CIE Economics AS-level

Topic 5: Government Macro Intervention

c) Policies to correct inflation and deflation

Notes

The effectiveness of fiscal policy, monetary policy and supply-side policies to correct inflation and deflation

- If governments employ deflationary fiscal and monetary policy, the effects of demand-pull inflation could be reduced. For example, higher rates of income tax could cause disposable income to fall, so consumers spend less.
- However, higher income taxes may result in workers demanding higher wages to make up for it. This could increase costs of production for firms and if workers decide that it is not economically worthwhile to work, they might leave the labour force. This results in a fall in the productive capacity of the economy.
- Interest rates could also be used. A high interest rate is likely to deter consumers from borrowing and encourage saving. This is likely to cause the rate of inflation to fall. However, this is likely to cause investment to fall, which will cause AS to fall and put an upward pressure on the average price level.
- Sometimes supply-side policies might be used. If the increase in the rate of AS can match that of AD, economic growth can occur without upward pressure on inflation.