Principles of Economics I:
Topic 9 Money & Inflation Tutorial

Question 1

http://www.marketwatch.com/story/deutsche-bank-thinks-this-is-the-biggest-threat-to-the-economy-2016-05-12

Deutsche Bank thinks this is the biggest threat to the economy

By Sue Chang

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Markets are not prepared to deal with this emerging risk

The Federal Reserve is trying to send the markets a message, but one Deutsche Bank economist says people are just not getting it — there is a looming threat to the economy and it's not another recession or a crisis.

"Many clients I meet worry that the biggest macro risk on the horizon is another financial crisis," said Torsten Slok, Deutsche Bank's chief international economist. But the bigger threat, according to Slok, is accelerating inflation.

"This is what the Fed is trying to tell us when they repeatedly point out that we are near full employment," he said.

Slok expects inflation to pick up in the coming months on the back of building wage pressure, but investors are mostly unprepared nor understand how it will impact the Federal Reserve's monetary policy.

"Combining the upward pressure on wages with the ongoing depreciation of the dollar, I think we will continue to see upward pressure on core personal consumption expenditures over the coming quarters," he said.

Wages have been ticking higher in recent months, with average wages up 0.3% to $25.53-an-hour in April, while hourly pay increased 2.5% in the past 12 months. Data also showed that the labor-force participation dropped for the first time since last fall to 62.8%.

The decline in the labor participation rate is likely to be a consistent trend in the foreseeable future due to aging demographics, leading to a tighter labor market, according to Michael Pearce, global economist at Capital Economics.

Meanwhile, the PCE index, the Federal Reserve's preferred inflation gauge, rose 0.8% year-over-year last month, following a 1% jump in March. The consumer price index edged up 0.1% in March, on a seasonally adjusted basis, after slipping 0.2% in February.

Cleveland Fed President Loretta Mester said Thursday that recent data support the Fed's view that inflation will gradually accelerate over time, and noted that the PCE index rose 1% in the first quarter compared with 0.2% in the first quarter of last year.

Slok isn't the only economist to sound the alarm on inflation.

Perma-bear Albert Edwards of Societe Generale likewise predicted that accelerated inflation is likely to force the Fed to resume its tightening cycle. But unlike Slok, Edwards believes this uptick in inflation is ephemeral and if the central bank does opt to hike rates, it will inevitably push the U.S. economy over the edge.

"They will, like Don Quixote, tilt their interest-rate lance at some imaginary inflation windmills, which merely represent temporary end-cycle phenomena, before a slump into outright deflation in the next recession," he said in a note.

a) Both individuals cited believe inflation is on the near horizon. What is the difference between the two views?
b) Describe of each individual's hypothetical scenario using AD-AS supply analysis.

Question 2

a) Suppose that the central bank sells a government bond for $50,000 and that the reserve ratio is the same for in all the banks in the country, 5%. What is the total change in the money supply?
b) Suppose that now half the banks in the country have a reserve ratio of 5% and half have a reserve ratio of 10%. Write down a formula that you could use to approximately calculate the change in the money supply and explain why it won't be exactly correct.

Question 3

Explain, with the aid of a diagram, how monetary policy affects aggregate demand, the inflation rate and output.

Question 4

What are the main reasons to keep a central bank independent from the government?

Question 5

Explain three reasons why targeting a set, positive, low rate of inflation is a good thing.

QUESTIONS FOR SUBMISSION

Students are to submit answers to the following exercises for grading on MyUni by **6pm Friday May 19th**

Question 6

Suppose the following table illustrates the values of real and potential GDP and the associated inflation rate if the central bank was not to act.

Year	Potential GDP	Real GDP (estimates)	Inflation Rate (estimates)
2016	$1660 billion	$1660 billion	2%
2017	$1677 billion	$1665 billion	1.5%

a) If the central bank wants to keep estimated real GDP equal to its potential GDP in 2017, should the central bank use expansionary or contractionary policy? Explain. (3 marks)
b) Should it raise or lower its target interest rate? Explain. (2 marks)
c) How should it conduct open-market operations to achieve its goal? (3 marks)
d) Discuss two reasons why the change in the money supply might not change by the amount expected when the government buys or sells government bonds. (2 marks)