



Economics Questions By Topic:

**Conflicts & Trade-Offs Between
Objectives & Policies (2.6.4)**

A-Level Edexcel Theme 2

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SECTION B

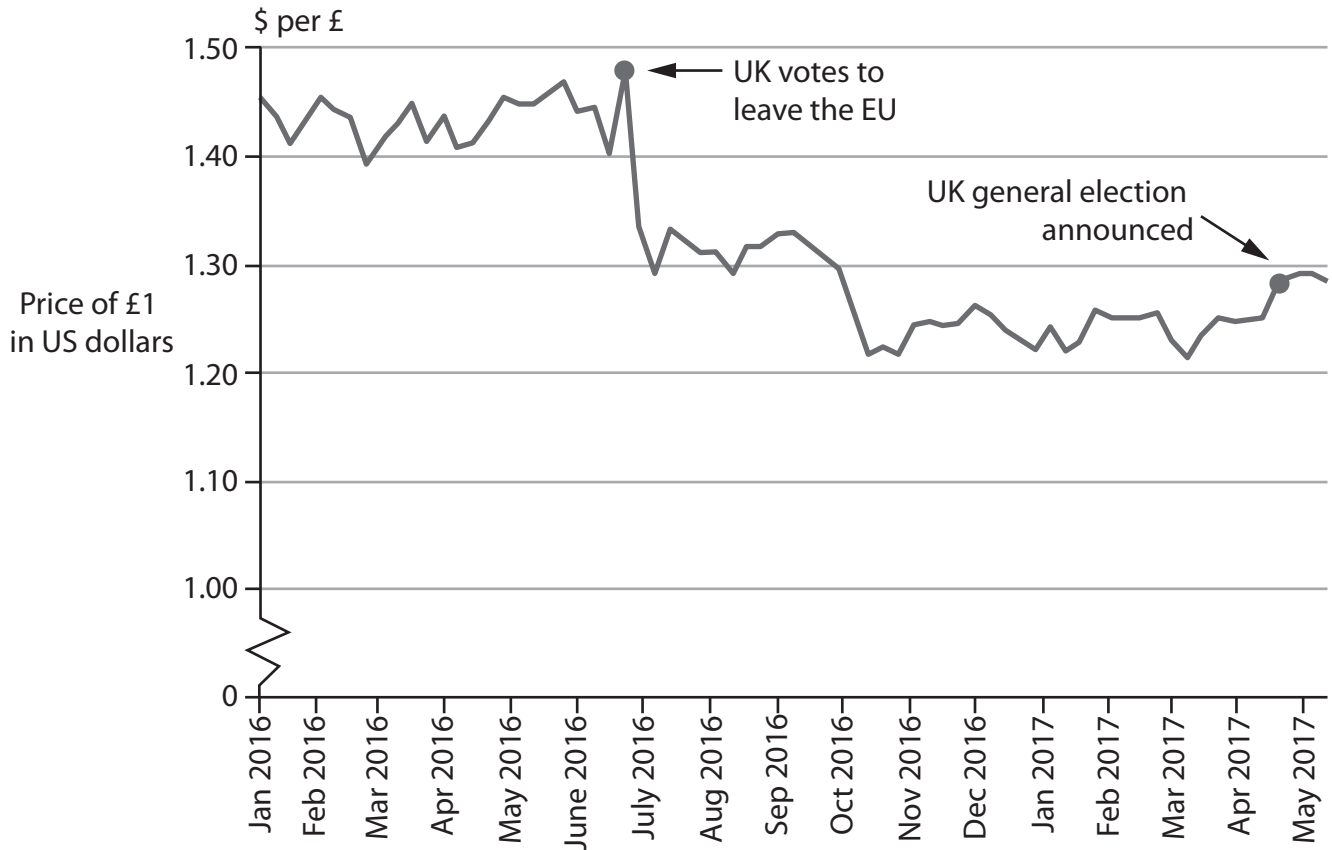
Read all extracts/figures before answering.

Write your answers in the spaces provided.

Question 1

The UK economy since the financial crisis

Figure 1: Pound sterling to US\$ exchange rate, 2016-17



(Source: adapted from <https://www.ft.com/content/d50ce580-3968-11e7-ac89-b01cc67cfeec>)

Extract A

UK companies use forward currency market

The Norfolk-based picture frames maker Nielsen Bainbridge recently made forward contracts in the foreign exchange market to reduce the impact of currency fluctuations. The pound's post-Brexit referendum depreciation has been a test of nerve for Nielsen Bainbridge and many other importers. At present the company's suppliers are located in Europe or China. "Currency therefore has a big impact on our business and the margins we can obtain," says Ms Burdett, the Finance Director. Forward contracts enable institutions, businesses and individuals to lock in an exchange rate over a certain period of time regardless of how the rate moves during that time. Ms Burdett buys currency as soon as Nielsen Bainbridge confirms a large order as a way to fix costs. One third of UK business managers are considering shifting from EU to UK suppliers.

(Source: adapted from 'UK companies use pound strength to hedge forex risk' by Roger Blitz, Markets, © FT.com, 16 May 2017. <https://www.ft.com/content/d50ce580-3968-11e7-ac89-b01cc67cfeec>)

Extract B

Bank of England seeking to prevent future bank bailouts

The Bank of England has ordered big lenders in the UK to find £116 billion of funding to ensure that taxpayers will never again have to bail out the banking sector. The Bank intends to publish details of how each of the big lenders would cope in the event they find themselves in a situation similar to Royal Bank of Scotland and Lloyds Banking Group, which needed £65 billion of taxpayer bailouts during the 2008 Global Financial Crisis. This had a significant negative impact on the UK government's national debt and, many would argue, increased the need for contractionary fiscal policy. Having said that, the UK government sold all its shares in Lloyds Banking Group in 2017 and, according to the Chancellor of the Exchequer, "recovered every penny of its investment in Lloyds".

Sir Jon Cunliffe, the deputy governor at the Bank responsible for financial stability, said regulators needed to let banks fail in a similar way that traditional companies collapse. This has not been possible in the past because of the risk that savers lose their money and because a system did not exist to allow banks to be put into insolvency.

"Just like when other businesses fail, losses arising from bank failure would be imposed on shareholders and investors. This protects the public from loss and incentivises banks to operate more prudently," said Cunliffe.

(Source: adapted from 'Bank of England tells lenders to find £116bn to help prevent bailouts', by Jill Treanor, 02 October 2017, Copyright The Guardian News and Media Ltd <https://www.theguardian.com/business/2017/oct/02/bank-of-england-bailouts-rbs-lloyds> and 'Lloyds bank bailout repaid in full, Philip Hammond claims', by Jill Treanor, Larry Elliott, 21 April 2017, Copyright Guardian News & Media Ltd 2017 <https://www.theguardian.com/business/2017/apr/21/lloyds-bank-bailout-repaid-in-full-philip-hammond-claims>)

Extract C

Bank of England tells lenders to increase capital reserves

The Bank of England has told lenders they will need to build a special reserve worth £11.4 billion by the end of 2018 as it tries to make banks more resilient to the risk posed by mounting consumer debt. This reserve of assets that can be readily turned into cash is a way of forcing banks to set aside capital reserves in good times in order to keep lending to the wider economy at a steady level, even during an economic downturn. In 2017 the Bank of England told UK banks it would raise the reserve ratio, relative to all assets, from zero to 0.5% and also forecast a further increase to 1% by the end of 2017. 5

The move is not intended to directly reduce consumer demand for credit, which in 2017 grew by 10.3% on an annual basis, but it may well lead to banks becoming less willing to lend to consumers. Since the Bank of England has recently become increasingly concerned about consumer borrowing, including rising car loans and credit card debt, this may be no bad thing as far as the Bank of England is concerned, even if it does have a negative impact on the wider economy. 10

Analysts are concerned about the impact on consumer confidence of rising inflation, partly caused by a falling pound. With falling real incomes consumers could become more vulnerable to falling behind with their credit card and personal loan repayments. Despite these concerns the UK economy recently recorded the lowest rate of unemployment since 1975. 15

(Source: adapted from 'Bank of England tells lenders to increase capital buffers by £11.4bn' by Caroline Binham, Gemma Tetlow and Martin Arnold © Financial Times 2017 <https://www.ft.com/content/9bc99294-5b1b-11e7-9bc8-8055f264aa8b>)

1 With reference to Extract C, discuss the potential conflicts between macroeconomic objectives when the central bank attempts to control inflation.

(12)

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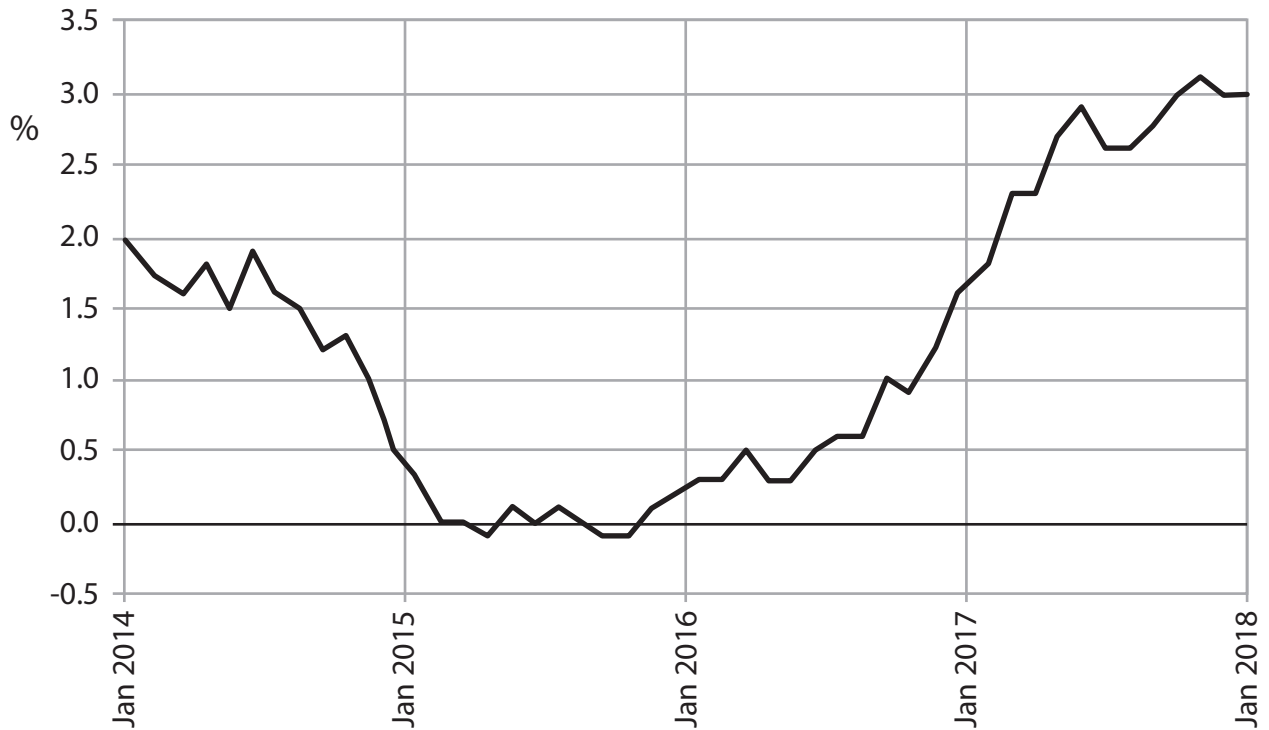
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(Total for Question 1 = 12 marks)

Question 2

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



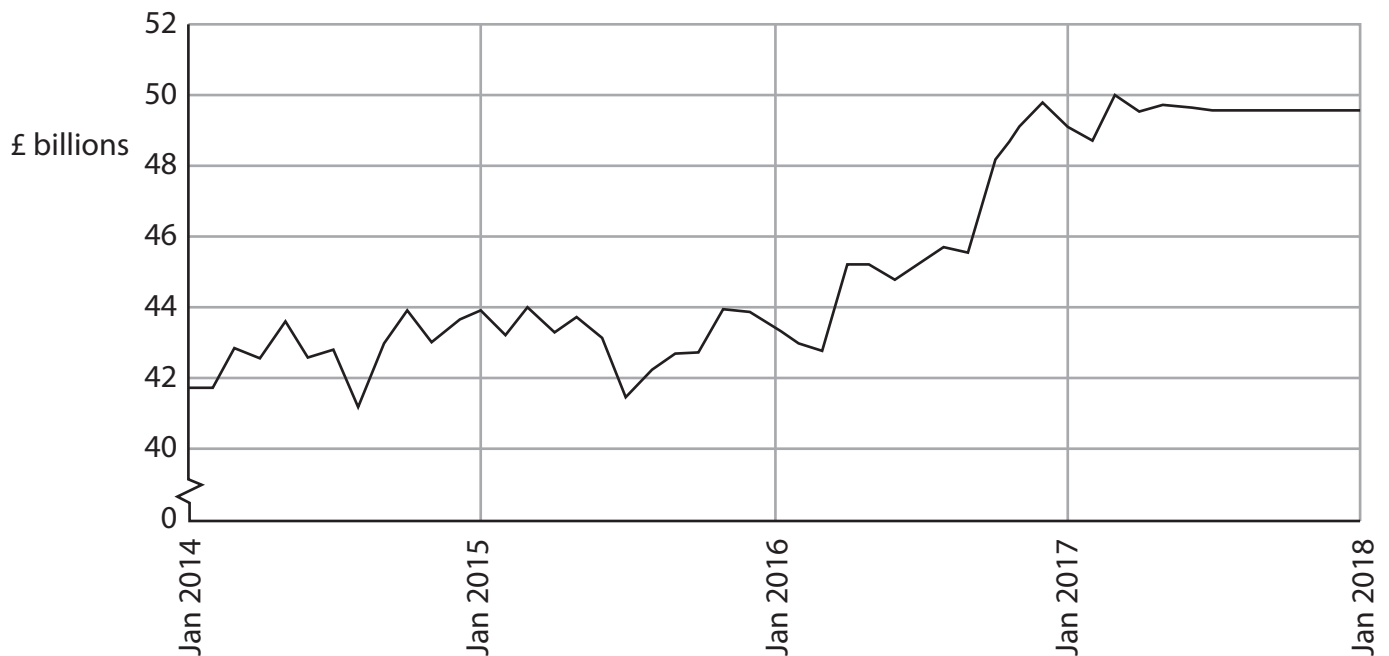
(Source: www.bankofengland.co.uk/publications/Pages/inflationreport/2017/aug.aspx)

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/>)

2 Evaluate the potential conflicts between the objective of economic growth and **two** other UK macroeconomic objectives.

(20)

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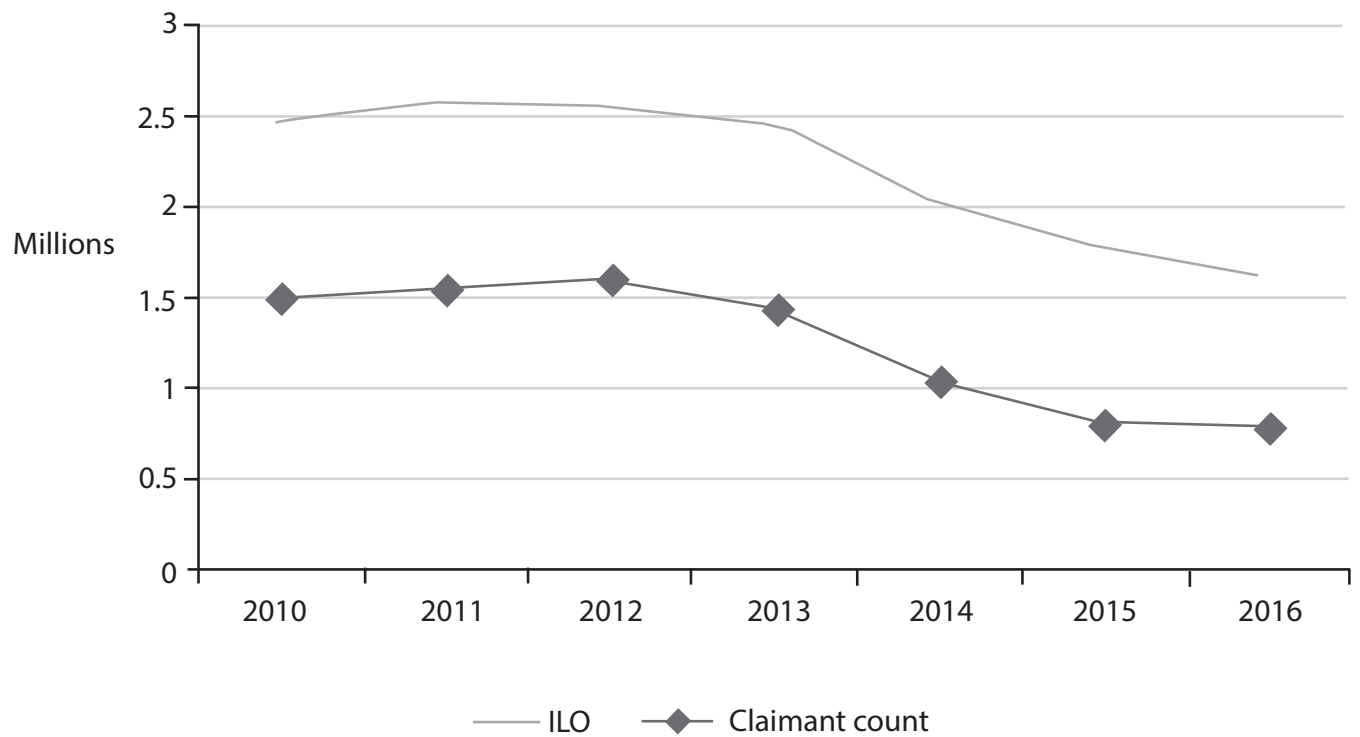
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(Total for Question 2 = 20 marks)

Question 3

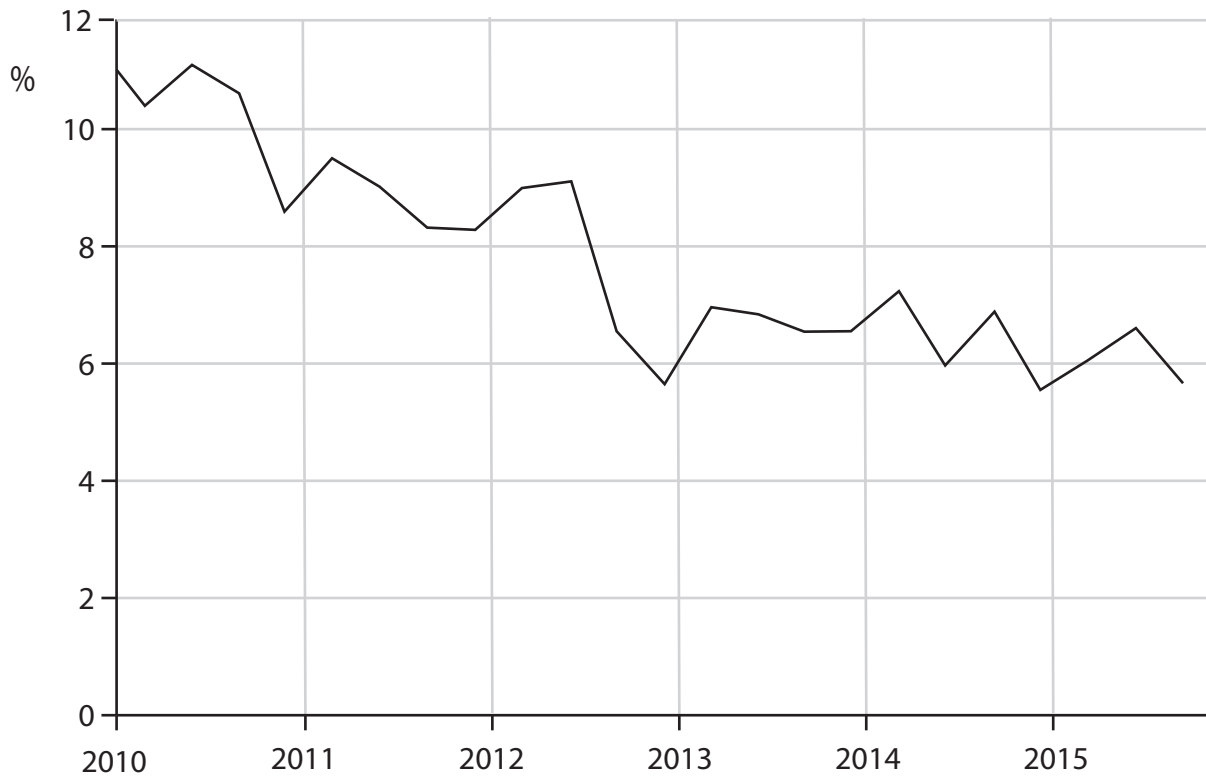
The UK economy

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



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

Figure 2: Household savings*, 2010-2015



* Savings as a percentage of household disposable income

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

Figure 3: UK average house prices, 2005-2016



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

Extract A

Soaring house prices

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

5

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

10

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

15

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

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

Extract B

UK migration trends in the year ending June 2016

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

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

5

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

10

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

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

(20)

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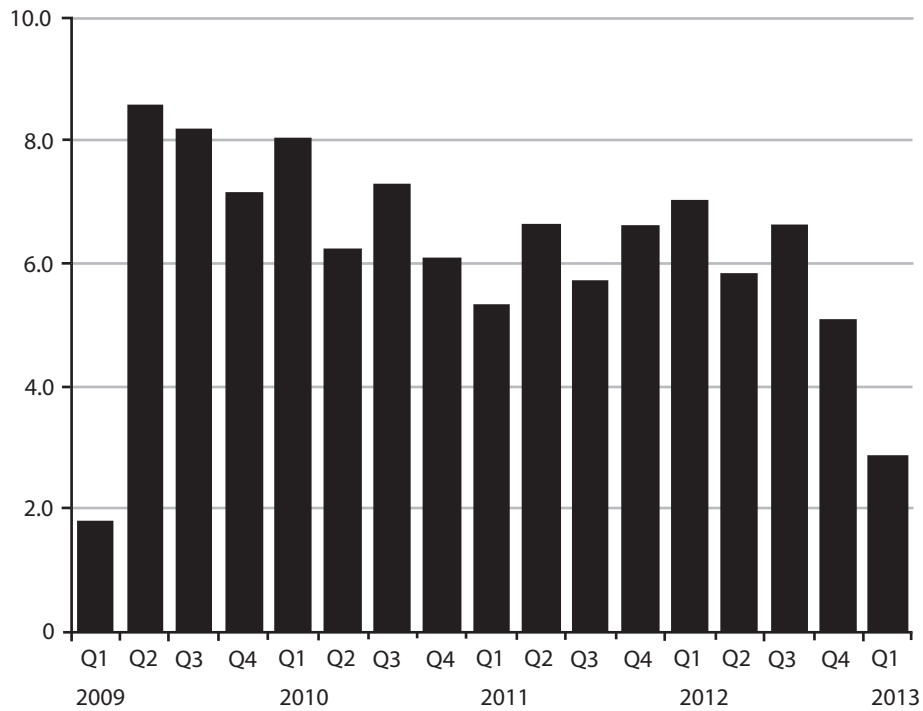
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(Total for Question 3 = 20 marks)

4 Savings, GDP, housing market and monetary policy

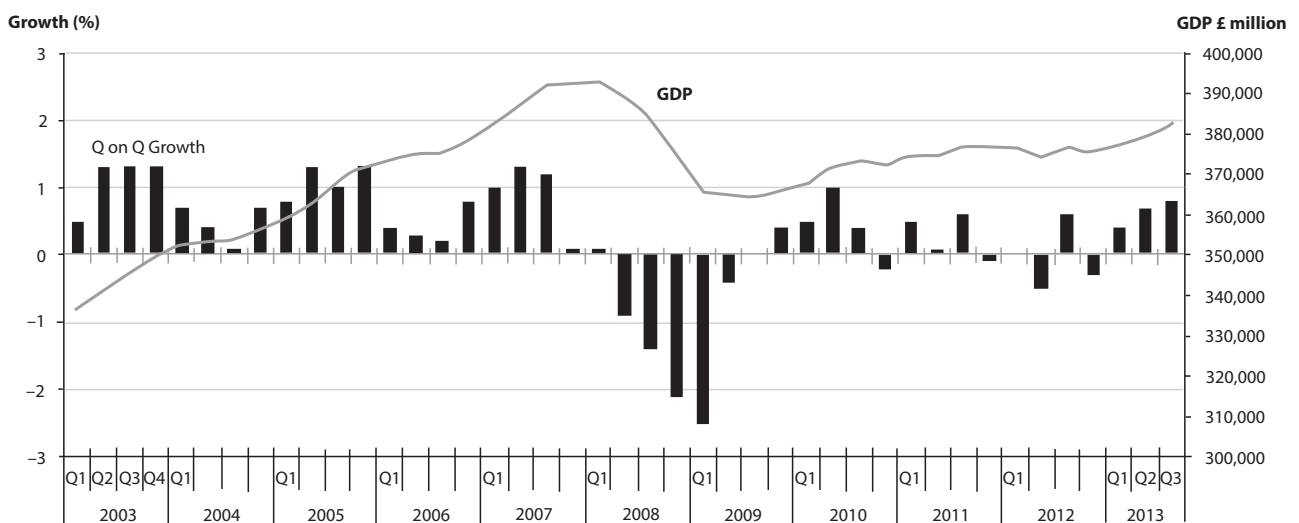
Figure 1 UK household savings ratio*



*Savings as a percentage of household disposable income

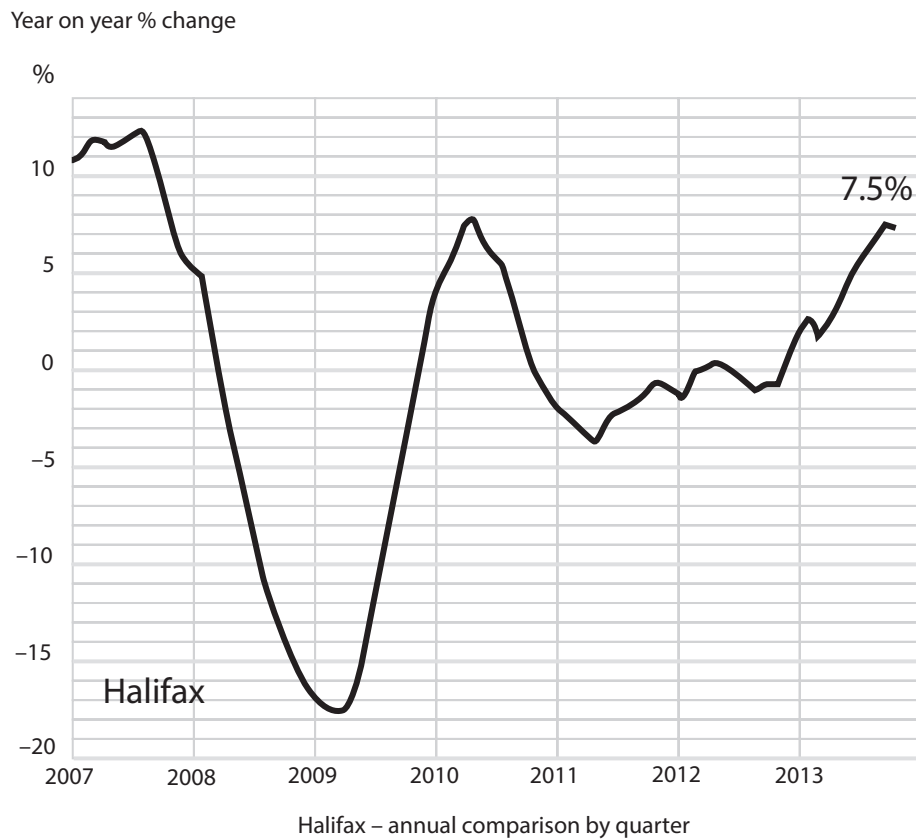
(Source: <http://www.ons.gov.uk/ons/publications/re-referencetables.html?edition=tcm%3A77-324888>)

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.

5

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

http://www.lse.co.uk/AllNews.asp?code=kkj6mz7d&headline=MARKET_COMMENT_UK_House_Prices_Continue_To_Rise_As_US_Government_Remains_Shut)

Extract 2 UK monetary policy

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

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

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

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

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

*4 To what extent do demand-side policies lead to conflicts between macroeconomic objectives?

(30)

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Handwriting practice area with 20 horizontal dotted lines.

Handwriting practice area with 25 horizontal dotted lines.

(Total for Question 4 = 30 marks)

5 Public Sector cuts, unemployment and inflation targets

Extract 1 Cutting back the state

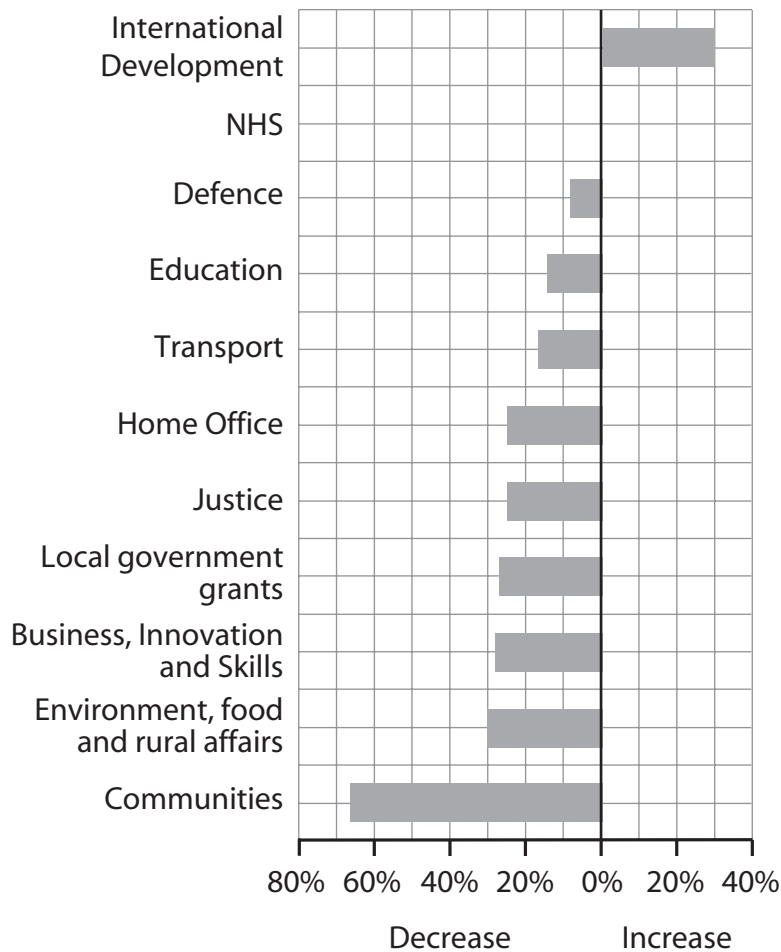
The Chancellor of the Exchequer, George Osborne, insisted that harsh medicine was vital to cut Britain's huge budget deficit, expected to be 10% of GDP in 2010–11. Total cuts in public sector spending of £81 billion are to be made by 2014–15. Nevertheless, total spending is planned to be 6% higher in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

5

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

10

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



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

Extract 2 The inflation overshoot continues

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

5

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

10

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

15

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

20

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

25

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

30

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

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

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

(30)

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Handwriting practice area with 25 horizontal dotted lines.

(Total for Question 5 = 30 marks)

6 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

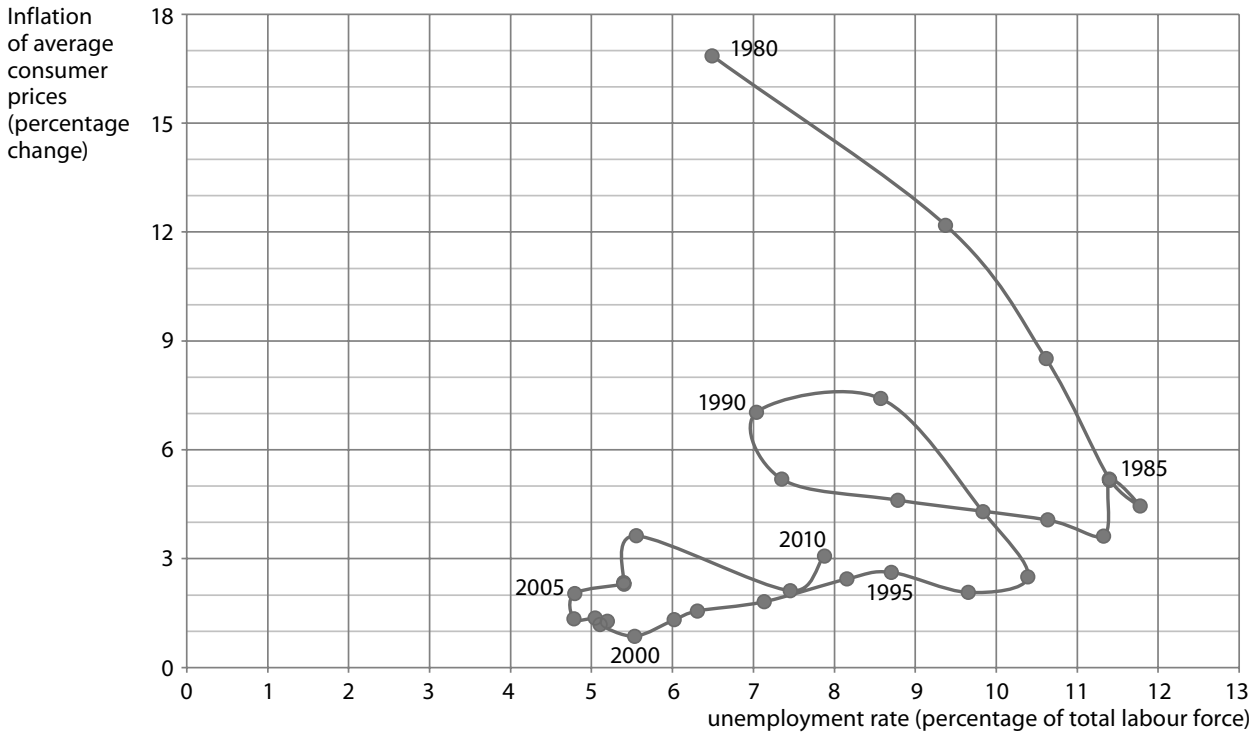
<http://www.ft.com/cms/s/0/d29d8984-1aea-11df-88fa-00144feab49a.html> and
<http://www.ft.com/cms/s/3/3963580c-1199-11df-9195-00144feab49a.html>

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>

(a) What relationship might be expected between average earnings growth and the unemployment rate?

(6)

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(b) Is the relationship supported by the data in Figure 2?

(4)

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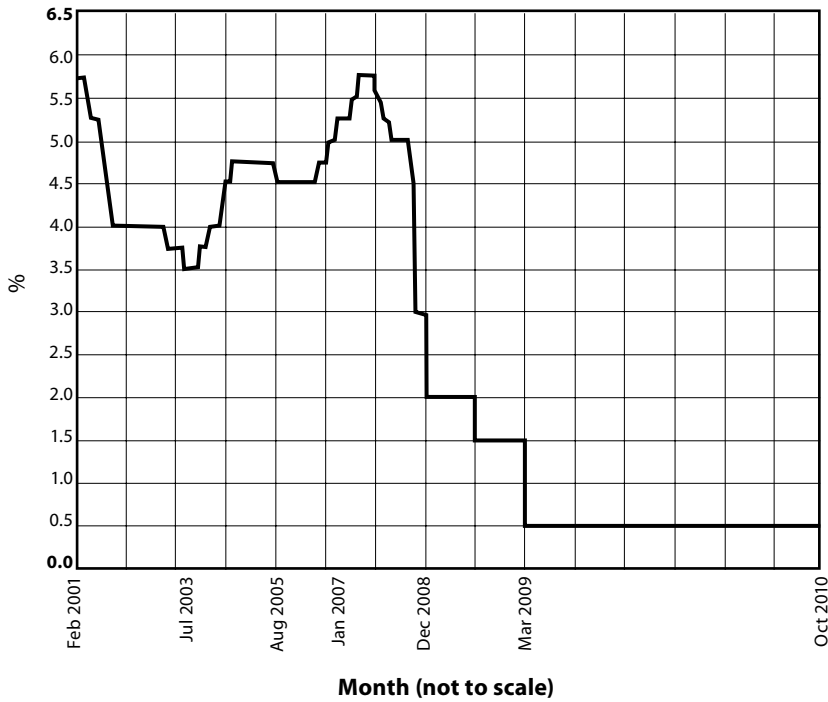
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(Total for Question 6 = 10 marks)

7 Interest Rates, House Prices, Savings and Growth

Figure 1 UK base rate of interest, 2001–2010



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

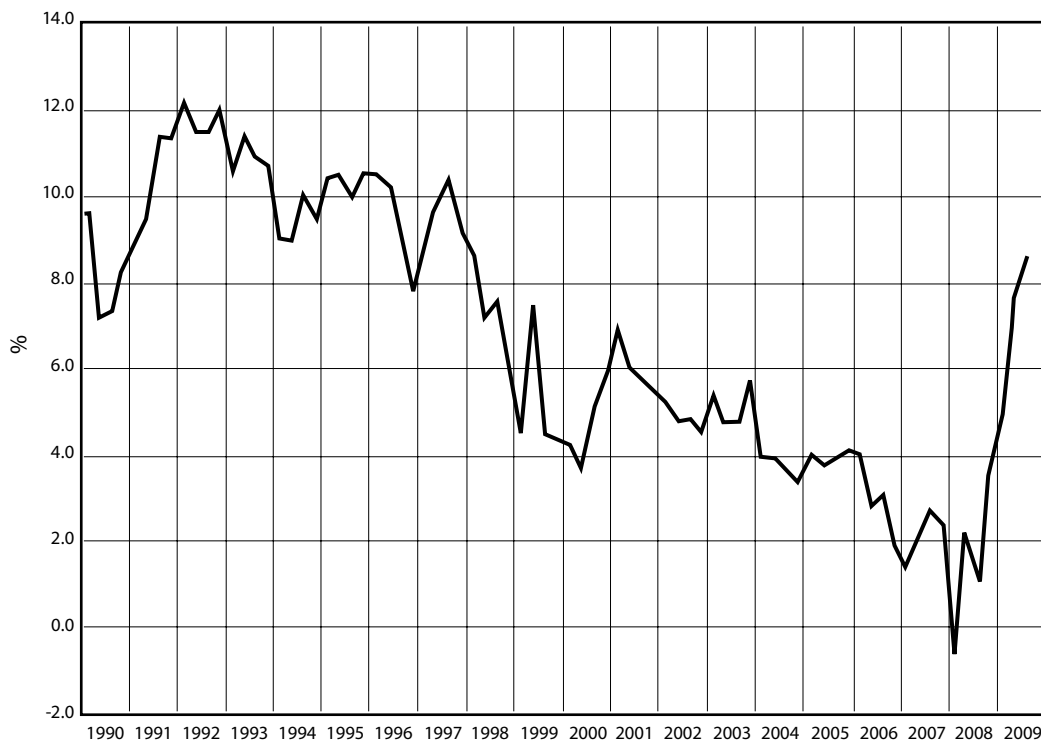
Figure 2 Quarterly percentage change in UK house prices, April 2007 to April 2010



Source: http://www.nationwide.co.uk/hpi/historical/Apr_2010.pdf

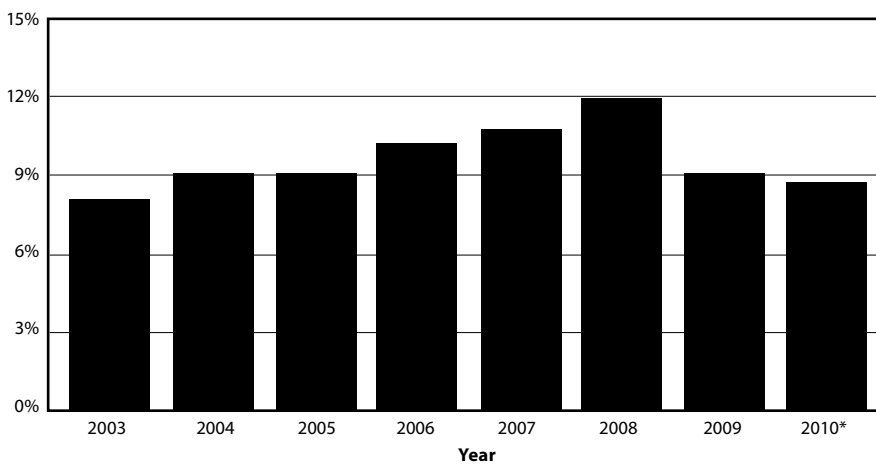
Figure 3 UK Household Savings Ratio

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



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

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



* Forecast

Source: http://www.indexmundi.com/china/gdp_real_growth_rate.html

***7** To what extent might rapid economic growth conflict with at least **two** other macroeconomic objectives?

(30)

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

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(Total for Question 7 = 30 marks)

Question 8 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.

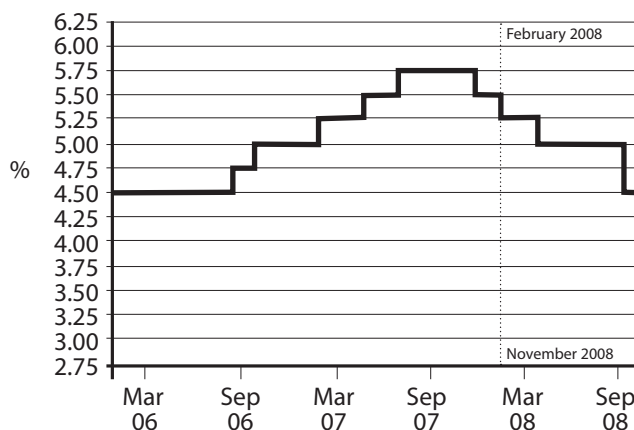
5

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.

10

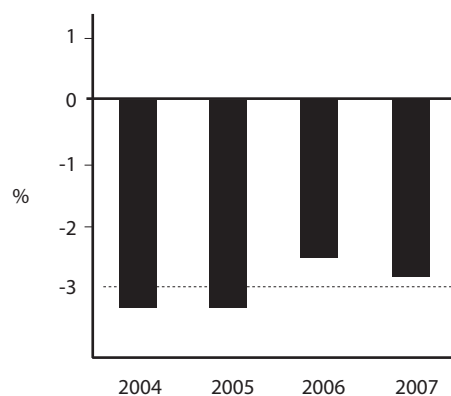
Source: Adapted from press release February 2008 www.bankofengland.co.uk

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



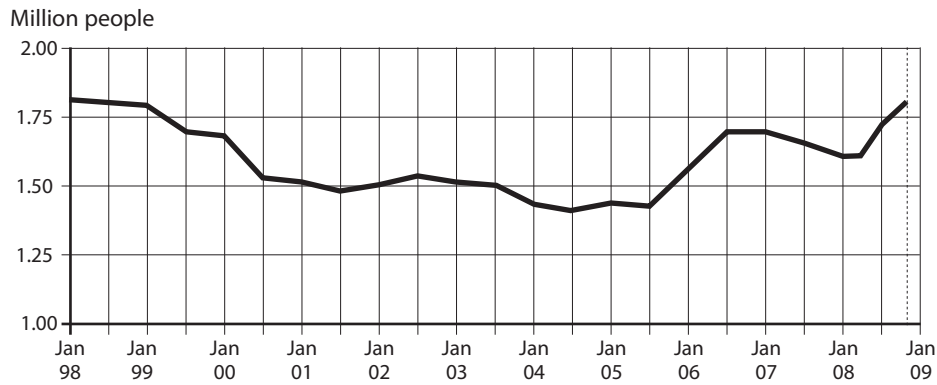
Source: www.statistics.gov.uk 7 April 2008

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

8 To what extent do demand-side policies lead to conflicts between macroeconomic objectives?

(30)

A series of horizontal dotted lines for writing the answer to question 8.

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

Handwriting practice area with 25 horizontal dotted lines.

Blank writing area with horizontal dotted lines.

(Total for Question 8 = 30 marks)

END OF SECTION B

SECTION C

Write your answers in the spaces provided.

- 9** It has been estimated that if climate change led to the world's temperature rising 2.5°C compared to the temperature in 2010, then global GDP per capita would be 15% lower by 2100. If temperatures rise by 4°C compared to the temperature in 2010, then by 2100 global GDP per capita would decline by more than 30%.

(Source adapted from: <https://www.nature.com/articles/s41586-018-0071-9>)

Evaluate the potential trade-offs between environmental protection and other macroeconomic objectives.

(25)

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A large rectangular area containing 25 horizontal dotted lines, intended for writing or drawing.

A large rectangular area containing 25 horizontal dotted lines, intended for writing or drawing.

A large rectangular area containing 25 horizontal dotted lines, intended for writing or drawing.

A large rectangular area containing 25 horizontal dotted lines, intended for writing or drawing.

(Total for Question 9 = 25 marks)