ECON2113 Macroeconomics

Chapter 9 Exercises

Solutions

1. If α, the inflation coefficient in the Taylor rule, is negative, then any increase in the actual inflation rate suggests to the central bank that it should lower interest rates. But lower interest rates will stimulate aggregate demand and therefore increase inflationary pressure. This, in turn, will suggest to the central bank that a further decrease in interest rate may be appropriate. In the end, the country can easily experience runaway inflation. There is some evidence that the U.S. Fed's attempts in the 1970s to achieve low interest rates in response to the oil shocks eventually led to double digit inflation. After Paul Volcker was appointed Chair of the Board of Governors, the Fed decided that long-run nominal interest rates could only be lowered by controlling inflation, which meant that short-run interest rates had to be raised by lowering monetary growth.