Employment and unemployment, Inflation and deflation

Cambridge IGCSE \,\textperiodcentered\, Economics \,\textperiodcentered\, 4.7, 4.8

THREE UNEMPLOYMENT RATES THAT SHOULDN'T MAKE SENSE

E

Malawi beats Britain

Malawi's government reports a lower unemployment rate than the United Kingdom's, even though far more people in Malawi are struggling to get paid work.

Two rates, one country

South Africa publishes two official unemployment rates for the same three months, and they don't agree with each other.

A number that moved by itself

Zimbabwe's unemployment rate changed sharply in one year without a single person losing or finding a job.

Each one of them gets explained before this act ends.

By the end of this topic you should be able to…

- [ ] Work out who a country's unemployment figure counts, and why two countries measuring the same thing report very different numbers.
- [ ] Say what unemployment costs a person, a firm and a country, and decide from a described case which of the three types it is.
- [ ] Match a government policy to the kind of unemployment it can actually reduce, and say what would stop it working.
- [ ] Define inflation and deflation exactly, measure inflation from a weighted basket, and name what caused a price change.
- [ ] Argue both sides of whether falling prices are a problem, separating the two kinds of deflation by name.

1.1 Who counts as unemployed

state the three conditions that must all be true before a person counts as unemployed, and say why full employment does not mean nobody is out of work

Malawi's government counts about two people in every hundred of working age as unemployed. South Africa counts about thirty-three in every hundred. Before you read any further, answer this for yourself: is it easier to find paid work in Lilongwe, Malawi's capital, than it is in Johannesburg? Write down an answer and one reason for it. Section 1.3 comes back to this question, and the answer most people give on a first guess turns out to be wrong.

A person is **employed** when they are in paid work — whether that means working for an employer, or working for themselves and earning an income from it. A person is **unemployed** when three separate conditions are all true at once: they have no paid job, they are willing and able to work, and they are willing to work at the current wage rate — the going pay for that kind of job, not some higher figure they would prefer. All three have to hold together. Drop any one of them, and "unemployed" stops applying.

It's tempting to read "unemployed" as simply "without a job." That fails in two directions at once. It sweeps in people who aren't looking for work at all, like a retired teacher. And it lets through someone who could take a job tomorrow but refuses to accept one unless it pays more than the going rate — that person is **voluntarily unemployed**. The fix is mechanical: run the three conditions in order, and stop at the first one that fails.

Full employment is the situation in which everyone of working age who is willing and able to work at the current wage rate has a job. It does not mean zero unemployment. People change jobs constantly — leaving one, searching, starting the next — and that movement never fully stops. So even an economy at full employment has some people out of work at any given moment. That leftover unemployment has its own name, and it comes in Act 2.

Everyone else of working age — not employed, and not unemployed either — is **economically inactive**: not in work, and not seeking it. A full-time student, a retired person, someone caring for family full-time, someone too unwell to work: none of them is trying to get a paid job right now. There is one more case that belongs here. Someone who has given up looking for work altogether, because they have come to believe there is nothing out there

for them, is not unemployed under the strict definition — they are not actively searching, so the third condition fails. Hold on to that case. Section 1.3 needs it.

Four people, four countries, and each one breaks the definition at a different point. A worker in Malawi has no job, is actively looking, but has told anyone who will listen that he won't take anything below a wage well above what's actually on offer locally — he fails the third condition. A graduate in the United Kingdom has just finished her degree and isn't applying for jobs because she's started a full-time master's — she isn't seeking work. A subsistence farmer in Zimbabwe grows food that his household eats and sells nothing at all — this one is genuinely arguable, and Section 1.3 shows why two countries' statisticians have answered it differently. And a street trader in South Africa sells goods from a stall every day and earns cash from it, with no formal employer and no registration anywhere — she is employed, because the definition asks whether someone is in paid work, not whether that work is registered or taxed. Two of these four are clean. Two are not.

The whole definition compresses into four questions, asked in order. Here it is as a decision tree — the same conditions you have just read, laid out as a sequence of yes/no questions you can run through for any person you are trying to classify.

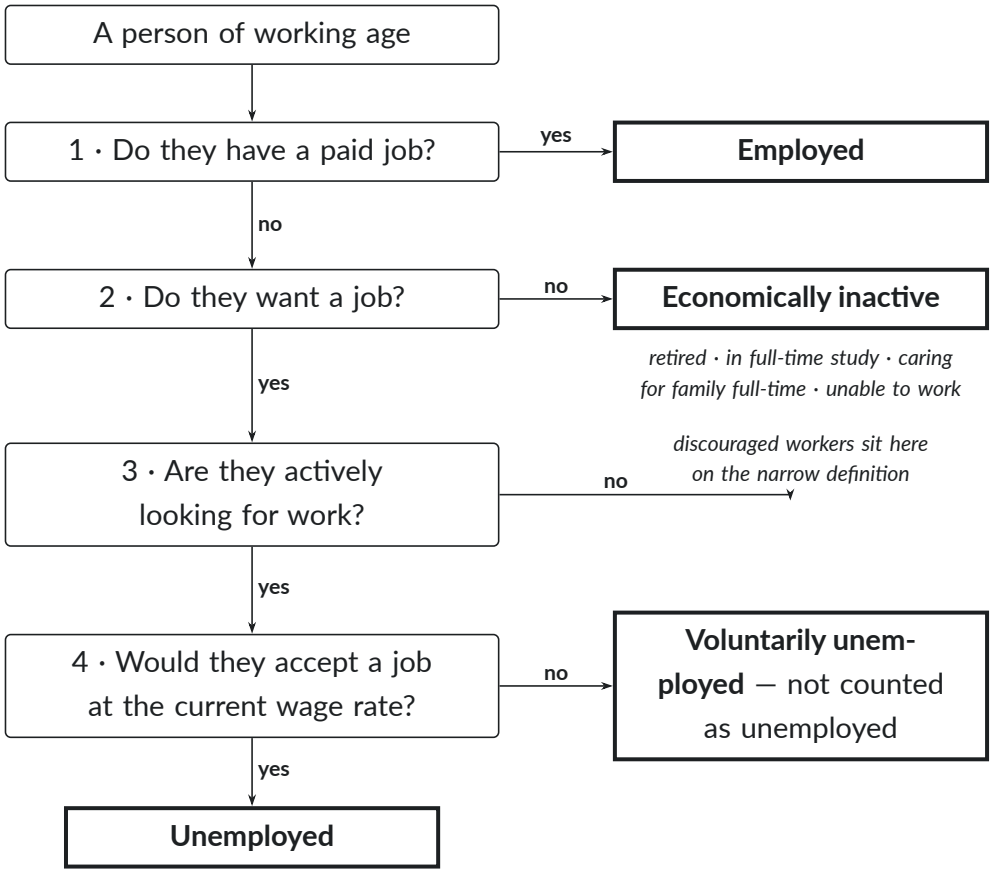

Figure 1 · *Four questions, in this order. Stop at the first one that fails.*

EX 1.1 Q1

Which one of these four people is unemployed, using the three conditions above?

A A woman who retired last year and has no wish to work again.

B A man in full-time study who isn't looking for work.

C A woman who lost her job three months ago, is actively applying, and would take work at the going wage.

D A man who turned down a job last week at the standard rate because he wants more money. [1 mark]

EX 1.1 Q2

For each person below, state whether they are employed, unemployed, or economically inactive, and give one reason for your answer.

(a) A street trader in South Africa who sells goods from a stall every day for cash, and is not registered with any authority.

(b) A graduate in the United Kingdom studying full-time for a master's degree, and not applying for jobs.

(c) A subsistence farmer in Zimbabwe who grows food for his household to eat and sells nothing.

(d) A worker in Malawi who has no job, is looking for one, but has told a survey that he will not accept work at the local going wage. [4 marks]

1.2 How the shape of employment changes

name three ways the pattern of employment changes as an economy develops, and give a reason for each

As an economy develops, the pattern of employment moves through the sectors in a fairly consistent way: the proportion of workers in the primary sector — farming, fishing, mining, and other extraction of raw materials — falls, while the proportion in the tertiary sector — services — rises. Two forces drive it. As people's incomes rise, they don't keep buying proportionally more food; a rising share of extra income goes on services instead. At the same time, farming and manufacturing become more productive, meaning the same output can be produced with fewer workers, which frees up labour to move into services.

A second shift runs alongside it: as an economy develops, a rising share of employment moves from informal to formal. **Formal** employment is registered with the authorities, taxed, and covered by the country's employment law. **Informal** employment is none of those things — no registration, no tax paid on the income, no legal protection attached to the job. The street trader from Section 1.1 is a clear case of informal work: real, paid, genuine employment, but entirely outside the formal system.

Workers generally prefer formal employment when they can get it. Pay tends to be higher and more predictable; workers are protected against unfair dismissal; a minimum wage applies; workers can join a trade union; formal work carries entitlement to unemployment and retirement benefits; and a documented income makes it far easier to get a loan or rent a home.

This split also explains why counting the unemployed gets harder in economies where informal work is common. A government agency that pays out unemployment benefits, or a household survey that asks precise questions about registered work, sees a salaried employee clearly. It has a much harder time seeing a street trader or a subsistence farmer the same way — not because that work doesn't exist, but because the measuring instruments were built with formal employment in mind. Section 1.3 is where that difficulty turns into an actual number.

A third shift, driven by different forces, is a rising share of women in the labour force. Changing social attitudes about who works, wider access to

education for girls and women, women having children later in life on average, the growth of the service sector itself — which has historically employed more women than heavy industry did — and legislation against discrimination at work have together pushed this share up in most developing and developed economies over recent decades.

There's a fourth shift worth knowing, even though none of the five countries in this kit is currently going through it in an obvious way. As a country moves from a planned economy, where the state runs most industries directly, towards a market economy, the proportion of workers employed by the state tends to fall. Industries the government once owned and ran — mines, railways, telecommunications — get sold to private firms, and the workers in them move from being state employees to being employed by a private company instead.

EX 1.2 Q3

Identify two reasons a worker might prefer a job in the formal economy to work in the informal economy. [2 marks]

EX 1.2 Q4

Which of the following would you expect to see as a country's economy develops?

A A rising proportion of workers in the tertiary sector.
B A rising proportion of workers in the primary sector.
C A rising proportion of workers in the informal economy.
D A rising proportion of workers employed by the state. [1 mark]

1.3 Two ways to count, two different answers

calculate an unemployment rate from a table of labour market figures, and explain why two countries measuring the same thing can report very different rates

The **labour force** is the employed plus the unemployed — nothing else. It excludes the economically inactive completely. The **unemployment rate** is then the number unemployed divided by the labour force, multiplied by one hundred:

unemployment rate = (number unemployed ÷ labour force) × 100

Anyone economically inactive is missing from both the top and the bottom of that fraction.

Two different methods are used to produce this figure in practice. The **claimant count** counts people who are claiming unemployment-related benefits from the government. The **Labour Force Survey** asks a large, representative sample of households whether each working-age person is out of work, available to start work, and has actively looked for a job recently. Naming the method earns half the marks available, and saying what it actually measures earns the other half.

The two methods miss different people. The claimant count misses anyone who is unemployed but doesn't qualify for benefits, doesn't bother claiming them, or lives in a country where the benefit system barely reaches most of the working-age population. It can also count some people who are claiming without genuinely searching for work. The Labour Force Survey catches people who aren't claiming anything, and it's built to be comparable across countries in a way the claimant count isn't — but it is still a sample, and its result depends entirely on how it defines "looking for work." Change that definition, and the number changes with it, without a single person's circumstances being any different.

South Africa's Quarterly Labour Force Survey publishes two rates for the same three months, and both are official. The narrow rate counts only people who actively searched for work during the survey period. The expanded rate adds in discouraged workers — people who want a job but have stopped searching because they believe there's nothing available. The two numbers differ substantially, and neither one is the "real" rate with the other one

wrong; they are answers to two slightly different questions, both worth asking.

Zimbabwe's national statistics agency changed its own definition in 2011, so that any informal or subsistence economic activity — including the kind of subsistence farming from Section 1.1's contested case — counted as employment rather than being left out. The headline unemployment rate moved sharply as a direct result of that single change in wording. Neither of these cases is a scandal, and neither statistics agency did anything improper. Each is the syllabus's own point arriving as documented fact: a measurement is the output of a definition.

Which brings the opening question back round. A low measured unemployment rate in an economy where most people work informally, or on land that feeds their own household, tells you that very few people are recorded as searching for a formal job — it does not tell you that work is easy to find, or that it pays well when you find it. A high rate in an economy where almost all work is formal and recorded tells you something much closer to what the number sounds like it's telling you. Malawi's rate is not lying, and neither is South Africa's. Each is answering a narrower question than it appears to be answering, and which question it's actually answering depends on what counted as employment in the first place.

The table below sets all five countries on the same footing — the same working-age population in each, so the rate column is the one honest comparison — and gives you the numbers the calculations below run on.

Illustrative figures. Every country's working-age population has been set to 10.0 million so that the five can be compared directly. These are not published statistics.

Country	Employed (m)	Unemployed (m)	Not economically active (m)	Unemployment rate
South Africa	6.0	3.0	1.0	33.3%
United Kingdom	9.5	0.4	0.1	4.0%
United States	9.4	0.4	0.2	4.1%
Zimbabwe	9.6	0.3	0.1	3.0%
Malawi	9.7	0.2	0.1	2.0%

Of South Africa's 1.0 million not economically active, 0.6 million say they want a job but have stopped looking for one.

Figure 2 · *Five countries, ten million people of working age each. Read the rate column last.*

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Read: The South African labour market: all the facts (GroundUp)

`https://groundup.org.za/article/south-african-labour-market-all-facts_842/`

Scan the code with your phone camera, or type the link.

EX 1.3 Q5

Explain one method used to measure unemployment. [2 marks]

EX 1.3 Q6

Using the table above, calculate South Africa's unemployment rate (a) on the narrow definition, and (b) on the expanded definition, which also counts the 0.6 million people who want work but have stopped looking for it. [2 marks]

EX 1.3 Q7

Using the table, explain why Malawi's unemployment rate is lower than the United Kingdom's, even though work is generally harder to find and lower paid in Malawi. [2 marks]

2.1 What losing a job does to a person give two consequences of unemployment for the individual, each with the reason it follows

A question that asks you to explain two disadvantages of something, worth four marks, is really two questions stapled together: one mark for naming a disadvantage, one mark for the reasoning that shows why it follows. Name four disadvantages and explain none of them, and you have earned two marks out of four while using all the space you had. The examiner is not paying for a list. They are paying for the step.

South Africa's youth unemployment is among the highest in the world, and has been for years. Picture someone who left school at eighteen and has spent the time since applying for work, with nothing to show for it yet: no job, still looking, still willing to work at the going wage — exactly the strict definition of unemployed from Act 1. Hold that person in mind. Every disadvantage below is something that could be happening to them right now, and by the end of the section you'll be able to say which parts of it apply to someone who has never had a first job at all, and which don't.

Start with the disadvantages that stand on their own, each with the reason it follows. The plainest is loss of income, which lowers a person's standard of living directly: without wages coming in, there is simply less to spend on food, rent and transport. Outgoings like these do not pause just because income has stopped, so a person without a job is more likely to fall into debt to cover them. A lender wants to see a record of income before agreeing to a loan, so unemployment can mean an inability to borrow at all. Fringe benefits such as medical cover or an employer's pension contributions are usually tied to the job itself, so they are lost the moment the job is. Unemployment has documented effects on mental health, arising from the loss of income security, the loss of a daily routine, and the loss of the status that comes with having a job. And a person can be pushed into selling possessions simply to keep meeting costs a wage used to cover.

There is one more disadvantage, and it needs a warning attached. Several routes all arrive at the same destination — "it makes it harder to get another job" — and the mark scheme credits that destination once, however many roads you take to reach it. Skills that decay from disuse, a gap in a work history that an employer reads as a warning sign, and simply falling out of touch with how a job is now done: these sound like three separate reasons, but

they are one disadvantage, restated three times. The safe second disadvantage has to come from somewhere else entirely — income, debt, health, or possessions.

Now go back to the person you pictured. For someone who has never held a first job, the loss-of-skills route barely applies, because there are no job-specific skills yet to lose. But almost everything else above still bites, and bites harder with every year that passes. There is no income record to show a lender, so borrowing stays closed off from the start. There is no work history at all, which an employer tends to read even less favourably than a gap in one. The consequences do not reset each year; they accumulate, and a first job becomes harder to get the longer it is delayed.

The longer a search goes on without success, the more likely a person is to become demotivated and stop looking altogether. At that point they are no longer unemployed in the strict sense from Act 1 — they fail the third condition, because they are no longer actively searching — and they become what Section 1.3 called a discouraged worker: economically inactive, not unemployed.

Try the examined version of this question yourself before you check the exercise below. Pick two disadvantages that do not both collapse into the same "harder to find work" point, and write out the mechanism for each — the step that makes the disadvantage follow, not just the disadvantage itself.

EX 2.1 Q8

Explain two disadvantages for a person of losing their job. [4 marks]

2.2 What it costs the firms and the country

explain how unemployment reaches firms and the government, including what happens to tax revenue and to the output the country never produces

The individual level is the one you can feel your way into, which is why it came first. Firms and the economy as a whole are where the higher-tariff questions actually sit, so this section moves faster.

For firms, the effect cuts both ways. Against firms: households without an income spend less, so demand for what firms sell falls, their revenue falls, and some firms respond by cutting jobs of their own — the same mechanism that put the first worker out of work, now repeating itself. That is how a downturn can feed itself. In firms' favour, though, unemployment does one thing for them: a larger pool of people looking for work makes recruiting easier, and it puts downward pressure on the wages a firm has to offer to fill a vacancy, which lowers its costs. An answer that mentions only the cost to firms has told half the story.

For the economy as a whole, five consequences follow. Output is lost permanently: workers who are willing and able to produce are sitting idle, so the country produces less than it is actually capable of producing. On the production possibility curve, that is a point inside the curve rather than on it. Tax revenue falls, because there are fewer incomes to tax and less spending on which to collect tax. Government spending rises at the same time, because more people are claiming unemployment-related benefits. Put those two together and the gap between what government raises and what it spends — the **budget deficit** — widens, so government either borrows more or cuts spending elsewhere, and that cut is a real opportunity cost. And poverty and inequality rise, because households that had an income no longer do.

One further consequence deserves its own paragraph. Skilled workers — doctors are the clearest example — sometimes leave a country altogether when they cannot find suitable work there. When they go, the country loses not just a worker but the training it paid to produce, and that loss lowers its productive capacity permanently. This is not the same as the temporary output loss two paragraphs back. It does not reverse when demand recovers, because the person is no longer there to come back to work.

It is worth running the whole thing in reverse, because the benefits of full employment are examined separately and they are exactly these consequences with the arrows pointing the other way. Higher output, because nobody willing and able to work is sitting idle. Higher tax revenue, without any tax rate having to change. Lower spending on unemployment benefits. Higher living standards, because more households have an income to spend. There is one qualification: an economy pushed to and past full employment starts to run short of workers, and wages get bid upwards as firms compete for the ones who are left.

The table below sets all three levels side by side. Read it across, not down — the useful comparison is what the same event does to a person, a firm and a country. One cell in the firms column runs the opposite way to everything around it. Find it before you read on.

For the individual	For firms	For the economy
Income lost, so living standards fall	Households have less to spend, so demand for firms' output falls	Output is lost — the country produces less than it could
Skills decay, so the next job is harder to get	**[in the firm's favour]** more people looking for work, so recruiting is easier and wage pressure falls	Tax revenue falls — fewer incomes and less spending to tax
Debt rises and borrowing becomes harder without an income record	Firms may cut more jobs as revenue falls, which repeats the first row	Benefit spending rises, so the deficit widens or other spending is cut
Effects on mental health, from lost routine, status and security		Poverty and inequality rise; skilled workers may emigrate

Figure 3 · *The same event, read three ways. One of these cells is a benefit.*

EX 2.2 Q9

Explain two consequences of high unemployment for a country's economy as a whole. [4 marks]

2.3 Three reasons people are out of work

tell frictional, structural and cyclical unemployment apart by what has changed in each, and name the other types an examiner will credit

You now know what unemployment costs. That is exactly why it matters, from here on, what kind of unemployment you are looking at — the cost is the same whatever the cause, but the cure is not. The syllabus names three types of unemployment. Mark schemes credit closer to ten. Both lists are worth having.

Frictional unemployment is what is left when nothing else is wrong with the economy. It covers people between jobs — someone who has left one post and is searching for the next, or someone entering the labour force for the first time and still looking. Matching a person to the right job takes some time even in a healthy economy, and that time shows up as frictional unemployment. This is the answer to a question Act 1 left open: full employment does not mean zero unemployment, because frictional unemployment is still present even when the economy is working exactly as it should.

Structural unemployment is a mismatch between the workers an economy has and the jobs it currently has on offer. Something about the structure of the economy has changed — an industry has shrunk or disappeared, a new technology has replaced a process that used to need people, work has relocated to another region — and the workers left behind hold skills suited to jobs that no longer exist, or live somewhere the remaining jobs are not.

South Africa's unemployment is overwhelmingly of this kind. A labour force shaped by decades of unequal access to education sits alongside an economy that has moved away from mining as a major employer of low-skilled labour, and the mismatch between the two does not close on its own. Structural unemployment takes years to resolve, because the fix is retraining people or moving them to where the jobs are, and neither of those happens quickly.

Cyclical unemployment, also credited under the name **demand-deficient** unemployment, is caused by a fall in total demand across the whole economy at once. When that happens, firms in every industry — not just one — sell less, produce less, and need fewer workers to produce it. It rises and falls with the trade cycle: worse in a recession, better in a recovery. The United Kingdom and the United States both saw sharp jumps in unemployment through 2020, followed by substantial recoveries, driven by a sudden collapse in how much people were spending across the whole economy — not by any change in what British or American workers were able to do.

The wider list has to be learned alongside the three named types. **Voluntary** unemployment is a person choosing not to accept work at the current wage rate. **Involuntary** unemployment is the opposite: willing to work at the current wage, but no job available. **Seasonal** unemployment comes from work whose demand varies through the year — agriculture, tourism and retail all show it, and it is a live feature of Malawi's labour market. **Regional** unemployment concentrates in one part of a country whose main industry has declined. **Technological** unemployment follows a machine replacing a worker directly. **Classical** unemployment happens when wages are held above the level at which the labour market would clear. **Casual** unemployment describes work that is irregular by its nature. Three of these are worth holding apart from the rest: seasonal, regional and technological unemployment are not rivals to structural unemployment, they are narrower cases of it.

The mistake worth naming directly is sorting by how long the unemployment lasts. Frictional unemployment usually clears in weeks; structural unemployment can run for years. Duration is a consequence of the cause, not the definition of it.

The second, more expensive confusion is between structural and cyclical, because both can produce a large number of job losses concentrated in one industry. The test that actually distinguishes them is whether demand has fallen across the whole economy — in which case it is cyclical — or whether this one industry has been displaced while the rest of the economy carries on

much as before — in which case it is structural. A mine that closes because its ore has run out is structural unemployment even if it happens to close in the middle of a national recession.

Zimbabwe does not sort cleanly into any of the categories above. Its unemployment has structural roots, in a labour force shaped by a shrinking formal sector, but it also has causes closer to institutional collapse than to any single industry's decline: a currency crisis and a period of hyperinflation damaged the normal channels through which an economy recovers from a downturn. Hold on to the case without trying to force it into one box.

The table below sets the three named types against exactly what has changed in each — that is the column to read for the sorting work in the next section, not the "how long" column at the far end.

Type	What has changed	Example	How long it usually lasts
Frictional	Nothing — this person is between jobs	A developer leaves one firm and starts at another six weeks later	Short
Structural	This industry, skill or region has been displaced; the rest of the economy carries on	A mine closes permanently and its workers' skills are not wanted elsewhere	Long — it takes retraining or relocation
Cyclical (demand-deficient)	Total demand has fallen across the whole economy	Export orders collapse and firms in every industry cut staff	As long as the downturn

Also credited in an exam: voluntary, involuntary, seasonal, regional, technological, classical and casual unemployment. Seasonal, regional and technological are narrower cases of structural. Demand-deficient is another name for cyclical.

Figure 4 · *Sort on the second column, never on the fourth.*

▶ Watch: Unemployment Types (Cyclical, Structural, Frictional) (EconplusDal)

`https://www.youtube.com/watch?v=ki4cmpJhFXk`

Scan the code with your phone camera, or type the link.

EX 2.3 Q10

Read the following description of a country's labour market: a large mine has closed permanently after its ore reserves were exhausted, and several thousand miners have not found other work. Tourism employment falls every year once the holiday season ends. Across the rest of the economy, a national fall in consumer spending has led firms in many industries to cut staff. Identify two types of unemployment present in this description. [2 marks]

2.4 Sorting the cause

written his own rule for deciding which type of unemployment a described case is, and has tested it on cases the kit has not sorted for him

Everything you need for this section is already in your head. Nothing new gets taught here — the whole point is finding out whether what you learned in 2.3 actually works as a tool, on cases nobody has pre-sorted for you.

Before you look at either case below, write your own rule. In your own words, not copied from anywhere above: what is the one question you would ask about a described situation to decide whether it is frictional, structural or cyclical? Write it down now, as a single sentence, before reading any further.

Here is the rule the last section was building towards. Ask what changed. If total demand has fallen across the whole economy, it is cyclical. If one particular industry, skill or region has been displaced while the rest of the economy carries on, it is structural. If nothing has changed at all except that this person happens to be moving between jobs, it is frictional. Two things never belong in that test: how long the person has been out of work, and how many people lost their job at the same time. Both of those are consequences of the cause. Neither of them is the cause.

Try the two cases below using your own rule first, then check it against the one above.

EX 2.4 Q11

A software developer leaves one firm on a Friday and starts at another six weeks later, having spent the time applying and interviewing for jobs. Which type of unemployment does this describe? [1 mark]

EX 2.4 Q12

A clothing factory in one town closes, and its four hundred workers lose their jobs. In the same year, export orders across the whole country fall sharply, and firms in every industry reduce staff. Identify the type of unemployment in each case, and explain how you can tell them apart. [2 marks]

3.1 Three levers, and which unemployment each one reaches

say what fiscal policy is, and match each of the three policy types to the kind of unemployment it can actually reduce

Section 2.2 totalled up what unemployment costs a person, a firm and a country. The obvious next question is what a government can actually do about it, and the least useful answer you could give in an exam is "spend more money" — because that is not one policy, it is three different policies wearing the same slogan.

Fiscal policy is the government's use of its own spending and taxation to influence the economy. It has two instruments. Taxation comes in two kinds: **direct taxes**, charged directly on income and profits — income tax paid by workers, corporation tax paid by firms — and **indirect taxes**, charged on spending rather than income, such as value added tax on purchases and duties added to the price of fuel. Government spending is the other instrument: money spent on public services, benefits, and infrastructure such as roads, schools and hospitals.

Expansionary fiscal policy means the government spending more, taxing less, or both — either move raises the amount of total demand in the economy. **Contractionary** fiscal policy is the reverse: spending less, taxing more, or both, which lowers total demand. Both directions carry a cost. Spending more or taxing less, without any extra income to pay for it, means the government has to borrow the difference, and borrowed money carries interest — interest that has to be paid out of future tax revenue.

Two further levers need only a sentence each here. **Monetary policy** is the central bank changing the interest rate, the money supply or the exchange rate to influence total demand. **Supply-side policy** is government action to raise what the economy is actually capable of producing — training and education, better information about the jobs that are available, lower income tax to strengthen the incentive to work, deregulation, privatisation, and subsidies to firms that locate where the jobs are needed.

The three levers are not interchangeable. Each type of unemployment from Section 2.3 has something specific missing, and the right policy is whichever one actually supplies that missing thing.

Cyclical unemployment is missing total demand — firms across the whole economy have less to sell, so they need fewer workers to produce it. The lever for it is demand-side policy: expansionary fiscal policy, or a cut in interest rates, both of which put more spending directly back into the economy.

Structural unemployment is not missing demand at all — somewhere in the economy, the jobs genuinely exist. What is missing is workers who can do them, or workers who live near enough to take them. The lever for it is supply-side policy: retraining, education, and help with relocation, aimed at closing the actual mismatch rather than at raising spending that mismatched workers still could not use.

Frictional unemployment is missing something smaller: information. A worker between jobs does not need retraining or a demand stimulus — they need to find out where the next job actually is. The lever for it is better job-matching services, and sometimes a shortening or reduction of benefits, which gives search time a reason to shrink rather than drift on.

The mistake to catch before it costs you marks is treating any policy that "creates jobs" as a cure for any unemployment. A retraining programme does nothing for a worker whose entire economy is in recession and whose old employer would take them back tomorrow if orders picked up. A demand stimulus does nothing for a worker whose skills no longer exist in any industry, at any level of demand. Name the type of unemployment first. Choose the lever second.

The table below puts all three types of unemployment against what each is missing and which lever supplies it.

Type of unemployment	What is missing	Which policy	One limit
Cyclical	Total demand	Demand-side: expansionary fiscal policy (spend more, tax less) or a cut in interest rates	It must be financed, and with no spare capacity it raises prices instead of output
Structural	Workers who can do the jobs, or who live near them	Supply-side: training, education, help with relocation, subsidies to firms that locate where the jobs are needed	It takes years, and the wrong skills can be trained
Frictional	Information	Better job-matching services; shorter or lower benefits to reduce search time	Some search time is unavoidable, so it cannot be driven to zero

Figure 5 · *Name the type first. Choose the lever second.*

▶ Watch: Policies to Reduce Unemployment, with Evaluation (EconplusDal)

`https://www.youtube.com/watch?v=0QKb_b2WGdU`

Scan the code with your phone camera, or type the link.

EX 3.1 Q13

Which of the following is a supply-side policy to reduce unemployment?

A A government training programme for workers whose industry has closed.

B A cut in the interest rate.

C An increase in unemployment benefits.

D An increase in government spending on hospitals. [1 mark]

EX 3.1 Q14

For each situation below, identify the type of policy — demand-side or supply-side — that would be the right response, and name one specific measure of that type.
(a) A country where consumer spending has fallen sharply and firms in every industry have cut staff.
(b) A country where firms report thousands of unfilled vacancies for technical roles, while thousands of former factory workers cannot find work. [2 marks]

3.2 Following a policy through to jobs

write a chain of linked steps from a government decision to a fall in unemployment, naming which type of unemployment falls at each link

The six-mark Analyse question built on this objective is marked one mark per linked step in the chain, not one mark for reaching the right destination. An answer that jumps straight from "the government spends more" to "so unemployment falls" has stated something true, and earned one mark out of six for it. What is new here is what the mark scheme in this topic is specifically built around: naming which type of unemployment — from the three you sorted in Act 2 — falls at each link.

Take the sampled question's own setting: the government decides to spend more on building houses. Construction firms take on more workers to build the houses, so unemployment among people whose skills are in construction — structural unemployment — falls. Those firms also need more materials: cement, steel, timber, so the firms that supply them take on more workers too. All of those newly employed workers now have incomes they did not have before, and they spend them. That extra spending raises total demand across the economy, so firms in other industries — shops, transport, manufacturing — sell more, produce more, and take on staff of their own: cyclical

unemployment falls. Housing built where the jobs actually are makes it easier for workers to move to work, which reduces structural unemployment further still. And building of this kind adds to the economy's productive capacity.

The step where spending becomes someone's income, and that income gets spent again, is the reasoning the mark scheme actually wants. There is a name for that repeating effect, the **multiplier effect**: an initial injection of spending leads to a larger final increase in total demand, because each round of spending becomes someone else's income, which is then spent again in turn. Using the term is credited. It is not expected, and a chain that reasons through the effect without ever naming it loses nothing.

One caution carries over from Section 2.1. If two different steps in your chain arrive at the same destination — say, one route and another both end at "so cyclical unemployment falls" — that destination is credited once, not twice.

The same chain runs the other way for a tax rise. An increase in direct taxation leaves households with less income to spend, so consumer spending falls, total demand falls, firms produce less, and cyclical unemployment rises; at the same time, firms facing a higher tax on their profits invest less in new equipment, which leaves workers with less capital to work with and raises structural unemployment over the longer term.

The diagram below draws the house-building chain as six linked steps, with the mark each one earns written on the arrow. Two of the boxes name the type of unemployment falling at that point.

Figure 6 · *Six links, six marks. Two of them name the type.*

EX 3.2 Q15

Analyse how a government decision to build a new railway line could reduce unemployment. Write your answer as a chain of linked steps, one step per line, naming the type of unemployment falling at each link where you can. [6 marks]

3.3 Why the same policy fails somewhere else

give three reasons a policy that reduces unemployment in one economy might not reduce it in another, and argue both sides of whether it is worth trying

You have just written a chain that works. Now break it. Two governments each spend the same extra amount on building houses. In one country, unemployment falls sharply, just as the chain in 3.2 predicts. In the other, it barely moves at all. Both governments did exactly the same thing. Before reading on, commit to an answer of your own: using only the mechanism you have just learned, what do you think is different about the second country?

The chain in 3.2 was never wrong — it was incomplete. It described how the mechanism works when nothing gets in its way. This section supplies the three ways it does.

The first is a **supply ceiling**. The chain in 3.2 quietly assumed that when demand for materials and labour rises, firms can respond by producing more. Where they cannot — because the electricity supply is unreliable and factories cannot run full shifts, because the skilled workers the jobs need do not exist in the country at all, because the roads and ports needed to move materials are already congested — the extra spending runs into output that simply cannot rise to meet it. What rises instead is prices, and the amount the country has to import to make up the shortfall. South Africa's persistent electricity supply problems this decade are the documented case of the first kind of ceiling, and its structural skills mismatch, from Act 2, is the second half of the same constraint.

The second is a **broken transmission channel**. A cut in the interest rate only reduces unemployment if it actually changes what households and firms do — if cheaper borrowing genuinely persuades people to spend and invest more than they otherwise would. That depends on people trusting the currency the policy is set in. Zimbabwe, following its currency collapse and the hyperinflation mentioned in Act 2, is the case where that trust broke down: once a currency is not trusted, the interest rate a central bank announces stops governing people's decisions the way the theory assumes it will.

The third is a **wage floor**. If wages in an industry are set above the level at which firms would be willing to hire — by a minimum wage set high relative to what workers actually produce, or by a centralised bargaining system that

fixes a rate across a whole sector — firms will not take on extra workers even when demand for what they make rises, because each additional worker costs the firm more than that worker adds to output. This is classical unemployment from Section 2.3, arriving here as a live policy problem. South Africa's centralised bargaining arrangements are the case in point, and the honest way to present it is as a genuine trade-off: those same arrangements protect the pay of workers who are already in employment.

A further set of limits applies everywhere a policy like this is tried. Supply-side measures in particular take time: a worker being retrained is not retrained this month, and some supply-side policies take years to show any effect at all. Every policy has to be financed, and that financing has an opportunity cost — money spent on one thing is money not spent on something else, and government borrowing can push interest rates up generally, which discourages private firms from investing. And a demand stimulus applied to an economy already close to full employment tends to produce inflation rather than new jobs. Finally there is **government failure**: a training scheme can genuinely train people for skills that turn out not to be the ones firms actually want.

The objective this section sits under asks "how effective might it be," and that wording is doing real work — it is not asking you to pick the best policy, it is asking you to say what effectiveness depends on. A strong answer names the conditions: which type of unemployment the country actually has, whether the economy can physically expand output to meet the extra demand, and whether the channel the policy relies on is actually intact.

One rule carries over unchanged from earlier weeks: a point is credited once, on whichever side of the argument you place it. A bare reversal of a point you have already made — restating it as its opposite with no new reasoning attached — earns nothing further.

> **Read: Why is South Africa's unemployment rate so high?** (**GroundUp**)
>
> `https://groundup.org.za/article/why-south-africas-unemployment-rate-so-high/`
>
> *Scan the code with your phone camera, or type the link.*

EX 3.3 Q16

Discuss whether an increase in government spending will reduce unemployment in a country where most unemployment is structural. [6 marks]

4.1 Inflation, deflation, and the three near-misses

define inflation and deflation exactly, and separate deflation from the three things it is most often confused with

Three acts have now asked "what's behind the number?" of a figure describing unemployment. The next two ask exactly the same question of a different figure: the inflation rate. A single percentage can describe two completely different situations underneath it, and reading it correctly starts by getting the definition exactly right.

Inflation is a sustained rise in the general price level. **Deflation** is a sustained fall in the general price level. *Sustained* rules out a single month's movement: a spike in the price of maize after a poor harvest is not inflation on its own. *General* rules out one product moving while the rest of the economy stays where it was. Notice what is missing from both definitions — a cause. Neither one says anything about why prices moved, only about what they did.

The confusion is common enough to be worth taking apart three separate times, once for each near-miss.

The first near-miss is **a sustained fall in total demand**. This is a genuine cause of one kind of deflation. It is not the definition, because a fall in demand does not have to show up as falling prices at all: a firm facing weaker demand can respond by cutting output and laying off workers instead of cutting its prices, in which case you get a recession with no deflation anywhere in it.

The second near-miss has its own name. **Disinflation** is a sustained fall in the rate of inflation — prices are still rising, the general price level is still climbing, just more slowly than it was before. An economy whose inflation rate falls from eight per cent one year to three per cent the next still has more expensive goods at the end of that year than it had at the start. Nothing has fallen except the speed. Calling that deflation is the single most common error this objective produces.

The third near-miss does not sit next to deflation — it reverses it completely. **A sustained fall in the value of money** describes inflation, not deflation. The **value of money**, also called its purchasing power, is how much a fixed sum will actually buy. When prices rise, the same banknote buys less than it used to, so the value of money falls — that is inflation. When prices fall, the same banknote buys more than it used to, so the value of money rises — that is deflation. Prices and the value of money always move in opposite directions.

One further term belongs here. **Hyperinflation** is inflation so rapid that money stops working as a way of storing value at all: people spend it the moment they receive it, or abandon it altogether for a currency they trust more. Zimbabwe's episode in 2007 and 2008 is the case this kit keeps returning to.

You already carry one piece of what this section needs. Real GDP set against nominal GDP drew exactly this distinction between a money figure and what that figure is actually worth. What you do not yet have is any way of turning "the general price level" into an actual number. That is what Section 4.2 builds.

EX 4.1 Q17

Which of the following is the correct definition of deflation?

A A sustained fall in the general price level.

B A sustained fall in total demand.

C A sustained fall in the rate of inflation.

D A sustained fall in the value of money. [1 mark]

EX 4.1 Q18

A country's inflation rate falls from 8% in one year to 3% the year after. State what has happened to the general price level over that second year, and give the term economists use to describe it. [2 marks]

4.2 What the Consumer Prices Index actually measures

work out which item in a weighted basket moves the index most, and say why the largest price rise is often not the answer

"The general price level" has been a phrase up to this point. The **Consumer Prices Index**, or CPI, is what turns it into a number, and it does the job in three steps. First, a survey of household spending builds a **basket**: a fixed list of the goods and services a typical household buys. Second, each item in the basket is given a **weight**, reflecting the share of household spending that goes on it, so that all the weights across the whole basket add up to exactly one. Third, the price of every item is collected regularly, and each item's price change is multiplied by its weight; adding all of those weighted changes together gives the change in the index — which is the inflation rate itself.

The step worth doing rather than just describing is the multiplication. Here is one household's basket for a year, with five items, their price changes, and their weights.

Item	Price change	Weight	Contribution (change × weight)
Electricity	**+12%** ← biggest rise	0.10	1.2
Bread and cereals	+6%	0.15	0.9
Public transport and fuel	+9%	0.20	**1.8** ← biggest effect
Rent	+3%	0.30	0.9
All other items	+4%	0.25	1.0
Total		**1.00**	**5.8**

Inflation rate for the year: 5.8%.

Figure 7 · *The biggest price rise is not the biggest number in the last column.*

Read the contribution column, not the price change column. Electricity has the largest price rise in the whole basket, at twelve per cent — but it is only a tenth of household spending, so its contribution to the index is 1.2. Public transport and fuel rose by less, at nine per cent, but they make up a fifth of spending, and nine per cent of a twenty per cent weight contributes 1.8 — more than anything else in the basket. Rent rose least of all, at three per cent, but it is the largest single item at thirty per cent of spending, so it still contributes 0.9. Add all five contributions together and the basket's infla-

tion rate for the year is 5.8 per cent. Weight and price change matter equally, because the contribution to the index is their product, not either one on its own.

Three limitations of the index are worth a short paragraph each. The basket belongs to the average household, and no real household spends exactly like the average — a household that spends a third of its income on food feels a rise in food prices far more sharply than the published CPI figure suggests.

Spending patterns change over time — people buy things now that barely existed a generation ago — so the basket itself has to be revised periodically to keep matching what households actually buy. That means a comparison of inflation across a long period is, strictly, a comparison between two different baskets.

And because the basket reflects one country's own pattern of spending, an index built for one country reflects that country's habits, not some universal standard. The same shock to world prices — a jump in the price of oil, say — produces a different measured inflation rate in different countries, purely because oil, fuel and transport make up a different share of spending in each of their baskets.

One more distinction belongs here. A **real** value is one that has been adjusted for the change in prices; a **nominal** value is simply the money amount as stated, with no such adjustment made. Real income rises when nominal income rises faster than prices do, and falls when it does not.

You now have both halves of what Section 4.1 was missing: a precise pair of definitions, and a way of turning "the general price level" into an actual measured number. What you do not yet have is any account of what makes that number move. That is Section 4.3.

> **▶ Watch: Inflation and its Measurement (CPI)**
> **(EconplusDal)**
> `https://www.youtube.com/watch?v=vIxlDlRZ_Hg`
> *Scan the code with your phone camera, or type the link.*

EX 4.2 Q19

Using the table above, state which item's price change has the largest effect on the index, and explain why it is not the item with the largest price rise. [2 marks]

4.3 What pushes prices up, and what pulls them down

sort a cause of inflation into demand-pull or cost-push, and say whether a fall in prices came from the demand side or the supply side

Four causes explain what actually moves the index, and they split into two pairs. The first pair explains why prices rise. The second explains why they fall.

Demand-pull inflation happens when total demand rises faster than the economy's output can rise to meet it, so buyers end up bidding prices up rather than simply buying more at the old price. Total demand is made up of consumer spending, investment, government spending, and exports minus imports — written as AD = C + I + G + (X − M). Anything that raises one of them can start demand-pull inflation.

Cost-push inflation happens the other way round: the cost of producing goods rises, and firms raise their prices to protect the profit margin they were making before. Wages rising faster than productivity, dearer imported raw materials or energy, a falling exchange rate that makes every import more expensive in local currency, and higher indirect taxes can all start it. South Africa's inflation carries a strong cost-push element for exactly these reasons — rising electricity tariffs, and a heavy dependence on imported fuel.

The two causes can also reinforce each other, in a pattern with its own name: the **wage-price spiral**. Prices rise, so workers press for higher wages to protect what those wages will actually buy; wages rise, so firms' costs rise; firms raise prices again to protect their margin, and the cycle repeats. The United

Kingdom's inflation between 2021 and 2023 is the clearest recent case of demand-side and cost-push pressure acting together.

There is one combination worse than either cause on its own: the sharpest inflationary pressure of all comes when demand rises and supply falls at the same time, because both movements are pushing price in the same direction at once.

Deflation splits along exactly the same demand-and-supply line. **Demand-side deflation** happens when total demand falls — a recession, collapsing consumer confidence, high interest rates, or a government cutting its own spending sharply — and firms respond by cutting prices to shift the goods they already have. **Supply-side deflation** happens when total supply rises instead — better technology, falling costs of production, or cheaper imports — so that the same level of demand now meets a greater quantity of goods, and prices fall to clear it.

Read those two definitions back to back and notice what is identical between them and what is not. The prices did the same thing in both cases: they fell. Almost nothing else about the two situations is the same — one is driven by an economy in trouble, the other by an economy getting more efficient — and Act 5 turns entirely on that gap. These two kinds of deflation are sometimes given shorter names: demand-side deflation is called **malign deflation**, and supply-side deflation is called **benign deflation**.

The grid below sets out all four causes together, with what starts each one.

	Demand side	Supply side
Prices rise	**Demand-pull inflation** — total demand rises faster than output can, so buyers bid prices up. Started by higher consumer spending, investment, government spending or export demand, by lower interest rates or tax cuts, or by an increase in the money supply.	**Cost-push inflation** — production costs rise and firms raise prices to protect margins. Started by wage rises above productivity, dearer imported energy or raw materials, a fall in the exchange rate, or higher indirect taxes.
Prices fall	**Demand-side (malign) deflation** — total demand falls, so firms cut prices to sell. Started by a recession, falling confidence, high interest rates or a contractionary budget.	**Supply-side (benign) deflation** — total supply rises, so the same demand meets more goods. Started by better technology, cheaper inputs or rising productivity.

Figure 8 · *Prices moved the same way in each row. Nothing else about the two cells is the same.*

You now have every definition this act needs: inflation and deflation from 4.1, a way of measuring them from 4.2, and all four of their causes from this section. What you do not yet have is any account of who actually gains and who loses when one of these four things happens, or what that means for whether a falling price level is good news or bad. That question is Act 5.

> **▶ Watch: Causes of Inflation (Demand Pull and Cost Push) (EconplusDal)**
>
> `https://www.youtube.com/watch?v=cs3tExfrIZA`
>
> *Scan the code with your phone camera, or type the link.*

EX 4.3 Q20

For each event below, identify whether it would cause demand-pull inflation or cost-push inflation.
(a) A country's currency falls sharply against the currencies of the countries it imports oil and machinery from.
(b) Interest rates are cut, and households borrow and spend substantially more. [2 marks]

EX 4.3 Q21

Analyse how a large increase in household spending could cause inflation. [6 marks]

5.1 Winners and losers

say what inflation and deflation each do to a saver, a borrower, a worker and a firm, and explain why a fixed debt gets heavier when prices fall

Picture a farmer in Malawi who borrowed money to buy an irrigation pump, agreeing to repay a fixed 5,000 kwacha every month for three years. Whether that repayment feels manageable or crushing depends entirely on what happens to prices while the loan runs. If prices rise steadily over those three years, wages and revenues tend to rise with them, so 5,000 kwacha becomes a smaller slice of a larger income each year — the debt gets lighter to carry. If prices fall instead, incomes stay flat or shrink, and that same fixed 5,000 kwacha becomes a larger and larger slice of a smaller income. Same loan, same number, opposite experience.

The syllabus asks you to trace this pattern across six named groups: consumers, workers, savers, lenders, firms, and the economy as a whole. The whole point that makes the eight-mark question in Section 5.3 answerable is that the same event helps one group and harms another at the same moment.

Under inflation, consumers lose real income wherever prices rise faster than money income does, and the hardest-hit are those on a fixed money income that does not move at all when prices rise — a pensioner living on a fixed monthly pension is the clearest case. Workers are not automatically protected either: some can negotiate a wage rise to keep pace, but workers with weak bargaining power tend to get less than the inflation rate, so their real wage falls even while their nominal wage goes up.

Savers lose in the same way the pensioner does, unless the interest rate paid on their savings is higher than the inflation rate. Lenders and borrowers are the pairing worth holding onto hardest: a debt fixed in money terms becomes easier to repay as prices and incomes rise around it, so borrowers gain from inflation and lenders lose, because the money a lender eventually gets back buys less than the money they originally lent out.

Firms carry costs on both ends. Repricing goods, catalogues, price lists and computer systems every time prices move is a real cost, called a **menu cost**. Uncertainty about future prices makes planning and investment harder, and if a country's inflation runs consistently above its trading partners', its ex-

ports become relatively more expensive abroad. Set against that, firms can raise their own prices more easily than a wage-earner can raise their pay, and any money a firm itself owes shrinks in real terms. For the economy as a whole, the costs are uncertainty and lost competitiveness, and at the extreme of hyperinflation, money can stop working as a reliable store of value at all. Low, stable, predictable inflation is not something economists worry about. The distinction that actually separates a manageable inflation from a damaging one is between **anticipated inflation**, which people and firms see coming and can plan around, and **unanticipated inflation**, which catches wages, savings and contracts by surprise.

Run every one of those effects backwards, and you have deflation's consequences. Consumers' real incomes rise, provided their money incomes hold steady. Savers gain real value on what they hold. And borrowers, who gained under inflation, now lose: a debt fixed in money terms gets heavier as prices fall. Go back to the Malawian farmer: falling prices are the version of the story where the 5,000-kwacha repayment starts eating a bigger and bigger share of a shrinking income.

It is tempting to conclude that falling prices must be good for everyone, because everyone buys things, and cheaper things sound like an obvious win. That is half true: a buyer whose income has not changed genuinely is better off when the same goods cost less. It fails because it quietly assumes incomes hold steady while prices fall, and in the malign deflation caused by falling demand, from Section 4.3, they do not. Before deciding who gains from a falling price level, the question is not "did prices fall?" but "what happened to demand first?"

The table below sets all six groups against both directions side by side. Read across each row — that is where the reversal actually shows — and pay particular attention to the borrowers and lenders row.

Group	Under inflation	Under deflation
Consumers	Real income falls if prices rise faster than incomes; those on fixed money incomes lose most	Real income rises if money incomes hold — but they may not
Workers	Wage rises may not keep pace; those with weak bargaining power lose real pay	Real pay rises if it holds, but wage cuts and job losses follow demand-side deflation
Savers	Real value of savings falls unless interest paid exceeds inflation	Real value of savings rises
Borrowers and lenders	Borrowers gain, lenders lose: a debt fixed in money terms gets lighter	Borrowers lose, lenders gain: the same debt gets heavier, and defaults rise
Firms	Menu costs, uncertainty, lost competitiveness if inflation is above rivals'; but prices are easier to raise and their own debt shrinks in real terms	Revenue and profits fall as buyers delay purchases; but input costs fall where the cause is supply-side
The economy	Uncertainty deters investment; competitiveness falls if inflation runs above trading partners'	Output and employment fall where demand caused it; both can rise where supply did

Figure 9 · *Borrowers gain under inflation and lose under deflation; lenders do the reverse.*

EX 5.1 Q22

A person owes a fixed amount of money, to be repaid in fixed monthly instalments. Prices in the economy then fall steadily for two years. What happens to the real value of the debt?

A It rises.

B It falls.

C It stays unchanged.

D It rises only if interest rates also rise. [1 mark]

EX 5.1 Q23

Explain how a period of high inflation affects two of the following: a saver, a worker on a fixed pension, a firm that exports, a person repaying a fixed loan. [4 marks]

5.2 What a central bank and a government can do

name a policy for controlling inflation and a policy for controlling deflation, and say what each one costs the economy

Section 3.1 gave you three levers against unemployment, and matched each type of unemployment to the lever that actually reached its cause. The same three levers — fiscal policy, monetary policy, and supply-side policy — are what governments and central banks reach for against inflation and deflation too, and the matching problem is identical: the policy has to act on whatever actually caused the price change, or it does not work.

Against demand-pull inflation, the instrument of first resort is monetary policy. A central bank raises the interest rate, which makes borrowing more expensive and saving more rewarding, so households and firms cut back on spending and investment; total demand falls, and the pressure pushing prices up eases. A higher interest rate tends to raise the exchange rate too, because savers abroad want to hold a currency that now pays more interest, and a stronger exchange rate makes imports cheaper. Contractionary fiscal policy does the same underlying job through a different door: raise direct taxes or cut government spending, and total demand falls either way.

Against cost-push inflation, the tools above are the wrong instrument. If prices are rising because the cost of imported energy has risen, raising the interest rate does nothing at all to the price of energy. What it does instead

is reduce household and firm spending across the whole economy, cut output, and raise unemployment. What actually acts on the cause is supply-side policy: measures that lower firms' costs or raise how much they can produce from the same inputs. These measures work on the actual cause. They also take years.

Against deflation, every one of those levers points the other way: cut the interest rate, increase the money supply, raise government spending, cut taxes. Two limits are worth holding onto. Interest rates cannot fall very far below zero, so in a deep deflation a central bank can run out of room to cut just when cutting is needed most. And if the deflation is supply-side rather than demand-side, the right response may be to do nothing at all.

Central banks generally set an **inflation target** — a specific rate, or range, they aim to keep inflation within — rather than aiming at zero. The Bank of England and the United States Federal Reserve both target inflation of about two per cent. South Africa's Reserve Bank also targets inflation, using a range rather than a single figure.

Raising the interest rate to control inflation raises unemployment, because it works by cutting total demand. In an economy where unemployment is already severe and mostly structural, that cost lands on people the policy was never aimed at, and does nothing to fix the mismatch causing their unemployment. And where a currency has lost public confidence — Zimbabwe's case from Section 3.3 — the interest rate may not reliably change what households and firms actually do at all.

EX 5.2 Q24

Explain one policy a central bank or government could use to reduce demand-pull inflation. [2 marks]

5.3 Two kinds of falling prices argued a full two-sided case on whether falling prices are always a problem, and has checked it against the marking levels himself

This is the hardest single piece of work in the kit, and also its whole point: every idea from the last four acts becomes one tool you use. From Section 4.1, you have deflation's exact definition. From Section 4.3, you have its two causes. From Section 5.1, you have who gains and who loses, group by group. From Section 5.2, you have what a policy costs to fix it, and where policy runs out of room. All four come together in a single question: is falling prices ever good news? The honest answer is that it depends entirely on which cause produced the fall.

Malign deflation starts with total demand falling — a recession, a collapse in confidence, high interest rates. Firms cut prices to try to shift the goods they already have. But buyers, seeing prices fall, delay their own purchases, expecting prices to fall further still — which cuts demand again. Firms' revenue and profits fall, jobs go, and the real value of existing debt rises while the incomes needed to repay it are shrinking, so defaults rise. Interest rates cannot fall far below zero, so monetary policy loses its grip exactly when the chain is at its worst.

Benign deflation starts somewhere completely different: total supply rising, because technology has improved or production costs have fallen. The same level of demand now meets a greater quantity of goods, so prices fall to clear it — the identical price movement as the malign chain, and the only step the two chains genuinely share. Everything downstream of that shared step runs the other way. Firms are producing more, not less, so they employ more people, not fewer. Real incomes rise, because money incomes hold steady while prices fall around them. And a country whose costs have fallen becomes more competitive internationally.

One ruling has to govern how you use all of that. An argument that deflation raises employment or output is only creditable when you have derived it from the supply-side cause specifically — you have shown, in the same answer, that this deflation started with supply rising. Attach the same claim loosely to deflation in general, without saying which kind you mean, and it earns nothing.

The question you are about to answer is worth eight marks, and it is marked by levels. A one-sided answer cannot reach the top level. Level 3, six to eight marks, specifically requires reasoning that examines both sides plus a judgement between them. Level 2, three to five marks, is where a well-argued but one-sided answer is capped. Level 1, one to two marks, is simple use of definitions with no real argument built on them. And a point is credited once.

Before you write, check your plan against this. A Level 3 answer on either option below does all of the following: states the definition precisely, using the exact wording from Section 4.1, not one of that section's three near-misses; gives a reason on each side, each with its own mechanism rather than just an assertion; if you take Option A, names the malign–benign distinction explicitly and applies the employment ruling above correctly; and closes with a judgement that states the condition the answer actually depends on, rather than simply picking a side.

Here is a short outline for Option A — not a full essay, and not something to copy, but the shape a Level 3 answer takes. Problem side: malign deflation triggers delayed spending, falling revenue and jobs, and heavier real debt, with monetary policy losing traction as rates near zero. Not-a-problem side: benign deflation, driven by rising supply, brings rising real incomes, rising output and employment, and improved competitiveness. Judgement: whether deflation is a problem depends on its cause, not on the fact that prices fell.

The diagram below draws both chains stacked so that the one step they share — prices fall — lines up between them, with everything above and below that step pointing in opposite directions.

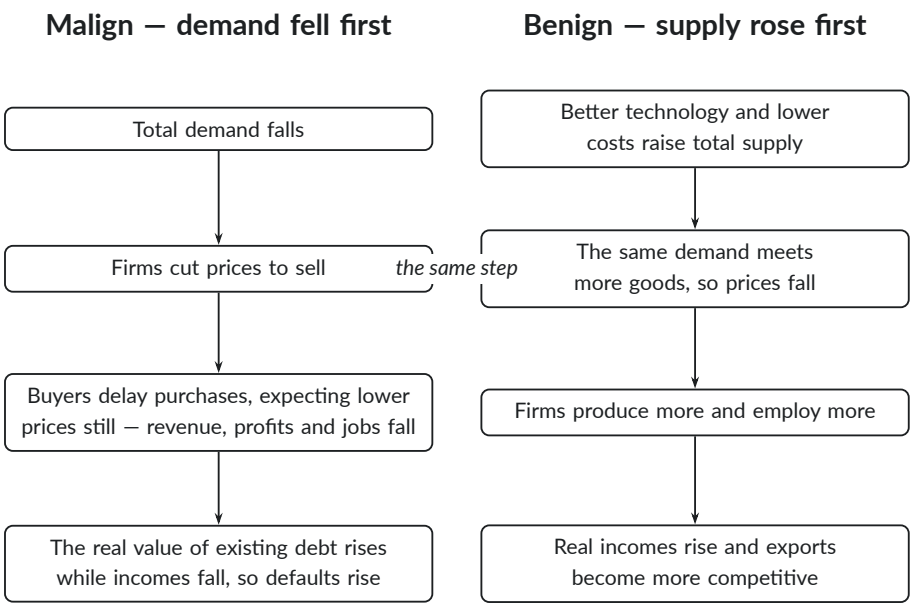

Figure 10 · *The middle step is the same in both. Nothing on either side of it is.*

Choose one of the two questions below and answer it in full. Both are marked out of eight against the levels above.

EX 5.3 Q25

Answer **either** Option A **or** Option B. [8 marks]

Option A Discuss whether deflation is always a problem for an economy.

Option B Discuss whether a central bank should raise interest rates to control inflation in a country where unemployment is already very high.

Before you close this kit, check yourself against one line for each act. Tick it only if you could do it right now, without looking anything back up.

- [ ] Act 1: I can state the three conditions for "unemployed," and explain why two countries' unemployment rates can be measuring genuinely different things.

- [ ] Act 2: I can say what unemployment costs a person, a firm and a country, and sort a case into frictional, structural or cyclical by naming what changed.

- [ ] Act 3: I can match a policy to the type of unemployment it targets, and give three reasons a policy that should work sometimes doesn't.

- [ ] Act 4: I can define inflation and deflation precisely, reject the three near-misses, and sort a price change as demand-side or supply-side.

- [ ] Act 5: I can say who gains and who loses from a price change, group by group, and argue both sides of whether deflation is always a problem.

Any line you didn't tick names exactly where to go back to. Don't reread the whole act — go straight to the section that line points at, work through its worked instance again, and try its exercises a second time before moving on.

EX 1.1 Q1 Who counts as unemployed · 1 mark

C — the woman who lost her job three months ago, is actively applying, and would take work at the going wage.

⚠ UNANSWERABLE (partial) — the stem refers to ”the three conditions above” but that list is not present in the material given to me. I answer using the standard ILO/textbook three conditions for unemployment (no job; actively seeking work; available/willing to work at the going wage), which is the only definition an IGCSE course of this kind would be teaching at this point.; A — retired, no wish to work again: fails ”seeking work” and ”available” → economically inactive, not unemployed.; B — full-time student not looking for work: fails ”seeking work” → economically inactive, not unemployed.; C — lost job 3 months ago, actively applying, would take work at the going wage: meets all three conditions.; D — turned down a job at the standard rate because he wants more money: fails ”available for work at the going wage” → not counted as unemployed on this definition.

Check: only C satisfies all three stated conditions (no job + actively seeking + available at the going wage).

EX 1.1 Q2 Who counts as unemployed · 4 marks

(a) Employed — paid informal work counts as employment. (b) Economically inactive — in education, not seeking work. (c) Employed — subsistence production for own use counts as employment. (d) Economically inactive — not available for work at the going wage, so not counted as unemployed.

⚠ UNANSWERABLE (partial) — as in Q1, the ”three conditions” text is not available to me; I use the standard ILO framework (in work for pay or profit = employed, including unregistered/informal work and subsistence production; no work but seeking and available = unemployed; neither working nor seeking = economically inactive).; (a) Street trader, South Africa, sells goods daily for cash, unregistered: she is doing paid work, so she counts as **employed** — reason: she produces and sells goods for income, even though the activity is informal/unregistered; registration status does not change ILO employment status.; (b) UK graduate studying full-time for a master’s, not applying for jobs: **economically inactive** — reason: not in work and not seeking work (in full-time education), so she is outside the labour force.; (c) Subsistence farmer, Zimbabwe, grows food only for his household, sells nothing: **employed** — reason: under the ILO definition, production of goods for one’s own household’s consumption counts as employment even though no cash income is earned.; (d) Malawi worker, no job, looking, but says he will not accept work at the local going wage: **economically inactive (not counted as unemployed)** — reason: he fails the ”available for work at the going wage” condition, so despite searching he is not classified as unemployed on the standard three-condition definition.

Check: each classification rests on which of the three conditions (has work / seeking work / available at going wage) is met or failed, applied consistently to all four cases.

EX 1.2 Q3 How the shape of employment changes · 2 marks

(1) Legal protection and rights (contract, minimum wage, safe conditions, protection from unfair dismissal). (2) Access to benefits (pension, sick pay, unemployment insurance) and easier access to credit through a verifiable income.

1. Legal protections and entitlements: a formal job comes with a written contract, minimum-wage law, safe-working-conditions rules, and protection against unfair dismissal, none of which apply to informal work.; 2. Access to benefits and security: formal employment usually gives access to a pension, sick pay, unemployment/social insurance, and a verifiable income record that makes it easier to get credit or a loan — none of this is available to an informal worker.

Check: both reasons identify a benefit that exists specifically because the job is registered/regulated, distinguishing it from informal work.

EX 1.2 Q4 How the shape of employment changes · 1 mark

A — a rising proportion of workers in the tertiary sector.

A — rising tertiary sector: correct. As economies develop, employment shifts from primary (agriculture) to secondary (manufacturing) and eventually the tertiary (services) sector becomes the largest and still-growing share.; B — rising primary sector: incorrect, primary employment share falls with development.; C — rising informal economy: incorrect, the informal economy's share typically shrinks as an economy develops and formalises.; D — rising state employment: not a general pattern of development.

Check: standard structural-change theory (Clark/Fisher sector model) — primary share falls, secondary rises then falls, tertiary rises and becomes dominant.

EX 1.3 Q5 Two ways to count, two different answers · 2 marks

Labour Force Survey — a sample of the population is asked whether they are working, seeking work and available for work (the three ILO conditions); those who are jobless but seeking and available are classed as unemployed, and the rate is calculated from the sample and applied to the whole labour force.

Labour Force Survey method: a sample of households is surveyed and each working-age person is asked questions based on the three ILO conditions — whether they did any paid work in the reference period, whether they are actively seeking work, and whether they are available to start work. Anyone with no work who is seeking and available is classed as unemployed, and the number is scaled up from the sample to the whole population to give the unemployment rate.; (Alternative valid method, not developed here: the claimant count, which simply counts the number of people registered as claiming unemployment-related benefits.)

Check: the explanation states what is measured (labour-market status via a sample survey), how (against the three ILO conditions), and how the rate is derived (scaling the sample to the population).

EX 1.3 Q6 Two ways to count, two different answers · 2 marks

Cannot be calculated from the stem alone — the labour force and narrow-definition unemployment figures from "the table above" are missing from the material supplied.

⚠ UNANSWERABLE — the stem instructs "using the table above," but no table of South Africa's labour force / employed / unemployed figures was supplied in the material given to me. The 0.6 million figure for discouraged workers is stated in the stem, but the number of people unemployed on the narrow definition and the size of the labour force (needed as the denominator for both rates) are not given anywhere in what I received. Without those figures, neither the narrow rate nor the expanded rate can be calculated.

EX 1.3 Q7 Two ways to count, two different answers · 2 marks

Malawi's low recorded rate reflects its large informal and subsistence sector (counted as employment) and the absence of benefits that would let jobless people register as actively seeking work, rather than reflecting how easy it actually is to find well-paid work.

This does not require the table's specific figures, only the general reasoning about how the measured rate is constructed.; - Malawi has a very large informal economy and a large subsistence-farming sector; under the standard definition, subsistence farming and informal cash work both count as employment, even though such "jobs" pay little and are insecure. This pulls a large share of the workforce into the "employed" category rather than "unemployed."; - Malawi has little or no unemployment benefit system, so a jobless person there generally cannot afford to search for a formal job while remaining unemployed; they take almost any available informal or subsistence work (or exit the labour force) rather than being recorded, actively seeking, as unemployed — whereas in the UK, benefits and a large formal labour market let jobless people register and search for longer, keeping them counted as unemployed.; - As a result, the measured unemployment rate reflects how easy it is to be officially recorded as jobless and seeking work, not how good the jobs on offer actually are — so a lower recorded rate in Malawi is consistent with work there being scarcer and worse-paid.

Check: the explanation accounts for the apparent contradiction (harder/worse-paid work in Malawi, yet a lower recorded rate) purely through how "employed"/"unemployed" are defined and measured, without needing specific figures.

EX 2.1 Q8 What losing a job does to a person · 4 marks

(1) Fall in income and living standards. (2) De-skilling / lower future earning potential, often accompanied by psychological harm (stress, loss of self-esteem).

1. Loss of income: the person's household income falls, reducing their living standards and, if the spell of unemployment is long, potentially pushing them into poverty or debt.; 2. Loss of/erosion of skills and lower future earnings: time out of work means skills become outdated (de-skilling) and work experience stops accumulating, making it harder to find an equally well-paid job later and often lowering lifetime earnings; unemployment is also linked to negative psychological effects such as stress, loss of self-esteem and poorer mental health.

Check: both disadvantages are consequences specific to the individual (income and future employability/wellbeing), matching "for a person" in the stem.

EX 2.2 Q9 What it costs the firms and the country · 4 marks

(1) Lost potential output/GDP (economy produces below capacity). (2) Worse government finances — higher benefit spending and lower tax revenue — plus wider social costs such as inequality and crime.

1. Lost output: unemployed workers who could be producing are not, so the economy produces below its potential (a negative output gap), meaning GDP and living standards are lower than they could be.; 2. Fiscal cost to government: government spending on unemployment/welfare benefits rises while tax revenue (income tax, VAT from spending) falls, worsening the government's budget position; high and persistent unemployment can also widen income inequality and raise social costs such as crime.

Check: both consequences are economy-wide (national output and the public finances/social fabric), matching "for a country's economy as a whole" in the stem.

EX 2.3 Q10 Three reasons people are out of work · 2 marks

Structural unemployment (mine closure) and cyclical/demand-deficient unemployment (economy-wide fall in spending) are the clearest two; seasonal unemployment (tourism) is also present in the passage, so any two of these three should be credited.

- Mine closed permanently, ore exhausted, miners not finding other work: **structural unemployment** (a permanent decline of an industry leaves workers with skills that are no longer in demand).; - Tourism employment falls every year once the season ends: **seasonal unemployment** (demand for labour in that industry varies predictably with the time of year).; - National fall in consumer spending causing firms in many industries to cut staff: **cyclical (demand-deficient) unemployment** (a general fall in aggregate demand across the whole economy).

Check: each cause is matched to the type of unemployment whose textbook definition it fits (permanent industry decline → structural; predictable annual pattern → seasonal; economy-wide demand fall → cyclical).

EX 2.4 Q11 Sorting the cause · 1 mark

Frictional unemployment.

This is a worker who has voluntarily left one job and is taking a short time to search for and secure another, without any structural mismatch or lack of demand being described.

Check: matches the textbook definition of frictional unemployment — short-term unemployment while moving between jobs during a job search.

EX 2.4 Q12 Sorting the cause · 2 marks

Clothing factory closure = structural unemployment; nationwide fall in export orders and staff cuts across every industry = cyclical (demand-deficient) unemployment. They are told apart by scope (one industry vs. the whole economy) and cause (permanent mismatch of skills to available jobs vs. a general shortfall in aggregate demand).

Clothing factory in one town closes, 400 workers lose their jobs: **structural unemployment** — a single industry/location has declined (e.g. due to changing demand or competition), leaving workers with specific, no-longer-wanted skills.; Export orders fall across the whole country, firms in every industry reduce staff: **cyclical (demand-deficient) unemployment** — a general, economy-wide fall in demand (here, a fall in export demand reducing national income and spending) causes job losses across many/all industries simultaneously.; How to tell them apart: structural unemployment is confined to a particular industry, occupation or region and is caused by a permanent change in the demand for a specific type of labour (decline of an industry, automation, changing trade patterns); cyclical unemployment appears simultaneously across most or all industries and is caused by a general fall in aggregate demand in the economy, and would be expected to reverse once demand recovers (unlike structural unemployment, which does not reverse without retraining or a new industry replacing the old one).

Check: the distinguishing test used — one industry/place vs the whole economy, and permanent skills mismatch vs demand-driven and potentially reversible — is applied consistently to both cases.

EX 3.1 Q13 Three levers, and which unemployment each one reaches · 1 mark

A — a government training programme for workers whose industry has closed.

A — government training programme: a supply-side policy, since it improves the skills/quality of the labour supply to match employers' needs.; B — cut in interest rate: a demand-side (monetary) policy, stimulates aggregate demand.; C — increase in unemployment benefits: not a policy to reduce unemployment; it typically reduces the incentive to take a job and increases government spending on welfare, but it is not classed as supply-side or aimed at cutting unemployment.; D — increase in government spending on hospitals: a demand-side (fiscal) policy, raises aggregate demand.

Check: only A works on the supply side of the labour market (improving workers' skills/employability) rather than on demand.

EX 3.1 Q14

Three levers, and which unemployment each one reaches · 2 marks

(a) Demand-side policy — e.g. cut interest rates to boost consumer spending. (b) Supply-side policy — e.g. government-funded retraining schemes to give workers the technical skills employers need.

(a) Consumer spending has fallen sharply, firms in every industry cut staff: this is cyclical (demand-deficient) unemployment, needing a **demand-side policy**. Measure: the central bank cuts interest rates (or government cuts taxes / raises spending) to stimulate consumer spending and aggregate demand.; (b) Thousands of unfilled technical vacancies alongside thousands of unemployed former factory workers: this is a skills mismatch, i.e. structural unemployment, needing a **supply-side policy**. Measure: government-funded retraining/vocational education programmes to give former factory workers the technical skills employers are seeking.

Check: (a) is matched to demand-side because the cause (fall in aggregate demand affecting all industries) is exactly what demand-side policy targets; (b) is matched to supply-side because the cause (mismatch between workers' skills and available vacancies) is exactly what supply-side policy targets.

EX 3.2 Q15

Following a policy through to jobs · 6 marks

Government spending on the railway directly creates construction jobs (reducing cyclical unemployment), the wages spent create further jobs via the multiplier (more cyclical unemployment reduced), some workers are retrained into these new roles (reducing structural unemployment), and once open, the railway improves access to jobs and encourages further business investment (reducing structural and frictional unemployment further).

Government commits spending to build a new railway line.; → Construction firms hire workers directly (engineers, labourers, project managers) to build the line, reducing cyclical/demand-deficient unemployment among those newly employed.; → These workers earn wages and spend them in the wider economy, raising demand for goods and services elsewhere (the multiplier effect), which leads other firms to take on more staff too, further reducing cyclical unemployment.; → Firms supplying materials (steel, concrete, signalling equipment) also see higher demand for their output and increase employment, spreading the effect of the government spending across several industries.; → If some of the new construction and rail-operation jobs go to workers whose previous industry had declined, and they are retrained for these roles, this also reduces structural unemployment among those workers.; → Once complete, the railway lowers transport costs and journey times for firms and commuters, making it easier for workers to reach jobs in a wider area; this can reduce both structural unemployment (workers gain access to more/different job opportunities) and frictional unemployment (job search and travel-to-interview times fall).; → Improved transport links can also make the area more attractive to new businesses (better infrastructure lowers their costs), encouraging further investment and permanent new jobs, reinforcing the earlier fall in cyclical and structural unemployment.

Check: each step follows from the one before it (spending → direct jobs → multiplier/indirect jobs → retraining/access effects → longer-run investment), and a type of unemployment affected is named at each relevant link, matching the instruction.

EX 3.3 Q16 Why the same policy fails somewhere else · 6 marks

Limited effect at best: general government spending is a demand-side tool, while structural unemployment stems from a skills/location mismatch rather than a lack of demand, so spending will create some jobs via the multiplier but is unlikely to substantially cut structural unemployment unless it is specifically targeted (e.g. retraining, regional investment) at the mismatch itself.

Case that it will help: extra government spending raises aggregate demand and, via the multiplier, creates some new jobs across the economy, which could re-employ a portion of the unemployed, including some structurally unemployed workers if the new jobs happen to use their existing skills, or if the spending is specifically targeted at retraining or at the declining region/industry.; Case that it will not solve the underlying problem: structural unemployment exists because the unemployed have skills, or are located, in industries that no longer need them — it is a mismatch problem, not a shortage-of-demand problem. Simply raising aggregate demand (e.g. general government spending on, say, healthcare or general public-sector wage increases) does not automatically give a former factory worker the technical skills employers in the growing industries are looking for, or move a declining region's workers physically closer to where jobs are being created. The new jobs created by the spending are likely to go to workers who already have the appropriate skills and location, leaving structurally unemployed workers unemployed. There is also a risk that broad demand-side spending mainly generates demand-pull inflation rather than genuine extra output/jobs, if the economy is already close to full capacity in the sectors with vacancies.; Conclusion: an increase in government spending may reduce structural unemployment only to a limited extent, and mainly if it is specifically targeted (e.g. spent on retraining schemes or on new industries in the affected region) rather than general; on its own, general spending is a demand-side tool poorly matched to a supply-side (skills/location mismatch) problem, so a supply-side policy such as retraining or relocation subsidies is likely to be more effective.

Check: the discussion weighs a demand-side cause-and-effect chain against the defining feature of structural unemployment (mismatch, not demand shortfall), and reaches a reasoned, not one-sided, conclusion, as an 8-mark "discuss" answer requires.

EX 4.1 Q17 Inflation, deflation, and the three near-misses · 1 mark

A — a sustained fall in the general price level.

A — a sustained fall in the general price level: this is the standard definition of deflation.; B — a sustained fall in total demand: this describes a recession/fall in aggregate demand, not deflation itself (though it can cause deflation).; C — a sustained fall in the rate of inflation: this is disinflation, not deflation.; D — a sustained fall in the value of money: a fall in the value of money is actually associated with inflation (rising prices), not deflation, so this is also incorrect.

Check: only A matches the textbook definition — deflation is measured by prices, not by demand or by the inflation rate itself.

EX 4.1 Q18 Inflation, deflation, and the three near-misses · 2 marks

Prices kept rising, but more slowly (by 3% instead of 8%) — this is called disinflation, not deflation.

python3 check: inflation of +3% in the second year is still positive, so prices continued to rise, just at a slower rate than the +8% of the year before (8 − 3 = 5 percentage points slower).; The general price level continued to rise (by 3%) over the second year — it did not fall. The term for a slowdown in the rate of inflation (while prices still rise) is **disinflation**.

Check: 3% > 0, so prices rose, ruling out "deflation," which requires a fall in the price level; the fall is only in the rate of increase, which is the definition of disinflation.

EX 4.2 Q19 What the Consumer Prices Index actually measures · 2 marks

Cannot name the specific item — "the table above" with the price changes and weights was not supplied. In principle, the item with the largest effect on the index is the one with the highest weight × price-change, which need not be the item with the single largest price rise if that item has only a small weight in the average household's spending basket.

⚠ UNANSWERABLE (partial) — the stem refers to "the table above" giving items, their price changes and (implicitly) their weights, but no such table was supplied in the material given to me, so I cannot name the specific item. The underlying economic principle, however, can be stated without the figures: a Consumer Prices Index is a weighted average of price changes, where each item's weight reflects its share of average household spending. An item's effect on the overall index depends on (price change) × (weight), so an item with a smaller price rise but a much larger spending weight (e.g. housing or food, which take up a large share of typical budgets) can move the index more than an item with a large price rise but a very small weight (e.g. a rarely-bought luxury good).

EX 4.3 Q20 What pushes prices up, and what pulls them down · 2 marks

(a) Cost-push inflation (currency depreciation raises the cost of imported inputs). (b) Demand-pull inflation (lower interest rates raise household spending and aggregate demand).

(a) Currency falls sharply against the currencies of countries the country imports oil and machinery from: imported oil and machinery become more expensive in domestic currency, raising firms' costs of production (fuel and capital inputs) → this is **cost-push inflation**.; (b) Interest rates are cut and households borrow and spend substantially more: lower interest rates reduce the cost of borrowing and the reward for saving, so households increase consumption spending, raising aggregate demand → this is **demand-pull inflation**.

Check: (a) operates through firms' costs (supply side) while (b) operates through household spending (demand side), matching the definitions of cost-push and demand-pull respectively.

EX 4.3 Q21

What pushes prices up, and what pulls them down · 6 marks

A sharp rise in household spending raises aggregate demand; once this outstrips the economy's productive capacity, firms raise prices (demand-pull inflation), and competition for scarce labour and inputs pushes up wages and costs, which can further sustain rising prices across the economy.

Household spending rises sharply.; → Aggregate demand (total planned spending in the economy) increases.; → If the economy is already at, or close to, full capacity, firms cannot expand output quickly enough to meet all of the extra demand.; → Demand for goods and services then exceeds the supply firms can currently provide.; → Firms respond to the excess demand by raising their prices, since they can sell all they produce even at a higher price — this is demand-pull inflation.; → To increase output where they can, firms also compete more strongly for scarce workers and raw materials, bidding up wages and input costs.; → Higher wages and costs raise firms' costs of production, which firms pass on as further price rises (feeding into cost-push pressures too).; → If wages rise across the economy in response, workers have more money to spend, which can sustain the higher demand and prices further, producing a sustained rise in the general price level — inflation.

Check: the chain moves consistently from the initial demand increase, through the capacity constraint, to the price and wage responses that generate a sustained (not one-off) rise in prices, which is the definition of inflation being explained.

EX 5.1 Q22

Winners and losers · 1 mark

A — the real value of the debt rises.

The nominal amount owed and the nominal monthly instalments stay fixed. If prices fall (deflation) while the debt is fixed in money terms, the same nominal debt/instalment represents a larger amount of real purchasing power (goods and services) than before, because money is now worth more in real terms. In addition, wages typically stall or fall in a deflationary economy, making a fixed nominal repayment harder to afford out of a shrinking or static income.; A — it rises: correct.; B — it falls: incorrect (falls would be the effect of inflation, not deflation).; C — stays unchanged: incorrect, since the price level (not just interest rates) determines the real value.; D — only if interest rates also rise: incorrect, the real value of a fixed nominal debt rises purely because of the falling price level, regardless of what happens to interest rates.

Check: real value = nominal value ÷ price level; if the price level falls while the nominal debt is unchanged, the real value of the debt (in terms of goods/services or relative to falling wages) rises.

EX 5.1 Q23 Winners and losers · 4 marks

Saver: worse off, as inflation above the savings interest rate erodes the real value/purchasing power of their savings. Person repaying a fixed loan: better off, as inflation erodes the real value of their fixed repayments while their nominal income (typically) rises. (A fixed-pension worker is worse off in real terms and an exporting firm is worse off through lost price competitiveness, if either pair is chosen instead.)

Choosing the saver and the person repaying a fixed loan (any two of the four are equally valid for the stem, which leaves the choice open):; Saver: if the interest rate paid on savings is lower than the rate of inflation, the real interest rate is negative — the purchasing power of the saver's money falls over time even though the nominal balance grows, so the saver is worse off in real terms.; Person repaying a fixed loan: their repayments are fixed in nominal (money) terms, but if their income rises roughly in line with inflation, the real burden of the fixed repayments falls over time — the same nominal instalment represents a smaller share of a now-larger nominal income, so the borrower is better off in real terms (the opposite effect to the deflation case in Q22).; (For completeness: a worker on a fixed pension is worse off, as their income does not rise with prices, so its real value/purchasing power falls; an exporting firm is worse off if domestic inflation exceeds inflation in its trading partners' economies, since its goods become relatively more expensive abroad, reducing its price competitiveness and sales.)

Check: each effect follows from comparing a fixed nominal figure (savings balance, pension, repayment schedule) or a domestic price level against a rate of inflation that changes real purchasing power/competitiveness.

EX 5.2 Q24 What a central bank and a government can do · 2 marks

Raise the interest rate: this discourages borrowing and spending and encourages saving, reducing aggregate demand and thereby easing demand-pull inflationary pressure.

The central bank raises the interest rate. This raises the cost of borrowing and increases the reward for saving, so households and firms borrow and spend less and save more; this reduces consumer spending and investment, lowering aggregate demand. Since demand-pull inflation is caused by aggregate demand exceeding the economy's productive capacity, reducing aggregate demand in this way eases the upward pressure on the general price level.

Check: the mechanism (higher rates → less borrowing/spending → lower AD → less demand-pull pressure) directly targets the cause of demand-pull inflation named in the stem.

On balance, raising interest rates risks worsening an already very high unemployment problem by further reducing aggregate demand, so it is only clearly justified if the inflation is demand-pull in origin and controlling it is judged the more urgent priority; otherwise a more cautious or targeted approach is preferable.

Both options are worked below, since the stem leaves the choice to the student.; **Option A — Discuss whether deflation is always a problem for an economy.**; Case that deflation is a problem ("bad" deflation, caused by falling demand): if deflation results from a collapse in aggregate demand, consumers may postpone purchases in the expectation that prices will fall further, which reduces spending even more and creates a self-reinforcing downward spiral; falling revenues push firms to cut output and jobs, raising unemployment; as shown in Q22, the real value of debt rises during deflation, which can push over-indebted households and firms into default; wages tend to be sticky downward, so firms cut jobs rather than cut wages, worsening unemployment.; Case that deflation is not necessarily a problem ("good" deflation, caused by falling costs/rising productivity): if deflation is driven by falling production costs (e.g. technological improvement, cheaper raw materials, increased efficiency) rather than by falling demand, output and employment need not fall — firms can maintain profit margins at lower prices. Consumers benefit from increased real purchasing power (the same nominal wage buys more), which can raise living standards without requiring any fall in output or jobs.; Conclusion: whether deflation is a problem depends on its cause — demand-driven deflation is generally harmful (it can trigger a downward spiral of falling demand, output and jobs, and raises real debt burdens), while cost/productivity-driven deflation can raise real living standards without necessarily being harmful. Deflation is therefore not always a problem; its effects depend on why prices are falling and for how long.; **Deflation is not always a problem: demand-driven deflation tends to be harmful (falling demand, output, jobs, and rising real debt burdens), whereas deflation caused by falling costs/productivity can raise real incomes without necessarily reducing output or employment.**; **Option B — Discuss whether a central bank should raise interest rates to control inflation in a country where unemployment is already very high.**; Case for raising rates: if inflation is high and driven by excess demand (demand-pull), raising interest rates reduces borrowing and spending, cools aggregate demand and helps bring inflation back under control, protecting the real value of incomes and savings and preserving the international competitiveness of exporters (see Q23).; Case against raising rates given high unemployment: higher interest rates reduce consumer spending and business investment, which lowers aggregate demand further; with unemployment already very high, this is likely to reduce output and jobs still further, worsening cyclical unemployment rather than easing it — the policy directly conflicts with the goal of reducing unemployment. If the inflation is actually cost-push in origin (e.g. from rising import or energy costs) rather than demand-pull, raising interest rates does nothing to address the underlying cause of the price rises, while still depressing demand and jobs — it would then worsen unemployment for little benefit against inflation.; Conclusion: raising interest rates is a reasonable response only if the inflation is clearly demand-pull and the central bank judges controlling prices to be the priority; where unemployment is already very high, most economists would be cautious about raising rates, since doing so risks deepening the unemployment problem, and would consider whether the inflation is cost-push (in which case interest rate rises are largely ineffective at the source) before acting. A more targeted or gradual approach, or accepting a degree of inflation while addressing unemployment first, may be preferable.

E ✂ TEAR THIS OUT — keep it beside you as you work

✂ TOOLKIT

employed — in paid work, whether as an employee or self-employed

unemployed — has no paid job, is willing and able to work, and is willing to work at the current wage rate — all three at once

voluntarily unemployed — wants a job but won't accept one at the current wage rate; fails the third condition, so not counted as unemployed

budget deficit — the gap between what government raises in tax and what it spends

frictional unemployment — unemployment from people moving between jobs or entering the labour force for the first time; present even at full employment

structural unemployment — a mismatch between the skills or location of workers and the jobs available, caused by a change in the structure of the economy

fiscal policy — the government's use of its own spending and taxation to influence the economy

direct taxes — taxes charged directly on income and profits, such as income tax and corporation tax

indirect taxes — taxes charged on spending, such as value added tax and fuel duties

inflation — a sustained rise in the general price level

deflation — a sustained fall in the general price level

disinflation — a sustained fall in the rate of inflation; prices are still rising, just more slowly than before

menu cost — the cost to a firm of changing its prices — reprinting price lists and catalogues, relabelling stock, updating systems

anticipated inflation — inflation that people and firms see coming and can plan around, so it does comparatively little damage

unanticipated inflation — inflation that catches wages, savings and contracts by surprise, and does the most damage

✎ YOUR SIDE — this half is yours to fill in

Fill it in from memory first, then turn the card over and check. Where the two disagree, the printed side is right — that is what it is for.

Three things I keep mixing up

The one rule I'd write on my hand before the exam

A question I would ask if I could ask one