TUTORIAL 6

(Week 7)

Reading Guide: Review Section 8.4 and Chapter 9 of BOF as preparation for this tutorial. You should also look over your lectures notes for Week 6.

Key Concepts: Policy Reaction Function; the Taylor Rule; Aggregate demand-aggregate supply diagram; sources of inflation; Disinflation.

REVIEW OF CONCEPTUAL UNDERSTANDING

These are to be attempted before the tutorial. They will **not normally be covered** in the tutorial, maybe, except for a quick review, time permitting. The answers are typically found in the textbook and lecture notes.

1. How has the way monetary policy is conducted in Australia evolved since 1990? Why?
2. What do you understand by the policy reaction function?
3. What do you understand by the concept of disinflation? How does a policy of disinflation affect the economy in the short run, and in the medium or long run?

PROBLEMS

Textbook page 283 (end of Chapter 9): Problems 1, 3 and 5

1. Suppose that the government cuts taxes in response to a recessionary gap, but because of legislative delays the tax cut is not put in place for 18 months. Using an AD–AS diagram and assuming that the government's objective is to stabilise output and inflation, show how this policy action might actually prove to be counterproductive.

2. Suppose that a permanent increase in oil prices creates an inflationary shock and reduces potential output. Use an AD-AS diagram to show the effects of the oil price increase on output and inflation in the short-run and the long-run, assuming that there is no policy response. What happens if the Reserve Bank responds to the oil price increase by tightening monetary policy?

3. Explain how a disinflationary macroeconomic policy (e.g. a contractionary monetary policy) can successfully reduce the inflation rate to a permanently lower level. Use the AD-AS model to describe the initial policy actions, a short run equilibrium, adjustment process toward a new long run equilibrium.

Delve deeper: Attempt Problems 9, 10 and 11 in the Textbook page 284.