ECONOMICS

2003 26. Discuss the causes of inflation and the policies available to the Australian Government to control the rate of inflation.

Plan:

Intro: Define inflation, outline causes, outline policies

Body 1: Demand Pull Inflation

Body 2: Cost-Push Inflation

Body 3: Inflationary Expectations

Body 4: Imported Inflation

Body 5: Taxes and Increases in the money supply

Body 6: Monetary Policy (demand pull inflation)

Body 7: Fiscal Policy (demand pull inflation)

Body 8: Reduced Protection (Imported Inflation), Labour Marker Reforms (Cost-Push), Spending on Infrastructure (Cost-Push)

Inflation which is currently at 3.6% is the sustained increase in the general price level of an average Australian household basket of goods and services over a period of time or the loss of purchasing power for consumers. There are several causes of inflation including demand-pull, cost-push, inflationary expectations, imported inflation as well as government taxes and excess money supply. Increasing inflation is a concern for the economy as it reduces the purchasing power of consumers and distorts economic decision making. For this reason the government uses its various economic policies including monetary, fiscal and microeconomic reforms to reduce inflation levels.

Demand-pull inflation is caused by the increase in aggregate demand in an economy. This occurs when aggregate demand exceeds the productive capacity of an economy and consumers bid against each other for the limited goods and services available, as there is no increase in short term output. This type of inflation occurs during upturns in the business cycle such as that pre-GFC, when inflation was at highs of ___. The figure below demonstrates the relationship between aggregate demand, total output and inflation (general price level).

Cost-push inflation is caused by increases in the cost of factors of production i.e. land, labour and capital. When the cost of production rises due to these factors, firms will attempt to push on the costs to consumers so they can maintain profit margins. This will ultimately raise the price level of the good or service, reflected in the consumer price index and thus result in inflation. In Australia, the main types of cost push inflation are a result of wages and oil prices which are used in nearly all industries as a raw material and have risen almost ______ throughout the last decade. Wages typically comprise 60% of total production costs and when wage growth exceeds productivity growth, the cost of labour increases and businesses push these onto consumers resulting in inflation.

Inflationary expectations are another possible cause of inflation which arises from consumer and business expectations on future prices. If consumers expect prices to rise in the future, they will spend more in the short term to avoid paying higher prices and subsequently this will result in demand-pull inflation. Firms that expect demand for their product to increase will raise prices to gain maximum profit once again increasing inflation. Similarly if employees expect price levels to rise in the future, they will demand higher wages in order to preserve their purchasing power. This will

result in increased wage costs and result in cost-push inflation. In the 70s and 80s, inflationary expectations were common and employees often negotiated higher wages without improvements in productivity leading to cost-push inflation of ____.

Imported inflation does not have a significant effect on the Australian economy but is nevertheless a direct form of inflation. The main form of imported inflation is simply through more expensive imports from overseas markets which are experiencing inflation and since 25% of all consumption of import consumption, the general level of prices in the economy will rise.

This could however be brought upon by a depreciation in the exchange rate which would result in imports being more expensive in Australian dollar terms once again causing inflation. Imported inflation may not occur if importers have strong competition with domestic producers and do not want to lose market share. Imported inflation occurred in Australia in the mid 80s when the value of the dollar dropped against the US and inflation rose to _____.

Government taxes can lead to direct short term increases in the price of goods and services leading to inflation. Evidence of this is the GST which raised inflation by ____ and taxes on tobacco and alcohol which are used to discourage the consumption of these products. These are short term increases in price levels and thus are not reflected in the underlying inflation rate which measures the rise in general price levels with exclusions to one-off shocks. Monetary inflation occurs when the increase in money supply outstrips economic growth and the same volume of goods and services correspond with greater volumes of money raising the general price level of all goods and services resulting in inflation.

To reduce the inflation rate, the Australian government must target policies towards the root of inflation i.e. the causes. In recent times the government has been relatively successful in maintaining low inflation in the economy despite strong growth and increasing capacity constraints such skill shortages. Though monetary policy is the most commonly used to target inflation, it cannot sustain low inflation while allowing the government to achieve other economic objectives and is thus used in conjunction with both fiscal policy and microeconomic reforms.

Monetary policy is a demand management tool that has been the main course of action in order to battle inflation since the early 90s. The RBA set an official inflation target of 2-3% in 1996 and has influenced the level of interest rates in the economy in order to keep inflation within this target range. Monetary policy involves the RBA (on behalf of the government) selling to and buying securities from financial institutions in order to decrease or increase the money supply in the short term money market and thus influence the cash rate. If the RBA tightens monetary policy through higher interest rates, it will increase the cost of borrowing and result in lower consumption and investment. Since these are the main components of aggregate demand, demand-pull inflationary pressures will be reduced and result in lower levels of inflation. Interest rates were at all-time highs of 7.4% pre-GFC as a result of rising inflationary pressures sustained at between 2-3%.

Though this strategy has been relatively successful, limitations include that its impacts often have a 6-12 month time lag. For this reason monetary policy has been pre-emptive as it is based on forecasts and estimates about economic conditions in the medium term. Not only this, but use of monetary policy often harms economic growth and this can be viewed as another negative side effect. Since monetary policy id demand side management, it not only slows economic growth in the short term but can be harmful to growth if the cause is not aggregate demand. In such cases tightening monetary policy will simply reduce inflation slightly and economic growth heavily but not target the real cause which may be supply side factors such as cost-push inflation.

Fiscal policy is a macroeconomic policy involving the alteration of the government budget that is not used to target inflation directly but can play a support role to monetary policy. The government can reduce spending to ease demand-pull inflation as government spending often makes up 20-25% of aggregate demand in the economy. An example of this is the continuous budget surplus' during the

Howard government's tenure during strong growth in the economy. In recent decades fiscal policy has assisted with supply side factors such as structural adjustment in the economy to help reduce production costs resulting in lower cost-push inflation. If fiscal policy is successful in target low inflation, it will reduce the need for higher interest rates and decrease the impact on economic growth. However fiscal policy is not as effective in dampening growth as it is in stimulating and this often limits its ability to combat inflation.

Microeconomic reform can be a major policy tool for the government to decrease inflationary pressures in the economy in the long term. Targeted at supply side factors to increase the economy's productive capacity, microeconomic reform can result in lower cost-push and imported inflation. In recent times, greater infrastructure investment and spending on education and training has reduced capacity constraints on the economy resulting in lower cost-push inflation. Similarly labour market reforms have linked wage growth to increase in productivity to ensure that business costs do not rise and result in cost-push inflation. Reduced protection has also resulted in cheaper imports and resulted in lower imported inflation as well as increased competitive pressures resulting in lower prices for goods and services across whole industries. Though microeconomic reforms is highly useful against supply-side inflation, it has no effect on demand-pull inflation and this can be viewed as a limitation.