MACROECONOMICS AT WORK EXERCISE

MONETARY POLICY

REFERENCE: **'Growing inflation raises the pressure for a rate rise before June'** (by Alan Wood), *The Weekend Australian,* 29-30 January 2005, p.37.

CHAPTER RELEVANT TO THIS EXERCISE: 16

CONTEXT

The rate of interest is used as the principal policy instrument for regulating aggregate demand so that in the short term demand is neither deficient (with the result that GDP and aggregate employment is lower than it potentially could be) nor excessive (with the result that the demand for goods and services outruns the capacity of the economy – the potential GDP at any point in time – and there is pressure on prices of both products and resources i.e. inflation). The Australian central bank uses a 'target range' of inflation of 2-3 %. When inflation exceeds, or looks like exceeding, this level the bank acts to influence the rate interest and hence aggregate demand. This article (written in January 2005) examines the economic context in which monetary policy is formulated and predicts that the central bank will increase interest rates within the forthcoming six month period.

QUESTIONS

1. Explain the statement in the sub-heading of the article: 'on the road to capacity, growth must slow'.

2. What was the level of inflation for the year 2004, and what are the indicators of 'rising inflationary pressures'?

3. How literally does the Reserve Bank operate according to its 'target range' of inflation as an indicator of the need to change interest rates?

4. Explain the dangers of the Bank 'over-reacting'.

5. Explain the statement in the article that 'slowing economic growth is not a sign of economic weakness'.

6. Discuss the observations and predictions in the article from the perspective of the time that you are currently reviewing the article.