



**Economics Questions By Topic:**

**Aggregate Demand & Aggregate  
Supply (2.2 & 2.3)**

**A-Level Edexcel Theme 2**

 0207 060 4494

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 The Foundry, 77 Fulham Palace Road, W6 8JA

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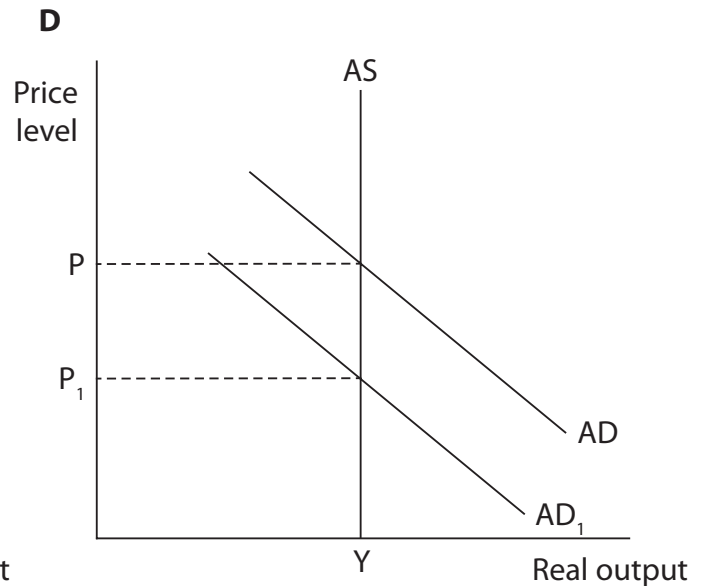
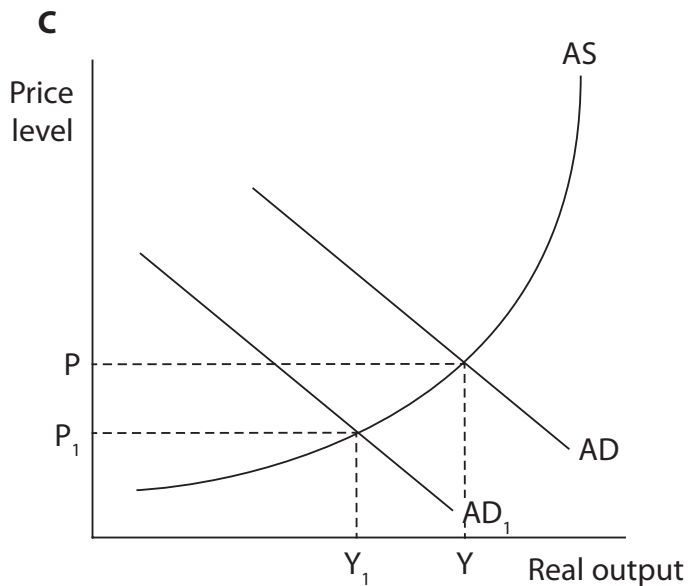
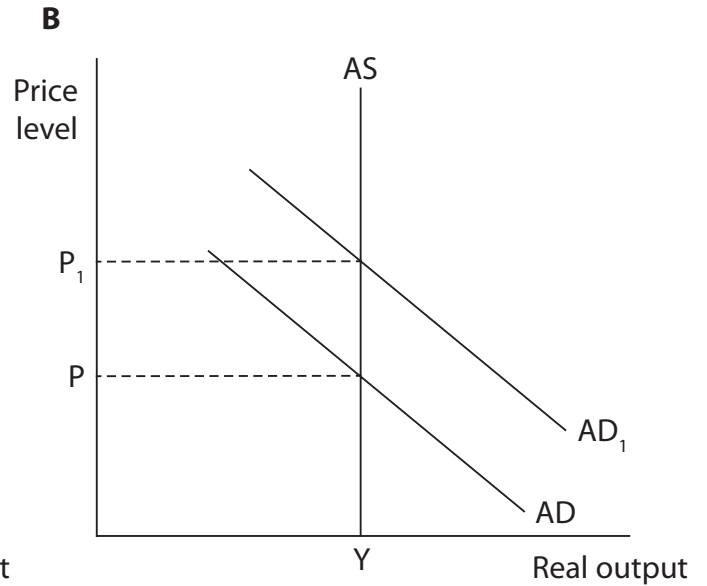
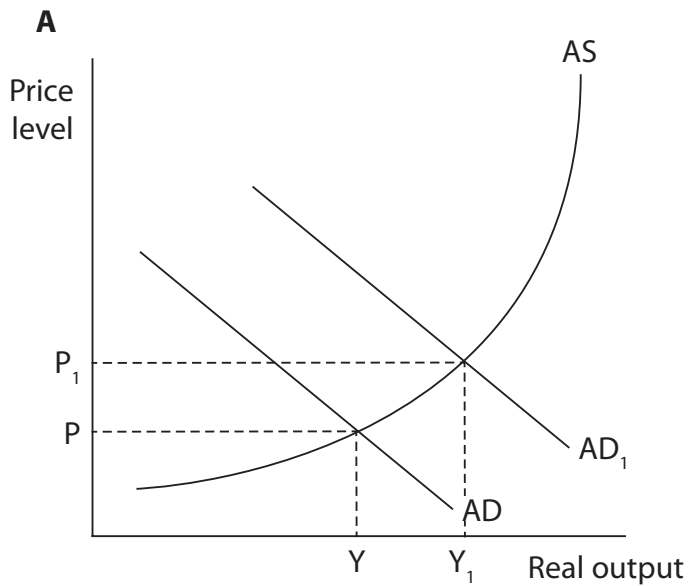
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## SECTION A

**Write your answers in the spaces provided.**

- 1** (a) Which **one** of the following diagrams illustrates the impact of an increase in net exports along a Keynesian long-run aggregate supply curve?

(1)



- A**
- B**
- C**
- D**

(b) Using the classical long-run aggregate supply curve, explain what will happen in the long run to real output if aggregate demand increases.

(2)

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(c) Explain the likely impact on aggregate demand of a fall in average house prices.

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**(Total for Question 1 = 5 marks)**





- 3** The Hong Kong-Zhuhai-Macau Bridge is the world's longest sea bridge. It reduces the journey time from Hong Kong to Zhuhai from 4 hours to just 30 minutes. It cost the equivalent of \$18.8 billion and was government funded.

(Source adapted from: [www.theguardian.com](http://www.theguardian.com))

Draw an aggregate demand and aggregate supply diagram to show the likely impact of this new bridge on the price level and real output in the region.

(4)



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**(Total for Question 3 = 4 marks)**

4 (a) Illustrate the shape of the **Classical** long-run aggregate supply (AS) curve on the diagram below.

(1)



(b) Explain the reason for the shape of the Classical long-run AS curve.

(2)

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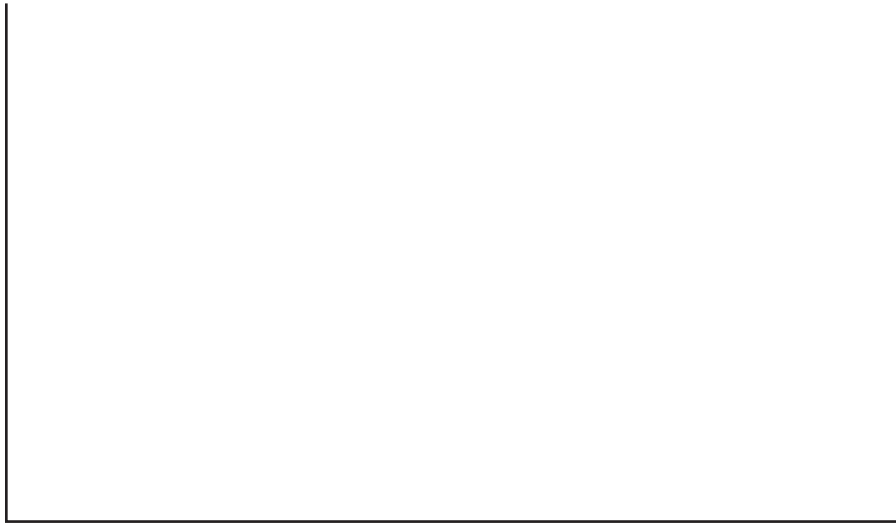
**(Total for Question 4 = 3 marks)**

- 5 The International Monetary Fund has called on the G20 group of large industrialised countries to boost government spending on infrastructure.

(Source: <https://www.theguardian.com/business/2016/jul/23/imf-calls-for-more-government-spending-as-rate-cuts-lose-their-impact>)

Draw an aggregate demand and aggregate supply diagram to show the likely impact of an increase in government spending on infrastructure on a country's price level and real output.

(4)



**(Total for Question 5 = 4 marks)**

6 (a) Illustrate the shape of the Keynesian long-run AS curve on the diagram below.

(1)



(b) Explain what is meant by spare capacity in an economy.

(2)

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(c) Which **one** of the following is most likely to cause a movement along the AS curve?

Changes in:

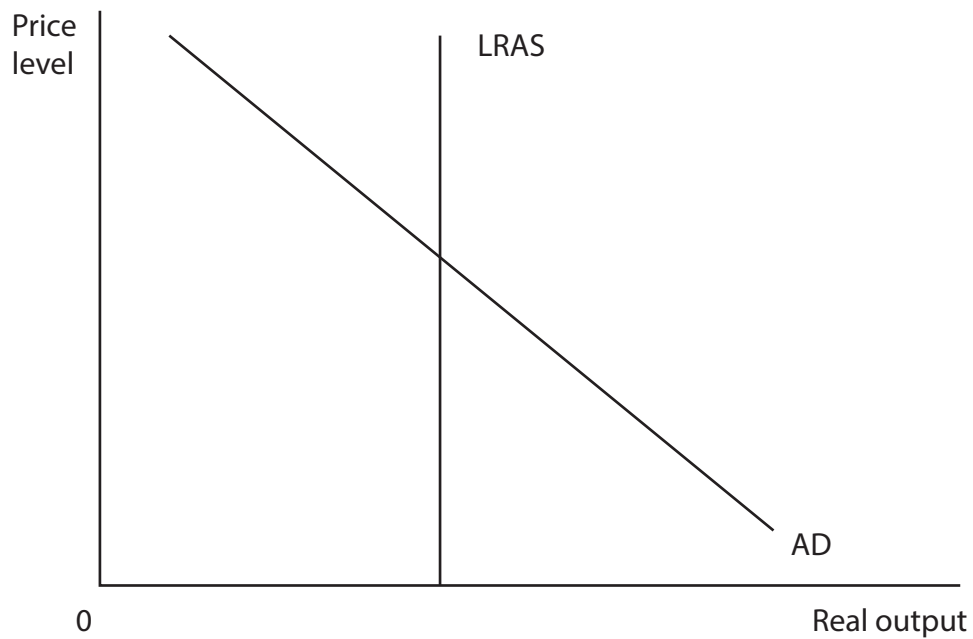
(1)

- A** competition policy
- B** relative productivity
- C** the cost of raw materials
- D** the level of aggregate demand

**(Total for Question 6 = 4 marks)**

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- 7 The diagram below shows the aggregate demand (AD) and a possible long-run aggregate supply (LRAS) for the UK.



Annotate the diagram above to show the likely impact of government policy to promote business competition on the equilibrium level of real output and price level.

(2)

**(Total for Question 7 = 2 marks)**

8 (a) Which **one** of the following would be most likely to cause aggregate demand to increase?

**A fall in:**

(1)

- A** government spending
- B** net trade (X-M)
- C** the marginal propensity to consume
- D** the marginal propensity to save

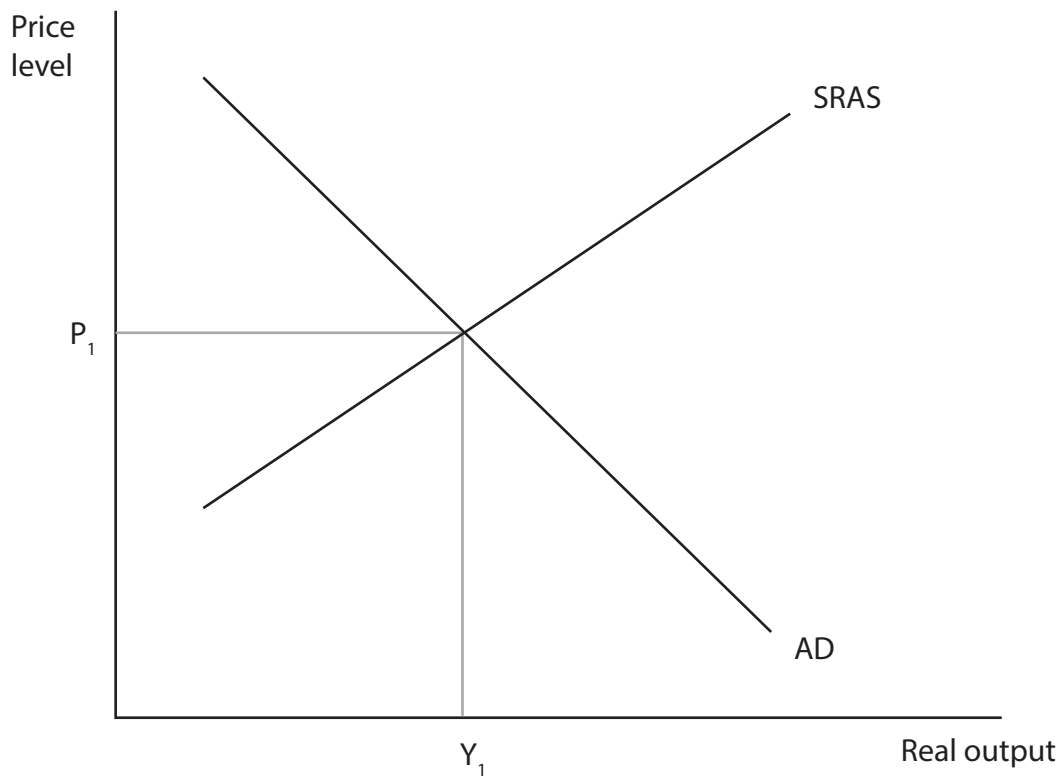
(b) Draw an aggregate demand and aggregate supply diagram illustrating the likely impact of a rise in interest rates on the price level and real output.

(4)

(Total for Question 8 = 5 marks)



- 9 The diagram below shows the aggregate demand (AD) and short-run aggregate supply (SRAS) for the UK.



- (a) Define the term 'aggregate demand'.

(1)

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- (b) Annotate the diagram above to show the likely impact of a rise in the cost of raw materials on the UK's equilibrium level of real output and price level.

(2)

(c) Which **one** of the following factors is most likely to cause an increase in the long-run aggregate supply?

(1)

- A** Decrease in investment
- B** Increase in relative productivity
- C** Increase in the level of unemployment benefits
- D** Reduced access to credit for consumers and businesses

**(Total for Question 9 = 4 marks)**

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**10** Define the term 'budget deficit'.

(1)

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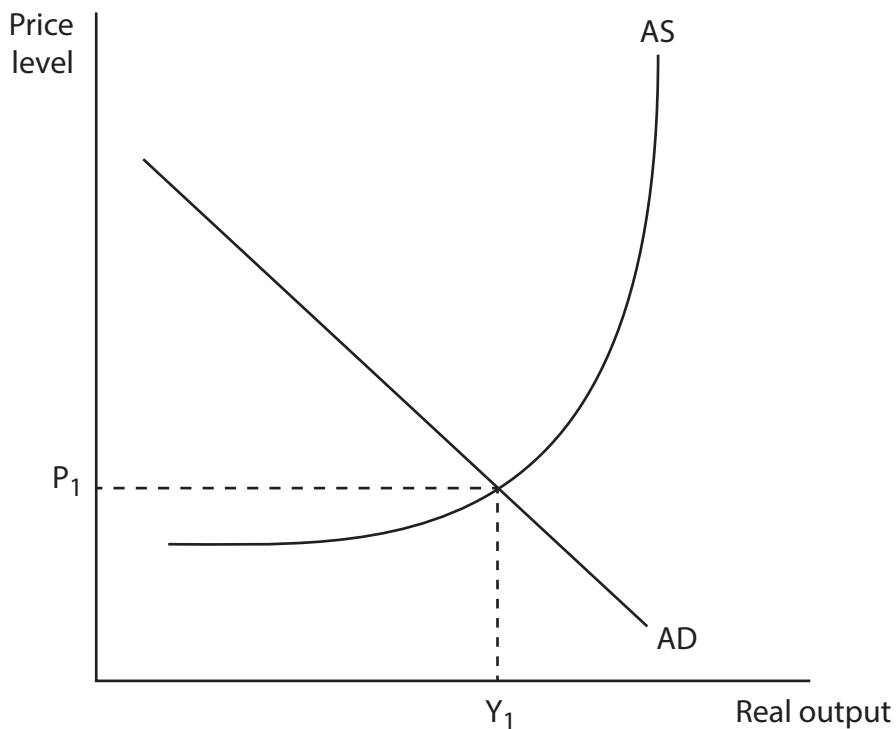
**(Total for Question 10 = 1 mark)**

11 The Chancellor announced in the 2015 Budget that the personal allowance (the annual income that can be earned before starting to pay income tax) would increase from £10 600 to £11 000 in April 2016. This means most consumers will pay less income tax.

(Source: adapted from <http://www.telegraph.co.uk/finance/personalfinance/how-budget-affect-me/11721785/Budget-2015-what-to-expect-for-income-tax-and-the-personal-allowance.html>)

(a) Annotate the aggregate demand and aggregate supply diagram below to show the likely impact of the increase in the personal allowance on the UK's price level and real output.

(2)



(b) Define the term 'direct tax'.

(1)

(c) Which **one** of the following is an example of a direct tax?

(1)

- A Value Added Tax
- B Vehicle Excise Duty
- C Corporation tax
- D Alcohol duty

(Total for Question 11 = 4 marks)



(b) Which **one** of the following is most likely to result from an improvement in UK consumer confidence? A decrease in the marginal propensity to:

(1)

- A** consume
- B** tax
- C** import
- D** save

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**(Total for Question 12 = 4 marks)**

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**13** Which **one** of the following is most likely to cause a rightward shift in the aggregate supply curve?

(1)

- A** A decrease in real output
- B** A rise in price level
- C** A fall in price level
- D** An increase in productivity

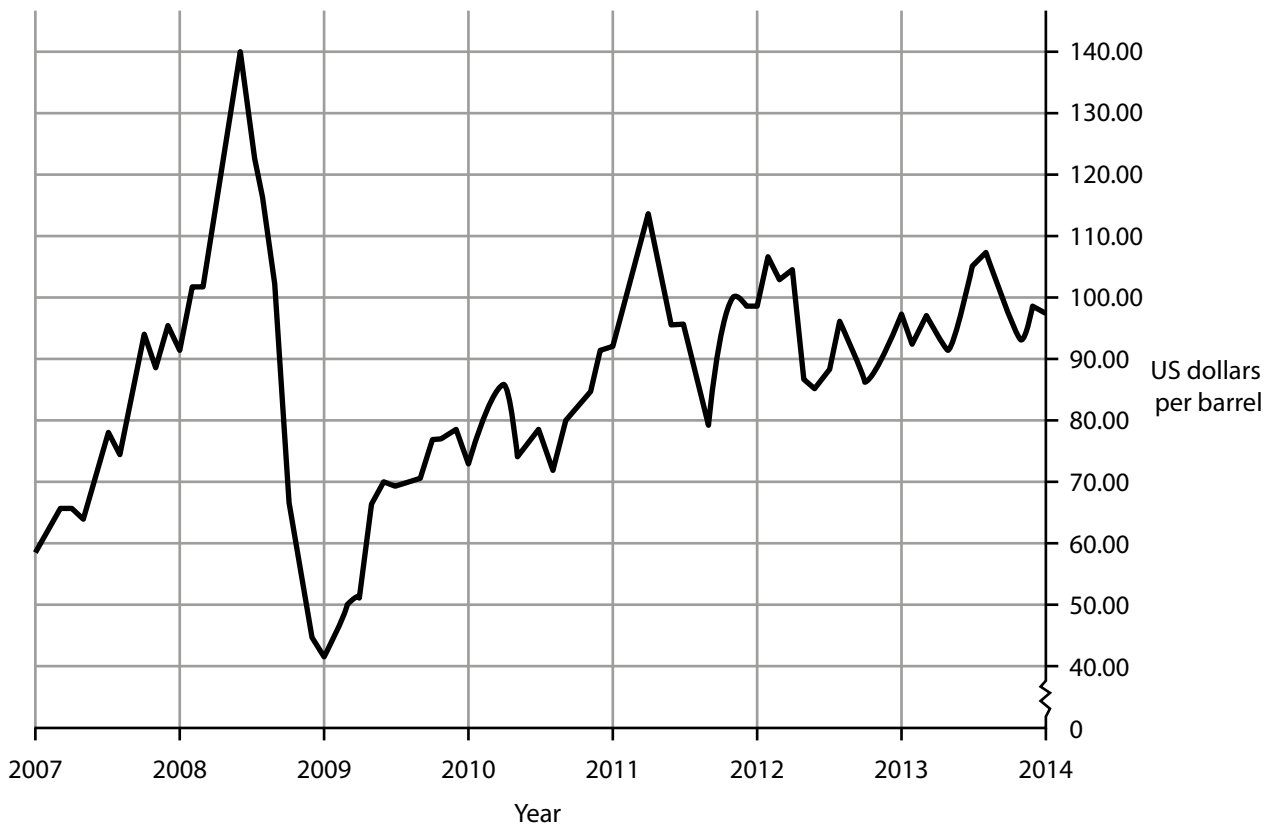
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**(Total for Question 13 = 1 mark)**

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14 The chart below shows the price of crude oil from 1 January 2007 to 1 January 2014.

**Crude oil price, 1 January 2007 to 1 January 2014, US\$ per barrel**



(Source: [http://oilprice.com/commodity-price-charts?1=&page=chart&sym=CL\\*1&name=Crude Oil WTI&domain=advancedmedia&sg=true&display\\_ice=1&studies=Volume;&cancelstudy=&type=LINE&a=M](http://oilprice.com/commodity-price-charts?1=&page=chart&sym=CL*1&name=Crude%20Oil%20WTI&domain=advancedmedia&sg=true&display_ice=1&studies=Volume;&cancelstudy=&type=LINE&a=M))

(a) The best approximation of the percentage increase in crude oil price per barrel from 1 January 2009 to 1 January 2014 is:

(1)

- A 40%
- B 60%
- C 110%
- D 130%

Answer



(b) An economy is a net exporter of crude oil. Draw an AD/AS diagram to show the effect of an increase in global crude oil price on the equilibrium level of real national output of this economy.

(4)

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**(Total for Question 14 = 5 marks)**

**END OF SECTION A**

## SECTION B

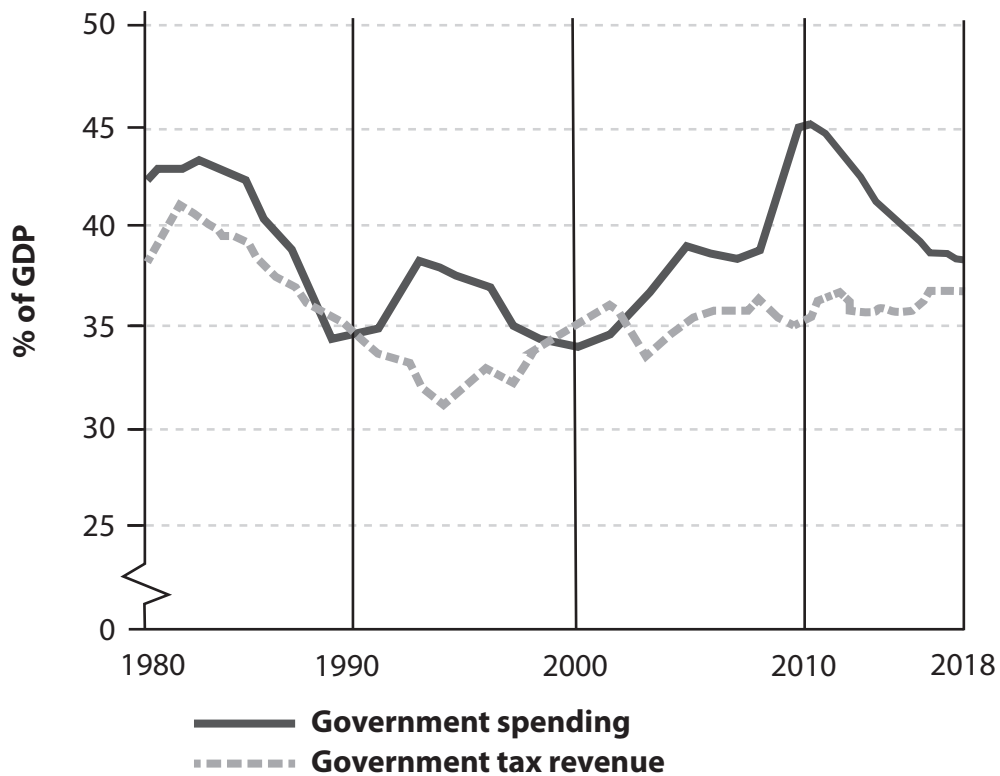
Read all extracts/figures before answering.

Write your answers in the spaces provided.

### Question 15

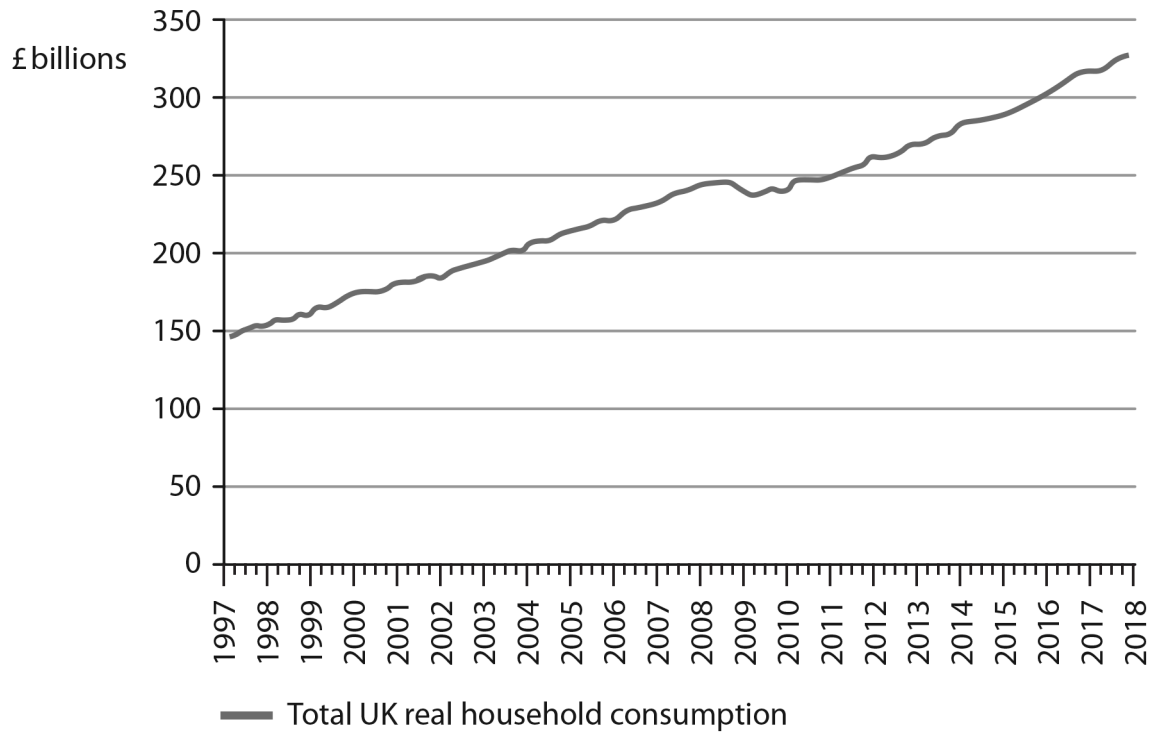
#### UK government budget and household consumption

Figure 1: UK government spending and tax revenue as % of GDP, 1980–2018



(Source: adapted from Office for Budget Responsibility (OBR), [http://cdn.obr.uk/EFO-MaRch\\_2018.pdf](http://cdn.obr.uk/EFO-MaRch_2018.pdf) © Crown copyright 2018)

**Figure 2: UK real household consumption, quarterly, £ billions, 1997 to 2018**



(Source: adapted from ONS, [www.ons.gov.uk/economy/nationalaccounts/satelliteaccounts/bulletins/consumertrends/apriltojune2018](http://www.ons.gov.uk/economy/nationalaccounts/satelliteaccounts/bulletins/consumertrends/apriltojune2018))

## Extract A

### UK household consumption

Despite the slow growth in real household disposable incomes, consumer spending rose in 2017. Annual spending per person increased by £589, when compared with 2016. This may have reflected UK households' delay in adjusting to the increase in inflation that was associated with the fall in the exchange rate of the British pound. The increase in consumption has also been driven by low interest rates. In 2017 UK house prices increased by an average of 5.1%. 5

UK consumers have financed most of their spending by borrowing on credit cards in order to maintain their living standards. In 2017 borrowing on credit cards rose by 9.6%, the second-highest level since before the financial crisis. This has increased the Bank of England's concerns about the sustainability of borrowing, given the slow growth in real incomes. The Bank has also indicated that the base interest rate was likely to rise faster than previously expected. More expensive credit could therefore constrain the ability of households to spend. 10

(Source: adapted from 'Consumer Trends UK', ONS, <https://www.ons.gov.uk/economy/nationalaccounts/satelliteaccounts/bulletins/consumertrends/octobertodecember2017> and © Crown copyright 2018)

## Extract B

### Reduction of the UK's budget deficit

Since 2010 many economists have believed that the biggest problem facing the government was the rising budget deficit. In late 2017, the UK's Chancellor of the Exchequer announced that the government would continue with its plans to decrease its budget deficit. To address this issue, the government further reduced welfare payments and introduced extra spending cuts in the public sector. 5

The UK government had estimated that the fall in UK productivity since the financial crisis was only temporary. However, it has now accepted that this fall in the level of productivity is a long-term issue. Subsequently, the UK's forecast long-term trend rate of growth was reduced. Slower growth means lower tax receipts, higher spending and a bigger budget deficit. 10

Some economists have suggested that the government should not pursue additional reductions in the budget deficit. They have also claimed that the responsibility of the government is not to balance the budget but to balance the economy by moving it to full employment. 15

(Source: adapted from 'Philip Hammond must ditch deficit reduction and invest. But will he?', The Guardian, <https://www.theguardian.com/politics/2017/nov/19/philip-hammond-must-ditch-deficit-reduction-and-invest-but-will-he>)





(c) With reference to Figure 2 and Extract A, explain **two** likely influences on the level of UK real household consumption.

(6)

A series of horizontal dotted lines for writing the answer.

Handwriting practice area with 20 horizontal dotted lines.





Handwriting practice area with 25 horizontal dotted lines.

Handwriting practice area with 20 horizontal dotted lines.

**(Total for Question 15 = 25 marks)**

## Question 16

### UK inflation and economic growth

**Figure 1: UK inflation rate as measured by annual percentage changes in the Consumer Price Index (CPI), January 2014 to January 2018**



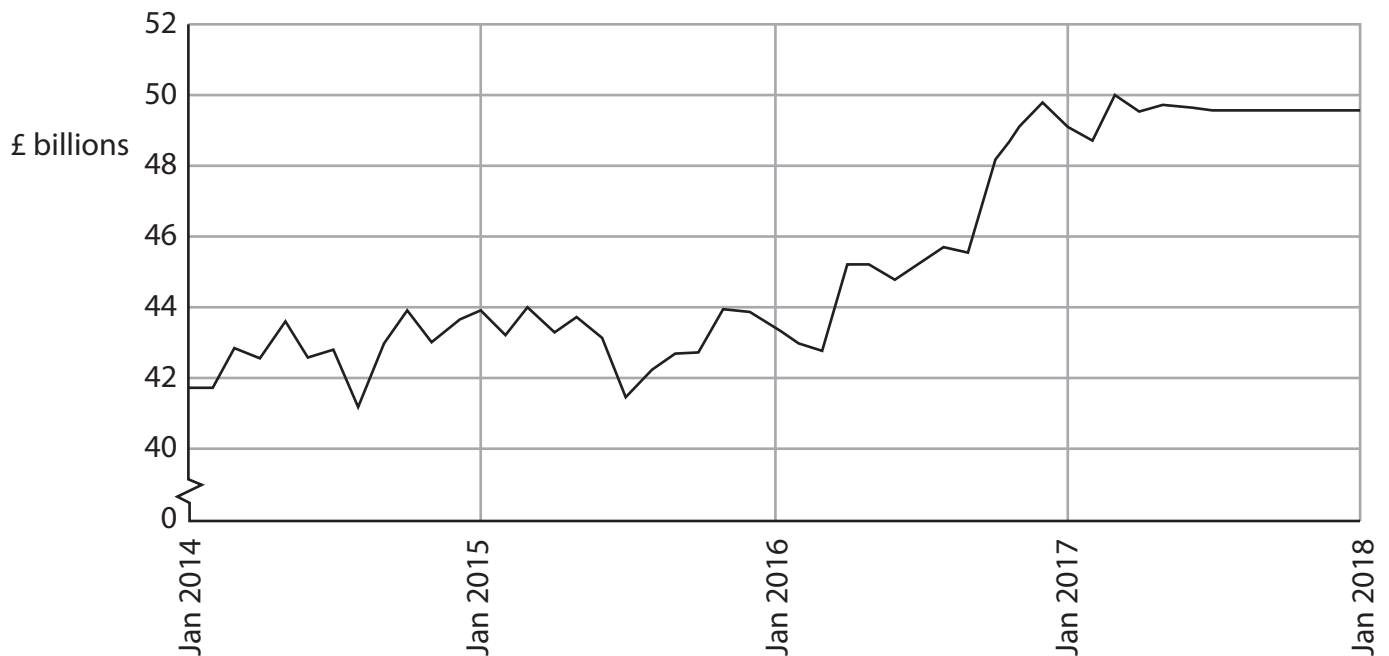
(Source: [www.bankofengland.co.uk/publications/Pages/inflationreport/2017/aug.aspx](http://www.bankofengland.co.uk/publications/Pages/inflationreport/2017/aug.aspx))

**Figure 2: Selected changes to the CPI basket of goods and services, 2017**

IN	OUT
Non-dairy milk	Apple cider
Jigsaw puzzles	Menthol cigarettes
Child scooters	Child swings
Cycling helmets	Basic mobile phones

(Source: [www.theguardian.com/business/2017/mar/14/uk-inflation-ons-basket-goods-gin-cycling-helmets](http://www.theguardian.com/business/2017/mar/14/uk-inflation-ons-basket-goods-gin-cycling-helmets))

**Figure 3: UK exports, £ billions per month, January 2014 to January 2018**



(Source: Trading Economics, ONS - <https://tradingeconomics.com/united-kingdom/exports>)

**Figure 4: Annual percentage change in real Gross Domestic Product (GDP), 2014-2017**

	2014	2015	2016	2017
United Kingdom	3.1	2.2	1.8	2.0
Developing countries (average)	4.7	4.2	4.1	4.5

(Source: IMF, World Economic Outlook 2017)

## Extract A

### Rising inflation

After January 2017, the inflation rate, as measured by the Consumer Price Index (CPI), in the UK has exceeded the Bank of England's 2% target. Sharp increases in food prices as a result of the fall in the exchange rate of the pound have contributed to rising inflation. Between January and September 2017, food prices have increased by 3.5 percentage points. 5

The Office for National Statistics (ONS) has identified that the rapid increase in food prices affected people on low fixed incomes the most. It leaves them with very little money to spend on relatively more expensive items. Moreover, the Bank of England has observed a rise in the size of personal debt relative to income. In order to maintain their standard of living, many consumers on low fixed incomes are using their credit cards and taking out short-term loans to fund their spending. 10

Inflation rose to over 3% at the end of 2017 leading to the Monetary Policy Committee increasing the base rate of interest by 0.25 percentage points to 0.5% in November 2017. Wage growth has been lagging behind price rises and this is expected to continue. Basic wage increases are expected to be only around 1%. This has heaped considerable pressure on households. 15

The ONS has updated the shopping basket that is used in the measurement of UK inflation, to reflect the lifestyle of households in the country. Technological advancements, changes in consumer tastes and a move towards health, fitness and gluten-free products have made it essential to revise the 2017 basket. 20

(Source: adapted from 'UK inflation tipped to rise again with wages forecast to stagnate', The Guardian, <https://www.theguardian.com/business/2017/aug/13/uk-inflation-tipped-to-rise-again-with-wages-forecast-to-stagnate#img-1>)

## Extract B

### Economic growth and living standards

Economic growth is expected to accelerate again as foreign demand for UK exports increases due to the global economic recovery. According to some economists, consumer spending is no longer the engine of growth for the UK. The increase in exports, which is largely due to the fall in the exchange rate of the pound, is expected to be the most significant driver of the UK's economic growth.

5

Some economists have proposed that the quality of economic growth needs to be measured and not just the quantity. This will allow governments to understand how GDP growth affects the living standards of its citizens. They want governments to publish data on the quality of life alongside GDP data as economic growth varies across the country with jobs and wages distributed unevenly. Economic growth figures also hide differences that are not considered in GDP calculations. In 2017, it was estimated that the relative size of the informal economy of developing countries was nearly five times greater than that of the UK.

10

(Source: adapted from 'Growth to accelerate as UK economy bounces back', The Telegraph, <http://www.telegraph.co.uk/business/2017/08/01/growth-accelerate-uk-economy-bounces-back/>; 'GDP is not enough: economists and businesses demand new measure of inclusive growth', The Telegraph, <http://www.telegraph.co.uk/business/2017/03/07/gdp-not-enough-economists-businesses-demand-new-measure-inclusive/>)





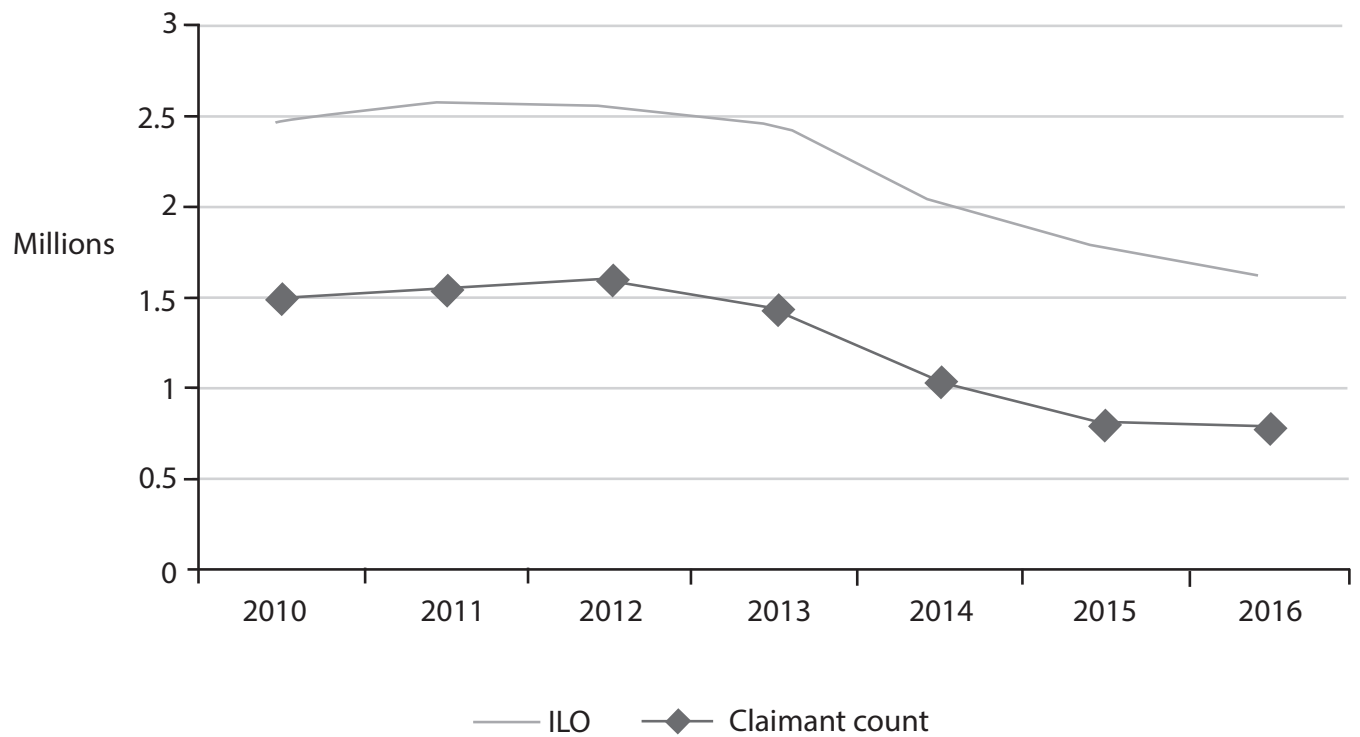
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**(Total for Question 16 = 10 marks)**

### Question 17

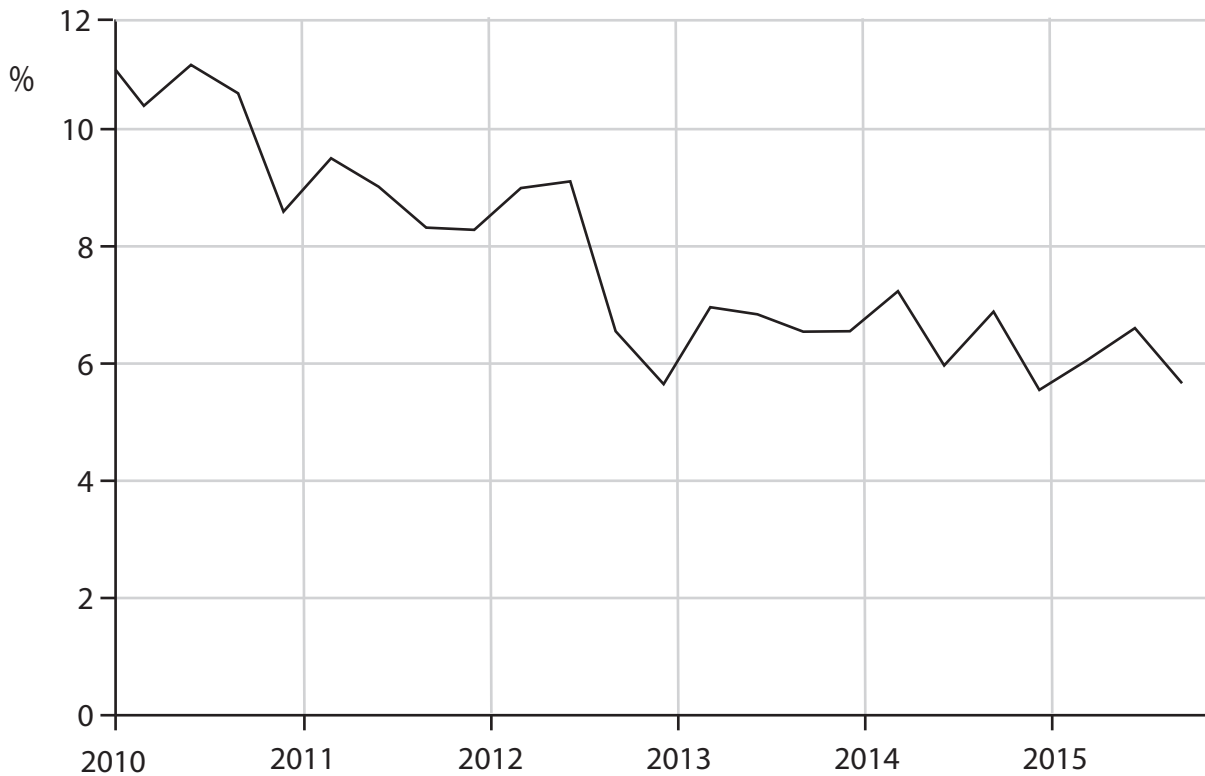
#### The UK economy

**Figure 1: Unemployment – International Labour Organisation (ILO) and the claimant count, millions, 2010-2016**



(Source: ONS Datasets, <https://www.ons.gov.uk/>)

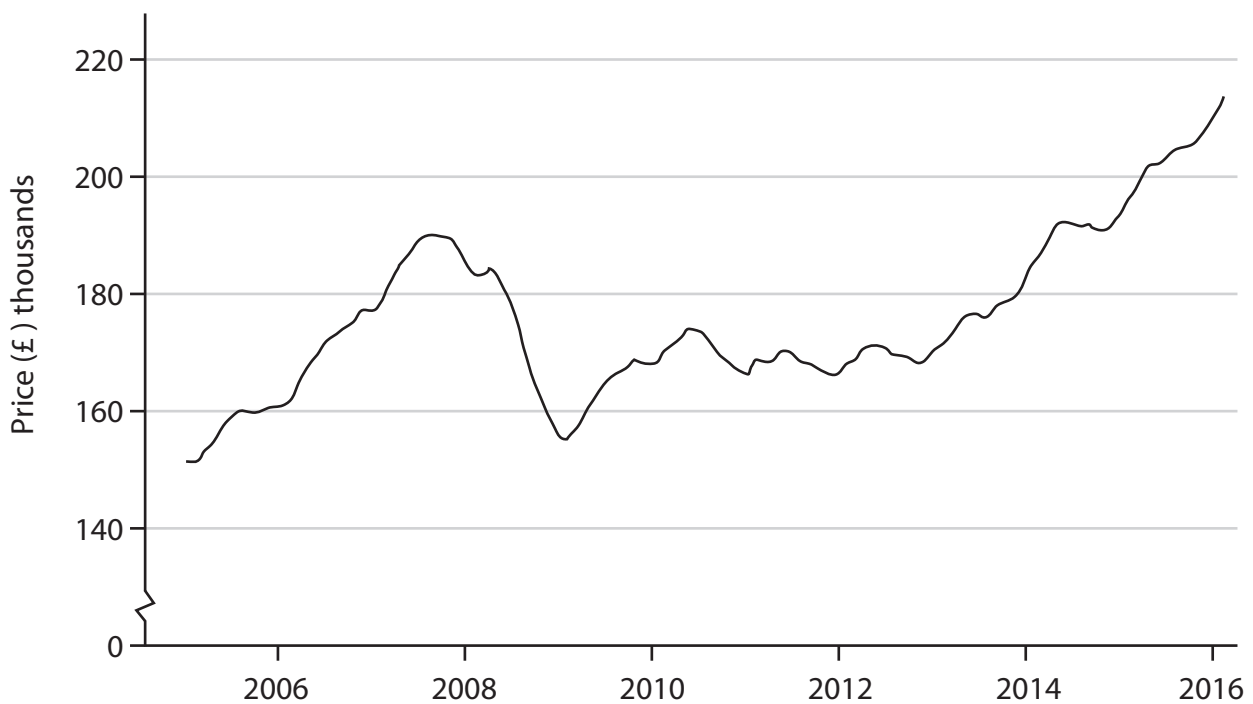
**Figure 2: Household savings\*, 2010-2015**



\* Savings as a percentage of household disposable income

(Source: <http://www.tradingeconomics.com/united-kingdom/personal-savings>)

**Figure 3: UK average house prices, 2005-2016**



(Source: <http://www.telegraph.co.uk/property/house-prices/the-state-of-the-uk-housing-market-in-five-charts/>)

## Extract A

### Soaring house prices

House prices are still rising rapidly. The average UK house price was £214 000 in June 2016, according to the Office for National Statistics (ONS). This is £24 000 more than it was at its peak in September 2007, just before the economic downturn. First-time buyers have experienced the largest rise in house prices.

5

Even the loss of consumer confidence over Britain's vote to leave the EU did not stop house prices from rising – annual growth increased from 5.2% in July 2016 to 5.6% in August 2016. House price growth was the strongest in London, with annual average prices rising by 9.6%. However, in Wales average house prices actually fell by 0.5% during the same period. In its first post-Brexit referendum forecast, estate agency Countrywide said that house prices will fall by 1% across the UK in 2017, before rising by 2% in 2018.

10

Real household income in the UK fell by 10.4% in the years following the financial crisis. This increased the difference between real income and house prices. In 1997, a house cost little more than twice the average income. By early 2015, the average price of a house was five times the average annual income.

15

The rate of home ownership for 25 to 34-year-olds has fallen to 35.8% over the last twenty-five years as houses became less affordable. First-time buyers have to wait longer to save up for a house deposit. Conversely, home ownership has risen to 78.6% among those aged 65 to 74.

(Source: adapted from 'The state of the UK housing market in five charts', The Telegraph, <http://www.telegraph.co.uk/property/house-prices/the-state-of-the-uk-housing-market-in-five-charts/>; 'UK house price growth slows as demand cools after Brexit vote', The Guardian, <https://www.theguardian.com/business/2016/sep/30/uk-house-price-growth-slows-demand-cools-brexit-vote-nationwide>)

## Extract B

### UK migration trends in the year ending June 2016

Inward migration levels are among the highest ever recorded with an estimated 650 000 people moving to the UK. This is an increase of around 11 000 from the previous year.

Employment remains the most common reason for long-term migration (312 000) to the UK, with around 182 000 of these coming with a definite job and 130 000 looking for work.

5

Long-term migration to the UK for study was estimated to be 163 000. In addition, 80 000 long-term migrants arrived in the UK to accompany their families. There were 41 280 refugees applying for asylum, including dependants, of which 10 547 people were granted asylum. Asylum applicants cannot usually accept offers of employment while their case is being processed.

10

(Source: adapted from 'Migration Statistics Quarterly Report: December 2016', ONS, <https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/internationalmigration/bulletins/migrationstatisticsquarterlyreport/dec2016>)

**17** With reference to the information provided, explain **one** likely factor, other than changes in house prices, that could influence the level of savings of UK households.

(5)

(Total for Question 17 = 5 marks)

## Question 18

### UK economic recovery

Figure 1: Components of aggregate demand in selected countries 2014

Country	Consumption	Investment	Government spending	Exports - Imports
UK	66%	14%	21%	-2%
Germany	57%	17%	19%	6%
France	57%	20%	25%	-2%
China	34%	49%	14%	3%

**NB: Figures may not add up to 100% due to rounding calculations.**

(Source: World Bank 2014)

**Figure 2: Nominal GDP per capita at Purchasing Power Parities (PPPs)**  
(the base year 2000=100)



(Source: <https://www.imf.org>)



## Extract A

### The UK economy – a strange recovery

At the Autumn Statement in November 2015, the Chancellor of the Exchequer had good reason to cheer his economic record. The UK economy appeared to have returned towards its long-term trend in the rate of economic growth.

GDP growth has remained strong, with output rising at the highest rate in the G7 group of seven major industrialised countries. Unemployment continued to drop and business investment grew by 5%. 5

However, a number of concerns remain, particularly in relation to the UK's current account deficit, which reached a record high of 6% of GDP in the third quarter of 2014. This was primarily a result of a sharp decline in the rate of return on UK investments overseas. Low export growth meant that the UK's trade deficit persisted. 10

In 2012, the Chancellor had announced a target for the UK to export £1 trillion of goods and services by 2020, which would require an annual growth rate of 8%. However, the annual growth in UK exports had reached just 2.7%. The Office for Budget Responsibility (OBR) forecast that UK exports will only reach £630 billion by 2020 – a third lower than the government's target. 15

Exports in services continued to grow in 2015, but the UK's goods industries were struggling. It was particularly concerning that data showed output in the UK's construction and manufacturing industries falling. Indeed, the output of the manufacturing sector remained 6.3% below its pre-recession peak.

Households, meanwhile, are set to become even more indebted over the coming years. It is projected that the household gross debt to income ratio will rise by 26 percentage points between 2015 to 2020, returning to levels last seen before the Global Financial Crisis. The economy did not appear to be rebalancing away from consumer driven growth towards export-led growth, making another recession almost inevitable. 20

Fundamental to this problem is the UK's low productivity, which in 2015 remains around 20 percentage points below the average for the rest of the G7. It is vital that the government tackles this problem, particularly in the sectors that are currently facing difficulties. This will require relaxing the planning system to promote more house-building, the removal of burdens on UK manufacturers such as carbon taxes, finally getting shale gas exploration going, and reforming apprenticeships to rapidly improve skills in construction, manufacturing and technology. 25 30

(Source: adapted from <http://www.cityam.com/229481/chancellor-beware-uk-not-out-woods-yet>, 25 November 2015 by Daniel Mahoney)

**18** With reference to Extract A, paragraph 2, explain **one** likely influence on UK investment.

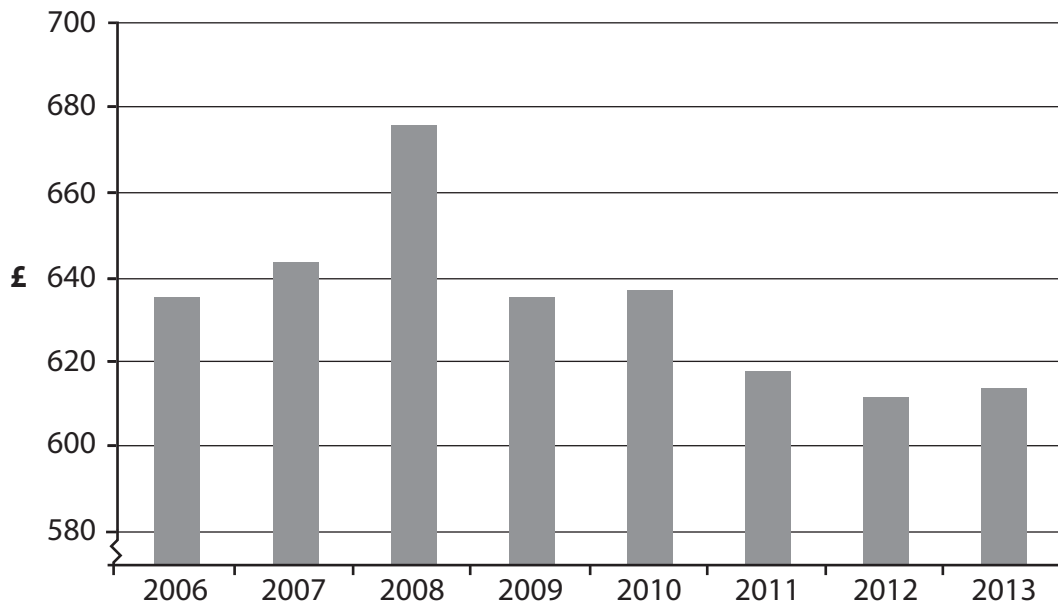
(5)

(Total for Question 18 = 5 marks)

## Question 19

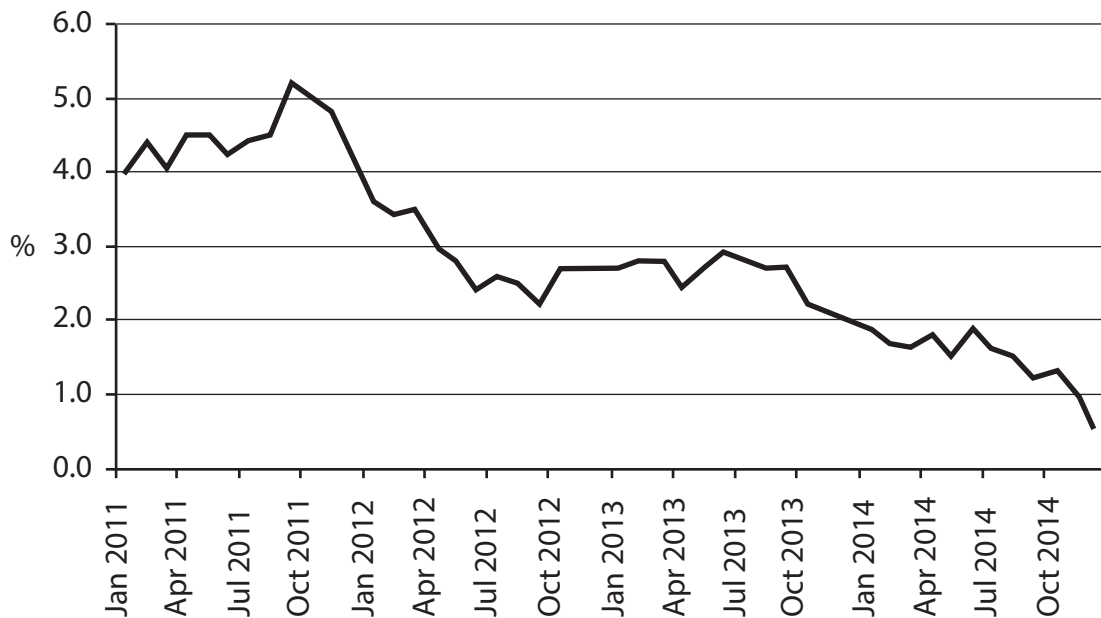
### UK incomes, inflation and monetary policy

Figure 1 – UK average weekly household real income



(Source: <http://www.ons.gov.uk/ons/rel/family-spending/family-spending/2014-edition/rft-a44-final-2013.xls>)

Figure 2 – UK inflation rate as measured by percentage changes in the Consumer Price Index (CPI)



(Source: <http://www.bankofengland.co.uk/publications/Pages/inflationreport/2015/feb.aspx>)

## Extract A

### Britons should not fear rise in interest rates

The Monetary Policy Committee (MPC) of the Bank of England is prepared to raise interest rates “in the near future” if inflation increases, one of its senior policymakers has warned.

Kristin Forbes, a member of the MPC, said a rise in borrowing costs would also be necessary should household debt reach unhealthy levels. However, she stressed that this was not yet a cause for concern. 5

With the UK’s base rate of interest at 0.5% and inflation at a record low and expected to be negative, the MPC is currently under no pressure to raise interest rates, despite Britain’s economic recovery.

UK inflation is being driven lower by the slump in global oil prices, which have roughly halved since summer 2014, and the Bank’s governor Mark Carney warned earlier this month that a strong domestic economy would translate into higher UK inflation over the medium term. “The most likely next move in monetary policy is an increase in interest rates. The message is clear,” Carney said. 10

Forbes said that “even the more lagged effects of the rise in the value of the pound will likely peak in the first part of this year and also gradually fade. Inflation will then most likely bounce back. 15

“Since interest rates take well over a year to be fully effective, they should be adjusted to respond to inflationary risks at that time horizon – when all of these effects have diminished – rather than respond to today’s inflation.”

(Source: adapted from <http://www.theguardian.com/money/2015/feb/24/britons-should-not-fear-rise-in-interest-rates-when-they-come-says-boe-member>)

## Extract B

### Deflation is bad news

The problem with deflation is that once you have it you can’t get rid of it. Central banks know what to do about inflation but they do not have the policy tools to deal with deflation when interest rates are almost as low as they can go. Just look at Japan, which had deflation in nine separate years from 1999-2012, with two additional years at zero, averaging minus 0.3%. The highest in any single year was minus 1.3% in 2013. 5

In the European Union (EU) in 2008, at the start of the financial crisis, there were fears of deflation but at that time central banks had the ability to cut interest rates by nearly 5 percentage points. Those fears may now be coming true, with the EU experiencing deflation of 0.5% in 2015.

This was driven primarily by declines in energy prices, but there was also deflation in non-energy industrial goods and telecommunications. The collapse in the cost of shipping goods potentially suggests something deeper is going on and may lead to a more persistent form of deflation than Mark Carney has currently claimed. 10

(Source: adapted from <http://www.independent.co.uk/news/business/comment/david-blanchflower/david-blanchflower-deflation-is-bad-news--and-britain-is-likely-to-be-next-to-get-it-10078832.html>)



## 20 UK inflation

**Figure 1 UK Consumer Prices Index (CPI) inflation, year on year**



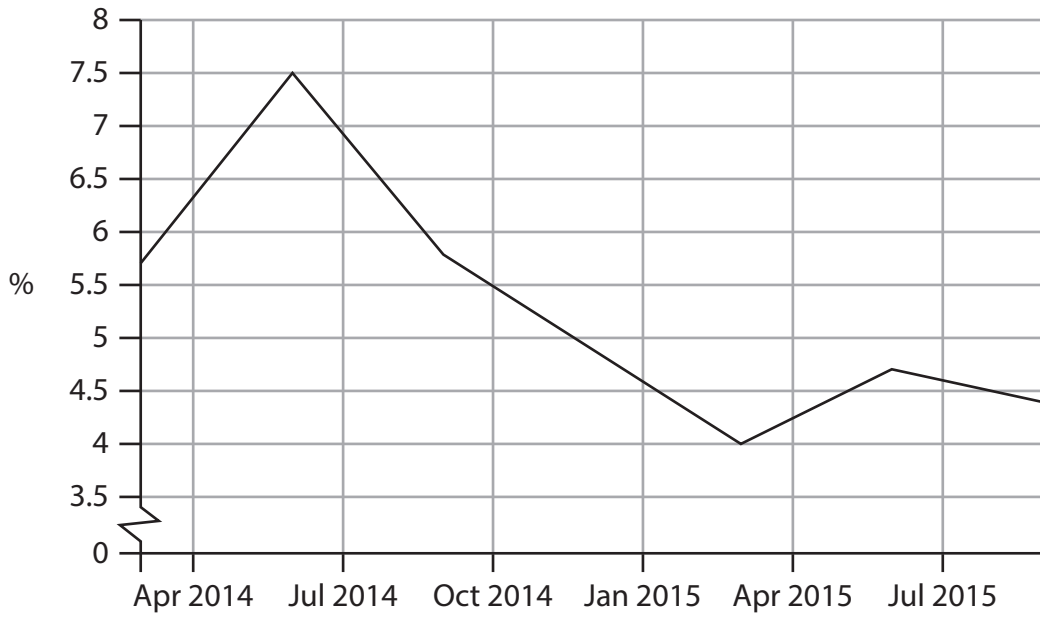
(Source: [http://www.ons.gov.uk/ons/dcp171780\\_427182.pdf](http://www.ons.gov.uk/ons/dcp171780_427182.pdf))

**Figure 2 Oil price (\$) per barrel**



(Source: <https://www.tradingview.com/chart/?symbol=FX:USOIL>)

**Figure 3 UK savings ratio (percentage of disposable income saved by households)**



(Source: <http://www.tradingeconomics.com/united-kingdom/personal-savings>)

## Extract 1 UK prices

Deflation (fall in average price level) can cause concern. For the second time in 2015, the UK economy has slipped into deflation. But it is nothing to worry about. This is 'good' deflation, not bad.

Deflation is bad when it is the result of less money in the economy, meaning consumers are buying fewer products and services and firms are cutting prices in a bid to stimulate demand. This can lead to worsening company performances, cost cutting and redundancies. Less spending means lower demand, which damages economic growth. 5

Worse still is the potential for a deflationary spiral – where people hold on to their money rather than spend it because they think it will be worth more in the future. This reduces aggregate demand, in turn pushing prices down further, so people hang on to their money for longer. Breaking this spiral can be difficult to achieve. 10

But we do not have to worry about that yet. Here is why the UK is experiencing good deflation.

- **Falling commodity prices**

An excess supply of oil has driven down its price. This has had a positive knock-on effect on many businesses in the form of lower costs. In the retail sector in particular, prices are lower because goods are cheaper to manufacture and transport. Also lower petrol prices have eased the pressure on drivers' wallets. Many commodity prices have fallen, from oil to agricultural produce to metals. Often, these lower prices are passed on to the consumer – which pulls down inflation. 15 20

Falling food and fuel prices have boosted the spending power of households across the country and businesses can spend less on moving goods and people across the world and more on paying down debt, investing in equipment, hiring staff or offering pay rises.

- **Real wage growth is stronger and consumers are still spending money** 25

For much of 2015, CPI inflation has been at or very close to 0%. At the same time, wage growth excluding bonuses, rose to 2.9% over the year, according to the ONS. Previously, real wages had been in decline, so this is a welcome reversal. If consumers were not spending, we would be worried. But amid record high employment levels and real wage increases, consumer spending is on the rise while the household savings ratio is falling. 30

- **Inflation has been stable and is set to rise soon**

Investec Economics, an investment bank, reported: "The inflation rate has remained remarkably stable in recent months: today's data marks the eighth month running where the inflation rate has remained fairly steady within the -0.1% to +0.1% range. During this period, we have not seen a worrying change in inflation expectations." 35

- **It gives the Bank of England breathing space on interest rates**

Policymakers at the Bank of England are juggling when best to raise the base rate from its all-time low of 0.5% as the economy recovers from the financial crisis. This is to stop people taking excessive advantage of cheap credit in a booming economy, which would carry substantial financial risks. But the Bank of England must target 40



a 2% inflation rate over the medium term. So if it raises interest rates, it will cost more to borrow money – so less of it will make its way into the economy.

Most households and businesses have debts. When interest rates rise, repayment costs on these debts will also go up, leaving less to spend or save.

45

(Source: adapted from <http://www.ibtimes.co.uk/uk-inflation-why-this-good-deflation-1523810>)

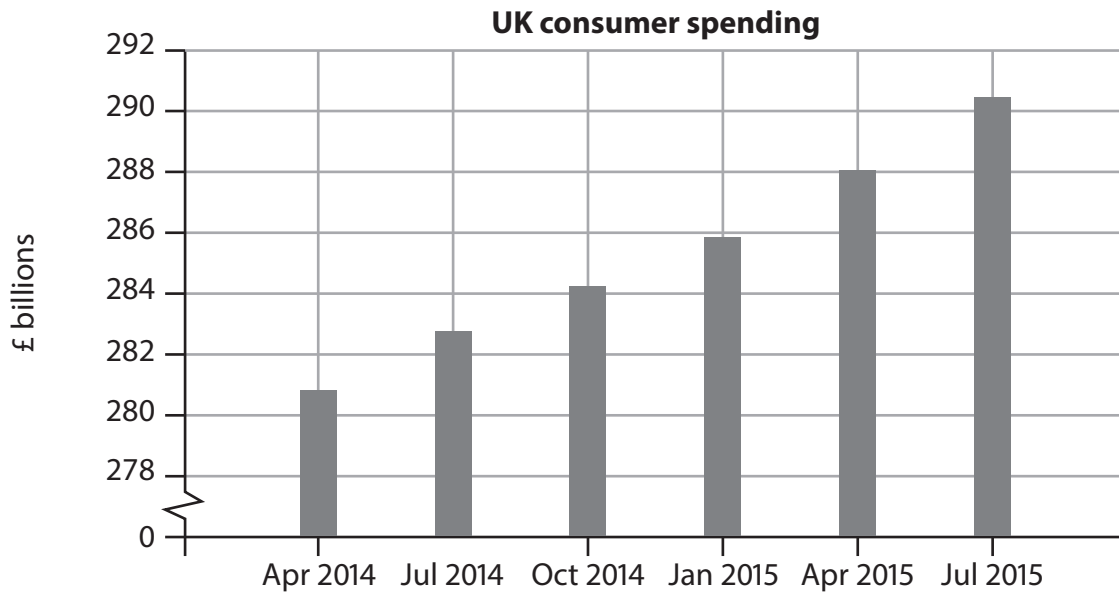


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**(Total for Question 20 = 12 marks)**

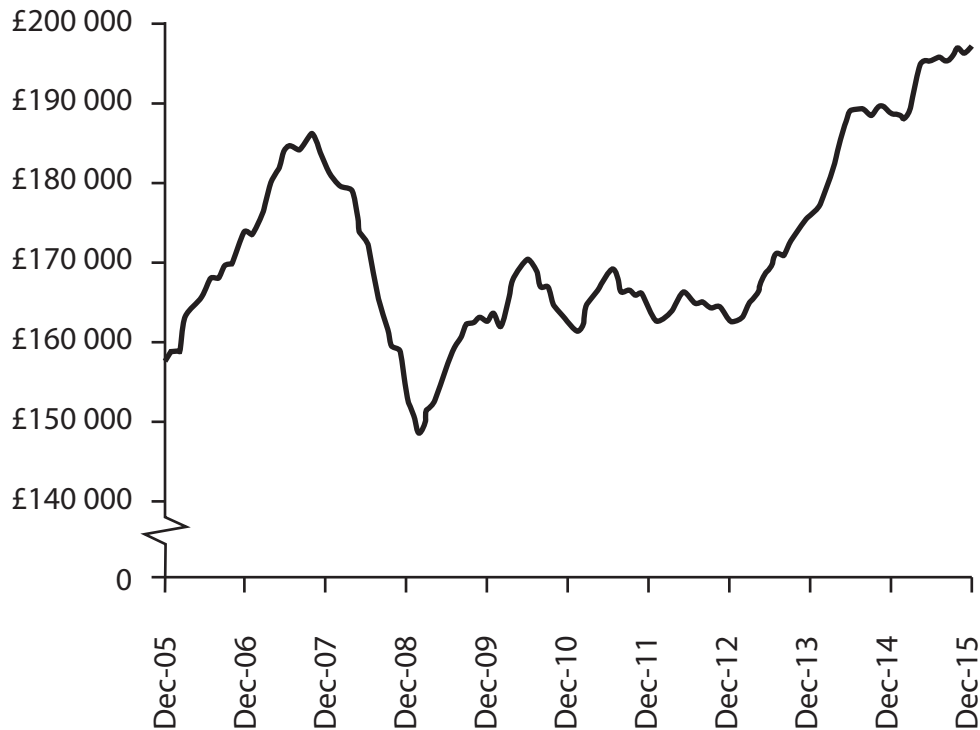
## 21 Stability of the UK economy

Figure 1 UK nominal consumer spending by quarter (£ billions)



(Source: <http://www.tradingeconomics.com>)

Figure 2 Average UK house prices December 2005 - December 2015



(Source: <http://www.nationwide.co.uk/~media/MainSite/documents/about/house-price-index/Dec-Q4-2015.pdf>)

## Extract 1 Warning over rising household debt

Britain risks becoming dependent on rising consumption fuelled by household debt as factory output and exports fall, MPs have been told. SNP economics spokesman Stewart Hosie issued the warning after figures showed that household debt has increased substantially since summer 2015 while manufacturing output turned in its worst performance since 2013.

5

Mr Hosie said Chancellor George Osborne was failing to keep his promise to make exports a significant contributor to growth in order to rebalance the economy away from household consumption.

The rising debt figures, with average family debt now at £13 520, are inconsistent with a rebalanced economy, he suggested. These figures are being further fuelled by low interest rates and rising incomes.

10

Mr Hosie said: "The key thing about the impact of trade and exports on GDP is that it is negative. As we saw in the reports yesterday, because industrial output is down and exports are likely to continue to fall, we are going to continue to see or need a dependence on household consumption and a rise in household debt which would be inconsistent with a properly rebalanced economy."

15

Mr Hosie said that many jobs depend on thriving manufacturing exports and he criticised the Chancellor for setting an "unachievable" target of doubling exports to £1 trillion by 2020. Instead, exports fell from £521 billion in 2013 to £513 billion the following year, and the independent Office for Budget Responsibility said Mr Osborne's target would be missed by £350 billion.

20

Mr Hosie said encouraging more innovation would prove key in boosting manufacturing – which still accounts for 44% of all UK exports. "That is as much a part of building a larger, more productive and faster growing manufacturing base as it is important in its own right."

25

Mr Hosie criticised plans to change the funding model of the Government's innovation agency, Innovation UK. He said £165 million of grants for innovation will now be turned into loans, which may suppress innovation even further. He argued that it was important to encourage innovation because as it had declined, so had manufacturing output, exports and employment.

30

Labour Party spokesman Bill Esterson commented that the UK spent less on research as a share of GDP than France, Germany, the US and China. There was also, he said, "slow progress" in infrastructure projects and the quality of infrastructure was now the second worst in the G7, the group of leading industrialised nations, adding "capital spending has more than halved as a proportion of GDP since 2010".

35

The problem of UK exports, he added, was made worse by low productivity. ONS statistics showed that, in 2014, productivity measured as output per hour worked in the UK was 21% lower than the average for the rest of the G7 countries.

Mr Esterson proposed encouraging small businesses, looking to export for the first time, to work together with other firms who are already successfully exporting. "I think that that would be really helpful because I think... having to deal with all the VAT, National Insurance, marketing, manufacturing – that is actually quite frightening for a small company and I think that is what is so off-putting."

40

(Source: adapted from: <http://www.heraldscotland.com/news/homenews/14201611>.  
Stewart\_Hosie\_issues\_warning\_over\_rise\_of\_household\_debt/)





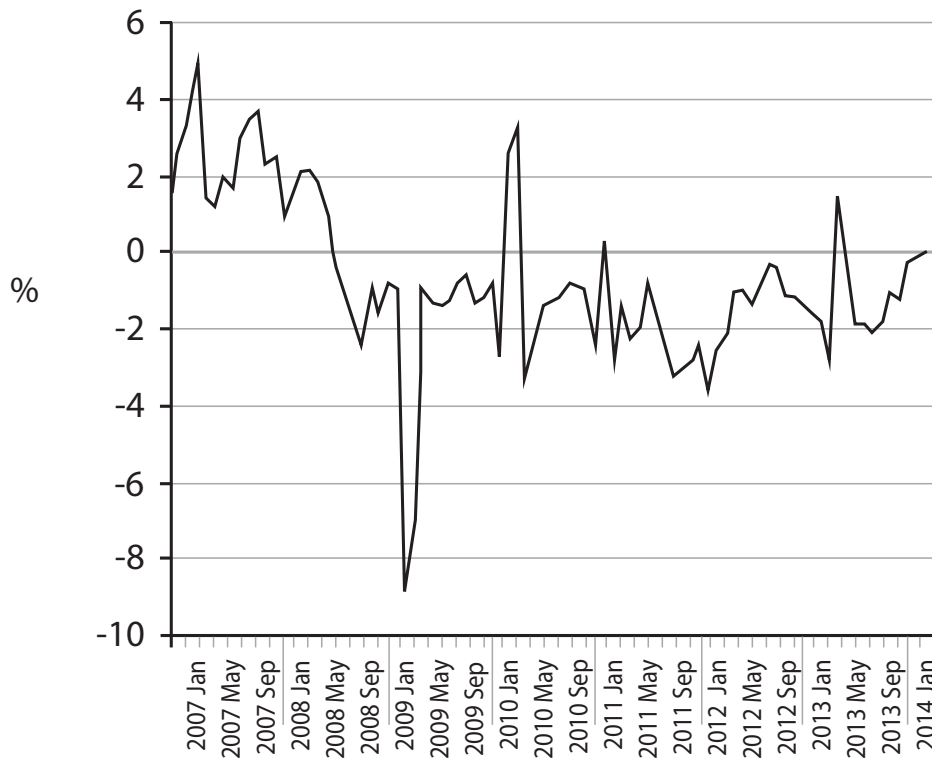
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**(Total for Question 21 = 12 marks)**

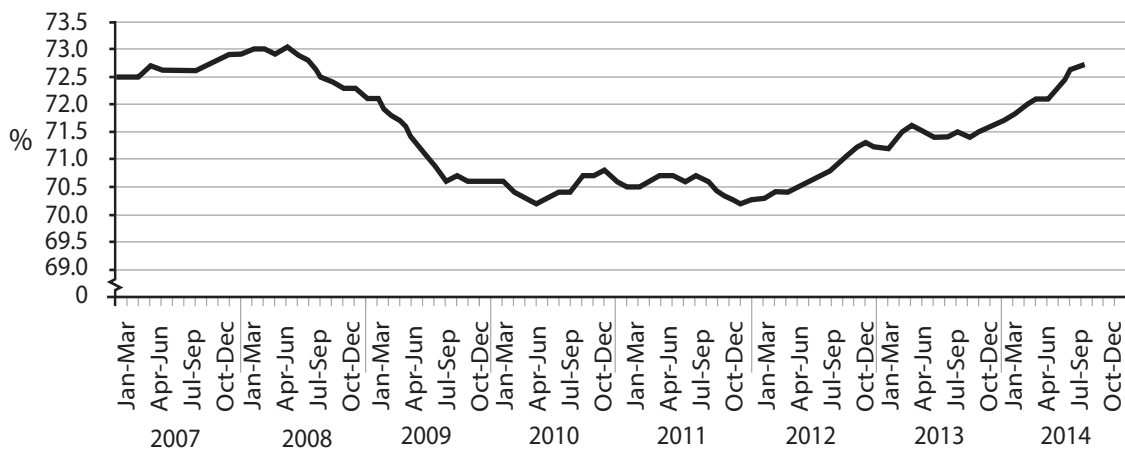
## 22 UK wages, employment, migration and the trade deficit

**Figure 1 Real wage growth, per cent change on the same month a year ago**



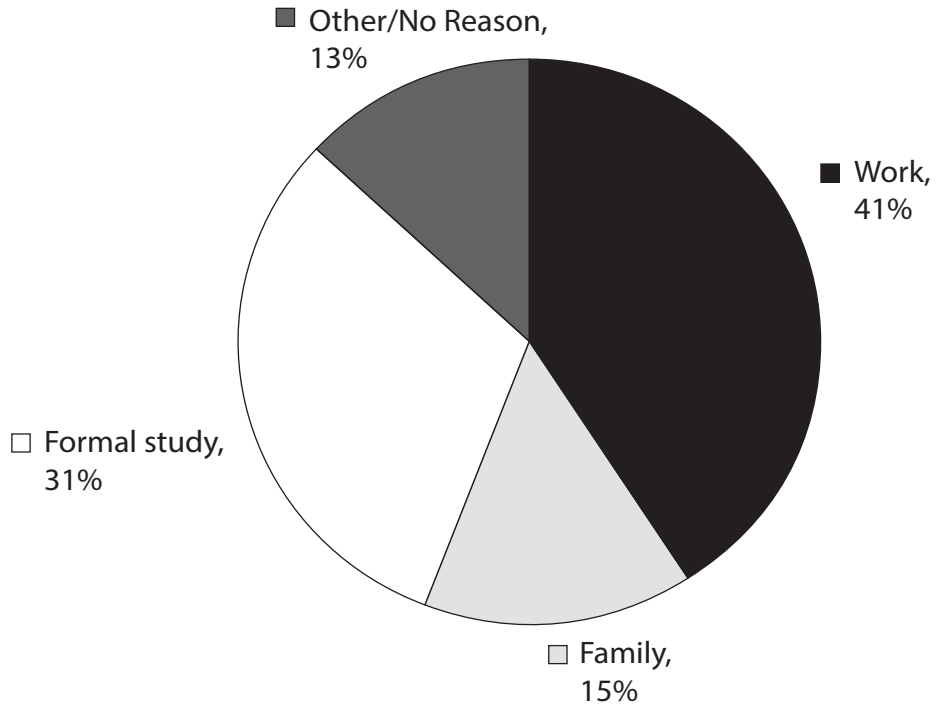
(Source: © ONS Economic Review June 2014, [http://www.ons.gov.uk/ons/dcp171766\\_365818.pdf](http://www.ons.gov.uk/ons/dcp171766_365818.pdf))

**Figure 2 UK employment rate, % of 16–64 age group**



(Source: © ONS Economic Review June 2014, [http://www.ons.gov.uk/ons/dcp171766\\_365818.pdf](http://www.ons.gov.uk/ons/dcp171766_365818.pdf))

**Figure 3 Main reason for immigrating to UK, year ending March 2014**



(Source: © ONS Migration Statistics Quarterly Report, August 2014, [http://www.ons.gov.uk/ons/dcp171778\\_375307.pdf](http://www.ons.gov.uk/ons/dcp171778_375307.pdf))

**Extract 1 Migration trends**

- Net long-term migration to the UK was estimated to be 244 000 in the year ending March 2014, an increase from 175 000 in the previous 12 months.
- 560 000 people immigrated to the UK in the year ending March 2014, an increase from 492 000 in the previous 12 months.
- An estimated 316 000 people emigrated from the UK in the year ending March 2014. Long-term emigration has been relatively stable since 2010.
- There was an increase in immigration for work (up 38 000 to 228 000).

5

(Source: adapted from © ONS Migration Statistics Quarterly Report, August 2014, [http://www.ons.gov.uk/ons/dcp171778\\_375307.pdf](http://www.ons.gov.uk/ons/dcp171778_375307.pdf))

## Extract 2 Trade deficit widens

The UK's trade position deteriorated unexpectedly in July 2014 after imports increased more than exports, frustrating the Coalition Government's ambitions to rebalance the economy. The trade in goods deficit widened to £10.2 billion from £9.4 billion in June 2014. It almost matched the largest monthly deficit on record. The broader trade in goods and services deficit also widened in July 2014, to £3.3 billion from £2.5 billion in June 2014. The Office for National Statistics data showed a larger goods deficit in July 2014 driven by a £1.3 billion rise in imports to £34.2 billion, outpacing a £0.5 billion increase in exports to £24 billion. 5

In 2012, the Government set a target of doubling UK exports to £1 trillion by 2020 as part of a broader ambition to rebalance the economy away from consumer spending and towards manufacturing and exports. However, exports increased by just 2.1% in 2013 to £505.6 billion, and this target is looking increasingly challenging. With the eurozone economy remaining weak and ongoing unrest in Eastern Europe and the Middle East, export growth is likely to remain low in the short term. 10

Exchange rates are of particular concern for UK trade, according to Martin Beck, a senior economic advisor: "With around 45% of UK manufactured goods exported, overseas sales are key for continued growth in the sector. The recent fall in the value of sterling should, temporarily, boost prospects for UK exporters." 15

(Source: adapted from © Guardian Newspaper Ltd., September 2014, <http://www.theguardian.com/business/2014/sep/09/uk-trade-deficit-widens-unexpectedly>)



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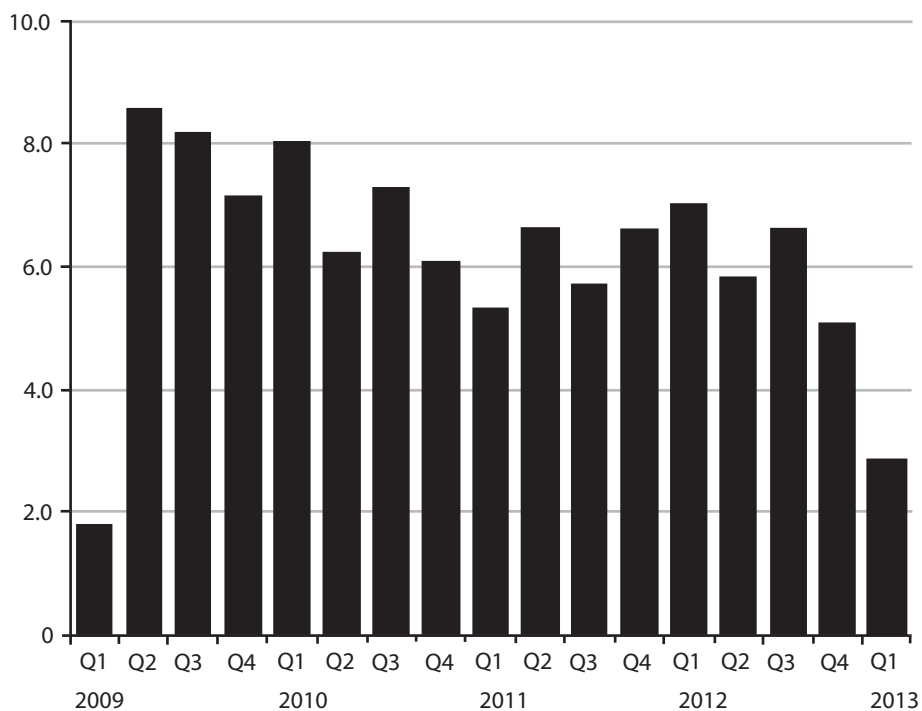




(Total for Question 22 = 20 marks)

## 23 Savings, GDP, housing market and monetary policy

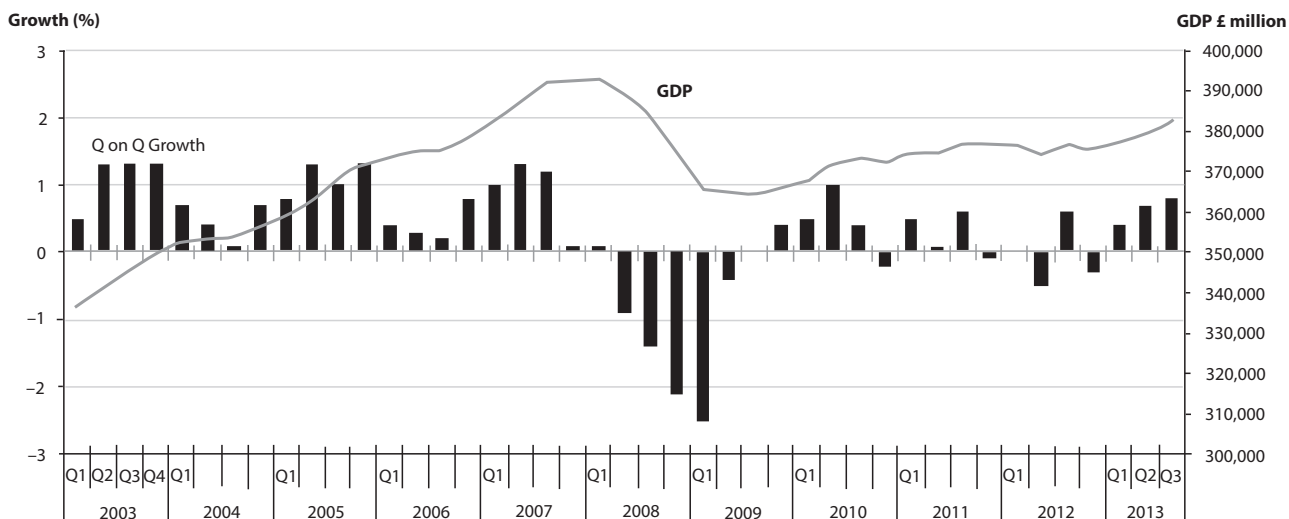
**Figure 1 UK household savings ratio\***



\*Savings as a percentage of household disposable income

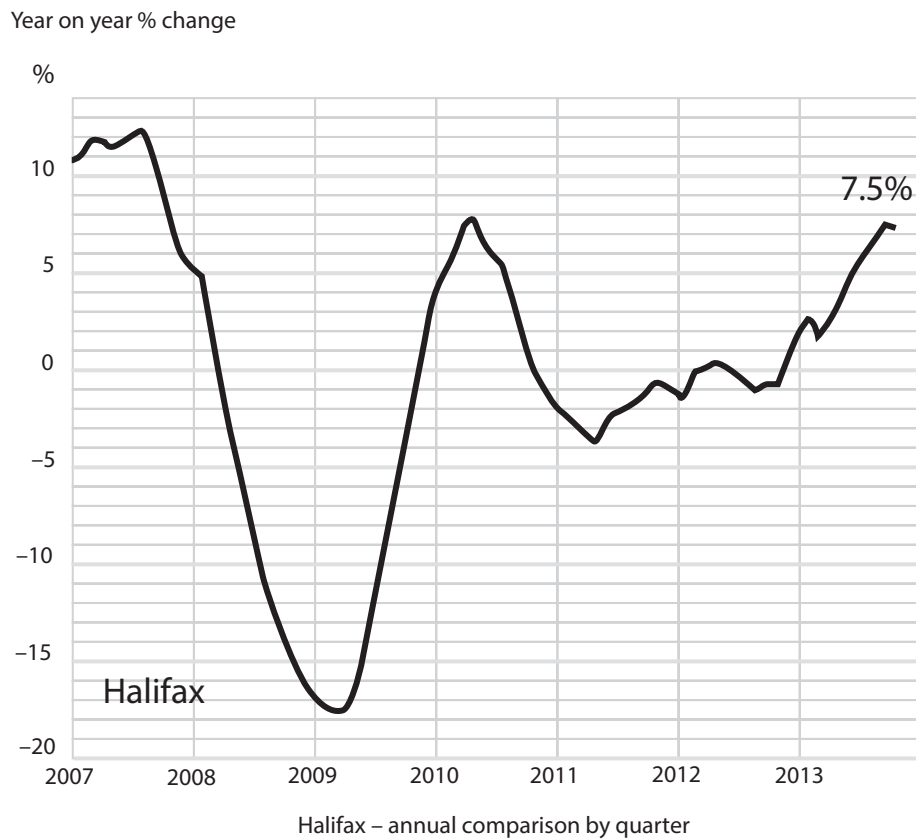
(Source: <http://www.ons.gov.uk/ons/publications/re-referencetables.html?edition=tcm%3A77-324888>)

**Figure 2 UK GDP and GDP growth (quarter on quarter)**



(Source: [http://www.ons.gov.uk/ons/resources/figure3\\_tcm77-332895.png](http://www.ons.gov.uk/ons/resources/figure3_tcm77-332895.png))

**Figure 3 Percentage annual change in UK house prices**



(Source: Halifax)

### **Extract 1 House prices and the government's Help-to-Buy Scheme**

The UK house price index from the Royal Institute of Chartered Surveyors showed that in September 2013 British house prices rose at their fastest monthly rate in 11 years and sales hit a four-year high. Both measures pointed to a sustained recovery in the property market. Prices rose in all regions except the north-east of England, and respondents now expect prices to grow by 2.6% in the next 12 months. Concerns have been expressed that a housing price bubble could threaten financial stability.

5

(Sources: adapted from <http://uk.reuters.com/article/2013/10/07/uk-house-prices-idUKBRE9960YL20131007> and

[http://www.lse.co.uk/AllNews.asp?code=kkj6mz7d&headline=MARKET\\_COMMENT\\_UK\\_House\\_Prices\\_Continue\\_To\\_Rise\\_As\\_US\\_Government\\_Remains\\_Shut](http://www.lse.co.uk/AllNews.asp?code=kkj6mz7d&headline=MARKET_COMMENT_UK_House_Prices_Continue_To_Rise_As_US_Government_Remains_Shut))

## Extract 2 UK monetary policy

Since 1997, the focus of the Bank of England's Monetary Policy Committee had been to maintain a low and stable inflation rate. However, the financial crisis forced a change in priorities.

The Governor of the Bank of England, Sir Mervyn King, stood down after holding the post for 10 years between 2003–2013. Amongst other things his governorship was marked by two major policy decisions. 5

Firstly, he encouraged a highly expansionary monetary policy. Interest rates traditionally moved in quarter-point changes, but once the full extent of the financial crisis was plain, Sir Mervyn persuaded the Monetary Policy Committee to cut rates by 1.5 percentage points in November 2008 and further big reductions over the following months. By March 2009, interest rates had been cut to 0.5% and remain at this level. In the same month, the Bank of England began to inject money into the economy through quantitative easing in a bid to reflate the economy. Normalising monetary policy will take many years. 10

Secondly, Sir Mervyn publicly supported rapid fiscal consolidation, a policy of reducing the budget deficit as quickly as possible, in order to reduce the national debt. His comments were used by the Coalition Government to justify its decision to accelerate the budget deficit reduction programme. 15

(Source: adapted from <http://www.ft.com/cms/s/0/e2fb7570-dfea-11e2-bf9d-00144feab7de.html#ixzz2hRoUSZMD> June 29 2013)



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(Total for Question 23 = 20 marks)

## 24 UK investment, productivity and the balance of payments

Figure 1 UK business investment (£bn at 2010 prices)

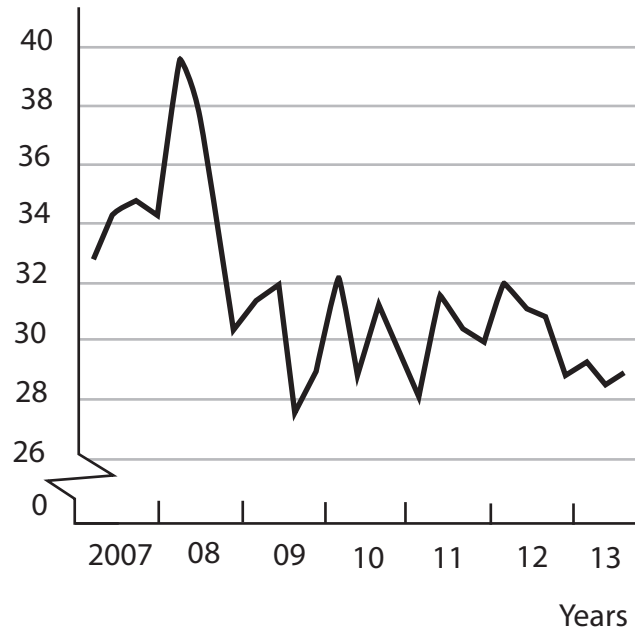
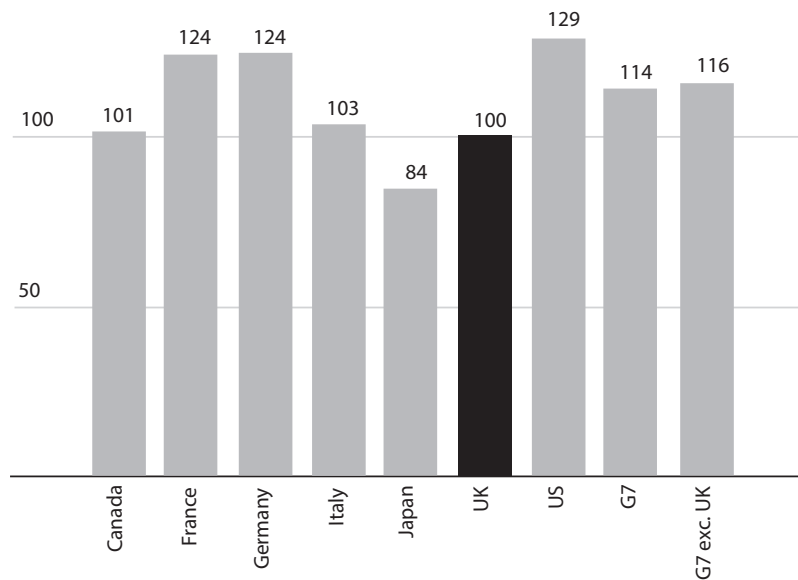
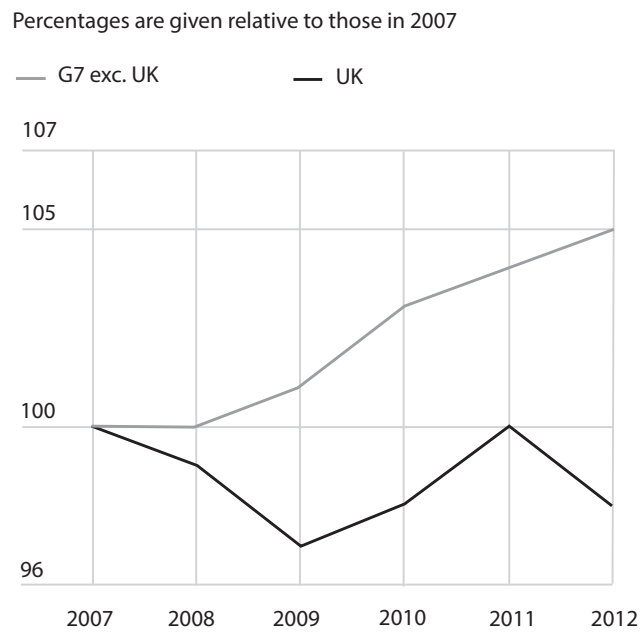


Figure 2 GDP per hour worked relative to the UK in 2012



(Source: <http://www.theguardian.com/news/datablog/2013/sep/18/uk-workers-less-productive-ones>)

**Figure 3 Productivity per hour worked (GDP) since 2007**



G7 countries: USA, UK, France, Germany, Italy, Canada and Japan

(Source: <http://www.theguardian.com/news/datablog/2013/sep/18/uk-workers-less-productive-ons>)

**Figure 4 Current account of the UK's balance of payments as a percentage of GDP at current market prices**

Year	% of GDP
2002	-2.1
2003	-1.7
2004	-2.0
2005	-1.8
2006	-2.8
2007	-2.2
2008	-0.9
2009	-1.4
2010	-2.7
2011	-1.5
2012	-3.8

(Sources: <http://www.ons.gov.uk/ons/rel/bop/united-kingdom-balance-of-payments/2013/index.html> and <http://www.theguardian.com/business/2011/sep/20/uk-productivity-falls-behind-competitors>)

## Extract 1 Productivity gap between UK and the other G7 nations widens to largest in 20 years

Deep recession and slow recovery have widened Britain's productivity gap with the other rich G7 nations to its largest since 1994, according to official figures.

Data from the Office for National Statistics (ONS) showed that the output per hour from UK workers in 2012 was 2% down on its pre-slump levels in 2007 and 16% below the average of other leading industrialised nations. 5

The ONS said that output per hour worked in Britain was 29% lower than in the US and 24% lower than in Germany and France. Canada and Italy had slightly higher productivity than the UK and only one G7 nation – Japan – had a worse record.

Britain's gross domestic product is still below its peak reached in 2008, but despite the deepest recession of modern times, the shake-out in the labour market was less severe than in the downturns of the 1980s and 1990s. The combination of weak output and a willingness of workers to accept pay cuts to keep their jobs has resulted in a poor productivity record. 10

The ONS said that the gap with the rest of the G7 was even wider – 19% – using an alternative measure of productivity, output per worker. 15

John Philpott, Director of The Jobs Economist, said: "The relative improvement in the UK's productivity performance from the mid-1990s to the late 2000s has clearly gone into reverse in an economy reliant on falling real wages, rather than increased output, as the main driver of employment growth. According to the ONS output per hour in 2012 would have been 15 percentage points higher had the pre-recession rate of growth been maintained. Though some of this latter growth may have been 'illusory', in that it was propelled by an unsustainable boom, the UK economy clearly needs, in particular, a strong resurgence of business investment in order to regain its pre-recession productivity mojo." 20

The Bank of England is assuming that Britain's productivity will improve as demand recovers, although opinions differ about how much of the shortfall is caused by permanent damage from the recession. 25

Howard Archer, Chief UK Economist at IHS Global Insight, said the ONS's international comparisons made "very uncomfortable reading." He added: "An element of the UK's poor productivity performance does appear to have been companies' willingness to hold on to workers, particularly when the workers are skilled or experienced. There have also been reports that some companies employed more people, or at least retained workers, as they found winning and delivering work more resource-intensive in an environment of persistently weak demand." 30

(Source: adapted from <http://www.theguardian.com/business/2013/sep/18/productivity-gap-uk-g7-output>)





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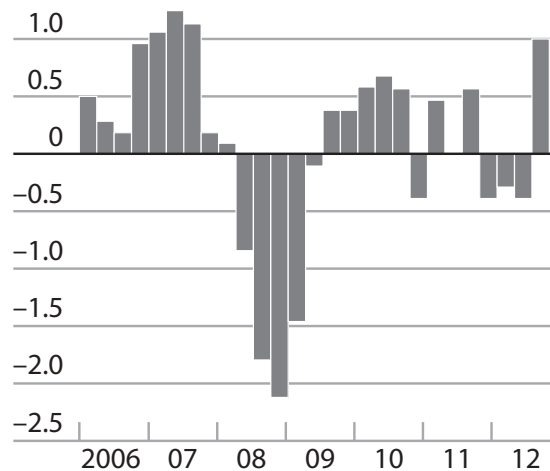


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**(Total for Question 24 = 26 marks)**

## 25 Growth, Productivity and Unemployment

**Figure 1**  
**UK Growth, percentage change in real GDP from previous quarter**



### **Extract 1** **Exceptional effects on growth**

The 1% growth rate in real GDP in the third quarter of 2012 from the previous quarter was the strongest in five years. However, the economy is still no bigger than it was a year ago, and is 3% smaller than it was before the financial crisis hit in 2008. One-off factors such as the Queen's Diamond Jubilee and the London Olympics also improved the third quarter figure, which was better than the 0.6% economists predicted.

5

But few believed the better data signalled the start of a strong economic recovery. Employment is rising, real disposable incomes are recovering and retail sales are picking up. However, the global economy is slowing, the government plans to reduce its budget deficit further next year and confidence among businesses and households remains fragile.

10

(Source for Figure 1 and Extract 1: © The Financial Times Ltd 2013)

### **Extract 2** **UK unemployment and employment**

UK ILO unemployment is at 2.51 million, up 55% since 2007, a similar increase to the US and the eurozone, according to the OECD. That eurozone average disguises huge variations, however, from rises of well over 100% in Greece and Spain to a fall of 33% in Germany.

In past recessions, the proportion of the unemployed out of work for more than 12 months in the UK has typically increased to 40–50%. This time it has reached only 35%. This has been partly attributed to the welfare-to-work policies of current and previous governments which try to push people quickly back into whatever jobs are available.

5

The UK's strength in creating jobs, taking the number employed back above the pre-crisis level, has been balanced by concern about the quality of those jobs – a lot of them self-employed, part-time or temporary – and a poorer productivity performance than the average for developed countries.

10

(Source for Figure 1 and Extract 2: © stats.oecd.org)



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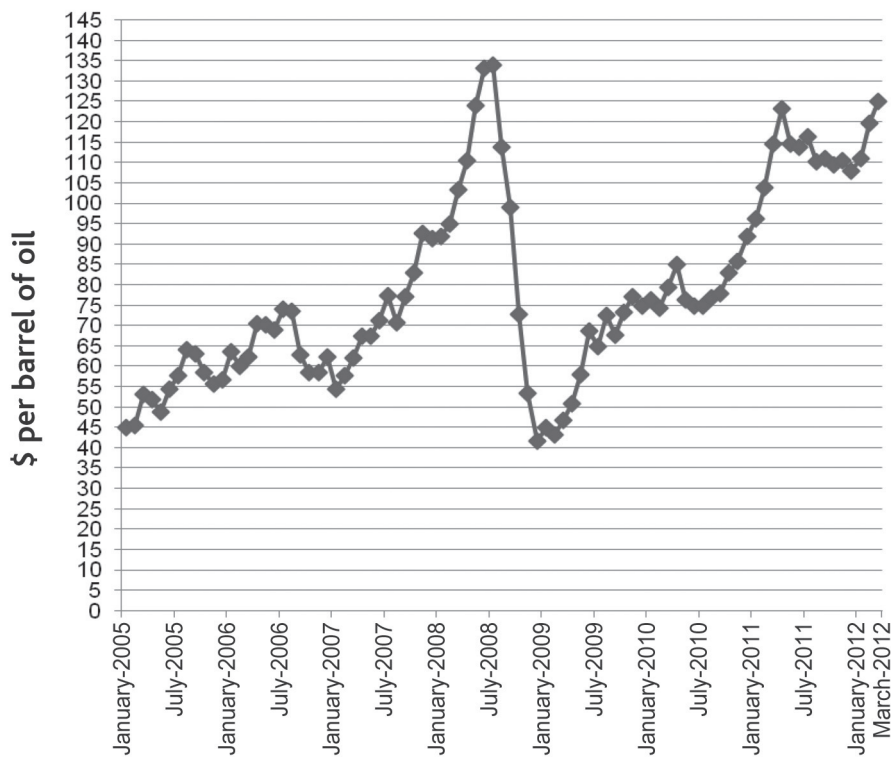






## 26 Balance of payments, Inflation and Investment

Figure 1 Oil price (Brent Crude Oil), US dollars per barrel from January 2005 to March 2012



(Source: adapted from © Financial Times, May 3rd 2012)

## Extract 1 The deficit on the current account of the balance of payments continues into the first quarter of 2012

When sterling's exchange rate fell 25% between mid-2007 and early 2009, economists thought that this would reduce the deficit in the trade of goods and services on the current account of the balance payments and boost the UK's economic growth. They were only half right. Exports of British goods have indeed recovered from the depths of recession – volumes are up 21% since 2009 – and a recent survey of manufacturers suggested activity expanding at a healthy pace. However the volume of goods imported has also increased, by 16% since 2009, and inflation has continued well above target. 5

David Blanchflower, a former member of the Bank of England Monetary Policy Committee, said: "We underestimated the uplift to inflation from the depreciation ... but we probably overestimated the positive effect of UK manufacturers replacing imports." In a recent paper, two Bank of England economists tried to explain these inaccurate estimates. Perhaps, they suggested, after the long contraction of UK manufacturing, some goods are no longer made in the UK, so it is impossible to replace certain imports. British manufacturers have almost entirely abandoned some markets, particularly those for products that are labour intensive. In 1997, for example, UK producers made 16% and 22% respectively of all the leather goods and clothing sold in the country. In 2009, these market shares had fallen to 6% and 8%. 10 15

Manufacturing goods in the UK also often necessitates importing raw materials, components and capital goods. This dependency on overseas suppliers is partly explained by the fact that many manufacturers agreed long-term supply contracts with cheaper overseas suppliers before the depreciation of sterling. 20

The Bank of England economists also noted there is still a large price differential with countries such as China and India, even after sterling's depreciation. Furthermore, many UK manufacturers learnt long ago to compete on brand and quality rather than price, which can mean that big changes in the exchange rate have little effect on sales. 25

However, there are hints that things might start to change as the lower exchange rate and other factors have an impact on strategic decisions. Many manufacturers are discussing bringing parts of their production home because of high wage inflation in emerging markets, the desire for more responsive supply chains and lower shipping costs. 30

(Source: adapted from © Financial Times, April 3rd 2012)

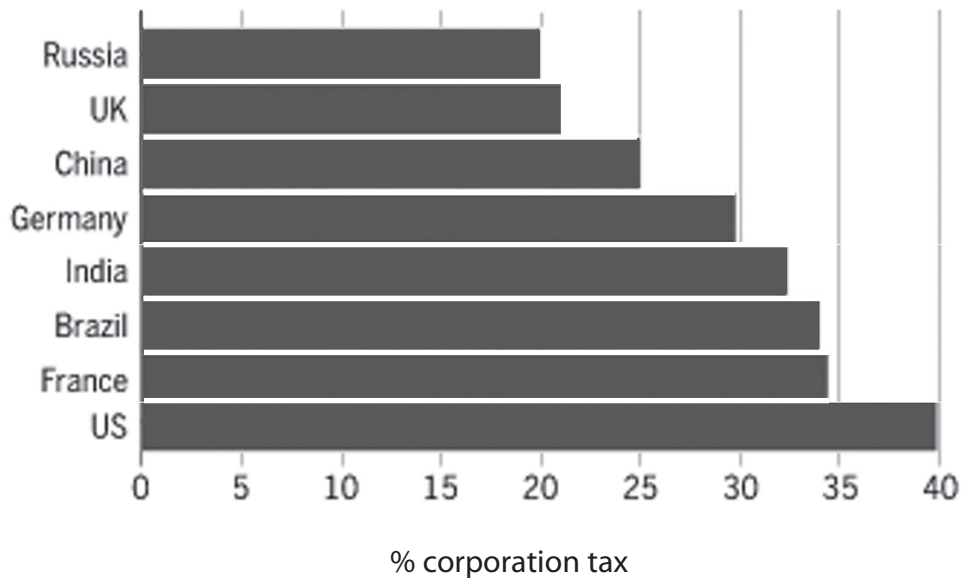
## Extract 2 Business Investment and Corporation tax

Business investment as a share of GDP fell from nearly 13% in 2000 to below 8% in 2011 and surveys of business confidence are pessimistic. The previous government reduced corporation tax – a tax on company profits – from 30% to 28% in 2008. The current Chancellor is gradually reducing it further to 21% by 2014, which he hopes will increase investment by between 5% and 10% per annum during 2013–16.

5

(Source: adapted from © Crown copyright)

**Figure 2 Main corporation tax rate (%) planned for 2014 (selected G20 and G7 countries)**



(Source: © Financial Times, 21 March 2012)

**26** Using an aggregate demand and aggregate supply diagram, assess the effect on the UK economy of the rise in oil prices since 2009.

(12)

A series of horizontal dotted lines for writing the answer.



## 27 Consumption, Investment and the UK Government's Fiscal Target

### Extract 1 Components of Aggregate Demand (Report from the Office of Budgetary Responsibility)

The real disposable income of UK households is forecast to have fallen by 2.3% in 2011, a post-war record. Earnings growth is not expected to overtake inflation again until 2013 and not by a significant margin until 2014. As a result, we expect consumer spending to remain broadly constant in real terms in 2012 before picking up as real household disposable income starts growing again.

5

We expect private sector employment to rise by around 1.7 million between the start of 2011 and the start of 2017, but this will be partly offset by a fall of around 710,000 in general government employment. The government still aims to reduce the budget deficit rapidly in order to achieve its fiscal target.

Business investment has shown virtually no growth in 2011. The CBI's latest Quarterly Industrial Trends Survey suggests that the investment that has taken place has largely replaced worn out assets, rather than added to the capital stock.

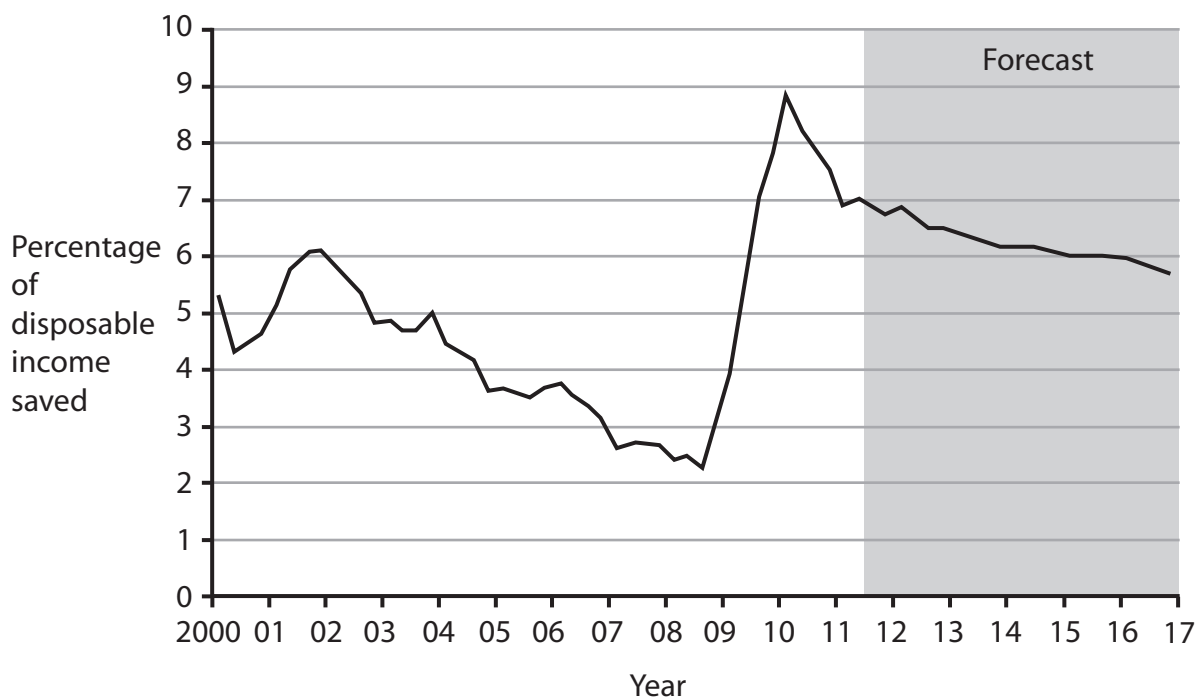
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Businesses have used some of their profits to pay back bank loans and they may also have started to build up cash reserves against further shocks as uncertainty over the outlook has risen. This might lead to a reduction in business investment in 2012. We also continue to predict a small current account deficit in the medium term.

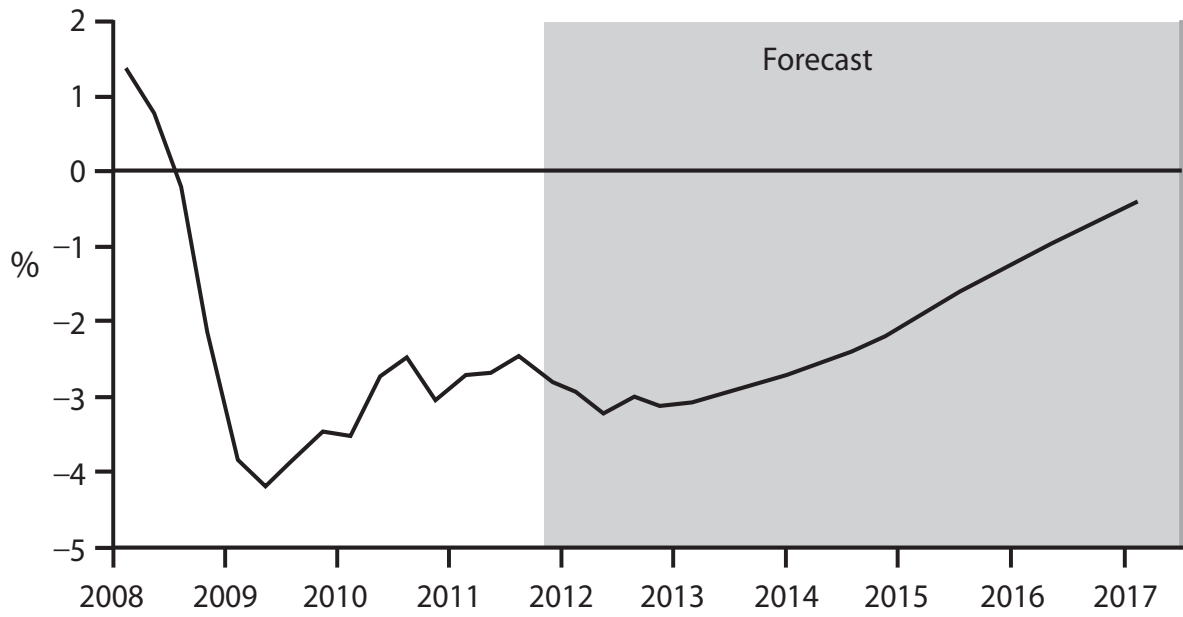
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(Source: © Crown Copyright Office of Budgetary Responsibility Autumn Report, November 2011)

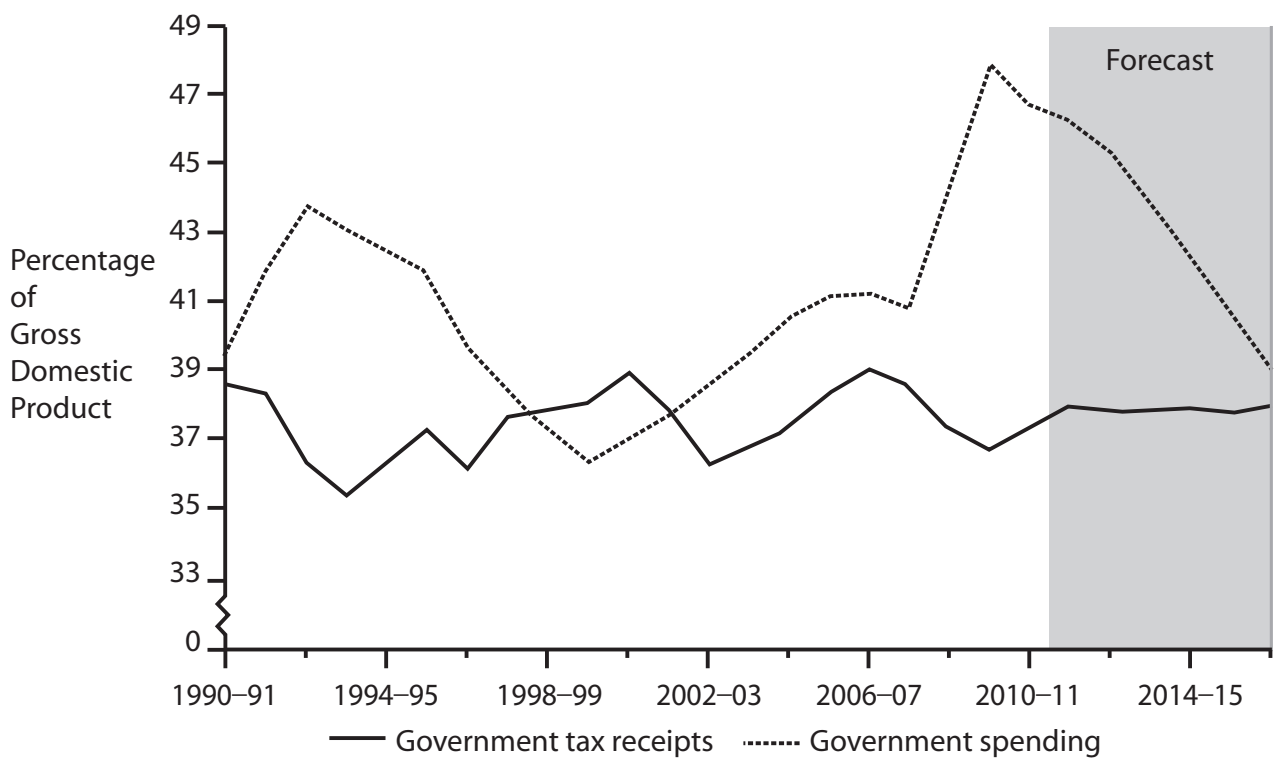
**Figure 1 UK savings ratio: percentage of UK household disposable income saved**



**Figure 2 The UK output gap**



**Figure 3 Total UK Government public spending and tax receipts**



(Source for Figures 1-3: © Crown Copyright Office of Budget Responsibility Economic and Fiscal Outlook, November 2011)





(b) Identify and explain **two** factors that influence the level of business investment (Extract 1, line 10).

(8)

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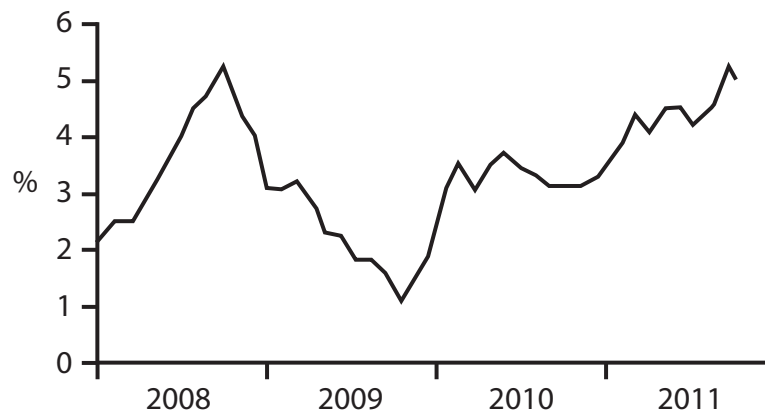


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**(Total for Question 27 = 26 marks)**

## 28 Inflation and the Standard of Living

**Figure 1 UK rate of inflation (annual percentage change as measured by the CPI)**



### **Extract 1 The UK rate of inflation falls**

A supermarket price war, cheaper air fares and lower petrol prices caused inflation to slow to 5% in October 2011, ending its recent upward trend and prompting economists to predict it will fall sharply in 2012. The annual increase in the consumer price index peaked at 5.2% in September 2011. With the cost of petrol, food and air travel all dropping in October, having risen in the same month in 2010, the overall rate of inflation was pushed down. 5

Even though the rate of inflation has begun to fall as economists had expected, the annual rate remains well above the Bank of England's 2% target, prompting another letter of explanation from Sir Mervyn King, Governor of the Bank of England, to George Osborne, Chancellor of the Exchequer. In November 2011, Sir Mervyn wrote that "inflation will fall back sharply in the next six months or so and continue falling thereafter to around target by the end of next year". 10

He could make the prediction because large price rises that occurred towards the end of 2010 were beginning to drop out of the inflation calculation, since they happened over a year previously. The rate of inflation would fall sharply as this process accelerated in early 2012 once the rise in value added tax to 20% no longer counted in the measure. 15

Even though Sir Mervyn pointed to lower inflation in the future, the average rate tolerated by the Bank of England over the previous four years had been 3.5%, far above the 2% target.

He said the Bank had used low interest rates and monetary expansion ('quantitative easing') to aid the economy's adjustment to higher energy and import prices. Without these policies, the economy would have been more vulnerable to a recession. 20

(Source for Figure 1 and Extract 1: adapted from 'Supermarket price war eases inflation', © Financial Times, 15 November 2011)

**Figure 2 Selected data on living standards**

	Human Development Index (HDI) 2011	Gross National Income per head 2011 (Constant 2005 PPP \$)
Germany	0.905	34,854
Spain	0.878	26,508
United Kingdom	0.863	33,296
Fiji	0.688	4,145
China	0.687	7,476
Ethiopia	0.363	971

(Source: Data retrieved from the UNDP Human Development Report website: <http://hdr.undp.org/en/statistics/> © UNDP)



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**(Total for Question 28 = 12 marks)**

## 29 Real Income and Unemployment

### Extract 1 UK households' real disposable incomes

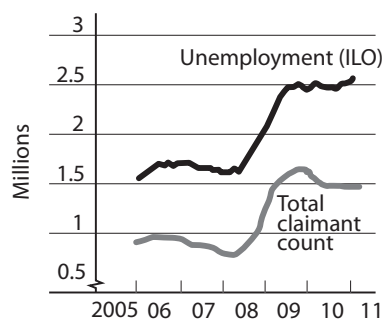
New GDP figures show real household disposable incomes falling by 0.8% in 2010. This is the first time the measure has fallen since 1981.

Nominal wage growth edged up with average earnings rising 2.3% in the year to January 2011. This annual growth rate for workers' pay was mainly driven by bonus payments in the finance and business services sector. Meanwhile, CPI inflation was 4.0% in January 2011.

5

(Source: Adapted from an article by Brian Groom from the Financial Times on 16 March 2011  
© The Financial Times Limited 2011)

### Figure 1 UK unemployment at 17-year high, millions



(Source for Figure 1: Adapted from the Financial Times on 16 March 2011  
© The Financial Times Limited 2011)

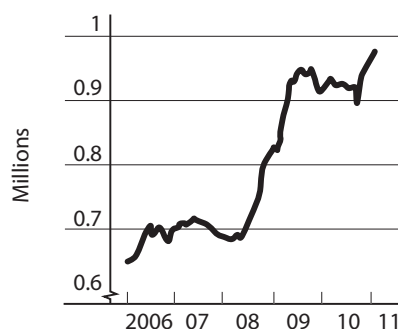
### Extract 2 Unemployment measurements diverge

The unemployment rate, as measured by the International Labour Organisation (ILO), for the three months to January 2011 was 8.0% of the economically active population. The total number of unemployed people, using the ILO measure, increased by 0.1% (27,000) over the three months to January 2011 to reach 2.53 million, the highest figure since 1994. The number of people claiming Jobseeker's Allowance (the claimant count) fell by 10,200 between January and February 2011 to reach 1.45 million.

5

(Source for Extract 2: Adapted from the Office of National Statistics 16 March 2011  
© Crown Copyright)

### Figure 2 ILO survey of youth (aged 16-24) unemployment, millions



(Source: Adapted from the Financial Times on 16 March 2011  
© The Financial Times Limited 2011)



### **Extract 3 Youth unemployment**

The ILO unemployment level for those aged from 16 to 24 reached 974,000 in the three months to January 2011, the highest figure in percentage and absolute terms since comparable records began in 1992. Chris Grayling, the employment minister, has questioned the accuracy of the ILO figure and the survey method used.

Grayling claimed that youth unemployment had fallen if young people in education were excluded from the figures. The ILO survey should make sure that full time students who cannot find a part-time job while they study are not included in this measure of unemployment.

5

(Source: Adapted from © Guardian News & Media Ltd 2011, April 13 2011)

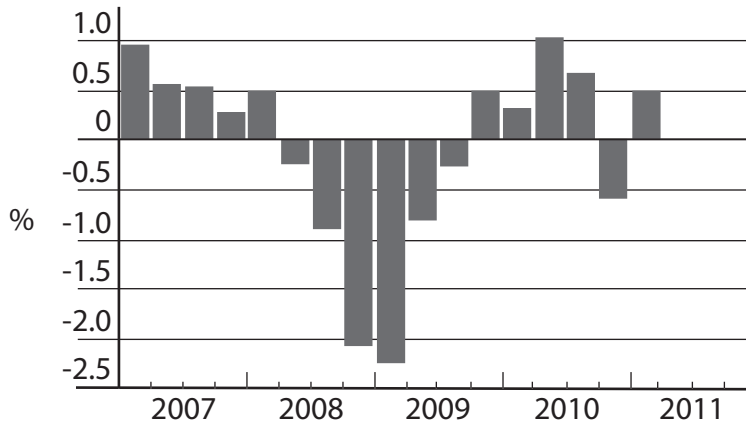


(Total for Question 29 = 12 marks)

### Question 30

#### UK Growth and the Balance of Payments

**Figure 1 UK Real GDP growth, quarter on quarter**



Source: ONS, Thomson Reuters

(Source: Adapted from the Financial Times © The Financial Times 2011)

**Figure 2 UK Balance of Payments Current Account 2009-10 (£ billions)**

	2009	2010
Trade in goods	-82.4	-97.8
Trade in services	52.7	49.3
<b>Subtotal: Trade in goods and services</b>	<b>-29.7</b>	<b>-48.5</b>
Income (interest, profits and dividends)	20.6	31.8
Current transfers	-4.9	-19.7
<b>Total: Current account balance</b>	<b>-14.0</b>	<b>-36.4</b>
<b>Current account balance as % of GDP</b>	<b>-1.7%</b>	<b>-2.5%</b>

(Source: Adapted from the Office of National Statistics © Crown Copyright)

### Extract 1 For many the real recession starts now

The economy is still showing only very limited signs of the hoped-for rebalancing of aggregate demand away from debt financed consumption and government spending to investment and exports.

The government's deflationary fiscal policy will start to reduce its budget deficit. The Office for Budget Responsibility forecasts that in order to maintain their living standards, households will have to reduce their savings and increase their borrowing further. Household debt is forecast to grow from 160% of disposable income to a record 175%, or £2.1trillion, by 2015.

5

Exports are growing, but not as strongly as those of some other European countries. What is more, the 20% plus depreciation in the pound since 2008 seems to be having virtually no impact on imports. This has contributed to the UK's largest ever recorded trade in goods deficit in 2010. As the Bank of England's Monetary Policy Committee (MPC) said in minutes to its last meeting, it's possible "that domestic substitutes for some imported goods and services are not available".

10

Britain's manufacturing base is so depleted that the economy may no longer be capable of responding to gains in competitiveness. The recent decisions of the MPC to maintain a record low 0.5% base interest rate have not yet led to the hoped-for increase in business investment. Some economists now predict an early rise in this base rate to act against inflation being above the target rate.

15

(Source: Adapted from © Copyright Telegraph Media Group Limited 2011, 25th April 2011)

**30** With reference to Extract 1, assess **two** factors likely to affect the level of aggregate demand in the UK.

(12)

A series of horizontal dotted lines for writing the answer.

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**(Total for Question 30 = 12 marks)**

### 31 Productivity, Investment, Trade and Employment

**Figure 1 Annual average international labour productivity growth, %**

	1995 – 2007	2007 – 2009
United States of America (US)	2.1	2.1
United Kingdom (UK)	2.2	-0.7
European Union (EU)	1.5	-0.5

(Source: [http://www.mckinsey.com/mgi/publications/UK\\_report/pdfs/MGI\\_UK\\_growth\\_and\\_renewal\\_full\\_report.pdf](http://www.mckinsey.com/mgi/publications/UK_report/pdfs/MGI_UK_growth_and_renewal_full_report.pdf))

**Figure 2 UK Gross Investment and GDP Growth (percentage change over previous year), 2001–2009**

Year	Gross investment	GDP Growth
2001	2.6	2.5
2002	3.6	2.1
2003	1.1	2.8
2004	5.1	3.0
2005	2.4	2.2
2006	6.4	2.8
2007	7.8	2.7
2008	-5.0	-0.1
2009	-15.0	-4.9

(Source: © Crown Copyright 2010/HMSO)



### **Extract 1 Trade risks are main threat to UK Economy, says Bank**

According to the Governor of the Bank of England, Mervyn King, the biggest risk to growth in the UK is that if the economies of its trading partners suffer badly, demand for UK exports will slow and will make it difficult for the nation to undertake a rebalancing of its economy. Mr King said "the biggest risk that we face is bad news on the world economy and in particular in the euro area". He noted that more than 60% of UK exports were to the eurozone - including 7% to Ireland alone.

5

Mr King went on to say that the central issue facing the UK economy is to reduce its dependence on credit-fuelled household consumption and on the public sector, replacing it with demand for exported goods and services and increased investment.

Nearly three years after a 25% drop in the value of sterling, there has been little improvement in Britain's trade balance.

10

(Source: adapted from the Financial Times © The Financial Times Limited 2010  
"Trade risks are main threat to UK, says Bank" By Norma Cohen and Daniel Pimlott  
November 10 2010 <http://www.ft.com/cms/s/0/e6a628a8-ecbf-11df-88eb-00144feab49a.html#>)

### **Extract 2 Latest figures show the majority of claimants being found fit for work**

The conditions for people to receive Job Seeker's Allowance have become more and more difficult. Some economists see a link between this and the increase in people claiming long term sickness benefit, or incapacity benefit (IB) over the same period. This increase could well be concealing many long term unemployed.

5

The Government has therefore started reassessing those on the old style IB for a replacement benefit, the Employment and Support Allowance (ESA) programme. This will be completed in 2011. According to official statistics from a pilot study, three-quarters of people applying for the new ESA were either found to be fit for work or withdrew their benefit claim before they completed a medical assessment.

10

The Employment Minister, Chris Grayling, commented that with over two million people trapped on incapacity benefits, this pilot study underlined how important it is to make sure that everyone who has the potential to work gets the right help to move off benefits and into a job. He also expressed his view that the medical assessment should be designed fairly and explained that an independent review is being undertaken with a number of charities representing disabled people and those with mental health issues.

15

The following day the Daily Mail's headline was "75% of incapacity claimants are fit to work" and the paper estimated this reform would slash the £12.5 billion spent on incapacity benefits a year to just over £4 billion.

(Source: © Crown copyright and '75% of incapacity claimants are fit to work', Gerri Peev © Daily Mail  
27 October 2010 )

(a) With reference to Figure 1, what is meant by 'labour productivity'?

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(b) Explain **two** possible reasons why UK labour productivity declined during the period 2007-2009 (Figure 1).

(8)

A series of horizontal dotted lines for writing the answer.

(c) With reference to the data, evaluate the effects of declining productivity on the UK economy.

(12)

A series of horizontal dotted lines for writing the answer.

Handwriting practice area with 25 horizontal dotted lines.

(d) Explain **two** factors that might lead to an increase in investment in the UK.

(8)

A series of horizontal dotted lines for writing the answer.

**(Total for Question 31 = 32 marks)**

## 32 Public Sector cuts, unemployment and inflation targets

### Extract 1 Cutting back the state

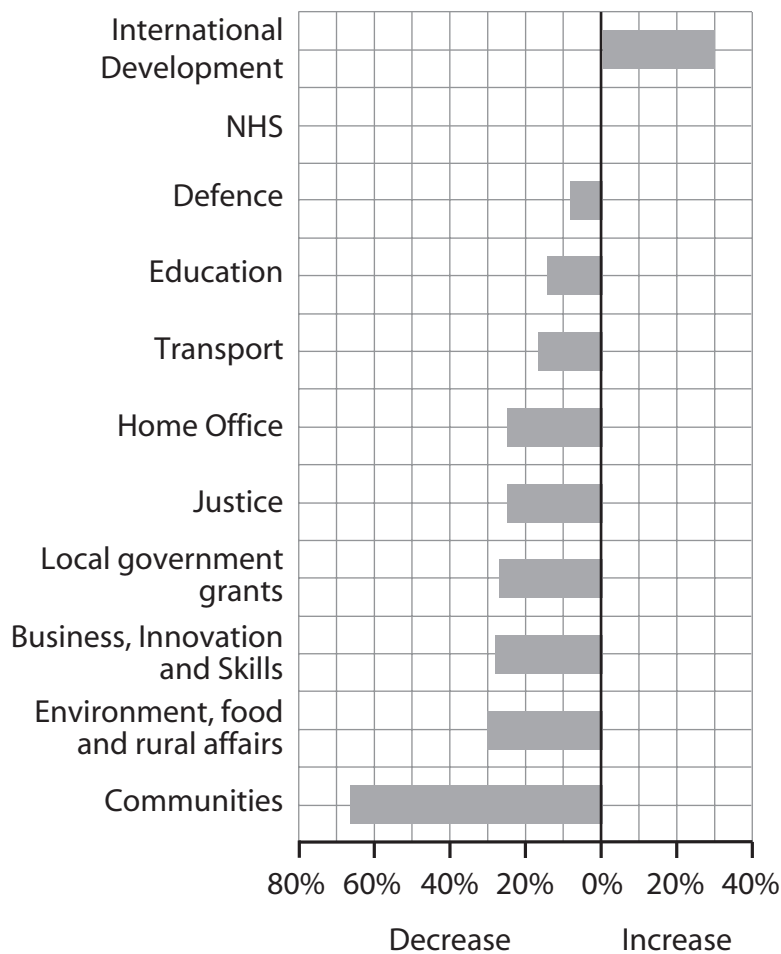
The Chancellor of the Exchequer, George Osborne, insisted that harsh medicine was vital to cut Britain's huge budget deficit, expected to be 10% of GDP in 2010–11. Total cuts in public sector spending of £81 billion are to be made by 2014–15. Nevertheless, total spending is planned to be 6% higher in cash terms in 2014–15 than 2010–11, but in real terms to be 3% lower. Some spending is beyond the Chancellor's control: debt interest is likely to rise from £43 billion this year to £63 billion by 2014–15 as a result of the surge in government borrowing.

5

As well as efficiency savings, one obvious way to reduce costs is to keep pay down. The government has already announced a two-year pay freeze for public-sector staff. State employers could carry on in this spirit after that, pointing out that the more pay can be kept down, the fewer the job losses. But job losses there will be, amounting to probably about half a million (out of a public sector workforce of about 6 million) by the end of 2014.

10

**Figure 1 Planned real percentage changes in UK public expenditure by government department between the fiscal years 2010–11 and 2014–15**



(Source for figure 1 and extract 1: © The Economist Newspaper, Oct 21st 2010)

## Extract 2 The inflation overshoot continues

For the fourth time this year, the Governor of the Bank of England, Mervyn King, has had to write to the Chancellor of the Exchequer explaining why inflation is above 3%. According to the Bank's own forecast published in its Inflation Report on November 10th 2010, Mr King is likely to be writing yet more letters in 2011 to George Osborne at the Treasury.

5

Figures out today from the Office for National Statistics showed that consumer prices rose by 3.2% in the year to October 2010. The new numbers triggered the letter, which the Governor has to write every three months if inflation remains more than a percentage point above (or below) the 2% target. It marked the ninth since the Bank of England's Monetary Policy Committee was given operational control over monetary policy in 1997. Since the spring of 2007, inflation has been above the 2% target in all but nine of the past 54 months.

10

Britain is unusual in facing high inflation. Consumer prices in the Euro zone rose by 1.9% in the year to October 2010 and in the USA annual inflation was 1.1% in September 2010.

15

In his letter to the Chancellor, Mr King struck what has become a familiar note, by drawing a distinction between temporary upward and long term downward pressures on inflation. The inflation overshoot, he said, largely reflected a number of temporary factors, including the restoration of the main rate of VAT from its emergency rate of 15% during the recession to 17.5% in January 2010, past rises in oil prices and the continued effects of higher import prices resulting from the big 25% fall in sterling from mid-2007. These factors were offsetting the downward effects from spare capacity caused by the recession.

20

However, the temporary effects keep on coming. World food prices have risen by 31.5% in the past year. On January 4th 2011 the standard rate of VAT will rise again, to 20% as part of the coalition government's budget deficit reduction strategy.

25

Mr King argued that once these further temporary effects ended, inflation would fall back towards the target, due to spare capacity in the economy. He insisted that "the depth of the recession means that a margin of spare capacity is likely to persist for some while". However, there is considerable uncertainty about just how much spare capacity there is in the economy.

30

The main danger from the persistence of inflation overshoots is that people start to expect higher inflation and to demand higher wages. Mr King was concerned that this would make it "more costly to bring inflation down".

(Source: © *The Economist Newspaper*, Nov 16th 2010)



**32** Using an aggregate demand and aggregate supply diagram, evaluate the effect on output of the half a million public sector job cuts (Extract 1, Line 12).

**(12)**

A series of horizontal dotted lines for writing the answer.

Handwriting practice area with 25 horizontal dotted lines.

**(Total for Question 32 = 12 marks)**

### 33 Inflation and Unemployment in the UK

**Figure 1 Selected changes to the CPI basket of goods and services, 2010**

IN	OUT
Cereal Bars	Hairdryer
Fruit drink in a bottle	Fizzy canned drink
Blu-ray disc players	Disposable camera
Lip gloss	Lipstick

<http://www.guardian.co.uk/news/datablog/2010/mar/15/inflation-basket>

#### **Extract 1 King says inflation surge 'short term'**

When inflation, measured by the Consumer Price Index (CPI), moves outside the tolerance of 2% + or – 1%, the Governor of the Bank of England is required to write an open letter to the Chancellor explaining the reasons for it. In February 2010 CPI inflation reached 3.5%.

In his February letter the Governor, Mr King, pointed to three factors: the rise in VAT back to its pre-recession 17.5% rate, a sharp increase in oil prices of roughly 70% over the past year, and the sharp depreciation of sterling in 2007 and 2008.

However, Mr King also stressed that inflation might eventually fall below target because of the sharp fall in consumer and investment spending and the build-up of spare capacity in the economy as labour, factories and equipment lie idle.

He noted that the Monetary Policy Committee (MPC) has already cut interest rates to 0.5% and the Bank of England has bought £200 bn of government bonds to encourage the commercial banks to increase lending.

Source: Based on the following articles in the FT "King says inflation surge 'short term'" by Norma Cohen published on February 16 2010 and "Farewell to QE" by Lex on 4 February 2010

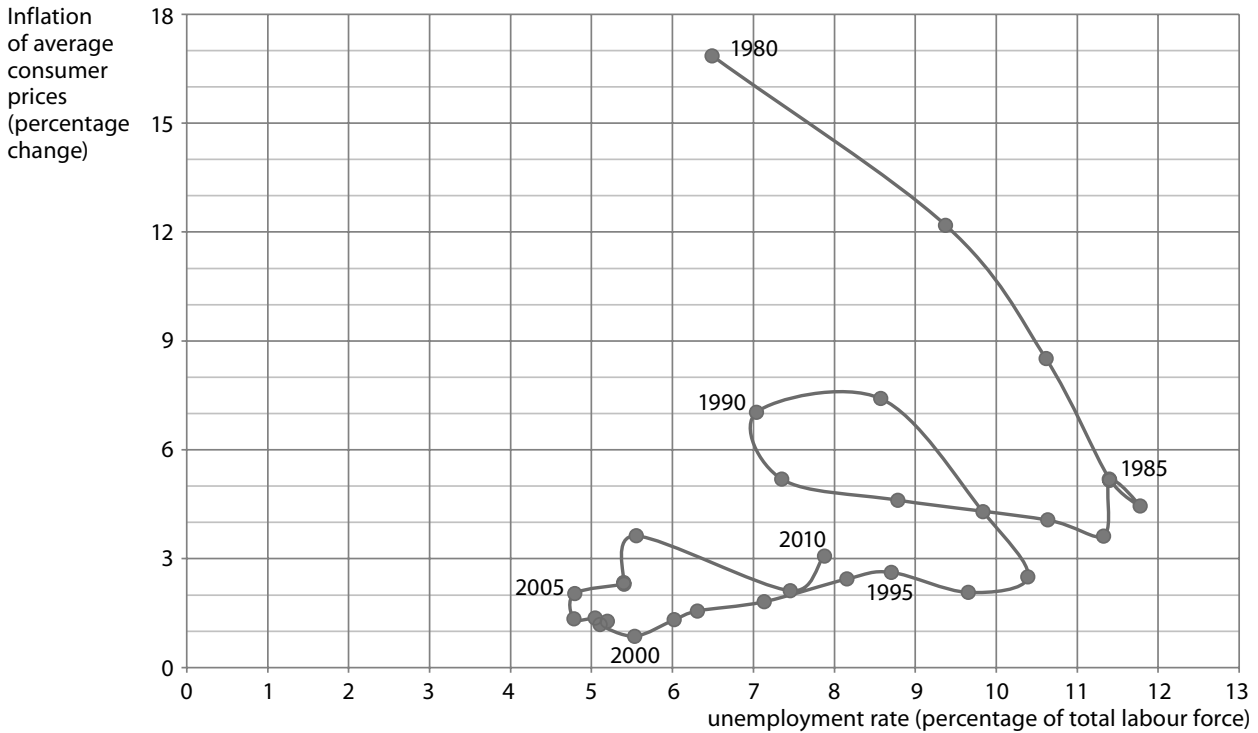
<http://www.ft.com/cms/s/0/d29d8984-1aea-11df-88fa-00144feab49a.html> and  
<http://www.ft.com/cms/s/3/3963580c-1199-11df-9195-00144feab49a.html>

#### **Extract 2 Unemployment Headlines from the Guardian, March 2010**

- Claimant count falls to 1.59 million people
- Labour Force Survey measure falls 33,000 to 2.45 million people
- But 'economically inactive' people rises to record 8.16 million
- Youth unemployment (16–25) reached over 20% (1 million)
- Employment level hits lowest since 2006

<http://www.guardian.co.uk/business/2010/mar/17/unemployment-fall-raises-recovery-hopes>

**Figure 2 UK Inflation and Unemployment 1980–2010\***



\*The 2010 figure is predicted

Source: <http://www.imf.org/external/pubs/ft/weo/2010/02/weodata/index.aspx>

**Figure 3 United Kingdom Unemployment rate by duration (annual data from the Labour Force Survey)**

Date	Unemployed for less than one year %	Unemployed for more than one year %	Total %
2004	3.8	1.0	4.8
2005	3.9	1.0	4.9
2006	4.2	1.2	5.4
2007	4.1	1.3	5.4
2008	4.3	1.4	5.7
2009	5.8	2.0	7.8

Source: <http://www.bankofengland.co.uk/publications/inflationreport/ir10feb3.xls>

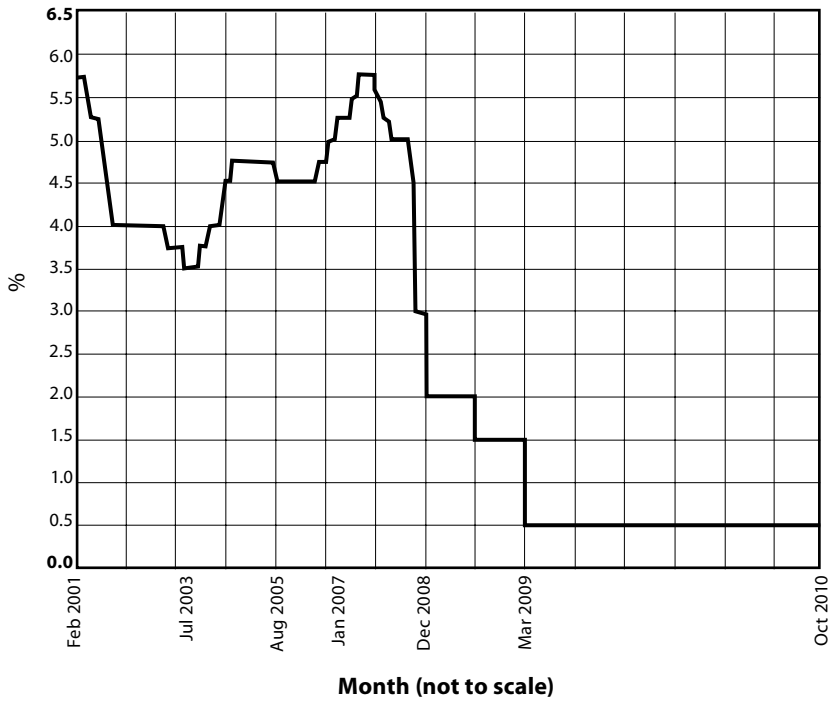


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**(Total for Question 33 = 10 marks)**

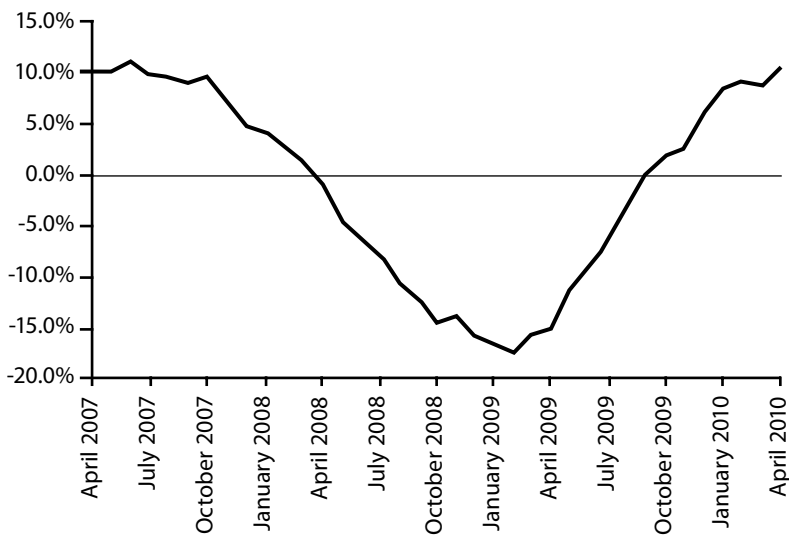
### 34 Interest Rates, House Prices, Savings and Growth

**Figure 1 UK base rate of interest, 2001–2010**



Source: <http://www.thisismoney.co.uk/interest-rates>

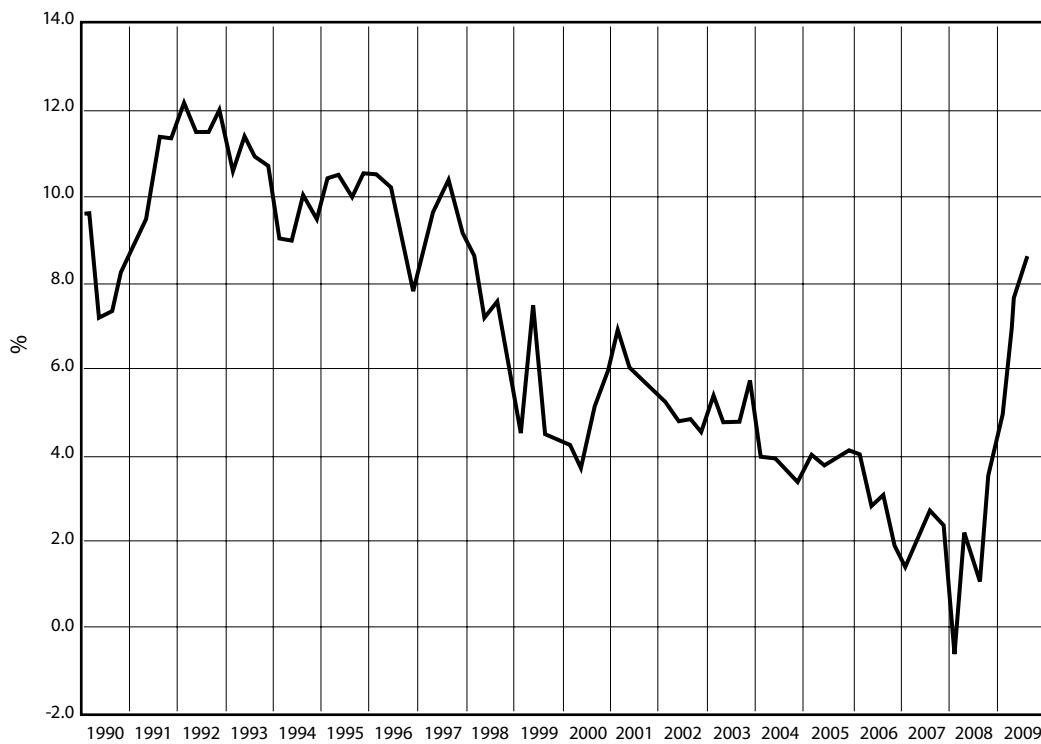
**Figure 2 Quarterly percentage change in UK house prices, April 2007 to April 2010**



Source: [http://www.nationwide.co.uk/hpi/historical/Apr\\_2010.pdf](http://www.nationwide.co.uk/hpi/historical/Apr_2010.pdf)

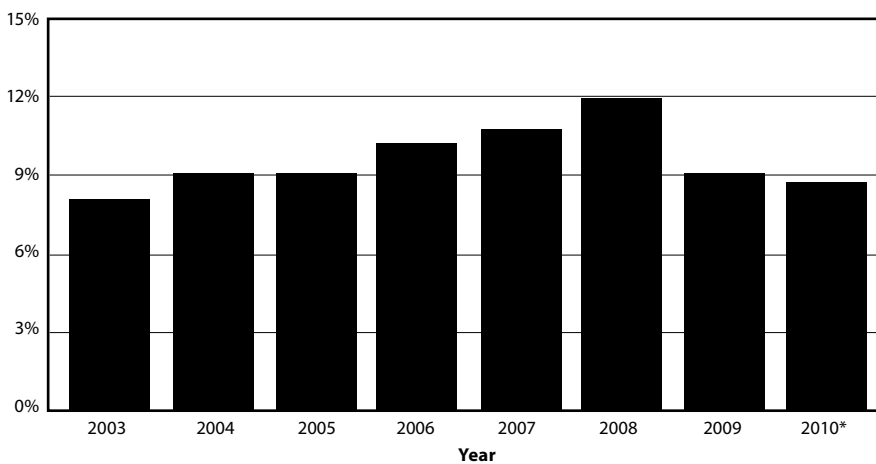
**Figure 3 UK Household Savings Ratio**

(percentage of disposable income that is saved, using quarterly data)



Source: <http://www.tutor2u.net/blog/index.php/economics/tagged/tag/savings+ratio>

**Figure 4 Real GDP growth rates in China, 2003–2010**



\* Forecast

Source: [http://www.indexmundi.com/china/gdp\\_real\\_growth\\_rate.html](http://www.indexmundi.com/china/gdp_real_growth_rate.html)







Handwriting practice area with 20 horizontal dotted lines.

**(Total for Question 34 = 16 marks)**

## 35 Public finances

### Extract 1 Some initial reactions to the 2009 Pre-Budget Report

No Chancellor would wish to publish a forecast showing that the government will need to borrow £178 billion in 2009/10. But when you consider that the economy has shrunk more in the last six months than the Chancellor, Alistair Darling, predicted in Spring 2009, an increase of just £3 billion in the forecast deficit from £175 billion actually looks like good news.

5

Far from reducing the fiscal deficit immediately, the Chancellor has actually announced a modest increase in the fiscal deficit over the next three years. The Chancellor increased planned spending by around £15 billion in total over 2011/12 and 2012/13, while recovering only £9 billion through new tax increases.

The Chancellor said that the extra spending would allow modest real increases in spending on 'frontline' schools and no real cuts in the 'frontline' National Health Service plus no cuts in police numbers. But this will leave remaining public services, such as housing, transport and higher education, facing severe real cuts. By 2015, the planned spending increases become less generous while the planned tax increases continue to bring in more revenue.

10

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Source: adapted from The Institute for Fiscal Studies, the article 'Some initial reactions to the 2009 Pre-Budget Report', 9th December 2009 <http://www.ifs.org.uk/pr/pbr09.pdf>.

**Figure 1 Changes in UK GDP and Components of Aggregate Demand in real terms (£ millions)**

	2008	2009	Percentage Change
Consumption	852,918	826,436	-3%
Investment	232,202	199,962	-14%
Government Spending	282,681	288,133	2%
Stocks	866	-15,644	-1906%
Exports	361,535	321,155	-11%
Imports	401,137	349,189	-13%
Exports-Imports	-39,602	-28,034	29%
GDP	1,330,088	1,266,533	-5%

Source: adapted from <http://www.bankofengland.co.uk/publications/inflationreport/ir09nov.pdf> and data from Daiwa Capital Markets, 6th January 2010.

**Figure 2 Value of £1 sterling, expressed in Euros and Dollars, annual averages**

	EURO	US\$
2004	1.43	1.90
2005	1.46	1.74
2006	1.48	1.95
2007	1.41	2.01
2008	1.15	1.52
2009	1.10	1.62

Source: adapted from Yahoo Finance.



(b) Illustrating your answer with an aggregate demand and aggregate supply diagram, evaluate the likely effect of an increase in the fiscal deficit on the level of real output and on the price level. Refer to the multiplier effect in your answer.

(16)

Area with horizontal dotted lines for writing the answer.

Handwriting practice area with 25 horizontal dotted lines.



Handwriting practice area with 25 horizontal dotted lines.



## 36 Monetary Policy

### Extract 1 MPC agreement on rates freeze

All nine members of the Bank of England's Monetary Policy Committee (MPC) voted in favour of freezing interest rates at an historic low of 0.5 per cent, according to the minutes of their April 2009 meeting. The MPC has aggressively cut the cost of borrowing from 5 per cent to 0.5 per cent since October 2008 in an effort to stimulate UK economic growth.

5

Policy makers noted that the prospect of households holding back on spending was probably the biggest risk to an economic recovery. Household consumption fell by 1 per cent in the fourth quarter of 2008 and the ratio of savings to disposable income was higher than expected.

Since then, developments in household spending have been more encouraging. Data on retail sales and car registrations have suggested a slowdown in the rate of decline of consumption. There are indications that confidence and affordability in the housing market are improving, although from very low levels, in the first quarter of 2009. Nevertheless, it is too soon to be sure whether a more significant recovery in consumers' expenditure is in prospect.

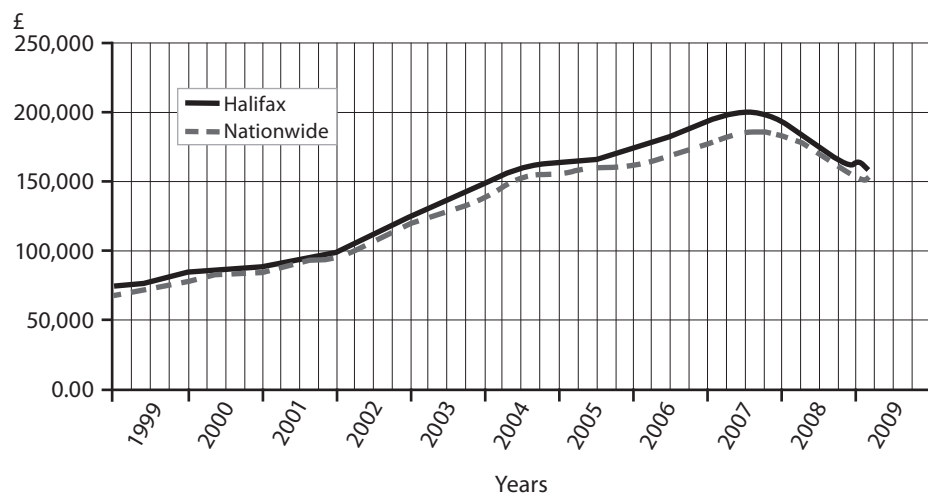
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The Committee noted that consumer price inflation had risen to 3.2 per cent in February, higher than expected and above the MPC's own target. Despite this, the Committee continued to hold the view that inflation would fall back below its 2 per cent target by the second half of the year.

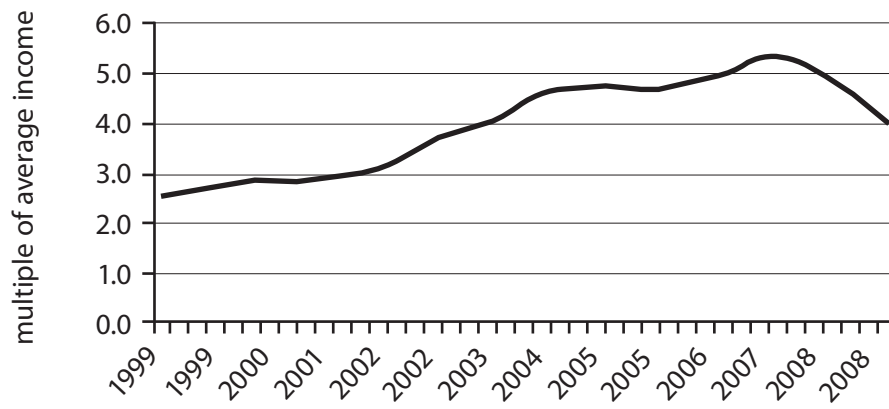
Source: adapted from *The Times* Online April 22, 2009.

**Figure 1: UK average house prices indicated by two large mortgage lenders, by quarter, 1999–2009**



Source: Halifax/Nationwide

**Figure 2: Average house prices (bought by first-time buyers) as a multiple of average income, by quarter**



Source: <http://www.nationwide.co.uk/hpi/historical.htm>

(a) With reference to Figures 1 and 2,

(i) identify changes in house prices and affordability of houses in the UK since 2005.

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(ii) define the term *wealth effect*.

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\***(b)** Assess the likely effects on real output and the general price level of changes in house prices since mid-2007. Use an aggregate demand and supply diagram to support your answer.

**(16)**

A large rectangular area containing 25 horizontal dotted lines, intended for drawing an aggregate demand and supply diagram and providing an answer.

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**(Total for Question 36 = 24 marks)**

**END OF SECTION B**





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A large rectangular area with rounded corners, containing 25 horizontal dotted lines for writing.

Handwriting practice area with 20 horizontal dotted lines.

Handwriting practice area with 25 horizontal dotted lines.

**END OF SECTION C (Total for Question 37 = 25 marks)**