eLearneconomics: Inflation – general price level changes (1)

Student response ____________________

CELLPHONE PRICE SET TO RISE

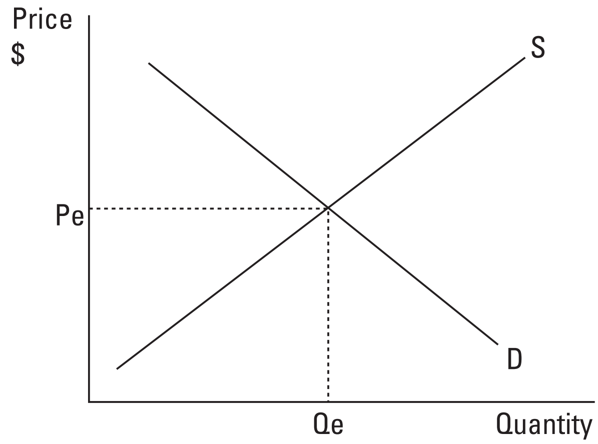
Cellphone prices are set to rise on the back of a falling New Zealand dollar and decrease in direct taxes.

(a) Explain the reason for cellphones increasing in price.

In your answer you should:

- Illustrate the effects of the events described in the resource material. Label the diagram fully and show the new equilibrium price as P1 and quantity as Q1.
- Explain any curve shifts you made AND the change in equilibrium price.

Market for cellphones



(b) Explain why an increase in the price of a cellphone is not considered inflation.

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Solution

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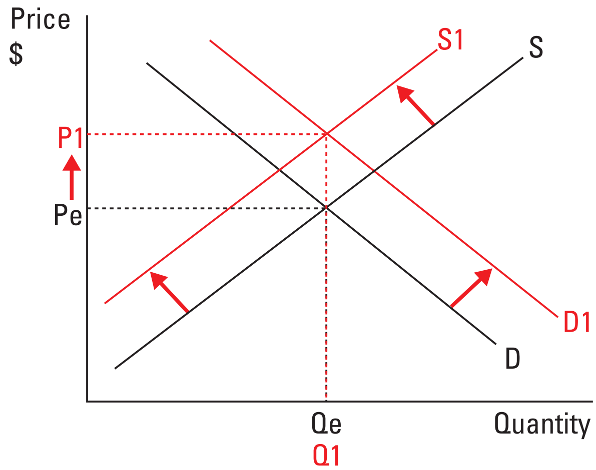
Market for cellphones



S1 shifted left
D1 shifted right
P1 higher than Pe
Q1 labelled
Direction arrows

The supply curve for cellphones will shift to the left (from S to S1) because a depreciation of the New Zealand dollar will increase the costs of production, as costs increase supply will decrease – it will be less profitable for firms to sell cellphones at Pe. A decrease in direct tax will increase disposable incomes and households will be able to afford more at each and every price, therefore the demand curve will shift outward (shown as D shifts to D1).

The price of cellphones will rise because the decrease in supply and the increase in demand creates excess demand or a shortage at the original equilibrium Pe. Consumers will bid up the price to P1.

Equilibrium is restored as quantity demanded equals quantity supplied at the new higher P1.

(b) Explain why an increase in the price of a cellphone is not considered inflation.

The increase in the price of a cellphone is a price increase in one market only. For inflation to occur there must be an increase in the general price level.

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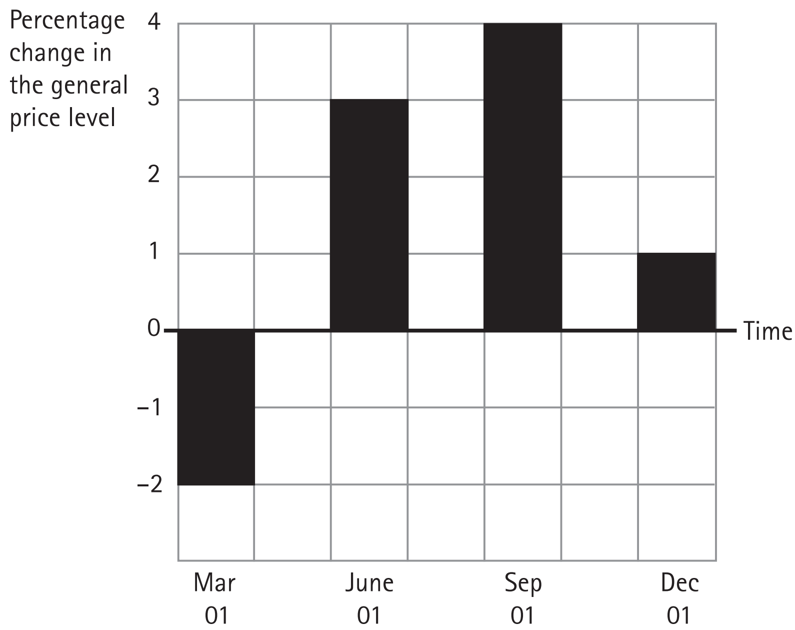
eLearneconomics: Inflation – general price level changes (2)

Student response

Complete the table below by:

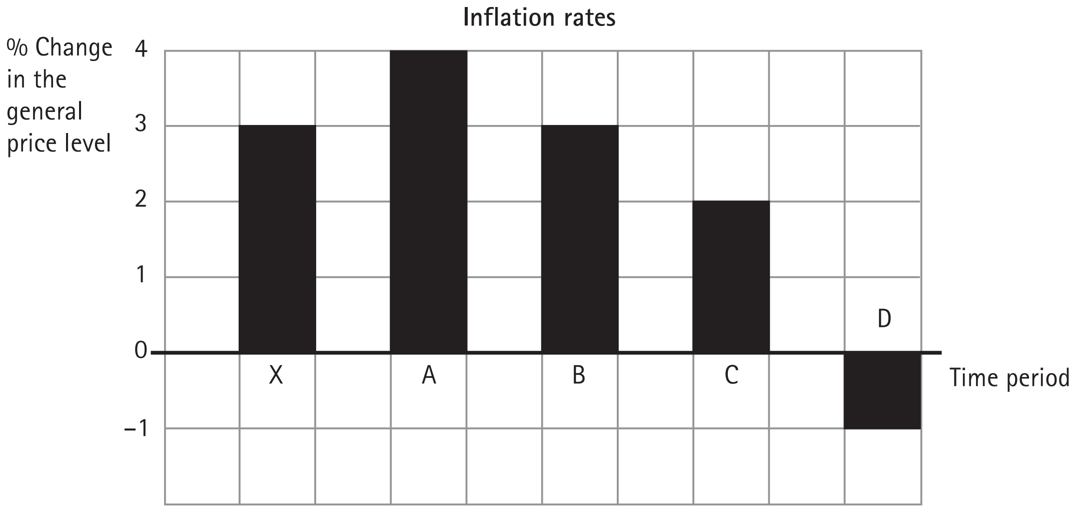
(a) (i) Identifying a quarter in which deflation, disinflation or inflation occurs when compared with the previous time period.

(ii) Give a reason to justify your choice of quarter.



	Deflation	Disinflation	Inflation
(i) Quarter			
(ii) Reason			

(b) Use the graph to complete the table below.



Term used to identify what is happening	Time period
(i) Deflation	
(ii) Inflation/disinflation	
(iii) Inflation	

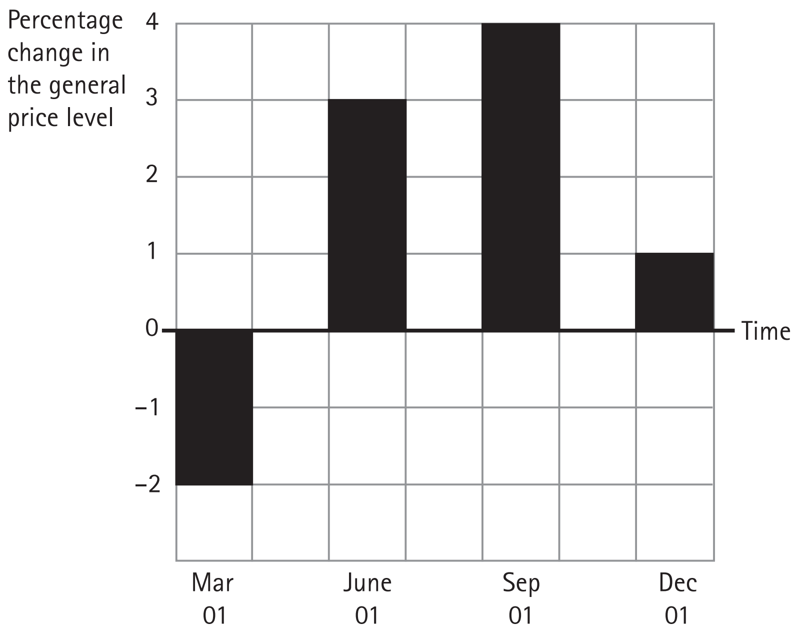
eLearneconomics: Inflation – general price level changes (2a)

Solution

Complete the table below by:

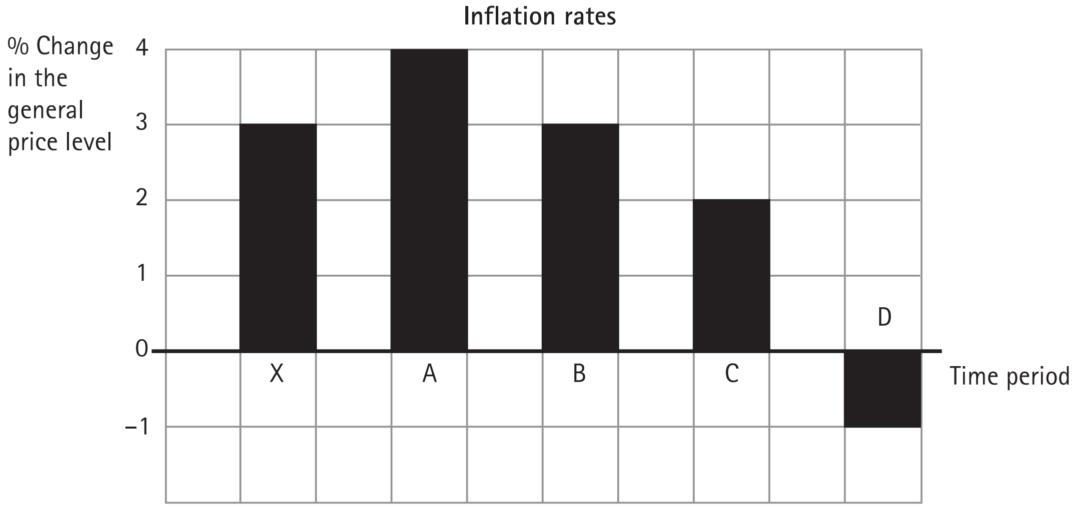
(a) (i) Identifying a quarter in which deflation, disinflation or inflation occurs when compared with the previous time period.

(ii) Give a reason to justify your choice of quarter.



	Deflation	Disinflation	Inflation
(i) Quarter	March 01	December 01	June 01 (September 01)
(ii) Reason	There is a fall in the general price level i.e., –2%	The rate of inflation is falling i.e., inflation was 4% in Sep 01 but 1% in Dec 01	The average level of prices increase by 3% (or 4%)

(b) Use the graph to complete the table below.



Term used to identify what is happening	Time period
(i) Deflation	D
(ii) Inflation/disinflation	B or C
(iii) Inflation	A or X

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eLearneconomics: Inflation – general price level changes (3)

Student response ______________________

(a) Is a price rise in a particular market the same as a rise in the general price level? Justify your answer.

(b) Explain the terms 'disinflation' and 'deflation'.

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eLearneconomics: Inflation – general price level changes (3a)

Solutions

(a) Is a price rise in a particular market the same as a rise in the general price level? Justify your answer.

No. A price rise in a particular market indicates a rise in the price of a single good or service whereas a rise in the general price level means that inflation is occurring and the average price level of all goods and services has increased.

An increase in the price of a particular good or service does not mean that inflation has occurred. Inflation means the average level of prices is rising and a dollar will buy less now compared with a previous time period, i.e., the purchasing power of the dollar is falling.

(b) Explain the terms 'disinflation' and 'deflation'.

Disinflation is the term that describes the process of reducing or eliminating inflation.

Disinflation occurs when the rate of inflation is falling, i.e., the average price level is increasing but by a smaller percentage than before.

Deflation is the opposite of inflation and occurs when the general price level is falling. Inflation is a negative and the Consumer Price Index will be falling. In times of deflation individuals may be put off spending because they expect prices to fall, this may cause economic activity to slow down.

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