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CAMBRIDGE A LEVEL ECONOMICS TOPICAL ESSAY QUESTIONS

INFLATION

PAST QUESTIONS

1. The International Oil Market

Fig. 1 shows how the price of oil has varied greatly over the last thirty years.

World Price of Oil 1970-1999

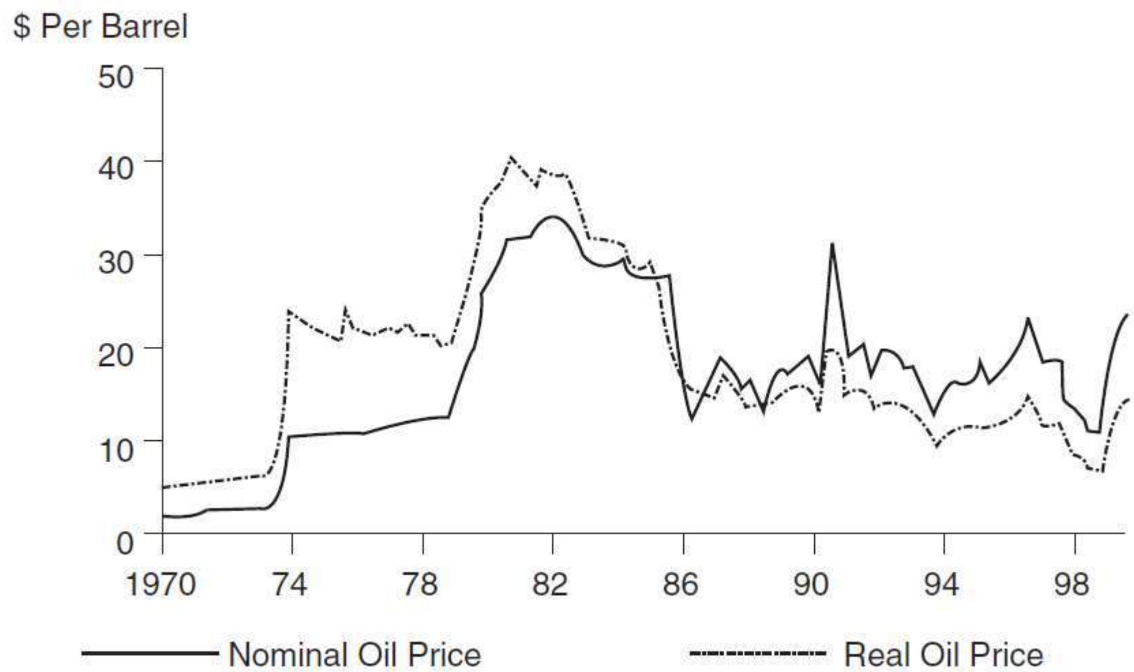

Fig. 1

Oil prices at the end of 1999 were averaging $25 per barrel. This compared with less than $10 per barrel a year earlier. This change was influenced by two main factors. First the Organisation of Petroleum Exporting Countries (OPEC), excluding Iraq, cut production by 4.3 million barrels per day from the level prevailing in 1998. Secondly, after slowing markedly in 1998, world demand grew by about 1 million barrels in 1999 as a result of the upturn in world economic activity.

(a) (i) Explain the difference between the meaning of 'nominal' and 'real' oil prices. [2]

(ii) Describe the general trends in the nominal price of oil between 1970 and 1999 shown in Fig. 1. [2]

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(iii) Using Fig. 1, summarise the relationship between real and nominal oil prices over the period 1970 to 1999. [2]

(b) (i) Identify one year in which the nominal price of oil rose sharply and was subsequently maintained at the higher level. [1]

(ii) Suggest two problems for producers caused by the variability of oil prices. [2]

2. (a) Explain why a country may experience a persistent rise in its general price level. [8]

(b) Discuss why reducing inflation is often the most important task for a government. [12]

3. (a) Explain the difficulties of measuring inflation accurately. [8]

(b) Discuss whether inflation is necessarily harmful. [12]

4. Inflation in Jamaica and the UK

In August 2001 the Bank of Jamaica reported that the monthly rate of inflation in Jamaica for June 2001 had been 1.7% and that the Consumer Price Index (CPI) stood at 1404 compared to its base figure in 1988.

Table 1 gives the monthly inflation rate for each of the different groups of products included in the Jamaican CPI and the percentage weights of each group. It also gives the weights for the same groups in the UK Retail Price Index (RPI) for the same year.

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Table 1

Product group	Jamaican CPI		UK RPI Weight*
	Monthly inflation %	Weight*	
Food and drink	0.7	56	29
Fuels and other household supplies	0.4	7	11
Housing and other housing expenses	−1.3	8	16
Household furnishings and furniture	0.8	3	7
Healthcare and personal expenses	0.5	7	4
Personal clothing, footwear, etc	0.3	5	7
Transport	22.6	6	15
Miscellaneous expenses	0.2	8	11
All groups	1.7	100	100

*rounded to percentages

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Figs 1 and 2 show the rates of inflation in Jamaica and the UK between 1989 and 2000.

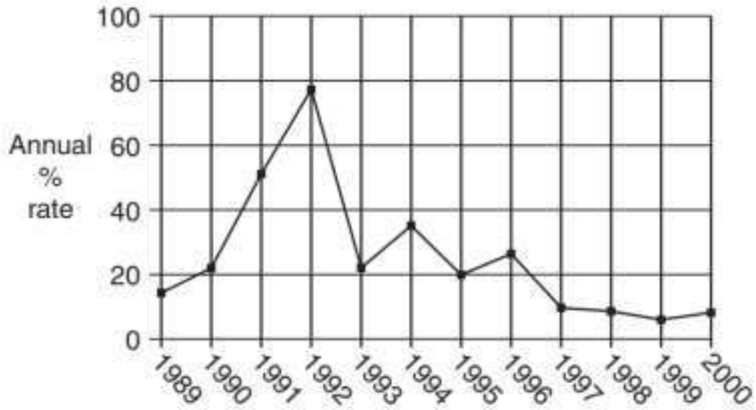

Fig. 1 Inflation in Jamaica

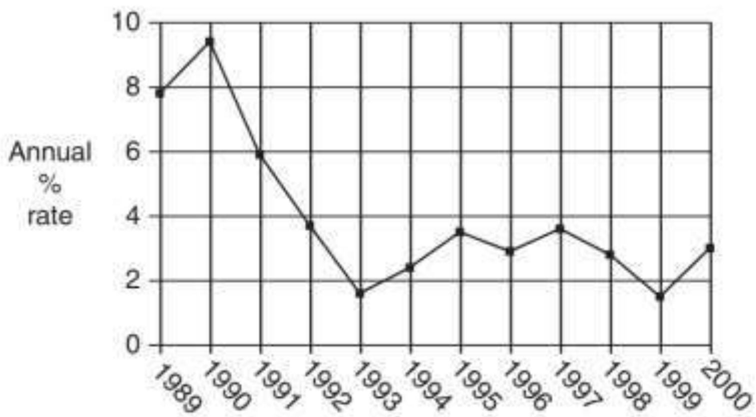

Fig. 2 Inflation in the UK

(a) What happened to the Consumer Price Index in Jamaica between 1988 and 2001? [2]

(b) Choose two product groups from Table 1.

Explain for each of these two product groups one possible reason for the difference in the weights between Jamaica and the UK. [4]

(c) (i) Explain whether food and drink or transport contributed more to the monthly inflation rate in Jamaica in June 2001. [4]

(ii) Comment on the effect of the change in the price of housing and other housing expenses on the monthly Jamaican inflation rate in June 2001. [2]

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(d) Compare inflation in Jamaica and the UK between 1989 and 2000. [2]

(e) Discuss whether inflation is always caused by government action. [6]

5. Inflation in Bangladesh

The annual inflation rate in Bangladesh, as measured by changes in the Consumer Prices Index (CPI), has varied in the period from 2009 to 2019 between 5.4% and 11.4%. The average annual rate of inflation over this period has been 6.7%, one of the highest in Asia.

Table 1.1: Bangladesh Annual Inflation Rate, February 2009 to 2019

Year	Inflation Rate (% change in CPI)
2009	5.4
2010	8.1
2011	11.4
2012	6.2
2013	7.5
2014	7.0
2015	6.2
2016	5.5
2017	5.7
2018	5.5
2019	5.5

Source: World Bank

The relatively high rate of inflation has been caused by price rises in both the food and the nonfood sectors. In terms of the food sector, there have been significant rises in the price of fish, chicken and vegetables, particularly onions. In terms of the non-food sector, price rises have been significant in healthcare, transport and energy resources such as gas.

The Bangladesh Government is concerned about the possible consequences of a relatively high rate of inflation. It has now therefore set an annual inflation rate target of 5.5%.

The central bank of Bangladesh has the maintenance of price stability as one of its main objectives. It uses monetary policy to control the rate of increase of prices in the country. However, there is always the possibility that tough monetary policies could do more harm than good to an economy, compared with the possible use of fiscal policy.

The central bank recognises that inflation can be caused by both demand-pull and cost-push factors in the economy. A particular cause of inflation is the increase in wages. The Wage Rate Index (WRI) rose in December 2019 by 6.6% compared with a 6.4% rise in the index in November.

Source: Adapted from 'Inflation hits 9-month high', The Daily Star, Bangladesh,

16 October 2019, accessed on 24 February 2020

(a) Describe the trend in the annual inflation rate of Bangladesh between 2009 and 2019. [2]

(b) Explain why price changes in the food and the non-food sectors in Bangladesh are treated differently when calculating the CPI. [2]

(c) Explain one domestic consequence and one external consequence for Bangladesh of having 'a relatively high rate of inflation'. [4]

(d) Analyse, with the help of aggregate demand and aggregate supply diagrams, how increasing wages can cause both demand-pull and cost-push inflation in Bangladesh. [6]

(e) 'However, there is always the possibility that tough monetary policies could do more harm than good to an economy, compared with the possible use of fiscal policy.'

Discuss whether monetary policy or fiscal policy is more likely to be effective in controlling inflation. [6]

6. (a) Explain, with the help of a diagram(s), how changes in aggregate demand and aggregate supply can cause inflation in an economy. [8]

(b) Discuss whether deflation is more of a problem in an economy than inflation. [12]

7. Inflation Targeting

Many central banks use 'inflation targeting'. Their principal aim is to achieve a particular annual rate of inflation within an acceptable range. For example, they might aim for a 2% rate of inflation but will accept a rate between 1% and 3%. Some economists claim that inflation targeting will help reduce the actual rate of inflation. The Central Bank of Turkey uses this approach and Table 1 shows how well it has worked.

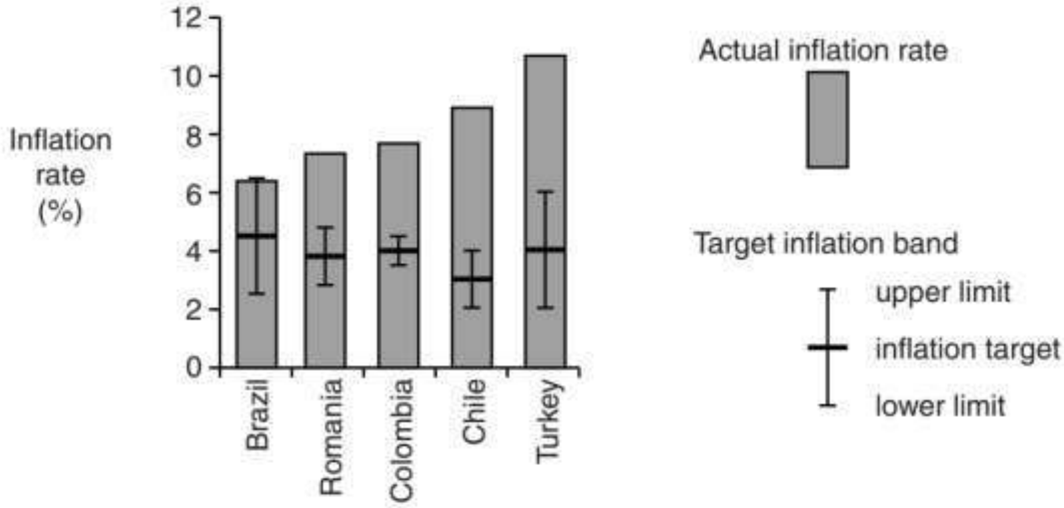
Table 1: Inflation in Turkey 2003–2008 (annual % rate)

	2003	2004	2005	2006	2007	2008
Target rate	20	12	8	5	4	4
Actual rate	18.4	9.3	7.7	9.7	8.4	10.8

In 2008 Turkey faced two particular difficulties. The New Turkish Lira (TRY) depreciated by 30% and food prices rose because of drought. Within the Turkish Consumer Price Index, food has a high weighting of 31%.

How successful five countries were in controlling inflation in 2008 is shown in Fig. 1.

Fig. 1 Target and actual inflation rates in five countries, 2008



(a) (i) In which year was Turkey most successful in meeting its inflation target? [1]

(ii) In which year was Turkey least successful in meeting its inflation target? [1]

(b) Explain the likely effect of the depreciation of the New Turkish Lira on Turkey's rate of inflation. [4]

(c) With reference to Fig. 1, how might differences between the inflation targets and actual inflation rates in Chile and Brazil in 2008 be explained? [4]

(d) How might having a target for inflation affect the causes of inflation? [4]

(e) Discuss the possible problems of constructing an accurate consumer price index. [6]

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8. (a) Explain how unemployment and inflation are measured. [8]

(b) With the help of diagrams, analyse the factors that will lead to an increase in aggregate demand in an economy, and discuss whether this increase is more likely to have an impact on inflation or unemployment in that economy. [12]

9. Problems put the brakes on India's economic growth

With developed economies heavily in debt, the ability of the BRICs (Brazil, Russia, India and China) to drive the global economic engine is increasingly in doubt. China's growth has slowed to its lowest rate in three years. Brazil's growth has decreased and Russia is heavily dependent on oil and energy prices, which are falling. India's growth has slowed but is still high by the standards of developed countries, though well below the levels required to maintain economic momentum and improve the living standards of its citizens.

However, there are still positives in the Indian story. There is a youthful population, a large domestic demand and high savings. But India's economic difficulties, including its weak international position and inadequate infrastructure, threaten to overwhelm the country's potential. In critical sectors such as power, transport and utilities more investment is needed, and although its workforce is young and growing, there is a shortage of skills.

The country is running a current account deficit of more than 3% of GDP. The cause is slowing exports as a result of weakness in India's trading partners and higher imports, mainly purchases of commodities and oil (India imports around 75% of its crude oil).

In addition, India has a weak external position. It has around US$ 270bn in currency reserves. But foreign debts that must be repaid in the current year are about 40–45% of this amount.

Source: Adapted from The Independent

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Table 1: Selected Economic Indicators for India 2007–2013

	2007	2008	2009	2010	2011	2012*	2013*
Gross Domestic Product % change	10.0	6.9	5.9	10.1	6.8	4.9	6.0
Inflation Index 2001=100	130.7	141.7	157.1	175.9	191.5	211.1	231.5
Current Account Balance US$ billion (bn)	–8.08	–30.97	–25.91	–52.22	–62.75	–74.54	–69.07
Exchange Rate: Indian Rupees per US$	41.3	43.5	48.3	45.7	46.6	52.1	52.9

*Forecast *Source: The World Bank and other international organisations*

(a) Calculate the rate of inflation in India between 2001 and 2011. [1]

(b) Calculate the expected rate of inflation in India between 2011 and 2013. [1]

10. (a) Explain how the rate of inflation is measured. [8]

(b) Discuss how a rapid rate of inflation might affect different groups within an economy. [12]

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11. (a) Explain why there can be problems for an economy if the internal value of its money is unstable. [8]

(b) Discuss whether it is possible to construct a consumer price index that is an accurate measure of changes in the cost of living for all households. [12]

12. Dilemma for the European Central Bank (ECB)

The Eurozone consists of 19 European Union (EU) states that have agreed to use a common currency (the euro) and monetary policy, both of which are governed by the ECB. The ECB sets interest rates for all 19 members of the Eurozone and since July 2021 has aimed to maintain the rate of inflation at 2% in the medium term. Interest rates have been held at 0% since March 2016.

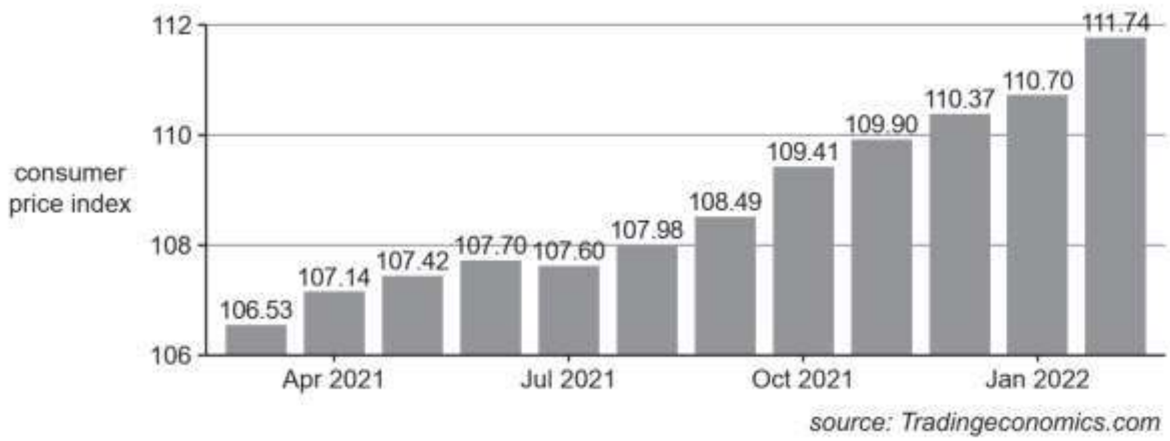


Fig 1.1: Eurozone Consumer Prices Index (CPI) March 2021 – February 2022

In March 2022, the annual rate of inflation hit a record high for the Eurozone of 7.5% and is forecast to continue to rise throughout 2022. Additionally, according to the ECB vice president, annual economic growth is expected to fall from 4.6% at the end of 2021 to around 0% at the end of 2022. Most of the impact of these changes is expected to fall on consumers. Much higher energy costs and rising food prices tend to have a more severe effect on poorer households and those on fixed incomes.

The main causes of the rapid increase in the inflation rate are supply-side factors. The rise in energy prices result from a combination of the Covid-19 pandemic and the conflict between Russia and Ukraine which have reduced supplies of oil and gas. Additionally, the Eurozone labour market is increasingly suffering from a shortage of supply as unemployment has fallen to a record low of 6.8% in February 2022 with further falls predicted. Because the rise in the rate of inflation is almost exclusively supply-side driven, the ECB fears that this will lead to further falls in economic growth leading to a period of 'stagflation', where an economy experiences high inflation and low economic growth at the same time.

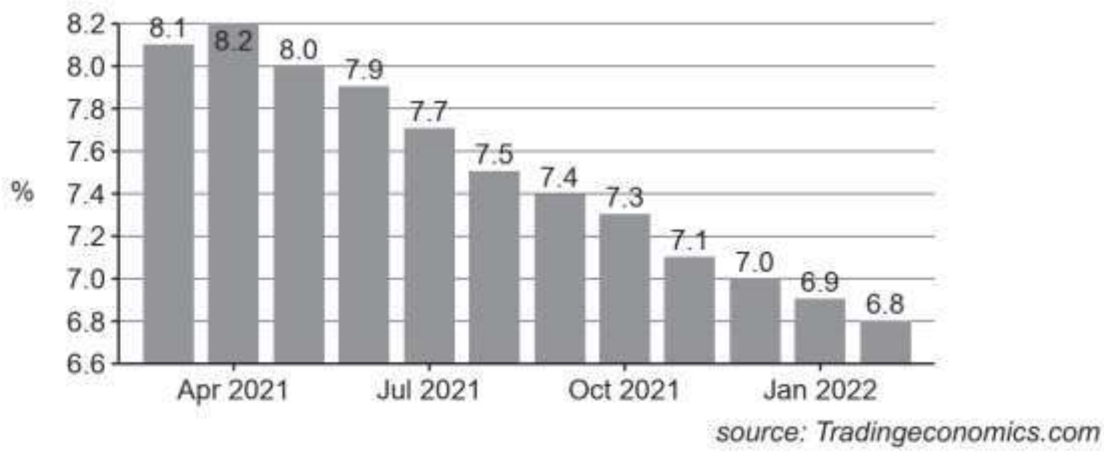


Fig 1.2: Eurozone % unemployment rate March 2021 – February 2022

All this leaves the ECB with a dilemma. Should it:

• increase interest rates substantially now to control the increasing rate of inflation and risk weakening economic growth even further, or

• increase them slightly in the hope that supply pressure will ease soon (this runs the risk of making high inflation more permanent if the pressure does not ease), or

• leave interest rates unchanged?

Sources, adapted from: reuters.com 31 March 2022

and reporting by Balazs Koranyi 1 April 2022

(a) Describe what has happened to consumer prices in the Eurozone between March 2021 and February 2022. [2]

(b) With the help of an aggregate demand and aggregate supply diagram, identify the main type of inflation in the Eurozone. [2]

(c) Consider the extent to which the shortage of supply of labour in the Eurozone may have contributed towards the increasing rate of inflation. [4]

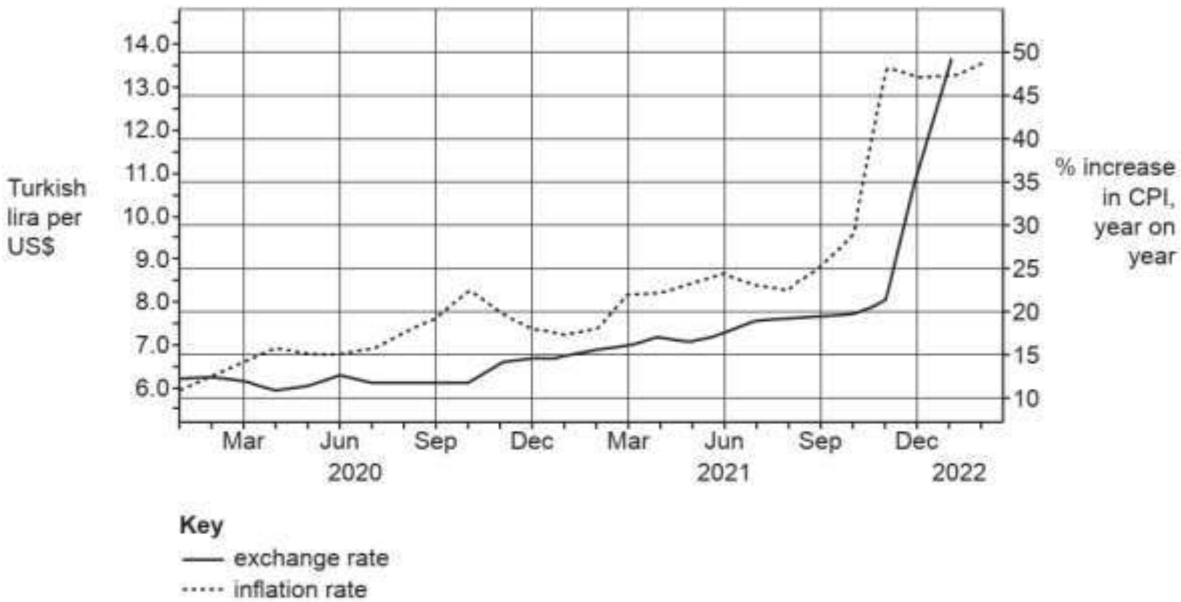
(d) Using the concept of price elasticity of demand, assess the relative impact on poorer households, including those on fixed incomes, of rising prices of food and energy. [6]

(e) Assess the advantages and disadvantages of the ECB 'substantially' increasing the interest rate to control rising inflation. [6]

13. Turkey's unconventional way of managing its economy

The relationship between interest rates and the general price level is one that is central to macroeconomic theory; namely that an increase in the rate of interest produces a reduction in the rate of inflation in an economy. Most economists agree on this relationship. Not so, according to President Erdoğan of Turkey, who has defied conventional economic theory in tackling his country's fundamental economic challenges.

Two economic challenges stand out. There is spiralling inflation and a collapse in the external value of Turkey's currency (the lira) in the foreign exchange market, as shown in Fig. 1.1.



Source: Turkstat, Bloomberg, February 2022

Fig. 1.1 Inflation and the exchange rate of Turkey, January 2020 to February 2022

In January 2022, the year-on-year rise in consumer prices was 48.7%, against a 36.1% year-on-year increase for December 2021. Much higher food prices and transport and energy costs accounted for most of the increase. Despite this rise, the country's Monetary Policy Committee (MPC) held the short-term interest rate at 14%. This was the rate set in September 2021 when the MPC cut the rate substantially from 19%. In short, the President had used his influence over the MPC to reduce interest rates in an attempt to reduce the increasing rate of inflation.

The President's unconventional approach has had a dramatic effect on the external value of the lira. The rapid depreciation in the value of the lira from September 2021 has had serious repercussions for Turkey's economy as Mr Erdoğan has sought to prioritise exports over currency stability. Consumer and producer confidence are low; many who can, have converted their lira deposits into US dollars or euros, fearing a collapse of the banking system.

Despite these problems, the President remains adamant that his economics is right for Turkey. Moreover, he is convinced that when exports increase and international tourists return after the COVID-19 pandemic, employment will increase and the current account deficit on the balance of payments will be reduced. If true, this unconventional approach to Turkey's economic problems will be proved to be a success.

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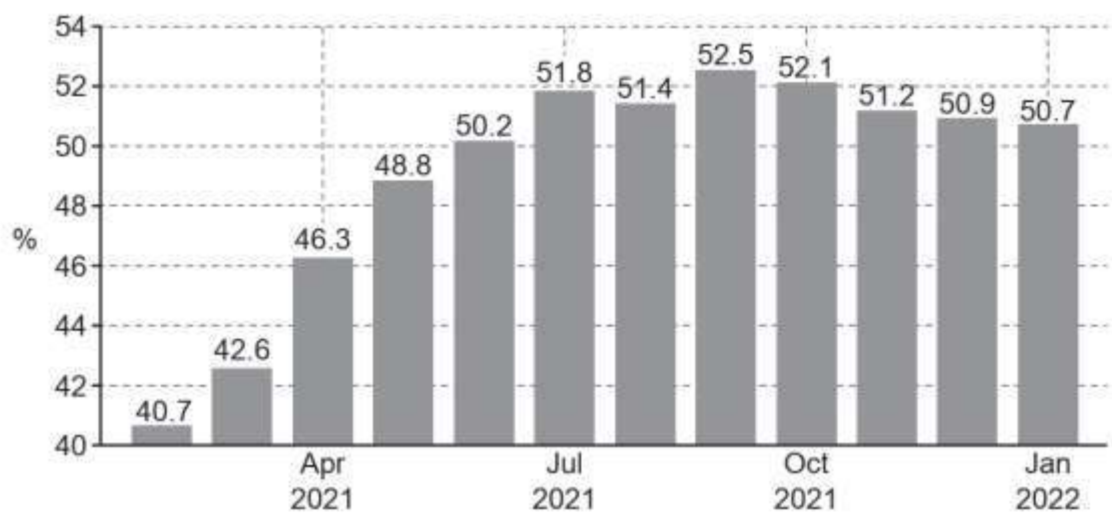
(a) Use the information provided to calculate the real interest rate for Turkey in January 2022. [2]

(b) Excluding interest rate changes, assess what alternative policies might be used to reduce Turkey's rate of inflation. [6]

14. Inflation in Argentina

Argentina's annual inflation rate increased from just over 40% in February 2021 to just over 50% in January 2022. Argentina's annual inflation rate, as measured by changes in the consumer price index (CPI) over 12 months is shown in Fig. 1.1.



Source: tradingeconomics.com, 19 October 2022

Fig. 1.1 Annual rate of inflation in Argentina, February 2021 to January 2022

Argentina has the fifth highest inflation rate in the world after Venezuela, Sudan, Suriname and Zimbabwe. It is forecast to continue to rise during 2022 to reach an annual rate of between 55% and 58% by the end of the year. One of the main reasons for this high rate of inflation is excessive growth of the money supply. The need to lower the rate of inflation in Argentina is considered essential by many economists.

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The government of Argentina has tried to control the increase in the rate of inflation by imposing maximum prices on 1432 products. This has the advantage of limiting price increases, but such a policy can also have a number of disadvantages. One such disadvantage is the creation of excess demand in markets.

Another policy has been to increase interest rates. In January 2022, Argentina's central bank raised its main interest rate from 38% to 40%, but many economists argued that this increase was insufficient to control inflation. This is because the real interest rate will be negative. A more appropriate monetary policy would be to lift the interest rate above the inflation rate so that the real interest rate will be positive.

Source: Adapted from: Buenos Aires Times, 15 February 2022

(a) Using the data in Fig. 1.1, describe the trend shown in the annual inflation rate in Argentina over the period February 2021 to January 2022. [2]

(b) Explain what is meant by 'the real interest rate will be negative' in Argentina in January 2022. [2]

(c) Consider the extent to which having 'the fifth highest inflation rate in the world' is likely to be a problem for Argentina's economy. [4]

(d) Assess the potential benefits and limitations of using monetary policy to control inflation in a country such as Argentina. [6]

15. (a) In 2021, year-on-year inflation in many economies increased to a level not experienced for fifty years.

With the help of a diagram, explain what is meant by cost-push inflation and consider whether this type of inflation has affected your own economy since 2021. [8]

(b) Assess whether the potential benefits of an increasing rate of inflation outweigh the potential costs for an economy. [12]

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16. (a) With the help of an AD/AS diagram(s), explain cost-push inflation and demand-pull inflation in an economy and consider in what circumstances one may be more damaging than the other. [8]

(b) Assess whether monetary policy or supply-side policy is likely to be more successful in reducing the rate of inflation in an economy. [12]

17. (a) Explain the difference between cost-push and demand-pull inflation and consider which is more likely to occur if there is a depreciation in the exchange rate of a country with few natural resources. [8]

(b) Assess whether monetary policy is the only way to control a high rate of inflation. [12]

18. (a) With the help of a diagram(s), explain one reason for an increase in aggregate demand and one reason for an increase in aggregate supply and consider whether an increase in aggregate demand will always lead to inflation. [8]

(b) Assess whether the internal effects of inflation are more serious than the external effects of inflation for an economy. [12]

MARK SCHEME

Table A: AO1 Knowledge and understanding and AO2 Analysis

Level	Description	Marks
3	• A detailed knowledge and understanding of relevant economic concepts is included, using relevant explanations. Explanations are supported by examples, where appropriate. • The response clearly addresses the requirements of the question and explains economic issues, and fully develops these explanations. • Analysis is developed and detailed and makes accurate and relevant use of economic concepts and theories. Where necessary, there is accurate and relevant use of analytical tools such as diagrams and formulae, and these are fully explained. • Responses are well-organised, well-focused and presented in a logical and coherent manner.	6–8
2	• Knowledge and understanding of some relevant economic concepts is included, using explanations and examples that are limited, over-generalised or contain inaccuracies. • The response addresses the general theme of the question and the relevant economic issues, with limited development. • Analysis is generally accurate with some development but little detail. Uses analytical tools such as diagrams and formulae where necessary. Use of these tools is partially accurate or not fully explained. • Responses are generally logical and coherent but are sometimes lacking in focus or organisation.	3–5
1	• A small number of relevant knowledge points are included and the response is limited by significant errors or omissions. • The response has little relevance to the question. • Analysis where provided is largely descriptive. Use of analytical tools such as diagrams and formulae, where necessary, may contain significant errors or be omitted completely. • Responses show limited organisation of economic ideas.	1–2
0	No creditable response.	0

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Table B: AO3 Evaluation

Level	Description	Marks
2	• Provides a justified conclusion or judgement that addresses the specific requirements of the question. • Makes developed, reasoned and well-supported evaluative comment(s).	3–4
1	• Provides a vague or general conclusion or judgement in relation to the question. • Makes simple evaluative comment(s) with no development and little supporting evidence.	1–2
0	No creditable response.	0

1. (a) (i) Nominal = money or current value (1), real = purchasing power or without inflation (1)

(ii) Upward 1970 – 1982 (1), downward 1982 – 1999 (1), erratic after 1986 (1). Any two aspects.

(iii) Two interpretations acceptable:

Pre 1985 real prices higher (1), post 1985 nominal prices higher (1) or both move in same direction (1), but to different extent (1).

(b) (i) 1979 (1) 1973 (1)

(ii) Unstable incomes (1), planning difficulties (1) or other acceptable problems.

2. (a) Inflation can result from cost push and demand pull influences, monetary inflation may also be treated as a distinct category. The influences at work may include import costs, wage costs and higher taxes with higher incomes and changing attitudes. Once started an inflationary spiral may develop.

L3 Explanation of the interaction of various causes

L2 Explanation of the causes

L1 Recognition of the causes

(b) Harmful effects on international competitiveness, distribution of income, market efficiency and planning capability may justify statement. Its importance to other government objectives may be explored. However, the rate of inflation, its comparative level and the seriousness of other economic problems may indicate alternative emphasis.

L3 Discussion of reducing inflation as the most important task

L2 Explanation of the harmful effects of inflation

L1 Recognition of harmful effects

3. (a) Inflation is a sustained rise in the general price level and is measured by an index of consumer (retail) prices. The accuracy of the index can vary with the effectiveness of the data collection, the construction and coverage of the index and the extent to which it is updated. Changes in quality cause problems as well.

For understanding inflation and its measurement	up to 3 marks
For identifying some difficulties	up to 3 marks
For explaining the basis of the difficulties	up to 2 marks

(b) Changes in the general price level give rise to problems in terms of uncertainty and planning, menu and shoe leather costs, redistributional and international effects. The rate of inflation (particularly compared to rivals), its trend and whether it is anticipated affect the severity of the problems it causes. A low rate of inflation

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may be desirable as an incentive to producers and a stimulus to the economy.

It is often advocated in preference to deflation.

For identifying some of the disadvantages	up to 3 marks
For explaining some of the disadvantages	up to 3 marks
For analysing the different possible conditions	up to 3 marks
For discussing the benefits of inflation	up to 3 marks

4. (a) It rose (1), it was 14 times higher or equivalent use of data (1)

(b) Candidates are likely to choose from food, housing, household furnishings and transport. Reasons may relate to differences in needs, income, relative costs and tastes. Accept any sensible comment. (1) per identification of influence + (1) per explanation. **up to max. [4]**

(c) (i) Food and drink contributed .392, while transport contributed 1.356 as weighted inflation (3), transport contributed more (1) over three times as much (1). Recognition of significance of weight or product price % increase to rate of inflation (1) **up to max. [4]**

(ii) These experienced a price fall (1) so would have reduced the inflation rate (1)

(d) The pattern was not dissimilar falling from early high (1), although the points do not coincide exactly (1), the levels were much higher for Jamaica (1), Jamaica above 10%, UK below 10% (1). Either two conclusions or one conclusion with supporting data. A direct comparison must be made for credit. **up to max. [2]**

(e) Government action may contribute by increases in money supply, excessive government spending, increases in indirect taxes or reductions in direct taxation.

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Other influences may be responsible such as wage increases, changes in spending behaviour, increased profit margins, falling exchange rates and rising input prices.

up to 4 marks for each side with a 6 mark maximum.

5. (a) Although the inflation rate is virtually the same in 2009 and 2019, the trend has been up and down during this period, i.e., the trend is fluctuating. (1 mark)

Within this overall trend, it rose between 2009 and 2011 and then fell between 2012 and 2019, although within those years it both rose and fell. (1 mark)

The inflation rate was not lower than 5.4% in any of the years between 2009 and 2019 but was significantly higher in four of the years: 11.4% in 2011, 8.1% in 2010, 7.5% in 2013 and 7.0% in 2014. (1 mark)

2 marks maximum

Guidance:

No mark to be given to answers that just state the eleven figures without any recognition of the overall trend.

(b) A basic recognition that price changes in the food and the non-food sectors in Bangladesh may be different, possibly including some appropriate examples (1 mark)

A clear recognition of the importance of weights in the construction of a CPI/a specific reference to, and explanation of, weightings in the calculation of the CPI for a country. There needs to be a clear reference to weights/weightings by a candidate to award the second mark (1 mark)

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Guidance

Bangladesh:

• There have been significant price rises in the food sector, including: vegetables, particularly onions

• fish

•chicken

There have also been significant price rises in the non-food sector, including:

• healthcare

• transport

•energy resources such as gas

Weighting:

• the situation where certain products are given larger weights to reflect the greater proportion of income spent on them takes into account the relative importance of the components of a CPI

(c) For an identification of one possible domestic consequence. (1 mark)

For an explanation of one possible domestic consequence. (1 mark)

For an identification of one possible external consequence (1 mark)

For an explanation of one possible external consequence (1 mark)

Guidance

The domestic consequences for Bangladesh of a relatively high rate of inflation could include:

• redistribution of income as the real earnings of some workers in Bangladesh rise and the real earnings of others in Bangladesh fall

• borrowers in Bangladesh will gain and lenders in Bangladesh will lose

• menu costs in Bangladesh, e.g., the cost of changing prices

• shoe leather costs in Bangladesh, e.g., the search for good returns

• greater uncertainty – could discourage investment in Bangladesh

• purchasing power of money for people in Bangladesh weaker

The external consequences for Bangladesh of a relatively high rate of inflation could include:

• if the rate of inflation in Bangladesh is higher than in other countries (it states it is one of the highest in Asia), this will make the country's exports less competitive (the effect will depend on PED)

• this may worsen the current account position of Bangladesh.

(d) For an analysis of demand-pull inflation in relation to wage increases. (1 mark)

For an AD/AS diagram to show demand-pull inflation.

(up to 2 marks)

1 mark for correct labelling of the diagram

1 mark for the shift to the right of AD, showing increase in price level

For an analysis of cost-push inflation in relation to wage increases.

(1 mark)

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For an AD/AS diagram to show cost-push inflation. (up to 2 marks)

1 mark for correct labelling of the diagram

1 mark for the shift to the left of AS, showing increase in price level

Guidance:

Demand-pull inflation:

• it is stated that there has been an annual increase in the Wage Rate Index (WRI) of 6.6% in the last month of 2019

• increased consumer spending, e.g., through greater consumer confidence resulting from an increase in income

• the AD curve will shift to the right causing an increase in the general price level

Cost-push inflation:

• wage increases to employees that are not linked to higher productivity

• the AS curve will shift to the left causing an increase in the general price level

The diagrams need to be accurately labelled, with the vertical axis labelled 'general price level' or 'price level' and the horizontal axis labelled 'real output' or 'real GDP'.

(e) For an explanation of the potential advantages and potential disadvantages of monetary policy in controlling inflation. (up to 3 marks)
(A maximum of 2 marks if only advantages or disadvantages are explained)

For an explanation of the potential advantages and potential disadvantages of fiscal policy in controlling inflation. (Up to 3 marks)
(A maximum of 2 marks if only advantages or disadvantages are explained)

5 marks maximum

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Reserve 1 mark for a conclusion

Guidance:

Potential advantages of monetary policy:

• a rise in interest rates can be effective in reducing the level of aggregate demand, especially if demand is interest-elastic; can be effective reducing demand-pull inflation

• other monetary policies to control inflation can include a reduction of the money supply and a rise in the exchange rate

Potential disadvantages of monetary policy:

• an increase in interest rates may not be significant enough to have an effect, i.e., demand is relatively inelastic

•the impact of an increase in interest rates can take a relatively long time to take effect

• it will be less useful in controlling cost-push inflation

• a rise in the exchange rate will not be useful if the PED for imports and exports is inelastic

• a reduction of the money supply may sometimes be difficult to bring about

Potential advantages of fiscal policy:

• a reduction in public expenditure can help to reduce the level of aggregate demand in an economy

• an increase in the level of taxes can also have such an effect

Potential disadvantages of fiscal policy:

• it may not always be easy for a government to change its expenditure/revenue plans

• increased taxes can have a disincentive effect

• less useful controlling cost-push inflation

6. (a) Knowledge and Understanding:

1 mark for diagram showing change in aggregate demand.

1 mark for diagram showing change in aggregate supply.

(KU: up to 2 marks)

Application:

Up to 3 marks for an explanation in relation to changes in AD and the cause of inflation in an economy.

Up to 3 marks for an explanation in relation to changes in AS and the cause of inflation in an economy.

(APP: up to 6 marks)

Guidance:

Demand-pull inflation:

• reflationary policies by a government

• increased consumer spending, e.g. as a result of greater consumer confidence

Cost-push inflation:

• wage increases to employees which are not linked to higher productivity

• an increase in the cost of imported raw materials, e.g. because of a fall in the value of a currency

• an increase in input prices, e.g. because of the monopoly power of suppliers or higher energy prices

(b) **Analysis:**

Up to 4 marks for analysis of the problems of inflation.

Up to 4 marks for analysis of the problems of deflation.

(AN: up to 8 marks)

Evaluation:
For exercising some judgement on whether deflation is more of a problem in an economy than inflation .

Up to 3 marks plus 1 mark for a conclusion
(EV: up to 4 marks)

Guidance:
Problems of inflation:
• redistribution of income

• investment planning difficulties for firms

• uncompetitiveness of exports (depending on relative inflation rates in different countries)

• menu costs

• shoe leather costs

Problems of deflation:

• fall in economic activity/output

• rise in unemployment

7. (a) (i) 2005

(ii) 2008

(b) Depreciation reduces export prices (1), raises import prices (1), lower export prices may increase demand inflation (1), higher import prices may raise cost-push pressures (1), higher import prices may raise demand for home produced goods, increasing demand inflation (1)

(c) Chile had a lower and/or narrower target band (1), a stricter policy towards inflation(1)

Chile had higher inflation (1), Chile less effective in anti-inflationary policy (1),
Brazil within target range; Chile exceeded target (1)
May be dealt with from Brazil's angle or Chile's, reward logical assumptions.

(d) Cost push: target influences attitudes/expectations (1), workers may limit pay claims (1), producers may restrict price rises (1)
Less direct effect on demand pull and monetary inflation (1)
Government intention may be accompanied by further policy moves (1)

Example with effect on inflation (1)

(e) Understanding of CPI (1 max.)
The problems include limited data, inadequate sampling, inaccurate calculation, incorrect weights, unsound base year and lack of objectivity.

Some problems may have limited importance e.g. the omission of minor goods and services, some may be easily solved e.g. the need for wider sampling while some may undermine the validity of the index e.g. government manipulation of the data.

Recognition of problems (1) and explanation of problems (2) = 3 marks
Comment on problems = 3 marks

8. (a) Candidates should display knowledge of both measures of unemployment and inflation.

Reference should be made to the unemployment rate, the claimant count and answers are likely to have some idea of the difficulties involved in measuring unemployment. In the case of the measurement of inflation either the CPI or the RPI are acceptable.

• For knowledge and understanding of how unemployment and inflation are measured (2 + 2). Up to 4 marks

• For application showing the issues involved in measuring unemployment and inflation with accuracy (2 + 2). Up to 4 marks

(b) Candidates should show a good understanding of the components of aggregate demand and be able to explain the factors that would cause an upward shift in the aggregate demand curve. The diagram should be accurate and clearly labelled and explain the point of equilibrium.

Whether the impact is on inflation or unemployment depends upon the full employment position and the shape of the aggregate supply curve.

• For analysis of shifts in the aggregate demand curve with appropriate diagrams and with accompanying explanation. Up to 8 marks

• For evaluative comment on the likelihood of the impact being on inflation or unemployment. Up to 4 marks

9. (a) 91.5% (1 mark)

Accept no other answer

There is no need to refer to %

(b) 20.9% (1 mark)

Accept any answer between 20.8 and 21.0

There is no need to refer to %

10. (a) Inflation is a sustained rise in the general price level, measured by a price index. Its main features are a basket of goods, a base year, weighting and data collection. Data is calculated at different times to show changes in the index and rate of inflation.

Understanding of inflation (2)

Explanation of the construction of a price index (6)

(b) Understanding of general effects and importance of relative rate of inflation (4)

Discussion of those who benefit (4)

Discussion of those who suffer (4)

11. (a) Money is anything generally acceptable as a means of payment and fulfils four functions. It will not fulfil these effectively if its value is unstable. Consequences will include obstacles to trading, problems for producers in planning output and for consumers in judging purchases, instability in foreign trade, saving and tax revenues. Economic progress and greater welfare require an efficient and stable system of exchange.

For knowledge of money and its functions up to 2 marks

For explanation of the impact on economic variables up to 6 marks

(b) CPI measures the rate of inflation or changes in the cost of living. It is constructed by selecting a basket of goods, allotting the items weights and sampling at different times outlets through which they are sold. Changes in the price level can then be calculated. Although this is done accurately it may not reflect the change in prices faced by all citizens. This will depend on the composition of the basket of goods, the weighting given to each item, how frequently values are taken and the range of outlets used. Some groups have spending patterns which differ from the average because of income and wealth levels and attitudes. Pensioners are an often quoted case, but house owners and young people might also not be representative.

For understanding the construction of CPI up to 4 marks

For analysis of areas of possible inaccuracy up to 6 marks
For discussion of spending patterns of different households up to 6 marks
to 10 marks

12. (a)

• **For example**, consumer prices / inflation/ CPI have risen over this period (1) by 4.89% (accept an answer between 4.8% and 4.9%) (1) rose every month except July 2021 (1).

Guidance:

Other examples may include, the largest increase was in February 2022 (1), the rate of increase was generally lower before October 2021 than after. (1)

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Note: simply stating consumer prices have increased from 106.53 to 111.74 or by 5.21% is worth 1 **MAX.**

Award one mark for each valid change between March2021 and February 2022. **Note:, it is not necessary to provide figures / calculations.**

(b)

• For clearly identifying that the main type of inflation in the Eurozone is cost-push inflation (1)

• Shown on a correctly labelled diagram that shows a shift to the left of the AS curve and the increase in the price level (1)

(c)

• Shortage of the supply of labour is likely to increase wage rates (1)

• Which will increase business costs of production/ and therefore cause cost-push inflation/shift AS curve to the left (1)

• However, energy costs have also increased further adding to costs of production (1)

For valid evaluation

• Extent therefore depends on (e.g.) relative increases in costs due to wages and energy costs (1)

Please use a text box to show the mark split e.g., 2,1

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(d)

For explanation/ analysis (up to 4 marks)

For a fully accurate formula of PED and / or an explanation of what it measures in terms of the responsiveness / percentage change in quantity demanded compared to a change in price (1)

For an explanation that food and energy would be classed as essential/necessity goods and therefore price inelastic meaning that quantity demanded would be less responsive to a change in price / the fall in quantity demanded would be less than the increase in price (1)

For an explanation that poorer households (including fixed income households) would suffer a great detrimental / negative effect because their income does not rise in line with inflation and / or they are unlikely to be in a position to negotiate for higher wages (1)

For an explanation that this situation can only be overcome if e.g., government support is made available to assist poorer households with the rising prices of food and energy. (1)

ALTERNATIVELY, the 4th mark can be given for a comparison to higher income households who will probably be in a position to either negotiate for income increases in line with inflation OR absorb the rising prices of food and energy.

For evaluation

That clearly assesses the extent of the impact solely on lower income households e.g., by considering the amount of possible government assistance possible, the degree to which such households can compensate for the price rises etc., **Reserve 1 mark** for a justified conclusion.

OR

That clearly assesses the relative impact on **different types of households (including high-income households)** by considering e.g., the proportion of income spent on food and energy together with their ability to negotiate for higher pay. **Reserve 1 mark** for a justified conclusion.

Please use a text box to show the mark split e.g., 3,1

(e)

Up to 2 marks for explanation / analysis of the advantages of substantially increasing the interest rate to control rising inflation e.g., it will curb demand-pull inflation by reducing AD and it is a relatively quick and easy policy to adopt.

Up to 2 marks for explanation / analysis of the disadvantages of substantially increasing the interest rate to control rising inflation e.g., this inflation is supply led and reducing AD will have little effect and in fact this policy may add to supply costs and cause other unintended serious consequences for the economy.

Up to 2 marks for evaluation

• That clearly considers **both** advantages **and** disadvantages / compares with an alternative policy such as supply-side policy / refers to the significance of a substantial increase**. No mark for eval can be awarded if only advantages or disadvantages are considered.**

• Comes to a reasoned conclusion as to whether advantages outweigh disadvantages or vice versa **(reserve 1 mark)**

Please use a text box to show the mark split e.g., 2,2,2

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13. (a)

• For a correct answer of -34.7% (2)

• For an answer of 34.7% without the minus sign (1) OR

• For the correct formula with an incorrect calculation OR no calculation (1)

Guidance: The case study gives the annual year on year increase in consumer prices (48.7%) and the interest rate of (14%). The real interest rate is negative and is the difference between the two, namely 34.7%

(b)

Up to 2 marks for explanation / analysis of the possible effect of one

alternative policy e. g., a reduction in money supply or tighter restrictions on credit i.e., additional monetary policy. These may successfully reduce AD due to less

money being available for C or I but may reduce economic growth. (1 mark for an explained advantage and 1 mark for an explained disadvantage)

Up to 2 marks for explanation / analysis of the possible effect of a second alternative policy e.g., fiscal policy to increase taxation or reduced government spending. This may reduce AD as it has a direct effect of reducing C and I but it may reduce e.g., the incentive to work as taxation increases. (1 mark for an explained advantage and 1 mark for an explained disadvantage)

Up to 2 marks for evaluation that clearly assesses the likely advantages and disadvantages of these policies in comparison with each other / against interest rate changes. Reserve 1 mark for a valid conclusion.

Guidance:

Other possibilities include:

• Use of supply side policy

Please use a text box to show the mark split e.g., 2 2 1

14. (a)

• The overall trend during this period has been upward/increasing/rising from 40.7% in February 2021 to 50.7% in January 2022. (1)

• Within this overall upward trend, there has actually been a downward trend from 52.5% in September 2021 to 50.7% in January 2022. (1)

(b)

• It is when the interest rate is lower than the inflation rate in Argentina. (1)

• In January 2022, it would be -10.7%/or method of calculation. (1)

(c) Explanation of why a high rate of inflation in Argentina might be a problem for Argentina's economy, such as in terms of:

• a reduced purchasing power of money

• less competitive exports

• menu costs

• shoe leather costs

• uncertainty in the economy and the possible impact on investment

• the possible negative impact on savers

• the possible negative impact on fixed income earners.

However, there could be some benefits, such as:

• increase in profits for firms

• lower debt in real terms.

Max 3 marks (Up to 2 marks for problems and up to 1 mark for benefits)

Evaluation

Offers a valid judgement on the extent to which a high rate of inflation in Argentina is a serious economic problem, taking into account how its rate of inflation compares with other countries and/or the fact that inflation can have benefits, such as an increase in profits for firms where prices rise by more than costs and an advantage for borrowers whose debt will be less in real terms.

Max 1 mark

(d) **Up to 4 marks for explanation/analysis:**

• Explanation/analysis of the potential benefits of using monetary policy to control inflation in a country such as Argentina, such as the possibility that this will lead to a reduction in aggregate demand and how this may reduce inflation. (Up to 3 marks)

• Explanation/analysis of the potential limitations of using monetary policy to control inflation in a country such as Argentina, such as the difficulty of knowing what the appropriate interest rate should be and the possibility that demand could be relatively interest-inelastic and the meaning of this.

(Up to 3 marks)

Max: 4 marks

Up to 2 marks for evaluation:

• Relevant evaluation which weighs up the potential benefits and limitations of using monetary policy to control inflation in a country such as Argentina.(1)

• A conclusion on the likely overall effect. (1)

15. (a) up to 3 marks for AO1 Knowledge and understanding, up to 3 marks for AO2 Analysis, and up to 2 marks for AO3 Evaluation.

AO1 Knowledge and understanding (max 3 marks)

• An explanation of cost-push inflation – when the price level rises due to higher costs of production and raw materials (1).

• An accurate aggregate and aggregate supply diagram showing a shift to the left of the short run AS curve (1).

• This results in a rise in the price level and a contraction/movement along the aggregate demand (AD) curve (1).

AO2 Analysis (max 3 marks)

Points to consider:

• For example, an increase in wages/salaries increases the firm's costs of production (1). Firms will look to pass these additional costs onto its customers which increase the price of all goods and services (1).

• Increased import prices (due to a depreciation of the domestic currency) (1) will increase the costs of production to firms that are reliant on other countries to produce raw materials/price inelastic demand for imports (1).

AO3 Evaluation (max 2 marks)

• Evaluation should explain the extent to which inflation in the named economy is the result of cost-push factors as opposed to demand pull causes (1), leading to a justified conclusion (1).

N.B: if the evaluation is not in the context of a named economy, then no evaluation marks can be awarded.

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AO1 Knowledge and understanding 3

AO2 Analysis 3

AO3 Evaluation 2

(b) AO1 and AO2 out of 8 marks. AO3 out of 4 marks.

Indicative content

Responses may include:

AO1 Knowledge and understanding and AO2 Analysis

Potential benefits of an increasing rate of inflation include:

• It stimulates output – a low and stable inflation rate caused by existing demand may make firms feel more optimistic about the future and encourage them to invest to expand their business.

• A possible reduction in the burden of debt. If inflation is rising faster than the nominal rate of interest on previous borrowing then real interest rates become negative which may stimulate consumer expenditure which, in turn, could lead to higher output and employment.

Potential costs of an increasing rate of inflation include:

• A reduction in net exports as rising inflation rates may reduce the international competitiveness of a country resulting in reduced export revenue and increased import expenditure.

• Fiscal drag – if tax rates are not increased in line with inflation, then people are 'dragged' (pulled) into higher tax brackets. As such, lower proportions of any increase in incomes are enjoyed by the taxpayer.

Level 1 responses will be assertive and lacking in explanations / mainly descriptive and/or or mainly lacking in relevance to the question.

Level 2 responses may contain some inaccuracies and will be one sided. Analysis will be explained at least in part and will be largely relevant to the question.

Level 3 responses will consider alternative policies / concepts etc. and will be balanced. Explanations of points raised will be offered and will be accurate and relevant to the question.

AO3 Evaluation

Requires an assessment of the benefits and costs of increasing rate of inflation (which may refer to specific groups) which leads to a justified conclusion as to which the benefits outweigh the potential costs.

Accept all valid responses.

N.B: A one-sided response cannot gain any marks for evaluation.

AO1 Knowledge and understanding and AO2 Analysis 8

AO3 Evaluation 4

16. (a) up to 3 marks for AO1 Knowledge and understanding up to 3 marks for AO2

Analysis

up to 2 marks for AO3 Evaluation.

AO1 Knowledge and understanding (3 marks maximum)

An understanding of the causes of inflation in an economy shown through an accurate diagram with correctly labelled axes (price level and real output) (1), with cost-push inflation shown by a shift of the AS curve to the left (1) and demand-pull inflation shown by a shift of the AD curve to the right. (1)

AO2 Analysis (3 marks maximum)

• Uses the diagram to explain the possible damaging effects of cost-push inflation in an economy.

(Up to 2 marks)

• Uses the diagram to explain the possible damaging effects of demand-pull inflation in an economy.

(Up to 2 marks)

3 marks maximum

AO3 Evaluation (2 marks maximum)

Offers a valid judgement on the comparison of the two causes of inflation in an economy, including the factors that could make one cause more damaging than the other (1) to reach a conclusion. (1)

AO1 Knowledge and understanding 3

AO2 Analysis 3

AO3 Evaluation 2

(b) AO1 and AO2 out of 8 marks. AO3 out of 4 marks.

Indicative content

Responses may include:

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AO1 Knowledge and understanding and AO2 Analysis

•The meaning of monetary policy.

• The tools of monetary policy appropriate to a contractionary monetary policy: decreases in the money supply and/or an increase in the rate of interest and an appreciation of the exchange rate.

• An explanation of the strengths and weaknesses of monetary policy to reduce the rate of inflation in an economy.

• The meaning of supply-side policy.

• Examples of supply-side policy to reduce the rate of inflation in an economy, such as making the labour market more flexible, increased expenditure on education and training and promotion of competition in markets.

• An explanation of the strengths and weaknesses of supply-side policy to reduce the rate of inflation in an economy.

AO3 Evaluation

• Consideration of whether each policy is appropriate for both types of inflation.

• To arrive at a conclusion on whether monetary policy or supply-side policy is likely to be more successful in reducing the rate of inflation in an economy.

Accept all valid responses.

AO1 Knowledge and understanding and AO2 Analysis 8

AO3 Evaluation 4

17. (a) up to 3 marks for AO1 Knowledge and understanding up to 3 marks for AO2 Analysis

up to 2 marks for AO3 Evaluation.

AO1 Knowledge and Understanding (max 3 marks)

Cost push inflation is inflation caused by increases in the costs of production (1). Demand pull inflation is caused by increases in AD not matched by equivalent increases in AS (1). A clear explanation of the differences between the two (1)

AO2 Analysis (max 3 marks)

A depreciation in the exchange rate will lead to a fall in the price of exports for the trading partner and a rise in the price of imports for the country in question. This should be analysed with reference to the impact on the different types of inflation.

Maximum of 2 marks if only demand-pull inflation is considered and should focus on the impact of the fall in price of exports and the rise in the price of imports and the possible impact on the X -M component of AD and therefore the impact on AD overall. Reference may be made to the PED of exports and the PED of imports.

Maximum of 2 marks if only cost push inflation is considered. Reference must be made to the importance of imports (1) and the fact that this country has few natural resources which probably means they must be imported for the 2nd mark.

AO3 Evaluation (max 2 marks)

For an answer that clearly considers the fact that this country has few natural resources (1) to come to a justified conclusion as to which type of inflation is most likely to be the outcome for a country with few natural resources (1)

AO1 Knowledge and understanding 3

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AO2 Analysis 3

AO3 Evaluation 2

(b) AO1 and AO2 out of 8 marks. AO3 out of 4 marks.

Indicative content

Responses may include:

AO1 Knowledge and understanding and AO2 Analysis (max 8 marks)

Explain the advantages and disadvantages of using monetary policy to control high rates of inflation to analyse its effectiveness. Points to consider may include:

• The use of interest rates to dampen AD.

• Reductions in money supply to dampen AD.

• The use of credit regulations to influence bank lending BUT

• There is also a time lag between implementing interest rate policy and it taking effect.

• Other factors other than interest rates may affect consumer spending and offset the impact of a rise in interest rates e.g., consumer confidence, expectations etc.

Monetary policy should be compared with the advantages and disadvantages of at least one other appropriate policy e.g., supply side and/or fiscal policy

A one-sided response can only gain a maximum of Level 2.

AO3 Evaluation (max 4 marks)

• Consideration of the relative effectiveness monetary policy to control high rates of inflation compared with at least one other appropriate policy.

• Although it is not necessary within the analysis / question, reference may be made to the relative effectiveness of these policies in controlling the different types of inflation.

• A justified conclusion showing which policy is most likely to be effective in controlling high rates of inflation.

A one-sided response cannot gain any marks for evaluation.

Accept all valid responses.

AO1 Knowledge and understanding and AO2 Analysis 8

AO3 Evaluation 4

18. (a)

• up to 3 marks for AO1 Knowledge and understanding.

• up to 3 marks for AO2 Analysis

• up to 2 marks for AO3 Evaluation.

AO1 Knowledge and Understanding (max 3 marks)

Aggregate demand is the total demand for an economy's goods and services at a given price level/it is the total of C + I + G +(X-M) (1)

Aggregate supply is the total output that producers in an economy are willing and able to supply at a given price level (1)

An accurate diagram showing AD and AS curves (1)

AO2 Analysis (max 3 marks)

Analysis must explain a valid cause of an increase in AD (1)

and a valid cause of an increase in AS (1)

and show these increases by rightward shifts in **both** curves **and** the resultant

impacts on the price level on an accurate diagram (1)

AO3 Evaluation (max 2 marks)

Whether an increase in AD will always lead to an increase in the price level (inflation) will depend on the increase in AS and/or the shape of/position on the AS curve (1). This must be clearly explained, and reserve one mark for a valid judgement (1)

AO1 Knowledge and understanding 3

AO2 Analysis 3

AO3 Evaluation 2

(b)

AO1 and AO2 out of 8 marks. AO3 out of 4 marks.

Indicative content Responses may include:

AO1 Knowledge and understanding and AO2 Analysis

The internal effects of inflation are those which affect the domestic economy directly and may include:

• Income redistribution

• Menu costs (or the costs to firms of having to change their prices frequently)

• Shoe leather costs (or the inconvenience of having to hold smaller quantities of cash/searching for the best rate of interest)

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• Uncertainty in transactions

• But also, may provide a stimulus for output and be a sign of economic growth.

The external effects of inflation are those which affect its international trade and may include.

• Declining price competitiveness of exports and increased competitiveness for imports

• This may increase the current account deficit.

• May lead to a depreciation of the exchange rate.

• Uncertainty in international transactions

• But also, depending on price elasticity of demand, it may boost revenue from exports plus it will improve the terms of trade and may be a sign of increased demand for its goods and further stimulate output.

• Both internal and external effects need to be considered to gain more than L2.

• One positive effect (in addition to negative effects) only for internal or external can gain low L3.

• Positive effects **and** negative effects analysed for **both** internal **and** external can gain top L3.

AO3 Evaluation

• Consideration of both the internal and external effects of inflation for an economy

• An assessment of which effects are likely to be the most serious.

• A justified conclusion as to which effect is likely to be the most serious.

Accept all valid responses.

A one-sided response cannot gain any marks for evaluation.

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