Economics 101: how issues with the global oil supply can lead to stagflation

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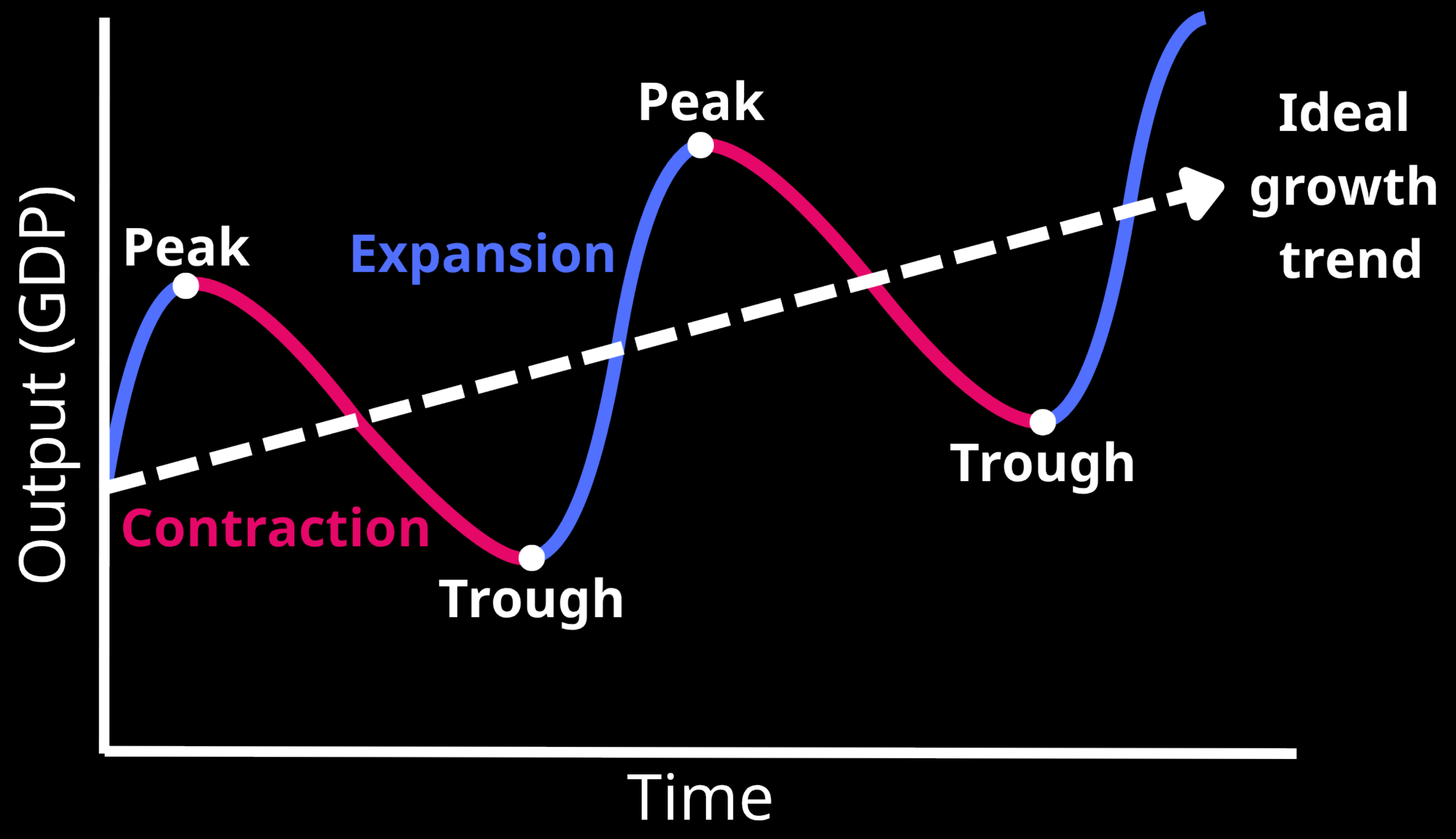
The business cycle

- Economies naturally move through periods of contraction and expansion



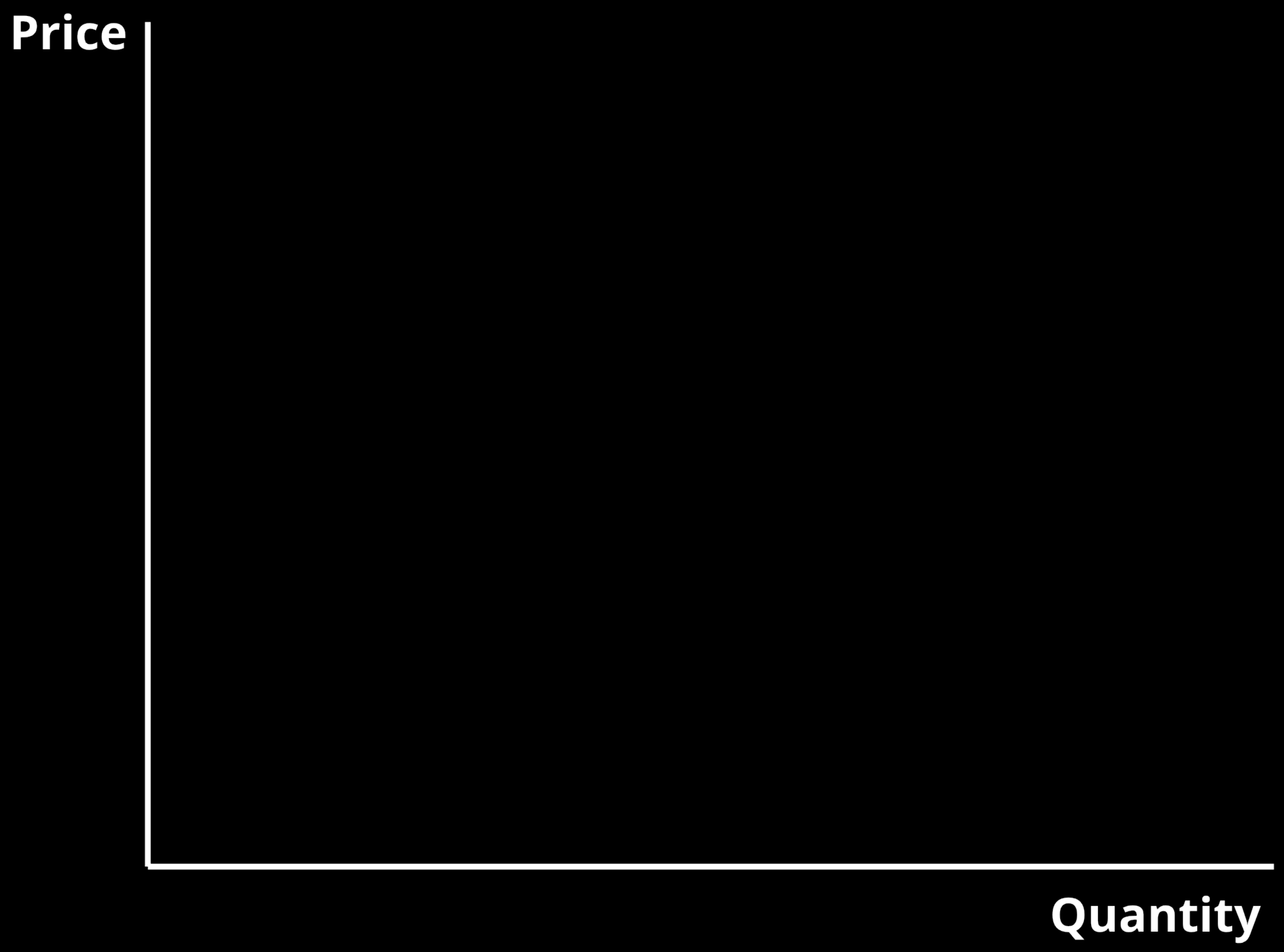
Key economics indicators

- **Gross domestic product (GDP)** = total value of all final goods & services produced within a country
- **Unemployment** = percentage of labour force that is actively seeking work but cannot find a job
- **Consumer spending** = total amount of money spent on goods & services
- **Inflation** = rate at which general price level for goods & services is increasing over time

	During a contraction	During an expansion
GDP	↓	↑
Unemployment	↑	↓
Consumer spending	↓	↑
Inflation	↓	↑

Demand and supply model

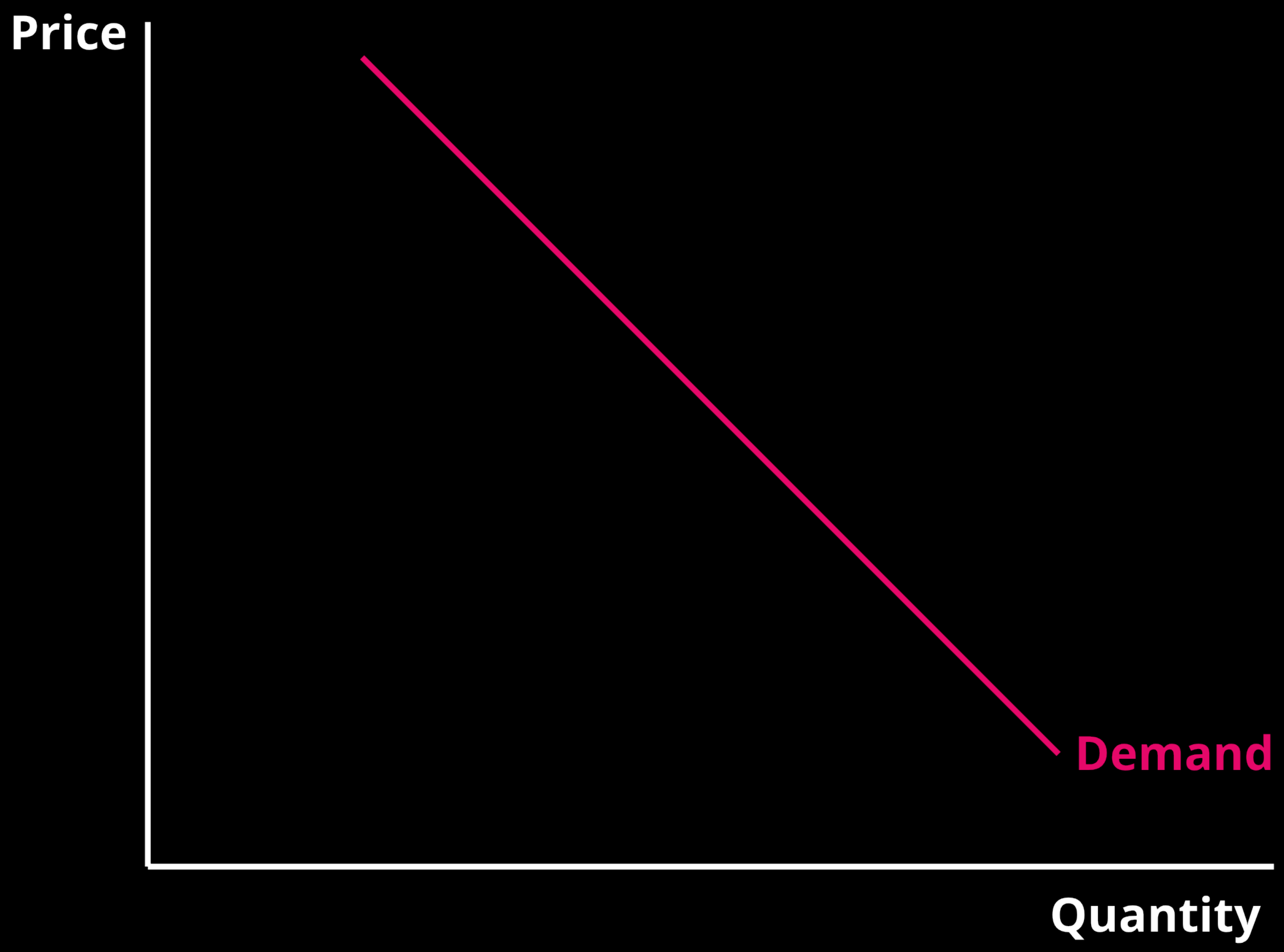
Quantity vs. price of goods & services



Demand and supply model

Demand curve:

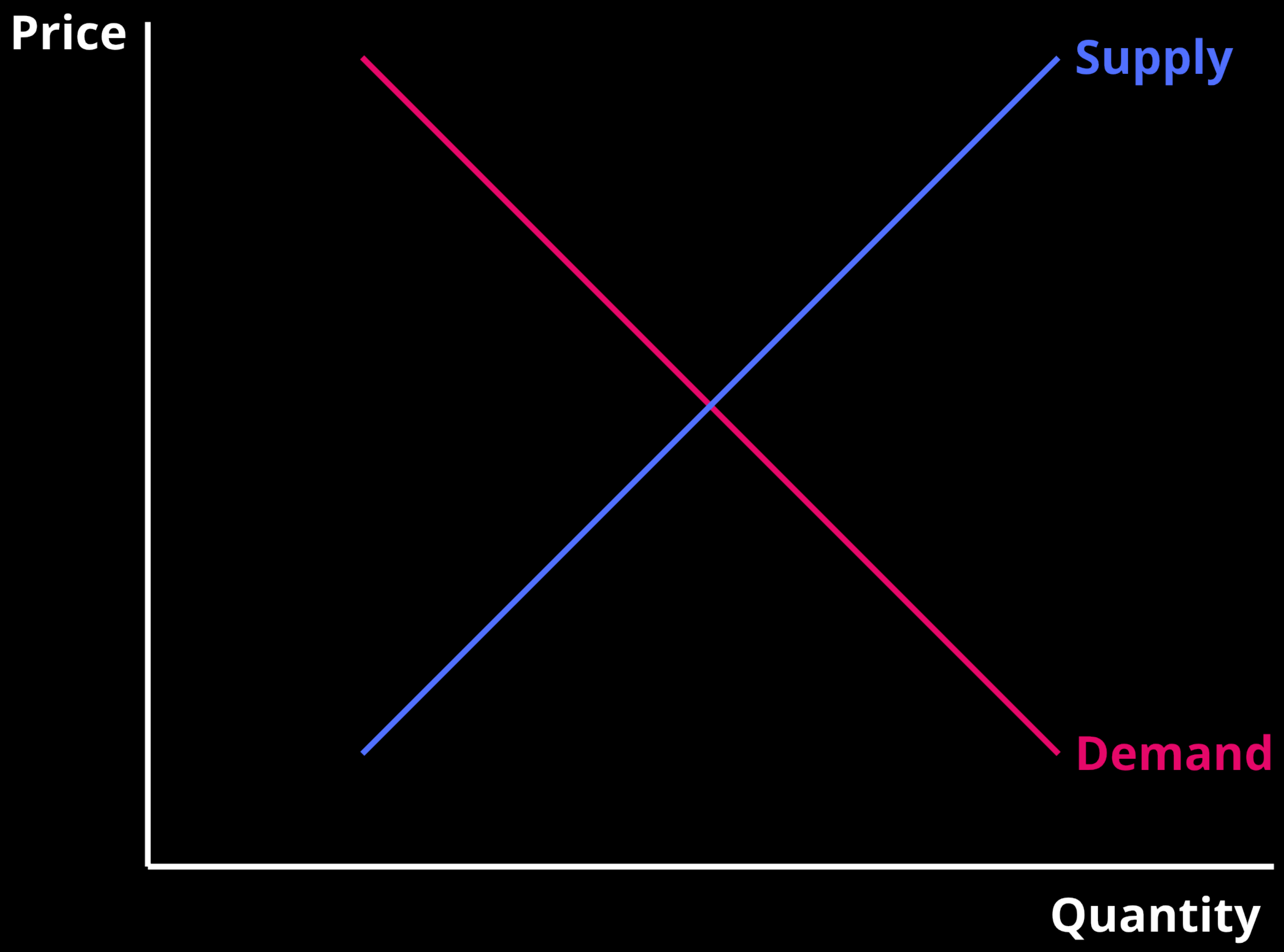
As price decreases, consumers want to buy more



Demand and supply model

Supply curve:

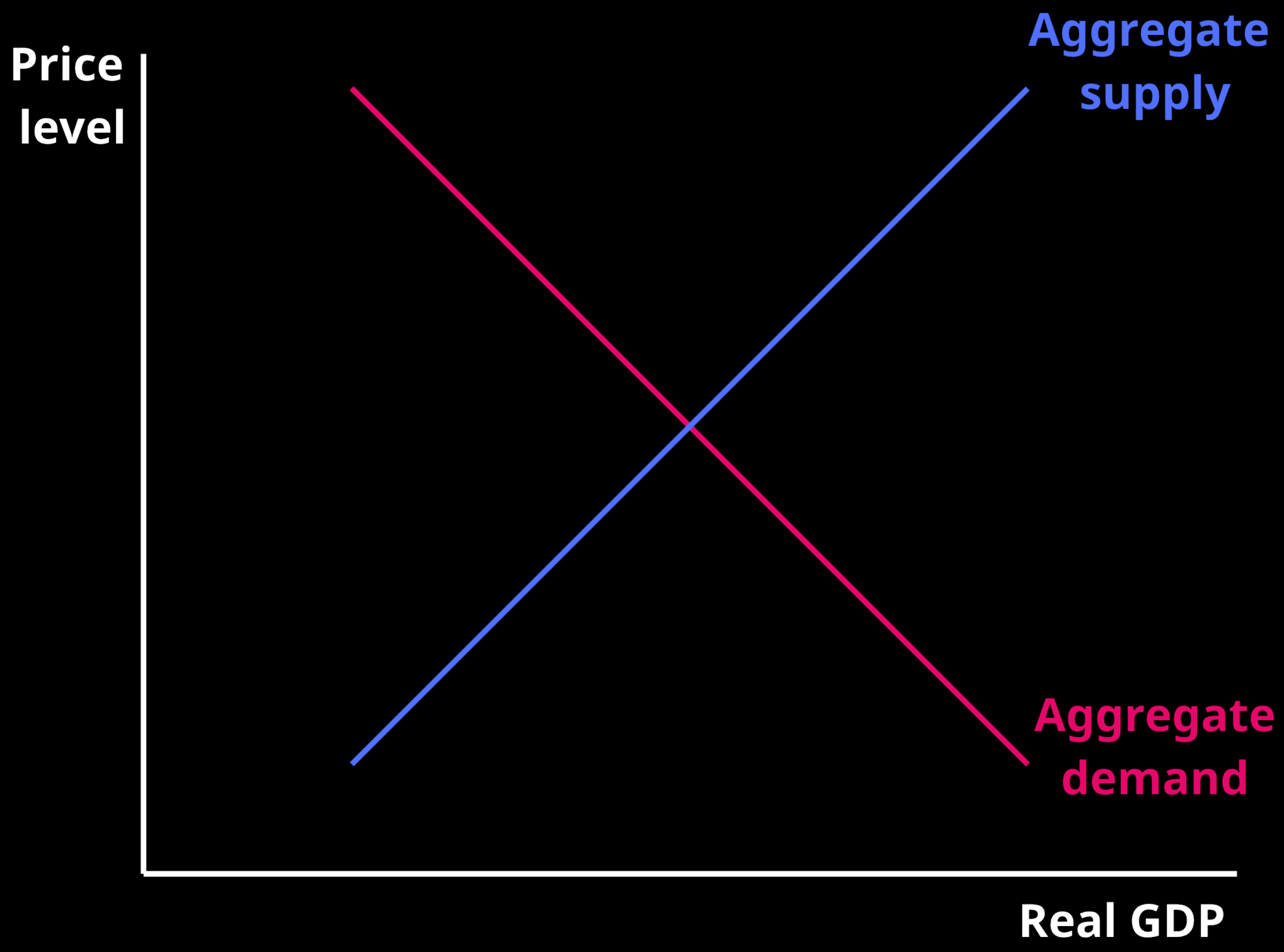
As price increases, businesses want to produce and sell more (maximising profit)



Aggregate demand – aggregate supply model

Applying model to an entire economy…

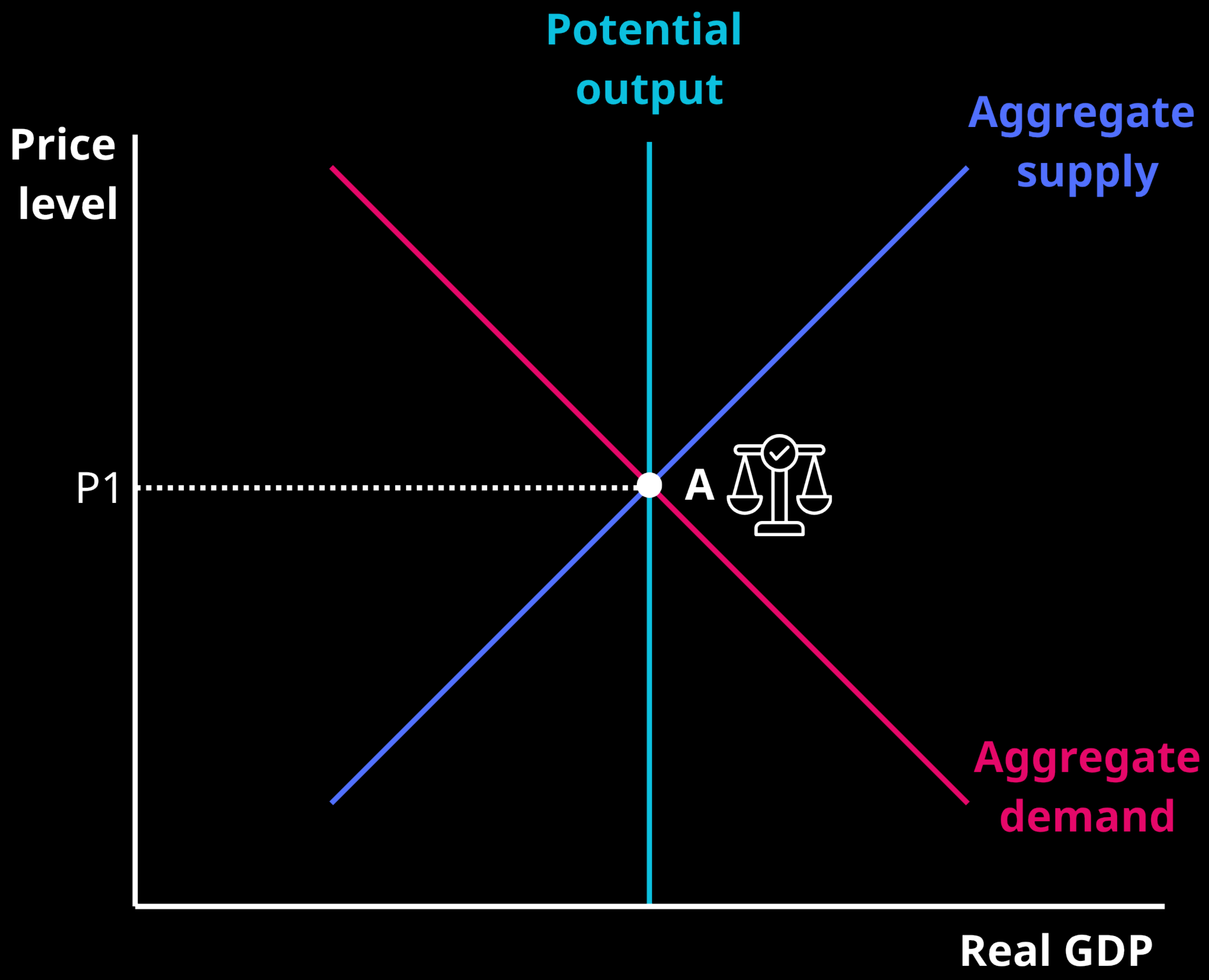
- **Aggregate Demand (AD)** = total demand for all final goods & services
- **Aggregate Supply (AS)** = total supply of all final goods & services



Aggregate demand – aggregate supply model

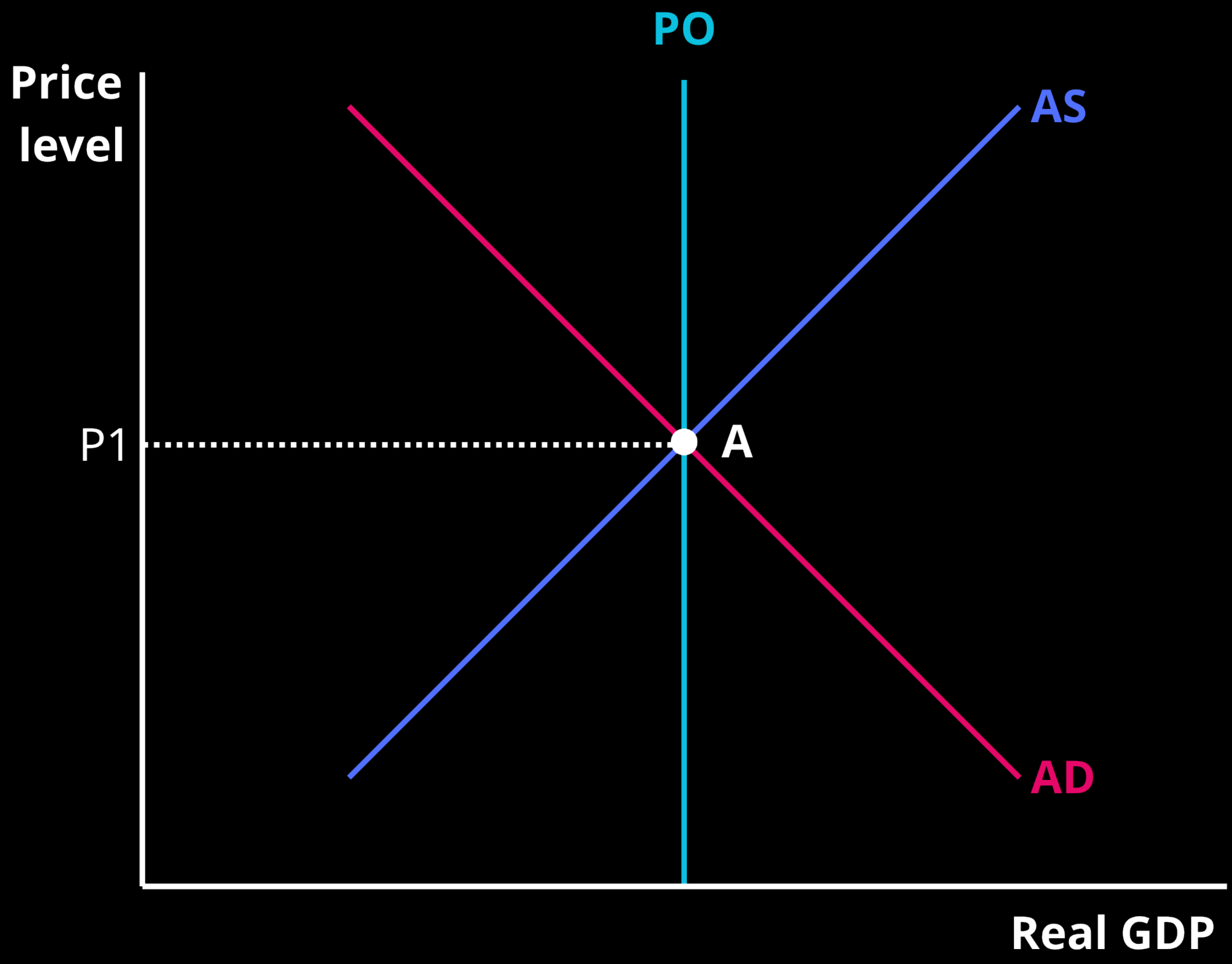
- **Potential output (PO)** = level of production an economy can **sustain** using labour, capital, and technology **efficiently**

- At point A, economy is in **equilibrium** with an average price level, P1



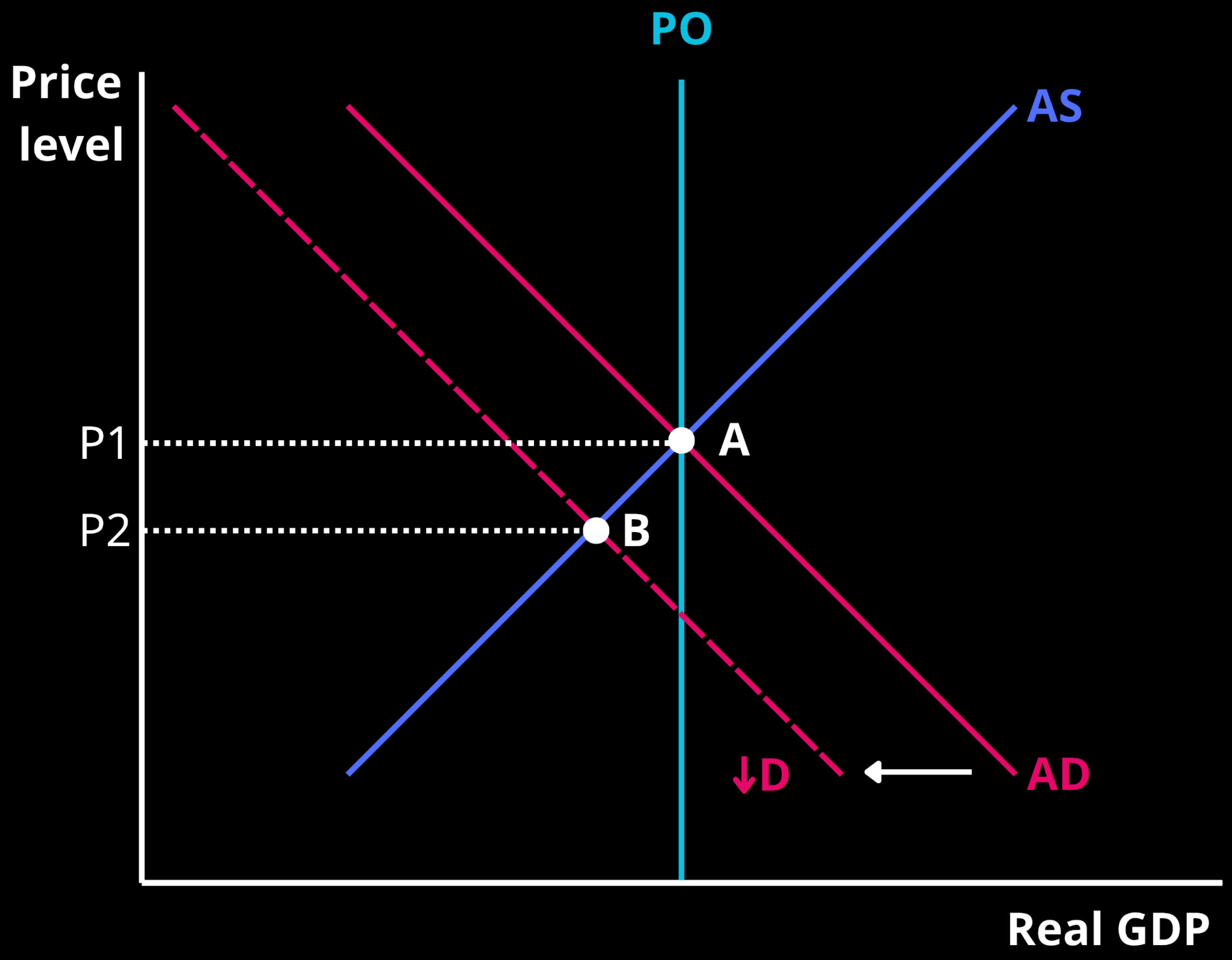
AD–AS model

- Changes in spending, investments, policies, or global events can shift AD and AS, **moving economy away from PO**
- Reserve Bank of Australia (**RBA**) can use **interest rates** to **influence AD** to help stabilise the economy



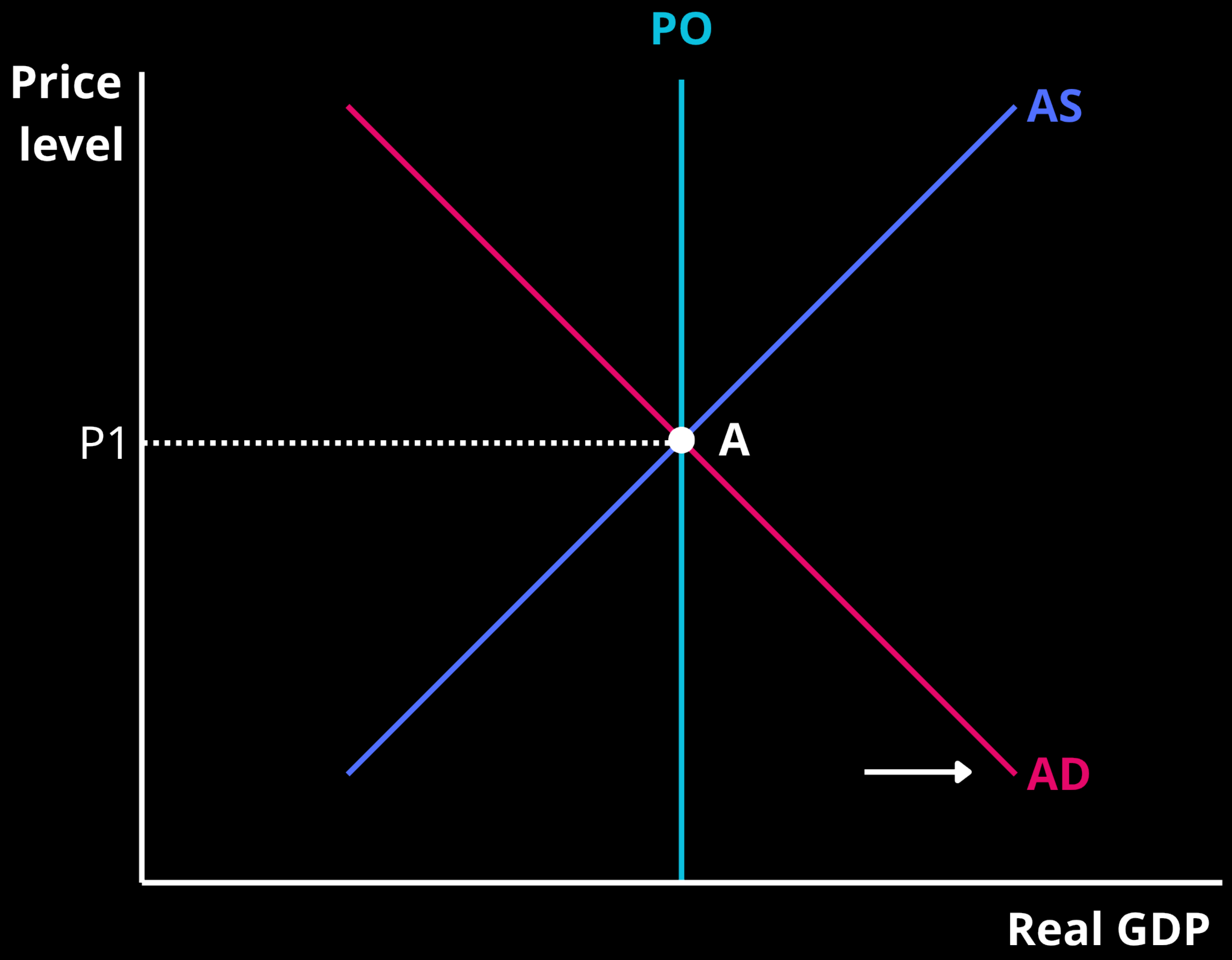
Decrease in demand

- Consumers, businesses, and governments **spend less** → demand for goods & services falls
- Businesses produce less → **fewer workers** needed
- Price pressures ease → **inflation falls**
- Prolonged contraction → **recession**



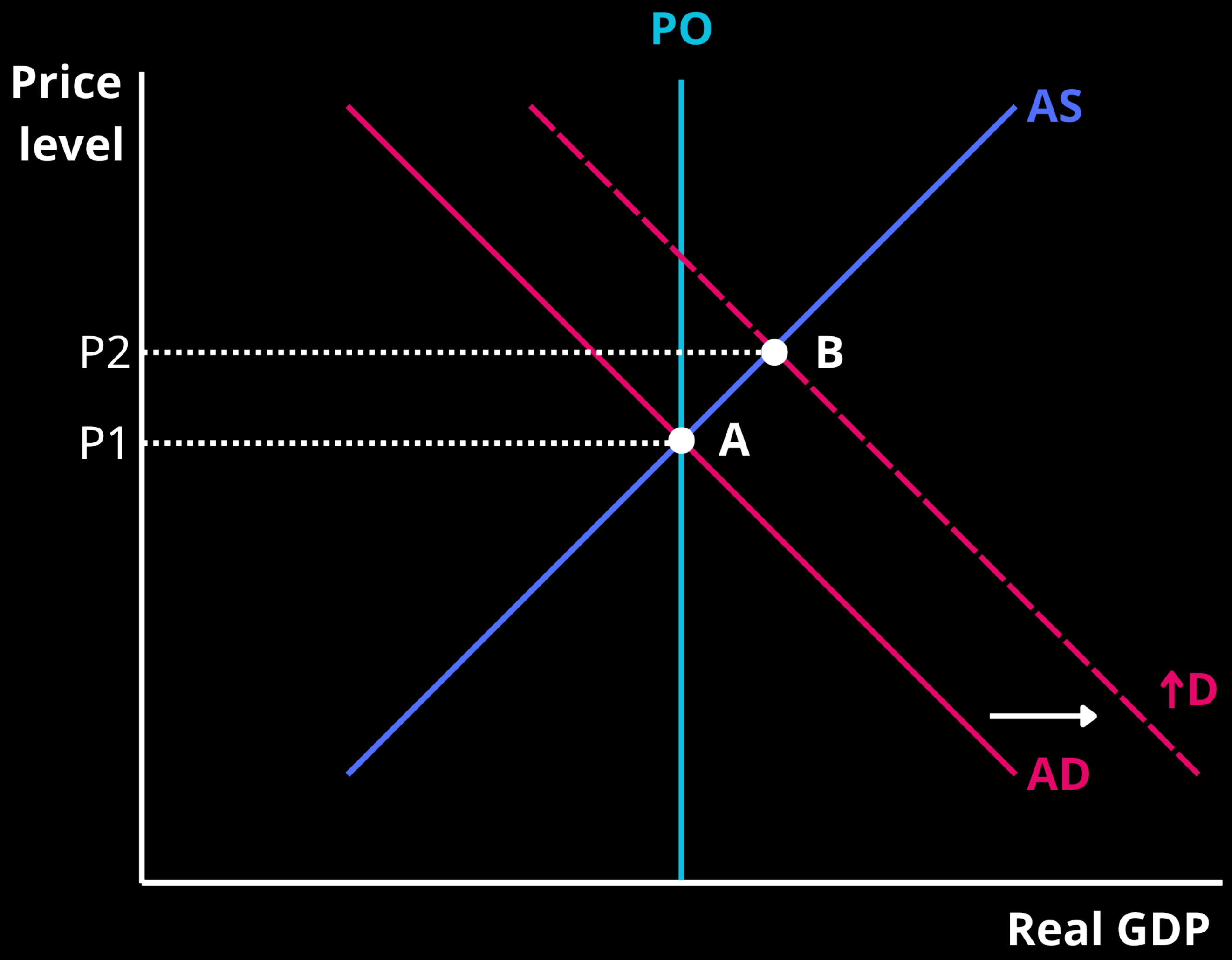
Decrease in demand: RBA response

- RBA **lowers interest rates** → encourages spending and investment
- AD **shifts back** towards PO



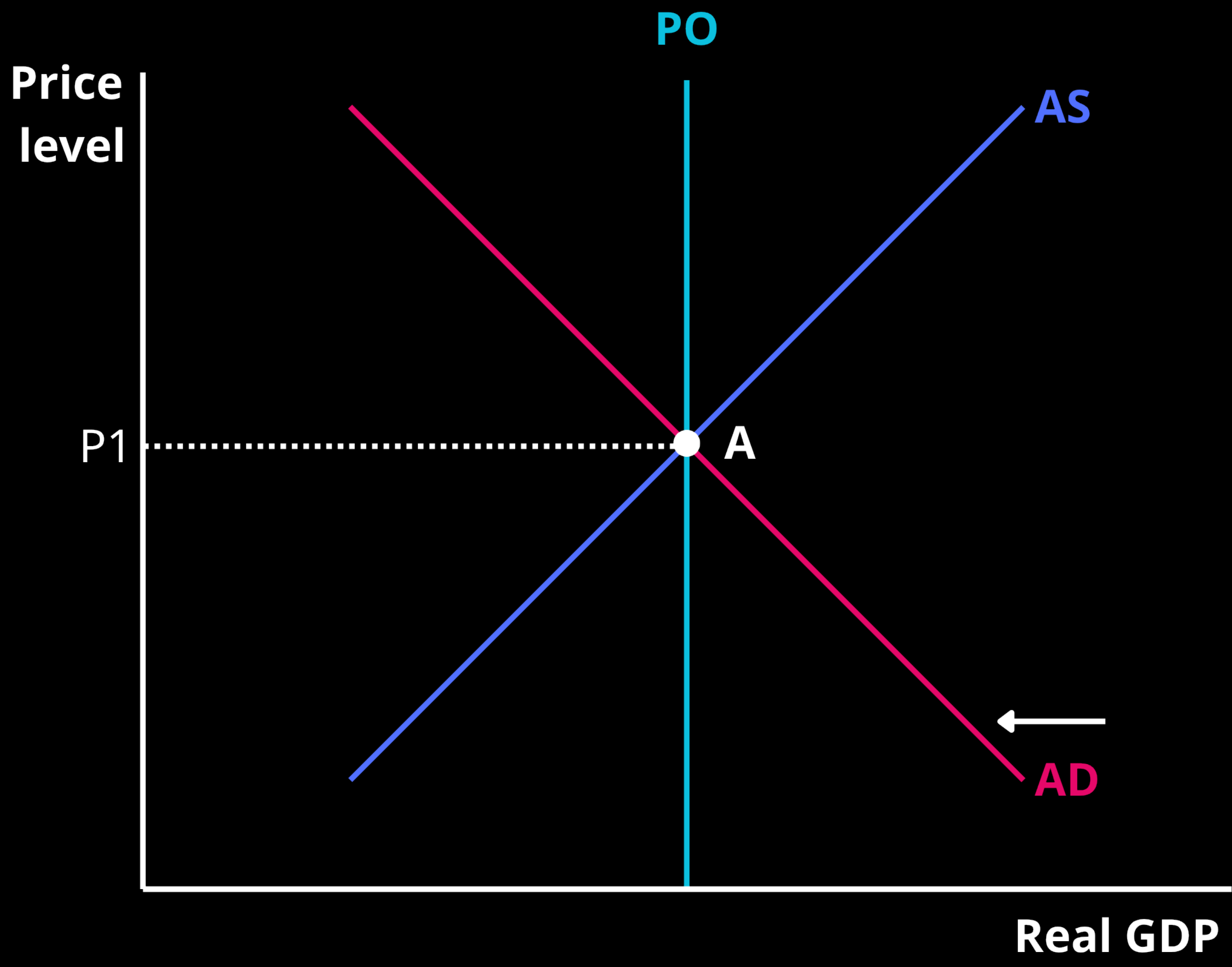
Increase in demand

- Consumers, businesses, and governments **spend more** → demand for goods & services rises
- Businesses produce more → **more workers** needed
- Price pressures increase → **inflation rises**
- High inflation **reduces purchasing power** and can harm economic growth



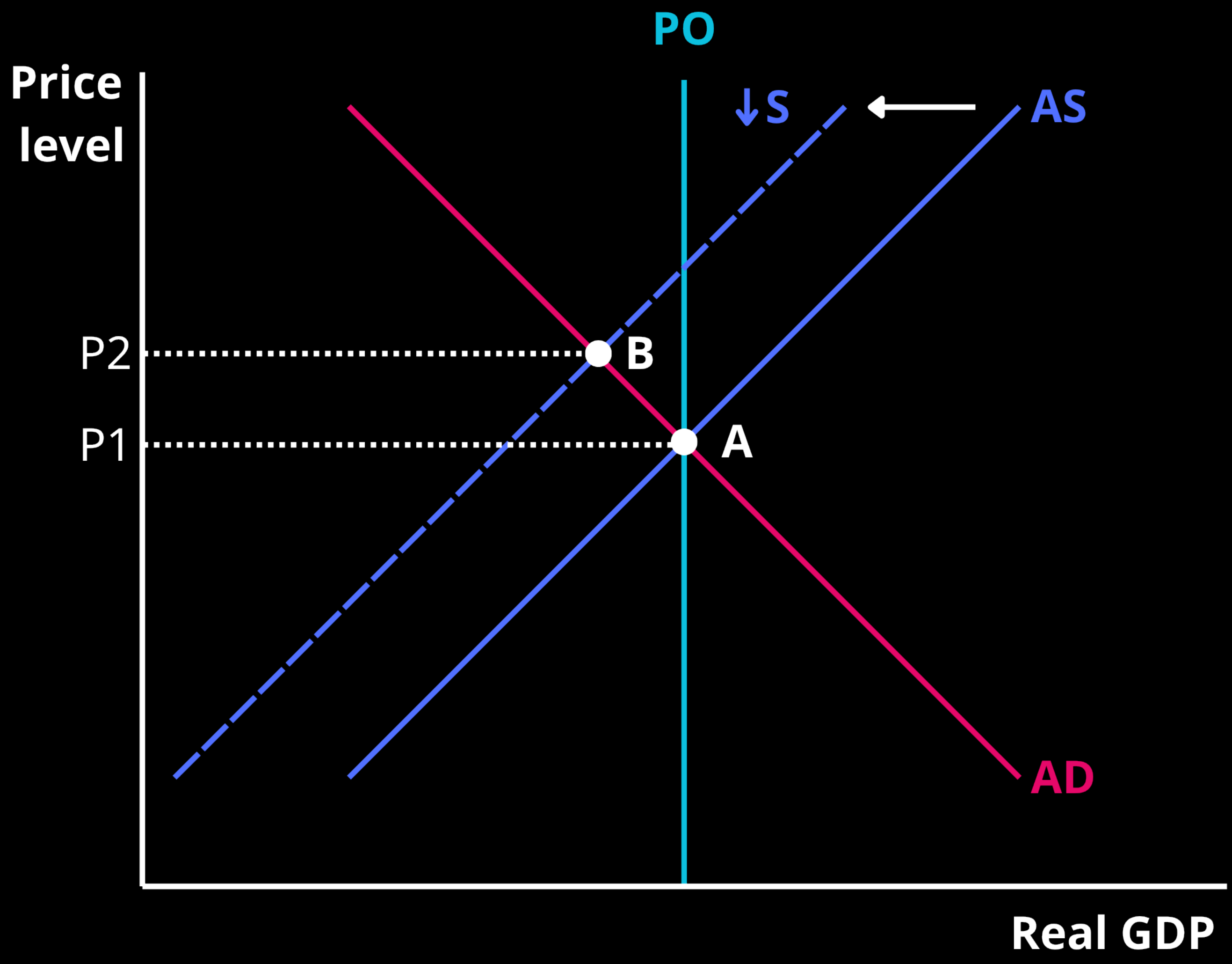
Increase in demand: RBA response

- RBA **raises interest rates** → slows spending and investment
- AD **shifts back** towards PO



Decrease in supply → stagflation

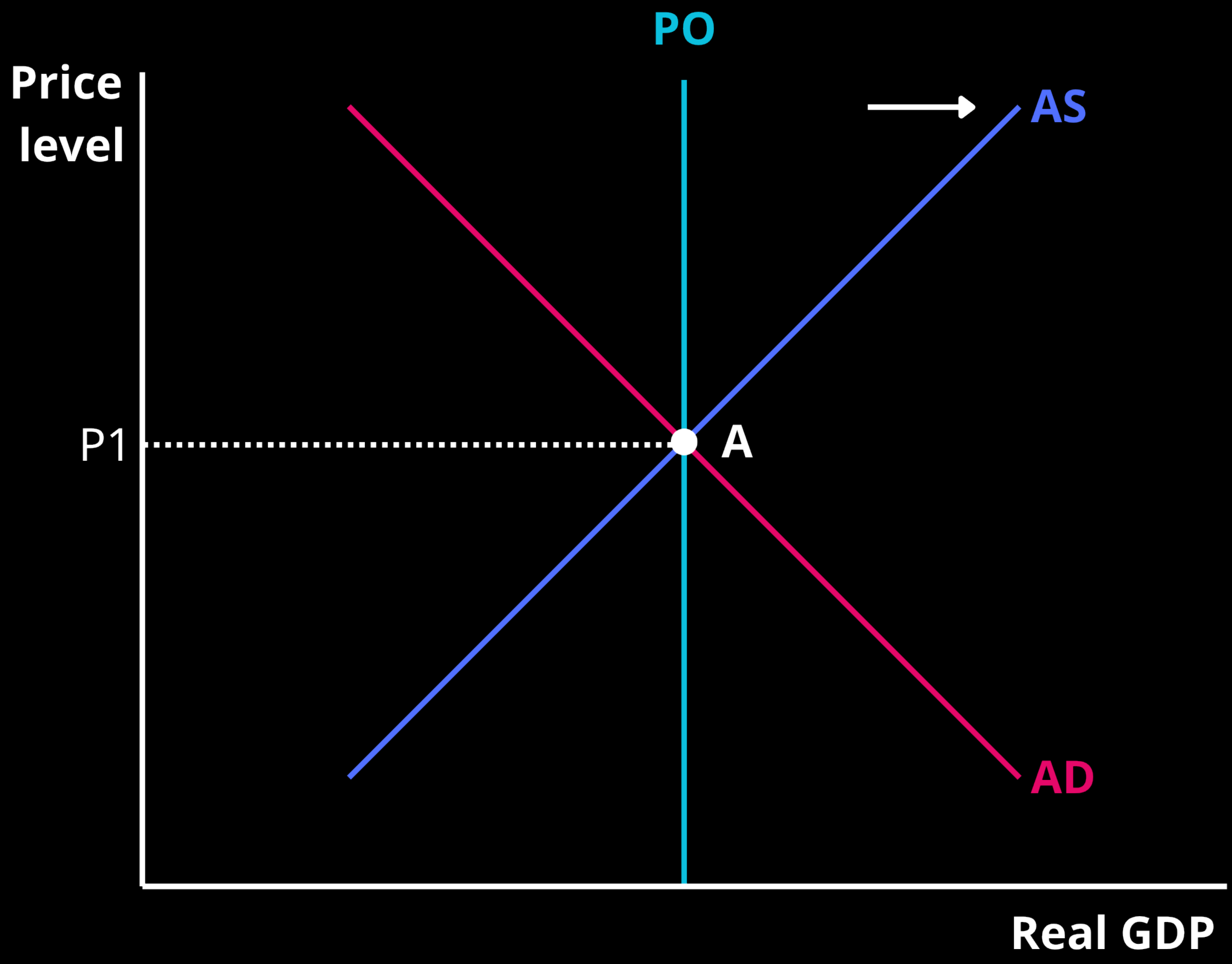
- Businesses face **higher production costs** (e.g. oil prices) → supply falls
- Businesses produce less → **fewer workers** needed
- Higher production costs → **inflation rises**
- Lower growth (higher unemployment) + higher inflation = **stagflation**



Decrease in supply: RBA response

Option 1 = do nothing

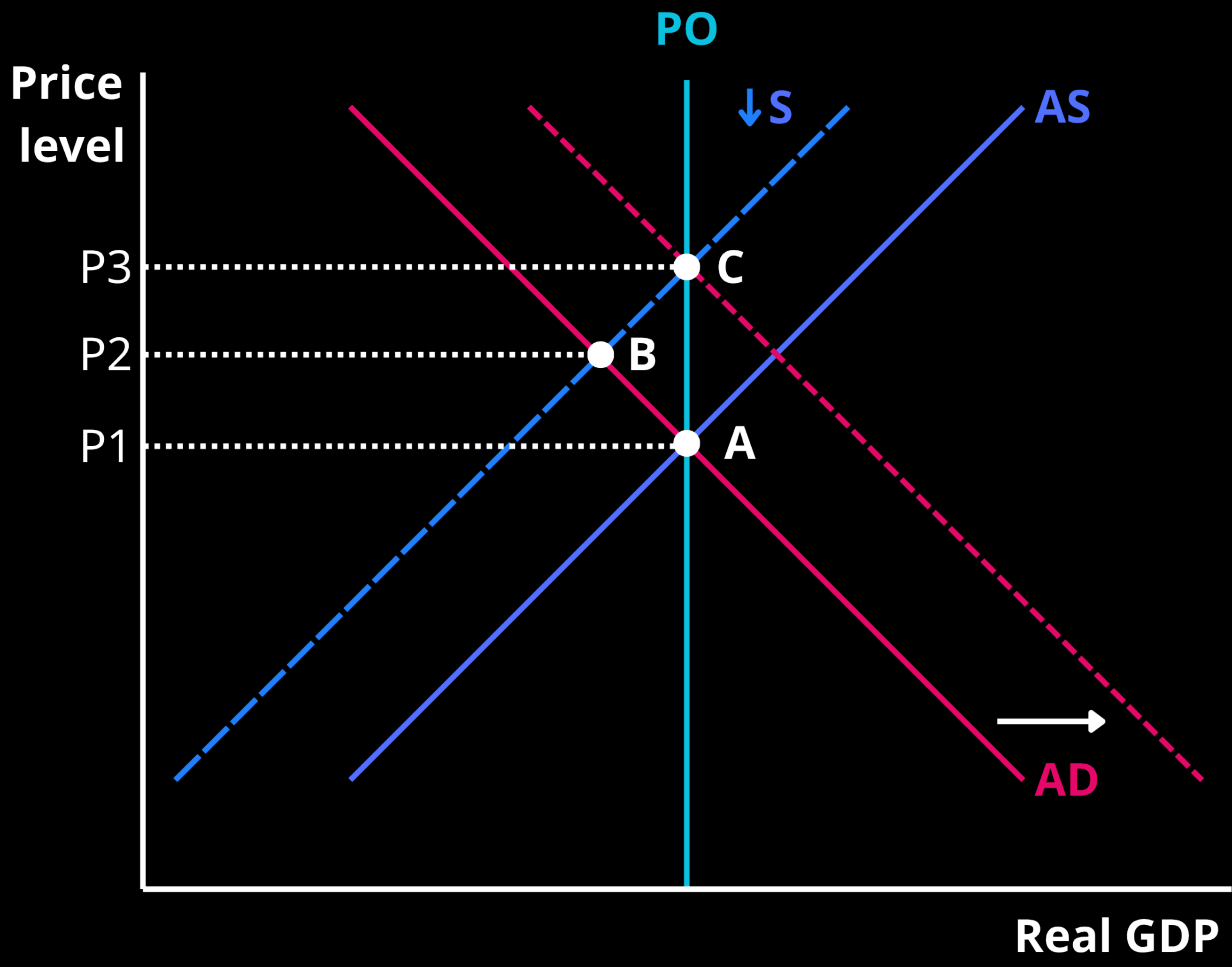
- Wait for the supply issue to **self-correct**



Decrease in supply: RBA response

Option 2 = lower interest rates

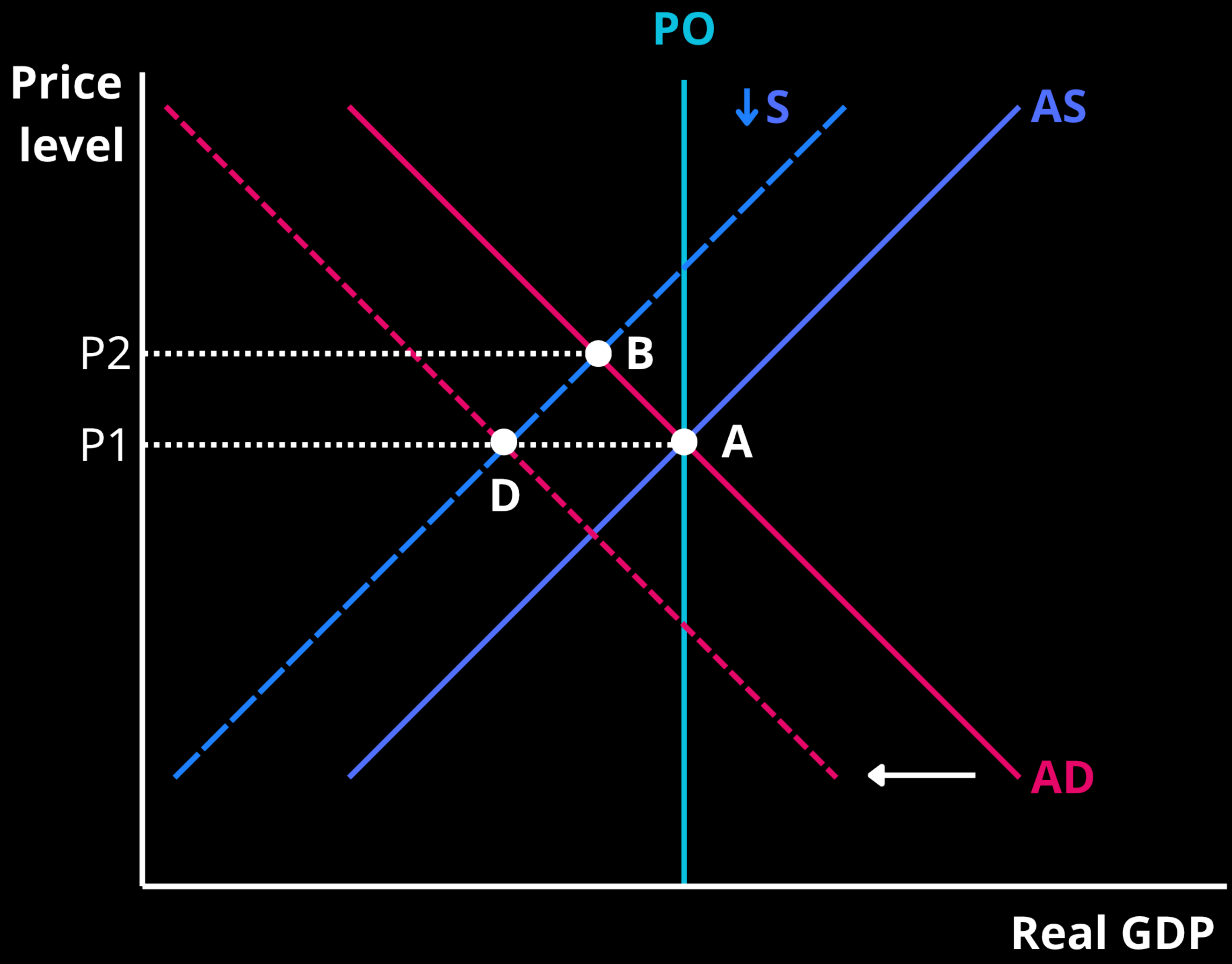
- Supports growth and employment 🙂
- Increases inflation 🙁



Decrease in supply: RBA response

Option 3 = raise interest rates

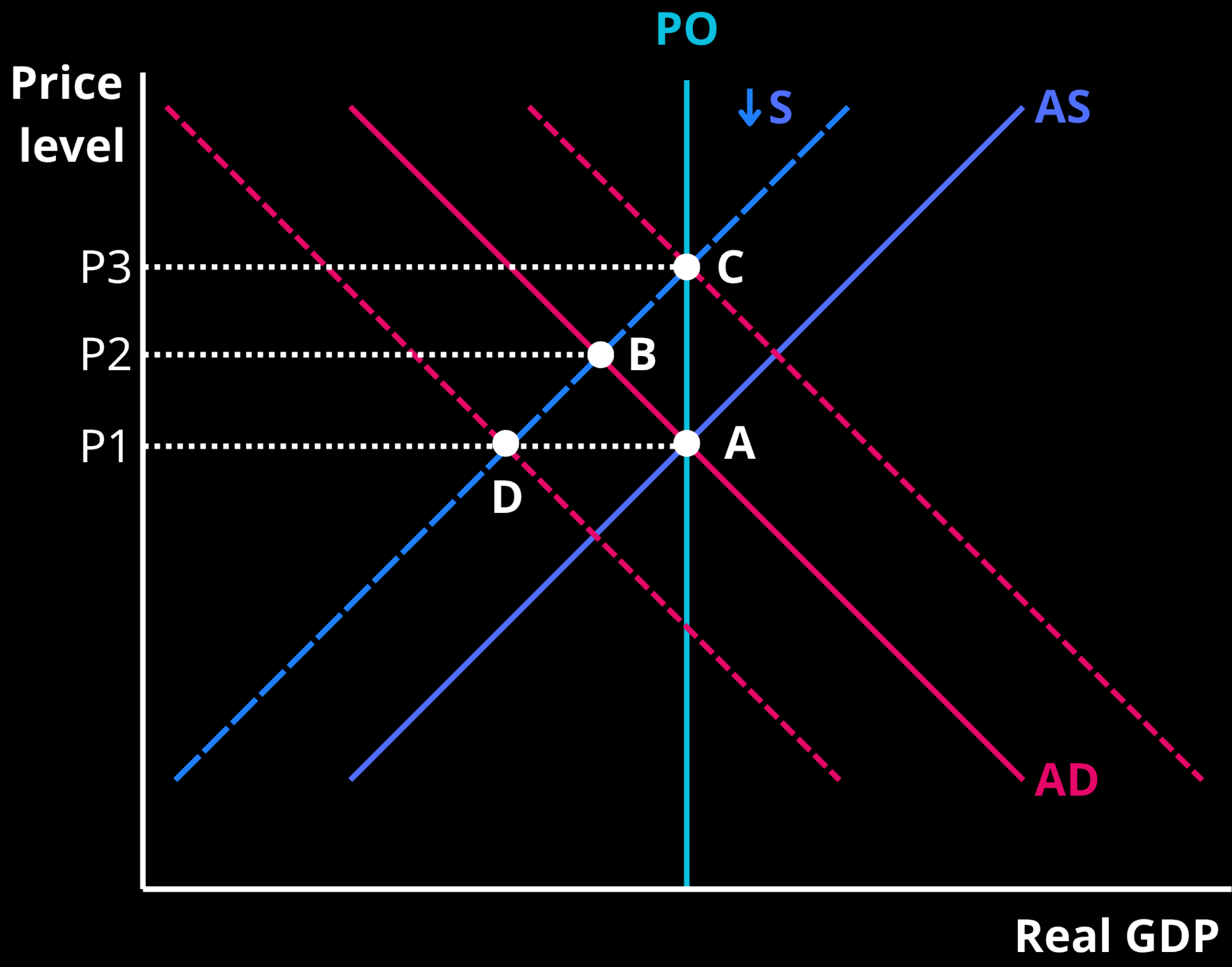
- Reduces inflation 🙂
- Further weakens growth and increases unemployment 🙁



Decrease in supply: RBA response

Stagflation is challenging

there is no policy that simultaneously lowers inflation and boosts economic growth



Summary

Global oil supply falls

↓

Production costs increase

↓

Business produce less & increase prices

↓

Lower economic growth + higher inflation

↓

Stagflation

Supply-side shocks create a **policy dilemma**:

- Support economic growth → higher inflation, higher cost of living
- Fight inflation → slower economic growth, higher unemployment

Thank-you!

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Bonus slide: RBA cash rate

- **Cash rate** = interest rate on overnight loans between commercial banks
- RBA adjusts **target cash rate** to keep inflation between **2-3%** over time
- Changes to cash rate can influence:
  - Mortgage rates
  - Savings account interest rates
  - Business loan rates
- Higher cash rates **slow** borrowing, spending, and economic activity
- Lower cash rates **encourage** borrowing, spending, and economic activity