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2. The Great Depression:

(a) When the Fed tightened monetary policy in 1928–29, it raised interest rates. In Figure 14.9, this is shown in the movement of the economy from point $A$ to point $B$, which caused a small slowdown in economic activity by reducing investment.

(b) The stock market bubble then popped, which created tremendous uncertainty in the economy, further reducing consumption and investment. This is modeled as a negative aggregate demand shock (a lower $\bar{a}_c$ and $\bar{a}_i$),

which shifts the IS curve down and to the left, depressing economic activity further as the economy moves from $B$ to $C$.

(c) The Phillips curve is shown in Figure 14.10. The recession in the economy caused the inflation rate to decline. Because the inflation rate was already approximately zero, the decline through the Phillips curve led to deflation—a negative inflation rate.
(d) If the Fed had left the nominal interest rate unchanged, then the deflation would have caused the real interest rate to rise even further. To see this, recall the Fisher equation, \( i_t = R_t + \pi_t \), which can be rearranged to yield \( R_t = i_t - \pi_t \). If \( i_t \) does not change, then a decline in \( \pi_t \) will cause the real interest rate to increase. This is shown in the original IS/MP diagram in Figure 14.9 by another shift up in the MP schedule. The economy moves from \( C \) to \( D \), causing yet another decline in short-run output. The combination of these three factors caused a large shortfall in output—that is, the Great Depression.

(e) This exercise reveals how a sequence of events can conspire to reduce GDP below potential by a significant amount (the exact numbers in this exercise—the \(-3\) percent, \(-6\) percent, and \(-9\) percent—are just examples). Moreover, we see the vicious circle between deflation and depression that can continue to push the economy further below potential unless some other change breaks this dynamic. In the actual Great Depression, the Fed devalued the dollar by breaking from the gold standard, which is essentially an “unconventional policy” that allowed the Fed to increase the money supply substantially and create some inflation, ending the deflationary spiral.
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