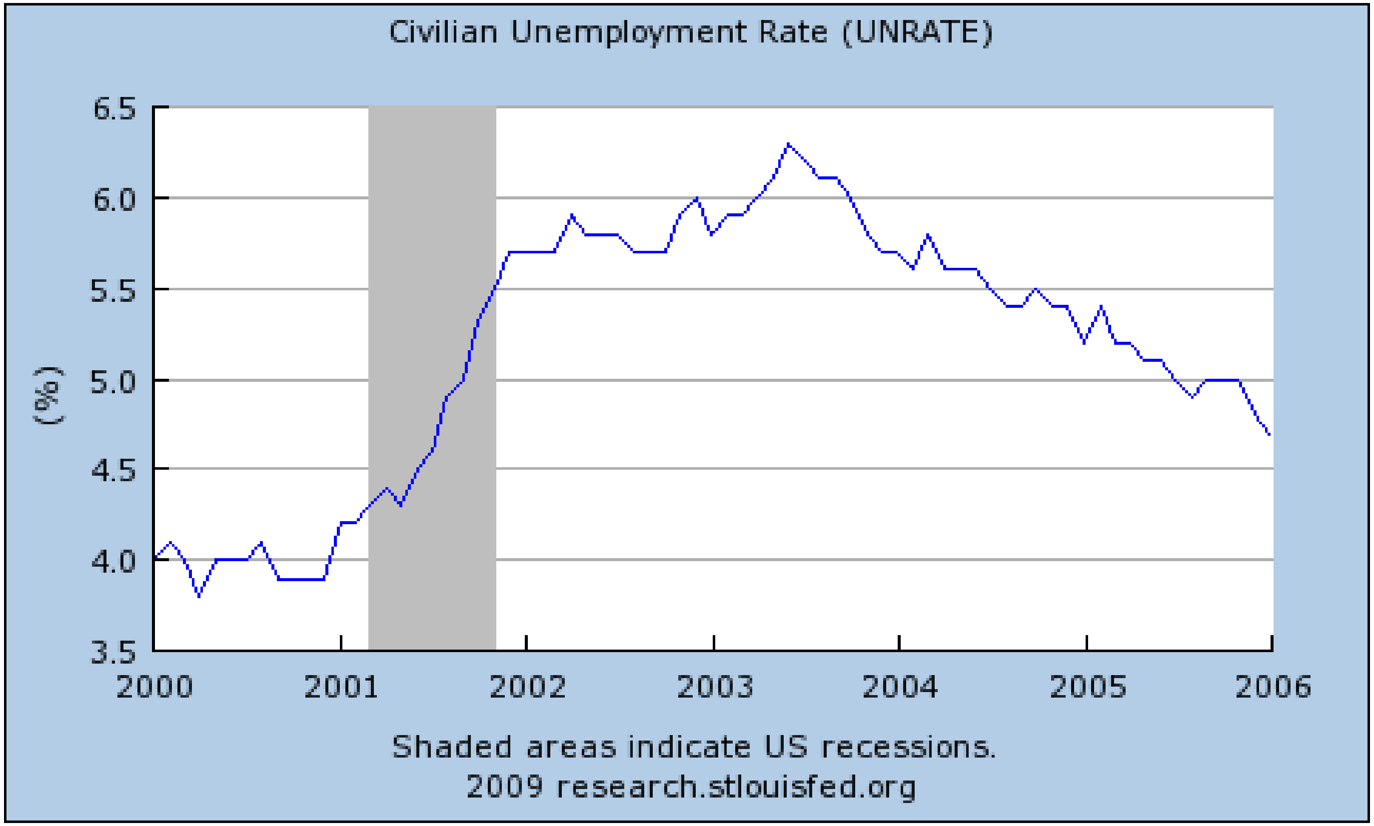
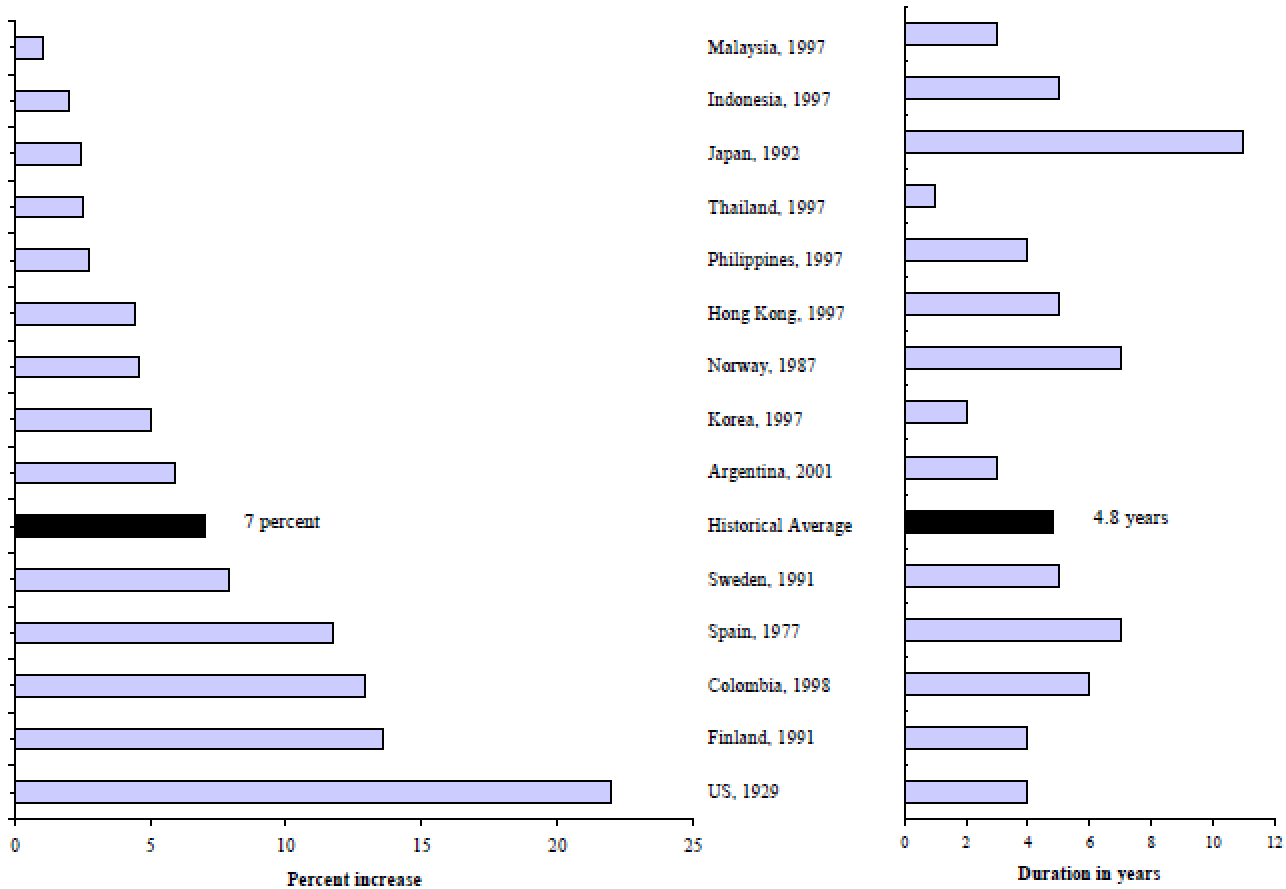
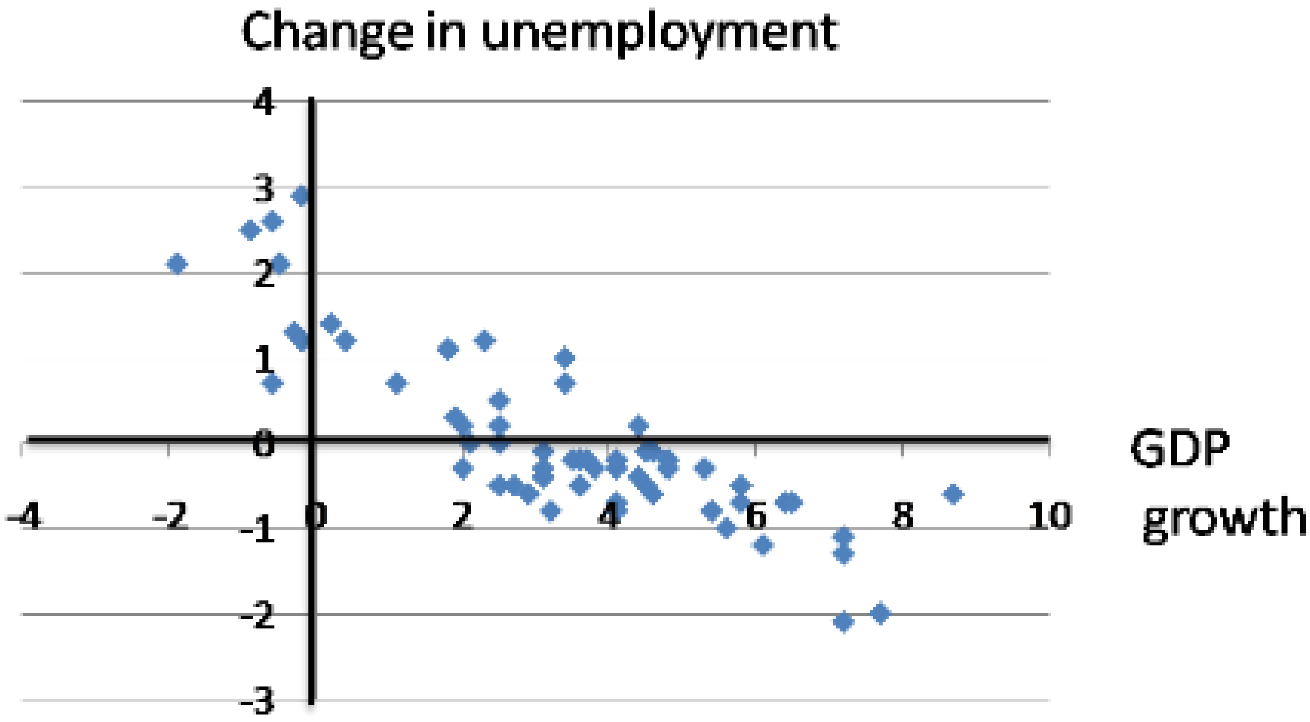

Civilian Unemployment Rate (UNRATE)
6.5
6.0
5.5
5.0
4.5
4.0
3.5
(%)
2000
2001
2002
2003
2004
2005
2006
Shaded areas indicate US recessions.
2009 research.stlouisfed.org

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)





Change in unemployment
GDP growth
4
3
2
1
0
-1
-2
-3
-4
-2
0
2
4
6
8
10

Thinking about policy: minimal NK framework

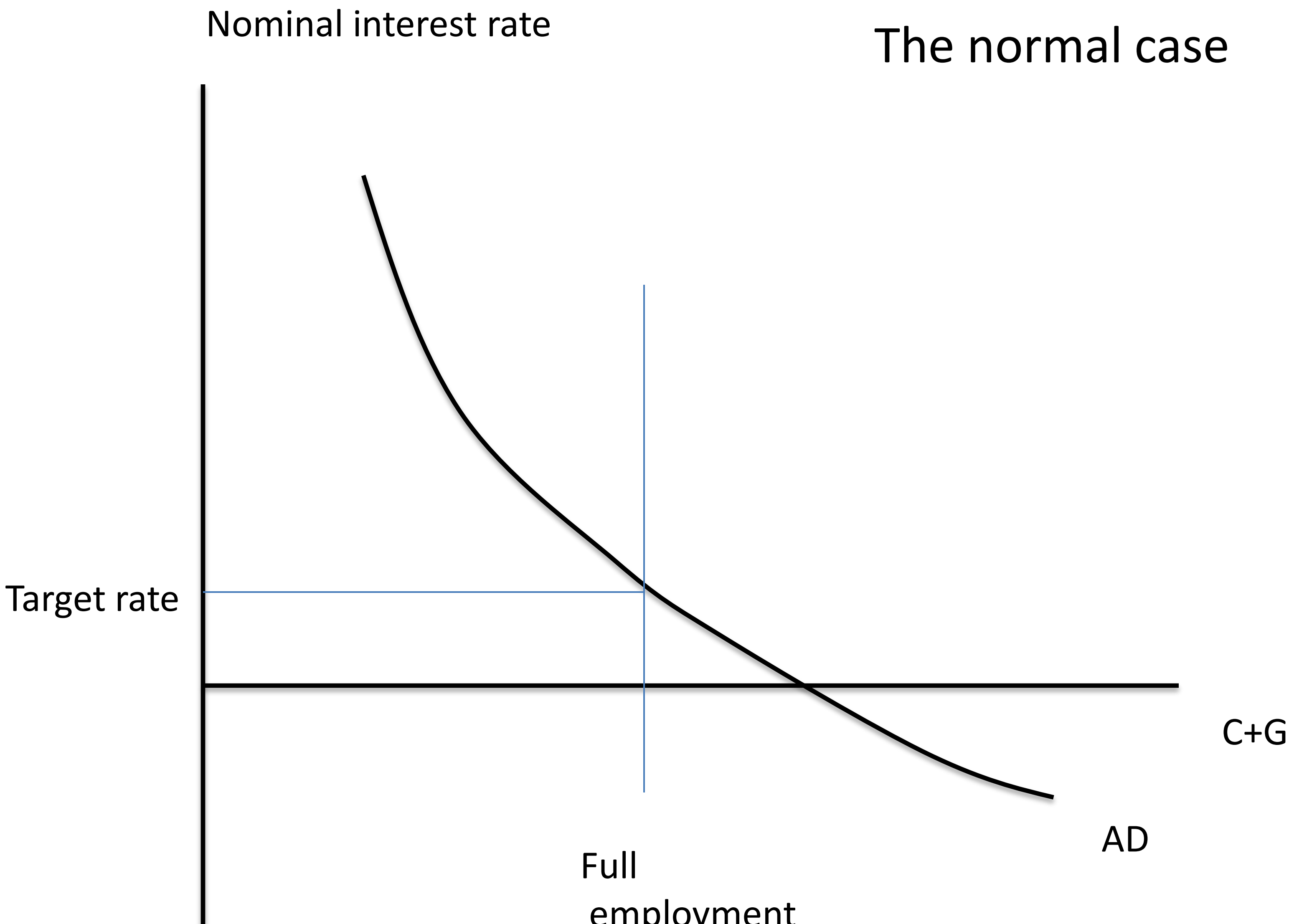
$$(1) \quad U = \sum_{t=0}^{\infty} \beta^t \left[\mathrm{s_t} \ln(C_t) + \chi \ln\left(\frac{M_t}{P_t}\right) + \ v(G_t) - \ \kappa \ell_t{}^2 \right]$$

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

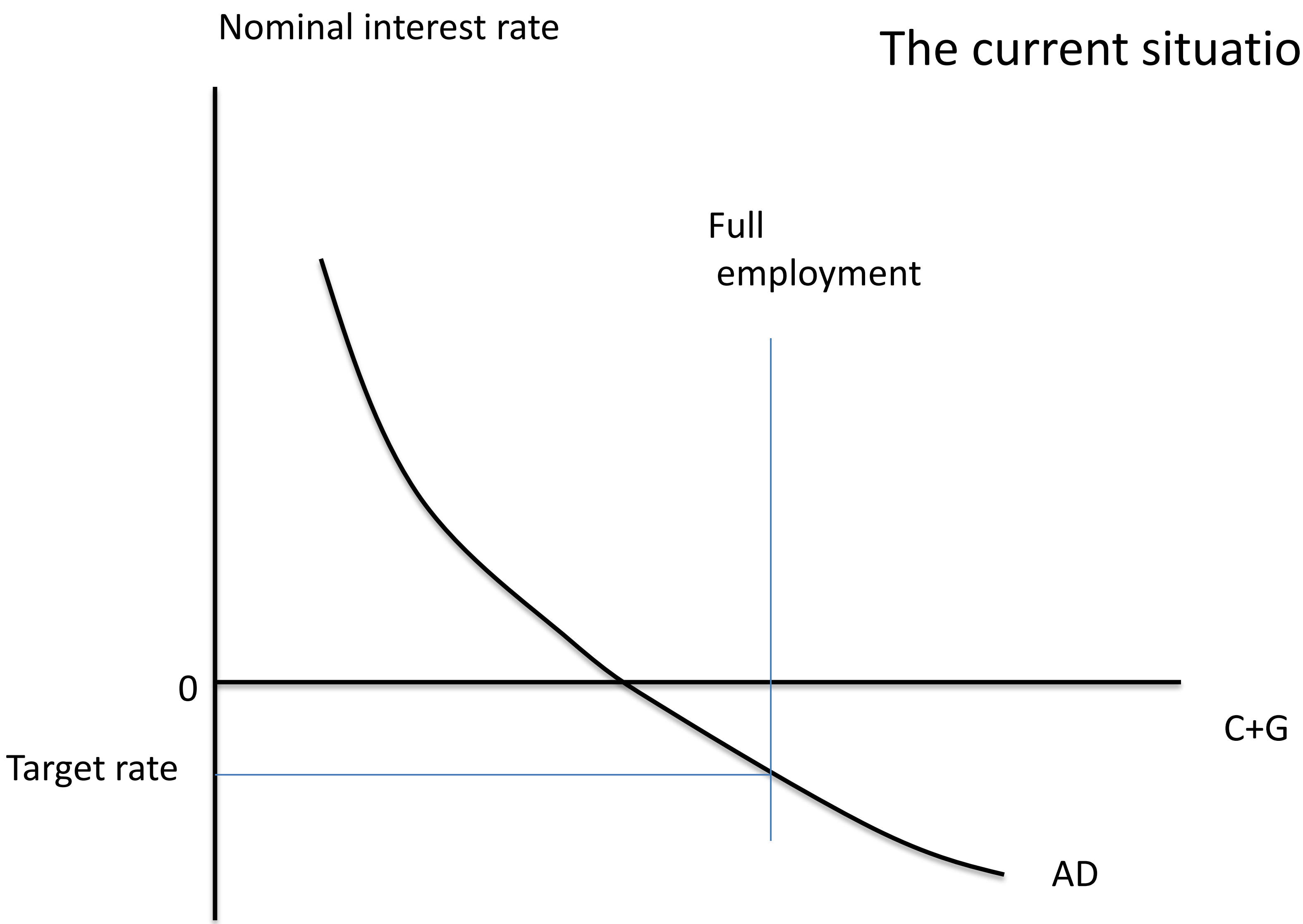
"Fudge factor" to get shock to aggregate demand.

Sticky prices (one period) to get output fluctuations

The normal case



The current situation



What to do?

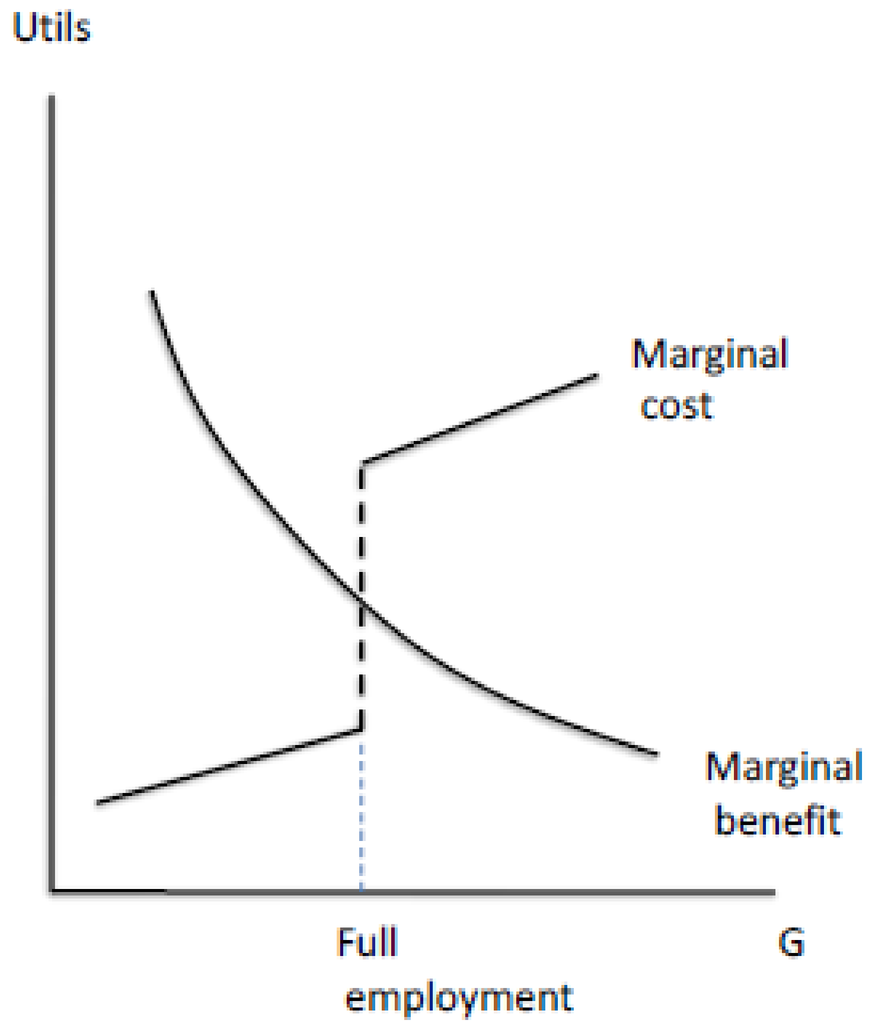
First best: Inflation targeting to reduce the real interest rate

Problem: Persuasion/credibility

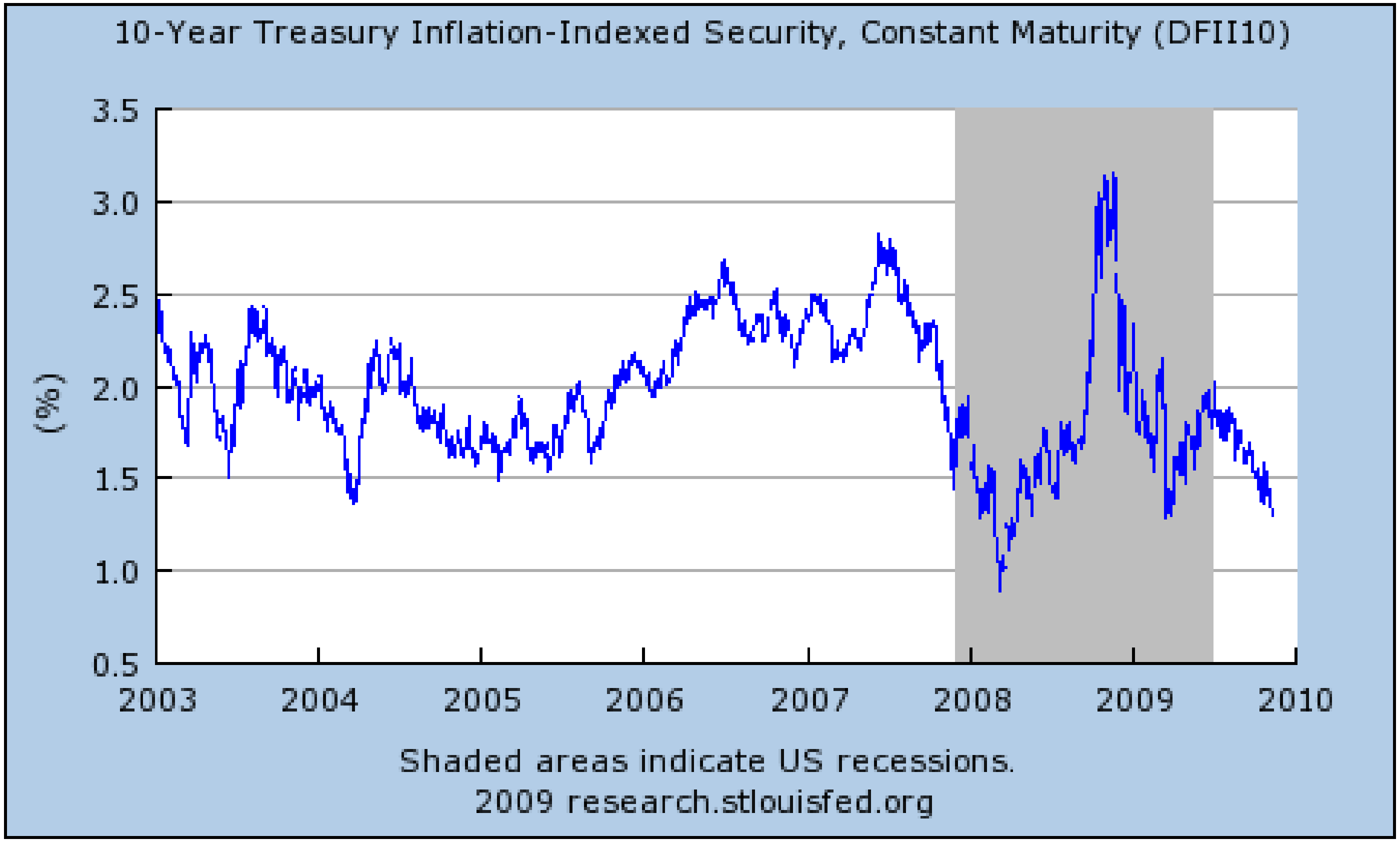
Second best: Strong fiscal expansion/quantitative easing

Problem: Deficit/inflation fears

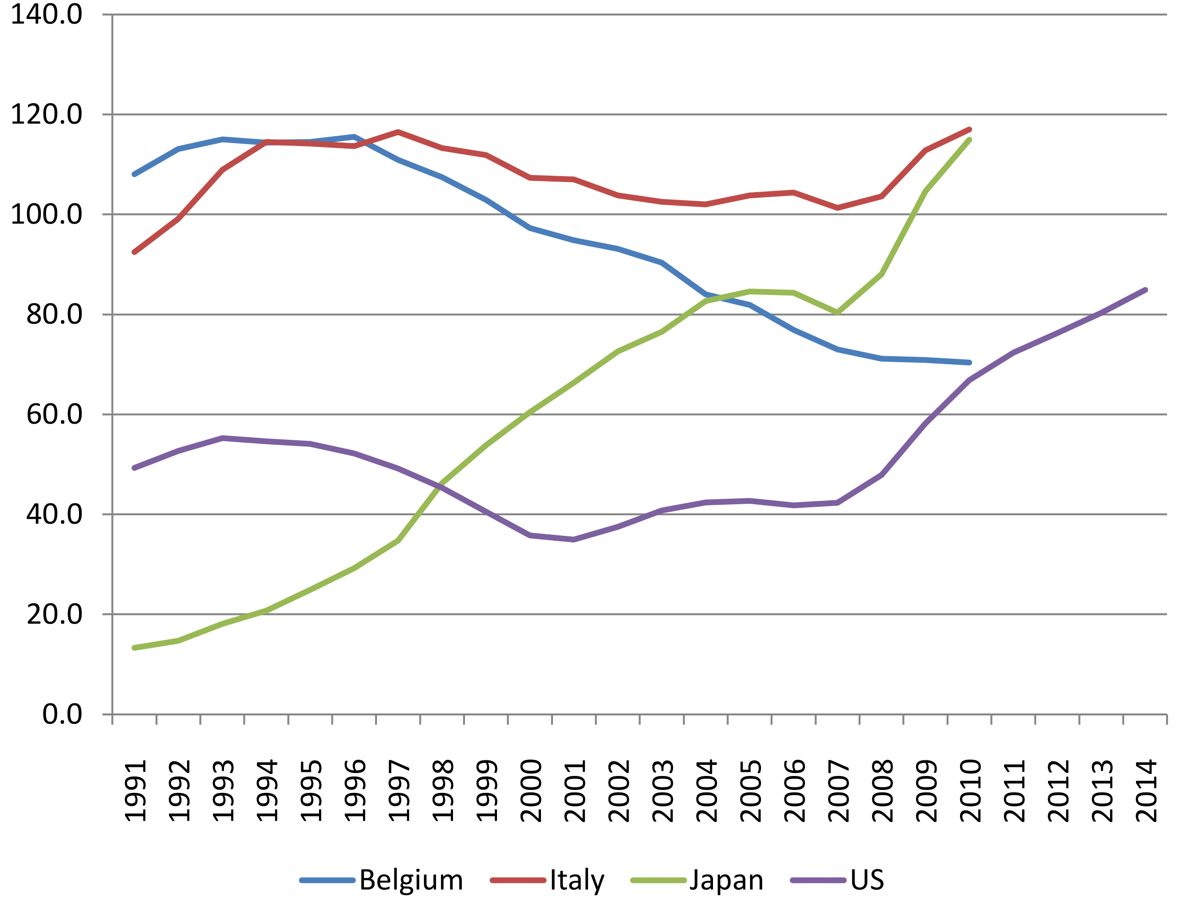
Third best: Job promotion/work sharing

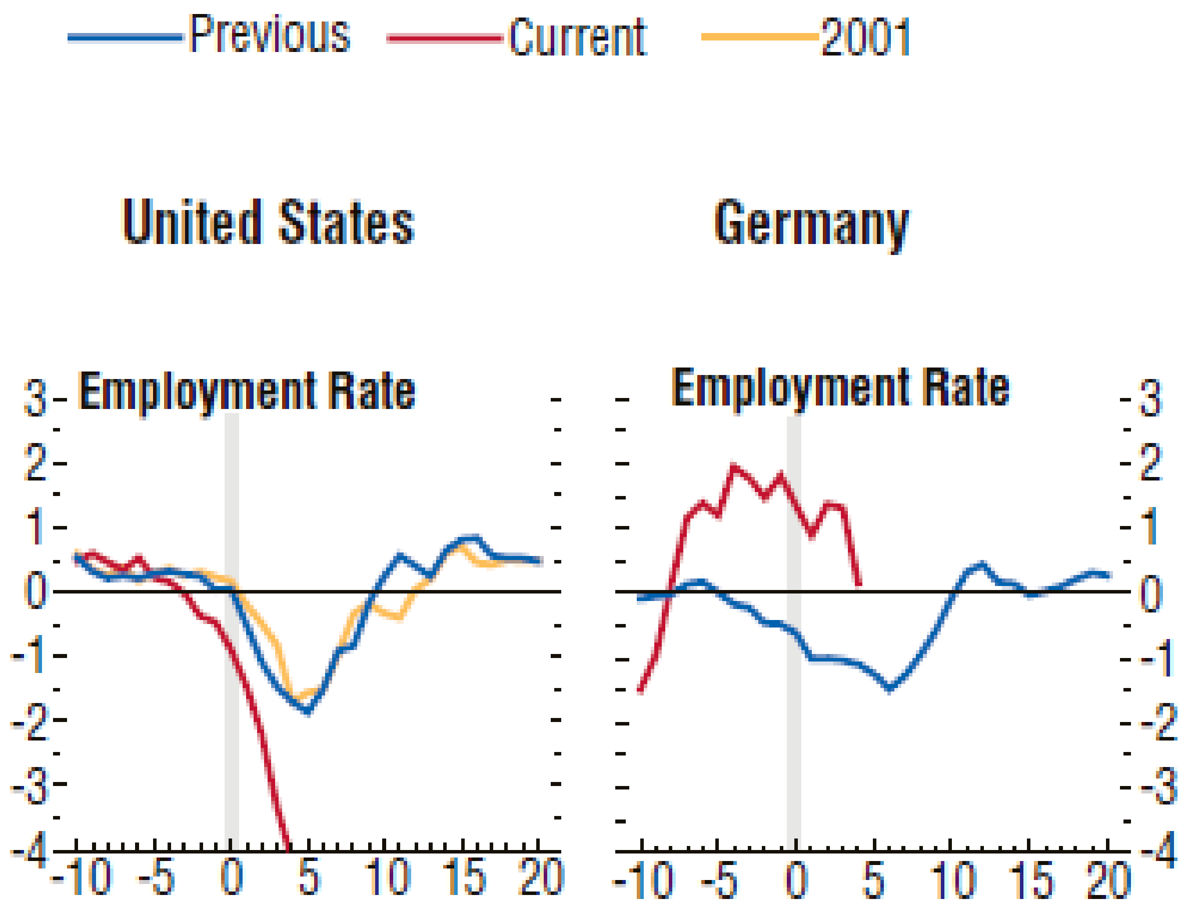

Utils
Marginal cost
Marginal benefit
Full employment
G

Real GDP: US
106
104
102
100
98
96
94
92
2007q04
2008q02
2008q04
2009q02
Actual
Trend


10-Year Treasury Inflation-Indexed Security, Constant Maturity (DFII10)
3.5
3.0
2.5
2.0
1.5
1.0
0.5
(%)
2003
2004
2005
2006
2007
2008
2009
2010
Shaded areas indicate US recessions.
2009 research.stlouisfed.org

Net debt as % of GDP





Previous
Current
2001
United States
Germany
Employment Rate
Employment Rate
3
2
1
0
-1
-2
-3
-4
-10
-5
0
5
10
15
20