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Inflation and Oil Prices

Inflation refers to persistent increase in the price level over time and is one of the most dangerous threats to an economy because if unchecked it will erode the purchasing power of a currency and if the monetary system of the country is destroyed, can ultimately force the individuals to adopt foreign currency.

There are two kinds of Inflation: Demand Pull and Cost Push Inflation.

Cost Push Inflation: A situation when inflation persists in the economy because of initial decrease in aggregate suppky caused by an increase in the real price of an important factor of production i. e wages and energy. Oil Crisis of 1970 is a suitable example of cost-push(supply shock) inflation.

Answer 1)

Short Run Aggregate Supply is the relationship between Real GDP and the Price Level. In other words, it shows how much the economy can produce in the short run. An increase in price level of oil in the short run will force the producers to reduce the supply of oil in the economy . Following diagram will suitably explain the effect of rise in oil prices on Short Run Aggregate Supply:

SRAS''

SRAS

Demand

The above figure shows that when the price of oil increases, producers will shift the supply backwards on account of high input prices. As a result, real

GDP falls and price level rises and a serious situation of Stagflation is created.

Answer 2)

Increasing price of oil will be a serious concern for the consumers also. Working on the law of demand, as the price of oil increases, the consumers of oil related products i. e gasoline, will reduce their demand at higher prices. Thus, as a result their consumption of oil for driving, burning and production will be curtailed.

Answer 3)

As we have already discussed that inflation refers to persistent increase in price levels in the economy, in such case it continues to be a threat for a general consumer also. As inflation knocks the door of an economy, prices of goods and services starts increasing and this reduce the purchasing power of the individuals. If inflation is left unchecked it can destroy the faith of consumers in the currency of home country.

Similarly, inflation also has its affect on time value of money. At times of inflation in the economy, value of each dollar in the pocket of consumers keeps on diminishing because of rise in cost of living and other necessary products. Thus, with reducing value of money where the salaries and income of the consumers are not able to set off the increased level of prices, inflation tends to reduce the time value of money.

Answer 4)

Increase in price levels of oil have high correlation with inflationary pressures. Commenting on general terms, if the price of oil increases, goods which are made or derived from crude oil will be expensive and will add pressure on the disposable income of the consumers.

Answer 5)

At times of persistent increase in price levels of oil, inflation will continue for a long period of time and will have the following effects on the economy:

- High oil prices directly increase the prices of goods made with petroleum products and will indirectly increase the costs of transportation and manufacturing. This increase in cost will affect the prices of many other goods ande services as producers will shift the burden on consumers. As a result, inflation as a whole persist.
- Also, continued increase in price levels will reduce the GDP level and high unemployment along with substantial increase in price level.

Answer 6)

If the price of oil continues to increase, in such case producers will be force to continue reduction in supply of oil in the market. Thus, as the supply continues to fall, price level will increase and with no initial change in aggregate demand, reduces the output to the level of GDP’’. Since the fall in supply is a cost push effect it will lead to fall in GDP level and with low production in the economy, will lead to high levels of unemployment.

In order to understand relation between inflation and unemployment, we have to work out our discussion on Philips Curve and AS-AD Model. Philips curve is a curve that represents the relationship between inflation and the unemployment rate.

SRAS’’

SRAS

Demand

Both of the above figures are drawn with the objective of illustrating effect of rising oil prices/inflation on GDP and Unemployment Levels. The AS-AD model shows a negative relationship between level of inflation and unemployment. In other words, with supply shocks because of rise in oil prices, a fall in GDP rate is experienced and this increases the unemployment rates. So higher prices of oil will not only lead to high inflation but also high unemployment and reduced economic growth. This same effect is shown in the Philips Curve.

Works Cited

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