



Economics Questions By Topic:

Balance of Payments (2.1.4)

A-Level Edexcel Theme 2

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SECTION A

Write your answers in the spaces provided.

- 1 British pound to US dollar exchange rate (value of one pound in dollars), June 2017 to June 2019.



(Source adapted from: <https://www.xe.com/currencycharts/?from=GBP&to=USD&view=2Y>)

- (a) Which **one** of the following has been the overall change in the British pound to US dollar exchange rate from 1st January 2018 to 1st January 2019?

(1)

- A Appreciation
- B Depreciation
- C Devaluation
- D Revaluation

(b) Explain the likely impact of the change in the exchange rate of the pound shown in the graph from 1st January 2018 to 1st January 2019 on the UK current account of the balance of payments.

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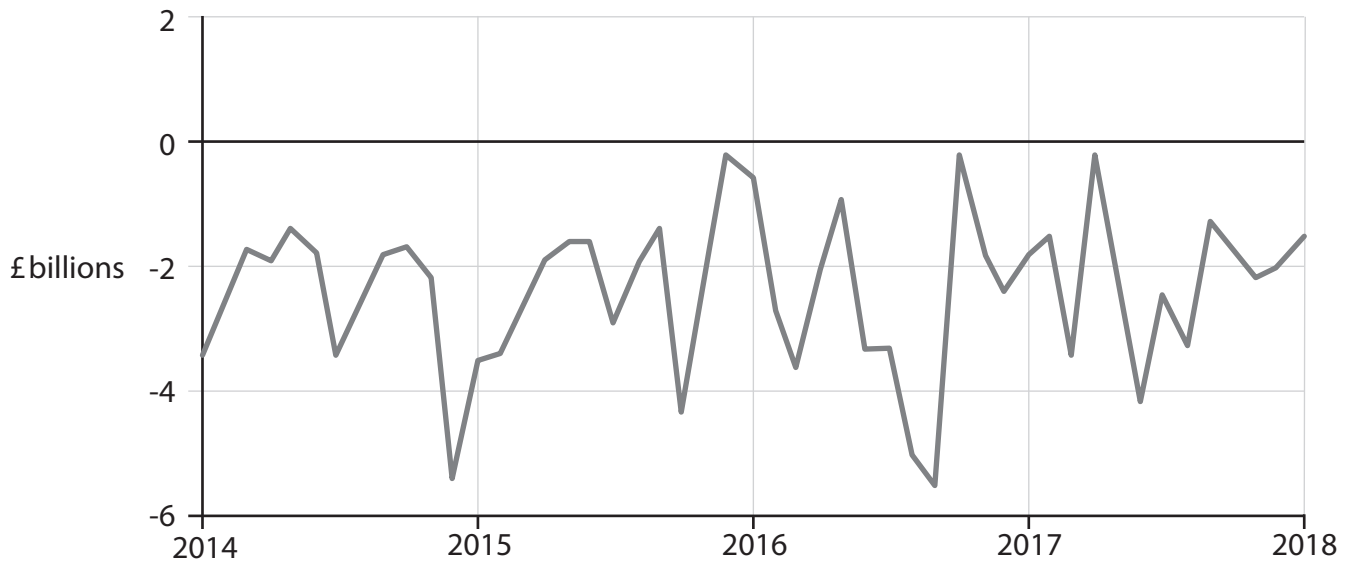
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(Total for Question 1 = 5 marks)

2 The UK's net monthly balance of trade in goods and services, by value, January 2014 to January 2018, is shown in the chart below.



(Source: adapted from <https://tradingeconomics.com/united-kingdom/balance-of-trade>)

(a) Which **one** of the following can be inferred from the above chart over the period shown?

(1)

- A The government was spending more than it received in taxation
- B The UK's balance of trade, by value, was always in equilibrium
- C The value of imports was greater than the value of exports
- D The value of inflows was greater than the value of outflows

(b) Explain **one** likely reason for the UK's balance of trade in goods and services over the period shown. Refer to the chart on page 6 in your answer.

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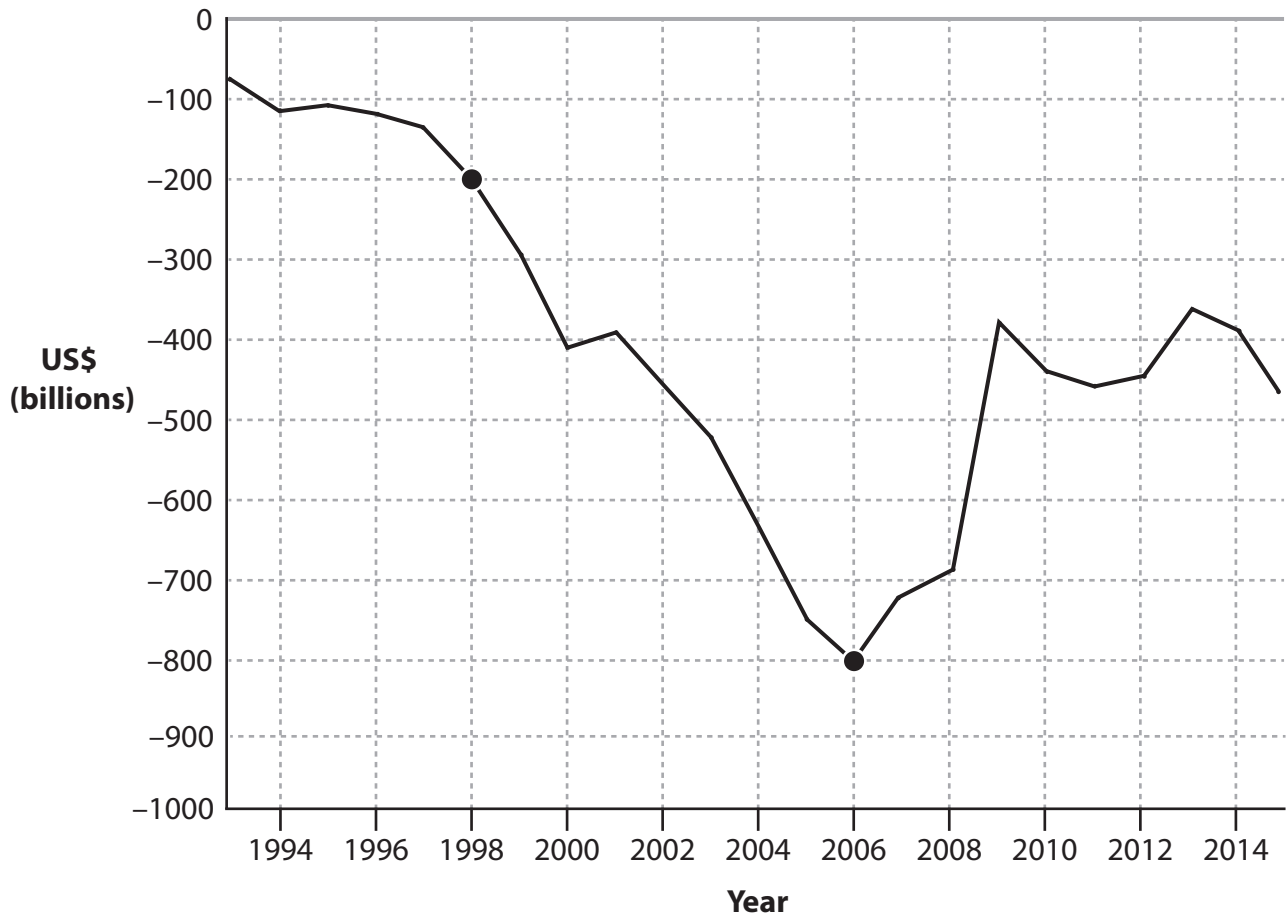
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(Total for Question 2 = 4 marks)

3 United States current account of the balance of payments, 1993–2015



(Source: <http://data.worldbank.org/indicator/BN.CAB.XOKA.CD?end=2015&locations=US&start=1993>)

(a) Calculate the percentage change in the United States current account deficit on the balance of payments between 1998 and 2006.

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(b) Explain the term 'current account of the balance of payments'.

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(c) Using the chart on page 6, which **one** of the following may be inferred about the United States balance of payments?

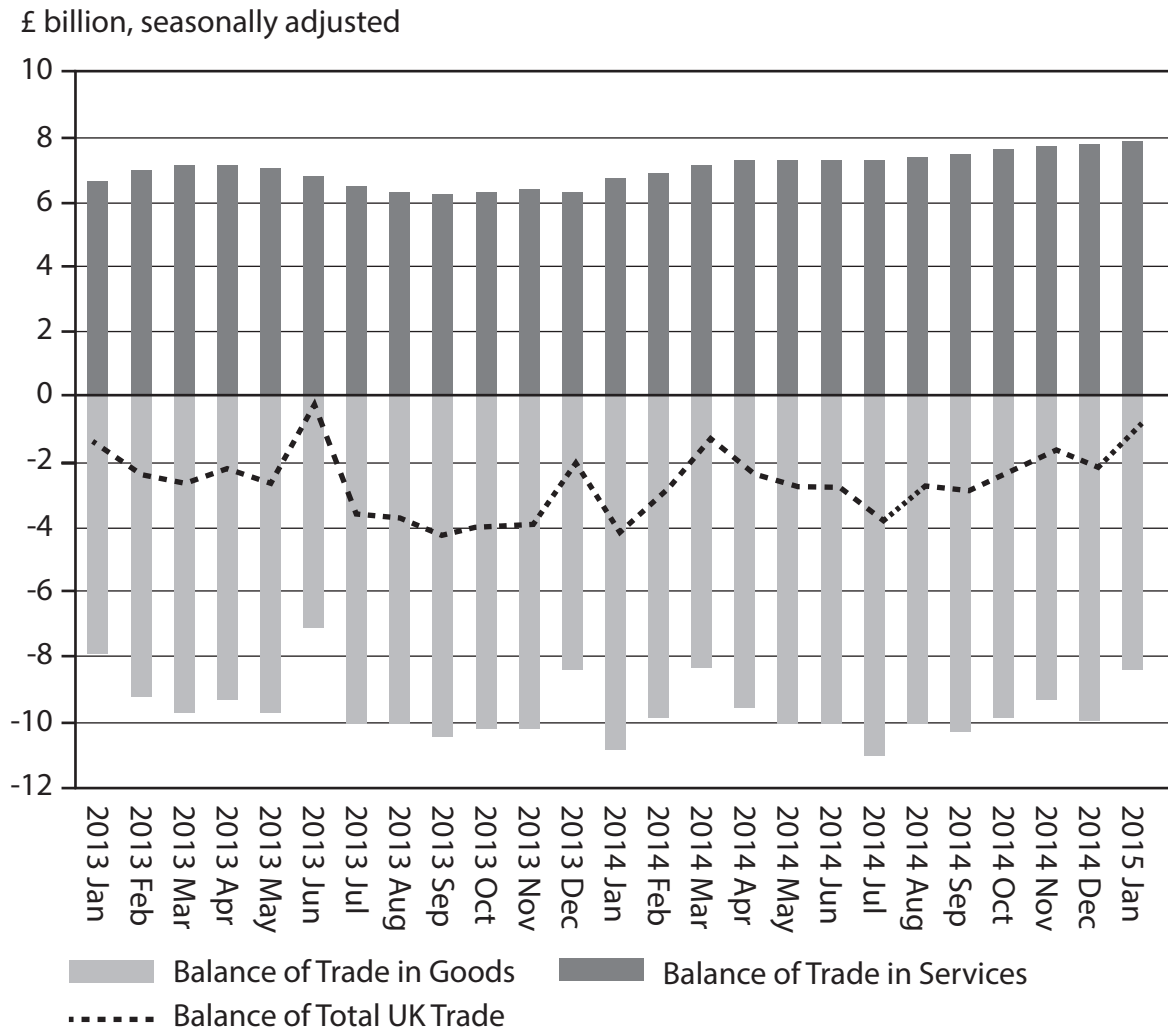
(1)

- A** The current account deficit decreased between 2001 and 2006
- B** The current account surplus increased between 2001 and 2006
- C** There was a current account deficit for the entire period shown
- D** There was a current account surplus for the entire period shown

(Total for Question 3 = 5 marks)

4 Figure 1 shows data on the UK's balance of trade.

Figure 1 – UK's balance of trade January 2013 to January 2015



(Source: <http://www.ons.gov.uk/ons/rel/uktrade/uk-trade/january-2015/summ-uk-trade--january-2015.html>)

(a) Which **one** of the following can be inferred from Figure 1 in the period shown?

(1)

- A** The total UK trade deficit was the largest in June 2013
- B** The trade in goods was always in surplus between January 2013 and January 2015
- C** The total UK trade deficit was the smallest in January 2014
- D** The trade in goods deficit was the smallest in June 2013

(b) Explain **one** likely reason for the reduction in the total UK trade deficit in January 2015.

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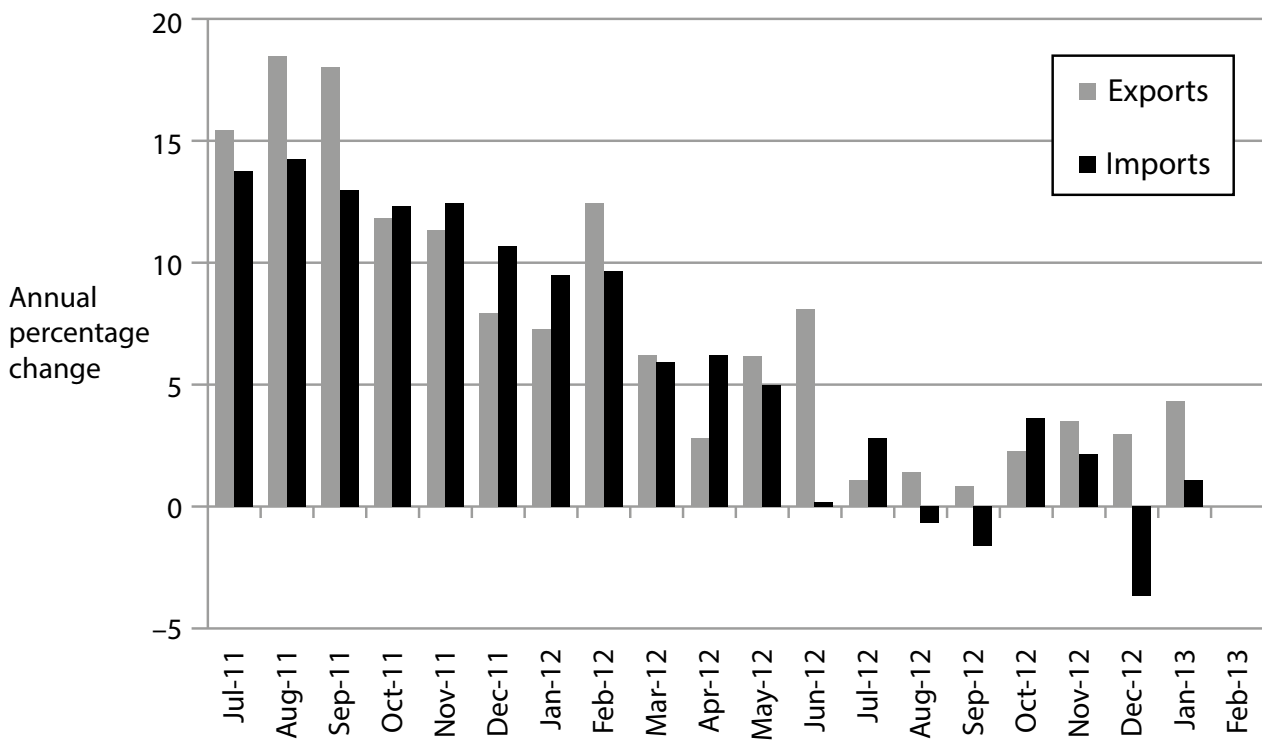
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(Total for Question 4 = 4 marks)

- 5 The chart below shows the annual percentage change in the value of US exports and imports. Throughout this period, the USA has run a trade deficit.

**Annual percentage change in the value of US exports and imports
(nominal values), July 2011–January 2013**



(Source: WTO Press Release, 10 April 2013, Press/688, http://www.wto.org/english/news_e/pres13_e/pr688_e.htm)

- (a) With reference to the chart above, which **one** of the following statements is correct?

(1)

- A** In the year to December 2012, the US trade balance improved
- B** In the year to September 2012, the US trade balance worsened
- C** In the year to November 2011, the US trade balance improved
- D** In the year to August 2012, the US trade balance worsened

Answer

(b) Explain the likely effect of an increase in US income tax rates on the US trade balance.

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(Total for Question 5 = 5 marks)

END OF SECTION A

SECTION B

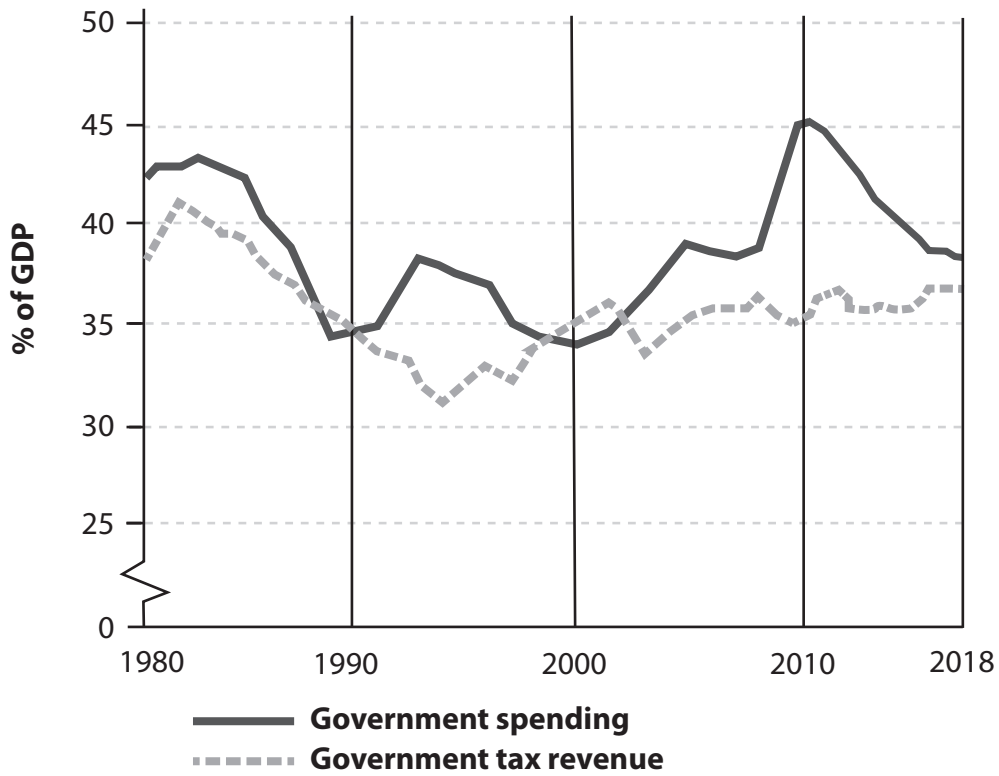
Read all extracts/figures before answering.

Write your answers in the spaces provided.

Question 6

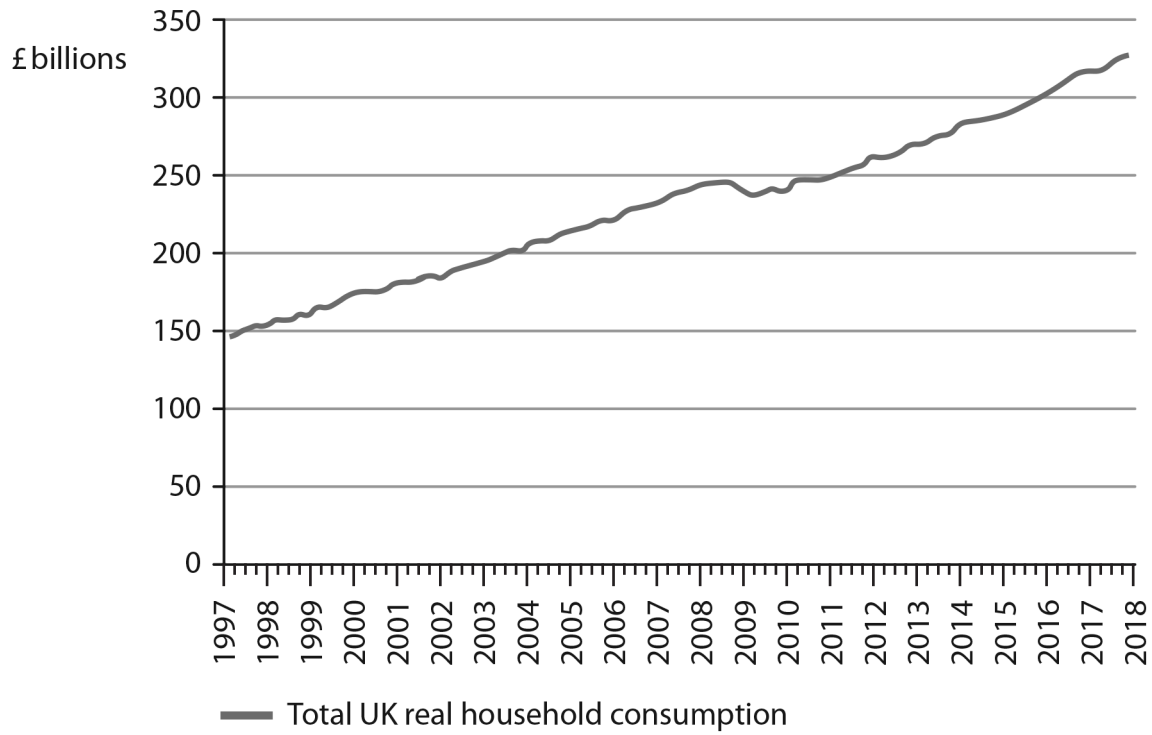
UK government budget and household consumption

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 © 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)

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>)

6 Explain the likely effect of a fall in the exchange rate of the British pound on aggregate demand. Refer to Extract A in your answer.

(5)

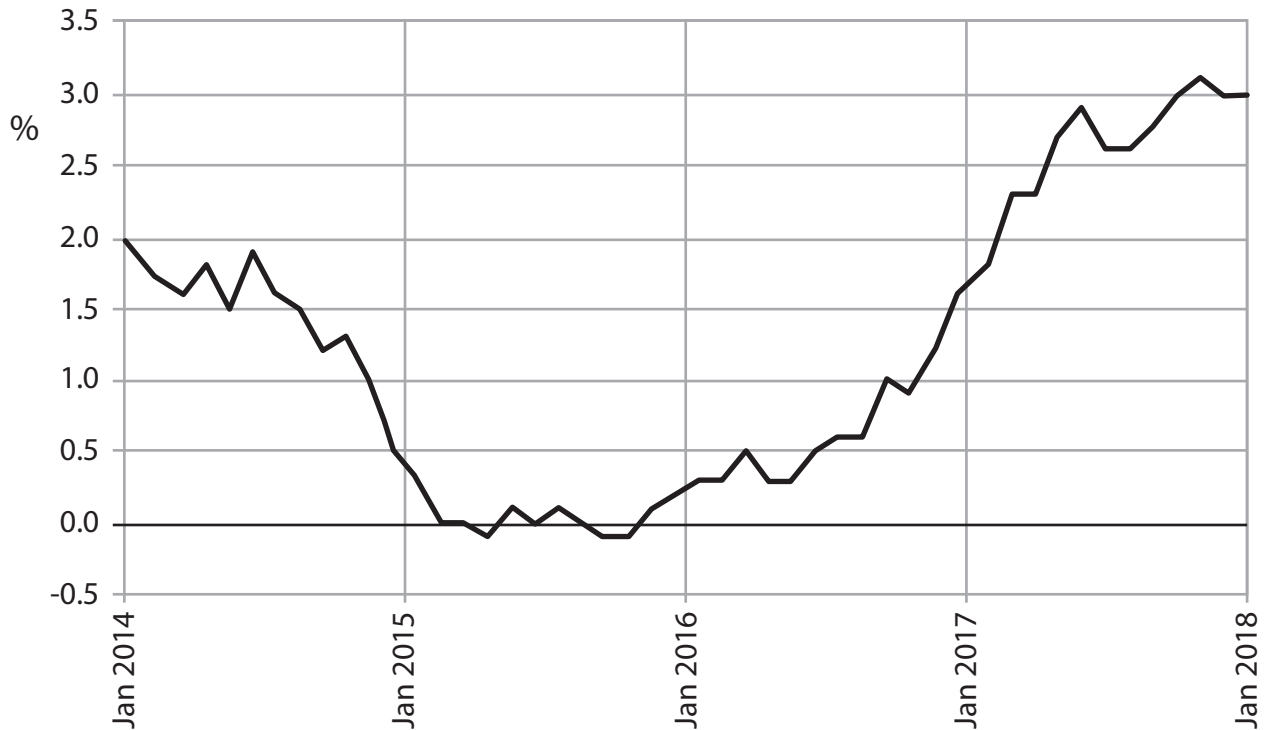
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(Total for Question 6 = 5 marks)

Question 7

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



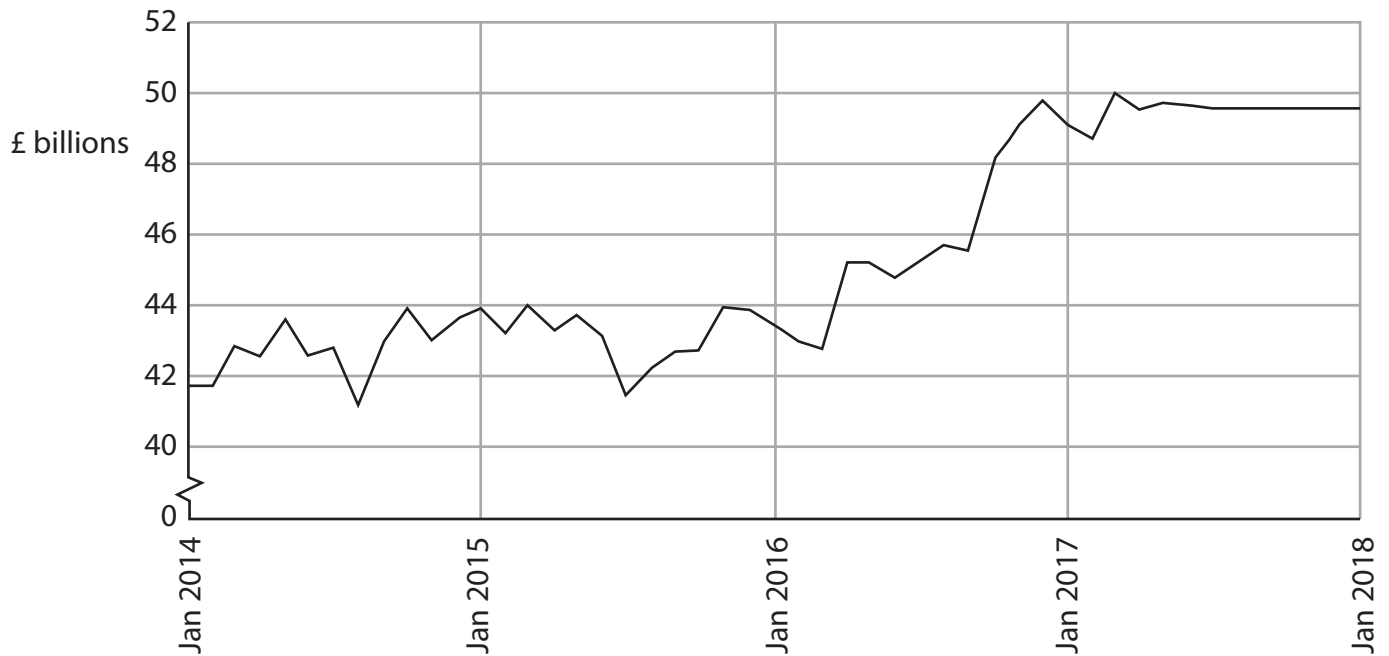
(Source: www.bankofengland.co.uk/publications/Pages/inflationreport/2017/aug.aspx)

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)

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/>)

7 With reference to the first paragraph of Extract A and Figure 1, explain how the change in the exchange rate of the pound has 'contributed to rising inflation' (Extract A, line 4).

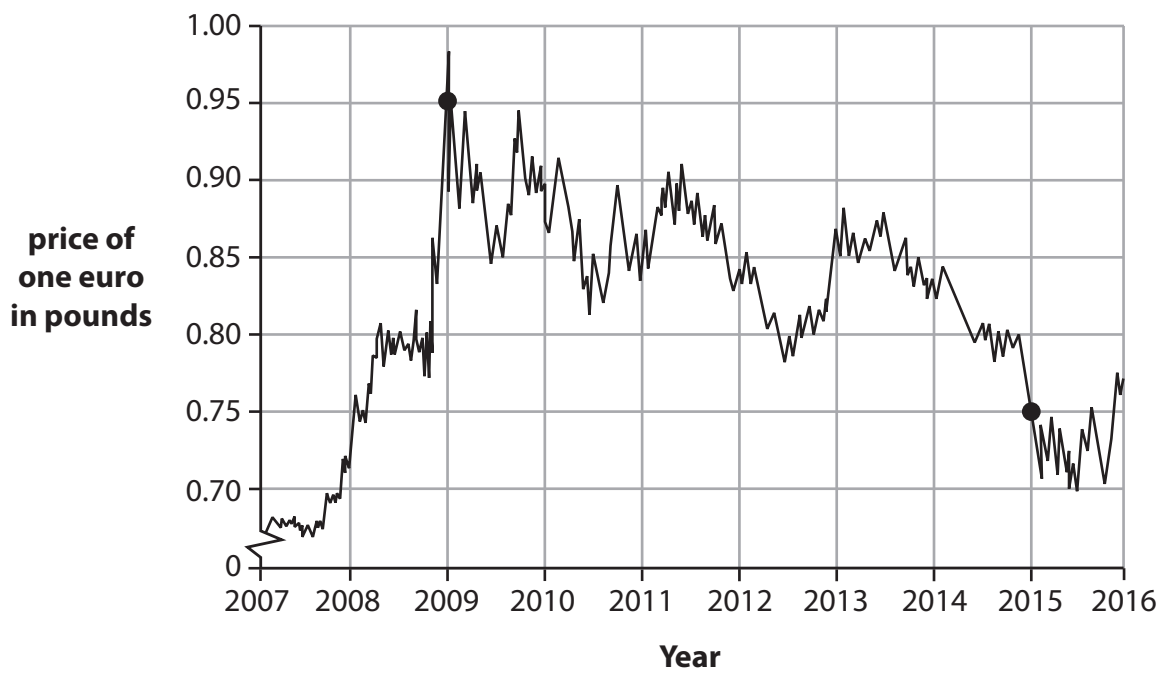
(4)

(Total for Question 7 = 4 marks)

Question 8

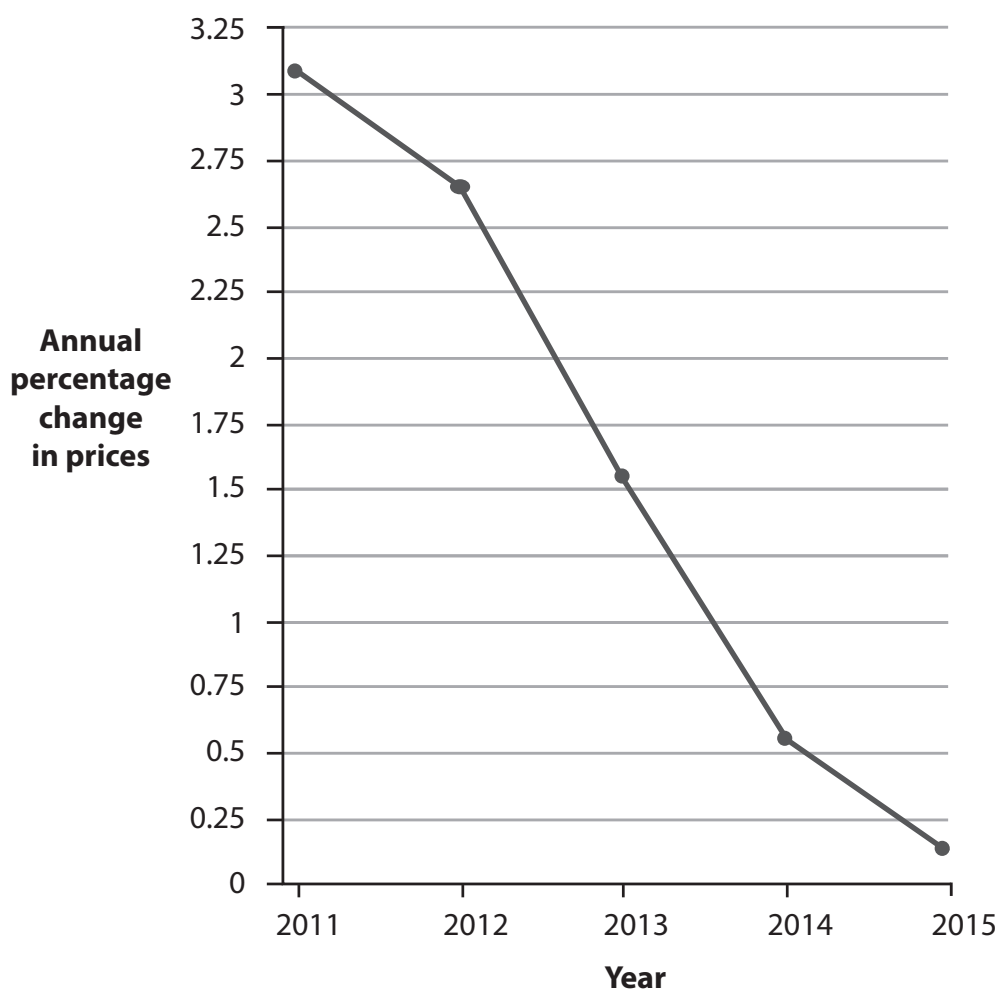
The Eurozone economy

Figure 1: Exchange rate of the euro (€) to the British pound (£)



(Source: <https://www.ecb.europa.eu/stats/exchange/eurofxref/html/eurofxref-graph-gbp.en.html#>)

Figure 2: Eurozone inflation rate as measured by the Consumer Prices Index (CPI)



(Source: adapted from <http://www.imf.org/external/pubs/ft/weo/2015/02/weodata/download.aspx>)

Extract A

European Central Bank disappoints markets with weaker than expected stimulus

Mario Draghi, president of the European Central Bank (ECB), surprised financial markets in November 2015 with a less ambitious package of monetary stimulus than many had anticipated.

The ECB cut its base interest rate by 0.1% to minus 0.3% in order to encourage private banks to lend funds to companies and households rather than deposit them at the central bank. The central bank agreed to extend its €60 billion (£45 billion) monthly bond-buying quantitative easing (QE) programme for a further six months. The ECB's €1.1 trillion QE scheme had originally been due to end in September 2016. 5

"We are doing more because it works," Mr Draghi said. Yet the ECB did not increase the size of its monthly asset purchases and also disappointed those expecting that it would cut interest rates more aggressively. 10

The euro rose almost 3% against the dollar to \$1.08 after the announcement. Italian and Spanish bond yields both jumped by 0.27% to 1.62% and 1.72% respectively.

The ECB's economists reduced their inflation forecasts for the next two years. They now predict consumer prices in the Eurozone rising by just 1% in 2016 and 1.6% in 2017 – still below the central bank's ceiling of 2%. In November 2015, the inflation rate was just 0.1% and core inflation, excluding volatile items such as fuel and food, dropped to 0.9%. 15

Mr Draghi stressed again that monetary policy alone could not restore the Eurozone to economic health. He called for looser fiscal policy among member states to support aggregate demand and more rapid implementation of supply-side reforms. "In order to reap the full benefits from our monetary policy measures, other policy areas must contribute decisively," he said. 20

(Source: <http://www.independent.co.uk/news/business/news/ecb-disappoints-traders-with-weaker-than-expected-stimulus-a6759786.html>, 4th December 2015)

8 Since mid-2015 the euro has appreciated. Assess the likely impact of an appreciation of the euro on the current account of the balance of payments for Eurozone countries.

(10)

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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.

(Total for Question 8 = 10 marks)

Question 9

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)

(a) With reference to Figure 1, explain the term 'net trade'.

(4)

A series of horizontal dotted lines for writing the answer.

(b) With reference to the information provided and your own knowledge, assess the likely causes of the UK's trade deficit.

(10)

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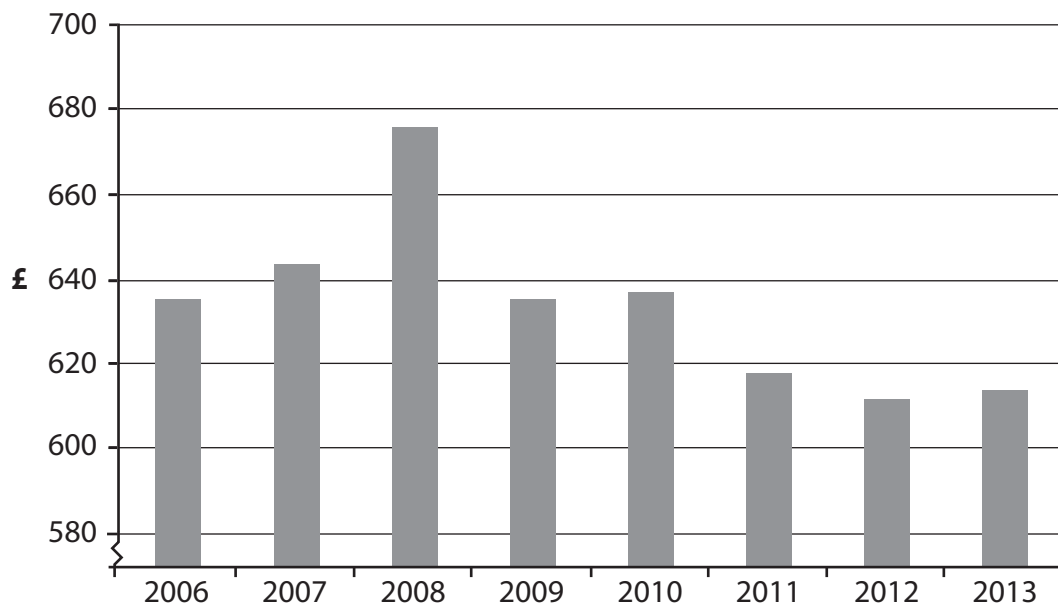
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(Total for Question 9 = 14 marks)

Question 10

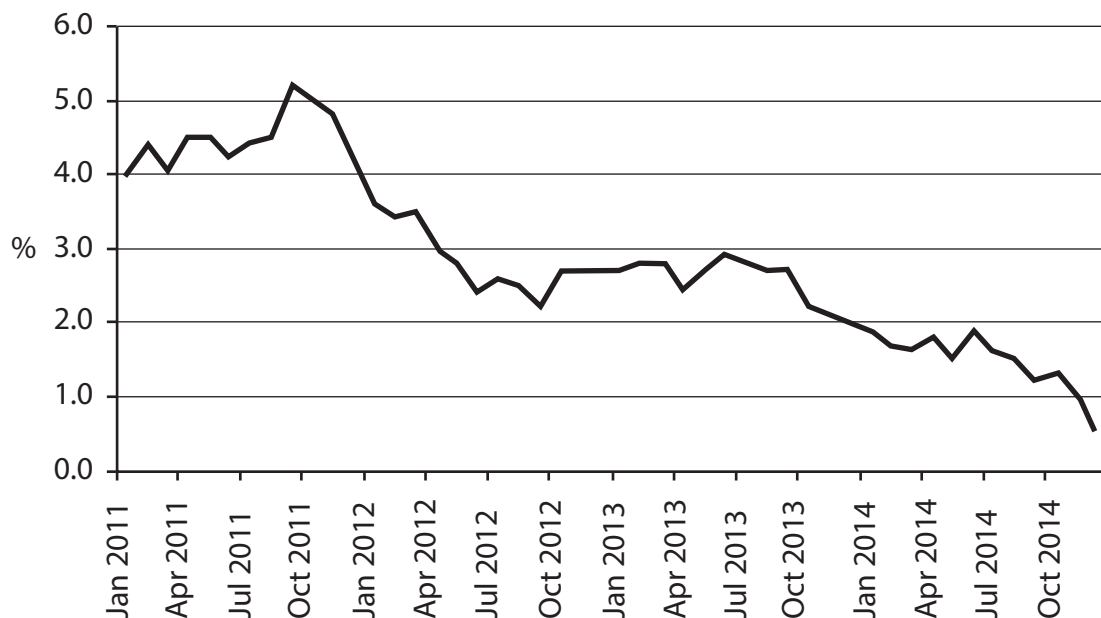
UK incomes, inflation and monetary policy

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>)

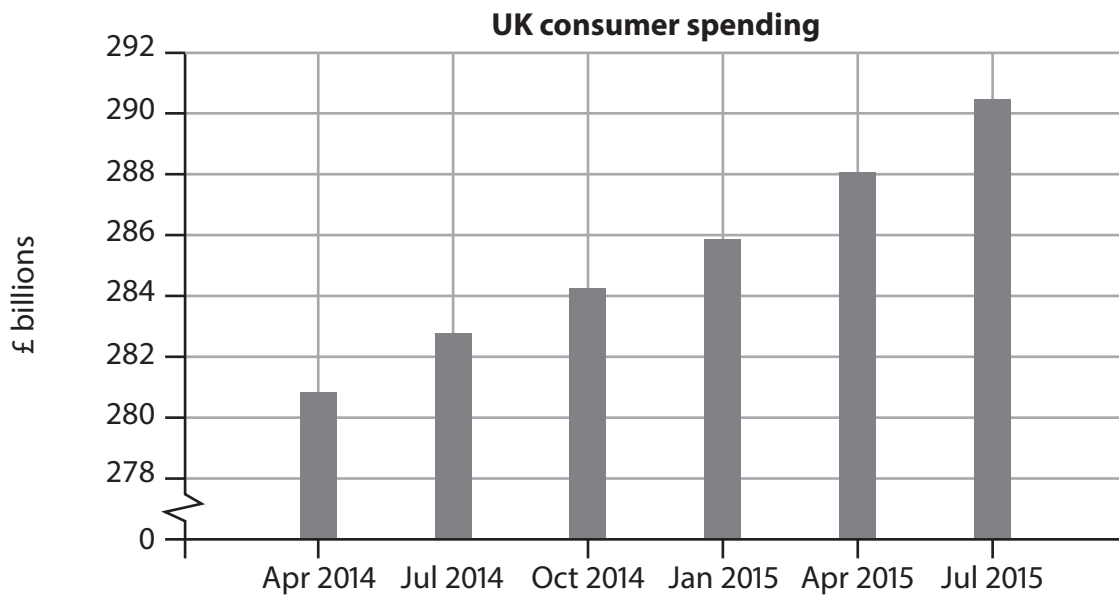
10 With reference to Extract A, explain the likely effect of a rise in the value of the pound on aggregate demand.

(5)

(Total for Question 10 = 5 marks)

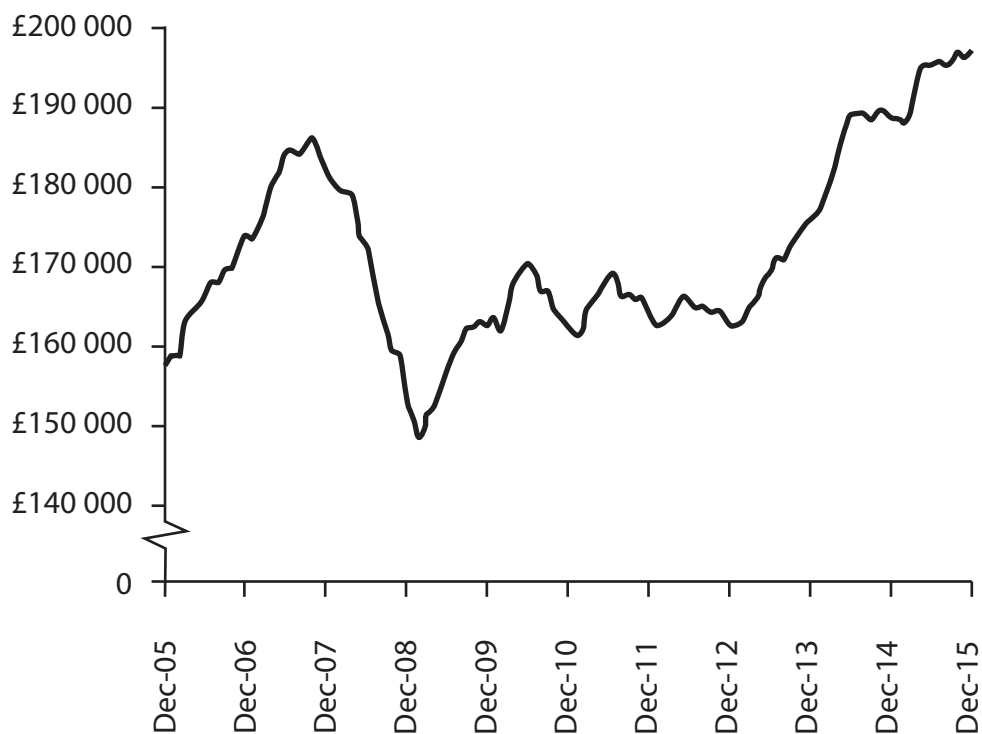
11 Stability of the UK economy

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.

11 With reference to the information provided and your own knowledge, evaluate the likely impact of a fall in the value of exports on the UK economy.

(12)

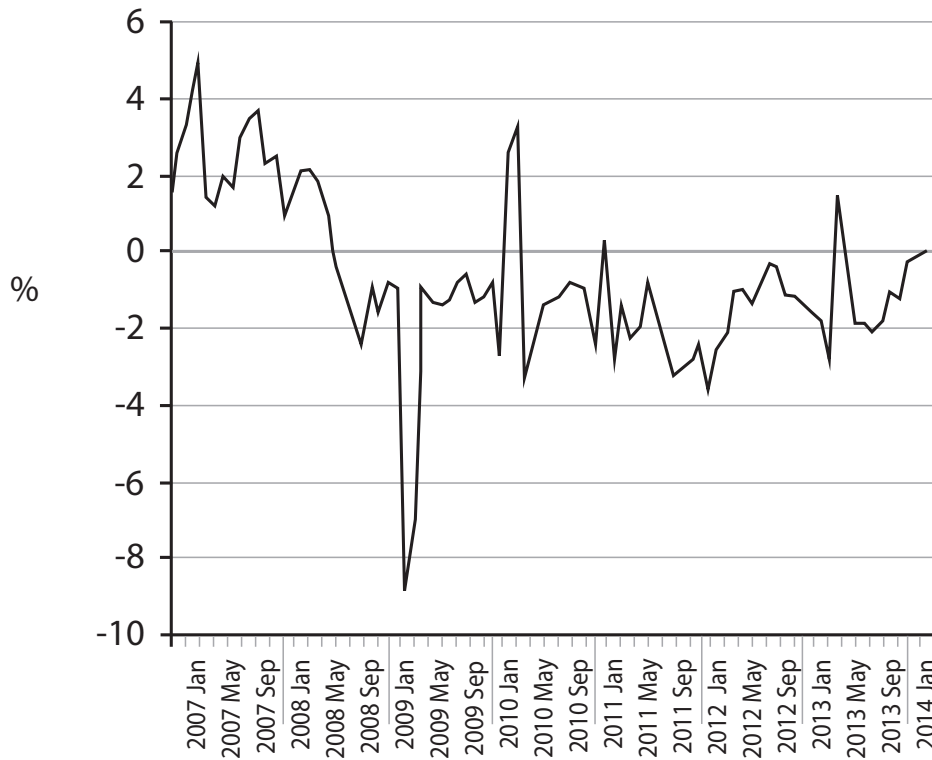
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(Total for Question 11 = 12 marks)

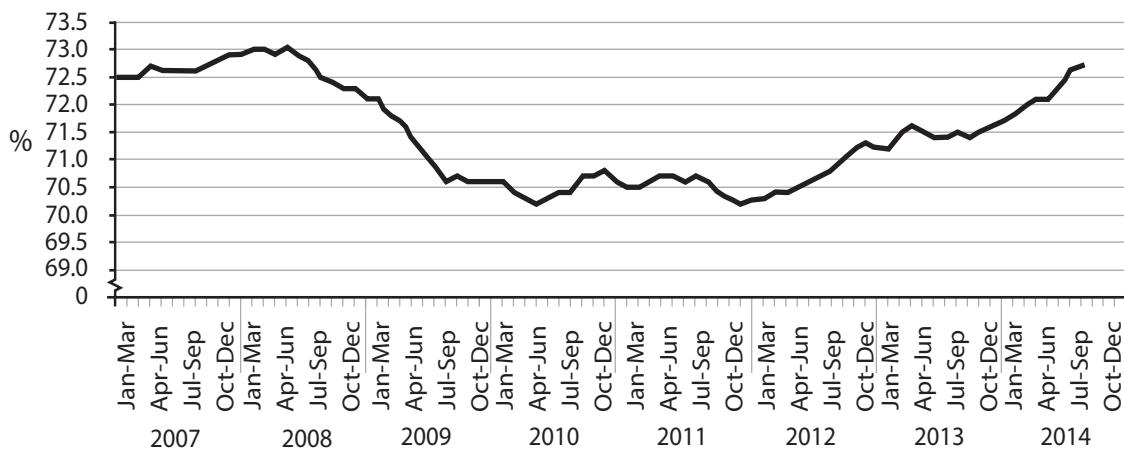
12 UK wages, employment, migration and the trade deficit

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



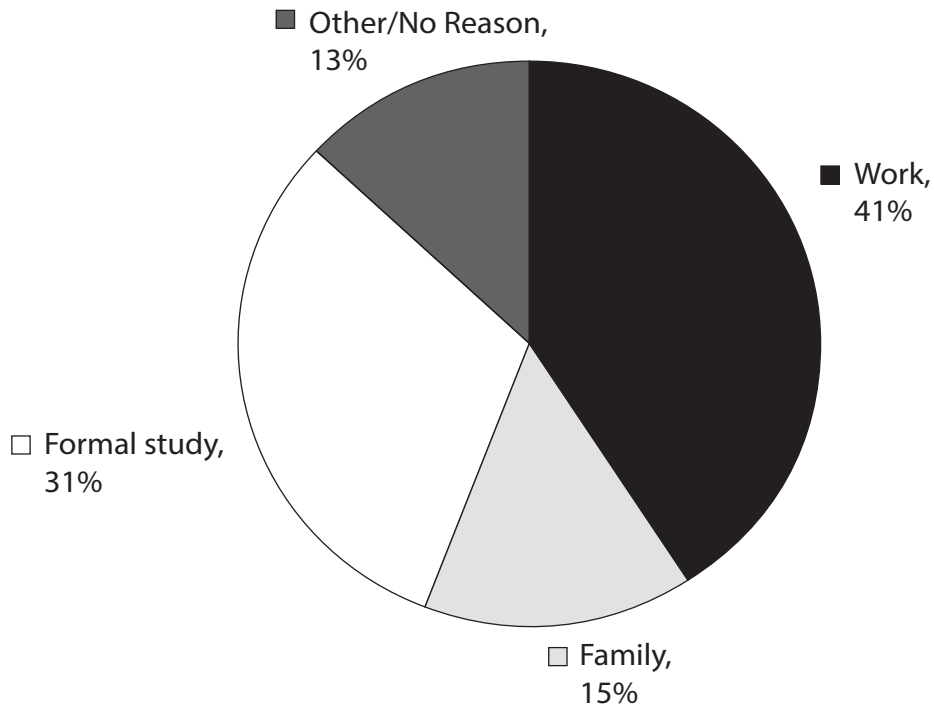
(Source: © ONS Economic Review June 2014, http://www.ons.gov.uk/ons/dcp171766_365818.pdf)

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)

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)

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)

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>)

*** (a)** With reference to Extract 2 paragraph 1, evaluate the likely impact of the UK's deteriorating trade balance on the UK's price level and real output. Use an aggregate demand and aggregate supply diagram in your answer.

(12)

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(b) Explain the likely consequence of weakness in the eurozone economy for the UK's balance of trade.

(6)

A series of horizontal dotted lines provided for writing the answer.

(c) Explain **two** likely effects of 'the recent fall in the value of sterling' (Extract 2, lines 17-18) on the UK economy.

(8)

A series of horizontal dotted lines provided for the student to write their answer.

(Total for Question 12 = 26 marks)

13 UK investment, productivity and the balance of payments

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

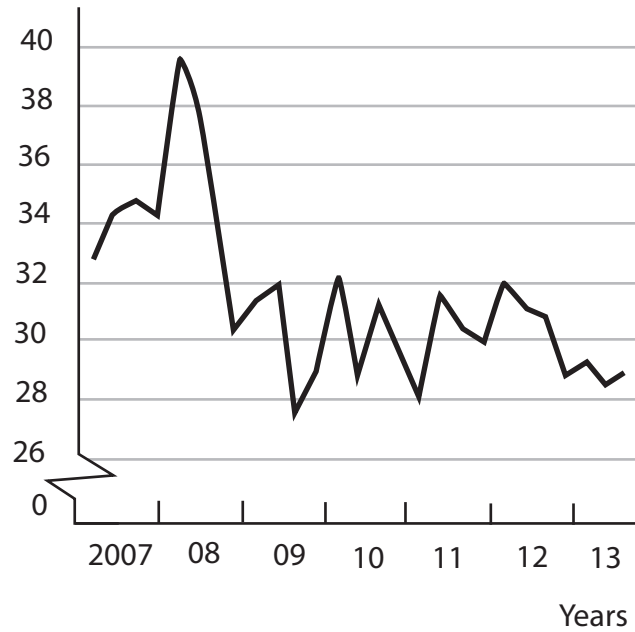
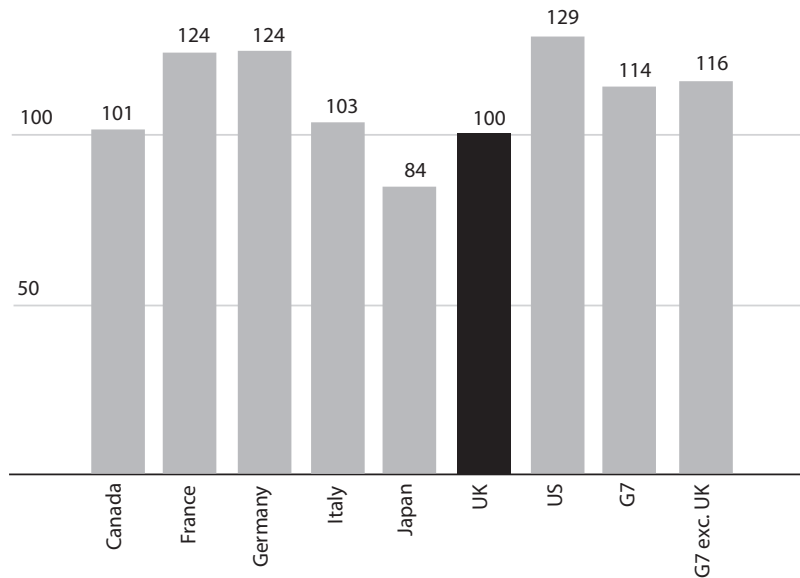
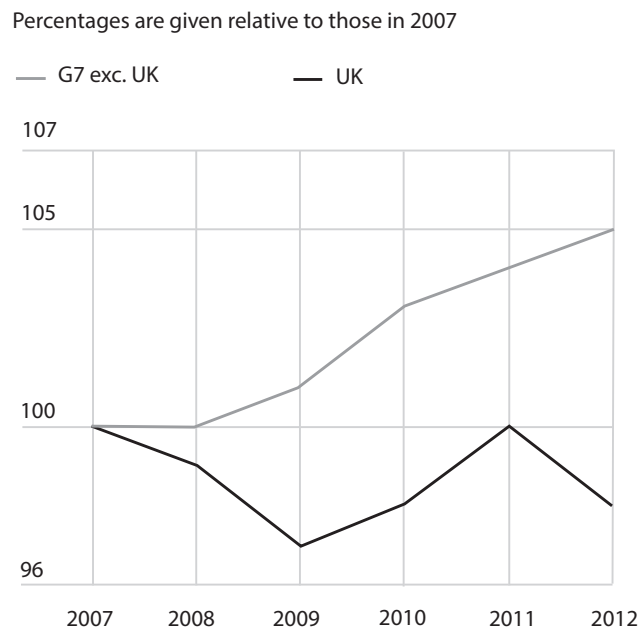


Figure 2 GDP per hour worked relative to the UK in 2012



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

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>)

(a) Outline the main components of the current account of the balance of payments.

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(b) Analyse **two** reasons, apart from the UK's productivity performance, that might explain the deficit in the current account of the balance of payments.

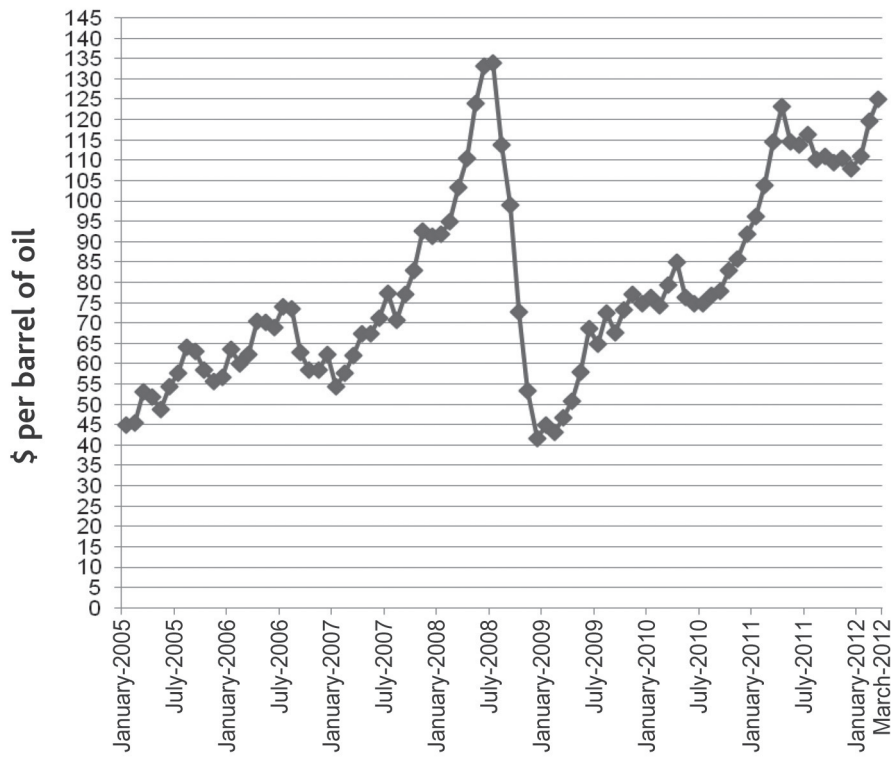
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(Total for Question 13 = 12 marks)

14 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)

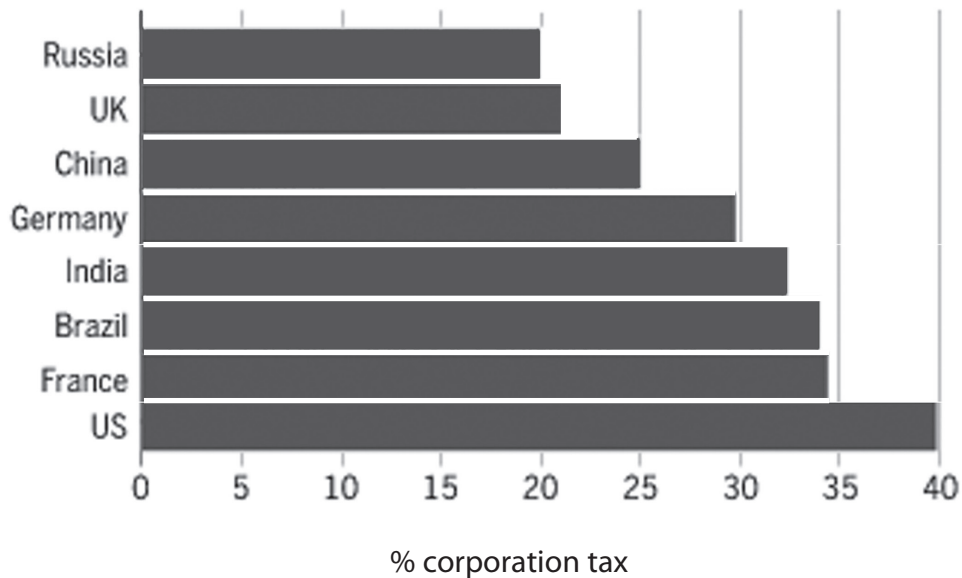
Extract 2 Business Investment and Corporation tax

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)

(a) With reference to Extract 1, define a “deficit in the trade of goods and services on the current account of the balance of payments” (lines 2–3).

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(b) Explain **two** likely costs to the UK economy of a sustained UK deficit in the trade of goods and services on the current account of the balance of payments.

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* (c) With reference to Extract 1, assess the likely effect of a fall in the sterling exchange rate on the UK's deficit in the trade of goods and services.

(12)

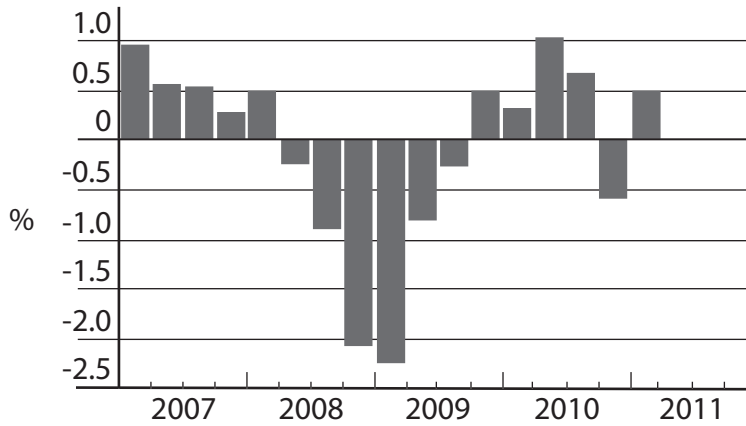
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(Total for Question 14 = 24 marks)

Question 15

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
Subtotal: Trade in goods and services	-29.7	-48.5
Income (interest, profits and dividends)	20.6	31.8
Current transfers	-4.9	-19.7
Total: Current account balance	-14.0	-36.4
Current account balance as % of GDP	-1.7%	-2.5%

(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)

(a) Explain **two** possible problems for the UK economy of its persistent and increasing current account deficit.

(8)

A series of horizontal dotted lines provided for writing the answer to the question above.

***(b)** Examine **two** possible causes of the “largest ever recorded trade in goods deficit in 2010” (Extract 1, lines 11-12).

(12)

A series of horizontal dotted lines for writing the answer.

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(Total for Question 15 = 20 marks)

16 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. 5

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. 10

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

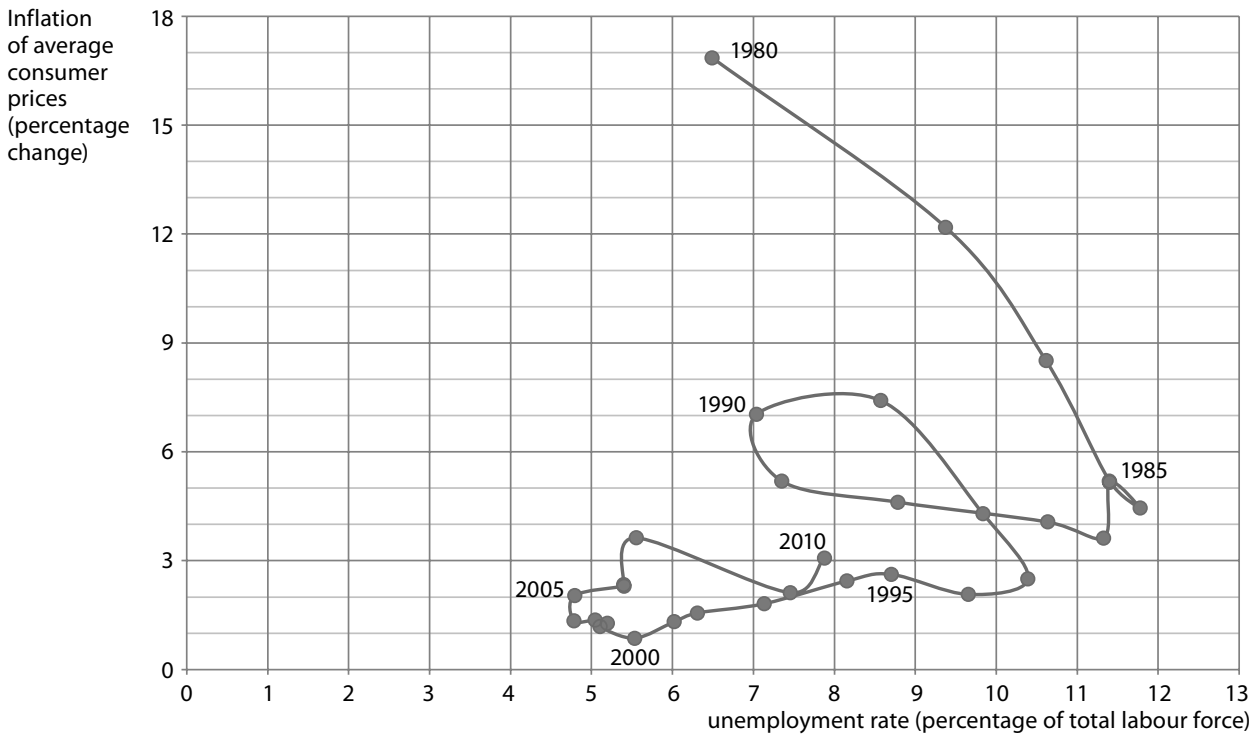
<http://www.ft.com/cms/s/0/d29d8984-1aea-11df-88fa-00144feab49a.html> and
<http://www.ft.com/cms/s/3/3963580c-1199-11df-9195-00144feab49a.html>

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 5

<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>

16 Assess the extent to which a sharp depreciation of the pound will improve the UK current account of the balance of payments.

(12)

A series of horizontal dotted lines for writing the answer.

Blank lined writing area for student response.

(Total for Question 16 = 12 marks)

17 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.

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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.

(a) With reference to Figure 2, explain the term *exchange rate*.

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(b) Using the data in Figure 2, calculate the percentage change in the value of the pound against the Euro between 2004 and 2009.

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(Total for Question 17 = 38 marks)

Question 18

Measures of economic performance

Figure 1 Measures of economic performance, selected developed countries

	Economic growth % (2006)	Inflation (% increase in CPI) (2006)	Current account of the Balance of Payments (% of GDP) (2006)	Human Development Index (HDI) value (2005)
France	2.0	1.8	-1.8	0.952
Germany	2.0	1.8	5.1	0.935
Spain	2.7	2.8	-10.2	0.949
United Kingdom	2.3	2.0	-3.6	0.946

Source: www.imf.org (2007 report) and www.undp.org (2007 report of HDI based on 2005 values)

Figure 2 School enrolment figures and HDI ranks, selected developed and developing economies (2005)

Economy	Combined enrolment ratio for primary and secondary education (%)	HDI Rank
France	99	10
Spain	98.5	13
United Kingdom	97	16
Pakistan	44.5	136
Kenya	60.5	148
Ethiopia	44.5	169
Niger	24	174

Source: <http://hdr.undp.org/en/statistics> (2007 report based on 2005 figures)

18 Outline **two** possible reasons for Spain's current account balance, with reference to the data in Figure 1.

(6)

(Total for Question 18 = 6 marks)

END OF SECTION B