**INFLATION**

**Textbook**: Understanding Economics Issues: Part B

**DESCRIBE:**

***Description of the difference between a persistent rise in the price level and a price rise in a particular market***

**STARTER**: What do you know…

1. Page 156- Fill in the blanks
2. Page 159- T and F Questions

**Definitions:**

**Inflation:** A rise in the **general level** of prices over a period of time

**Deflation:** Occurs when there is a fall in the **general price level**

**Disinflation:** When the **rate** of inflation is falling i.e. price level is rising by a smaller percentage than before

**TASKS:**

1. Mix and match the terms with their definitions
2. Label the graph- Page 159 together
3. Graphs- Page 161 (Inflation, deflation and disinflation)
4. Explain how an individual price could cause a general price increase

**Definitions Cont:**

**Consumer Price Index:** Measures the movement in prices of a typical basket of goods and services that represent the average expenditure pattern

**TASK:** On an A4 piece of paper draw a basket of goods and services that you believe is a ‘typical’ basket of goods for a household

**Percentage Change:** Year 2 – Year 1 / Year 1 x100

**TASK:**

Table 8- Page 160- Percentage Change

**Business Cycle:**

+

Changes in Real GDP

PEAK

DOWNTURN

BOOM

**0**

RECESSION

-

**TASKS:**

Put a blank business cycle up and label the business cycle

**USING ECONOMIC MODELS:**

Quantity theory of money to illustrate the relationship between the money supply and the rate of inflation:

**Definitions:**

**M1-** notes and coins held by the public plus account balances at banks (NARROW)

**M2-** M1 plus on call deposit accounts

**M3-** M1 and M2 plus term deposits e.g. Term deposits, Government Bonds, Treasury Bills

**TASK:** Classify the following items

* Your EFTPOS account
* Your online savings account
* Money you have at the National Bank where you get 8% interest- 12 month fixed term
* Cash in your wallet
* Your credit card limit
* Government money  
    
  **QUESTIONS:**
* Why do you think there is less notes and coins in circulation?
* Why is M1 called the narrow supply of money?
* What is a term deposit?

**Definitions Cont:**

**GDP (Gross Domestic Product)** - the total market values of goods and services produced by workers and capital within a nation's borders during a given period (usually 1 year)

**Quantity Theory of Money:** M x V = P x Q

**Purchasing Power:** Purchasing power is the number of goods/services that can be purchased with a unit of currency. For example, if you had taken one dollar to a store in the 1950s, you would have been able to buy a greater number of items than you would today, indicating that you would have had a greater purchasing power.

**Quantity Theory of Money:**

M= money

V= velocity (speed of circulation)

P= price

Q= quantity

Theory **assumes** that if the money supply increases, then inflation will increase **assuming** V and Q are held constant.

I.e. if money supply increases and velocity remains constant, then there must be an increase in either price or quantity to absorb the increase for this equation to remain true.

**Limitations:**

Assumes V and Q are unchanged but this is not always true

**E.g.** When prices rise rapidly people will be **reluctant** to hold money because it is losing its **purchasing power** so they will change it for goods and services as quickly as possible, so V changes.

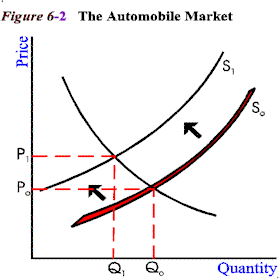
**TASKS:**

1. What products/services have you known about that has caused this type of consumer reaction?
   * Petrol
   * Car Registration
   * Milk
2. If money supply is 1000 and price level is 20 and the quantity of goods is 400, how many transactions would need to take place in the economy in one year?
3. If money supply is 5000 and price level is 50 and the quantity of goods is 1000, how many transactions would need to take place in the economy in one year?
4. What would happen to price if money supply increased by 20%?

**The basic AS/AD model to illustrate cost push and demand pull inflation:**

**ACTIVITY:** **COPY** graphs onto the whiteboard and get students to determine which label goes to each graph i.e. is it demand-pull inflation or cost-push inflation

**Cost Push Inflation**



AD

**Output and employment (Real GDP)**

AS

AS1

**Price Level**

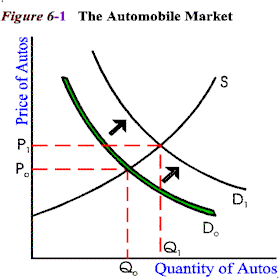
Y1

Y

PL1

PL

**Demand Pull Inflation**



**Output and employment (Real GDP)**

Y1

AD

AD1

AS

**Price Level**

PL1

PL

Y

**CAUSES OF INFLATION: COPY** notes

**Causes of Cost Push Inflation**:

* Wages and salary increases
* Increase in raw materials
* Government changes (indirect taxes or fees)

**Causes of Demand Pull Inflation**:

* Rising household incomes due to direct tax cuts, increased transfer payments and wage increases
* Increased investment by business due to lower interest rates or more confidence in the future prospects of the country
* Export boom due to the depreciation of the exchange rate OR
* Expansionary fiscal policy i.e. a Government budget deficit

**TASKS:**

* **Recap Task each lesson**: Draw a fully labelled cost-push inflation graph and a demand-pull inflation graph with at least three causes for each
* Which graph will be affected by the increase in GST in October, what effect will this have?
* Which graph would be affected by Company tax being lowered to 30%, what effect will this have?
* Pages 172 -173- Fill in the blanks
* Page 179- Graphs

**Interest rates and the rate of inflation:**

**NOTES:**

Higher interest rates mean you pay more for mortgages and credit cards = people have less to spend = reduced inflation as less consumers are placing demands on the economy

Higher interest rates will affect producers requiring loans = increased costs = less spending by firms = reduced inflation as producer spending is not placing demands on the economy

**Lower interest rates mean:**

* More people able to afford mortgages
* More consumer spending e.g. loan for a car, credit card spending
* More demand for goods and services and/or demand may not be able to be met = shortage
* Firms are able to expand through increased revenue or through loans

**QUESTIONS:**

* What does RBNZ stand for?
* Who is the governor of this organisation?
* What is the OCR?
* Why did the governor of the Reserve Bank lower the OCR last year? What result did this have on the economy?

**The Business Cycle:**

**RECAP QUESTIONS:**

1. Draw an illustration of the business cycle
2. What is meant by peak?
3. What is mean by downward turn?
4. What is meant by recession?
5. What is meant by boom?

**EFFECTS OF INFLATION**

**Impact of inflation on firms and households:**

**Questions:**

1. What effect does inflation have on household?
2. What effect will it have on your parents who are about to retire?
3. During hard times workers demand pay rises to help cover the increased cost of living, do you think this helps inflation?

**Impact of inflation on trade and growth:**

1. What effect will inflation have on the price of our exports to China? Why? (Increases costs/inputs, exports are more expensive = less revenue from exports)
2. What effect does inflation have on growth? (Limits growth within an economy, less expansion, less demand = less revenue)

**TEXTBOOK Task**- Page 175

**Inflation Re-cap:**

* 2009 Practice Exam
* 2008 Practice Exam