2002 HIGHER SCHOOL CERTIFICATE EXAMINATION

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 is the rate at which prices (demand-push) increases.

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

① An increase in prices of houses may force inflation to rise, which is caused by an increase in demand, and decrease in supply.
② Wage-price spirals can impact inflation: as wages are forced up (possibly by ↑ed level of industrial disputes), inflation rises which again forces wages up.

Question 24 continues on page 16

Marks

Question 24 (continued)

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

1 Inflation will force the cost of goods and services to increase. This will have negative effects on low income earners who may not be able to afford the new prices. 2 As inflation rises, the RBA may choose to increase interest rates to slow inflation which may cause a decrease in spending and ∴ an increase in unemployment.

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

(1) Monetary policy can be ~~use~~ implemented overnight to slow inflation to a sustainable level. Contractionary monetary policy will increase interest rates ~~&~~ slow spending and will slow the increasing rate of inflation.
(2) Labour market reforms → the movement to a decentralised labour market means that wages are determined by direct negotiations between employer and employee. This reduces the incidence of an increase in wages due to demand and supply and ∴ keeps inflation at a manageable level.

End of Question 24