MACROECONOMICS AT WORK EXERCISE

INFLUENCING INTEREST RATES

REFERENCES: 'Greenspan speech keeps rate cut alive' (by Philip Baker) and **'Fed urged to set inflation target'** (by Elizabeth Stanton), *The Australian Financial Review*, May 2, 2003, pp. 35, 38.

CHAPTERS RELEVANT TO THIS EXERCISE: Chapters 13, 16.

OVERVIEW

The first article illustrates the principle that economists need to have two hands (so they can say 'on the one hand…but on the other…'). In this case the economist quoted is Alan Greenspan, the Chairman of the US Federal Reserve (the Fed), a position equivalent to, though somewhat higher profile and more influential than, the Governor of the Reserve Bank of Australia. In a recent appearance before one of the committees of the US parliament, Greenspan identified a number of factors affecting the general state of the economy. Some were positive, some negative. The implication for the Fed's influence on interest rates was therefore ambiguous. The second article also refers to the Fed's policy on interest rates, specifically to the desirability of the Fed adopting a firmer position on its target rate. (At the moment it does not have a 'target rate' as do some other countries, including Australia — see p. 309.) Significantly, however, the concern of the commentator who called for a target rate was concerned not with the *maximum* rate (and hence the level of inflation that the central bank, by adjusting interest rates, should not allow to be exceeded) but rather the *minimum* rate (with a view particularly to avoiding *too low* a level of inflation — and, in particular, the possibility of *negative* inflation — or *de*flation).

QUESTIONS

1. What are the factors that Greenspan identifies as 'positives' — that are likely to lead to, or be associated with, higher levels of economic growth than recently experienced in the US economy?

2. What are the factors that he identifies as likely to cause, or be associated with, lower levels of economic activity and growth?

3. What can be said about Greenspan's overall conclusion, and what implication does this have for interest rates?

4. What is meant by deflation? Why is this a prospect in the US? Why is deflation considered undesirable? What can, and should, the Fed do in light of the possibility of deflation?

5. Would the adoption of a 'target rate' have any, or much, effect?