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 a term used to refer to the change in the price of a good or service over a period of time. In Australia we use the Consumer Price Index (CPI) which is measures the change in price of a basket of goods commonly purchases by individuals in the economy. This measures the headline inflation rate.

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

Demand Pull inflation is caused when demand for a good increases dramatically and the price of that good is increased in order for a company to capitalise on that demand. Cost - Push inflation is where the production costs of a good increase and to prevent job losses the price of that good rises so that a company can afford to pay the wages of his/her employees. These are two common types of inflation and their causes.

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Marks

Question 24 (continued)

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

International ~~competetiveness~~ drops as a result of the real value goods and service being worth less on world markets. The money an export buyer would pay would not be worth as much.
One other negative effect is that real incomes become worth less as the growth in incomes is counteracted by inflation increases as the money paid for their contribution to the factors of production is worth less.

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

The government can use its Macro-economic policies in a ~~Expan~~ Contractionary manner to reduce inflation.
Monetary policy can be used to reduce the rate of inflation, through the RBA's (Reserve Bank of Australia) ~~for~~ actions through its domestic market operations, to raise interest rates. (~~Expansionary Policy~~).
In Raising interest rates it effects Aggregate demand in the economy by reducing the demand for goods and services to fall, resulting in a decrease in prices, resulting in a reduction of inflation.
In a similar manner ~~expansionary~~ contractionary Fiscal Policy can be implemented to reduce the level of inflation. By either reducing government Expenditure ~~or~~ and/or increasing taxation levels it can reduce aggregate demand and reduce inflation.

End of Question 24