

MACROECONOMICS AT WORK EXERCISE

GUIDING THE ECONOMY

REFERENCE: 'RBA needs to keep a level head' (by Craig James), *Australian Financial Review*, 20 January 2005, p.47.

CHAPTERS RELEVANT TO THIS EXERCISE: 10, 16

CONTEXT

The rate of interest (by which is meant the general level of interest rates in an economy) is a determinant of the aggregate level of spending in an economy, and hence the level of GDP and, in turn, the aggregate level of employment. The interest rate is influenced by the actions of the central bank (in Australia the Reserve Bank), using the rate of inflation to indicate when action is necessary. (A rate of inflation that is considered 'too high' in terms of the Reserve Bank target is taken to indicate that the aggregate level of spending needs to be cut back by a higher interest rate, which is achieved by the Reserve Bank through open market operations.) – see esp. pp. 307ff. and 366ff. This article discusses some issues surrounding Reserve Bank policy in adjusting the interest rate, particularly the timing of adjustments in response to the level of inflation.

QUESTIONS

1. What are the macroeconomic indicators that action in regard to interest rates may be required by the Reserve Bank?
2. Why is the state of the housing market a difficult indicator to 'read'?
3. What is meant by the expression 'knee-jerk' reaction [on the part of the RBA] in this context?
4. Why might some commentators advocate policies that are considered by others to be 'knee-jerk' reactions and what arguments are put forward against such policies?
5. How do you interpret the fact that 2004 was the first year in a decade that the Reserve Bank had not adjusted interest rates?

6. What predictions are made in the article in regard to interest rates in 2005?