Inflation

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Multiple Choice

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

* An increase in export sales will improve the current account deficit.

Short Answers

Question 1

(a) Inflation in Year 3 = (CPI Year 3 – CPI Year 2) / CPI Year 2 x 100

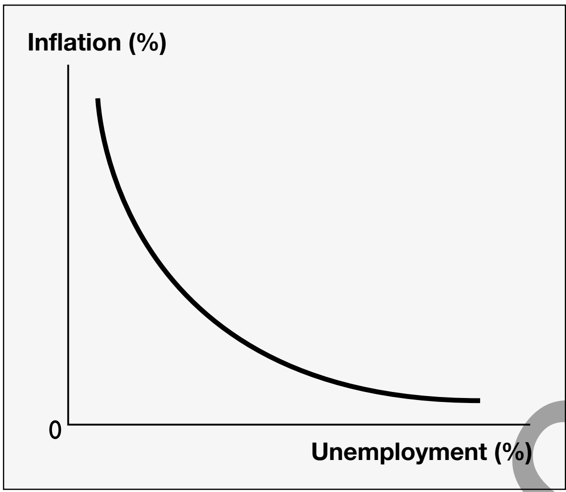
Inflation = (113-100) / 100 x 100

Inflation = 13 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 experienced a large increase from 100 to 110, a rate three times faster than in Year 2. Firms may have been forced to pass on the cost of higher wages to consumers in the form of higher prices, and this may explain the increase in inflation in Year 3.

(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) Inflation and unemployment have an inverse relationship in the short term, as illustrated by the Short-Run Phillips Curve.



The conditions that create lower unemployment generally lead to higher inflation, and the conditions that create lower inflation tend to lead to higher unemployment. Lower unemployment means that there is less available skilled labour to fill new jobs that are created. This shortage of labour supply results in greater bargaining power for workers, leading to higher wages. To maintain profit margins, producers increase the prices of goods and services, resulting in inflation. Similarly, the policies used to reduce the rate of inflation usually involve higher interest rates and a slowdown in economic growth, which in turn will lead to an increase in unemployment. While a short-term relationship exists between inflation and unemployment, in the longer term it is possible to achieve simultaneously low inflation and unemployment, as Australia has experienced in recent years. A combination of macroeconomic policy settings anchored around a low inflation target, plus microeconomic reform to increase competition in the economy, make it possible to shift the Phillips Curve inwards and sustain low rates of both unemployment and inflation.

Question 2

(a) Australia's headline inflation rate has fallen significantly from an average of around 8 per cent in the two decades before the early 1990s, to a level averaging between 2 and 3 per cent since the early 1990s. There have been several one-off spikes in inflation during recent years, including the introduction of the GST in 2000-01 and rising food prices in 2007-08, however inflation has consistently returned to its official target range of 2 to 3 per cent.

(b) The removal of trade barriers in the Australian economy has contributed to a lower rate of inflation. A reduction in tariffs has lowered the price of imported goods, and thus imported inflation. In addition, reduced protection has put greater pressure on domestic producers to be internationally competitive and put downward pressure on the prices of domestic goods.

(c) Higher levels of inflation have a negative effect on trade and investment flows. Higher inflation reduces the international competitiveness of Australian goods and services, resulting in lower export volumes and a worsening of Australia's balance of goods and services. Higher inflation is also likely to 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. A higher rate of inflation is also likely to cause a depreciation in the dollar over time, leading to higher levels of foreign debt and (along with higher interest rates) higher debt servicing costs.

(d) The Reserve Bank's use of monetary policy to keep inflation within a target range of 2 - 3 per cent on average over the economic cycle has been highly effective and has been the centrepiece of macroeconomic policy during the past two decades. Since the 1990s, only occasional one-off spikes in inflation – such as the introduction of the GST and rising food prices in 2007-08 – has seen 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. One of the most important features of this policy success is that low inflation has not come at the price of slow growth or rising unemployment. Instead, Australia has sustained its longest period of unbroken economic growth on record since 1991, and unemployment at around 5 per cent is considered to be around its natural rate.

Question 3

(a) Stagflation occurs where there is simultaneously high or rising unemployment and inflation.

(b) The use of pre-emptive monetary policy, guided by an inflation target, has contributed to low inflation because it has reduced inflationary expectations and allowed the Reserve Bank to act against any rising demand-pull inflation pressures. Second, increased competition in many sectors of the economy because of microeconomic reform has resulted in downward pressures on prices.

(c) There are several aspects to the relationship between inflation and the exchange rate. In the short term, higher inflation can indirectly affect the exchange rate by prompting higher interest rates, which in turn will affect the currency, chiefly through the impact on financial flows for speculative investment (higher interest rates will attract more inflows, possibly leading to an appreciation in the dollar). On the other hand, if the high inflation is expected to prompt a slowdown in the economy due to interest rate increases, foreign investors may lose confidence in the economy and the dollar may depreciate even in the short term. The medium to longer term relationship is felt through purchasing power parity. If two countries have different inflation rates then over time, the country with higher inflation will generally experience a depreciation in its currency.

(d) It is difficult for governments to combat stagflation in the short term, because most policy settings are likely to worsen either unemployment or inflation in the short term. Generally, the approach of governments in recent years has been to adopt an inflation target, and give priority to reducing inflation. However, this will generally cause higher interest rates, lower growth and increased unemployment. The short-term alternative of pursuing faster economic growth to reduce unemployment can also be adopted, through a reduction in interest rates that may stimulate consumption, investment and growth in aggregate demand. However this approach risks worsening the high level of inflation. In the longer term, microeconomic reforms can play an important role in reducing the trade-off between unemployment and inflation and so allow for the economy to increase employment without increasing inflation. Reforms such as increasing competition in different sectors of the economy, reducing trade barriers and decentralised wage determination can all contribute to lower inflation over the longer term without having a negative long-term impact on unemployment.

Skills Revision

Inflation rate in Year 2 = [(110-100)/100] x100 = **10%** Nominal rate of economic growth = [(550-400)/400] x100 = **37.5%** Real GDP in Year 2 = 550/110 x100 = **500** Real rate of economic growth = [(500-400)/400] x100 = **25%**	Inflation rate in Year 2 = [(105-100)/100] x100 = **5%** Nominal rate of economic growth = [(2016-1600)/1600] x100 = **26%** Real GDP in Year 2 = 2016/105 x100 = **1920** Real rate of economic growth = [(1920-1600)/1600] x100 = **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