

## MACROECONOMICS AT WORK EXERCISE

### TARGETING INFLATION

**REFERENCE:** ‘Central banks review firepower of inflation-targeting weapon’ (by Alan Wood), *The Australian*, 11 August 2004, p. 21.

**CHAPTERS RELEVANT TO THIS EXERCISE:** 13, 16.

### OVERVIEW

Whatever the causes of inflation, it is associated with a *demand* for goods and services in excess of what the economy is able to produce (its potential GDP at any point in time). Elements of aggregate demand can be influenced by the adjustment of *interest rates* (see pp. 306–7). The adjustment of interest rates is made in accordance with the measured level of inflation (this being done in modern economies by the central bank — in Australia the Reserve Bank — acting in the market for funds by supplying or withdrawing cash). The Reserve Bank (the bank) acts to increase interest rates (and thus lower elements of aggregate demand including investment and consumption) if it considers inflation is higher than desirable (i.e. aggregate demand is higher than the economy as a whole can sustain) and vice versa. It does this according to certain guidelines; different central banks have different inflation *targets* (or in practice target *ranges*) to which they aim in their adjustment of interest rates. This is referred to as ‘inflation targeting’ (see pp. 307–9).

### QUESTIONS

1. Comment on the question posed at the beginning of the article: ‘Why is [the Governor of the Reserve Bank] telling us [the Bank] will put up interest rates, even though it might not do so for a couple of months yet?’
2. What lies behind the argument that ‘inflation targeting’ has been critical to Australian macroeconomic performance in the last couple of decades?
3. Analyse the suggestion by a leading monetary policy theorist (as quoted in the article) that inflation targeting has amounted to

'a revolution in the way central banks talk to the markets and the public'.

4. What is meant by the suggestion that inflation targeting has allowed politicians to talk about interest rates, and in what sense is this considered 'paradoxical'?
5. What are the issues behind the question of whether or not inflation targeting will be able to cope with 'economic shocks' that will possibly occur in the next decade?