A-Level Edexcel Economics: Inflation and Deflation Past Paper Questions
Question 1

The chart below shows UK inflation as measured by the Consumer Prices Index (CPI), 2011 to 2015.

(Source: http://www.ons.gov.uk/ons/dcp171780_427182.pdf)

(a) Which one of the following statements is correct about the UK’s inflation record between September 2011 and January 2013?

Based on the data shown, the UK experienced:

☐ A deflation
☐ B disinflation
☐ C falling average prices
☐ D falling money supply
Question 2

(a) All other things being equal, demand-pull inflation is most likely to result from an increase in

   A  the rate of interest
   B  the cost of imported raw materials
   C  the rate of income tax
   D  government spending

Answer  

(1)
Question 3 (aii)

Question 1: Measures of economic performance

**Figure 1: Measures of economic performance, selected developed countries**

<table>
<thead>
<tr>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>2.0</td>
<td>1.8</td>
<td>-1.8</td>
<td>0.952</td>
</tr>
<tr>
<td>Germany</td>
<td>2.0</td>
<td>1.8</td>
<td>5.1</td>
<td>0.935</td>
</tr>
<tr>
<td>Spain</td>
<td>2.7</td>
<td>2.8</td>
<td>-10.2</td>
<td>0.949</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>2.3</td>
<td>2.0</td>
<td>-3.6</td>
<td>0.946</td>
</tr>
</tbody>
</table>


**Figure 2: School enrolment figures and HDI ranks, selected developed and developing economies (2005)**

<table>
<thead>
<tr>
<th>Economy</th>
<th>Combined enrolment ratio for primary and secondary education (%)</th>
<th>HDI Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>99</td>
<td>10</td>
</tr>
<tr>
<td>Spain</td>
<td>98.5</td>
<td>13</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>97</td>
<td>16</td>
</tr>
<tr>
<td>Pakistan</td>
<td>44.5</td>
<td>136</td>
</tr>
<tr>
<td>Kenya</td>
<td>60.5</td>
<td>148</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>44.5</td>
<td>169</td>
</tr>
<tr>
<td>Niger</td>
<td>24</td>
<td>174</td>
</tr>
</tbody>
</table>

(a) With reference to Figure 1,

(i) explain what is meant by the term economic growth. (4)

(ii) outline how the Consumer Price Index is calculated. (4)

(iii) discuss two reasons why economic growth is inadequate as a measure of changes in living standards over time. (12)

(b) (i) Does Spain's current account balance as shown in Figure 1 represent a net injection or withdrawal? Explain your answer. (4)

(ii) Outline two possible reasons for Spain's current account balance, with reference to the data in Figure 1. (6)

(c) With reference to Figures 1 and 2,

(i) explain what is meant by the term Human Development Index. (4)

*(ii) evaluate the advantages of the HDI in making comparisons between countries. (16)

*(d) Evaluate the use of supply side policies to achieve economic growth. (30)
Question 4

UK incomes, inflation and monetary policy

Figure 1 – UK average weekly household real income


Figure 2 – UK inflation rate as measured by percentage changes in the Consumer Price Index (CPI)

(Source: http://www.bankofengland.co.uk/publications/Pages/inflationreport/2015/feb.aspx)

(d) With reference to the data, explain **two** likely reasons for the UK’s falling inflation rate.
Question 5

Extract A

Britons should not fear rise in interest rates

The Monetary Policy Committee (MPC) of the Bank of England is prepared to raise interest rates “in the near future” if inflation increases, one of its senior policymakers has warned.

Kristin Forbes, a member of the MPC, said a rise in borrowing costs would also be necessary should household debt reach unhealthy levels. However, she stressed that this was not yet a cause for concern.

With the UK’s base rate of interest at 0.5% and inflation at a record low and expected to be negative, the MPC is currently under no pressure to raise interest rates, despite Britain’s economic recovery.

UK inflation is being driven lower by the slump in global oil prices, which have roughly halved since summer 2014, and the Bank’s governor Mark Carney warned earlier this month that a strong domestic economy would translate into higher UK inflation over the medium term. “The most likely next move in monetary policy is an increase in interest rates. The message is clear,” Carney said.

Forbes said “even the more lagged effects of the rise in the value of the pound will likely peak in the first part of this year and also gradually fade. Inflation will then most likely bounce back.

“Since interest rates take well over a year to be fully effective, they should be adjusted to respond to inflationary risks at that time horizon – when all of these effects have diminished – rather than respond to today’s inflation.”


Extract B

Deflation is bad news

The problem with deflation is that once you have it you can’t get rid of it. Central banks know what to do about inflation but they do not have the policy tools to deal with deflation when interest rates are almost as low as they can go. Just look at Japan, which had deflation in nine separate years from 1999-2012, with two additional years at zero, averaging minus 0.3%. The highest in any single year was minus 1.3% in 2013.

In the European Union (EU) in 2008, at the start of the financial crisis, there were fears of deflation but at that time central banks had the ability to cut interest rates by nearly 5 percentage points. Those fears may now be coming true, with the EU experiencing deflation of 0.5% in 2015.

This was driven primarily by declines in energy prices, but there was also deflation in non-energy industrial goods and telecommunications. The collapse in the cost of shipping goods potentially suggests something deeper is going on and may lead to a more persistent form of deflation than Mark Carney has currently claimed.


(e) With reference to Extracts A and B and your own knowledge, discuss whether the MPC should be concerned about the risk of deflation in the UK economy.
Question 6

Extract A

Why Britain needs a pay rise

UK growth in 2013 has been caused mainly by increases in consumption. Rising consumption tends to encourage companies to invest. The increase in demand for goods and services means firms need more productive capacity, often moving to bigger premises and buying capital equipment. Crucially, though, they only do so if they think the increase in consumption is likely to be permanent.

At the start of 2013, it was hard to see why consumer spending would rise. The economy had recorded little growth for two years and confidence was low. Inflation had been higher than earnings growth during 2012, making it hard for families to manage.

Three factors combined to change the picture: cheap credit, the Bank of England’s funding for lending scheme (FLS), and rising consumer confidence. The Bank of England cut its official interest rate to 0.5% in early 2009, but it took a long time for the monetary stimulus to have an impact.

It only really did so when FLS was announced in the summer of 2012. This was a deal under which the commercial (high street) banks could borrow more cheaply from the Bank of England provided they passed on the benefits to their customers.

The idea was that household and business borrowers would benefit: loans would become more readily available and the interest rates charged on them would be lower. Lending to businesses was disappointing, but the impact on the mortgage market was rapid and significant: more mortgages were approved, and at lower rates of interest. This contributed to the improvement in the housing market, which in turn boosted confidence, leading to higher spending, and this led to higher growth.

Consumers ran down their savings to fund this higher spending. Again, this is not unusual. Households become more cautious in troubled times and they save more just to be on the safe side.

However, unless consumers are willing to save less and less and borrow more and more, there is only so long this process can continue. Eventually, consumer spending growth has to be the result of rising real incomes rather than falling savings.

After a year in which the consumer has been the driving force behind the expansion of the economy, 2014 should be the year when investment contributes to growth. Many of the conditions for an increase in business spending are in place: companies are cash rich, profitability is good, interest rates are set to stay low, and ageing capital stock needs replacing.

The one factor not in place is the most important one of all: an increase in real wages. If companies believe that consumers will carry on spending, they are much more likely to go ahead with new investment projects. If they think consumer spending will not increase, then they will be unwilling to invest. This will mean that inflationary pressures build up and the trade deficit will continue to widen.


(e) Discuss the likely impact of both a lack of new investment and an appreciation of the British pound (£) on ‘inflationary pressures’ in the UK (Extract A line 36).
Question 7

(f) Evaluate whether the MPC has been successful in controlling the UK’s inflation rate since 2011.
Question 8

*(ii) Evaluate two benefits of low and stable inflation for the UK economy.

(12)

Question 9

Explain two reasons why the government has a low rate of inflation as a macroeconomic objective.

(8)
Question 10

Figure 1
UK Consumer Price Index (CPI)

<table>
<thead>
<tr>
<th>Year</th>
<th>UK CPI (Annual Average 2005 = 100)</th>
<th>UK CPI percentage change over 12 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>108.5</td>
<td>3.6%</td>
</tr>
<tr>
<td>2009</td>
<td>110.8</td>
<td>2.2%</td>
</tr>
<tr>
<td>2010</td>
<td>114.5</td>
<td>3.3%</td>
</tr>
<tr>
<td>2011</td>
<td>119.6</td>
<td>4.5%</td>
</tr>
<tr>
<td>2012</td>
<td>123.0</td>
<td>2.8%</td>
</tr>
</tbody>
</table>

(Source: adapted from data from the Office for National Statistics licensed under the Open Government Licence v.1.0.)

Extract 1

Living standards fall in the UK and inequality rises between generations

According to the Institute for Fiscal Studies the standard of living in Britain has fallen as the average household income fell by 2.4% over the period 2008–9 to 2010–11.

This has coincided with rising inequality of income between different generations. Using data from government income surveys of more than 750 000 households, analysis by the Financial Times shows that the average real household disposable income for people aged 20–29 fell 6.3% between 2008–09 and 2010–11. This figure takes account of CPI inflation reducing the purchasing power of money. If housing costs are included, the fall was even larger, at 9%.

In contrast, households with people in their 60s, 70s and 80s saw average real disposable incomes rise by about 1% over the same two-year period. That finding supports a longer-term study by the Office for National Statistics showing that pensioners saw the fastest growth in living standards for any group in Britain during the past 35 years.

According to Robert Joyce of the Institute for Fiscal Studies, the government’s planned changes to the tax and benefit system up to 2015 will mean pensioner households will lose less on average than younger adults aged 20–29, who will see their living standards squeezed further. This latter age group is particularly affected by a high rate of unemployment, annual benefit rises capped at 1% in nominal terms and falling real wages.

(Source: © The Financial Times Ltd 2013)
(Source: Adapted from www.ifs.org.uk/comms)
Extract 2  
Inflation

Recessions are normally associated with falling inflation rates. However, since the recession started in 2008 the Bank of England’s Monetary Policy Committee (MPC) has overseen several periods in which inflation has exceeded the upper limit of the target inflation rate’s tolerance. There have been four sources of inflationary pressure. First, oil prices rose sharply because of popular unrest in many Arab nations which led to the development of uncertainty around the security of supply. Secondly, a period of bad weather resulted in harvest failure in many areas and wheat prices soared. In addition, the sterling exchange rate has weakened and since 2008 it has fallen by around 25% against the U.S. dollar. A final factor was the increase in VAT from 15% to 17.5% in January 2010 and then in January 2011 it was raised to 20%.

The monetary tools available to the MPC of the Bank of England have most impact on the demand side of the economy, which has been weak and was not the source of the inflationary shocks. The danger with raising interest rates to achieve the inflation target in the short term is that they might weaken the economy further.

(Based on a variety of media sources)

With reference to the information provided, evaluate the significance of two likely causes of UK inflation over the period 2008 to 2012.
Question 11

With reference to Extract 2, evaluate the likely impact of higher inflation on three macroeconomic objectives. (30)