

Cambridge IGCSE · Economics 0455 · Notes

Inflation and deflation

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Read first: [The macroeconomic aims of government](#), [Fiscal policy](#), [Monetary policy](#), [Supply-side policy](#)

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What you need to know

This topic has five syllabus outcomes. In plain words, you should be able to:

1. **Definitions:** say what **inflation** and **deflation** are.
2. **Measurement:** explain how inflation and deflation are measured with a **Consumer Prices Index (CPI)**: a base year, a basket of goods and services, and weights.
3. **Causes:** explain the two causes of inflation, **demand-pull** and **cost-push**, and the two kinds of cause of deflation, **demand-side** and **supply-side**.
4. **Consequences:** explain how inflation and deflation affect **consumers, workers, savers, lenders, firms and the economy as a whole**.
5. **Policies:** describe the range of policies a government can use to control inflation and deflation, and judge **how well each might work**.

You do not need aggregate demand and aggregate supply diagrams: write about **total demand** and **total supply** in words. The policy tools themselves are taught in the fiscal, monetary and supply-side policy notes; here you use them on prices.

Understand it

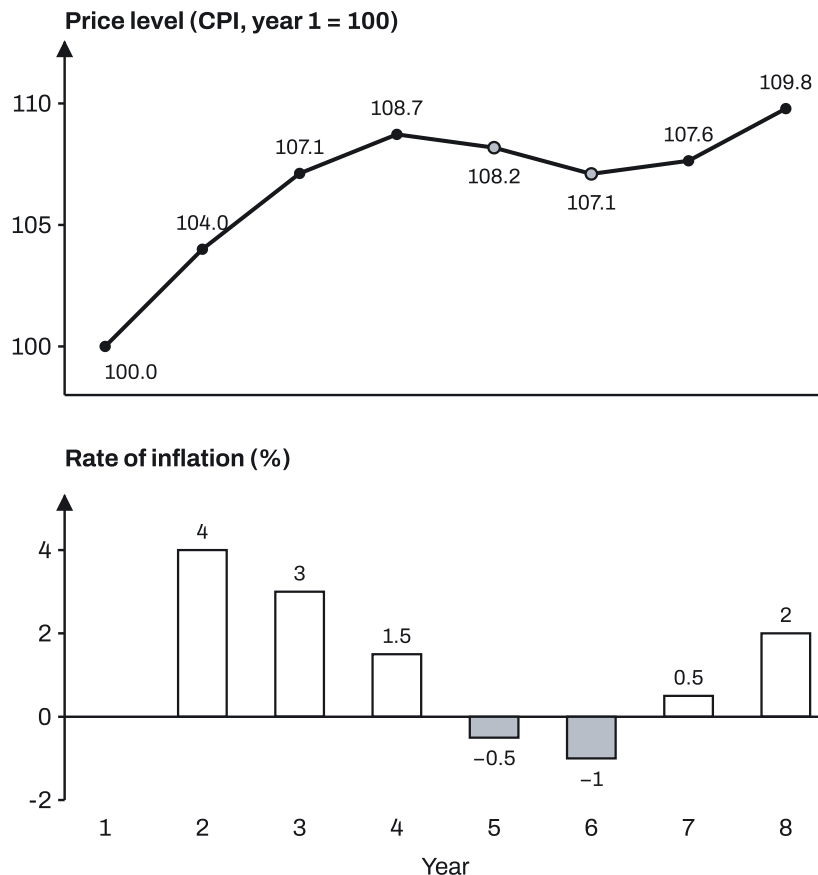
Inflation, deflation and the price level

Inflation is a **sustained rise in the general price level** over a period of time. Three words matter:

- **general:** the average price of all the goods and services people buy, not the price of one product. Dearer bananas alone are not inflation;
- **sustained:** it carries on over months or years, not a one-off jump;
- **rise in the price level:** so each unit of money buys less. Inflation is the same thing as a **fall in the value (purchasing power) of money**.

Deflation is a **sustained fall in the general price level**. Each unit of money then buys more.

Keep two ideas apart: the **price level** (how high prices are, shown by the CPI) and the **rate of inflation** (the percentage change in the price level over a year). If the rate falls from 4% to 1.5%, prices are **still rising**, just more slowly (sometimes called **disinflation**). Prices fall only when the rate is **negative**: that is deflation.



In years 2 to 4 the rate falls from 4% to 1.5%, yet the CPI rises from 104.0 to 108.7. In years 5 and 6 the rate is below zero, so the CPI falls to 107.1, its lowest point at the **end** of the run of negative rates. From year 7 prices rise again, and by year 8 the CPI (109.8) is above its earlier peak.

Measuring inflation: the Consumer Prices Index

A **Consumer Prices Index** is a **weighted** index of the prices of a **basket** of goods and services bought by a typical household, compared with a **base year**. It is built in four steps:

1. **Choose a base year** and give it the index number **100**. Every later year is compared with it.
2. **Find out what households buy**. A survey of household spending decides the basket (food, housing, transport, clothing, energy, leisure). Only things households buy in markets count: vegetables from your own garden have no price to record, and a firm's machinery is not consumer spending.
3. **Give each item a weight** equal to its share of household spending: 40% of the budget on food gives food a weight of 40 out of 100. Then a big price change on something people rarely buy (say, ink cartridges) moves the index less than a small change in food prices.
4. **Collect prices** every month in many shops and places, and work out the **weighted average** change.

An example. A household spends \$1000 a month: \$400 on food, \$350 on housing and \$250 on transport, so the weights are 40, 35 and 25. Over the year, food prices rise 10%, housing 4% and transport prices fall 2%.

Item	Weight	Price index (base = 100)	Weight × index ÷ 100
Food	40	110	44.0
Housing	35	104	36.4
Transport	25	98	24.5
CPI	100		104.9

So the CPI is **104.9** and the rate of inflation is **4.9%**. Each item's contribution is its **weight × its price change**: food adds 4.0 points, housing 1.4 and transport takes away 0.5. The item that moves the index most is not always the one whose price changed most; it is the one with the biggest **weight × price change**.

A **rising CPI** means the **average cost of living** has gone up; whether people are better off also depends on their incomes. A change in the **weights** means households now spend a **different share of their income** on each item: weights describe spending, not prices.

Working out the rate. From any two index numbers:

$$\text{rate of inflation} = \frac{\text{new CPI} - \text{old CPI}}{\text{old CPI}} \times 100$$

If the CPI falls from 180 to 171, the rate is $\frac{171-180}{180} \times 100 = -5\%$: deflation of 5%. The percentage is of the **old** figure.

Real income and the value of money

Your **money (nominal) income** is the number of dollars you receive. Your **real income** is what those dollars will **buy**, after allowing for price changes. A quick rule:

$$\% \text{ change in real income} \approx \% \text{ change in money income} - \text{rate of inflation}$$

- Pay up 6%, prices up 2%: real income rises by about **4%**.
- Pay up 3%, prices up 5%: real income **falls** by about **2%**, even though the pay packet is bigger.

The **purchasing power** of money moves the other way from the price level. If the CPI is 250 (base year 100), \$100 now buys what \$40 bought in the base year. Between any two years, \$100 at the new prices buys what $100 \times \frac{\text{old CPI}}{\text{new CPI}}$ dollars bought at the old prices. Whenever the price level **doubles**, each unit of money buys **half** as much.

Causes of inflation

Every cause works through **total demand** (all spending on a country's output) or **costs of production**.

Demand-pull inflation happens when **total demand grows faster than the economy's ability to produce** (total supply). Too much spending chases too few goods, so firms can raise prices and still sell. Total demand is

$$\text{total demand} = C + I + G + (X - M)$$

consumer spending + investment + government spending + exports minus imports. Consumer spending is usually the **largest** part. Anything that raises one of these can pull prices up:

- higher incomes, lower income tax, more confidence or cheaper loans → more consumer spending;
- lower interest rates or rising sales → firms invest more;
- the government spends more;
- foreigners buy more of the country's exports (for example a boom in visitors, or a fall in the exchange rate);
- a big rise in the **money supply**, which lets everyone spend more.

Demand-pull is strongest when the economy is close to **full capacity**: with idle workers and machines, firms can meet extra spending by producing more, so output rises instead of prices.

Cost-push inflation happens when **firms' costs of production rise** and firms pass them on as higher prices:

- **wages** rise faster than productivity (for example after strong trade-union bargaining, or because labour is scarce);
- **raw materials and energy** become dearer, such as oil, metals or food after a poor harvest;
- **imports** become dearer because the currency has fallen, so imported parts and fuel cost more;
- **indirect taxes** such as sales tax rise, or subsidies are cut.

The two causes can feed each other in a **wage-price spiral**: prices rise → workers ask for higher pay to keep their real income → firms' costs rise → firms raise prices again → workers ask for more.

The biggest rise in prices comes when **total demand rises and total supply falls at the same time**: both push prices the same way.

Causes of deflation

Demand-side deflation (sometimes called "bad" or malignant deflation) comes from **falling total demand**: households and firms lose confidence, unemployment rises, interest rates or taxes are raised sharply, government spending is cut, export markets collapse, or there is too little investment. Firms cannot sell their output, so they cut prices. Output and jobs fall too.

Supply-side deflation ("good" or benign deflation) comes from **rising total supply**: new technology, higher labour productivity, cheaper raw materials or energy. Each unit costs less to make, so firms can cut prices and still make a profit, while output and jobs can **rise**.

Consequences of inflation

Mild, steady, expected inflation does little harm. High, rising or unexpected inflation hits groups differently:

Group	How inflation affects them
Consumers	Each dollar buys less. People on fixed incomes (some pensions, fixed benefits) lose most, because their income does not rise with prices. Poorer households spend most of their income on essentials and cannot cut back easily.
Workers	Real wages fall unless pay rises keep up. Workers with strong bargaining power (trade unions, scarce skills) can win pay rises; others fall behind. If inflation makes exports less competitive, jobs may be lost.
Savers	Money in the bank loses value if the interest rate is below the rate of inflation. Saving becomes less attractive, so people may spend more of their income now instead.
Lenders	They are repaid in money that buys less than the money they lent, so they lose, unless the interest rate covers inflation.
Borrowers	They gain : the real value of their debt falls , because prices and incomes rise but the debt stays fixed.
Firms	Higher costs; menu costs (reprinting price lists, changing labels and websites); time spent shopping around (shoe-leather costs); harder to plan, so less investment; exports less competitive. But demand-pull inflation can mean rising sales and revenue, and debts become easier to repay.
The economy	Less international competitiveness if prices rise faster than in other countries → fewer exports, more imports, a worse current account; uncertainty → less investment and slower growth; an unfair, random redistribution from savers and lenders to borrowers; very high inflation (hyperinflation) can make people lose trust in money altogether.

A worked number. Someone saves \$5000 for a year at 2% interest and receives \$5100. If prices rise 6% over the year, \$5100 buys only what about \$4811 bought at the start. In money terms the saver is \$100 richer; in real terms they are about \$189 poorer. A borrower paying 2% on a loan during the same year gains in the same way.

The interest rate minus the rate of inflation is the **real interest rate**. Here it is $2 - 6 = -4\%$: **negative**. A negative real interest rate means borrowers repay less, in buying power, than they borrowed, so it encourages households and firms to **borrow more** and discourages saving.

Whether inflation actually does damage depends on three things:

- **Its size and predictability.** At a gentle, steady pace, workers and banks build the expected price rises into pay deals and interest rates, so few people lose.
- **How it compares abroad.** Exports depend on **relative** prices: a country with 2% inflation whose trading partners have 5% becomes **more** competitive, not less.
- **Where it comes from.** Prices pulled up by strong spending go with full order books, so many firms sell more and do well; prices pushed up by costs squeeze profits and jobs.

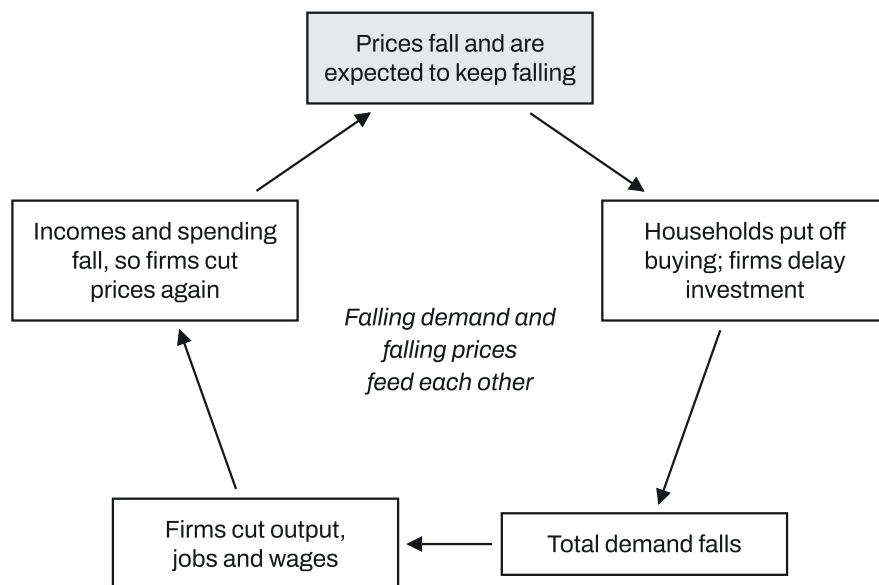
Anyone carrying a fixed debt, including firms and the government, also finds it easier to bear as prices and incomes rise.

Consequences of deflation

Deflation reverses most of the effects above, and adds a danger of its own.

Why it can be harmful:

- **Delayed spending.** If people expect prices to keep falling, they put off buying cars, phones and houses until they are cheaper. Firms delay investment too.
- **The deflationary spiral.** Delayed spending cuts total demand, so firms sell less, cut output, jobs and wages, and lower prices again to clear stock. Lower incomes cut spending further.



- **Debts become heavier.** The money value of a loan stays the same while prices and incomes fall, so the **real value of debt rises**. Borrowers struggle to repay, may default, and borrow less in future.
- **Unemployment and lower output.** Falling profits make firms cut workers; the economy may enter a **recession**.
- **Low confidence.** Firms and households become pessimistic, and foreign firms may be less keen to set up in the country.

Why it may not be harmful:

- **Purchasing power rises:** the same income buys more, so **real incomes** and living standards rise for people whose pay does not fall.
- **Savers and lenders** gain, as the money they hold or are repaid buys more.
- **Exports become cheaper** than rivals' products, so exports may rise and imports fall, helping the current account.
- If the deflation is **supply-side** (technology, productivity, cheaper energy), prices fall because costs fall, so output, profits and jobs can all rise.
- Mild deflation for a short time does much less damage than a long, deep one.

Policies to control inflation and deflation

The policy must match the **cause**.

Problem	Fiscal policy	Monetary policy	Supply-side policy
Demand-pull inflation	Raise income tax; cut government spending (contractionary)	Raise the interest rate; reduce the money supply; let the currency rise	Raise productive capacity so supply can keep up with demand
Cost-push inflation	Cut indirect taxes on key inputs; subsidies (short-term)	A stronger currency makes imported materials cheaper	Training and new technology raise productivity , so costs per unit fall; more competition
Deflation (demand-side)	Cut taxes; raise government spending (expansionary)	Cut the interest rate; raise the money supply; let the currency fall	Little short-term effect: the problem is too little demand

How effective might they be?

- **Time lags.** Interest-rate changes take months to work; training and new technology take years.
- **Conflicts with other aims.** Cutting total demand to lower inflation also slows **economic growth** and raises **unemployment**. Boosting demand to end deflation can later bring back inflation and suck in imports.
- **The wrong tool for the cause.** Cutting demand does little against cost-push inflation caused by a world oil price rise; it mainly costs jobs. Cuts in government spending on education, transport or subsidies can even **raise** firms' costs.
- **Confidence.** In deflation, people may not borrow or spend even when loans are cheap and taxes are low.
- **Causes from abroad.** A government cannot control world prices for fuel and food.
- **Political cost.** Higher taxes and spending cuts are unpopular, so governments may delay them.

Supply-side policy is the only kind that can lower inflation **and** raise output at the same time, but it is slow and costly. Demand-side policies act faster but trade one aim for another.

Key facts and formulas

There is no formula list for 0455. "Learn it" means you must remember it.

Formula or fact	Status
Inflation: a sustained rise in the general price level; deflation: a sustained fall in the general price level	Learn it
CPI: a weighted index of the prices of a basket of goods and services bought by households, compared with a base year (= 100)	Learn it

Formula or fact	Status
Weight of an item = its share of household spending	Learn it
$\text{CPI} = \frac{\sum(\text{weight} \times \text{price index of item})}{\sum \text{weights}}$	Learn it
Contribution of an item to inflation = weight (as a fraction) $\times$ % price change	Learn it
$\text{Rate of inflation} = \frac{\text{new CPI} - \text{old CPI}}{\text{old CPI}} \times 100$	Learn it
% change in real income $\approx$ % change in money income – rate of inflation	Learn it
Purchasing power: \$100 at new prices buys what $100 \times \frac{\text{old CPI}}{\text{new CPI}}$ dollars bought at old prices	Learn it
Real interest rate = interest rate – rate of inflation	Learn it
Total demand = $C + I + G + (X - M)$	Learn it
Inflation: borrowers gain; savers, lenders and fixed-income earners lose. Deflation: the reverse, and the real value of debt rises	Learn it

How to do it

We have tagged 85 questions on this topic (2021–2026, including one March 2026 paper): 57 multiple choice on Paper 1 and 28 structured questions on Paper 2. Three multiple-choice questions are repeat copies of others, so 82 are different. Two structured questions each have two parts about this topic, so the counts add up to 87.

Question type	Questions
Know how the CPI is built and read its weights	11
Pick an effect of inflation or deflation, or who gains and who loses (MCQ)	11
Pick a cause of inflation or deflation (MCQ)	10
Discuss whether inflation or deflation harms an economy, firms or producers	9
Work out what happened to real income from earnings and price changes (MCQ)	9
Read CPI or inflation-rate data and calculate the rate of inflation (MCQ)	8
Explain or analyse how a change causes inflation	7
Pick the policy mix that cuts inflation or prevents deflation (MCQ)	5

Question type	Questions
Define inflation or deflation	4
Analyse how a policy reduces inflation or avoids deflation	4
Explain or analyse the benefits of low, stable inflation	3
Discuss whether a change will cause inflation	3
Discuss whether a policy will reduce inflation	3

Written answers. Explain (4 marks) and Analyse (6 marks) are points-marked: a mark for each link in a chain. Write **two** developed points for 4 marks and **three** chains for 6. Discuss parts are worth 6 marks in Section A (up to 4 marks a side, a mark for each linked step, each point counted once) or 8 marks in Section B (levels-marked: Level 3, 6–8 marks, needs both sides developed). Plan every Discuss answer the same way: **point** → **developed chain of reasoning** → **the other side (new reasons, not the first side turned round)** → **a justified judgement** that says what the answer depends on. Aim for two or three developed points a side.

1. Know how the CPI is built and read its weights (11 questions)

Ten multiple choice and one 2-mark definition. Use the four steps under "Measuring inflation".

- **What a CPI needs:** a base year, a basket of household purchases, a weight for each item and prices collected over time. It does not need incomes, price stability or quantities supplied. Goods without a market price (homemade, home-grown) and goods bought by firms are outside it.
- **Which item moves the index most:** the largest **weight × % price change**, as in the food example above, not the largest price change.
- **Weights that change between years** show only how the **share of income** spent on each item has shifted; on their own they say nothing about prices or the index.
- **Why weights are used:** so that items households spend more on count for more in the average.
- **A rising CPI** shows that the cost of living has gone up. Draw no other conclusion from it alone.
- **Define the CPI** (2 marks): a weighted index of the prices of a basket of goods and services bought by households (1), measuring changes in the price level compared with a base year (1).

2. Pick an effect of inflation or deflation, or who gains and who loses (MCQ) (11 questions)

All multiple choice. Ask: **is this person's income or wealth fixed in money terms?** Use the tables in "Consequences of inflation" and "Consequences of deflation".

- **Inflation:** those who **owe** a fixed sum gain; those who **are owed** or **hold** a fixed sum lose (savers, lenders, holders of cash), as do people on fixed incomes and fixed state benefits. Exporters tend to lose as their prices rise against foreign rivals'.
- **Interest rate against inflation:** if inflation is **above** the interest rate on a loan, the real interest rate is negative, so the borrower gains and the lender loses; if the interest rate is higher, the lender gains.

- **Inflation speeding up:** anything fixed in money terms loses real value faster, while the cost of keeping up with price changes (**menu costs**) goes up.
- **A given rate:** whenever the price level **doubles** (100% inflation), each unit of money buys **half** as much.
- **Deflation:** everything flips. People holding or owed money gain; people who owe money lose as the **real burden of their debt grows**. What makes deflation undesirable is its effect on expectations: households put off spending and firms grow pessimistic.

3. Pick a cause of inflation or deflation (MCQ) (10 questions)

All multiple choice. Mark each option $\uparrow$ or $\downarrow$ for **total demand** and for **costs**, then read off the direction of prices, using "Causes of inflation" and "Causes of deflation" above.

- Extra demand when the economy is **already fully employed** goes almost entirely into prices.
- The **largest** rise in prices comes from demand rising **and** supply falling together.
- **A table of price rises** for energy, food, transport or housing means firms' costs are rising: cost-push inflation.
- **When a question asks about a fall in something**, work out what that fall does: a fall in income tax or the interest rate leaves people more to spend, so prices rise; a fall in the price of imported fuel cuts costs, so prices rise more slowly.
- **Demand-pull** specifically: the cause must add to C , I , G or $X - M$.
- **Deflation:** new technology and higher productivity (supply-side) or too little spending and investment (demand-side). More money, higher costs or more jobs push prices **up**, not down.

4. Discuss whether inflation or deflation harms an economy, firms or producers (9 questions)

Discuss, 8 marks in Section B or 6 in Section A: whether inflation harms firms or producers, whether deflation is a problem, whether high inflation means low growth, whether a central bank should aim for low inflation.

1. **Check the word in the question:** inflation or deflation, high or **low**. "Low inflation" means prices still rise, slowly; it is not deflation.
2. **Check who is affected** (firms, producers, the economy) and end every chain with an effect on **that** group.
3. **Build two or three chains a side** from "Consequences of inflation" and "Consequences of deflation" above. Choose; don't list them all.
4. **Judge** what the answer depends on: the **rate** and whether it is **stable and expected**, the **cause** (demand-pull or cost-push; demand-side or supply-side deflation), the rate in **rival countries**, and how long it lasts.

Variations you will meet:

- **Effects on firms:** one link per sentence. Not "inflation $\rightarrow$ fewer sales abroad", but "home prices rise faster than in rival countries $\rightarrow$ the firm's goods cost more in foreign markets $\rightarrow$ overseas buyers switch to rivals $\rightarrow$ export revenue falls $\rightarrow$ the firm cuts output". The other side: demand-pull inflation comes with rising sales and revenue, firms' debts become easier to repay, and low, steady inflation causes little harm.

- **Deflation (Section A, 6 marks):** a mark is available for saying that demand-side ("bad") deflation harms while supply-side ("good") deflation can help. Use the source: if it mentions purchasing power, saving, debts or exports, explain each, don't quote it.
- **High inflation and growth:** harm runs through uncertainty (less investment), lost export sales and, at the extreme, hyperinflation; the other side is that demand-pull inflation comes with rising spending and output, and a negative real interest rate encourages borrowing and investment.
- **Should a central bank aim for low inflation?** For: the benefits in type 11. Against: lowering inflation by cutting demand slows growth and raises unemployment (see "How effective might they be?").

5. Work out what happened to real income from earnings and price changes (MCQ) (9 questions)

All multiple choice. Use "Real income and the value of money".

1. For each person or country, **subtract** the rate of inflation from the % rise in money income; the **largest** result is the biggest rise in real income. Subtracting a **negative** inflation rate **adds**.
2. Real income falls whenever pay grows more slowly than prices; pay itself may still have risen. If incomes rise 2.5% and prices 3.5%, both rose, and real income fell.
3. Two groups with different pay rises both gain in real terms only if each pay rise beats the rate of inflation.

6. Read CPI or inflation-rate data and calculate the rate of inflation (MCQ) (8 questions)

All multiple choice. First check what the vertical axis or the table shows (see the two charts in "Understand it").

- **The CPI (price level):** prices fell only where the numbers **go down**. Use the formula for the rate between two years: 125 to 150 is $\frac{25}{125} \times 100 = 20\%$, not 25%.
- **The rate of inflation:** prices **rose** wherever the rate is above zero, however much it falls, and fell only where it is below zero. The price level is highest at the end of a run of positive rates and lowest at the end of a run of negative rates. The same positive rate two years running still means rising prices.
- **Which year had the most inflation:** work out each year's percentage change; don't compare index points.
- **A target range:** compare each year's **rate** with the target.

7. Explain or analyse how a change causes inflation (7 questions)

Explain (4) or Analyse (6). The question gives a **trigger**: more household spending, more visitors, higher wages, a fall in the exchange rate, or just "two causes".

1. **Name the type** in each chain: **demand-pull** or **cost-push**. "Prices rise" alone loses marks.
2. **Run the chain** from "Causes of inflation" above: trigger → a component of total demand rises → demand outgrows supply → firms raise prices; or trigger → wages or input prices rise → costs rise → firms raise prices.

3. **Extend** with the wage-price spiral or the capacity point. For 6 marks write **three** chains, mixing the two types. No diagram is needed.

Variations you will meet:

- **More household spending:** C is part of total demand → total demand rises → it outgrows supply → demand-pull; and firms expand → hire more workers and buy more materials → wages and input prices rise → cost-push, then a wage-price spiral.
- **A rise in tourism:** visitors' spending is extra demand for food and rooms (demand-pull); hotels and restaurants compete for workers and land, so costs rise (cost-push).
- **A fall in the exchange rate** works both ways: dearer imported materials (cost-push) and cheaper exports, so more foreign demand (demand-pull). Say which prices change.
- **Running it backwards** (why inflation fell): reverse the chains, for example less consumer spending, or workers with less bargaining power winning smaller pay rises.

8. Pick the policy mix that cuts inflation or prevents deflation (MCQ) (5 questions)

All multiple choice. Use the policy table under "Policies to control inflation and deflation".

1. **Lower inflation** needs less total demand (contractionary); **preventing deflation** needs more (expansionary).
2. Check that **every column** of the option points the same way: contractionary means interest rates and taxes **up**, government spending and money supply **down**; expansionary is the reverse.
3. If deflation comes **with rising unemployment and falling output**, pick the measure that raises total demand soonest.

9. Define inflation or deflation (4 questions)

All multiple choice here, but a 2-mark "Define" on Paper 2 uses the same words.

- **Deflation** is a sustained fall in the **general price level** itself (a fall in the CPI). Check that the option is about the price level falling, not about total demand falling, a recession or inflation merely slowing.
- **Inflation** (2 marks): a sustained rise (1) in the general price level (1).

10. Analyse how a policy reduces inflation or avoids deflation (4 questions)

Analyse (6): how a central bank could reduce inflation or avoid deflation; how a stronger currency or higher income tax could lower inflation.

1. **Name the policy and the cause it targets**, using the policy table above.
2. **Chain** each measure to total demand or costs, and on to the price level. Three chains for 6 marks.

Variations you will meet:

- **A central bank** has only monetary tools: interest rates, the money supply and the exchange rate. A higher interest rate → loans cost more and saving earns more → less borrowing and spending → total demand falls → less demand-pull inflation.
- **Avoiding deflation** needs **more** total demand: cut the interest rate, raise the money supply. A rate rise is the cure for inflation.
- **A stronger currency**: cheaper imported inputs (less cost-push) and dearer exports (less demand-pull).
- **Income tax**: less disposable income → less consumer spending → lower total demand → less demand-pull inflation. Keep it about the whole economy, and don't confuse it with taxes on goods.

11. Explain or analyse the benefits of low, stable inflation (3 questions)

Analyse (6) why a government aims for stable prices, or Explain (4) two reasons low inflation helps growth.

Every point is about prices rising **slowly and predictably**:

- firms can plan → more investment → more capacity and growth;
- exports stay competitive against countries with higher inflation → more export sales and jobs;
- savings and fixed incomes keep their value → confidence to save and spend;
- few menu costs and little time spent checking prices;
- workers need smaller pay rises → less risk of a wage-price spiral.

12. Discuss whether a change will cause inflation (3 questions)

Discuss (6 in Section A, 8 in Section B): whether falling unemployment, a new industry or a policy that creates jobs will raise inflation, or why some countries end up with lower inflation than others.

- **Will**: chains from type 7 (more incomes and spending → demand-pull; scarcer, dearer labour → cost-push).
- **Will not**: spare capacity (idle workers and machines), so output rises instead of prices; productivity rising as fast as wages; competition (including imports) stopping firms raising prices.
- **Judge** by how close the economy is to full capacity.
- **Why inflation differs between countries**: compare the **causes** in each; describing high and low inflation is not explaining it.

13. Discuss whether a policy will reduce inflation (3 questions)

Discuss (8): whether a cut in government spending, a cut in the interest rate or supply-side measures will reduce inflation.

1. **Name the policy and the cause it targets**, and chain it to total demand or costs.
2. **The other side** comes from "How effective might they be?": time lags, the wrong tool for the cause, side effects on costs.
3. **Judge** by the cause, how close the economy is to full capacity, and how big and quick the change is.

- **A cut in government spending:** less total demand → less demand-pull (strongest near full capacity) vs fewer subsidies or less spending on training and transport → higher costs → cost-push; and inflation may have other causes such as wage rises.
- **A cut in the interest rate:** cheaper loans lower firms' costs and raise investment and supply vs more borrowing and spending → total demand rises → demand-pull. **Read the direction:** a cut usually raises inflation.
- **Supply-side measures:** higher productivity → lower costs and more output vs slow and costly.

Worked examples

Example 1

(a) Define inflation. [2]

(b) A country's Consumer Prices Index rose from 160 to 168 over a year. Calculate the rate of inflation. [1]

(c) Over the same year, Leila's pay rose by 3%. Using your answer to (b), explain what happened to the purchasing power of money and to Leila's real income. [4]

(a) Inflation is a sustained rise (1) in the general price level of an economy's goods and services (1).

(b) $\frac{168-160}{160} \times 100 = 5\%$ (1).

(c) The general price level rose by 5%, so each dollar buys less than before: the purchasing power of money fell (1). At the new prices, \$100 buys only what \$95.24 bought a year earlier, since $100 \times \frac{160}{168} = 95.24$ (1). Leila's money income rose by 3%, but prices rose by 5%, so her pay did not keep up with prices (1). Her real income therefore fell, by about $3 - 5 = -2\%$, even though she is paid more dollars (1).

Example 2

Analyse how a period of high inflation could affect people with savings and people who have borrowed money. [6]

Inflation is a sustained rise in the general price level, so each dollar buys less as time goes on (1). Money kept in a bank account loses purchasing power if the interest it earns is lower than the rate of inflation (1). For example, \$5000 saved at 2% becomes \$5100, but if prices rise 6% this buys only what about \$4811 did a year earlier, so the saver is poorer in real terms (1). Saving therefore becomes less attractive, so households may spend more of their income now instead (1). Borrowers repay a fixed sum of money that is worth less when they repay it than when they borrowed it (1), so the real value of their debt falls, especially if their wages rise with prices (1). If the interest rate on the loan is fixed below the rate of inflation, the real cost of borrowing is negative (1), which may encourage households and firms to borrow more (1). (Any 6.)

Example 3

Discuss whether or not people on fixed incomes are the main losers from inflation. [8]

Inflation is a sustained rise in the general price level, so each unit of money buys less. People on fixed incomes, such as some pensioners and people living on fixed state benefits, receive the same number of dollars each month however much prices rise.

Why they may be the main losers. A fixed income cannot rise with prices, so its real value falls every year that prices rise. A pension of \$1000 a month buys only what about \$926 bought a year earlier if prices rise 8%, so the pensioner must cut back (developed point for).

Many people on fixed incomes are poorer households who spend most of their income on essentials such as food, rent and energy. They cannot cut back on these easily, and they usually have no way of bargaining for more money, unlike workers in strong trade unions, so their living standards fall furthest (developed point for).

Why they may not be. Savers and lenders can lose as much or more. Someone with \$20 000 in the bank at 2% interest has \$20 400 after a year, but with 8% inflation this buys only what about \$18 889 bought at the start: a real loss of about \$1111, which may be far larger than a pensioner's loss (developed point against).

Other groups also lose. Workers with little bargaining power see their real wages fall when pay rises lag behind prices, and if the country's inflation is higher than its trading partners', exporters lose sales abroad and some of their workers lose their jobs. Losing a job can cost a family more than a fixed income losing part of its value (developed point against).

Judgement. People on fixed incomes are among the clearest losers, because nothing protects their income from rising prices, and they lose most when inflation is high and unexpected. But they are not always the main losers: savers earning less interest than the rate of inflation, lenders, weak bargainers and workers in exporting firms can lose as much, while borrowers gain. And when inflation is mild and expected, banks build it into their interest rates and workers into their pay deals, so savers and workers are protected while fixed incomes still lose: then fixed-income groups really are the main losers. Both sides are developed and the judgement says what the answer depends on, so this meets the Level 3 descriptor (6–8 marks).

Common mistakes

- **Mixing up the price level and the rate of inflation.** In one 2023 question, half of the candidates chose an option that treated an inflation-rate graph as if it showed the price level; examiners called this a popular misconception. A falling but positive rate means prices are still rising.
- **Treating low inflation as falling prices.** In a 2021 question on the advantages of a low rate of inflation, many candidates assumed prices were falling and wrote about deflation, so they earned low or no marks. Low inflation means prices rise **slowly**.
- **Incomplete definitions.** In a 2022 definition question, most answers were satisfactory, but some lost a mark by not making clear that inflation is about prices across the whole economy or that it continues over a period; describing one good getting dearer earned least. Write all three parts: sustained, rise, general price level.
- **Not naming the type of inflation.** Weaker answers wrote "prices rise" without saying whether it was demand-pull or cost-push, and a few mixed the names up ("demand-push", "cost-pull").

- **Getting the causes of deflation the wrong way round.** In a 2025 question about the most likely cause of deflation, only about a third of candidates chose correctly; many picked changes that would push prices **up**, such as more money or higher costs. Ask whether each change raises or lowers prices before you choose.
- **Jumping stages.** Examiners advise that answers on inflation and firms gain depth by showing every step between a cause and its final effect, rather than leaping straight to the end (see the chain in How to do it, type 4).
- **Losing the focus of the question.** Some answers about inflation and firms wrote about inflation in general; some answers about cutting government spending drifted onto growth and unemployment rather than inflation, and some discussed an increase instead of a decrease. Every chain must end at the group and the variable in the question.
- **Using the wrong tools for a central bank.** When asked how a central bank could avoid deflation, some candidates analysed a rate rise (confusing deflation with inflation) and others used tax cuts and government spending, which a central bank does not control.
- **Copying the source.** In a 2025 Section A question on deflation, some candidates simply quoted the source's sentence about purchasing power, saving and debts without explaining any of it. Examiners singled out answers that contrasted "bad" with "good" deflation.
- **Confusing import and export prices.** On a fall in the exchange rate, some wrote "imported inflation" with no explanation, and some mixed up what happens to export and import prices.
- **Micro instead of macro.** On income tax and inflation, quite a few candidates wrote about demand for a single good; a few confused income tax with taxes on goods. Inflation is about total demand and the general price level.

How to get the marks

- **Define** (2 marks): two parts, such as "a sustained rise (1) in the general price level (1)". For the CPI: what it is (a weighted index of a basket of household purchases) and what it measures (changes in the price level against a base year).
- **Identify** (2 marks): two precise answers; only the first ones you write are marked.
- **Explain** (4 marks): two points, each identified (1) and developed (1).
- **Analyse** (6 marks): a mark per link. Three chains, each starting from the trigger in the question and ending at the price level (or at the group named). Say "demand-pull" or "cost-push" in each causes chain.
- **Discuss** (6 or 8 marks): both sides developed with **different** reasons, then a judgement that says **what it depends on**: the rate and stability of inflation, its cause, how it compares with other countries, how long deflation lasts and whether it is demand-side or supply-side. In Section A, quote the source's figures and explain them.
- **Use the terms**: general price level, purchasing power, real income, real value of debt, demand-pull, cost-push, wage-price spiral, menu costs, international competitiveness, deflationary spiral, contractionary and expansionary policy.
- **Multiple choice**: 1 mark each, no penalty for guessing. Write ↑ or ↓ next to each variable, and check whether a graph shows the price level or the rate of inflation, before you choose.

Quick check

1. A country's CPI was 240 in year 1 and 258 in year 2. In year 3 the price level fell by 2%. (a) Calculate the rate of inflation in year 2. (b) Calculate the CPI in year 3, to one decimal place. (c) What is the change in year 3 called?
2. A CPI has three items. Food has a weight of 0.5 and its prices rose 4%; transport has a weight of 0.3 and its prices rose 10%; other goods have a weight of 0.2 and their prices fell 5%. Calculate the rate of inflation shown by the index.
3. Amira's monthly pay rose from \$2000 to \$2060 over a year. Over the same year the CPI rose from 150 to 159. Calculate the percentage change in her pay and the rate of inflation, and say what happened to her real income.
4. Explain two ways a government could reduce cost-push inflation. **[4]**
5. Analyse why a fall in consumer confidence could lead to deflation. **[6]**

Answers

1. (a) $\frac{258-240}{240} \times 100 = 7.5\%$. (b) $258 \times 0.98 = 252.84$, so the CPI is **252.8**. (c) **Deflation**: a fall in the general price level.
2. $0.5 \times 4 + 0.3 \times 10 + 0.2 \times (-5) = 2 + 3 - 1 = 4$, so the rate of inflation is **4%**.
3. Pay: $\frac{2060-2000}{2000} \times 100 = 3\%$. Inflation: $\frac{159-150}{150} \times 100 = 6\%$. Prices rose faster than pay, so her real income **fell**, by about $3 - 6 = -3\%$.
4. The government could subsidise training (1), so workers become more productive and the cost of producing each unit falls, letting firms hold prices down (1). It could cut indirect taxes on fuel or other key inputs (1), which lowers firms' costs of production, so they have less need to raise their prices (1).
5. If consumers lose confidence, they worry about their jobs and incomes (1), so they save more and spend less, especially on big items such as cars and furniture (1). Consumer spending is the largest part of total demand, so total demand falls (1). Firms find they have unsold stock, so they cut prices to attract buyers (1). They also cut output and jobs, so incomes fall and spending falls further (1). If people then expect prices to keep falling, they delay purchases even more, so the general price level keeps falling: a deflationary spiral (1).

Past questions to try

- 0455/12/F/M/22 Q23: reading the price level from a graph of the inflation rate.
- 0455/22/M/J/22 Q2: part (d), whether inflation will harm producers.
- 0455/22/O/N/21 Q5: part (d), whether supply-side measures can reduce inflation.
- 0455/21/M/J/21 Q5: part (c), how a central bank could avoid deflation.