



ECO.MAC2 Causes and Consequences of Inflation and Deflation

AQA 7136 · Calculators not allowed · about 90 minutes

Total Marks

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Name: _____ Date: ____ / ____ / ____

Answer all questions. Write full sentences for all explain and evaluate questions. Time guidance: 90 minutes.

1 Multiple choice: In the context of inflation causes in a UK-style open economy, which of the following best describes demand-pull inflation?

- ☐ A. A sustained rise in the general price level caused by a persistent fall in aggregate demand
- ☐ B. A rise in prices resulting from increases in firms' costs of production, such as wages or raw materials
- ☐ C. A rise in the general price level because aggregate demand increases faster than aggregate supply
- ☐ D. A temporary increase in prices caused solely by one-off supply shocks such as poor harvests

(Total for Question 1 is 1 mark)

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

(Total for Question 2 is 2 marks)

3 Define 'deflation' and give one likely short-run economic cost for households in a UK-style economy.

(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** Real wage calculation. A UK worker's nominal annual pay rises from GBP 21,000 to GBP 21,000 (no change in nominal pay) while the annual inflation rate is 5.0%. Calculate the worker's real wage in GBP in current-year purchasing-power terms (i.e. adjust the nominal pay for inflation), rounded to the nearest whole pound. Show working.

(Total for Question 7 is 4 marks)

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

(Total for Question 8 is 2 marks)

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

(Total for Question 9 is 2 marks)

- 10** 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 10 is 4 marks)

- 11** Explain one likely effect of moderate inflation on a country's international competitiveness and one reason why very high inflation can worsen competitiveness further.

(Total for Question 11 is 3 marks)

- 12** Write an essay assessing whether deflation or inflation poses the larger overall threat to economic stability and growth in a modern UK-style open economy. Consider short-run and long-run effects, winners and losers, policy responses, and any conditions under which one is more damaging than the other. You should include analysis, consider diagrams where relevant (describe any diagram you would draw), and reach a supported judgement.

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

(Total for Question 12 is 25 marks)

Mark scheme · ECO.MAC2 Causes and Consequences of Inflation and Deflation

Question 1

- **B1** selects C, demand outstripping supply at existing prices causes demand-pull inflation
- **Answer: C**

Question 2

- **B1** 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
- **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 3

- **B1** deflation is a fall in the general price level, i.e. negative inflation
- **B1** one short-run cost: households may postpone spending expecting lower prices, reducing demand and possibly causing rising unemployment
- **Answer: Deflation is a fall in the general price level. A cost is that households delay purchases expecting lower prices, reducing demand and harming incomes and jobs.**

Question 4

- **M1** 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
- **A1** 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
- **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

- **M1** 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
- **A1** 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
- **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

- **M1** 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
- **A1** 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
- **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

- **M1** method: real wage = nominal pay / (1 + inflation rate) or nominal / 1.05
- **A1** accurate calculation: $21000 / 1.05 = 20000$
- **A1** statement of units: GBP 20,000
- **B1** working check: shows division or equivalent arithmetic

Question 8

- **B1** borrowers: unexpected inflation reduces the real value of fixed nominal debt, easing the real burden
- **B1** some firms with pricing power: can raise nominal prices faster than rising costs and so may see higher nominal profits in the short run
- **Answer: Borrowers, because unexpected inflation reduces the real value of fixed nominal debts; and firms with pricing power, because they can raise prices faster than costs and increase nominal profits temporarily.**

Question 9

- **B1** savers on fixed nominal interest rates: inflation erodes the real return on deposits
- **B1** workers on fixed nominal wages: real wages fall if nominal pay does not keep up with inflation
- **Answer: Savers on fixed nominal rates lose because inflation reduces the real return on their deposits; workers on fixed nominal wages lose because their real pay falls if wages do not rise with prices.**

Question 10

- **M1** deflation raises the real value of nominal debts because the money used to repay obligations gains purchasing power
- **A1** example: fixed mortgage payments stay the same in nominal terms while incomes and prices fall, so payments become harder to meet in real terms
- **M1** second mechanism: deflation can reduce incomes and profits, lowering borrowers' cash flows and increasing default risk
- **A1** link: falling revenues for firms make servicing existing nominal debt more difficult, amplifying solvency problems during deflation
- **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 11

- **M1** moderate inflation can erode price competitiveness if domestic prices rise faster than trading partners', reducing net exports
- **A1** give brief mechanism: higher domestic prices make exports relatively more expensive, lowering demand for them abroad
- **A1** very high inflation adds uncertainty, raises wage-price spirals and can cause a currency depreciation that initially raises import costs and may not restore competitiveness if inflation remains unchecked
- **Answer: Moderate inflation can reduce competitiveness because domestic prices rise relative to trading partners, lowering export demand; very high inflation increases uncertainty and wage-price spirals and can damage competitiveness even if the currency falls, because costs remain elevated and firms lose foreign market share.**

Question 12

- **Level 1** (1-5): Basic statements about inflation and deflation showing limited understanding. Rare or no use of examples. Judgement, if any, is weak and unsupported.
- **Level 2** (6-10): 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.
- **Level 3** (11-15): 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.
- **Level 4** (16-20): 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.
- **Level 5** (21-25): 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.
- **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.