MACROECONOMICS AT WORK EXERCISE

MACROECONOMIC CONDITIONS AND INTEREST RATES IN THE US AND AUSTRALIA

REFERENCE: 'The Fed's tough new task: doing nothing' and **'Rumblings of a rate cut'** (by James C. Cooper & Kathleen Madigan), *BusinessWeek*, 19 May 2003, pp. 15–16.

CHAPTERS RELEVANT TO THIS EXERCISE: Chapters 11, 13, 16.

OVERVIEW

The article on the US economy notes that interest rates during 2002 and the first half of 2003 have been virtually stable at low levels, in the context of low levels of inflation (in the 1–2% range). The overnight federal funds rate (the equivalent to what is termed the cash rate in Australia) is currently 1.25%. (The two charts in the article illustrate these levels.) It is noted also that there are high and continuing levels of *productivity* growth in the US. The implication of this is that the aggregate level of production that the economy is *capable* of producing (the potential level of GDP) is rising and requires an increase in aggregate demand to ensure that what is *actually* produced – and hence that labour is employed – keeps up with it. This may require a further lowering of interest rates (in order to stimulate demand and employment). However, a further lowering of interest rates may have a downward effect on the (already low) level of price increases and raises the spectre of the already low level of inflation turning negative, thus leading to a situation of *de*flation. The second article, on Australia, notes a similar dilemma though in the context of a higher level of interest rates (the overnight rate being 4.75% at the time of writing, a level at which it had been held for nearly a year) and a higher level of inflation which rather than being so low as to cause concerns about the possibility of deflation was instead near the upper end of the Reserve Bank's target range.

QUESTIONS

1. What is meant by 'price stability'? Why is price stability a policy goal?

2. Explain what is meant by the term 'output gap' used in the article (p.15). What is the significance of the existence of such a gap for monetary policy.

3. Analyse the statement made in relation to the US economy (p.16) that 'key precursors to stronger [economic] growth are falling into place'.

4. Explain the suggestion (p.16) that 'unlike in past recoveries, the Fed would most likely welcome a strong rebound with open arms – and not take it as a sign to start hiking rates to ward off future inflation'.

5. In terms of the implications for monetary policy, what are the similarities and differences between US and Australian circumstances?