

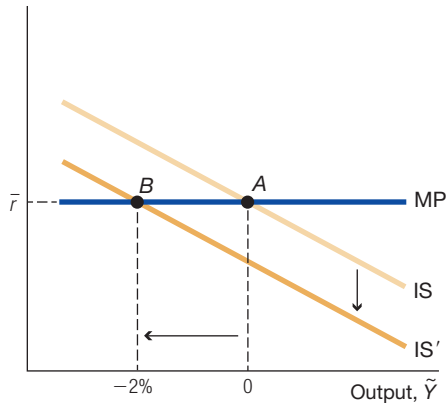
The negative shock leads to a recession as the economy moves from point *A* to point *B*.

The Fed responds by stimulating the economy with lower interest rates, moving output back to potential as the economy moves to point *C*.

FIGURE 12.5

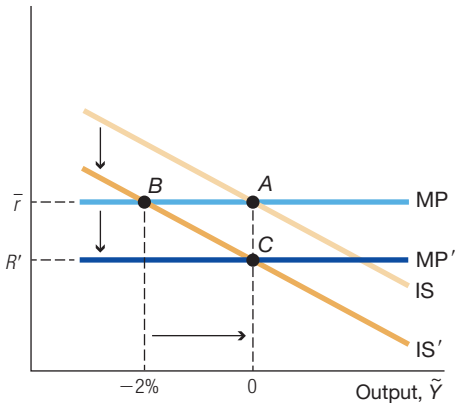
Stabilizing the Economy after a Housing Bubble

Real interest rate, R



(a)

Real interest rate, R



(b)