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## Answers

# Exam-style questions

## Questions on deflation

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This resource provides answers to the questions posed in the Exam-Style Questions column, in the February 2025 issue of ECONOMIC REVIEW.

### Question 1

Using only data from Table 1, calculate the percentage change in the price level over the period 2018–24 to two decimal places. (2 marks)

#### *Answer*

$$(136 - 132) / 132 \times 100 = 3.03\%$$

### Question 2

Using evidence from Table 1, to what extent do the data show that deflation leads to worsening economic performance? (4 marks)

#### *Answer*

- Deflation is where the price level falls over time. Can be good or harmful for an economy (depending on cause).
- Deflation – based on Table 1 – occurs in years 2022, 2023, 2024.
- Lowest economic growth occurs in 2022, 2023, 2024 (0.9%, -0.5%, -0.6%).
- Highest unemployment rates (5.6% and 6.5%) occur in periods of deflation (2023–2024)
- Other year of deflation (2022) has unemployment of 4.8% which is fifth highest out of 7 years shown.
- Strong evidence that deflation is accompanied by worsening economic performance; 2023 and 2024 have worst performance in growth and unemployment. 2022 has third-lowest year of growth but unemployment is not high (lagging variable, perhaps).

### Question 3

With the help of a diagram, explain how deflation can be harmful for an economy. (9 marks)

#### Answer

- Diagrams – AD/AS model with falling AD (a diagram that shows deflation caused by AS increasing isn't really harmful – though it should be allowed as even 'good' deflation can become 'bad' deflation if it persists).
- Economic growth should decrease – shown on diagram.
- Unemployment is likely to rise.
- Reverse/downwards multiplier effects on growth possible.

### Question 4

Evaluate the extent to which elimination of deflation should always be an economic priority for governments. (25 marks)

#### Answer

Possible issues to include:

- Deflation can be harmful for an economy – especially if caused by falling AD – leading to falling GDP and rising unemployment.
- Reverse/downward multiplier effects possible.
- Deflation can become self-perpetuating if it leads to postponement of purchases.
- Deflation increases the real value of debts.
- Deflation can lead to real-wage unemployment if wages are sticky downwards.
- Deflation caused by increases in AS may be beneficial for an economy (leading to increased GDP and falling unemployment).
- Policies to eliminate deflation would include expansionary fiscal or monetary policy.
- Other objectives may be more important – e.g. economic growth or unemployment.
- Difficult to use expansionary fiscal policy if budget deficit is already high.
- Difficult to use expansionary monetary policy if interest rates are already very low.
- Risks to inflation if policy is too expansionary.

Issues for evaluation

- May be difficult to determine the cause of the deflation.
- Depends on the 'size' of the deflation and likely duration of the deflation.
- Other economic objectives may be more important.
- Deflation caused by falling commodity prices (e.g. the UK deflation of 2015) are only temporary and may not be worth dealing with.