EXPERT TUITION

Economics Questions By Topic:

Inflation & Deflation (2.1.2)

A-Level Edexcel Theme 2

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SECTION A

Write your answers in the spaces provided.

1 In October 2019 the annual rate of inflation in the UK was 1.5%, as measured by the Consumer Prices Index (CPI), and 2.1%, as measured by the Retail Prices Index (RPI).

(a) Define the term 'inflation'.

(1)

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(b) Explain **one** likely cause of inflation.

(2)

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(c) From the above data, it can be deduced that the percentage point difference between CPI and RPI was:

(1)

☒ **A** 0.0

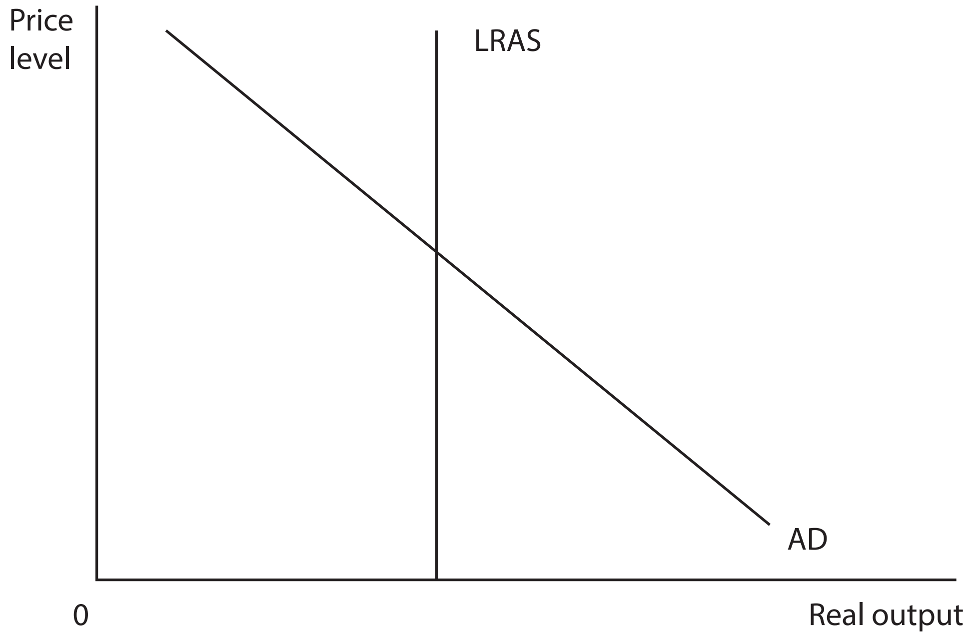
☒ **B** 0.2

☒ **C** 0.4

☒ **D** 0.6

(Total for Question 1 = 4 marks)

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



(a) Define the term 'price level'.

(1)

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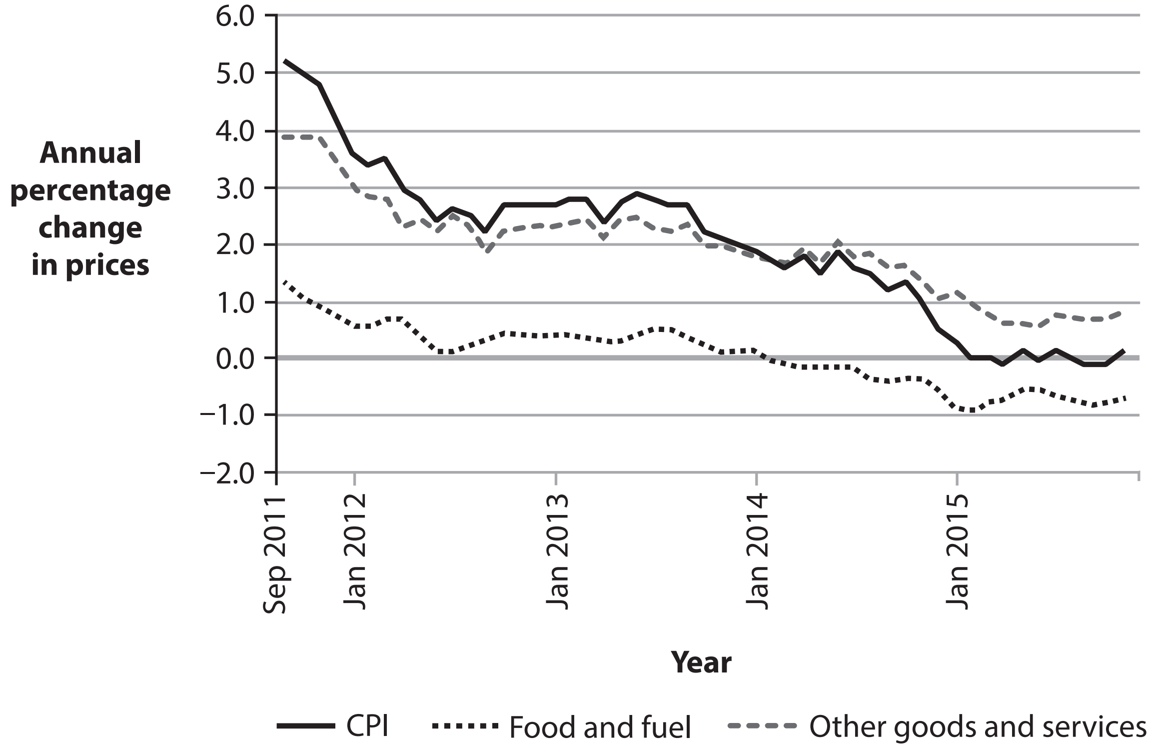
....

....

(Total for Question 2 = 4 marks)

3 The chart below shows UK inflation as measured by the Consumer Prices Index (CPI), 2011 to 2015.



(Source: http://www.ons.gov.uk/ons/dcp171780_427182.pdf)

(a) Which **one** of the following statements is correct about the UK's inflation record between September 2011 and January 2013?

Based on the data shown, the UK experienced:

(1)

☒ **A** deflation

☒ **B** disinflation

☒ **C** falling average prices

☒ **D** falling money supply

(b) With reference to the data provided, explain the process of calculating the rate of inflation in the UK using the Consumer Prices Index. Refer to the concept of weights in your answer.

(4)

(Total for Question 3 = 5 marks)

4 UK Consumer Prices Index (the base year 2005=100)

September 2013	126.8
September 2014	128.4
September 2015	128.2

(Source: http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-323657)

(a) Calculate the percentage change in the UK Consumer Prices Index from September 2014 to September 2015. You are advised to show your working.

(2)

....

....

....

....

(b) Define the term 'deflation'.

(1)

....

....

(c) Which **one** of the following is most likely to be a cause of deflation? A fall in:

(1)

☒ **A** oil prices

☒ **B** unemployment

☒ **C** income tax rates

☒ **D** interest rates

(Total for Question 4 = 4 marks)

END OF SECTION A

SECTION B

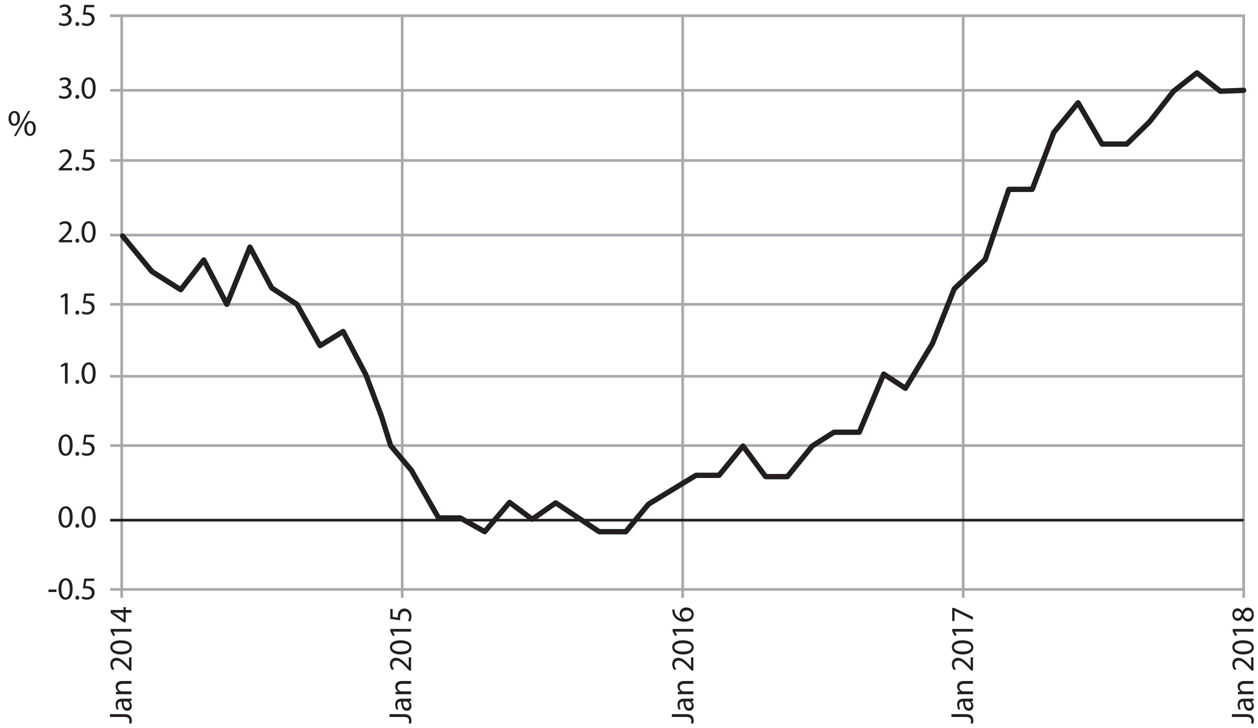
Read all extracts/figures before answering.

Write your answers in the spaces provided.

Question 5

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



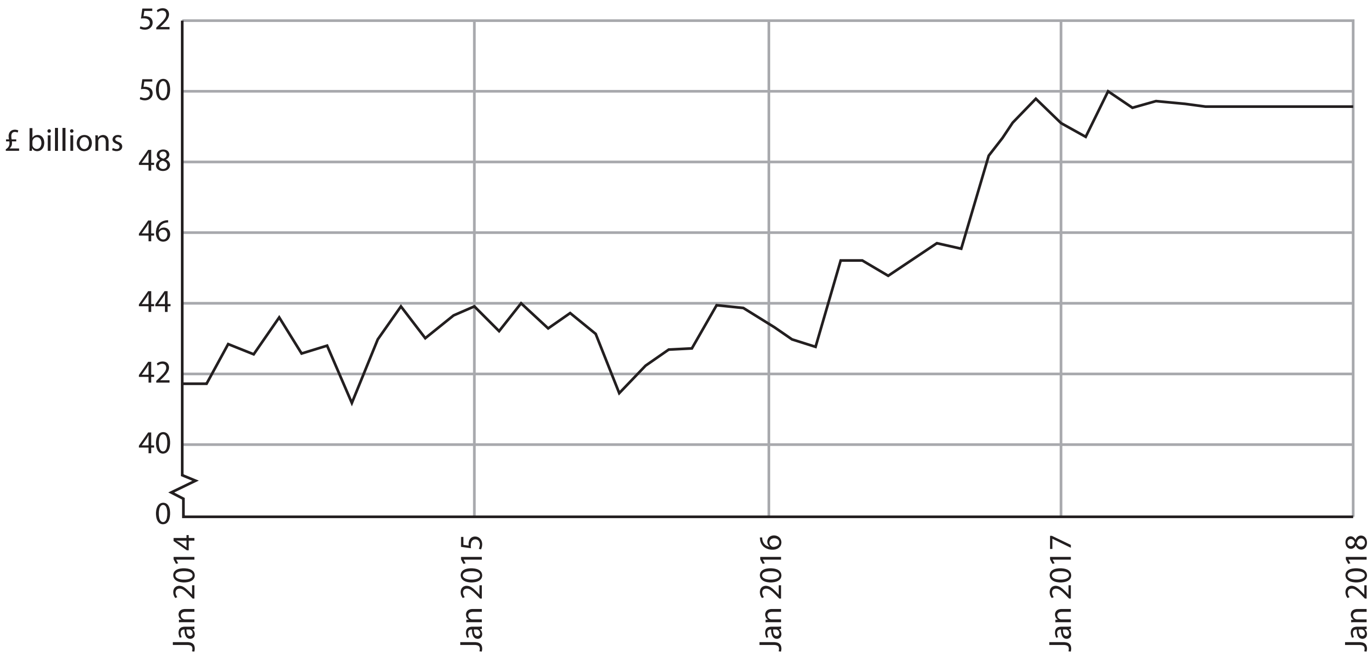
(Source: www.bankofengland.co.uk/publications/Pages/inflationreport/2017/aug.aspx)

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.

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.

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.

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.

(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.

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.

(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/)

(a) 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)

(b) With reference to Extract A, explain **two** likely economic effects of the higher rate of UK inflation.

(6)

(c) With reference to the last paragraph of Extract A and Figure 2, explain **one** reason why it is necessary to regularly update the CPI basket of goods and services.

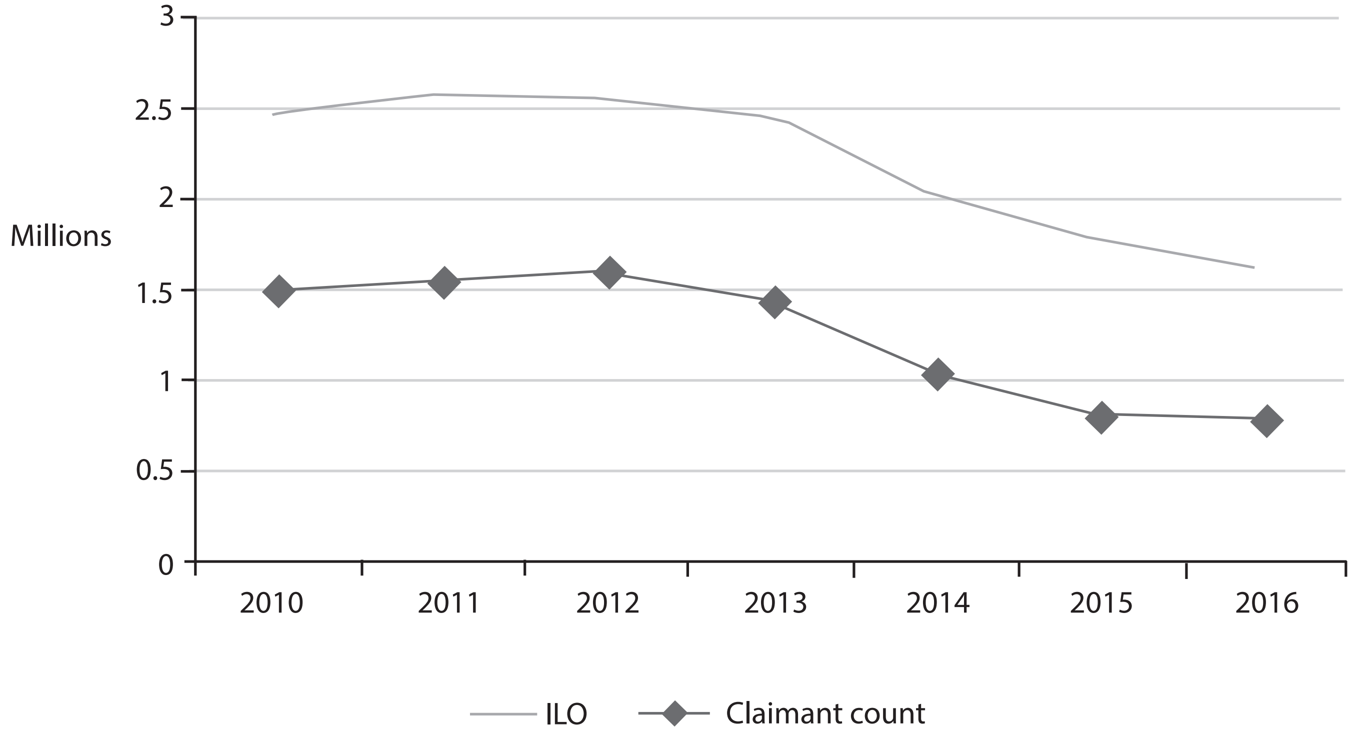
(5)

(Total for Question 5 = 15 marks)

Question 6

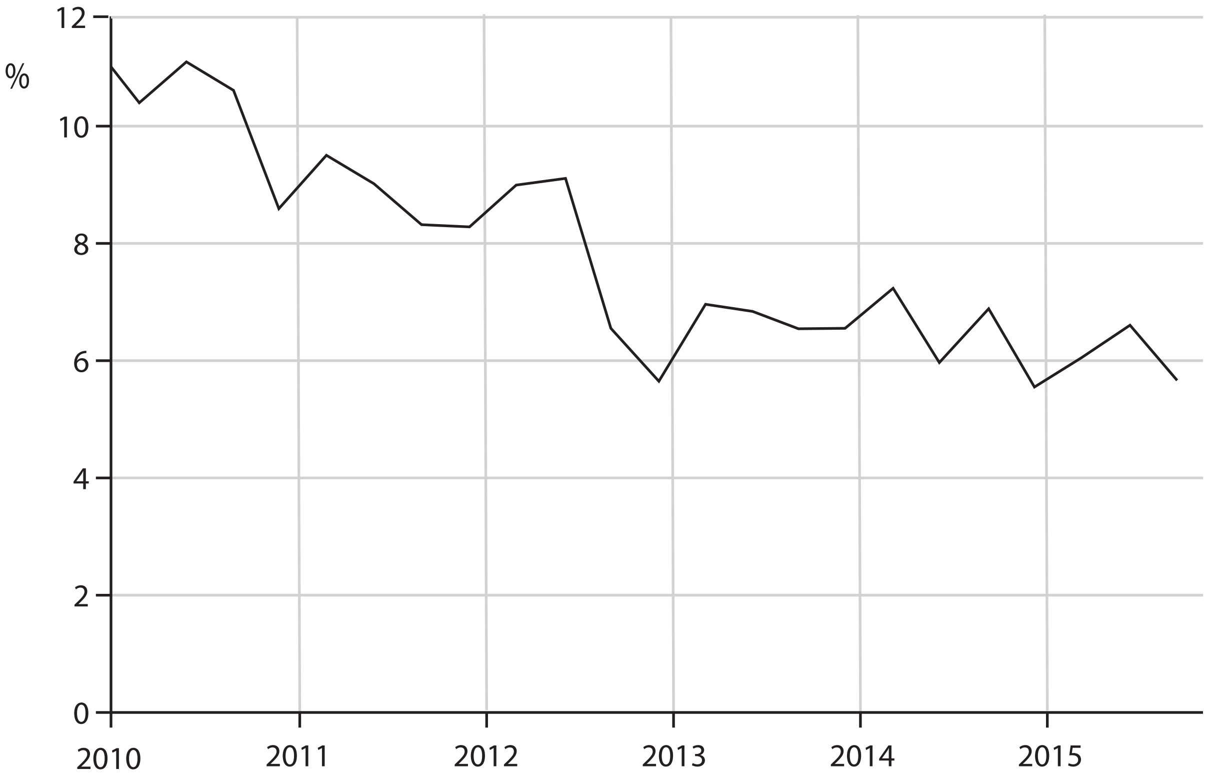
The UK economy

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.

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.

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.

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.

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.

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

6 Evaluate the likely impact of high inflation on the UK government's macroeconomic objectives.

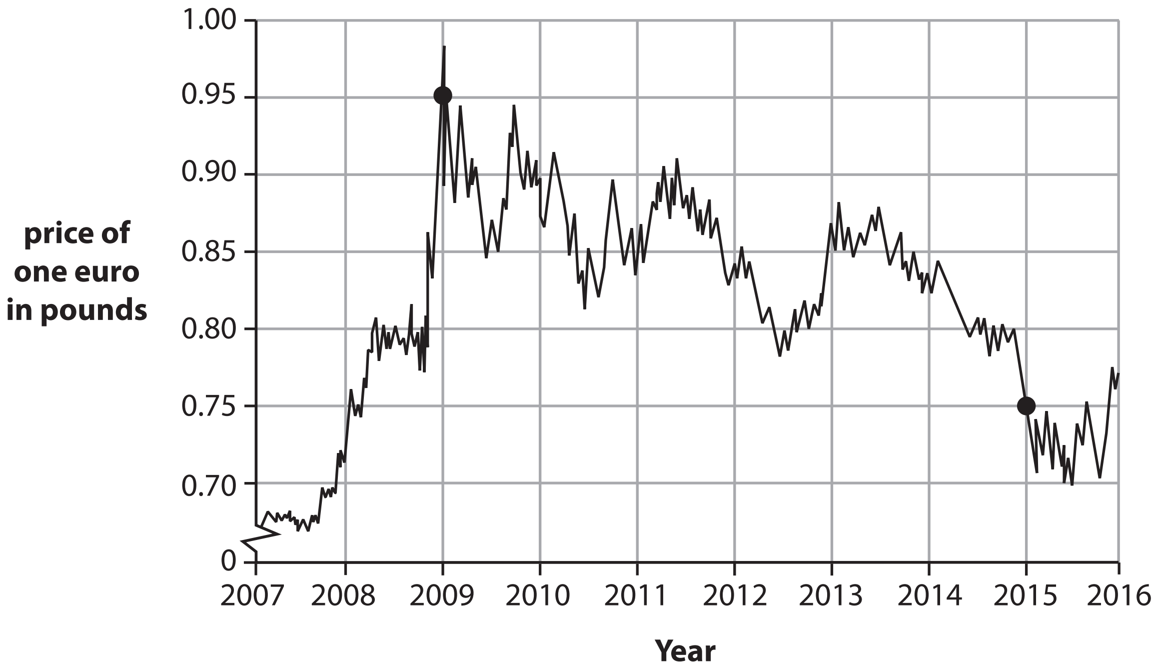
(20)

(Total for Question 6 = 20 marks)

Question 7

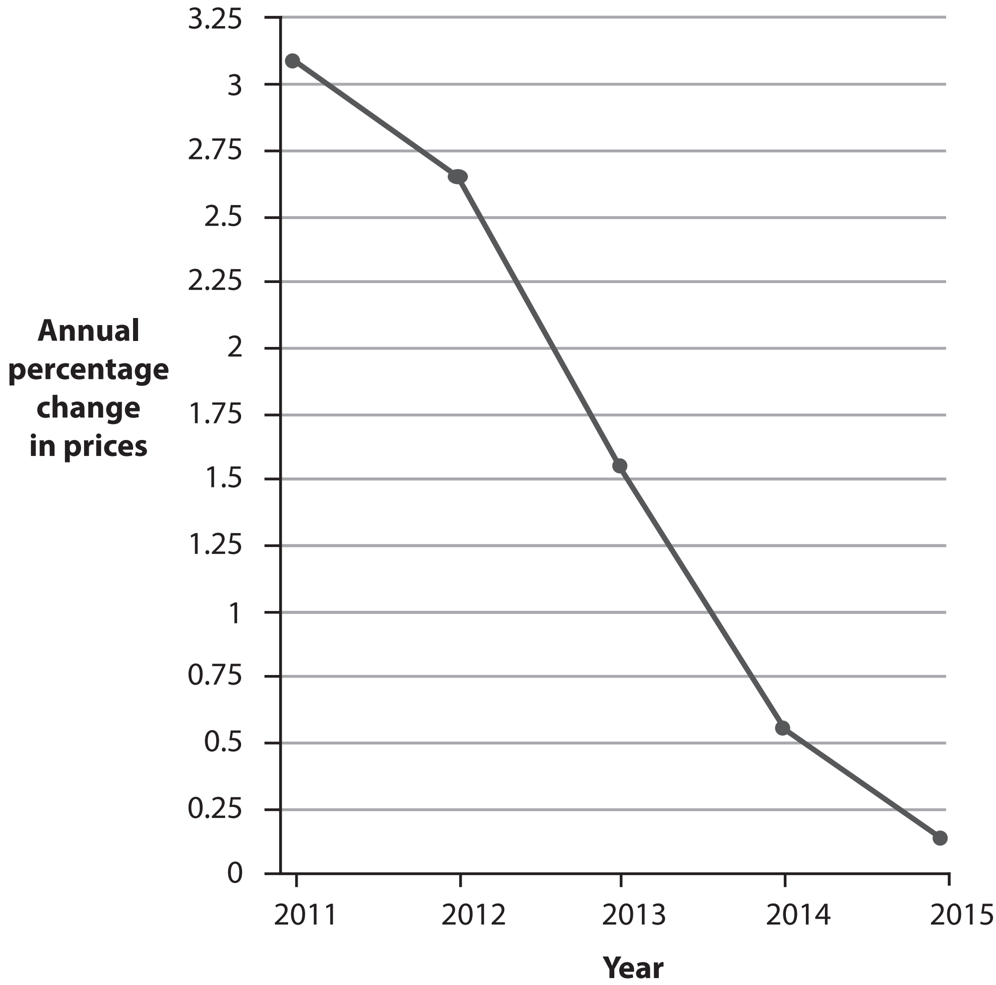
The Eurozone economy

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.

"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.

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%.

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.

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

7 With reference to the information provided and your own knowledge, examine **two** factors which might explain the change in the rate of Eurozone inflation as shown in Figure 2.

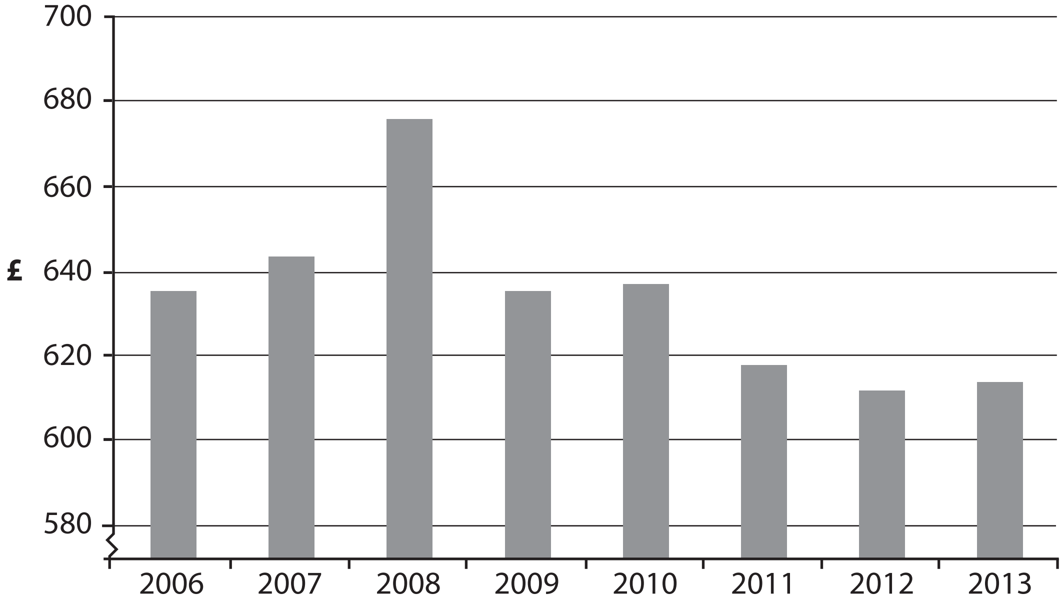
(8)

(Total for Question 7 = 8 marks)

Question 8

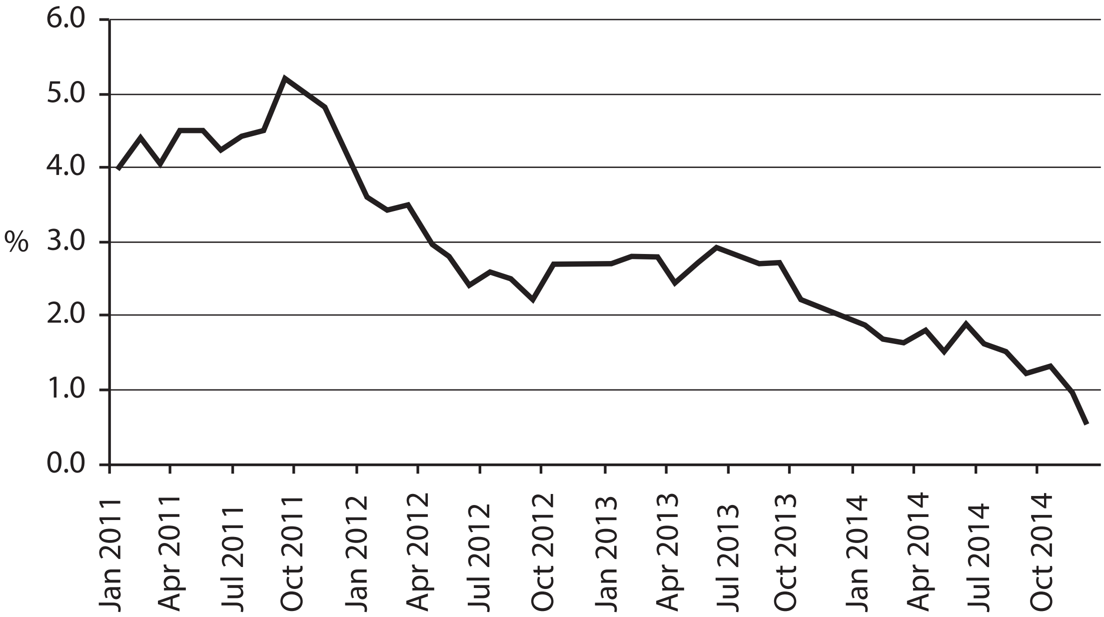
UK incomes, inflation and monetary policy

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.

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.

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.

"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.

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.

(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)

(a) With reference to the data, explain **two** likely reasons for the UK's falling inflation rate.

(6)

(b) With reference to Extracts A and B and your own knowledge, discuss whether the MPC should be concerned about the risk of deflation in the UK economy.

(15)

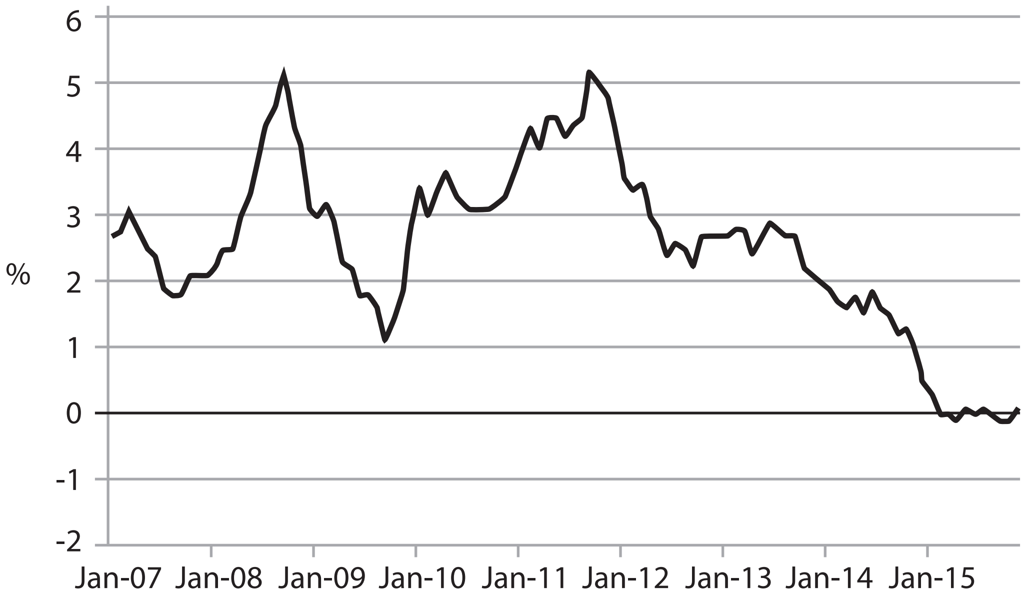
(c) Evaluate whether the MPC has been successful in controlling the UK's inflation rate since 2011.

(20)

(Total for Question 8 = 41 marks)

9 UK inflation

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

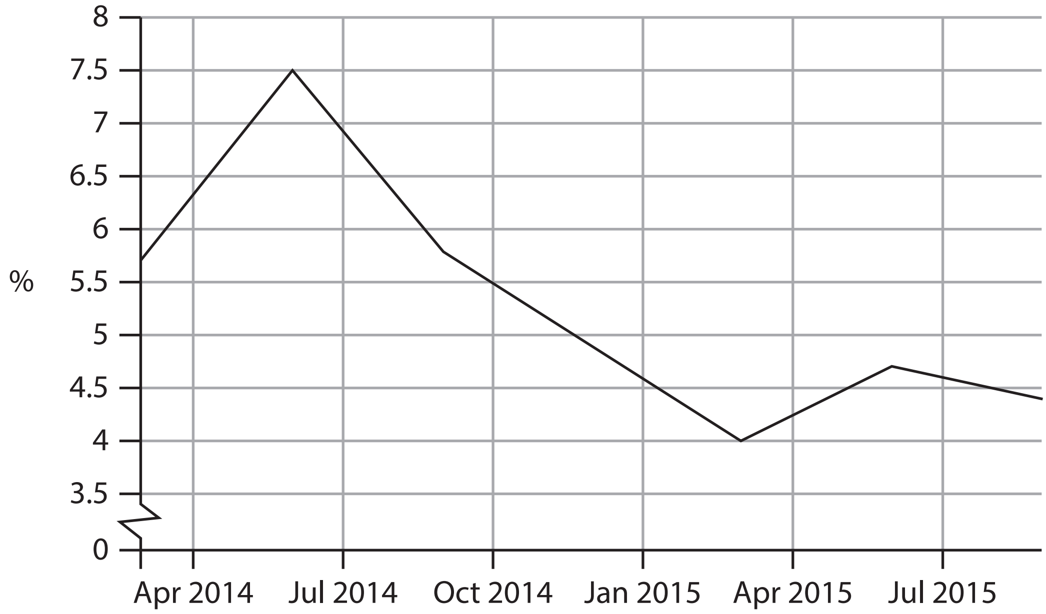


(Source: http://www.ons.gov.uk/ons/dcp171780_427182.pdf)

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.

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.

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.

  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**

  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.

- **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."

- **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

(a) (i) Explain how the UK rate of inflation as measured by the CPI is calculated. Refer to the concept of weights in your answer.

(4)

(ii) With reference to the information provided, explain **two** causes of the fall in the UK's rate of inflation since 2012.

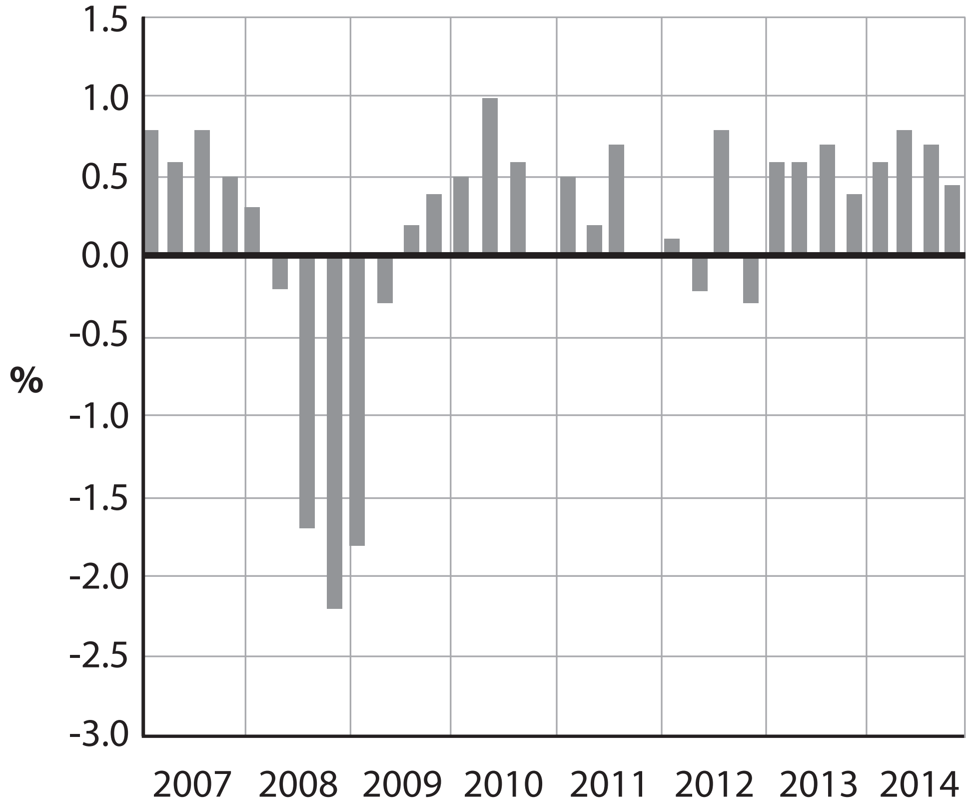
(8)

(b) With reference to the information provided, discuss **two** likely effects of a fall in the average price level on the UK economy.

(12)

(Total for Question 9 = 24 marks)

Figure 1 UK real GDP growth, quarter on previous quarter



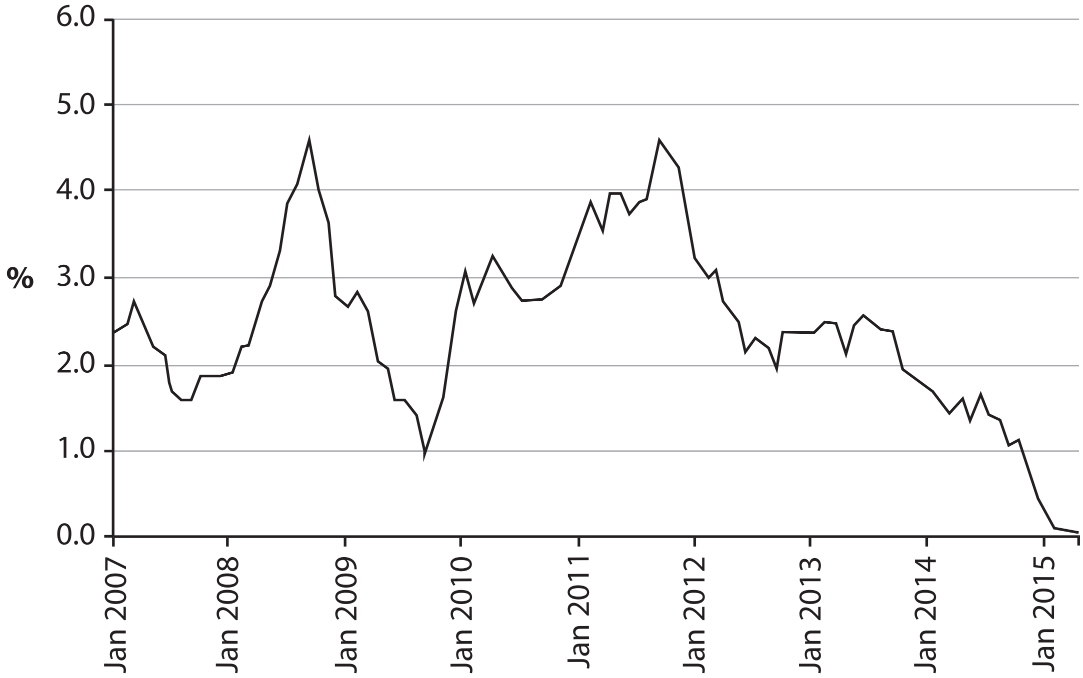
(Source: ONS, http://www.ons.gov.uk/ons/dcp171778_392909.pdf)

Figure 2 Top 5 countries in the Human Development Index (HDI)

HDI Rank	Country	Human Development Index 2013	Life expectancy at birth 2013 (years)	Mean years of schooling 2012	Expected years of schooling 2012	Gross national income per capita 2013 (2011 PPP US$)
1	Norway	0.944	81.5	12.6	17.6	63 909
2	Australia	0.933	82.5	12.8	19.9	41 524
3	Switzerland	0.917	82.6	12.2	15.7	53 762
4	Netherlands	0.915	81.0	11.9	17.9	42 397
5	United States	0.914	78.9	12.9	16.5	52 308

(Source: © United Nations Human Development Report, http://hdr.undp.org/en/content/table-1-human-development-index-and-its-components)

Figure 3 UK Consumer Price Index (CPI) Inflation



(Source: © Bank of England Inflation Report February 2015, http://ons.gov.uk/ons/rel/cpi/consumer-price-indices/april-2015/consumer-price-inflation-summary--april-2015.html)

Extract 1 Bank of England could raise interest rates next spring, says Monetary Policy Committee (MPC) member

A Bank of England policymaker, Ian McCafferty, has reinforced expectations that the first rise in interest rates will come as soon as Spring 2015, in remarks that pushed up the UK's exchange rate.

Under Governor Mark Carney, earlier this month the Bank overhauled its forward guidance policy on when rates would rise from their record low of 0.5%. At the time it said a view in the financial markets that rates could rise in the second quarter of 2015 was consistent with its goal of keeping inflation close to the Government-set 2% target.

"The exact timing of course is going to depend on events that have yet to unfold in terms of how the recovery proceeds over the course of the next six to 12 months or so" said Ian McCafferty. He added that he was watching for pressures on inflation from pay deals negotiated in coming months. After years above its target, inflation has now fallen below 2% to stand at 1.9% in January 2014.

"If we did see some inflationary pressure – more than we currently expect in our central case – that would if anything, I suspect, lead the Committee to consider slightly earlier rate rises."

(Source: adapted from © Guardian Newspaper Ltd., February 2014, http://www.theguardian.com/business/2014/feb/25/bank-england-raise-interest-rates-2015-mpc-mccafferty)

(a) Explain how the CPI measure of inflation is calculated. Refer to the concept of weighting in your answer.

(6)

(b) Explain **two** factors that might encourage the Monetary Policy Committee of the Bank of England to increase the UK base rate of interest.

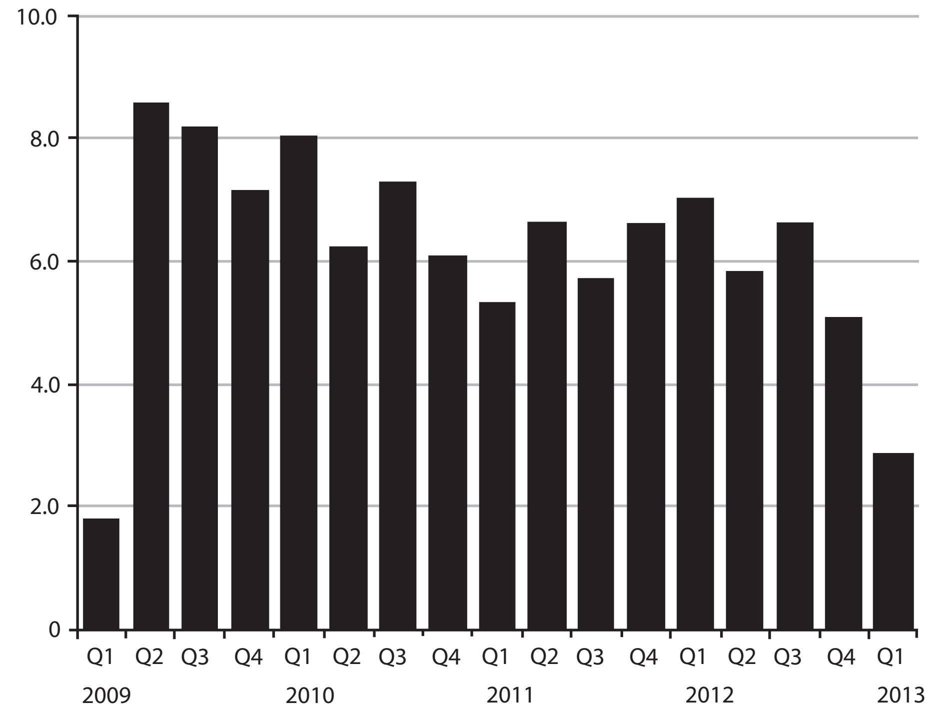
(8)

(c) Examine whether a very low rate of inflation is desirable for the UK economy. **(12)**

(Total for Question 10 = 26 marks)

11 Savings, GDP, housing market and monetary policy

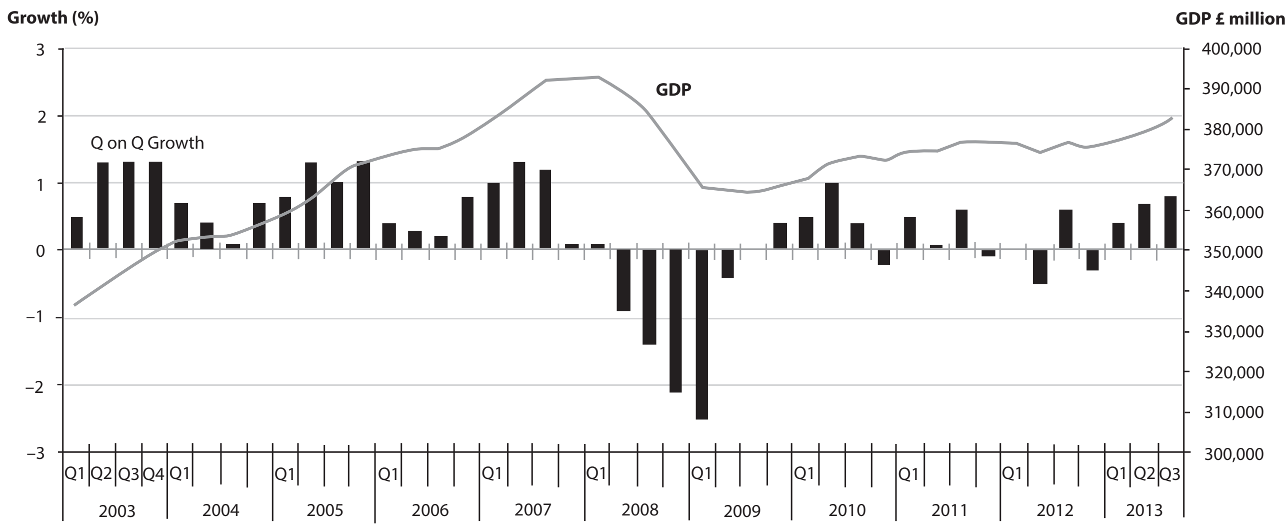
Figure 1 UK household savings ratio*



*Savings as a percentage of household disposable income

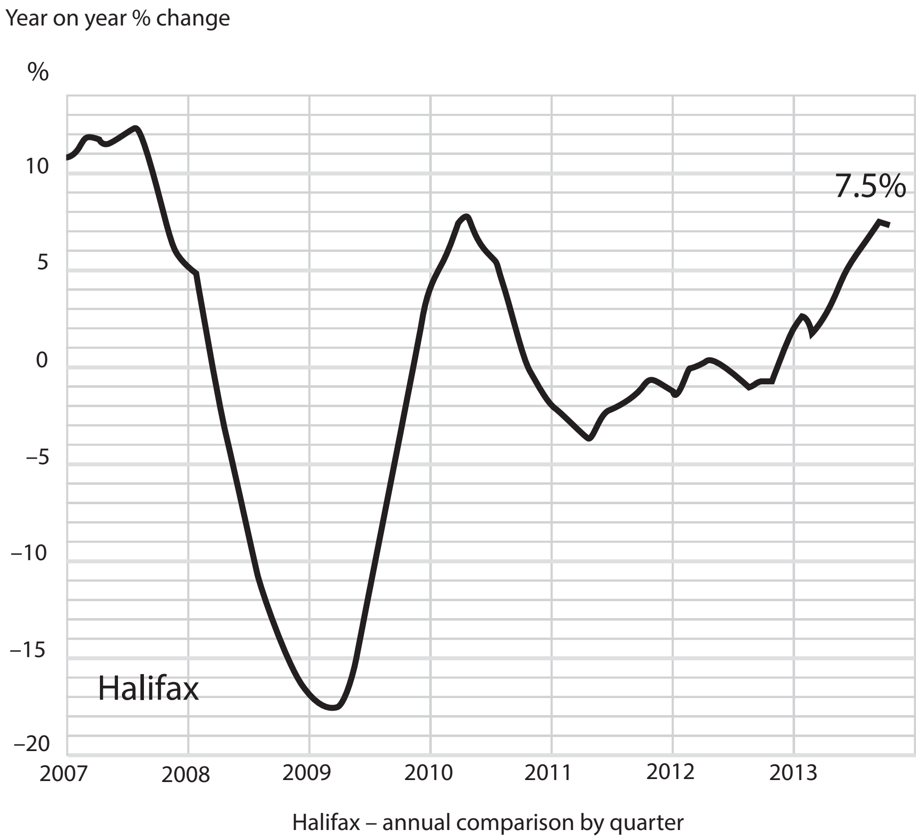
(Source: http://www.ons.gov.uk/ons/publications/re-referencetables.html?edition=tcm%3A77-324888)

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



(Source: http://www.ons.gov.uk/ons/resources/figure3_tcm77-332895.png)

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.

(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)

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.

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 reinflate the economy. Normalising monetary policy will take many years.

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.

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

11 Evaluate **two** benefits of low and stable inflation for the UK economy.

(12)

(Total for Question 11= 12 marks)

12 Inflation, living standards and monetary policy

Figure 1
UK Consumer Price Index (CPI)

	UK CPI (Annual Average) 2005 = 100	UK CPI percentage change over 12 months
2008	108.5	3.6%
2009	110.8	2.2%
2010	114.5	3.3%
2011	119.6	4.5%
2012	123.0	2.8%

(Source: adapted from data from the Office for National Statistics licensed under the Open Government Licence v.1.0.)

Extract 1
Living standards fall in the UK and inequality rises between generations

According to the Institute for Fiscal Studies the standard of living in Britain has fallen as the average household income fell by 2.4% over the period 2008–9 to 2010–11.

This has coincided with rising inequality of income between different generations. Using data from government income surveys of more than 750 000 households, analysis by the Financial Times shows that the average real household disposable income for people aged 20–29 fell 6.3% between 2008–09 and 2010–11. This figure takes account of CPI inflation reducing the purchasing power of money. If housing costs are included, the fall was even larger, at 9%.

In contrast, households with people in their 60s, 70s and 80s saw average real disposable incomes rise by about 1% over the same two-year period. That finding supports a longer-term study by the Office for National Statistics showing that pensioners saw the fastest growth in living standards for any group in Britain during the past 35 years.

According to Robert Joyce of the Institute for Fiscal Studies, the government’s planned changes to the tax and benefit system up to 2015 will mean pensioner households will lose less on average than younger adults aged 20–29, who will see their living standards squeezed further. This latter age group is particularly affected by a high rate of unemployment, annual benefit rises capped at 1% in nominal terms and falling real wages.

(Source: © The Financial Times Ltd 2013)
(Source: Adapted from www.ifs.org.uk/comms)

Extract 2
Inflation

Recessions are normally associated with falling inflation rates. However, since the recession started in 2008 the Bank of England's Monetary Policy Committee (MPC) has overseen several periods in which inflation has exceeded the upper limit of the target inflation rate's tolerance. There have been four sources of inflationary pressure. First, oil prices rose sharply because of popular unrest in many Arab nations which led to the development of uncertainty around the security of supply. Secondly, a period of bad weather resulted in harvest failure in many areas and wheat prices soared. In addition, the sterling exchange rate has weakened and since 2008 it has fallen by around 25% against the U.S. dollar. A final factor was the increase in VAT from 15% to 17.5% in January 2010 and then in January 2011 it was raised to 20%.

The monetary tools available to the MPC of the Bank of England have most impact on the demand side of the economy, which has been weak and was not the source of the inflationary shocks. The danger with raising interest rates to achieve the inflation target in the short term is that they might weaken the economy further.

(Based on a variety of media sources)

(a) Explain **two** reasons why the government has a low rate of inflation as a macroeconomic objective.

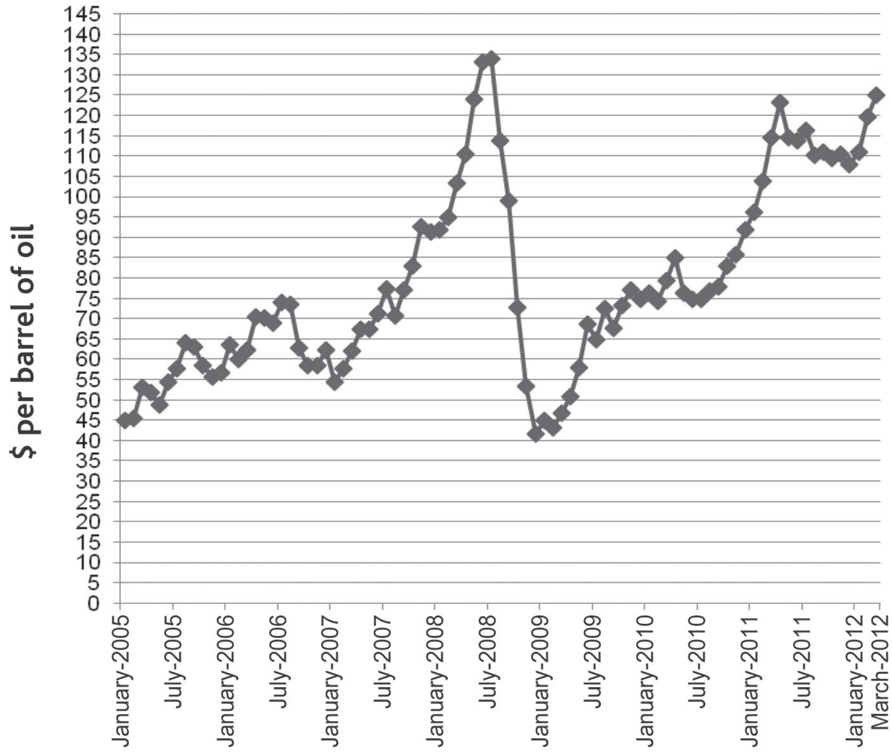
(8)

(b) With reference to the information provided, evaluate the significance of **two** likely causes of UK inflation over the period 2008 to 2012.

(12)

(Total for Question 12 = 20 marks)

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.

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%.

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.

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.

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.

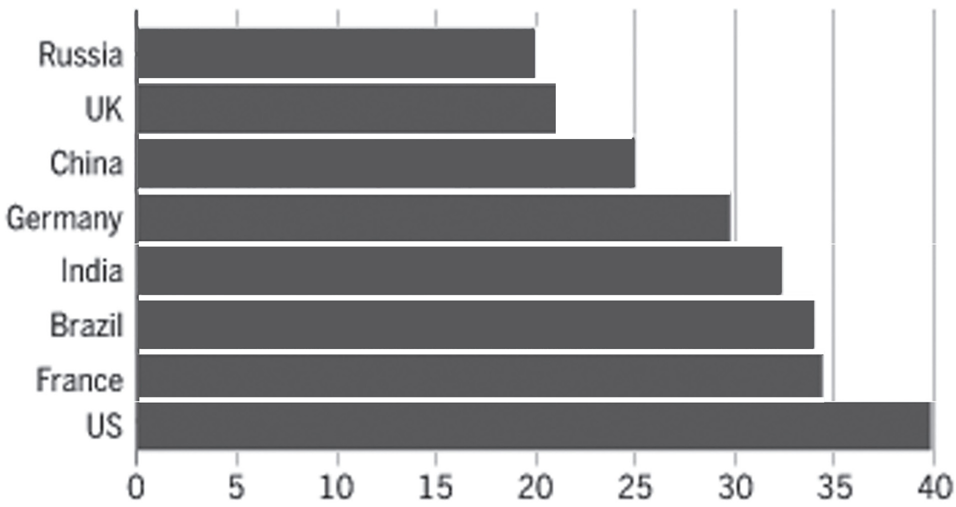
(Source: adapted from © Financial Times, April 3rd 2012)

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.

(Source: adapted from © Crown copyright)

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



% corporation tax

(Source: © Financial Times, 21 March 2012)

13 Referring to the data in Figure 1, calculate an index number for the oil price in March 2012, using January 2005 as the base period. Show your working.

(6)

14 Real incomes, growth and monetary and fiscal policy

Extract 1 UK incomes fall more than 3.5% in real terms in 2011, ONS reveals

UK households are facing pay cuts in real terms of more than 3.5% as salary increases fail to keep pace with inflation, official figures reveal. The median salary for a full-time worker in the UK rose 1.4% in 2011 to £26 244, compared with a headline Consumer Price Index (CPI) inflation rate of 5%, according to the Office for National Statistics (ONS).

The General Secretary of the Trades Union Congress (TUC), Brendan Barber, said the latest figures showed the UK's sluggish economic growth was due to a squeeze on wages rather than the wider economic crises. "Today's figures confirm that 2011 has been a year of wage stagnation, with pay rises far outstripped by inflation, and low-paid employees being squeezed particularly hard," he said. "Falling wages and self-defeating austerity have been the main reasons for the UK's economic woes, rather than a eurozone crisis which has yet to fully show up in official statistics," he further added.

(Source: © The Guardian News and Media Limited, 23 November 2011)

Extract 2 UK growth for final quarter of 2011 revised down

Britain's struggle to shake off the effects of the recession has been set back by news that the economy shrank more than previously thought in the final quarter of 2011 and remains no bigger than in the autumn of 2010. The Office for National Statistics estimated that the Gross Domestic Product (GDP) fell 0.3% in the fourth quarter of 2011, down from its previous estimate of 0.2%. Though most think the economy is now growing again, the figures still provided fresh information for critics of the coalition government's fiscal (budget) deficit reduction policies of cuts in government spending and increases in tax. An opposition spokesman said the news showed the March 2012 Budget from Chancellor George Osborne "made the wrong choice in sticking to policies that are failing on jobs, growth and the deficit."

(Source: adapted from © Financial Times, 28 March 2012)

Extract 3 Outlook for the UK Economy 2012–3

Weak international demand, continued low household consumption and the needed reduction in the fiscal deficit has halted the recovery. Growth will start to pick up during 2012 as exports and household consumption recover, with further strengthening in 2013. Unemployment is rising and will reach 9% in 2013, while inflation is presently peaking as anticipated and is expected to fall below the 2% target in 2013 as the temporary inflationary effects from the increase in VAT and higher commodity prices diminish. Monetary policy is supporting economic recovery, with the Bank of England interest rate at 0.5% and quantitative easing being resumed. The ambitious fiscal deficit reduction programme has helped to keep market interest rates low by maintaining confidence in the money markets.

(Source: adapted from © OECD Outlook 90 database)

(a) Explain how the Consumer Price Index (CPI) is calculated.

(6)

(b) Analyse **two** possible reasons why the CPI measure of inflation was above its target range in 2011.

(8)

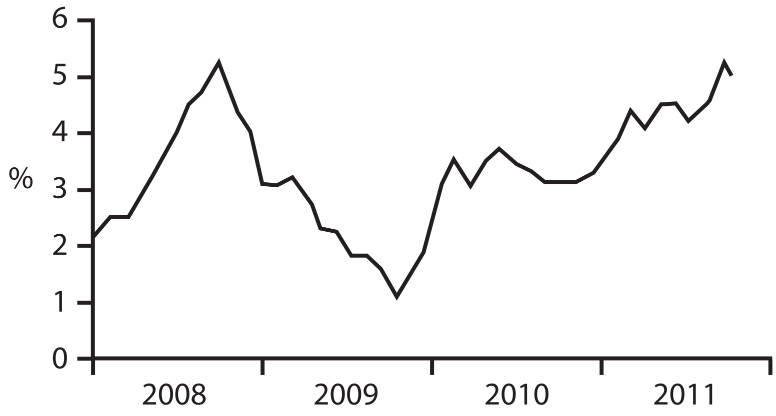
(c) Explain **two** likely economic consequences of inflation falling "below the 2% target" (Extract 3, lines 5–6).

(8)

(Total for Question 14 = 22 marks)

15 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.

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".

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.

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.

(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

(a) With reference to Figure 1, explain what happened to the UK price level from late 2008 to mid-2009.

(4)

(b) In Extract 1, the UK's rate of inflation is predicted to be significantly lower in 2012 than in 2011. Explain **two** likely economic consequences of the lower rate of inflation in 2012.

(8)

(Total for Question 15 = 12 marks)

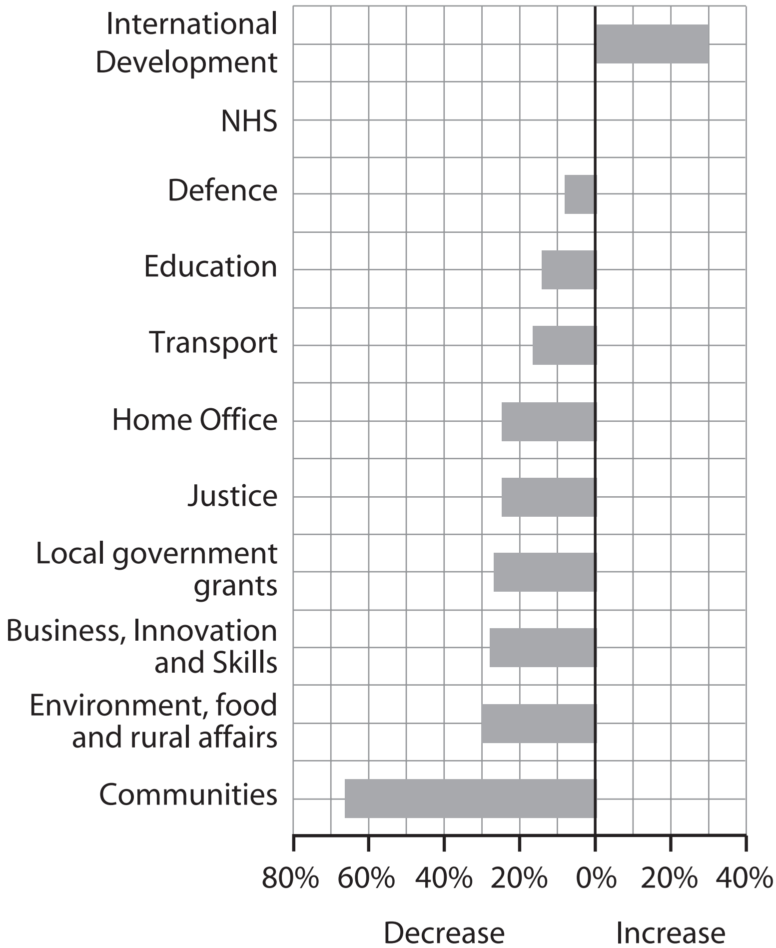
16 Public Sector cuts, unemployment and inflation targets

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.

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.

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.

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.

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.

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.

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.

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.

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)

(a) With reference to Extract 2, analyse **two** of the causes of inflationary pressure that the Governor views as "temporary".

(8)

*(b) In light of the information provided, assess the case for an increase in the base interest rate set by the Monetary Policy Committee.

(12)

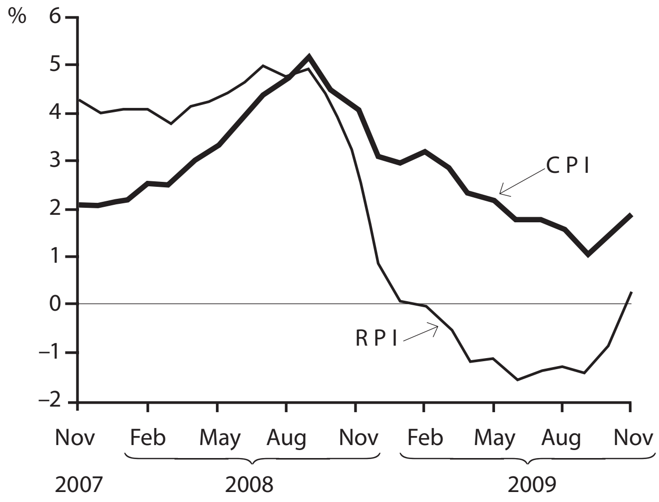
*(c) With reference to Extract 2, evaluate the likely impact of higher inflation on **three** macroeconomic objectives.

(30)

(Total for Question 16 = 50 marks)

17 Inflation and growth

Figure 1 Rates of Inflation in the UK, year on year percentage changes



Source: http://www.statistics.gov.uk/pdfdir/cpi1209.pdf produced on 15th December 2009.

Figure 2 Annual percentage change in Gross Domestic Product (GDP) at constant prices

				Forecast
Country	2007	2008	2009	2010
Germany	2.5	1.2	-5.0	1.2
United Kingdom	2.6	0.5	-4.9	1.3
United States	2.1	0.4	-2.4	3.1
Developing Economies	8.3	6.1	2.4	6.3

Source: www.imf.org (World Economic Outlook Database April 2010).

Extract 1 Recession to cause permanent damage

The effects of the 2008-09 financial crisis and recession (at least two consecutive quarters of negative growth) has similarities to the recessions of the 1920s, 1980s and 1990s: global output is on a persistently lower path than expected before the crisis; public finances are severely weakened; long term unemployment has increased and income inequality has risen.

Research by the International Monetary Fund (IMF) into previous recessions found three major forces which tended to prevent economies rebounding to their pre-crisis trends of output.

First, for a period of time after the recession there is likely to be high unemployment and misallocations of resources in several sectors of the economy. An example is residential construction. If unemployment remains high for some time, former employees may lose skills and the discipline of working.

Second, part of the capital stock is destroyed as some plant and equipment is scrapped prematurely. Other companies struggle to invest in viable and innovative projects because banks restrict credit to protect their finances.

Third, productivity falls because there is 'less innovation, as research and development spending tends to be scaled back in bad times', the IMF says.

Source: adapted from *The Financial Times*, the article 'Recession to leave permanent scars' by Chris Giles, 24th November 2009.

17 With reference to Figure 1, explain what happened to the price level in the period shown.

(6)

(Total for Question 17 = 6 marks)

18 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.

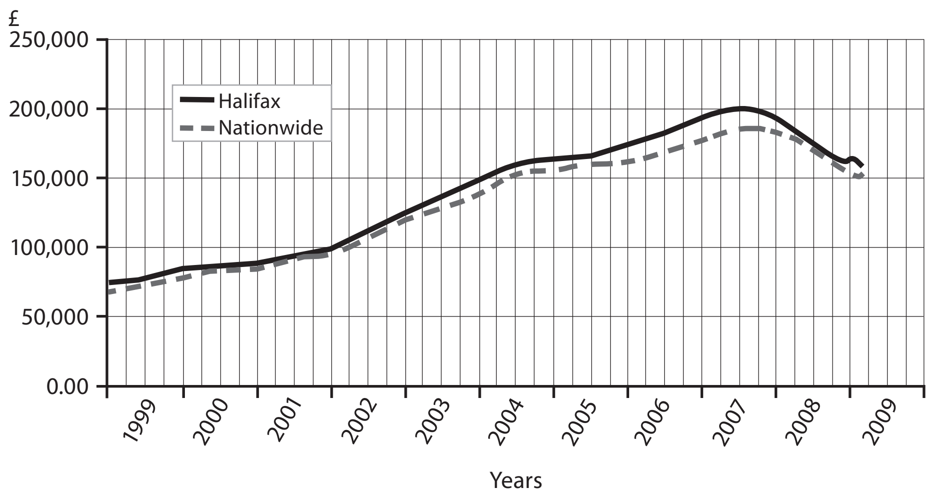
Policy makers noted that the prospect of households holding back on spending was probably the biggest risk to an economic recovery. Household consumption fell by 1 per cent in the fourth quarter of 2008 and the ratio of savings to disposable income was higher than expected.

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.

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.

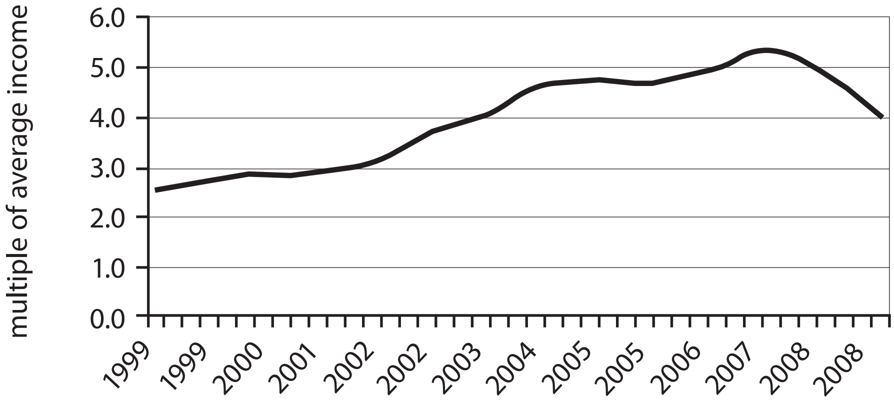
Source: adapted from *The Times* Online April 22, 2009.

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

With reference to Extract 1,

(a) explain how Consumer Price Inflation (CPI) is measured. Refer to weights in your answer.

(4)

(b) explain **two** reasons why the government has a low rate of inflation as a macroeconomic objective.

(8)

Reason one

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Reason two

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(Total for Question 18 = 12 marks)

Question 19

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)

19 With reference to Figure 1, outline how the Consumer Price Index is calculated.

(4)

(Total for Question 19 = 4 marks)

Question 20

Demand management

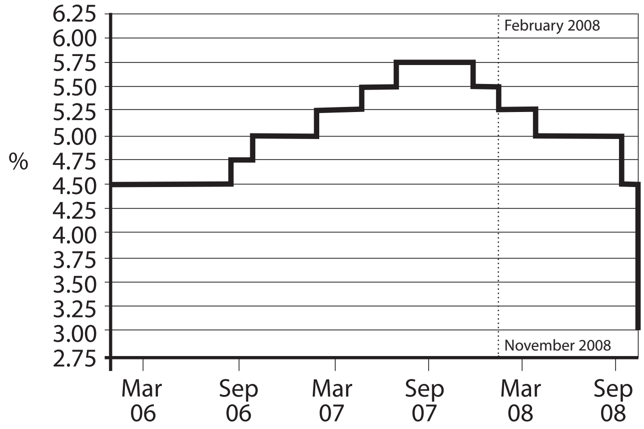
Extract 1 Bank of England cuts interest rates again

The Bank of England's Monetary Policy Committee today voted to reduce the official interest rate. The prospects for global output growth abroad have worsened and the disruption to world financial markets has continued. In the UK, credit conditions for households and businesses are tightening. Consumer spending growth appears to have eased. Although the substantial fall in the sterling exchange rate is likely to lessen the effects of the fall in aggregate demand, output growth has moderated to around its historical average rate and business surveys suggest that further slowing is in prospect. These developments might lead to CPI inflation falling below target in the long run.

CPI inflation, at 2.1% in December 2007, was close to the inflation target, but higher energy and food prices are expected to raise the rate of inflation, possibly quite sharply, in the short run. The lower level of sterling will significantly increase import costs.

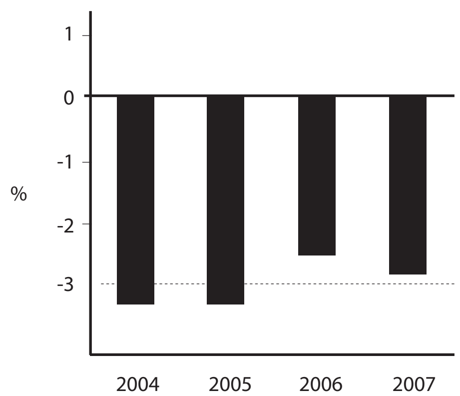
Source: Adapted from press release February 2008 www.bankofengland.co.uk

Figure 1 The Bank of England's official interest rate



Source: www.bankofengland.co.uk November 2008

Figure 2 Government fiscal position as a percentage of GDP



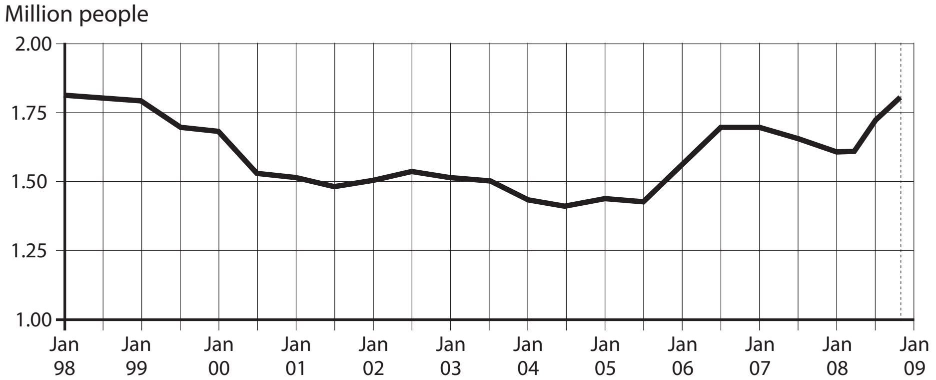
Source: www.statistics.gov.uk 7 April 2008

Extract 2 Government budget deficit

Provisional estimates show that for the calendar year 2007 the UK recorded a government budget deficit of £39.4 billion, which was equivalent to 2.8 per cent of gross domestic product (GDP).

Source: www.statistics.gov.uk 7 April 2008

Figure 3 Unemployment in the UK



Source: ONS

(a) What is meant by an *inflation target* (Extract 1, line 9)? **(4)**

(b) Using the evidence from Extract 1 and Figure 1, analyse **two** possible reasons why the MPC took the decision to cut the official interest rate in February 2008. **(10)**

END OF SECTION B **(Total for Question 20 = 14 marks)**