Inflation

Inflation can have significant economic effects. For example, it can influence the distribution of national income and wealth. The relative rates of inflation in Australia and overseas affect international competitiveness. A low and stable rate of inflation is desirable both for the health of the economy and for individual welfare. There are many measures of inflation, each suited to a different purpose.

Inflation – a continuous upward movement in the general level of prices – can impose costs on individuals and the economy. Inflation affects the purchasing power of income and wealth.

When price changes are large, unanticipated or volatile, inefficiencies can occur such as those associated with frequently changing list prices in shops or re-advertising goods and services. Variable rates of inflation can also distort the behaviour of consumers and businesses, who may find it more difficult to predict the effects of their saving and investment decisions.

Although inflation is defined as a rise in the general level of prices, not all prices change by the same proportion or even in the same direction. For this reason, inflation can also affect the distribution of real income and wealth among individuals and households. A relatively steep increase in the prices of items that make up a large part of low income households' expenditure, for example, can cause greater inequality in the distribution of real household income.[1]

Some changes in relative prices can have positive effects as well as the negative effects discussed above, and many economists believe that zero inflation might be undesirable. Changes in relative prices can act as a signal during times of economic restructuring. This restructuring might be brought about by, say, changes in tastes and technology, and can in turn lead to resources being allocated more efficiently.

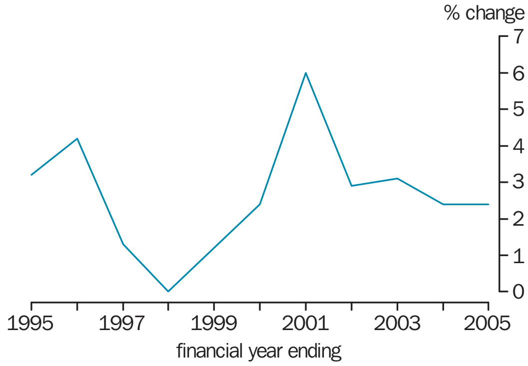
Ideally, an indicator of overall inflation would be comprehensive – it would cover price changes for all goods and services traded in the economy. But different measures of price change are suited to analysing different economic phenomena. Because of the different possibilities for weighting together the prices of various goods and services, there is no single correct measure of inflation.

Trends in inflation – 1995 to 2005

A commonly quoted indicator of inflation is the rate of change in the Consumer Price Index (CPI), which reflects the price of a fixed basket of goods and services acquired by households. Another important indicator is the national accounts chain price index for Domestic Final Demand (DFD). The DFD price index is more comprehensive than the CPI because it covers final purchases by businesses and government as well as households.

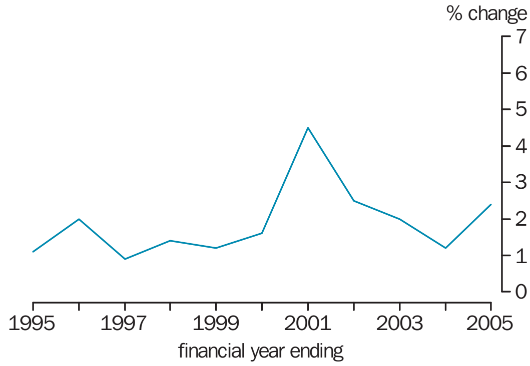
The graphs above show percentage changes in the CPI and DFD indexes for 1994–95 to 2004–05. The introduction of The New Tax System (TNTS) saw a large increase in both indexes between June 2000

CPI, percentage change from previous year



Source: Consumer Price Index, Australia, cat. no. 6401.0.

DFD chain price index, percentage change from previous year



Source: Australian System of National Accounts, cat. no. 5204.0.

and September 2001, the majority of which occurred in the September quarter of 2000. However inflation, measured by excluding items with volatile prices and price movements due to changes in tax regimes, is thought to have stayed relatively low during this period.

Trends in inflation – 1950 to 2005

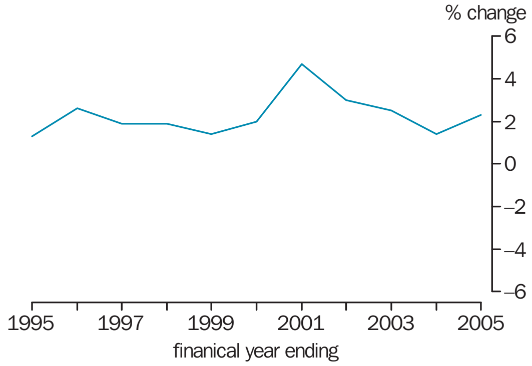
Inflation was relatively low from the mid-1950s to the late 1960s. The sharp rise in inflation in the first half of the 1970s was influenced by higher oil prices, wage growth and other factors. These inflationary pressures persisted into the 1980s, partly due to a second oil price shock.[2] Although at relatively high levels, inflation was fairly stable during the 1980s. It began to slow down in the early 1990s.

Components of inflation

The DFD chain price index can be split into capital and consumption components (for various reasons, the consumption component does not match the coverage of the CPI exactly).

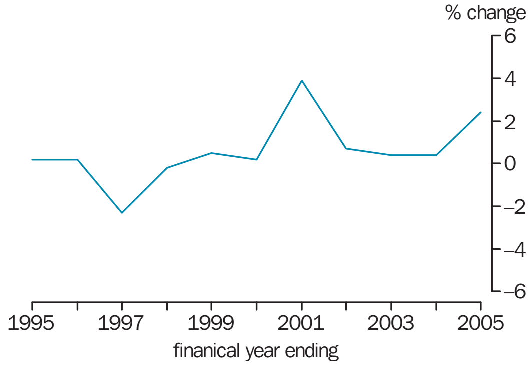
Final consumption expenditure and fixed capital formation involve a rather different mix of commodities, and the factors influencing price change are quite different – for example, changes in the exchange rate are likely to have a bigger impact on prices for fixed capital formation. And so

Chain price index of total final consumption expenditure, change from previous year



Source: Australian System of National Accounts, cat. no. 5204.0.

Chain price index of total gross fixed capital formation, change from previous year



Source: Australian System of National Accounts, cat. no. 5204.0.

one would not expect the two series to behave the same way.

The direction and magnitude of the year-on-year percentage change in the consumption series were often quite different to those in the capital series during most of the 1990s. However, the percentage movements for the two series were more similar in the 2000s.

Factors influencing change

The overall rate of inflation is the outcome of different rates of price rises (or, in some cases, price falls) for various goods and services.

Computer prices have been declining during the decade. At the same time, there have been large increases in the power and quality of computers.

Falling world prices for motor vehicles have also contributed to lower inflation during the past decade.[3]

Petrol prices contributed strongly to inflation during the 1990s (increasing 22.5% from March 1990 to December 1999) and more recently with prices increasing by 16.9% from March 2004 to June 2005, due to a substantial rise in the international price of crude oil.

The introduction of TNTS made a large contribution to the rise in the CPI and other price indexes between June 2000 and June 2001 but the rate of increase in the CPI has slowed since then.

During 1999 and early 2000 there were increases in housing expenditure due in part to many Australians making property purchases and alterations and additions, before the introduction of the Goods and Services Tax (GST) on 1 July 2000. This in turn may have had an upward influence on house prices during the period.

Links to other dimensions of progress

Inflation is linked with almost all other indicators of economic progress. It affects the distribution of income and wealth, and hence the decisions of consumers and businesses. It also affects the external competitiveness of the economy. If rises in the prices of domestically produced goods are small relative to rises in the prices of overseas goods, Australia's international competitiveness improves, provided that nominal exchange rates do not appreciate in response. Improvements in productivity and increased competition in goods and services markets are thought to have contributed to the low inflation rates of the 1990s.[4]

Endnotes

1 University of Melbourne Research Paper 1996, *The Distributional Effects of Inflation in Australia*, University of Melbourne, Melbourne.

2 Economic Planning Advisory Council 1990, *Office of EPAC Seminar 1990*: *Australia's Inflation Problem*, AGPS, Canberra.

3 Commonwealth Treasury 1999, *Budget Strategy and Outlook 1999–2000*, *Budget Paper 1*, Commonwealth of Australia, Canberra.

4 Reserve Bank of Australia 2000, *Australian Macroeconomic Performance and Policies in the 1900s*, RBA Conference Volume 2000 <http://www.rba.gov.au/PublicationsAndResearch/Conferences/2000/GruenStevens.pdf> last viewed 25 April 2006.