

MACROECONOMICS AT WORK EXERCISE

THE POSSIBILITY OF *DEFLATION*, AND MONETARY POLICY

REFERENCE: ‘Alarm bells ring at Fed’ (by Peter Hartcher), *Australian Financial Review*, 9 December 2002, p. 53.

CHAPTERS RELEVANT TO THIS EXERCISE: Chapters 16, 18.

OVERVIEW

The analysis of money and monetary policy is based essentially on the proposition (supported by historical fact) that the general level of prices will nearly always increase (that is inflation will nearly always be above zero) (see pp. 249–50). As high levels of inflation are harmful, the goal of monetary authorities will be to keep inflation within a range of zero to three per cent. (This is referred to as ‘inflation targeting’ – see p. 309.) *Decreases* in the general level of prices (or *deflation*) have been rare. However, this article (which is primarily about the US economy and the policy implications for the Federal Reserve [the Fed], the US equivalent of the Reserve Bank of Australia) discusses the possibility of deflation occurring in the present situation, some of the consequences of deflation and what the Fed should do if such a situation occurs.

QUESTIONS

1. What evidence is there that deflation in the US economy is a real possibility?
2. How could deflation occur when there is an 8 per cent increase in the money supply?
3. Why is deflation a bad thing?
4. What measures could be taken to reverse a deflation?