

Economics transition task – inflation and the cost of living

The Economics transition task for 2025 is a sequence of activities on the key macroeconomic issues around inflation. You will explore:

- what we mean by inflation and how we measure it
- how inflation is caused by both demand and supply side pressures in the economy
- the consequences of inflation, particularly in relation to the cost of living
- how governments can respond to control inflation

The tasks are organised around a set of notes - a modified version of those you will be given next year when you study inflation in Term 3/4. The tasks use recently published data, most of which were published over the last 12 months. The big ideas in economics are live!

What is inflation?

Inflation is a **sustained increase in the general price level across the economy** leading to a fall in the **purchasing power of money**.

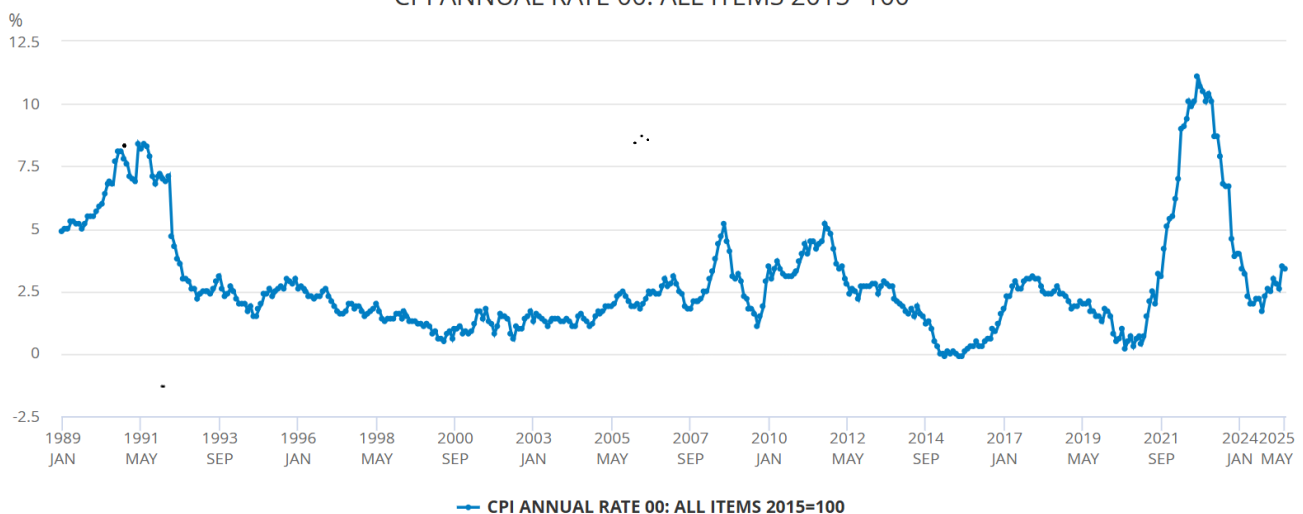
The Bank of England has a simple [inflation calculator](#). It shows for example that £10 worth of goods and services in 2009, when many of you were born, would now cost £15.99 (May 2025 data).

How is the rate of inflation measured?

- The **rate of inflation** is measured by the annual percentage change in consumer prices.
- The British government has an **inflation target** of 2% using the **Consumer Price Index (CPI)**
- It is the job of the Bank of England to set interest rates so that aggregate demand is controlled, inflationary pressures are stable and low and the inflation target is reached
- The Bank is independent of the government with control of interest rates and it is free from political intervention. *The Bank is also concerned to avoid **price deflation**.*

As you will have clearly seen for yourself over the last couple of years, the UK in common with many countries has an issue with high inflation – price levels are rising, generally faster than wages and this is creating a range of challenges for households, employers and the government.

CPI ANNUAL RATE 00: ALL ITEMS 2015=100



Task 1. The most recently published value, for May 2025 is 3.4%. Use the chart to estimate the inflation rate in May 1991. Annotate the chart to show your method.

Between 10%-20% of the marks in Economics are earned for *Quantitative Skills* - being able to read, commentate on, interpret and make calculations from data is an important part of being an A Level Economist.

A **fall in the rate of inflation** is not the same thing as a **fall in prices**. Have a look at the chart above which measures the rate of consumer price inflation. Note after the peak in October 2022 at 11.1%, there was a steep drop in inflation to 2.3 per cent in the year to April 2024. Inflation was falling (**disinflation**) – but the rate remained positive – meaning that prices were rising but at a slower rate. A slowdown in inflation is not the same as deflation. For this to happen, inflation would have to be negative.

How is the rate of inflation calculated?

The **cost of living** is a measure of changes in the average cost of buying a basket of different goods and services for a typical household. In the UK there are two key measures used, the **Retail Price Index (RPI)** & the **Consumer Price Index (CPI)**.

The CPI is a **weighted price index**. Changes in weights reflect shifts in the spending patterns of households. The following have occurred in 2025:



This hypothetical example shows how to calculate a weighted price index.

Category	Price Index	Weighting	Price x Weight
Food	104	19	1976
Alcohol & Tobacco	110	5	550
Clothing	96	12	1152
Transport	108	14	1512
Housing	106	23	2438
Leisure Services	102	9	918
Household Goods	95	10	950
Other Items	114	8	912
		100	10408

The price index for this year is: **the sum of (price x weight) / sum of the weights**.
 The price index for this year is 104.1 (one dp)

Task 2. The rate of inflation is the % change in the price index from one year to another. So if in one year the price index is 104.1 and a year later the price index has risen to 112.5, what was the annual inflation rate? (*show your working*)

Task 3. Try this question and show your working:

The table below shows details for a weighted price index which contains only two products, X and Y.

Product	Year 1 price (£)	Year 2 price (£)	Weight
X	10	12	2
Y	20	18	1

If Year 1 is the base year, what is the value of the weighted index in Year 2?

- A 100
- B 105
- C 110
- D 120

Consumer Prices Index including owner occupiers' housing costs (CPIH)

CPIH is the most comprehensive measure of inflation. It extends the Consumer Prices Index (CPI) to include a measure of the costs associated with owning, maintaining and living in one's own home, known as owner occupiers' housing costs (OOH), along with Council Tax. Both are significant expenses for many households and are not included in the CPI.

CPIH annual inflation rate by division UK May 2023	May 2023 %
CPIH All items	7.9
Food and non-alcoholic beverages	18.4
Alcohol and tobacco	9.2
Clothing and footwear	7.0
Housing and household services	7.3
of which owner occupiers' housing costs	4.2
Furniture and household goods	7.5
Health	8.5
Transport	1.3
Communication	9.0
Recreation and culture	6.8
All goods	9.7
All services	6.3

Task 4. Using the data above, what is the main driver of inflation, according to the categories given? What does an economist mean by a *driver*?

Did transport costs fall over the year? How do you know? What do you think is the likely most important determinant of whether transport costs rise or fall?

Task 5 - What is your personal inflation rate?

The headline rate of inflation is an average, based on a typical household's pattern of expenditure and how the prices of goods and services that they consume change.

Either for yourself or for your household (more useful) calculate your personal inflation rate using this tool on the website of the [Office for National Statistics](#), the government agency which is responsible for most of our national data. The website will produce a short summary report, which will show the cost of living in your household will have increased over the last year.

Limitations of the Consumer Price Index as a measure of inflation

When we use data in economics, as well as understanding how the data can be used, we also need to appreciate its limitations. The CPI has the following limitations, one of which is explored in task 5:

1. **The CPI is not fully representative:**

- The CPI represents the expenditure of the 'average' household, inevitably it will be inaccurate for the 'non-typical' household, e.g. 14% of the index is motoring expenses - inapplicable for non-car owners.
- spending patterns from households that include children, single people, young from old, male from female, rich from poor and minority groups.
- We all have our own 'weighting' for goods and services that does not coincide with that assigned for the consumer price index.

2. **Housing costs:** Housing costs vary greatly from person to person, so these will greatly affect a person's personal inflation rate.

3. **Changing quality of goods and services:** Although the price of a good or service may rise, this may also be accompanied by an improvement in quality as the product.

4. The CPI can be slow to respond to the emergence of new products and services.

Other key terms

Inflation relates to changes in prices. When we talk about inflation, we use other terms to describe specific patterns:

- **Deflation** happens when the **rate of inflation becomes negative**- i.e. the general price level is falling
- **Disinflation** refers to a falling but still positive rate of inflation – the general level of prices is rising across the economy, but at a slower rate as is currently the case in the UK.
- **Hyperinflation** is extremely rare. [In May 2025, the annual inflation rate in Malawi](#) was 27.7% - one of the highest in Africa. Malawi has a **hyperinflationary economy** - along with Burundi, Sierra Leone, Sudan, Venezuela and Zimbabwe. This is when there is cumulative inflation over three years of around 100% or more.
- **Stagflation**. For Britain the worst inflation experienced in modern times was during the mid to late 1970s when prices were rising at an annual rate of over twenty per cent. At the same time the economy was suffering from slow growth and rising unemployment and this gave rise to the idea of **stagflation**.

Real and nominal values

The distinction between real and nominal values is important to us as economists. The **nominal value** of money is what call its **face value** or **money value**. The face value of money generally doesn't change.

Inflation erodes the purchasing power of money – causing the real value of money to fall.

The £1 coin was introduced in 1983. Ten years later it was worth the equivalent of 63p (compared to 1983 prices) due to inflation across that period. We call this the **real value**, which takes the nominal value of adjusts it to show the effects of inflation. For example, **real income** refers to a person's income after accounting for the effects of inflation.

Average weekly earnings, three-month growth rates and CPI 2001 – April 2025 (Source ONS)



Task 6 – The difference between real and nominal values

Using the chart above, identify a period during which real weekly earnings fell. What does this mean?

Causes of Inflation

Economists distinguish between two different types of cause of inflation:

- **Demand-pull inflation** – where too much demand pulls up prices
- **Cost-push inflation** – where costs force suppliers to try to pass on higher prices to consumers

We also consider that it is important where inflation is coming from – in other words, are the causes:

External to the UK - factors/events overseas, for example:

- the war in the Ukraine pushed up the prices of commodities such as gas and wheat – these now cost more to import
- the current unrest in the Middle East involving Israel, the USA and Iran may push up the oil price
- Donald Trump's imposition of Tariffs on imports into the USA and retaliation from other countries, is pushing up import prices around the world

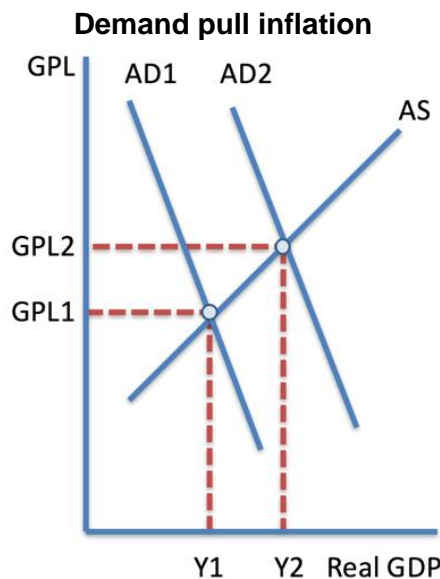
Internal - resulting from changes or pressures in the UK, for example:

- domestic producers deciding to raise prices to increase profits
- the pricing strategies of the food retailers based on the strength of demand and competitive pressure in their markets.
- a rise in the rate of VAT would also be a cause of increased domestic inflation in the short term because it increases a firm's costs.

Fluctuations in the exchange rate can also affect inflation – for example a fall of approximately 15% in the external value of the pound against the Euro in 2016-17, following the Brexit referendum, caused **higher import prices** for items such as food from Western Europe which fed through directly or indirectly into the CPI. Economists sometimes refer to this as **imported inflation**.

Demand-Pull Inflation

Task 6. Economists use aggregate supply and demand analysis to model what happens in in the macroeconomy. Annotate the diagram below, based on our discussion in class and the bullet points below the chart:



- Demand pull inflation occurs when aggregate demand is growing at an unsustainable rate leading to increased pressure on scarce resources

- When there is **excess demand**, producers are able to raise their prices and achieve bigger **profit margins** because demand is running ahead of supply
- Demand-pull inflation becomes a threat when an economy has experienced a boom with GDP rising faster than the long-run trend growth of potential GDP (the capacity of the economy to produce more goods)

Task 7. Demand-pull inflation is likely when there is full employment of resources/less spare capacity in the economy. What do you think this means – how does this lead to rising inflation?

Causes of Demand-Pull Inflation

1. A **depreciation of the exchange rate** increases the price of imports and reduces the foreign price of a country's exports. If consumers buy fewer imports, while exports grow, AD in will rise
2. **Higher demand from expansionary fiscal policy** - lower taxes or higher government spending. If direct taxes are reduced, consumers have more disposable income causing demand to rise. Higher government spending and increased borrowing creates extra demand in the economy
3. **Monetary policy.** A fall in interest rates may stimulate too much demand – for example in raising demand for loans or in leading to house price inflation. Monetarist economists believe that inflation is caused by “too much money chasing too few goods” and that governments can lose control of inflation if the money supply grows too quickly.
4. **Fast growth in other countries** – providing a boost to UK exports overseas. Export sales provide an extra flow of income and spending into the UK circular flow – so what is happening in the economic cycles of other countries definitely affects the UK

Cost-Push Inflation

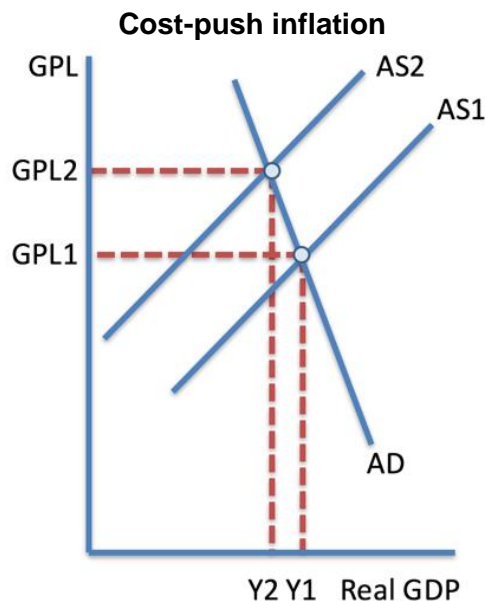
Cost-push inflation occurs when firms respond to **rising costs**, by increasing prices to **protect their profit margins**.

1. **Component costs:** e.g. an increase in the prices of raw materials and other components. This might be because of a rise in commodity prices such as oil, copper and agricultural products used in food processing. A recent example has been a surge in the world price of wheat.
2. **Rising labour costs** - caused by wage increases, which are greater than improvements in productivity. Wage costs often rise when unemployment is low because skilled workers become scarce and this can drive pay levels higher. Wages might increase when people **expect higher inflation** so they ask for more pay in order to protect their real incomes. Trade unions may use their bargaining power to bid for and achieve increasing wages, this could be a cause of cost-push inflation
3. **Expectations of inflation** are important in shaping what actually happens to inflation. When people see prices are rising for everyday items they get concerned about the effects of inflation on their real standard of living. One of the dangers of a pick-up in inflation is what the Bank of England calls “**second-round effects**” i.e. an initial rise in prices triggers a burst of higher pay claims as workers look to protect their real wages. This is known as a **wage-price spiral**.
4. **Higher indirect taxes** – for example a rise in the duty on alcohol, fuels and cigarettes, or a rise in Value Added Tax.

5. **A fall in the exchange rate** – this can cause cost push inflation because it leads to an increase in the prices of imported products such as essential raw materials, components and finished products – this can be referred to as **imported inflation**.
6. **Profit-push inflation** – where dominant firms in a market use their market power (at whatever level of demand) to increase prices well above costs. Some have accused the UK supermarkets of raising prices more than they need to.

Cost-push inflation such as that caused by a large and persistent rise in the world price of crude oil can be shown in a diagram by an **inward shift of the aggregate supply curve**. The fall in SRAS leads to a contraction of national output together with a rise in the level of prices. This is shown in the next diagram.

Task 8. Annotate the diagram below, based on our discussion in class:



The Main Consequences of Inflation

The current inflation rate in the UK is higher than it has been for many years. Economists are generally very concerned about the effects of inflation because it can cause a number of problems which are difficult to tackle.

1. **Income redistribution:** One risk of higher inflation is that it has a regressive effect on lower-income families and older people in society. This happens when prices for food and domestic utilities such as water and heating rise at a rapid rate.
2. **Falling real incomes:** With millions of people facing pay rises which are behind the rate of inflation.
3. **Negative real interest rates:** If interest rates on savings accounts are lower than the rate of inflation, then people who rely on interest from their savings will be poorer. Real interest rates for millions of savers in the UK and many other countries have been negative for years.
4. **Cost of borrowing:** High inflation may also lead to higher borrowing costs for businesses and people needing loans and mortgages as financial markets protect themselves against rising prices and increase the cost of borrowing on short and longer-term debt. This leads to pressure on the government to increase the value of the state pension and unemployment benefits and other welfare payments as the cost of living climbs higher.

5. **Risks of wage inflation:** High inflation can lead to an increase in pay claims as people look to protect their real incomes.
6. **Business competitiveness:** If one country has a much higher rate of inflation than others for a considerable period of time, this will make its exports less price competitive in world markets. Eventually this may show through in reduced export orders, lower profits and fewer jobs, and also in a worsening of a country's trade balance. A fall in exports can trigger negative multiplier and accelerator effects on national income and employment.
7. **Business uncertainty:** High and volatile inflation is not good for business confidence partly because they cannot be sure of what their costs and prices are likely to be. This uncertainty might lead to a lower level of capital investment spending.

How important is the cost of living according to public opinion?

The Government gathers information about what the public think is important through the Opinions and Lifestyle Survey (OPN). The following information is for the latest survey period, 7 May to 1 June 2025, based on adults in Great Britain.

- When asked about the important issues facing the UK today, the most commonly reported issues were the cost of living (86%), the NHS (85%) and the economy (70%).
- Around 6 in 10 adults (62%) said that their cost of living has increased in the last month; this proportion has decreased from 72% in the previous period (2 to 27 April 2025).
- Among adults who reported an increase in their cost of living in the past month, 92% said that the cost of their food shop went up, making it the most commonly reported reason.

What are the pressures and what actions do people take?



Controlling inflation – macroeconomic policies

Inflation can be reduced by policies that (i) slow down the growth of AD or (ii) boost the rate of growth of aggregate supply (AS)

1. **Fiscal policy** (taxation and spending):
 - a. Controlling aggregate demand is important if inflation is to be controlled. If the government believes that AD is too high, it may choose to ‘tighten fiscal policy’ by reducing its own spending on public and merit goods or welfare payments
 - b. It can choose to raise direct taxes, leading to a reduction in real disposable income
 - c. The consequence may be that demand and output are lower which has a negative effect on jobs and real economic growth in the short-term
2. **Monetary policy** (interest rates and the money supply):
 - a. A ‘**tightening of monetary policy**’ involves the central bank introducing a period of higher interest rates to reduce consumer and investment spending
 - b. Higher interest rates may cause the **exchange rate** to appreciate in value bringing about a fall in the cost of imported goods and services and also a fall in demand for exports
3. **Supply side economic policies**:
 - a. Supply side policies seek to increase **productivity, competition and innovation** – all of which can maintain lower prices. These are ways of controlling inflation in the medium term
 - i. A reduction in company taxes to encourage greater investment
 - ii. A reduction in taxes which increases risk-taking and incentives to work – a cut in income taxes can be considered both a fiscal and a supply-side policy
 - iii. Policies to open a market to competition to increase supply and lower prices
 - b. Rising productivity will cause an outward shift of aggregate supply
4. **Direct controls** - a government might choose to introduce direct controls on some prices and wages
 - a. Public sector pay awards – the annual increase in government sector pay might be tightly controlled or even frozen (this means a real wage decrease).
 - b. The prices of some utilities, such as the current energy price cap (EPC) – if the price capping regime changes, this can have a short-term effect on the rate of inflation

Evaluation points – how best can inflation be controlled?

- The most appropriate way to control inflation in the short term is for the government and the central bank to keep control of aggregate demand to a level consistent with our productive capacity
- AD is probably better controlled through the use of monetary policy rather than an over-reliance on using fiscal policy as an instrument of **demand-management**
- Controlling demand to limit inflation is likely to be ineffective in the short run if the main causes are due to **external shocks** such as high world food and energy prices
- The **UK is an open economy** in which inflation is strongly affected by events in the rest of the world
- If inflation is being caused by rising prices (supply pressure) is raising interest rates likely to be effective?
- Is it ethical to make households poorer to control rising prices?

In the long run, it is the growth of a country’s supply-side and its productive capacity that gives an economy the flexibility to grow without suffering from acceleration in cost and price inflation.