Analyse the causes of inflation and discuss the effects of inflation on the Australian economy. Evaluate the policies available to control the level of inflation in the Australian economy.

Inflation is the sustained rise in the general price level of goods and services over time. It can be caused by changes in either demand or supply, resulting in demand-pull or cost-push inflation. Alternatively, the depreciation of the Australian dollar (AUD) will also cause imported inflation. Inflation is an economic issue as it leads to the fall in the value of money or real purchasing power which has adverse effects on the current account, unemployment and income inequality. To combat this, the government employs macroeconomic and microeconomic policies to ensure inflation is at a sustainable level.

Demand-pull inflation is when aggregate demand exceeds aggregate supply as shown on diagram 1. As the AD curve moves outwards to AD' and AS curve remains constant, the output of the economy increases to Y' as an increase in aggregate demand will result in economic growth which causes the price level, P, to increase to P'.

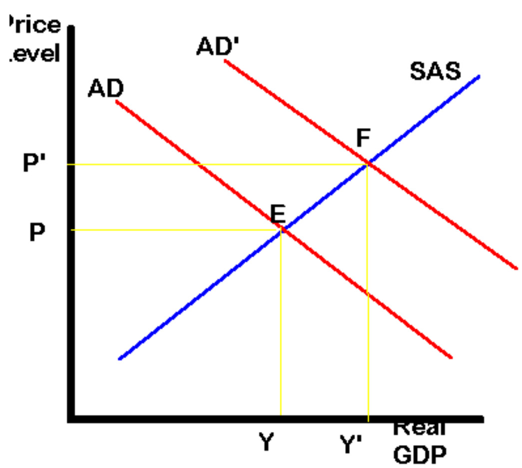


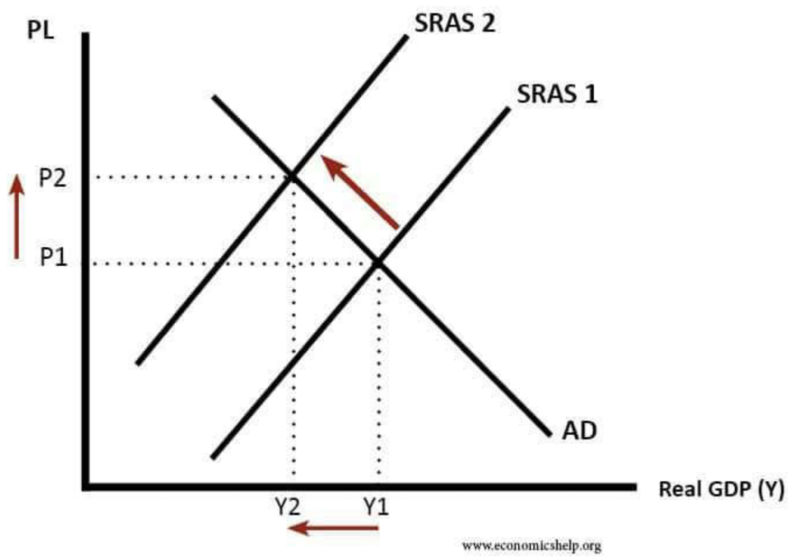
Diagram 1 - Aggregate demand and supply graph showing outward shift of AD

This is because higher demand for goods and services, caused by increased government or consumer spending, and the economy producing near its productive capacity, cannot respond by increasing output, so they must increase prices, leading to demand-pull inflation. This can be seen during the second mining boom (2010-11) where economic growth rose from 2.7% in 2010 to 3.4% in 2011, signifying the increase in aggregate demand which was a result of increasing export revenue from China. Australian producers could not respond with the increase in consumer spending so there was demand-pull inflation, shown as inflation increased from 2.7% in 2010 to 4.7% in 2011. Hence, inflation can be caused by an increase in aggregate demand without a proportional increase in aggregate supply.

Furthermore, inflation can occur when an increase in cost of production is passed on through higher prices. An increase in the cost of production will lower the level of technical efficiency and productivity and thus aggregate supply as shown in diagram 2. Assuming aggregate demand is constant, the increase in production cost will cause aggregate supply to decrease as shown,

Diagram 2 - Aggregate supply and demand graph showing inward shift of AS

SRAS 1 shifted inwards to SRAS 2, causing the economy's output to decrease from Y1 to Y2



and prices to increase, from P1 to P2. This is because disruptions in the production chain such as protectionist barriers or natural disasters will increase the cost for the producer and it will become unsustainable to produce at the same price as profits decrease. Cyclone Yasi in 2011 destroyed $300 million worth of crops in Queensland, mainly bananas and sugarcane. As Queensland provides 90% of Australian bananas, the cyclone obliterating 75% of banana crops caused its price to skyrocket to $12/kg, much greater than its usual less than $5/kg price. Inflation rose from 2.7% in 2010 to 3.3% in 2011 as a result.

Another cause for inflation is the depreciation of the AUD causing prices of imports to increase. With the depreciation of the AUD, prices of foreign goods increases as the purchasing power of Australian consumers decreases. Also, producers who input from overseas or purchase foreign capital will see higher production costs as their purchasing power decreases with a depreciation which may lead to cost-push inflation as they maintain their profit margins. From 2016 to 2017, the AUD depreciated from 0.76 to 0.72 which resulted in inflation rising from 1.28% to 1.95%, driven by price increases from automotive fuel and tobacco which tend to be sourced or produced from overseas. The final main cause for inflation is inflationary expectations where consumers and businesses expect prices to rise in the future so they purchase goods and services immediately to avoid higher prices. This instigates demand-pull inflation as there is an increase in aggregate demand and not enough time for producers to respond, thus aggregate supply stays constant.

High levels of inflation can worsen the current account deficit (CAD) as it impacts the BOGS account. If Australia's inflation rate is higher than global economies' then Australia's international competitiveness will decrease as their exports will be relatively more expensive than its competitors. Inflation will cause prices of exports to increase due to either demand-pull or cost-push and assuming price elasticity of demand of Australian exports, there will be decreased demand for Australian exports, leading to reduced export revenue, worsening BOGS. Furthermore, with domestic prices increasing and remaining higher than foreign substitutes, domestic consumers may prefer imported goods and services due to their relatively cheaper price, thus increasing import spending, further worsening the BOGS account. Conversely, low inflation will improve the BOGS account and reduce the size of the CAD as seen in 2017-2019, inflation was on a 2 year downward trend from 2% in 2017 to 1.61% in 2019 which caused BOGS to improve from -$1.6 billion in 2017 to $8.6 billion in July of 2019, causing the current account to enter a surplus of 0.3% of GDP in the same month. Therefore, a positive inflation rate differential will cause international competitiveness to decrease, worsening BOGS and increasing the size of the CAD.

The short run Phillips curve describes the inverse relationship between inflation and unemployment. High levels of inflation tends to indicate increased economic activity as there is an increase in aggregate demand causing that demand-pull inflation and in times of increased economic activity, unemployment is usually low as there is increased demand for goods and services and as labour is a derived demand, there is also an increase in demand for workers to respond to the increased economic activity, thus decreasing unemployment, moving to point A as shown on diagram 3.

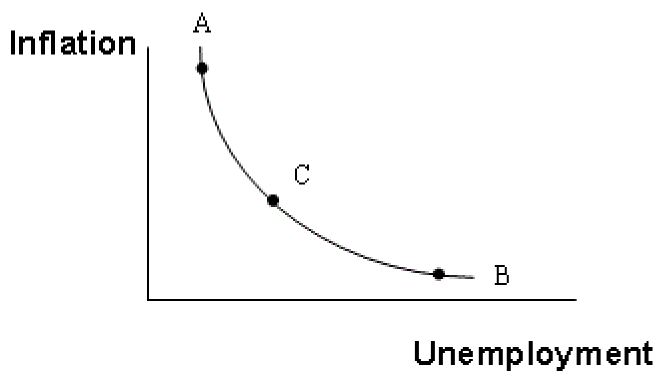


Diagram 3 - Inflation vs Unemployment

Conversely, low levels of unemployment can cause unnecessary cost-push inflation as businesses may have inefficient or unneeded workers due to a mismatch of skills, leading to higher inflation. This short-term inverse relationship can be seen in the later half of 2014 when inflation peaked at 3% before decreasing to 1.3% at the end of 2015, causing unemployment to rise from 5.6% to 6.1% in that same time period. The optimal point in this relationship is known as the non-accelerating inflation rate of unemployment (NAIRU) where cyclical unemployment is zero. This means that structurally or seasonally unemployed workers are allocated efficiently thus will not accelerate inflation to inefficient levels. Australia’s level of NAIRU historically tends to be around 5-6% however recently it has decreased to 4.5% due to low productivity and hence low wage growth over the 2010-2020 decade. Thus moderate levels of inflation can have positive effects such as low unemployment.

Low levels of inflation can improve the distribution of income as household goods and services are more affordable to low income households and high income households cannot benefit from rising asset prices. In times of high inflation, low income households cannot afford to save as their autonomous consumption increases whereas higher income households are not proportionately affected as much, allowing them to still save and invest their money elsewhere to generate more wealth, widening the gap between low income and high income earners, worsening income inequality. Inflation's downward trend from 2008 to 2015, decreasing from 4.44% to 1.51% has allowed the Gini coefficient to also decrease from 0.34 to 0.32, showing signs of improving income inequality. Moderate levels of inflation have further benefits for consumers and businesses as it enables price stability, allowing them to make long term decisions as future prices and costs remain predictable. This promotes investor and consumer confidence, allowing for greater investment and economic growth in the long term. Another benefit of low inflation is that it avoids deflation where prices decrease which leads to delayed consumption, decreasing economic growth and possibly leading to a recession.

To respond to inflation, the government can use two macroeconomic policies however monetary policy is favoured over fiscal policy as monetary policy can more directly influence an individual's decision to spend or save. Since inflation targeting in 1991, the RBA has successfully reduced the high levels of inflation through maintaining demand-pull inflation, shown as inflation was 7.33% in 1990 before falling to 1.94% in 1994 after inflation targeting. When inflation is above the target range of 2-3%, the RBA will employ tightening of monetary policy which incurs higher interest rates to incentivise savings as it will increase returns on investment while discouraging borrowing, decreasing consumption, leading to lower aggregate demand and thus lower demand-pull inflation. In 2016, inflation fell to 1% due to slowing economic growth and wage growth, leading to the RBA decreasing cash rate to 1.5% from 2.25%, causing inflation to rise to 2% in 2017. Monetary policy is the most effective tool to maintain low inflation however it has limitations of being subject to impact time lag and being a blunt instrument, it may have other impacts on the economy.

Another tool available for the government to utilise is microeconomic policies such as reducing protectionist barriers and introducing enterprise agreements, linking productivity to wages. Trade liberalisation throughout the 1980s saw a significant drop in inflation as overseas producers no longer had to increase their prices to cover for tariff costs, allowing them to decrease their prices to maintain competitiveness which will decrease CPI, leading to decrease in the level of inflation. Moreover, the introduction of the Fair Work Act 2009, allowed employees to bargain for their wages, leading to more productive employees to earn more. However this has had the converse effect due to historic low productivity in Australia, wage growth has been slow and thus inflation has been below the target band of 2-3%.

In summary, inflation can be caused by demand-pull or cost-push as well as the depreciation of the AUD, leading to imported inflation or inflationary expectations. Inflation can cause the CAD to worsen, lowering unemployment and worsening the distribution of income. It is commonly managed by monetary policy to be within the 2-3% target range in order to avoid the effects of deflation while incentivising consumption without creating uncertainty in the economy.