



# Economics lesson 2 – Answer sheet

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What is inflation?

### Extension task

Consider the different types of inflation.

Talk to the person next to you about it.

- Inflation is the sustained rise in price level over a period of time.
- Cost – push inflation – A rise in price level due to an increase in the costs of production.
- Demand – pull inflation – A rise in price level due to excessive increases in aggregate demand.

How is inflation measured?

### CPI – Consumer Price Index

- The government undertakes a survey to determine the goods and services average UK families spend their money on. This is known as 'the basket of goods and services'.
- Prices of all goods and services in this basket are recorded every month.
- These figures are recorded in the CPI.
- CPI is given the number 100 at the start of the period and if prices rise in the next month this will be reflected in the index.
- To make the CPI accurate, the government has to use a system called weighting.
- Each item in the 'basket of goods and services' is given a weight, which represents its importance in the total spending of the average family.
- The importance is measured dependant on the proportion of income that is being spent on the goods.

What are the consequences of inflation?

Clue: Think about the UK's cost of living crisis

- Loss of consumer confidence.
- Shoe leather costs – consumers have to spend more time shopping around.
- Real incomes fall.
- Producers lose business confidence.
- Consumers that have debt gain.
- Unemployment.
- The government spends more on benefits – e.g. pension.
- Income inequality rises.
- Menu costs – restaurants and shops have to spend money reprinting labels and menus.
- Wage costs rise.
- Government spends more money on wages – e.g. NHS, teacher salaries.

## Activity

The UK economy has been experiencing a cost of living crisis since late 2021. This has contributed to significantly high rates of inflation in the UK. In October 2022, the UK's inflation rate was at 11.1%. Sophia is a sole trader on a popular ecommerce website. She sells cards and gifts. The cost of living crisis has contributed to a significant rise in costs of production. Additionally, Sophia's business has been affected by the limited supply chains. These issues have predicted price changes for the future. Sophia has to make a huge decision on whether she buys her raw materials in bulk now or wait, taking into consideration whether inflation would continue to rise or fall.

### Question 1

Date	CPI
December 2021	114.7
December 2022	127.2

Using the table, calculate the annual inflation rate at December 2022 to one decimal place. Show your working.

Clue – Use the percentage change formula to help you complete this question –  $(\text{new-old}/\text{old}) \times 100$

- 10.9%

### Question 2

Explain two costs of inflation on Sophia's business.

Menu costs: Firms have to adjust their price lists more often when there is inflation. Sophia has experienced limited supply chains. This increased the price of her raw materials. A rise in costs of production means she would have to pass on higher prices to consumers.

Reduced business confidence: High rates of inflation can reduce business confidence. Businesses are much less likely to invest if they have great uncertainty about the future.

### Question 3

Year	Inflation Rate
2021	2.6%
2022	9.1%
2023	6.1%
2024	0.9%
2025	0.1%
2026	0.5%
2027	1.6%

Using the data given, explain whether Sophia should buy all of her raw materials in bulk now or wait and purchase them at a later date.

Write down your ideas in bullet form.

- The data shows that the level of inflation will fall as we go into the end of 2023 and enter 2024. This suggests that Sophia should wait to buy her materials at a later date, as they will be cheaper.
- However, there are benefits of buying in bulk, as her unit costs will fall, reducing Sophia's costs of production. A fall in the costs of production may lead to lower prices for Sophia's customers.

