

**MULTIPLE CHOICE**

- |      |       |       |       |
|------|-------|-------|-------|
| 1. B | 6. B  | 11. C | 16. A |
| 2. C | 7. A  | 12. C | 17. C |
| 3. C | 8. A  | 13. D | 18. A |
| 4. C | 9. A  | 14. D | 19. A |
| 5. D | 10. D | 15. C | 20. D |

**SHORT ANSWER QUESTIONS****Question 1**

(a) Inflation rate for year 2 =  $\frac{115 - 110}{110}$   
= 4.5%

Inflation rate for year 3 =  $\frac{122 - 115}{115}$   
= 6.1%

- (b) An answer to this question may include any two of the following:
- The increase in economic growth over the period may have led to demand rising faster than supply, creating upward pressure on prices.
  - If wages have grown faster than productivity, this increase in business costs will be passed on through higher prices.
  - A rise in import prices relative to domestic prices, perhaps due to a depreciation, will increase imported inflation.
  - An increase in taxes may have increased prices either directly, or as the value of an indirect tax is passed on to consumers.
- (c) An increase in aggregate demand stimulates demand for labour. As more people find employment, overall income increases. Where income rises faster than production, inflation will result, creating an inverse relationship between unemployment and inflation.
- (d) Sustained, low inflation benefits import-competing and export firms through increasing their international competitiveness, improving Australia's export performance and stimulating growth. Firms and individuals will also benefit, as the lack of inflationary pressure will keep interest rates low, decreasing the cost of borrowing. Lower prices will also improve individuals' purchasing power.

**Question 2**

- (a) Australia's inflation target is 2-3 per cent underlying inflation averaged over the course of the economic cycle.
- (b) Australia's inflation rate has fallen significantly since the adoption of the Reserve Bank's inflation target in 1996. The RBA has kept underlying inflation within its target band, averaging 2.6% since 1996.
- (c) The Reserve Bank has been successful in keeping inflation within its target band, with inflation averaging 2.6% since 1996. Its use of pre-emptive changes to interest rates to prevent inflation emerging has succeeded in keeping inflation under control. At the same time, it has successfully reduced inflationary expectations, a key source of inflation.
- (d) Microeconomic reform aims to remove barriers to aggregate supply through increasing efficiency of production. Increased efficiency increases total output at a lower cost. Lower costs or an increase in supply places downward pressure on prices, helping contain inflationary pressures. Ongoing microeconomic reform in Australia has contributed to maintaining low, stable inflation over the last decade.

**Question 3**

- (a) Inflation is a significant factor in determining Australia's international competitiveness. High inflation in comparison to Australia's overseas competitors means that prices of Australian-produced goods are comparatively more expensive, harming the international competitiveness of Australian exports and reducing domestic producers' ability to compete with imports.
- (b) An increase in productivity means that the same quantity of inputs can produce a greater quantity of output. Accordingly, each unit of production is cheaper to produce. Therefore, an increase in productivity places downward pressure on prices, slowing the rate of inflation.
- (c) High inflation harms economic growth because it creates uncertainty, deterring investment because firms are uncertain of future profits. Inflation also decreases consumption as it triggers interest rate increases, meaning that debt-repayments consume a higher proportion of individuals' disposable incomes. Inflation will also harm net exports as it reduces the international competitiveness of Australia's exports. Due to the decline in these components of aggregate demand, economic growth will slow in times of high inflation.