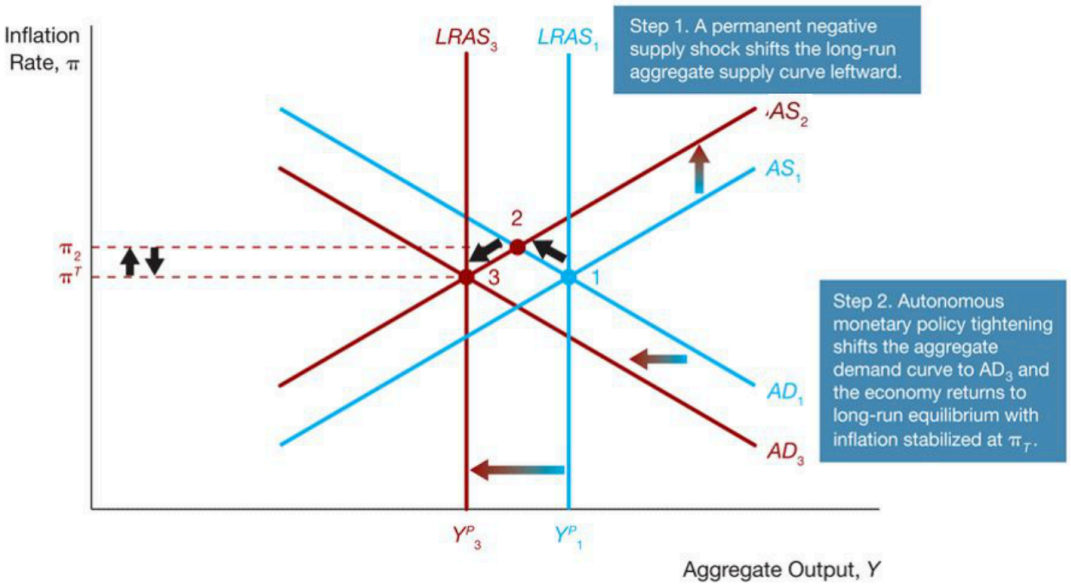
1: Divine coincidence

The divine coincidence exists when policies that are appropriate to achieve price stability also stabilize economic activity. In this case, policymakers have easier jobs because there is no trade-off between policy objectives and they do not have to choose between them. It is called divine as central banks are able to achieve its dual mandate – price stability and output stability (full employment).

The divine coincidence occurs when the economy has aggregate demand shocks or permanent supply shocks, but not when it experiences temporary supply shocks. When faced with either of the first two shocks, policymakers can stabilize both inflation and economic activity by enacting policies to shift the economy's aggregate demand curve and return to long-run equilibrium at potential output.

For example, a negative permanent supply shock (could be caused by an increase in ill-advised regulations that cause the economy to be less efficient). This causes LRAS to shift left to a new decreased potential output, and the new positive output gap will cause SRAS to keep shifting left until output settles at the new level of potential output. The central bank will conduct autonomous tightening of monetary policy to stabilise pi, thus reducing AD. An autonomous tightening of monetary policy is a rise in real interest rate for any given inflation rate. An increased real interest rate causes planned investment and net exports to decrease, thus decreasing AD. With decreased AD, the economy returns to the new LR equilibrium with inflation stabilised at initial level, and output at the new potential output. In other words, there is no trade-off between P & Y stability, and divine coincidence holds.



With negative supply shocks that are temporary, both inflation and the unemployment rate increase. In order to reduce the unemployment rate, an expansionary policy must be pursued, which further increases inflation. On the other hand, pursuing a policy to reduce the inflation rate requires a contractionary policy, which further increases the unemployment rate. Thus, with negative supply shocks stabilization policy requires a trade-off between achieving the objectives of inflation stabilization and stabilization of real economic activity.