

Inflation

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Multiple Choice Answers

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

Short Answer Questions

Question 1

- a) Inflation refers to a sustained increase in the general level of prices in an economy.
- b) Inflation rate = $\frac{110 - 100}{100} \times 100$
= 10 per cent
- c) The economy may be experiencing cost-push inflation due to rising wages. As shown in the table, the wage price index increased from 96 to 102 during year 3. Firms may have been forced to pass on the cost of higher wages in the form of higher prices.
- d) Rising international prices would raise the price of Australia's imports, as Australia is a price-taker in international markets. An increase in the price of imports would result in an increase in imported inflation, raising the Australian inflation rate.
- e) The level of inflation tends to be related to the level of economic growth. During a period of high economic growth, aggregate demand tends to rise faster than the increase in aggregate supply, and firms are forced to raise prices, leading to demand-pull inflation. High levels of economic growth can also cause a reduction in the level of unemployment, leading to a scarcity of labour resources. Workers may then find that they have increased bargaining power in wage negotiation, leading to higher wages which businesses are forced to pass on to consumers, increasing cost-push inflation. A sustained period of economic growth may also lead to a change in inflationary expectations as firms and individuals expect prices to increase and adjust their consumption and price-setting behaviour accordingly. Finally, high inflation can also affect the level of economic growth. Excessive levels of inflation tend to distort consumption patterns and discourages investment due to the uncertainty of the return. Also, high domestic inflation will worsen export competitiveness, leading to lower exports. This can lead to lower levels of economic growth. On the other hand, a low inflation environment may encourage a period of sustained economic growth as businesses are encouraged to undertake investment and export competitiveness improves.

* Please note that this question does not have a correct answer. The answer would be B if the AS curve was shifting leftwards.

Question 2

- a) Australia's inflation rate has fallen significantly from highs of over 10 per cent in the 1980s to around 2 per cent by the early 1990s. Since this time, Australia has generally sustained low, stable inflation between 2 to 3 per cent. This is particularly reflected in the level of underlying inflation.
- b) Globalisation has generally helped to lower Australia's inflation rate. Over the 1990s, falling global manufacturing prices due to heavy global competition helped to lower the price of high value-added products such as consumer electronics. In particular, the emergence of newly industrialising economies such as Hong Kong, Singapore, South Korea and Taiwan (over the 1990s) as well as China (over the 2000s) has caused prices to fall and remain low. Since Australia is reliant on imports for high value-added products, imported inflation has remained low. However, rising oil prices over the past few decades have tended to add to the level of imported inflation. Oil is an important input into production for many industries, as well as a major item of consumer expenditure. Increases in oil prices can lead to both imported inflation and cost-push inflation in the domestic economy. As oil prices have generally risen over the past few decades, this has added to domestic inflationary pressures.
- c) Low levels of inflation are generally beneficial to an economy, encouraging sustained economic growth and stability on financial markets. Low inflation provides certainty to investors that their return on investment will not be distorted by price movements in the future. Similarly, consumers can make their consumption decisions without needing to worry about large changes in prices which don't reflect changes in the value of the product. This encourages sustained stable consumption and investment, providing a sustainable source of economic growth. Low inflation also boosts an economy's international competitiveness as prices will not be rising faster than its trading partners. This boosts the level of exports, reducing the current account deficit and improving economic growth. Low inflation also reduces nominal wage demands in an economy, which means that firms will not face inflationary wage rises and encourages low inflationary expectations. Low inflation also generally improves the distribution of income and wealth since those on fixed incomes do not have their purchasing power eroded by high price rises. Finally, low inflation tends to result in low nominal interest rates which encourages investor confidence and stability on financial markets.

Question 3

- a) Inflation and unemployment tend to have an inverse relationship linked by the level of economic growth. When there is high economic growth, cyclical unemployment tends to fall as firms, facing higher aggregate demand, increase their demand for labour as an input into production. At the same time, prices begin to rise as aggregate demand outstrips aggregate supply, resulting in demand pull inflation. Conversely, when there is low or negative economic growth, demand pull inflation falls due to the fall in aggregate demand. Firms are forced to cut back on their production activities and cyclical unemployment rises.
- b) The level of productivity has an important impact on inflation through the increase in the nominal wage. If the rate of productivity is low and wages are increasing, firms will be forced to pay higher wages to workers without receiving any additional income or production to sell. This will force firms to increase their prices, resulting in cost-push inflation. This may in turn cause workers to demand higher wages to cover their loss in purchasing power, potentially leading to a wage-price spiral. However, when the level of productivity is high, inflation tends to be lower. If wages are rising because of improvements in productivity, firms will be able to pay their workers a wage rise without needing to raise prices since the greater productivity of the workers will mean that the firm has more products to sell. Additionally, when inflation is low, workers are generally forced to increase their productivity if they are to receive a wage increase, and so low inflation can encourage workers to improve productivity.

- c) The government may reduce the level of inflation by using contractionary macroeconomic policy to reduce the level of aggregate demand. The government may use a contractionary budget stance to lower aggregate demand, reducing demand pull inflation. Similarly the government may increase interest rates which lowers the level of consumption and investment, reducing aggregate demand and reducing demand pull inflation. Additionally, higher interest rates would cause an increase in financial inflows, increasing demand for the Australian dollar and causing an appreciation. This would reduce the Australian dollar price of imports, decreasing imported inflation. The Reserve Bank of Australia (RBA) has adopted an inflation target band of 2-3 per cent on average over the course of the economy cycle. By adopting an inflation target and credibly implementing it, the RBA has been able to reduce inflationary expectations as firms and individuals now expect that inflation will remain in the target band. Since the adoption of the target band in 1996, inflation has averaged in the middle of the target band. Finally, the government may use microeconomic policy to reduce cost push inflation. Labour market reforms aim to link wage increases to increases in productivity, reducing the number of inflationary wage increases and lowering cost push inflation. Also, policies such as National Competition Policy aim to increase the responsiveness of aggregate supply to changes in aggregate demand, increasing dynamic efficiency and decreasing demand pull inflation (as firms are better able to respond to changes in demand by increasing output rather than raising prices).