Quick Answers

Question 1

Analyse how a fall in unemployment may increase a country's inflation rate.

Coherent analysis which might include:

• A fall in unemployment may increase incomes (1) this may increase consumer spending (1) increasing total (aggregate) demand (1) causing demand-pull inflation (1).
• A fall in unemployment may result in a shortage of workers (1) this may raise wages (1) increasing firms' costs of production (1) causing cost-push inflation (1).

Question 2

Discuss whether or not an increase in the rate of income tax will reduce inflation.

Level 3 (6-8 marks)

A reasoned discussion which accurately examines both sides of the economic argument, making use of economic information and clear and logical analysis to evaluate economic issues and situations. One side of the argument may have more depth than the other, but overall both sides of the argument are considered and developed. There is thoughtful evaluation of economic concepts, terminology, information and/or data appropriate to the question. The discussion may also point out the possible uncertainties of alternative decisions and outcomes.

Why it might:

- reduce disposable income/purchasing power
- consumer expenditure likely to fall
- investment may fall
- total (aggregate) demand may fall
- demand-pull inflation may decrease
- higher government revenue may increase government spending on supply-side policy measures

Why it might not:

- workers may seek higher wages
- higher wages may increase costs of production
- cost-push inflation/wage-price spiral may occur
- higher tax revenue may increase government spending
- higher government spending may offset lower consumer expenditure leaving total (aggregate) demand unchanged
- people may be very confident about the future so they cut back on savings rather than spending.

Example of L3 answer:
Due to an increase in the rate of income tax, inflation may fall as disposable income will fall. People will have less money to spend so they may spend less and total demand will fall. A fall in demand will cause prices to fall as producers will not be able to sell as many goods and services. They will want to keep their market share.
Demand-pull inflation will decrease. However, an increase in income tax may not cause inflation to fall. Workers may force up the wage rate. Firms' labour cost and costs of production will increase so firms may push up prices to maintain profits. This can cause cost-push inflation and a wage price spiral. Plus, government revenue from high taxes will rise and government spending may rise. This may offset the fall in consumer expenditure and inflation may not fall.

Principal Examiner comment:
Strong on both sides

Question 3

Analyse how an increase in investment could influence inflation.

- Higher investment will mean higher spending on capital goods (1) it could increase total (aggregate) demand (1) this could increase demand-pull inflation (1) if total (aggregate) demand exceeds total (aggregate) supply (1)
- May increase demand for imported capital goods / raw materials (1) causing imported / cost-push inflation (1)
- Higher total (aggregate) demand could increase employment / decrease unemployment (1) which could increase total (aggregate) demand further (1)

- In short run may raise costs of production (purchase of machines) (1) causing cost-push inflation (1).
- In the long run it could increase output (1) may introduce advances in technology (1) increase efficiency / productivity (1) it could reduce costs of production (1) reducing cost-push inflation (1)
- Investment in human capital (1) raising workers' skills (1)

Question 4

Discuss whether or not a cut in income tax would stop deflation.

Up to 3 marks for why it might:

- A cut in income tax will increase disposable income / purchasing power (1) this may increase spending (1) higher spending may encourage more investment (1) higher total demand (1) may encourage firms to raise prices/demand-pull inflation (1)
- Higher demand may encourage firms to expand (1) they may take on extra workers (1) reduce unemployment (1) they may pay higher wages (1) increasing costs of production (1) causing cost-push inflation (1)

Up to 3 marks for why it might not:

- Consumers may lack confidence (1) and so not spend any more / may save (1) may still delay purchases (1) they may spend on imports rather than domestic products (1)
- Firms may lack confidence (1) and so not invest (1)
- Any extra investment which takes place may reduce costs of production (1) and so prices may fall further (1)
- Firms may have spare capacity (1) and so may be able to increase output without increasing average costs of production (1) and so prices may not rise (1)
- Government tax revenue may fall (1) reducing government spending which may mean that total demand does not rise (1)

Guidance

- Demand-pull inflation and/or cost-push inflation may be shown on a diagram

Question 5

Analyse how a high rate of inflation may harm the poor.

- Inflation may raise the price of basic necessities (1) reducing purchasing power of the poor (1) increasing absolute poverty (1)
- Inflation may reduce the value of any savings the poor have (1) reducing their ability to access e.g. healthcare, education and housing (1) reducing job opportunities (1)
- Inflation may reduce the country's international competitiveness (1) lower output (1) increase unemployment (1) making it more difficult for the poor to gain jobs (1)
- Inflation may reduce the purchasing power of state benefits (1) e.g. pensions or unemployment (1)
- The poor may be less likely to belong to trade unions (1) less ability to raise wages (1)

Question 6

Explain why inflation may fall even if there is an increase in total demand.

Logical explanation which might include:

- There may have been an increase in total supply (1) which may be greater than the increase in total demand (1)
- There could be an improvement in productivity (1) better technology / capital (1)
- Costs of production could have gone down (1) e.g. lower taxes / lower costs of raw material, stronger exchange rates (1)

Question 7

Discuss whether or not deflation will benefit an economy.

Level 3 (6-8 Marks)

A reasoned discussion which accurately examines both sides of the economic argument, making use of economic information and clear and logical analysis to evaluate economic issues and situations. One side of the argument may have more depth than the other, but overall, both sides of the argument are considered and developed. There is thoughtful evaluation of economic concepts, terminology, information and/or data appropriate to the question. The discussion may also point out the possible uncertainties of alternative decisions and outcomes.

Why it might:

- if due to lower costs of production, may be more internationally competitive
- improve the current account position
- may increase purchasing power if incomes do not fall
- may raise living standards
- may increase economic growth and employment

Why it might not:

- if due to lower total demand may result in a recession
- consumers may postpone purchases
- investment may fall
- firms may reduce output, reducing demand for raw materials
- unemployment may rise

Example of Level 3 answer:

When an economy undergoes deflation, the general price level in the economy falls resulting in goods and services in the country becoming cheaper. This results in a higher demand for the country's goods and services from both those living in the country and abroad. The revenue from exports will increase due to greater international demand resulting in a current account surplus. Lower prices may improve standard of living for consumers as more can be bought than before.

However, an economy may not benefit from deflation as a prolonged deflation may result in unemployment. Firms may lose confidence in future sales as consumers wait for prices to fall further. Lower output may result in less employment further reducing demand and causing a recession. The government may have to intervene by cutting taxes and interest rates to encourage increased consumption.

Principal Examiner comment:

This is a concise answer with reasonable argument for the benefits and a strong answer for why there may not be benefits.

Example of Level 1 answer:

Deflation makes prices of goods and services to be low which will entice consumers to buy more as prices are cheaper than before.

Principal Examiner comment:

A basic understanding of deflation without any discussion of whether or not it is beneficial to the economy.

Question 8

Explain two causes of inflation.

- demand-pull inflation (1) increase in total demand/ lower interest rate / increase business confidence / increase consumer confidence / depreciation of the currency / lower income tax / lower cost of borrowing / increase disposable income / increase exports (1) increase in money supply (1)
- cost-push / increase in costs (1) increase price of commodities / increase cost of production / depreciation of the currency / increase indirect taxes (1)

Question 9

Explain how the CPI is calculated.

- CPI uses a basket of goods and services (1) weighted to account for the proportion of income (1) spent by the average household (1) found in a survey (1) uses a base year (1) for comparison (1) prices around the country surveyed (1) various types of firms / sources e.g. physical shops and also online (1) weights multiplied by price changes (1)

Question 10

Analyse how lower unemployment may cause inflation.

- More people in work (1) incomes may rise (1) as more people are earning wages / higher purchasing power (1) this could increase spending (1) which may increase total (aggregate) demand (1) without a rise in output / supply (1) causing demand- pull inflation (1).

- There may be a shortage of workers/increased competition for workers (1) wages may be raised (1) to attract workers (1) this increases the average cost of production (1) firms raise prices to maintain profit margins (1) causing cost-push inflation (1).

Question 11

Explain how a rise in the price of food would affect a country's consumer prices index (CPI).

- **CPI is a measure of inflation** (1) Demand for food is inelastic / **necessity** (1)

- A rise in price of food would cause an increase in inflation / CPI (1)

- Food is an item in the CPI (1) it has a relatively high weighting (1) people spend a relatively high proportion on food (1) proportion declines as income rises (1)

Question 12

Discuss whether or not a higher inflation rate will benefit producers.

Up to 5 marks for why it might:

- Producers may receive higher prices / **revenue** for their products (1) if costs rise by less (1) profits will rise (1) **may encourage investment (1) expand the business (1).**

- Producers may be able to borrow more cheaply (1) the burden of past debts will fall (1) if the rate of inflation is above the rate of interest (1).

- An inflation rate may rise from a low or negative rate (1) and this would provide a greater incentive for producers (1).

- Higher inflation rate in other countries (1) will make this country's products more competitive (1).

- If demand is inelastic (1) a rise in price will increase revenue (1).
- Higher inflation will reduce the cost of borrowing (1).

Up to 5 marks it might not:

- **If cost of production rises** (1) output may fall (1) firms' profits may fall (1).
- Producers may have to spend time adjusting prices (1) menu costs (1).
- A lower and stable rate of inflation (1) may increase the confidence of producers (1).
- Producers may find it more difficult to export abroad / exports may fall (1) lower revenue (1).
- Producers may find it harder to assess relative prices (1) and so may make inefficient decisions (1).

Question 13

Identify, using information from the extract, two reasons why India's inflation rate fell in 2016.

Fall in oil prices (1).
Monetary policy (1).

Question 14

Discuss whether or not a government should aim for a low rate of inflation.

Up to 3 marks for why it should:

- A low rate of inflation may result in increased international competitiveness (1) improving the current account position (1)
- It may create certainty/stability (1) encouraging firms to invest (1) increasing output (1) increasing employment / lowering unemployment (1)
- It will not cause a random redistribution of income (1) protecting savers (1)

- It may raise profit (1) if demand-pull (1) encourage firms to expand (1) increasing employment (1)
- It stops purchasing power being eroded by too much (1)

Up to 3 marks for why it should not:

- It may involve policy measures such as e.g. higher income tax (1) which reduce total (aggregate) demand (1) and so cause unemployment (1)
- Inflation can reduce debts (1) keeping firms in business (1) stopping households getting into difficulty (1)
- Employment may be protected (1) wages can be raised by less than inflation (1) enabling firms in difficulty to continue in production (1)
- A government may have other policy objectives (1)
- There is a risk that this could lead to deflation (1) have adverse macroeconomic effects / lose benefits of low rate of demand-pull inflation (1)

Question 15

Analyse why deflation may cause a fall in output.

- A fall in the price level (1) may discourage spending / reduce total (aggregate) demand (1) households waiting for prices to fall further (1) the fall in demand may reduce firms' output (1)
- Deflation may reduce firms' profits (1) this may discourage investment (1) reduce demand for capital goods (1) lower the output of capital goods (1)

Question 16

Analyse the extent to which a rise in oil prices will cause inflation

- Rise in oil prices will increase costs of production (1) e.g. higher energy costs / transport costs (1) resulting in cost-push inflation (1)
- Demand for oil is price-inelastic (1) if prices rise most consumers will keep buying it (1) some producers and consumers however may switch to other products (1)

- The extent will depend upon the proportion of oil costs in the total costs of other products (1) other costs may be falling (1)
- Because of rising oil prices, workers may demand higher wages (1) causing cost-push inflation (1)
- Movements in exchange rates will affect the impact on inflation (1) a rise in the exchange rate would reduce the overall effect (1)
- For oil producing countries export revenue may rise (1) causing higher demand (1) and demand-pull inflation (1)

Question 17

Analyse how increased productivity could reduce inflation.

- An increase in productivity means that more could be produced / output increased (1) from a given set of factors/inputs (1) could also lower (average) costs of production (1) reducing prices (1)
- Increased productivity could reduce wage costs (1) reduce waste (1)
- increased profits of firms (1) increasing investments / expansion of business (1) new capital equipment could further lower costs of production (1) lowering cost-push inflation (1)

Question 18

Analyse how an increase in wages could cause inflation

- Higher wages may increase consumer expenditure (1) increasing total (aggregate) demand / diagram showing total (aggregate) demand increasing (1) causing demand-pull inflation (1) if demand rises by more than money supply / the economy is at, or near, full capacity (1)
- Higher wages may increase costs of production (1) decrease total supply / diagram showing total supply decreasing (1) causes cost- push inflation (1) if wages rise by more than productivity / may cause a wage-price spiral (1)

Question 19

Explain how inflation may affect borrowers and savers

- Borrowers may gain (1) if the inflation rate exceeds the interest rate/the real value of what they repay may fall (1)
- Savers may lose (1) if the inflation rate exceeds the interest rate/the real value of their saving will fall (1)

Question 20

Analyse why it is important to a government that inflation is measured accurately.

- It is important to ensure a government/central bank follows the right policies (1). If, for instance, a government overestimates inflation it may increase taxes (1) cut government spending (1) raise interest rates (1) which may increase unemployment (1) reduce economic growth (1)
- Measures of inflation e.g. CPI/RPI (1) can be the basis of wage claims (1) and rises in some state benefits/indexed linked state benefits (1)
- Helps planning (1) may encourage investment (1)

Question 21

Analyse why a government may want to reduce its country's inflation rate

- A lower inflation rate may increase a country's international competitiveness (1) increase exports
(1) reduce imports (1) improve the current account position (1)
- A lower inflation rate may create greater certainty (1) encourage investment (1) increase economic growth (1)
- A lower inflation rate may benefit savers (1) create funds for investment (1)
- A lower inflation rate will reduce the rate at which money loses its purchasing power/value (1) protect living standards (1) make products more affordable (1) helps people on fixed incomes (1)
- If cost-push inflation, total demand will fall/unemployment rise (1)

- Lower inflation tends to have larger benefits for the poor than the rich (1) and helps towards reducing inequality (1)
- There may be hyperinflation (1) which could lead to a breakdown in economic activity (1)

Guidance

- Reward an approach that analyses the disadvantages of inflation

Question 22

Analyse what can cause deflation

- A fall in the price level could be caused by a fall in total (aggregate) demand (1).
- This may be due to a fall in consumer expenditure / rise in saving (1) a fall in borrowing (1) a fall in investment (1) due to e.g. a lack of confidence (1) spending may be delayed due to the expectation that prices may be lower in the future (1) deflationary demand-side policy measures (1) e.g. a rise in the rate of interest (1) rise in direct taxation (1)
- Exports may fall (1) due to e.g. fall in incomes abroad (1) a rise in exchange rate (1)
- A rise in total (aggregate) supply (1) due to e.g. advances in technology (1) increased investment (1) reduced costs of production (1) increase in productivity (1) supply-side policy measures (1) resulting from e.g. improvements in education and training (1)

Question 23

Explain how the Consumer Prices Index (CPI) is calculated.

- A representative basket of most commonly purchased goods and services is constructed (1) the price of these goods and services is monitored over time (1) the goods and services are 'weighted' (1) according to the proportion of disposable income they account for (1) annual price changes are measured (1) and multiplied by weights (1) weighted price changes are measured against a base year (1)

Guidance

- Up to 2 marks for correct numerical examples