



Inflation

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Multiple Choice

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

Short Answers

Question 1

- (a) Inflation rate (%) = $[(113-106)/106] \times 100 = 6.6$ per cent
- (b) The economy may be experiencing cost-push inflation due to rising wages. As shown in the table, between year 2 and 3 the wage price index increased from 98 to 104. Firms may have been forced to pass on the cost of higher wages to consumers in the form of higher prices.
- (c) Higher rates of inflation tend to have a negative impact on the distribution of income and wealth. Often the incomes of lower income earners do not rise as quickly as prices, resulting in a decline in the real value, or purchasing power, of their income. In addition, the Reserve Bank may raise interest rates to combat higher inflation. Higher interest rates tend to benefit higher income earners as they are more likely to be savers. In contrast, lower income earners will be hurt by higher interest rates as they are more likely to be borrowers, and thus their loan repayments will increase.
- (d) During a period of high economic growth, aggregate demand tends to rise faster than 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. Workers may then have increased bargaining power in wage negotiation, leading to higher wages which businesses may pass on to consumers in the form of higher prices, increasing cost-push inflation. A sustained period of economic growth may lead to a change in inflationary expectations as firms and individuals expect prices to increase and adjust their consumption and price-setting behaviour accordingly. High inflation can also lead to lower economic growth. Excessive levels of inflation tend to distort consumption patterns and discourage investment. Also, high domestic inflation will worsen export competitiveness, leading to lower exports and dampening economic growth.

Question 2

- (a)** Australia's headline inflation rate has fallen significantly from highs of over 10 per cent in the 1980s to around 2 per cent in the early 1990s. Since then, Australia has generally sustained low, stable inflation between 2 to 3 per cent, aside from several one-off spikes including the introduction of the GST in 2000-01 and rising food prices in 2007-08.
- (b)** The removal of trade barriers in the Australian economy would contribute to a lower rate of inflation. A reduction in tariffs would lower the price of imports, and thus imported inflation. In addition, reduced protection would encourage domestic producers to be internationally competitive and put downward pressure on prices.
- (c)** A high inflation rate would cause a decrease in exports as Australia would be less internationally competitive. A high inflation rate would also cause a decrease in financial flows as the real value of investment in Australia would be eroded more quickly and investor confidence in the Australian economy may fall. On the other hand, a high inflation rate may prompt the Reserve Bank to increase interest rates, thus attracting financial flows.
- (d)** The Reserve Bank's use of monetary policy to keep inflation within a target band of 2 - 3 per cent on average over the economic cycle has generally been very effective. Since the 1990s, only several one-off spikes in inflation – such as the introduction of the GST and rising food prices in 2007-08 – saw inflation move outside the Reserve Bank's target band. The effectiveness of the Reserve Bank's attempts are due in part to the use of pre-emptive monetary policy to influence the levels of consumption and investment; while the inflation target provides an anchor for inflationary expectations.

Question 3

- (a)** The Phillip's Curve highlights the inverse relationship between inflation and unemployment. Higher aggregate demand leads to lower cyclical unemployment, as firms increase their derived demand for labour. At the same time, when aggregate demand increases in excess of aggregate supply, demand-pull inflation increases.
- (b)** If productivity increases less than the increase in the nominal wage, firms will be paying relatively higher wages without additional production. To maintain profit margins, firms will be forced to increase their prices, contributing to cost-push inflation. However, when productivity increases relative to the nominal wage, cost-push inflation tends to be lower. Additionally, when inflation is low, workers may be encouraged to increase their productivity if they are to receive a wage increase.
- (c)** The government may use contractionary macroeconomic policy to reduce inflation. For example the government may adopt a contractionary budget stance to lower aggregate demand, reducing demand-pull inflation. Similarly, the RBA could implement contractionary monetary policy by increasing interest rates in order to lower consumption and investment, reducing demand-pull inflationary pressures. Higher interest rates also attract financial inflows, thus causing an appreciation in the Australian dollar and reducing imported inflation. The RBA has also set an inflation target band of 2 to 3 per cent on average over the economic cycle, which has allowed the RBA to control inflationary expectations. Finally, the government may use microeconomic policy to reduce cost-push inflation. Labour market reforms encourage wage increases linked to productivity improvements, lowering cost-push inflation. Reductions in trade protection also aim to reduce imported and cost-push inflation by reducing the price of imported goods.

Skills Revision

Inflation rate in Year 2 = $[(110-100)/100] \times 100$ = 10%	Inflation rate in Year 2 = $[(105-100)/100] \times 100$ = 5%
Nominal rate of economic growth = $[(550-400)/400] \times 100$ = 37.5%	Nominal rate of economic growth = $[(2016-1600)/1600] \times 100$ = 26%
Real GDP in Year 2 = $550/110 \times 100$ = 500	Real GDP in Year 2 = $2016/105 \times 100$ = 1920
Real rate of economic growth = $[(500-400)/400] \times 100$ = 25%	Real rate of economic growth = $[(1920-1600)/1600] \times 100$ = 20%

Event	Impact on inflation	Type of inflation affected
Decrease in real wages growth	Decrease	Cost-push inflation
Consumer confidence and spending in the economy falls due to the onset of a recession	Decrease	Inflationary expectations Demand-pull inflation
Large depreciation of the exchange rate	Increase	Imported inflation
Government prints money to fund a budget deficit	Increase	Monetary inflation
Consumers expect that prices are likely to rise at some point in the future	Increase	Inflationary expectations
The government abolishes the GST	Decrease	Government induced inflation
The central bank increases interest rates	Decrease	Demand-pull inflation Inflationary expectations Imported inflation
The rate of unemployment in the economy rises	Decrease	Cost-push inflation Inflationary expectations
The economy's major trading partners all experience higher rates of inflation	Increase	Imported inflation
Labour productivity across the economy falls	Increase	Cost-push inflation