Effects of inflation

Finance, Financial Analysis

Inflation is defined as a sustained increase in the general level of prices which results in a decline in the purchasing power ofmoney. Inflation is measured through the Consumer Price Index (CPI) which measures proportional changes in prices in a representative " basket" of g'n's, weighted according to their importance in a typical Australian households budget. The RBA aims to keep inflation at an annual rate of 2-3%, and in order to do this a number of policies are available for the Australian government.

Keeping Inflation under control is a primary concern for the Australian Government as it affects so many different parts of the Economy, including Economic growth, standard of living and unemployment. There are three types of inflation, depending on their causes. Firstly, demand pull inflation occurs when there is an excessive aggregate demand at or near full employment. If aggregate demand exceeds aggregate supply, prices of g'n's rise as a rationing mechanism. This form of inflation is usually associated with periods of high economic activity.

Secondly is cost-push inflation. If business costs such as the cost of wages or materials rise, businesses may aim to maintain profit levels by passing these costs onto consumers. This will result in higher prices and therefore inflation. The final type of inflation is imported inflation. Imported inflation occurs when the price of imports rises, and either adds to business costs (resulting in cost-push inflation) or feeds into the CPI as the price of final goods. Furthermore, a depreciation in the Au$ will raise import prices, also adding to imported inflation.

There are a number of factors which may cause inflation in the Australian economy. A major cause of demand-pull inflation is excessive growth in aggregate demand. If aggregate demand increases from AD to AD1, aggregate supply which is the equivalent of real GDP will rise to GDP2 and the price level will rise from P to P2. This results in the inflationary gap of cd. This increase in aggregate demand may be the result of a number of factors, including increases in consumption expenditure, investment spending, net government expenditure, the money supply, or export incomes.

Another major cause of inflation, this time cost-push inflation, is a decrease in aggregate supply. If aggregate supply decreases from AS to AS1, real GDP will decrease to GDP2 and the price level will rise to P1. This results in both a contraction in real GDP and a rise in inflation. The main causes of this decrease in aggregate supply is excessive wage growth not accompanied by productivity increase, a rise in the cost of raw materials, and other inputs, or a rise in government taxes or other charges that raise costs for firms.

Cost-push inflation may also be the result of imported inflation it there is a rise in world prices of imported goods used in the production process (such as raw materials and intermediate goods) firms are likely to pass these costs onto consumers, resulting in inflation on the other hand if there is a rise in world prices of consumer goods, increased import prices will feed directly into the CPI, also resulting in inflation. Furthermore a depreciation in the Au$ in foreign exchange markets will result in a rise in the prices of imported raw materials, intermediate goods, and consumer goods, again contributing to Australia’s inflation.

This is demonstrated in the stimulus when the RBA credits the decrease in inflation to the fading impact of 2000s exchange rate depreciation. A less common cause of inflation is the existence of monopolies or oligopolies. If a monopoly or oligopoly exists in an industry, the lack of competition allows producers to push up prices. This again results in inflation. The final cause of inflation in Australia is inflationary expectations. Inflationary expectations refer to the behaviour of individuals and businesses who seek to compensate for the current inflation, as well as expected future price rises.

This may be the result of either firms pushing up prices, or wage earners seeking higher nominal wages. Also, if consumers expect future prices to rise, they rather buy g’n’s now, which leads to increases in spending. This results in demand-pull inflation. Inflation can impact the economy in 3 ways. 1)By encouraging investment in speculative and unproductive activities and discouraging investment in ventures considered productive. Inflation encourages investment in real assets such as gold and real estate because they are considered ‘ good shelters’ for inflation.

This is because the scarcity of them often outpaces or at least keeps pace with the rate of inflation. If inflation occurs, people will seek to own such assets, shifting resources to these speculative and unproductive assets. Similarly this discourages investment in other assets. This is because entrepreneurs will not think it is financially viable to invest and pursue a project that will only result in less profit, due to the higher costs of inflation. Similarly inflation increases the cost of production thus also discouraging entrepreneurs.

For example, if inflation is high, people will invest in gold and real estate. Otherwise known as the opportunity cost, because people will allocate their resources into such ventures (gold and real estate) they must then forego investing into other ventures that are considered productive such as a new business, that may be producing capital goods or normal goods and services. Also by discouraging entrepreneurs is the rise in the costs of production that occur due to inflation, for example the raw materials.

Similarly interest rates will rise, making it more expensive to borrow funds for investment purposes, making investment projects less profitable. Either way, inflation can cause a loss in production of capital goods, leading to lower living standards in the future, or a loss in the production of normal goods and services, leading to lowering current living conditions, as current needs and wants go unsatisfied. Since returns from productive capital take longer to materialise, it means that entrepreneurs are also faced with a lesser return.

This means that if the rate of inflation is greater than the return offered by the investment, then the project will not be considered economically viable, nor worthwhile. Similarly the risk of loss from any investment project will grow with inflation. Many small businesses take a couple of years before they start to make a profit, so if inflation is high, and is was not taken into account when the business was first planned, then the cost of production may rise, and the resulting price for the commodity will be too high for consumers.) If inflation is present and is greater than that overseas, it reduces the overseas competitiveness of the Australian economy. This is because inflation is not only associated with a rise in prices, but also an

increase to the costs of production. Therefore making overseas exports cheaper to the domestic market. Similarly the overseas firms do not have to put up with the rises in the costs of production. This provides a leakage in the circular flow (purchase of exports) and thus dampening demand in the domestic market, which if severe enough could lead to a recession, bringing with it many economic problems.

An example of how inflation can lead to a recession, would be the 1970s, when high inflation averaged at 10. 4%. Which due to the high oil prices and strong domestic demand led to high inflation in the 1980s (8. 1%). This period of high inflation led to a dampening in spending and a recession in the 1990s (1990-1992) causing many problems such as unemployment. 3) It also creates many winners and losers in the economy. Those that benefit are the owners of real assets (real assets and gold), because their assets are worth more.

As well as those belonging to well-organized groups who can demand wage increases (eg, strong trade unions.) This can lead to rapidly rising wages, increasing the costs of production, and also discouraging investment in productive capital as mentioned above. In addition to this inflation can benefit people who have already borrowed funds because the cost of repayment, represent less as inflation rises. This is because inflation is defined by a loss in the real value of money, therefore the repayment will diminish over time.

Conversely inflation disadvantages those on fixed incomes because they lose the real value of income as their money represents less purchasing power. Similarly for the same reasons it disadvantages those that keep their money

in liquid form (ie, bank deposits). Also those that lend money receive less back in terms of repayment, due to the loss in value (eg, A mortgage repayment in 1960 was worth more than in 1980, where high inflation had occurred).

Also since it reduces international competitiveness, inflation can disadvantage exporters who find themselves with less business opportunities. This can effect the economy, as overseas markets will not purchase Australian goods and services. Therefore the economy will not receive the injection into the circular flow that it would usually, without inflation. Without the strong domestic support that is present in Australia’s economy, the economy could have the effect of dampening economic activity, and aggregate demand.

When inflation occurs in the Australian economy it usually had a number of causes. The main causes are excess aggregate demand, cost-push inflation, inflationary expectations and imported inflation. inflation disadvantages many groups in the economy, who in turn benefit other groups. This is because inflation can influence the allocation of resources in regards to encouraging and discouraging investment, the overseas competitiveness of the Australian market, as well as effecting individuals and firms, who often benefit at the expense of others.