Inflation-Stabilization Program

- log of Consumer Price Index
- log of US Dollar Exchange Rate
GDP per capita growth (annual %) vs Unemployment Rate from 1977 to 1986.
High-Skill Wage

$w_s$

$\hat{w}_s$

Marginal Product of High-Skill Worker
\[
IN_S(0) = (1 - t)w + b + E(1 + r)
\]

\[
IN_S(c^*) = (1 - t)wp + b + (E - c^*)(1 + r) = I^0 c^*
\]

\[
I^0 c^* = I^0 - E(1 + r)
\]
Risk-adjusted domestic-currency return on foreign-currency deposits,

$$R^* = (E_{t+1}^{\text{exp}} - E_t)/E_t + \rho (B_t - A_t^1)$$

Sterilized purchase of foreign assets

$$R^* = (E_{t+1}^{\text{exp}} - E_t)/E_t + \rho (B_t - A_t^1)$$

Real domestic money holdings

$$M_t^2/P_t$$

Domestic interest rate,

$$L(i_t, Y_t)$$

Real money supply
Real Interest Rate

\[ r = i - \pi \]

Output Gap

Note: The down-pointing arrow indicates that the real interest rate is driven down by the central bank, which lowers the nominal interest rate at a pace faster than the rate of decline in inflation. The assumption is that the inflation rate reaches zero when the arrow touches the horizontal coordinate, at the point where the nominal interest rate is set at its zero lower bound.