2.4 Causes and Consequences of Inflation and Deflation

Total Marks

AQA 7136 · Calculators not allowed · about 70 minutes · Write-in edition

Name: _____ Date: ____ / ____ / _____

Answer all questions. Write full sentences for all explain and evaluate questions. Time guidance: 70 minutes.

1 Explain briefly two ways in which sustained deflation can raise the real burden of debt for households and firms in the UK.

(Total for Question 1 is 4 marks)

2 Evaluate the view that deflation is a greater threat to a modern UK-style economy than inflation.

(Total for Question 2 is 25 marks)

3 Define the term 'disinflation' in the context of UK consumer prices.

(Total for Question 3 is 2 marks)

4 Explain how a sustained rise in aggregate demand can lead to demand-pull inflation in an economy that is close to full capacity.

(Total for Question 4 is 4 marks)

5 Explain briefly how cost-push inflation occurs, giving one concrete example of a cost increase that can trigger it in the UK.

(Total for Question 5 is 4 marks)

6 Explain the basic idea of the quantity theory of money as a monetary cause of inflation, in the context of a UK economy.

(Total for Question 6 is 4 marks)

7 State two groups that tend to gain from unexpected inflation, and give a one-sentence reason for each (UK context).

(Total for Question 7 is 2 marks)

Mark scheme · 2.4 Causes and Consequences of Inflation and Deflation

Question 1

deflation raises the real value of nominal debts because the money used to repay obligations gains purchasing power	**M1**
example: fixed mortgage payments stay the same in nominal terms while incomes and prices fall, so payments become harder to meet in real terms	**A1**
second mechanism: deflation can reduce incomes and profits, lowering borrowers' cash flows and increasing default risk	**M1**
link: falling revenues for firms make servicing existing nominal debt more difficult, amplifying solvency problems during deflation	**A1**

Answer: Deflation increases the real value of nominal debts, making fixed repayments heavier in real terms; and it reduces incomes and profits, cutting borrowers' ability to service debt and raising default risk.

Question 2

Level 1 Basic statements about inflation and deflation showing limited understanding. Rare or no use of examples. Judgement, if any, is weak and unsupported.	**1-5**
Level 2 Some correct analysis of the effects of inflation and deflation, with a few relevant examples or mechanisms. Limited evaluation, and a weak or partially balanced judgement. May describe a diagram but not fully use it.	**6-10**
Level 3 Clear analysis of both inflation and deflation, including short-run and long-run consequences, distributional effects and likely policy responses. A balanced evaluation with a supported judgement and reference to diagrams where appropriate.	**11-15**
Level 4 Thorough analysis and evaluation across multiple dimensions: macro stability, growth, financial sector risks, and distributional consequences. Diagrams are correctly described and used to support argument. Judgement is well supported and considers conditions and caveats.	**16-20**
Level 5 Excellent, well-structured evaluation that integrates theory, empirical plausibility and policy realism. Presents nuanced arguments about when inflation or deflation is worse, considers magnitude and persistence, identifies winners and losers, and reaches a convincing, qualified conclusion. Diagrams and alternative perspectives are used effectively.	**21-25**

Indicative content:

- Explain costs of inflation: menu costs, shoe-leather costs, uncertainty, distortion of price signals, tax/BRacket creep, redistribution from savers to borrowers, loss of international price competitiveness if domestic inflation exceeds trading partners'.
- Explain costs of deflation: postponed consumption/investment, rising real debt burdens, falling nominal wages and profits, increased default risk, potential liquidity trap limiting monetary policy effectiveness.
- Distinguish expected versus unexpected inflation: predictable low inflation allows indexation and planning, unexpected inflation causes arbitrary redistribution and uncertainty.
- Consider magnitude and persistence: low, stable inflation may be benign or desirable; high or hyperinflation is clearly damaging. Mild deflation might occur with quality improvements, but prolonged deflation is harmful.
- Discuss who gains and loses under each scenario: borrowers vs savers, fixed-wage workers, firms with pricing power, exporters and importers.
- Policy responses: monetary policy to fight inflation (raise rates) but rate hikes have trade-offs for growth; for deflation, central banks may cut rates, use quantitative easing or fiscal expansion, but effectiveness is limited when rates are near zero.
- Diagram description: supply and demand or AD/AS diagram to show demand-pull inflation (AD shift right) and cost-push inflation (SRAS shift left) and how deflation might follow AD falling (AD shift left). Use diagram to discuss output vs price trade-offs.
- Consider open-economy aspects: exchange rate effects, imported inflation, competitiveness and the role of external shocks.
- Evaluate relative severity by context: in a modern economy with flexible policy tools, persistent deflation may be harder to escape; however, very high inflation can destroy financial intermediation and collapse savings, so relative threat depends on scale and persistence.
- Conclude with a qualified judgement, e.g. that persistent deflation is a greater threat to growth and financial stability in a low-rate environment, while uncontrolled high inflation is catastrophic for living standards and institutions; the correct policy priority depends on starting conditions, central bank credibility and fiscal capacity.

Question 3

a fall in the rate of inflation, i.e. prices are still rising but at a slower rate than before	**B1**
not to be confused with deflation, which is a fall in the general price level	**B1**

Answer: A fall in the rate of inflation: prices continue to rise but at a slower rate than previously; not the same as deflation.

Question 4

identify that AD increases (C, I, G or X-M rising)	**M1**
explain that with little spare capacity firms increase output only a little and begin to bid for scarce resources	**M1**
show that rising demand for inputs pushes up costs, or firms raise prices because of stronger demand	**A1**
conclude that the general price level rises, producing demand-pull inflation	**A1**

Answer: When AD rises near full capacity, firms cannot expand output much and instead compete for scarce inputs, pushing up costs and prices; stronger demand also lets firms raise prices, so the general price level increases.

Question 5

cost-push inflation arises when firms face higher costs and pass them onto consumers via higher prices	**M1**
state mechanism: higher input costs reduce short-run aggregate supply, shifting SRAS leftwards, raising price level and lowering output	**M1**
give example: a large increase in oil prices or a sharp rise in minimum wage or imported intermediate goods becoming more expensive	**A1**
link example to likely outcome: higher transport/production costs raise prices across many sectors, causing inflation	**A1**

Answer: Cost-push inflation happens when firms' costs rise and they increase prices. For example, a big rise in global oil prices raises transport and energy costs across the economy, shifting SRAS left and raising the general price level.

Question 6

state the core relation that if the money supply grows faster than real output, too much money chases the same goods	**M1**
mention the typical equation MV = PY in words: money supply times velocity equals price level times real output	**M1**
explain implication: if M rises rapidly while V and Y are stable, P must rise, i.e. inflation	**A1**
short evaluative note: velocity may change and central bank control of M is not perfect, limiting the theory's predictive power	**A1**

Answer: The quantity theory says rapid growth in the money supply relative to real output causes inflation because more money chases the same quantity of goods (MV = PY); if M rises much faster than Y then P must rise. In practice velocity changes and central banks influence money, limiting the theory's simple application.

Question 7

one valid group with a reason, e.g. borrowers on fixed nominal rates (the real value of their debt falls); firms with pricing power (raise prices faster than costs); owners of property or other real assets whose value rises with prices; the government as a large debtor (real debt falls, fiscal drag raises tax revenue), oe	**B1**
a second, different valid group with a reason, oe	**B1**

Answer: Any two distinct groups, each with a reason: borrowers with fixed nominal debts gain because their real debt burden falls; firms with pricing power may raise prices faster than costs; owners of real assets may be protected if asset values rise with prices; government as a debtor may see its real debt fall. Other valid, justified groups are accepted.