Economics

Section II (continued)

Marks

Question 24 (10 marks)

The following information refers to inflation.

> The Consumer Price Index (CPI) increased by 0.9 per cent in the December quarter, after rising by 0.3% in the September quarter, to be 3.1% higher over 2001. . . .
>
> However, the outlook for the medium term determinants of inflation has not changed substantially in the light of recent data. Wage and labour cost growth remain contained and are likely to continue to be so given the prevailing weakness in the labour market. The stability of the exchange rate over the past year, combined with downward pressure on world prices from the subdued global economy, suggests that there will be little inflationary pressure from import prices in the medium term.
>
> Adapted from Reserve Bank, *Statement on Monetary Policy*, February 2002

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(a) Define the term *inflation*. **2**

Inflation refers to the undermining of the value of a currency, typically seen by increasing prices for goods and services.

(b) Outline TWO causes of inflation. **2**

* Demand-pull inflation is caused by a increase in demand that is not matched by an increase in supply, this means more money is chasing the same goods so prices rise.
* Supply-cost inflation is caused when supply of a good or service drops, causing the same amount of money chasing less goods or services, meaning prices rise.

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Marks

Question 24 (continued)

(c) Outline TWO negative effects of inflation on an economy. **2**

~~[crossed out]~~ * Inflation greater than 3% leads to overseas investors loosing confidence in the economy, and capital inflow slowing as a result leading to lower interest rates.

* The cost of living increases as goods and services become more expensive, leading to a lower standard of living.

(d) Explain TWO government economic policies that could reduce the rate of inflation in an economy. **4**

* The main policy used for inflation targeting is monentary policy. When economic growth rises rapidly consumer confidence increases, meaning more spending. When Aggregate Demand exceeds Aggregate Supply then inflation occurs. By increasing interest rates (RBA) the government can slow economic activity, and consumer spending. This slows the rate of inflation as Aggregate Demand decreses.

* ~~[crossed out] budget~~ A surplus budget means that the government is taxing more than its spending. This means there is a leakages in the economy. In times of high economic growth, and also inflation, this takes money out of the economy and slows the rate of economic growth.

End of Question 24

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