Economics Questions By Topic:

Demand-Side Policies (2.6.2)

A-Level Edexcel Theme 2

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SECTION A

Write your answers in the spaces provided.

1 A number of business groups have signed an open letter to the UK Government asking it to commit to delivering the full High Speed 2 rail link. This will connect London to the northern cities of Manchester and Leeds at a cost of £56 billion and reduce journey times by as much as 50%.

(Source adapted from: https://www.theguardian.com/uk-news/2019/jun/22/business-heads-urge-next-pm-to-commit-to-finishing-hs2)

Government spending on the High Speed 2 rail link is an example of which of the following?

(1)

☒ **A** Automatic stabilisers

☒ **B** Capital expenditure

☒ **C** Current expenditure

☒ **D** Transfer payments

(Total for Question 1 = 1 mark)

2 In August 2018 the Monetary Policy Committee of the Bank of England raised the UK's base interest rate from 0.5% to 0.75%.

(a) Define the term 'interest rate'.

(1)

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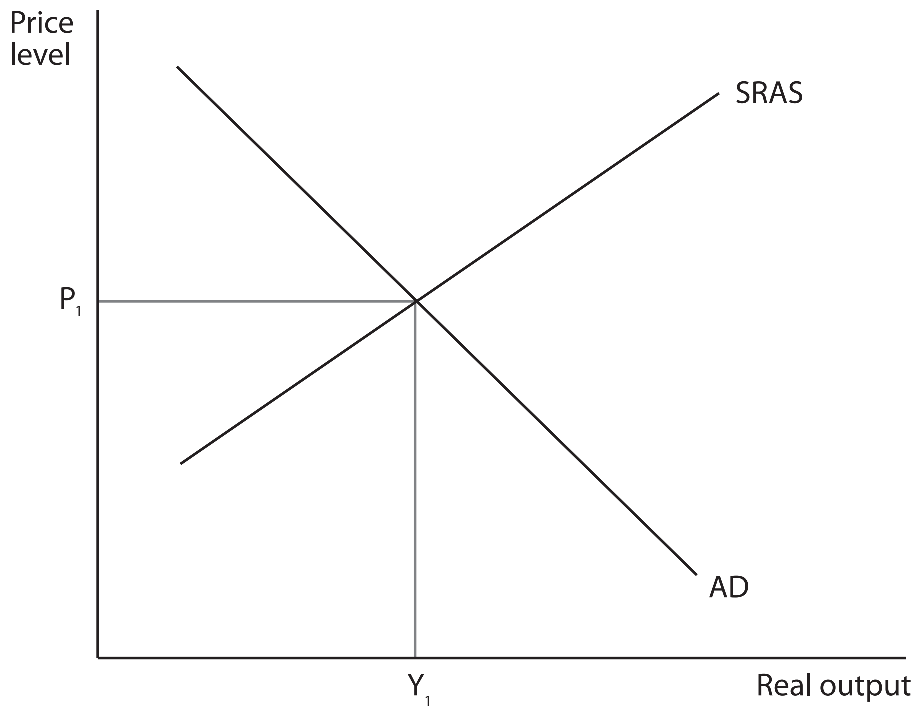
(b) Annotate the aggregate demand (AD) and short-run aggregate supply (SRAS) diagram below to show the possible impact of a rise in the base interest rate on the equilibrium level of real output and the price level.

(2)



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(c) Which **one** of the following demand-side policies best explains a rise in the base interest rate?

(1)

- ☒ **A** Contractionary fiscal policy
- ☒ **B** Contractionary monetary policy
- ☒ **C** Expansionary fiscal policy
- ☒ **D** Expansionary monetary policy

(Total for Question 2 = 4 marks)

3 The UK has experienced a budget deficit since 2001. The government aimed to reach a budget surplus by 2019, but in 2016 this target was abandoned.

(Source: adapted from https://www.gov.uk/government/news/autumn-statement-2016-some-of-the-things-weve-announced)

(a) Explain **one** likely reason why the 2019 budget surplus target was abandoned.

(2)

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(b) Explain the likely impact of abandoning the budget surplus target on the UK national debt.

(2)

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(c) If a government takes decisions to target a budget surplus, this is an example of:

(1)

- ☒ **A** contractionary monetary policy
- ☒ **B** discretionary fiscal policy
- ☒ **C** expansionary fiscal policy
- ☒ **D** expansionary monetary policy

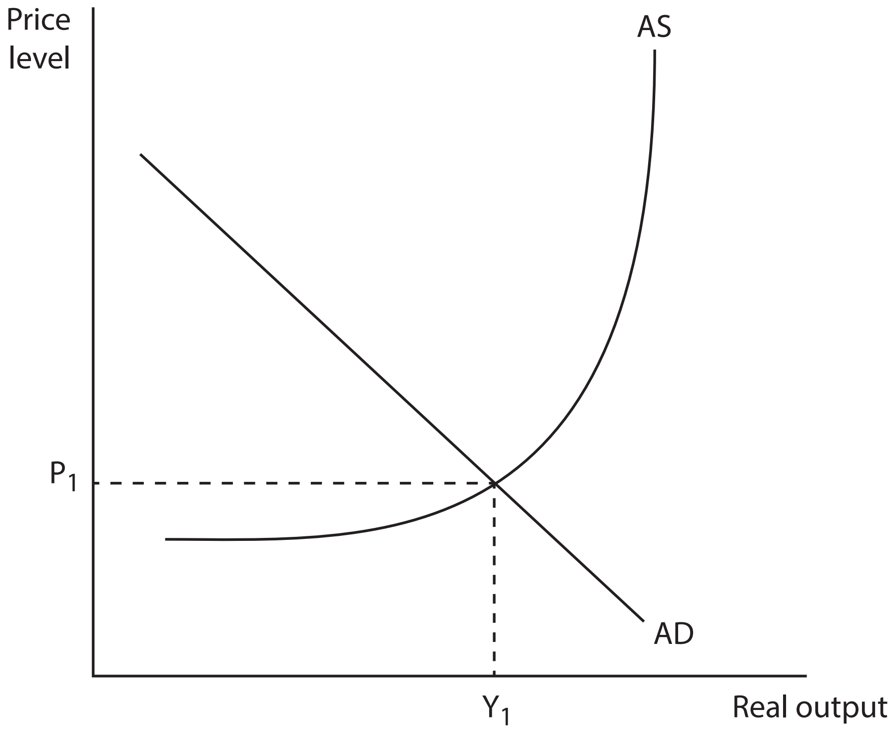
(Total for Question 3 = 5 marks)

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

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

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

(2)



(b) Define the term 'direct tax'.

(1)

....

....

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

(1)

☒ **A** Value Added Tax

☒ **B** Vehicle Excise Duty

☒ **C** Corporation tax

☒ **D** Alcohol duty

(Total for Question 4 = 4 marks)

END OF SECTION A

SECTION B

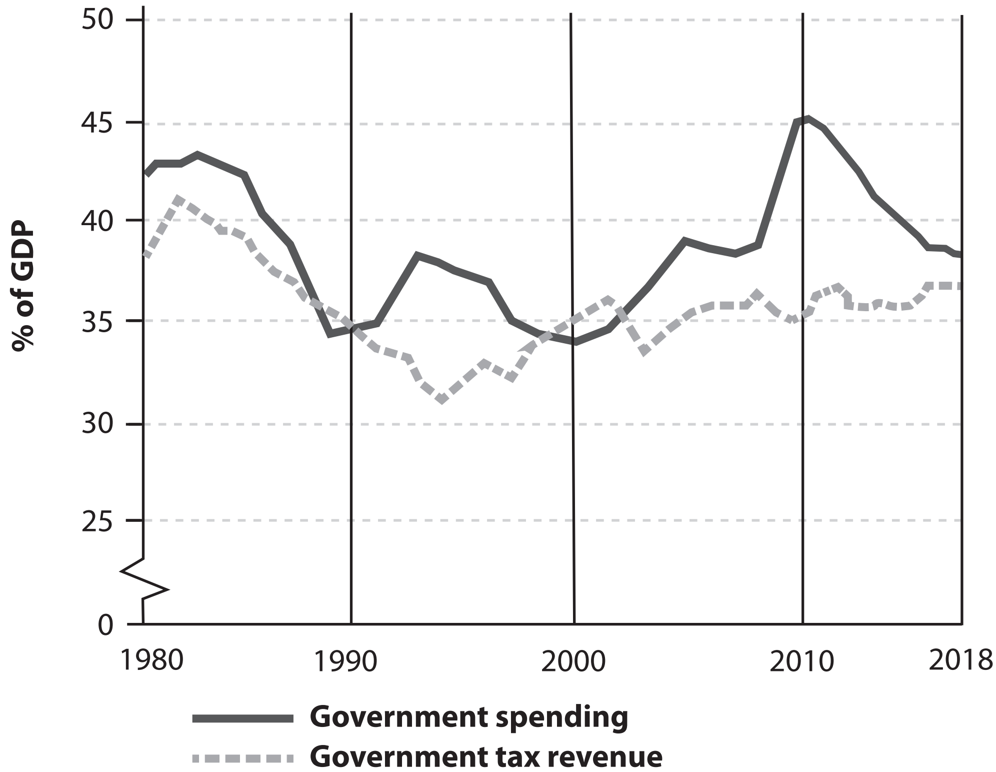
Read all extracts/figures before answering.

Write your answers in the spaces provided.

Question 5

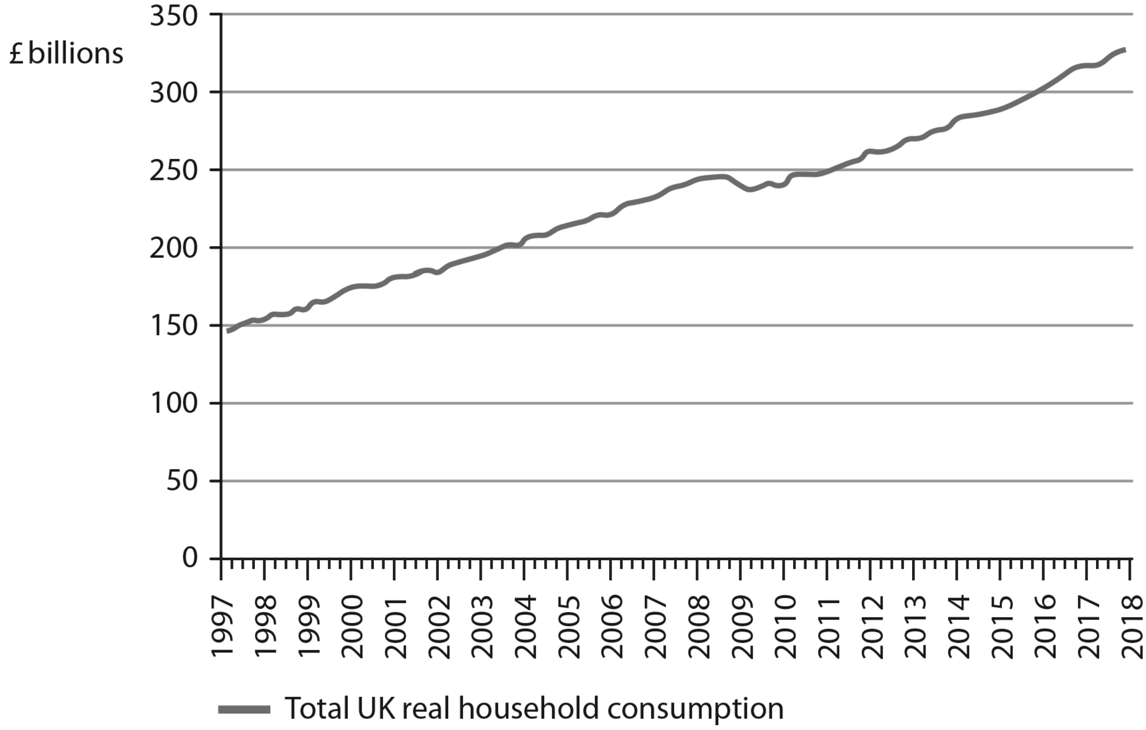
UK government budget and household consumption

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%.

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.

(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.

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.

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.

(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')

5 Evaluate the likely macroeconomic effects of the UK government pursuing a policy of reducing its budget deficit.

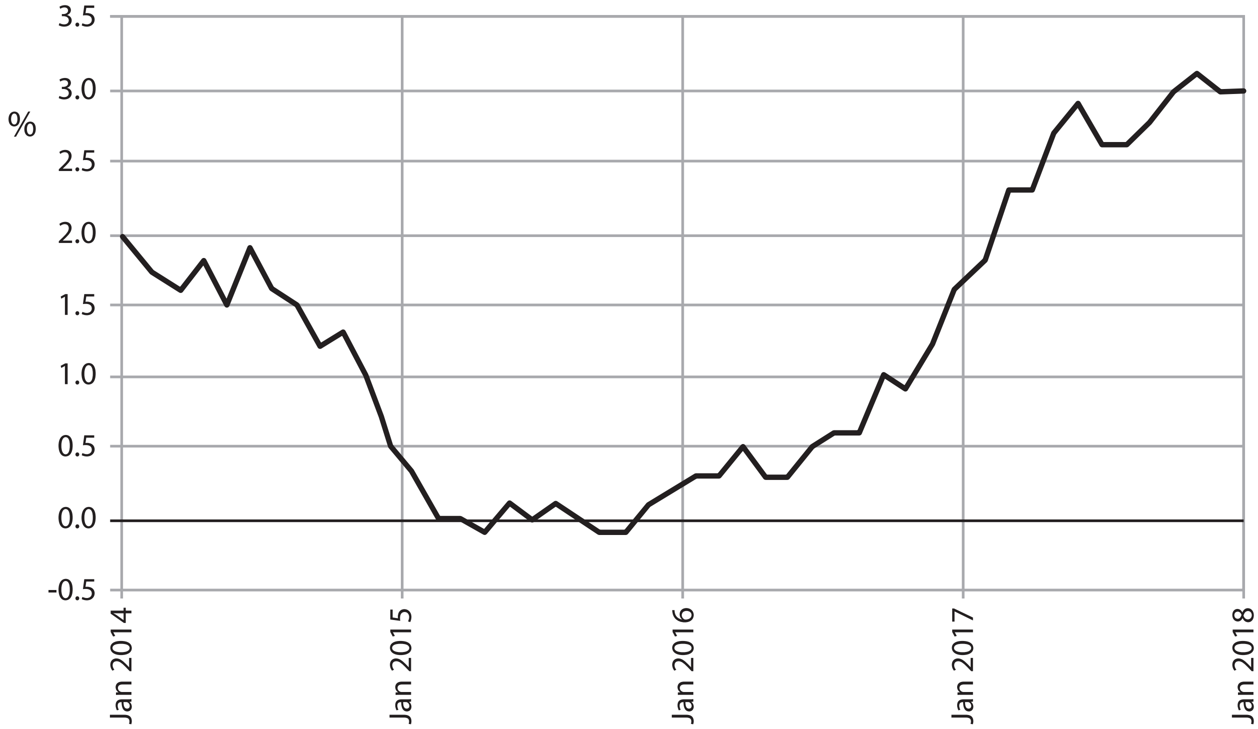
(20)

(Total for Question 5 = 20 marks)

Question 6

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



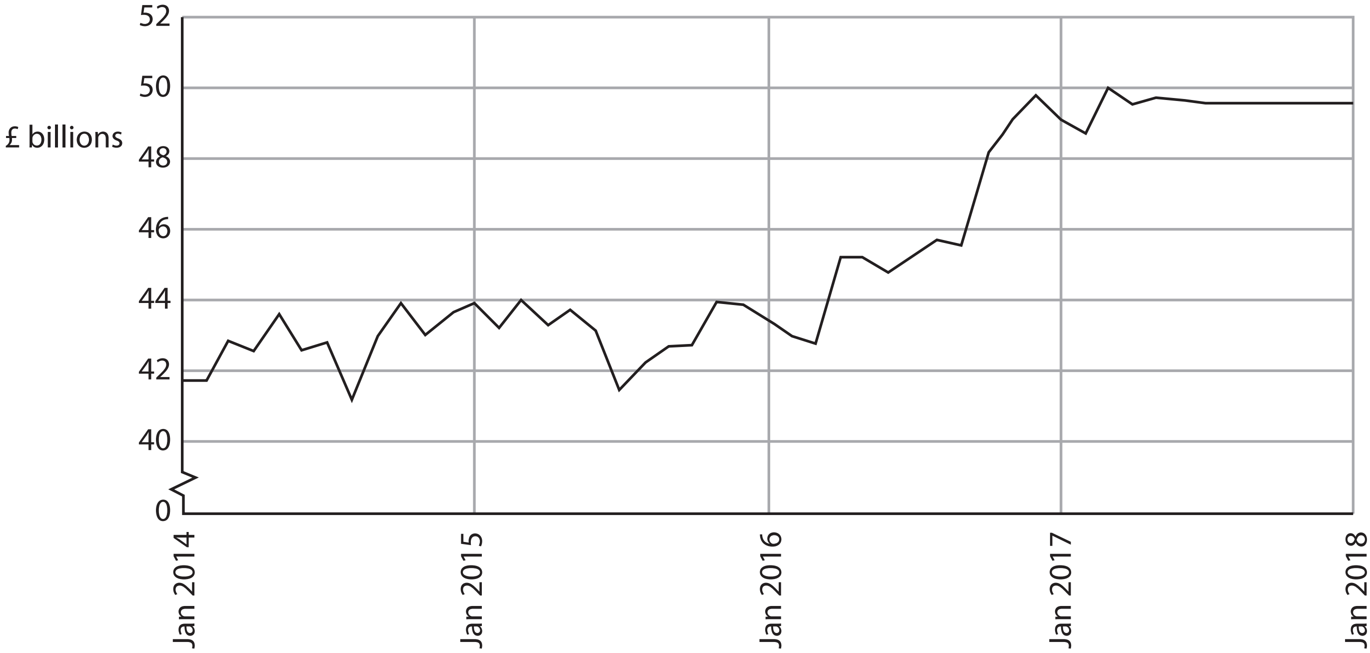
(Source: www.bankofengland.co.uk/publications/Pages/inflationreport/2017/aug.aspx)

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/)

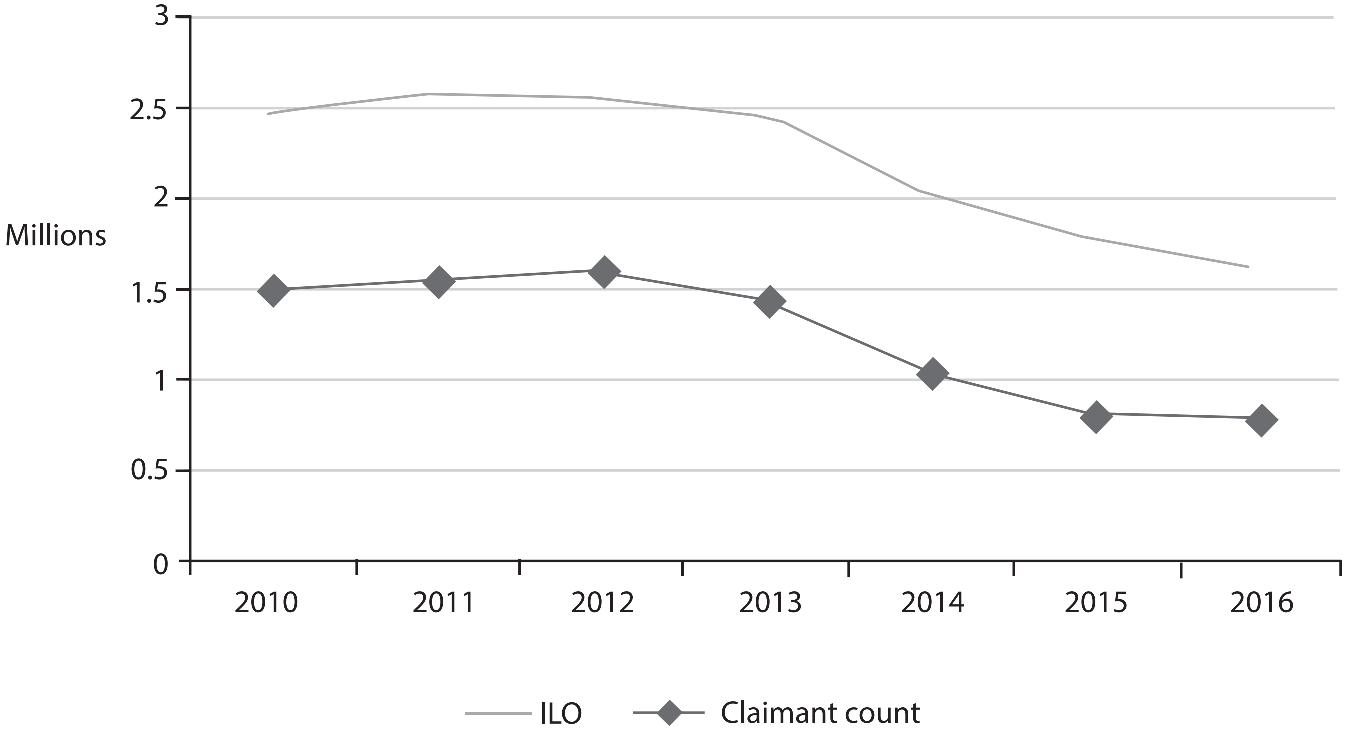
6 Evaluate the use of interest rate changes as a means of controlling UK inflation. **(20)**

(Total for Question 6 = 20 marks)

Question 7

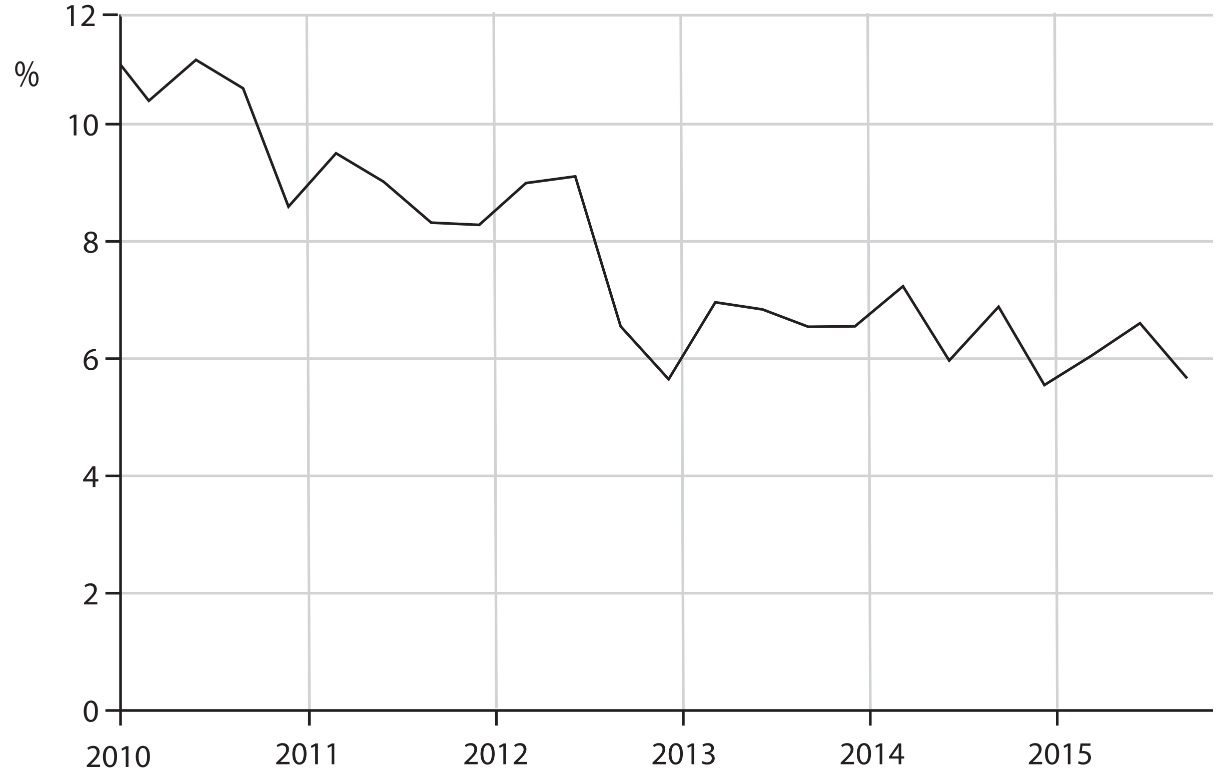
The UK economy

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



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

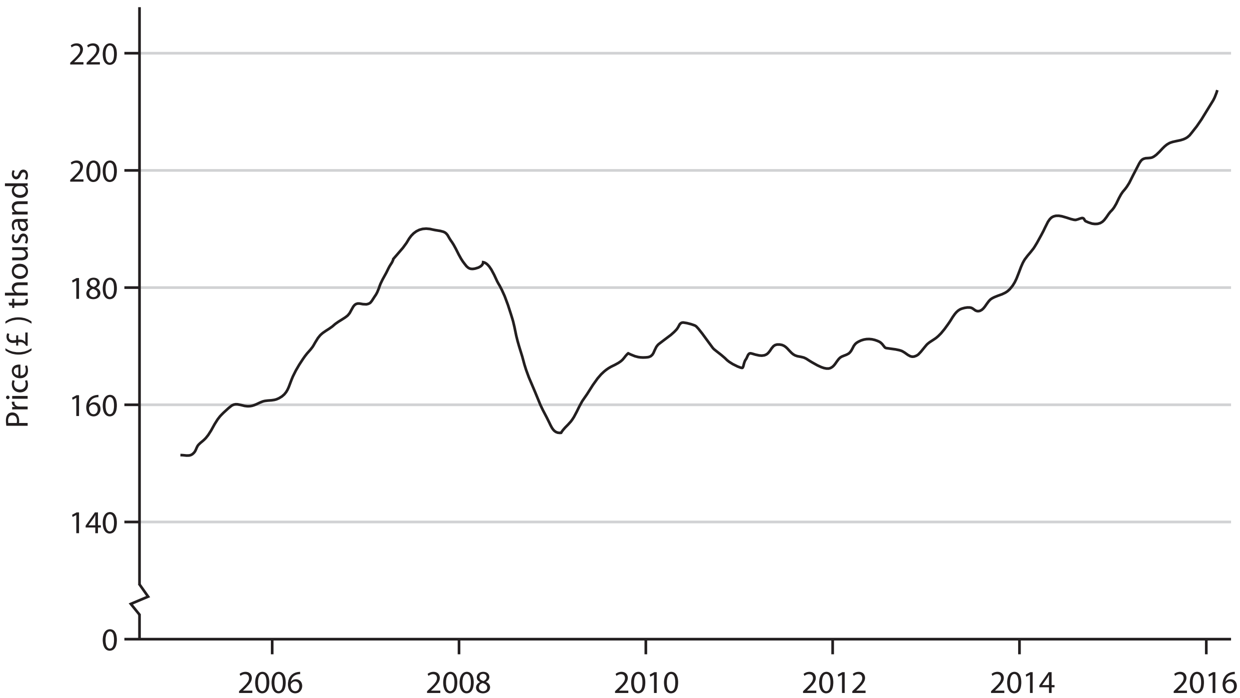
Figure 2: Household savings*, 2010-2015



* 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)

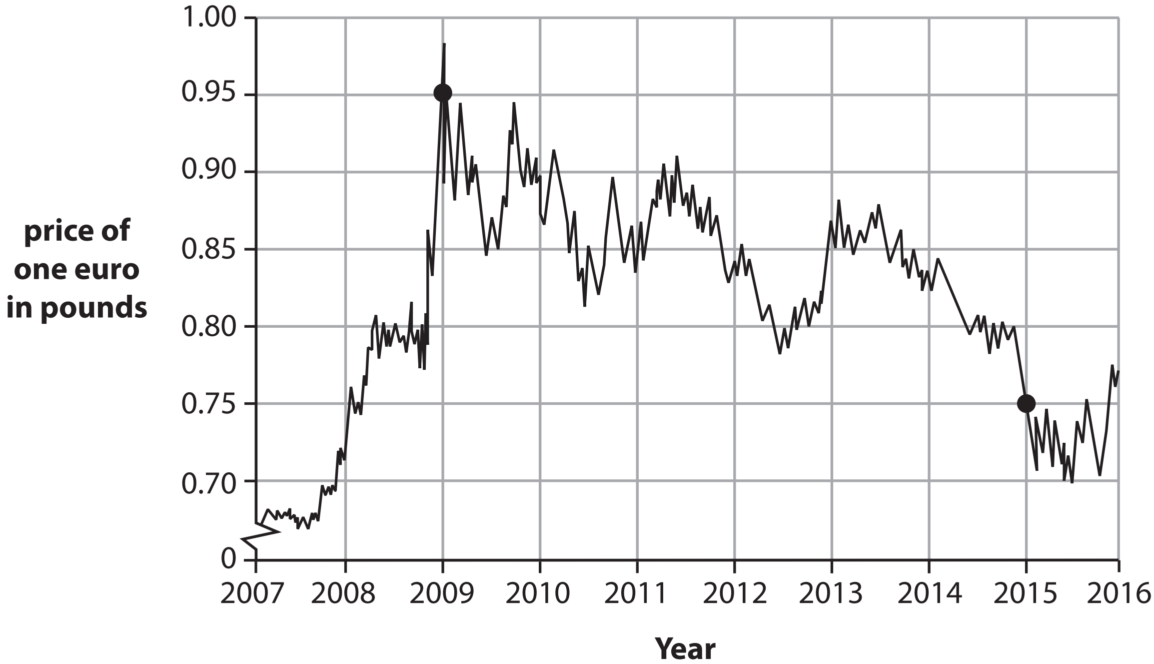
7 Evaluate government policies, apart from migration policies, that could be used to increase the employment rate in the UK. **(20)**

(Total for Question 7 = 20 marks)

Question 8

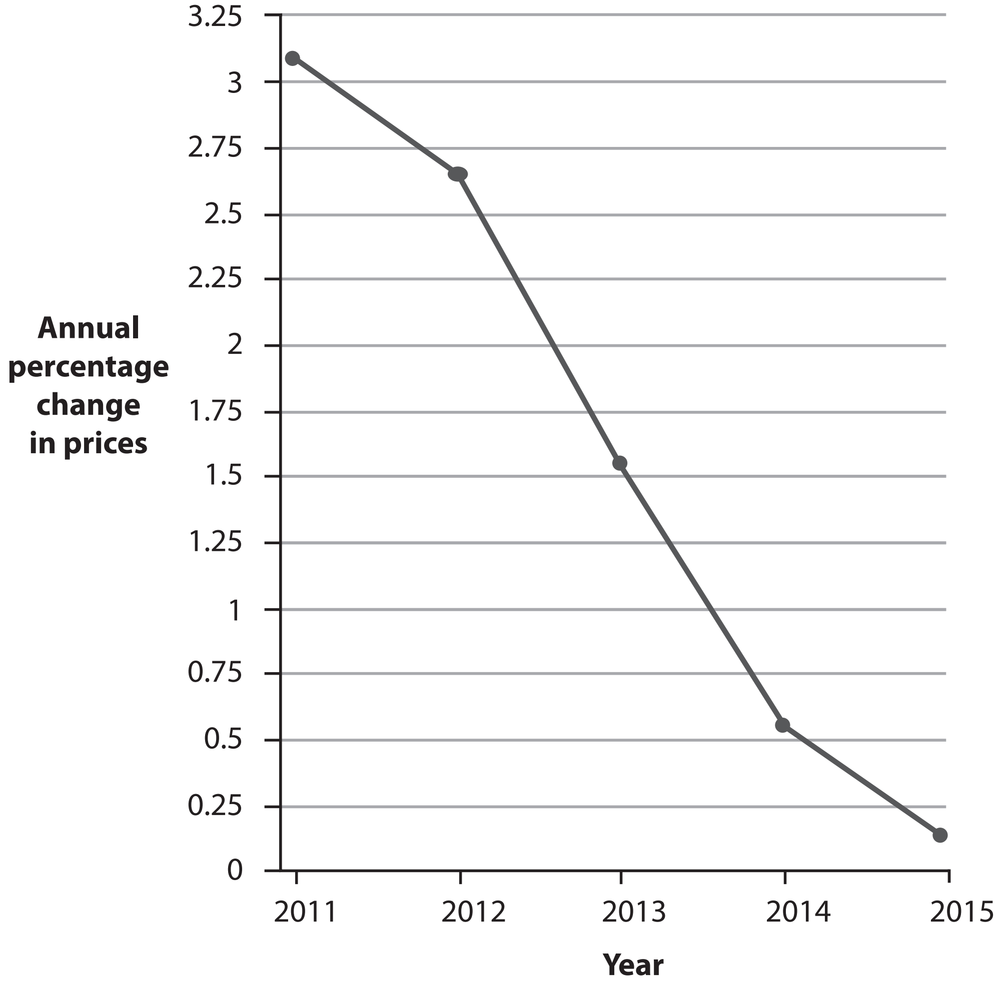
The Eurozone economy

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.

"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)

(a) Discuss the likely success of the ECB's quantitative easing programme in moving Eurozone inflation closer to 'the central bank's ceiling of 2%' (Extract A, line 17).

(12)

(b) Discuss 'looser fiscal policy' and 'supply-side reforms' (Extract A, lines 20 and 21) that may be used by governments of Eurozone countries to increase economic growth.

(15)

(Total for Question 8 = 27 marks)

Question 9

UK economic recovery

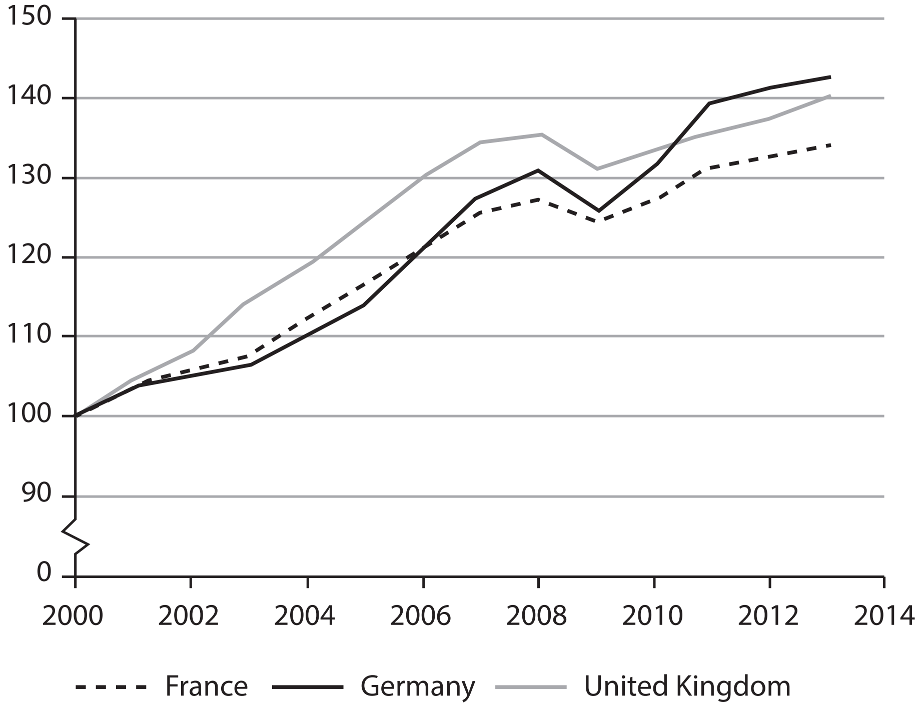
Figure 1: Components of aggregate demand in selected countries 2014

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%.

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.

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.

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.

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.

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

9 Evaluate policies the government could use to increase the UK's productivity.

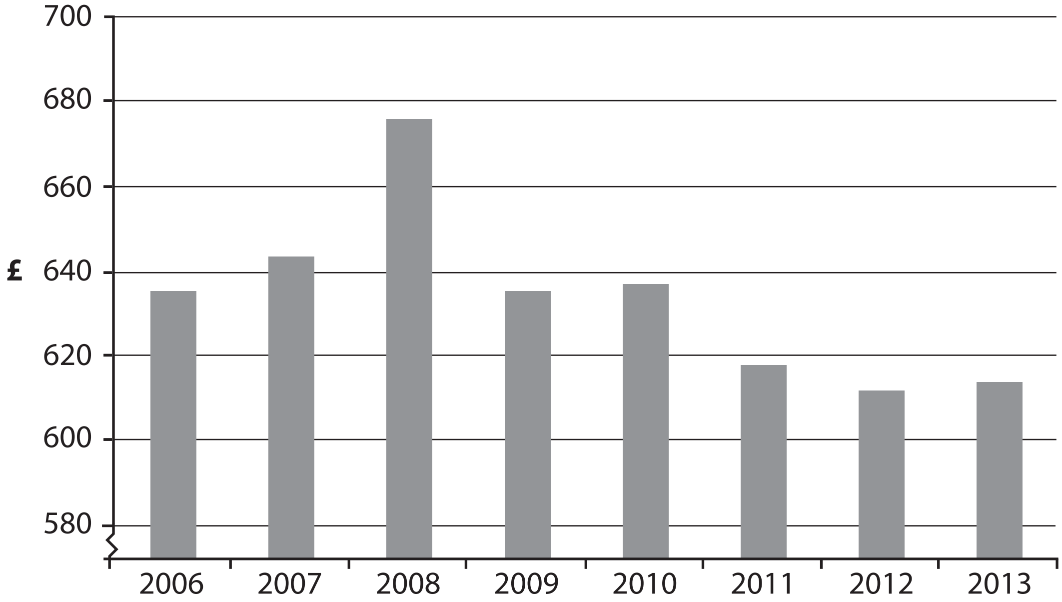
(15)

(Total for Question 9 = 15 marks)

Question 10

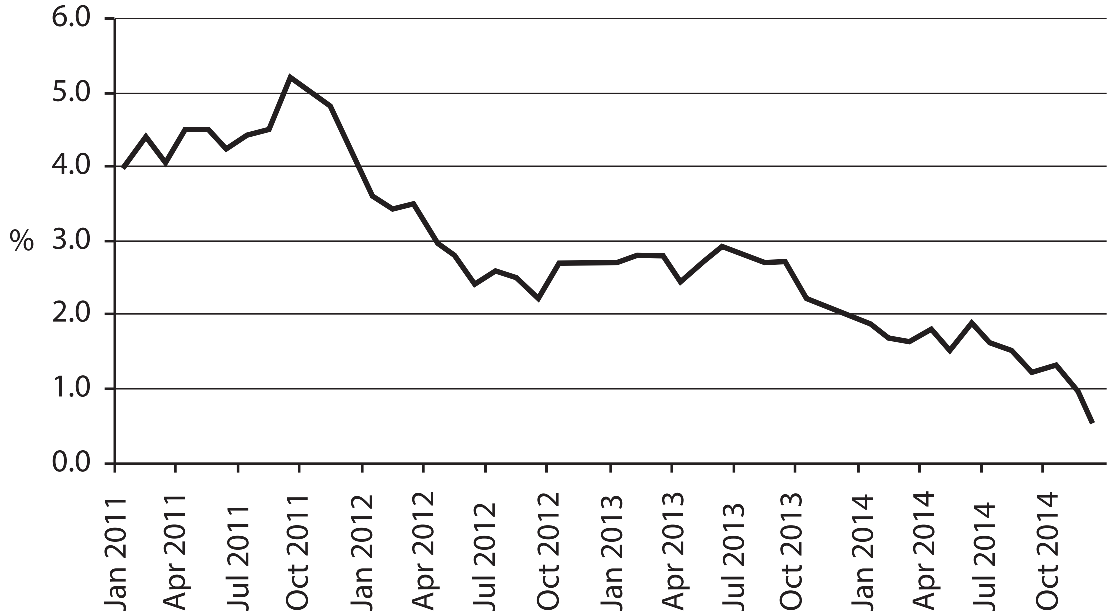
UK incomes, inflation and monetary policy

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.

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

(20)

(b) Evaluate demand-side policy responses to the Global Financial Crisis of 2008.

(20)

(Total for Question 10 = 40 marks)

11 UK inflation

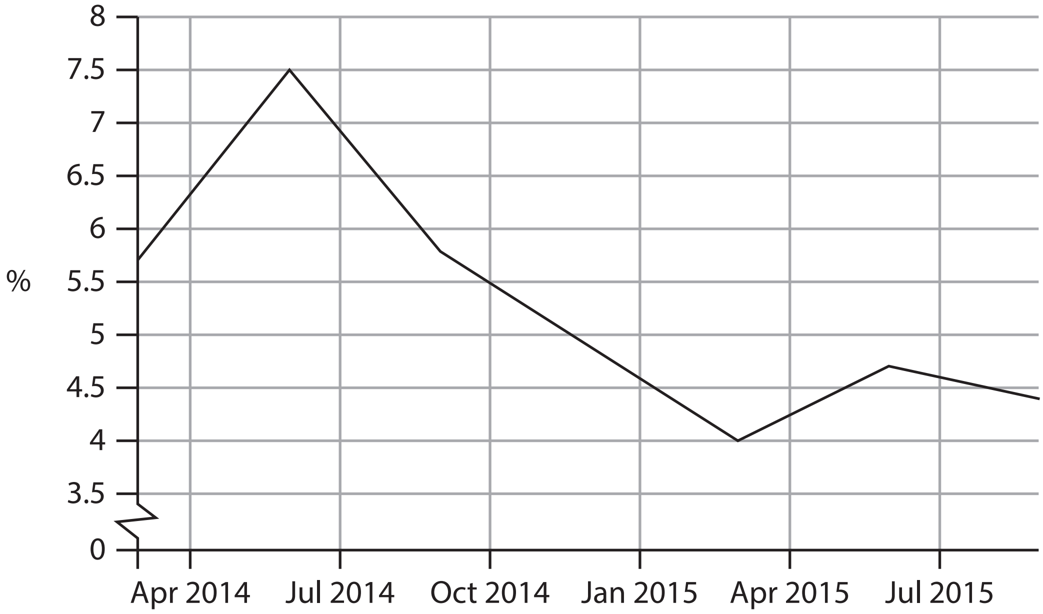
Figure 1 UK Consumer Prices Index (CPI) inflation, year on year

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

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

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

(a) Analyse **two** potential problems for the UK economy of an increase in the base rate of interest.

(8)

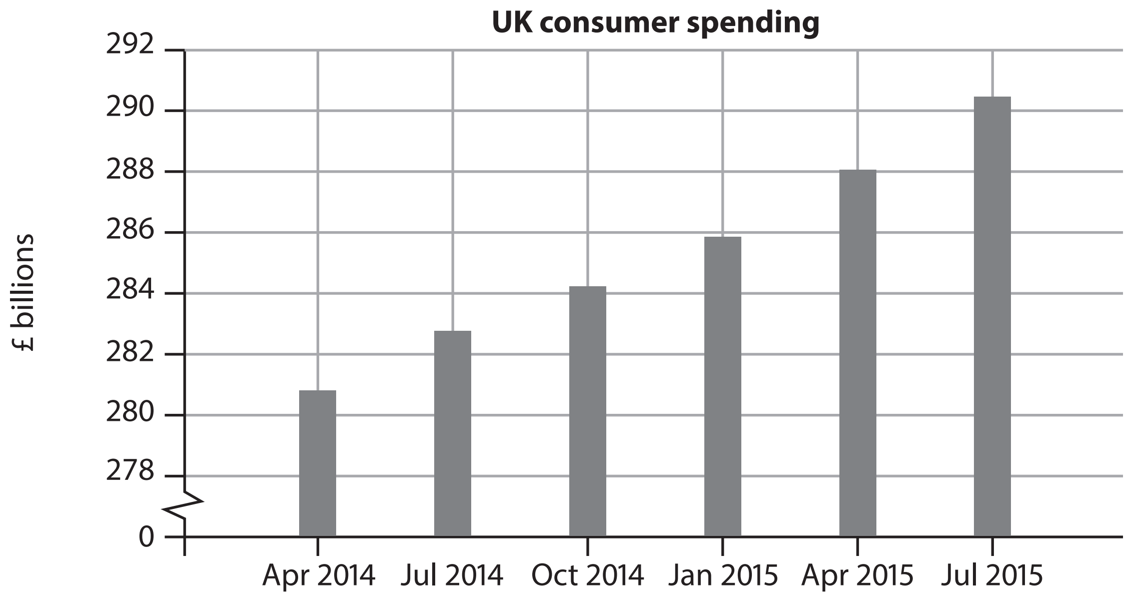
*(b) Evaluate policies that could be used to return the UK's inflation rate to its 2% target.

(30)

(Total for Question 11 = 38 marks)

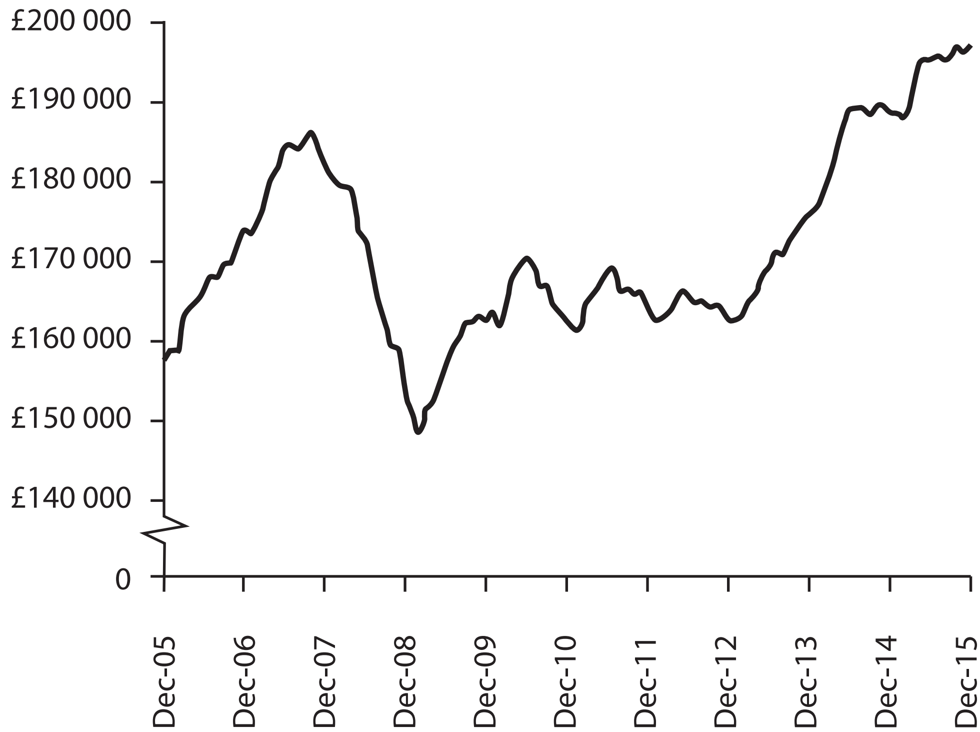
12 Stability of the UK economy

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.

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.

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."

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.

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."

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.

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".

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

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

(Source: adapted from: http://www.heraldscotland.com/news/homenews/14201611.Stewart_Hosie_issues_warning_over_rise_of_household_debt/)

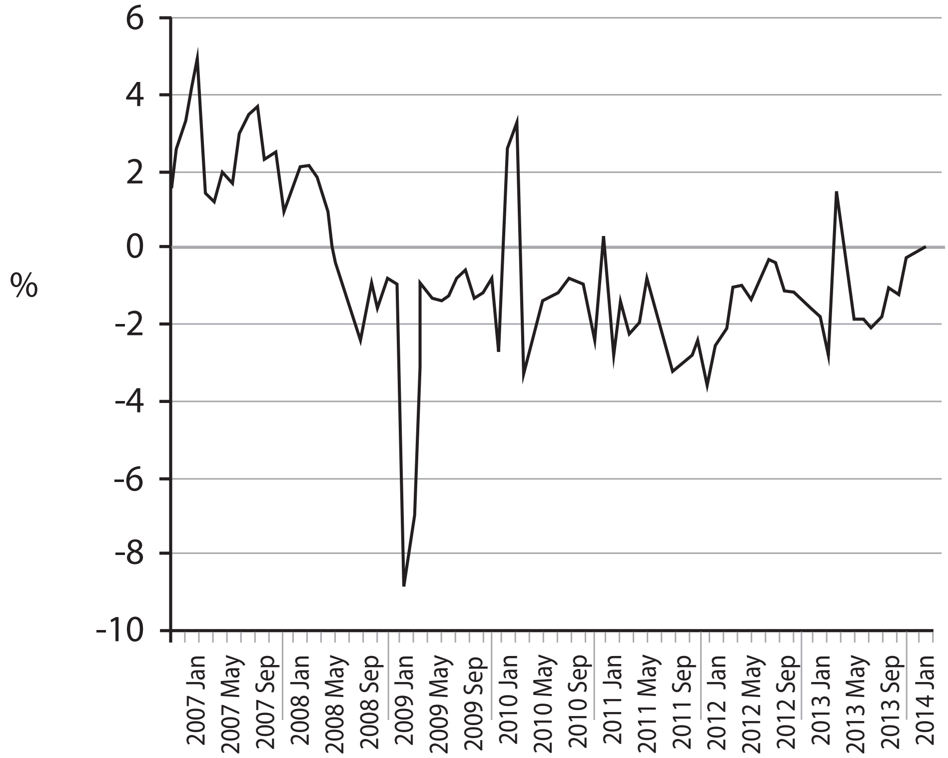
***12** Discuss policies that could be used to improve the productivity of the UK economy.

(30)

(Total for Question 12 = 30 marks)

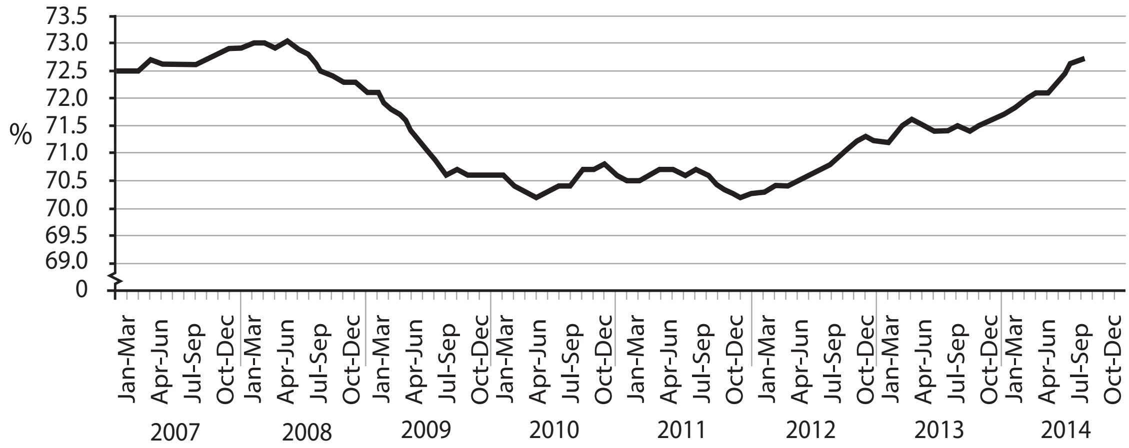
13 UK wages, employment, migration and the trade deficit

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



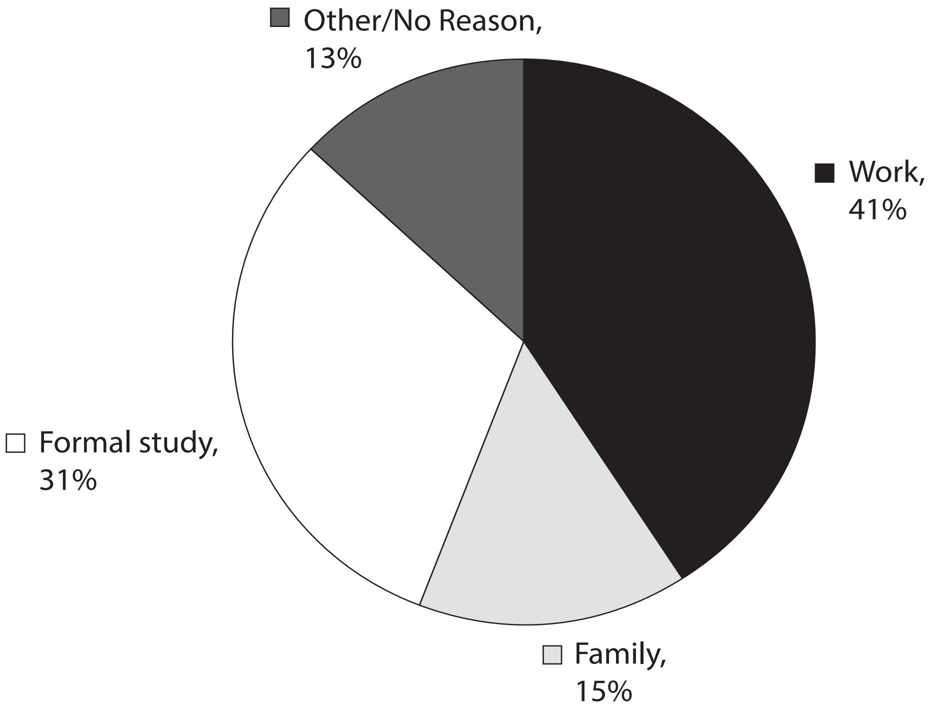
(Source: © ONS Economic Review June 2014, http://www.ons.gov.uk/ons/dcp171766_365818.pdf)

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).

(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.

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.

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."

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

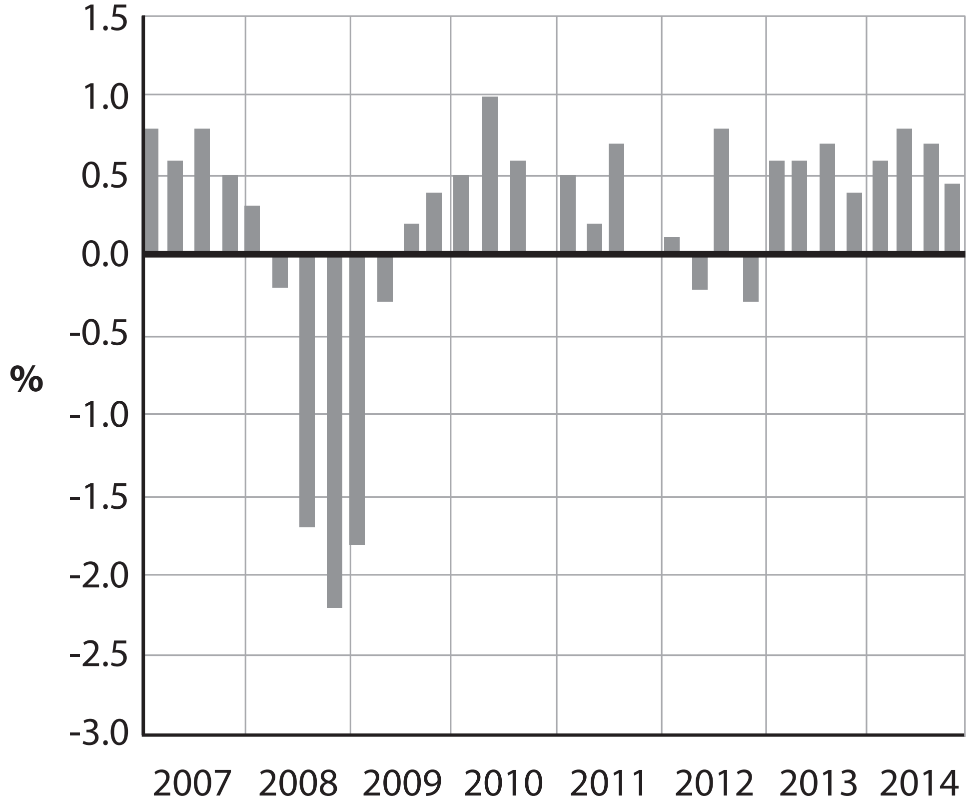
13 Evaluate government policies that could be used to increase the employment rate in the UK.

(30)

(Total for Question 13 = 30 marks)

14 Macroeconomic indicators and policies

Figure 1 UK real GDP growth, quarter on previous quarter



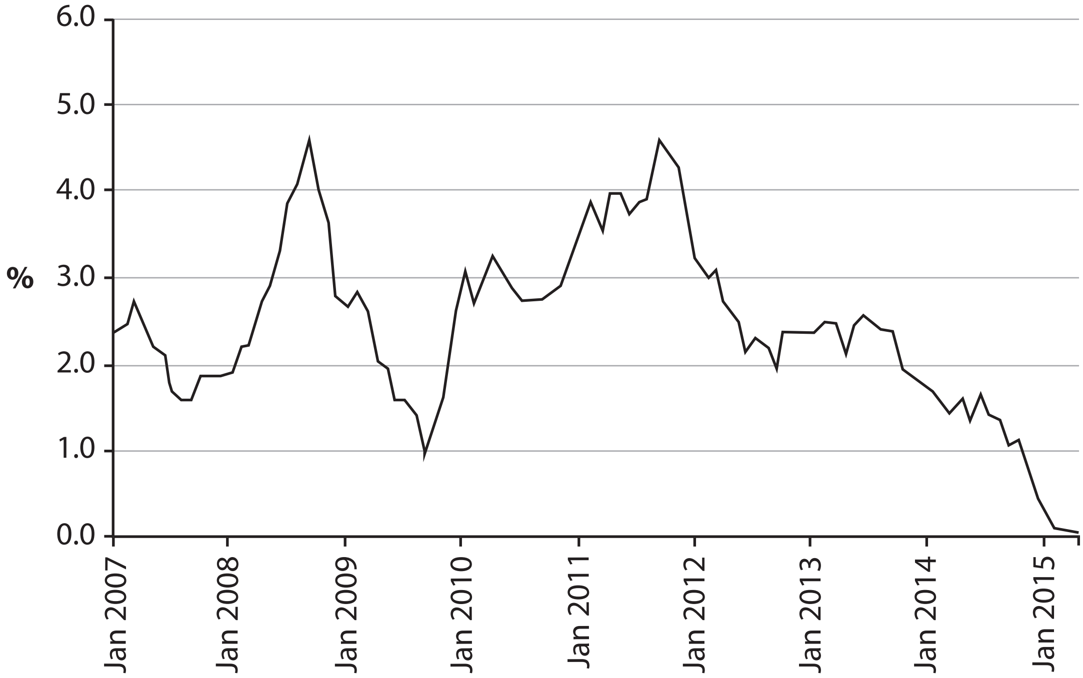
(Source: ONS, http://www.ons.gov.uk/ons/dcp171778_392909.pdf)

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)

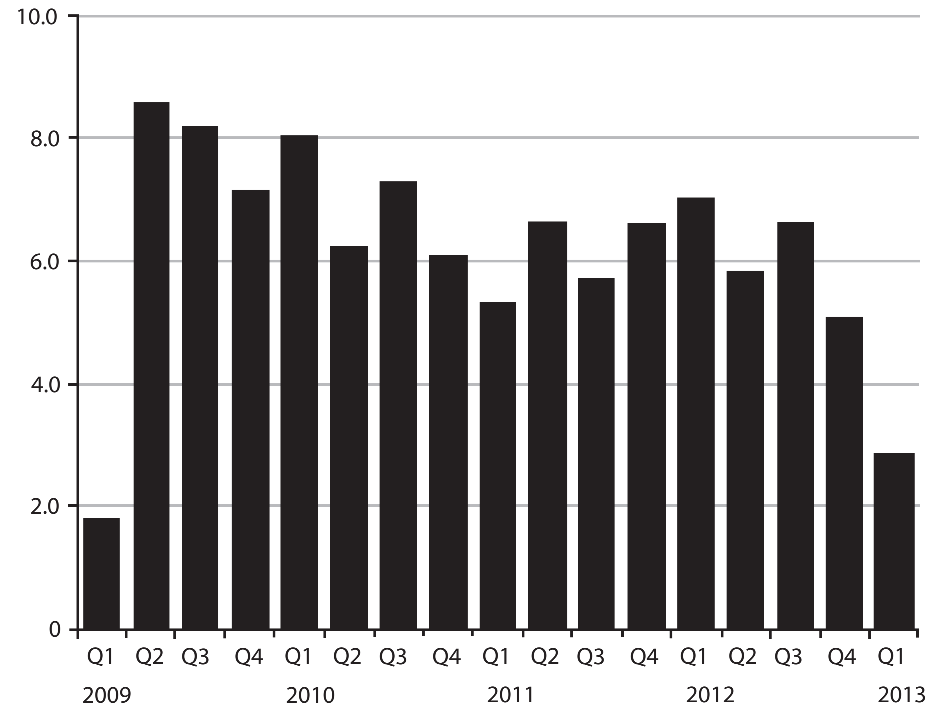
***14** To what extent is monetary policy effective in controlling the rate of inflation?

(30)

(Total for Question 14 = 30 marks)

15 Savings, GDP, housing market and monetary policy

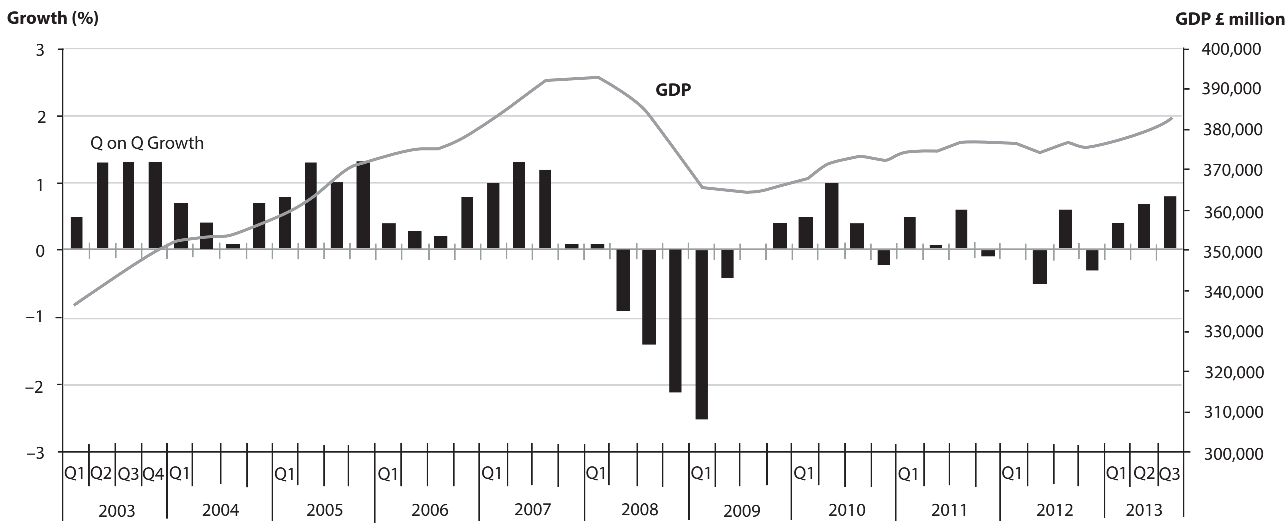
Figure 1 UK household savings ratio*



*Savings as a percentage of household disposable income

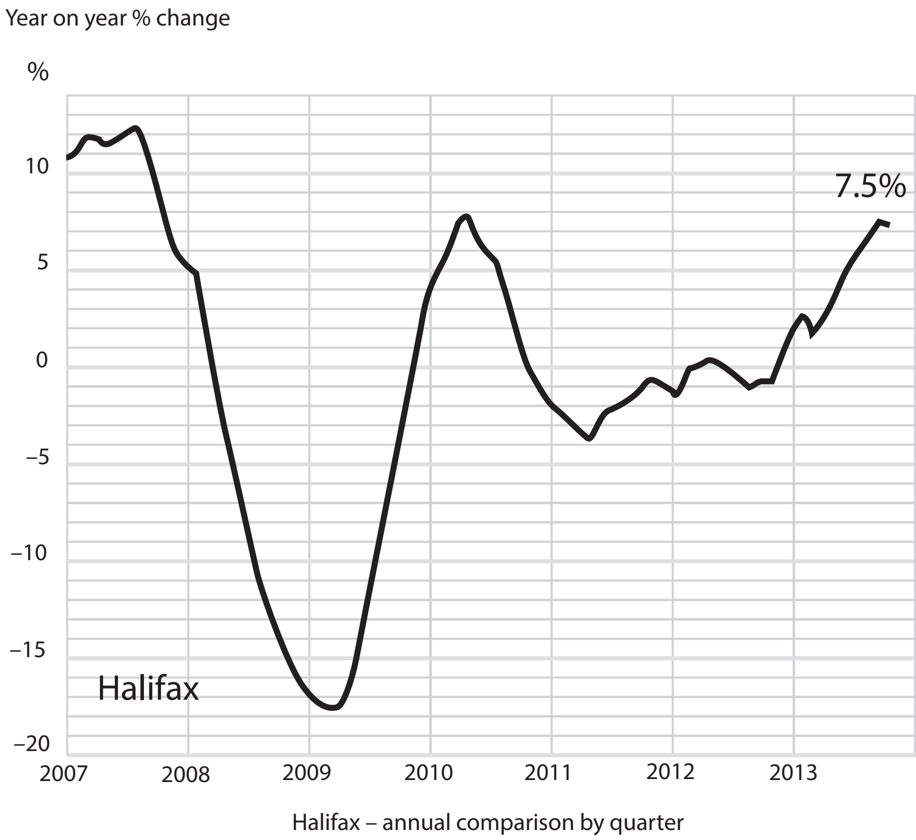
(Source: http://www.ons.gov.uk/ons/publications/re-referencetables.html?edition=tcm%3A77-324888)

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)

(a) With reference to Extract 2, explain the meaning of the term 'monetary policy'.

(4)

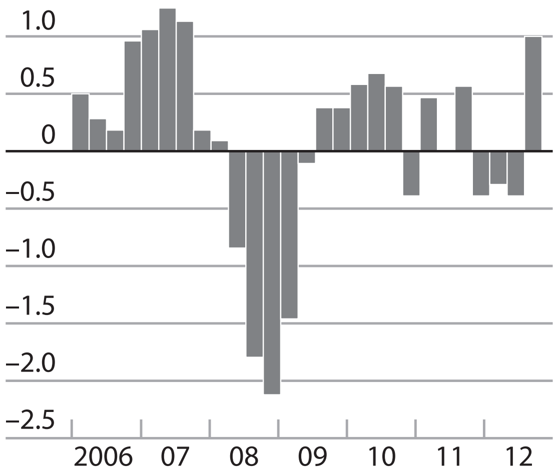
(b) Analyse **two** additional pieces of information, other than house price data, which the Bank of England's Monetary Policy Committee might have considered when deciding to keep interest rates unchanged since March 2009.

(8)

(Total for Question 15 = 12 marks)

16 Growth, Productivity and Unemployment

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



Extract 1
Exceptional effects on growth

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

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

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

Extract 2
UK unemployment and employment

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

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

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

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

16 With reference to the information provided and your own knowledge, evaluate the policies that the UK government could adopt to improve productivity.

(30)

(Total for Question 16 = 30 marks)

17 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) Evaluate possible changes in government spending and taxation aimed at increasing living standards for younger adults in the UK.

(12)

*(b) With reference to the information provided and your own knowledge, to what extent might monetary policy help the UK government achieve its macroeconomic objectives?

(30)

(Total for Question 17 = 42 marks)

18 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) With reference to Extract 3 and using an aggregate demand and aggregate supply diagram, discuss the extent to which "Monetary policy is supporting economic recovery" (Extract 3, lines 7–8).

(12)

*(b) To what extent is the policy of reducing the 'fiscal (budget) deficit' (Extract 2, line 7) helping the government to achieve its macroeconomic objectives?

(30)

(Total for Question 18 = 42 marks)

19 Consumption, Investment and the UK Government's Fiscal Target

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

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

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

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

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

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

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

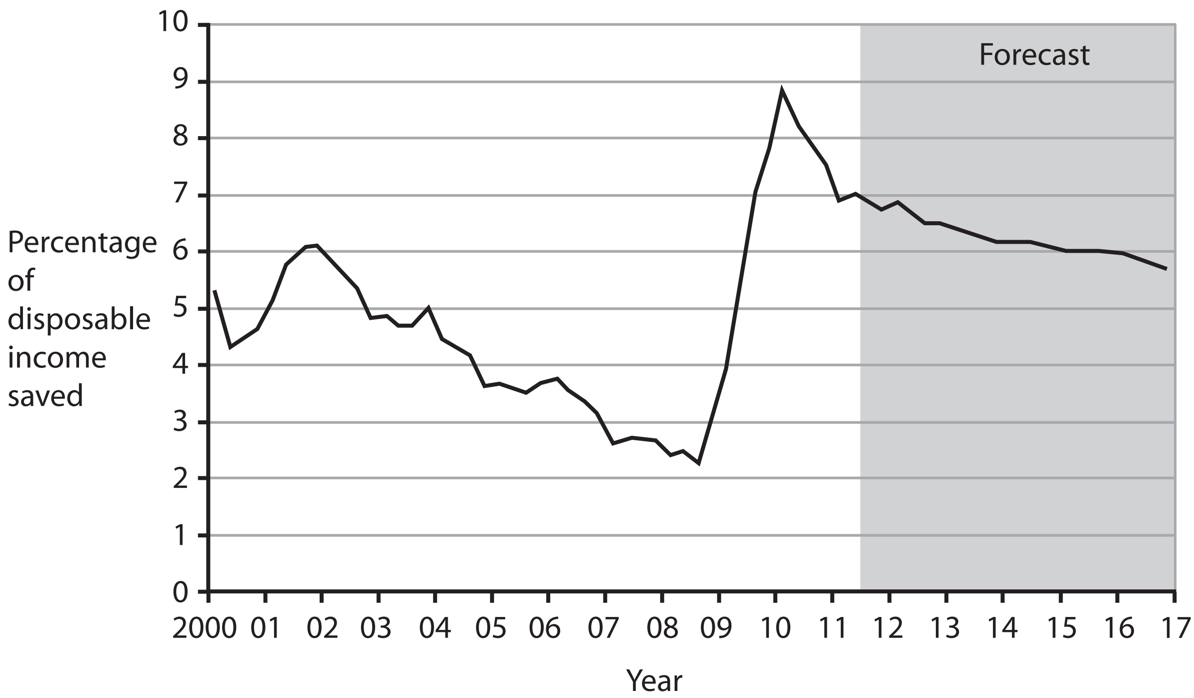


Figure 2 The UK output gap

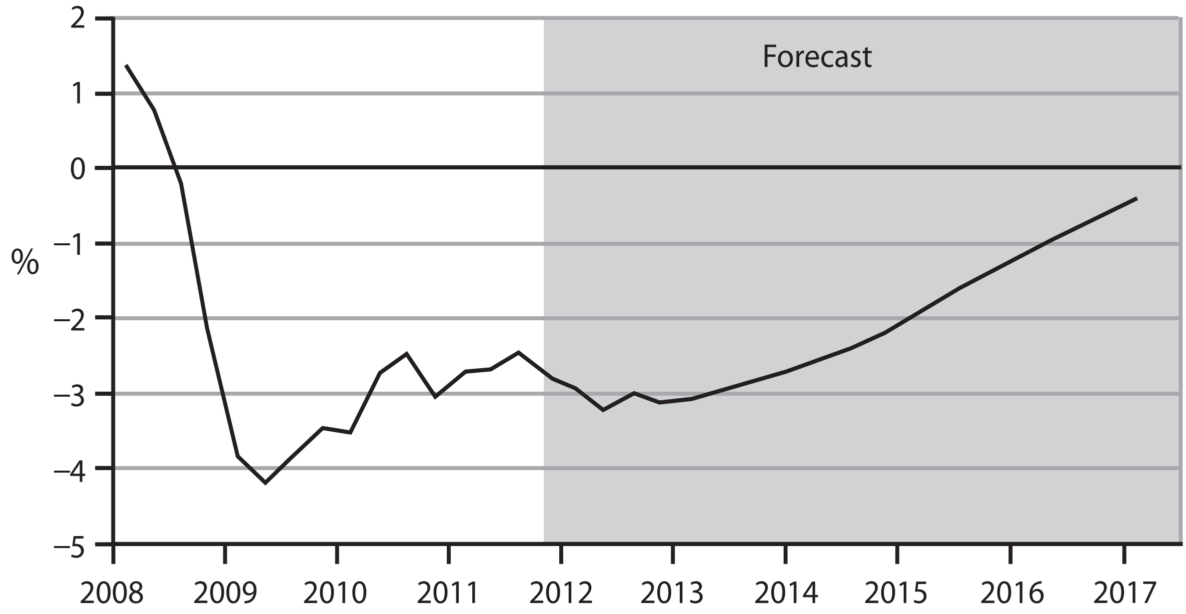
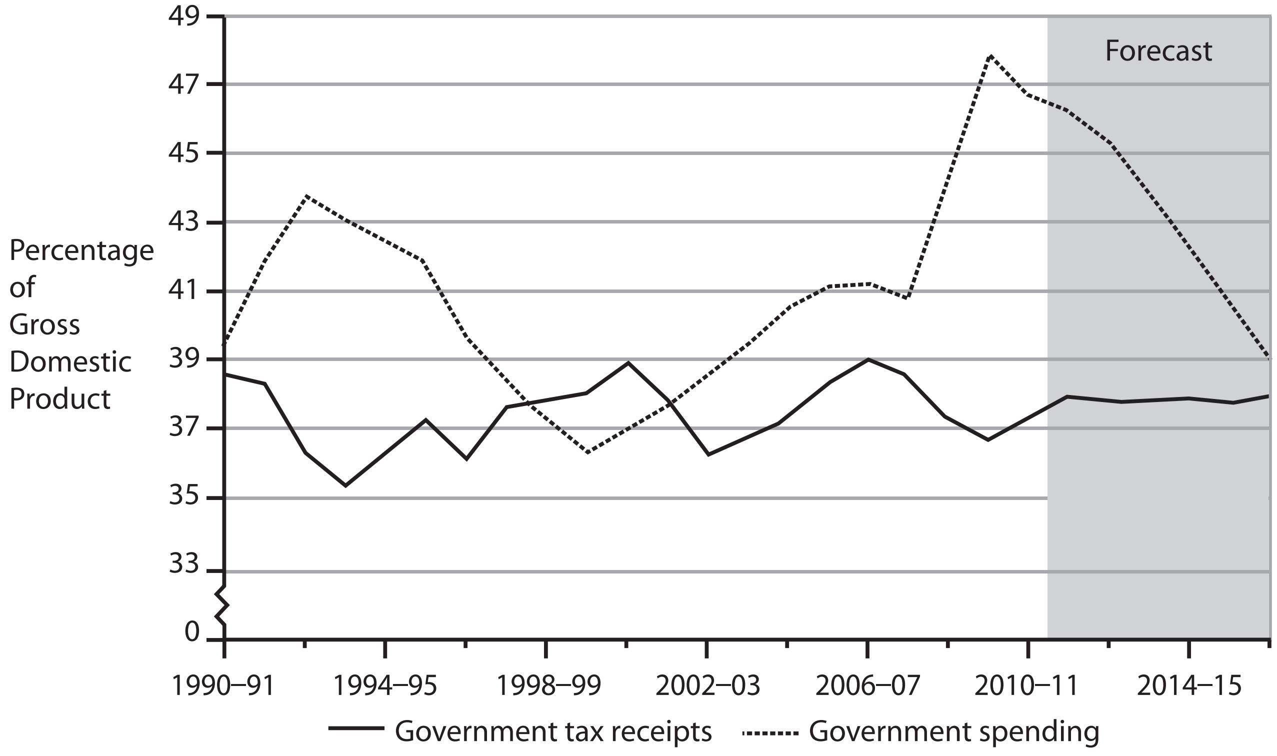


Figure 3 Total UK Government public spending and tax receipts



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

(a) With reference to Figure 3, identify the change in the UK budget deficit between 2002–03 and 2010–11.

(4)

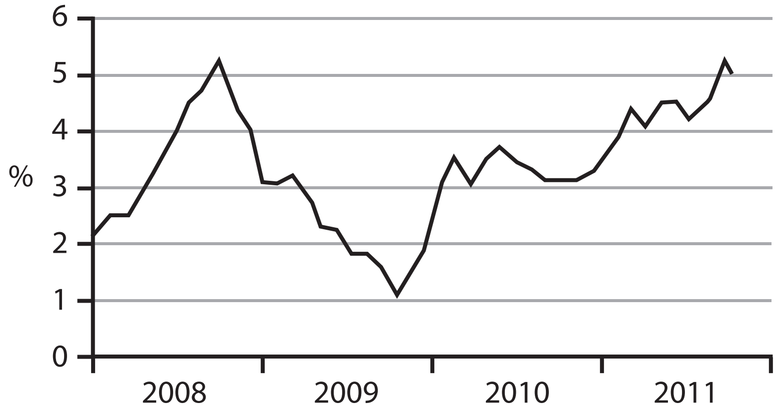
*(b) Evaluate the macroeconomic effects of the UK government trying to reduce its budget deficit, assuming economic growth remains weak.

(30)

(Total for Question 19 = 34 marks)

20 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, Extract 1 and your own knowledge, assess the effectiveness of UK monetary policy.

(12)

*(b) With the aid of an aggregate demand and aggregate supply diagram, assess the possible effects on the UK economy of an increase in government expenditure on education.

(12)

*(c) Other than investing in education, evaluate policies a government can implement to raise living standards.

(30)

(Total for Question 20 = 54 marks)

21 Real Income and Unemployment

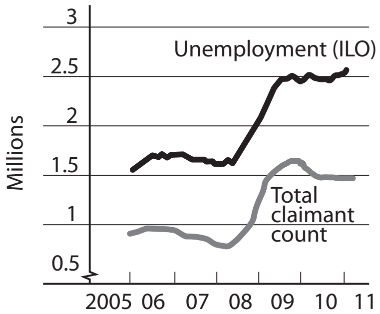
Extract 1 UK households' real disposable incomes

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

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

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

Figure 1 UK unemployment at 17-year high, millions



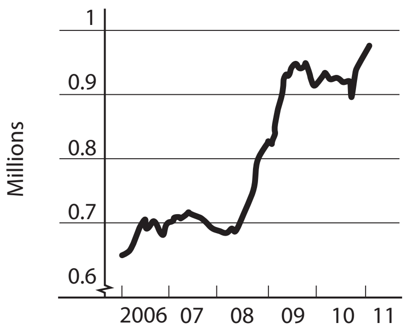
(Source for Figure 1: Adapted from the Financial Times on 16 March 2011 © The Financial Times Limited 2011)

Extract 2 Unemployment measurements diverge

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

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

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



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

Extract 3 Youth unemployment

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

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

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

*21 Evaluate macroeconomic policies which may be used to reduce the level of unemployment in the UK.

(30)

(Total for Question 21 = 30 marks)

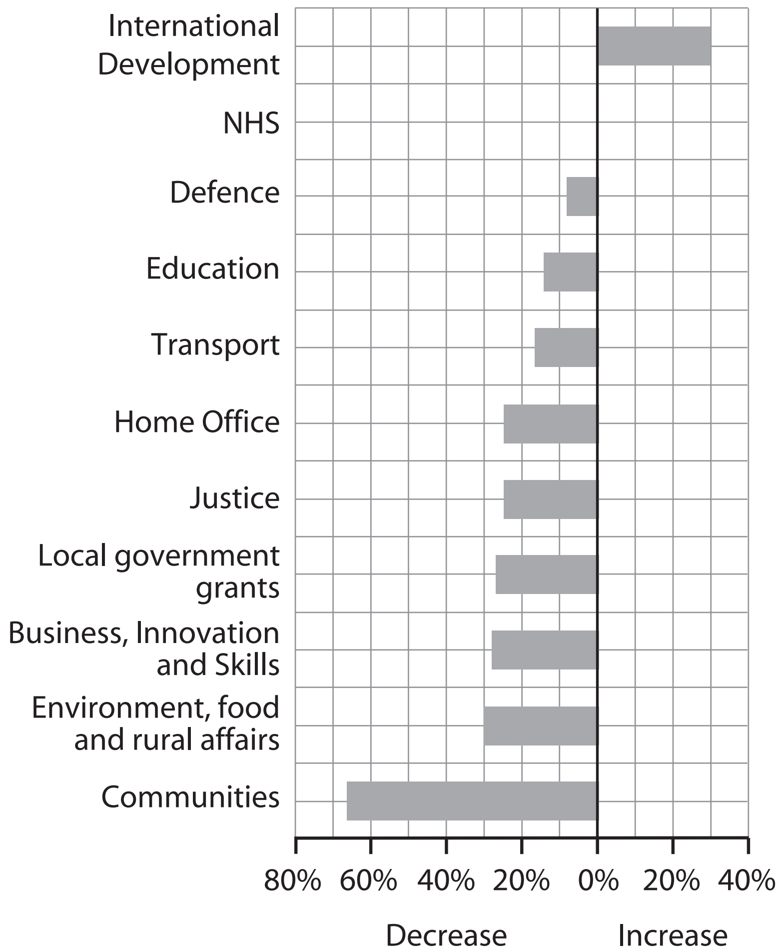
22 Public Sector cuts, unemployment and inflation targets

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

(12)

*(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)

(Total for Question 22 = 24 marks)

23 Inflation and Unemployment in the UK

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

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

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

Extract 1 King says inflation surge 'short term'

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

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

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

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

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

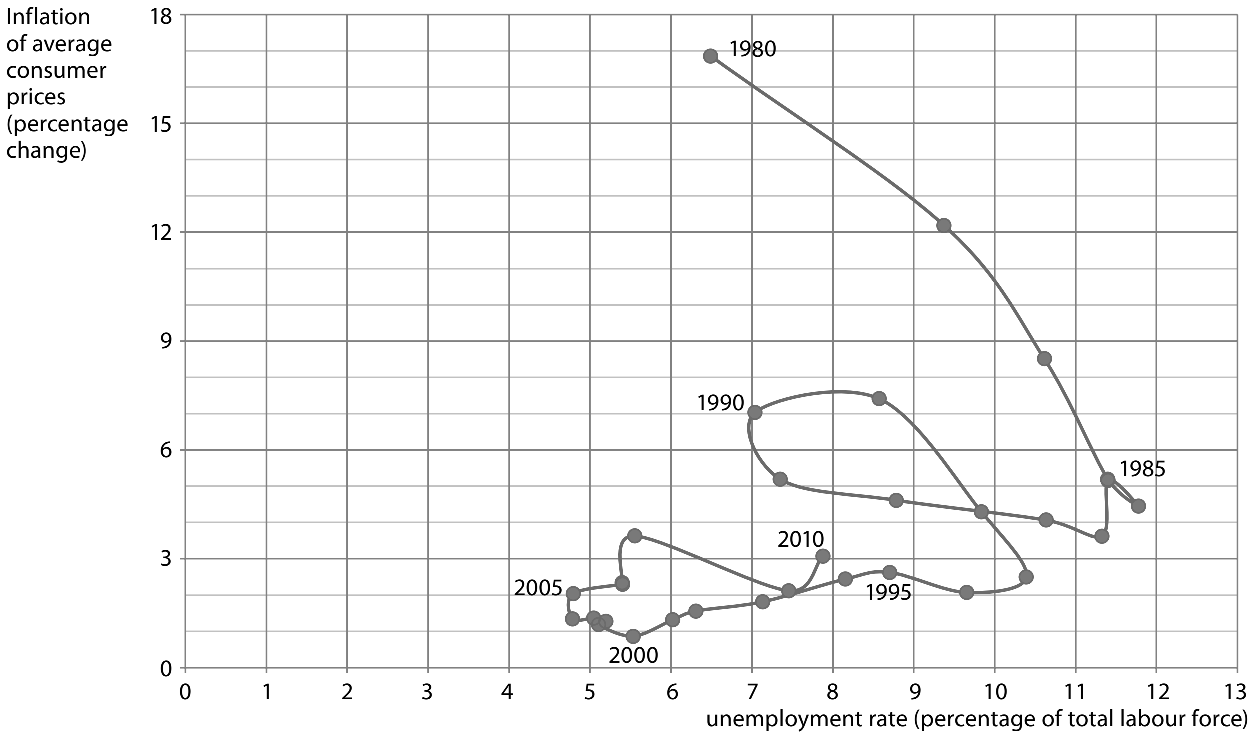
http://www.ft.com/cms/s/0/d29d8984-1aea-11df-88fa-00144feab49a.html and
http://www.ft.com/cms/s/3/3963580c-1199-11df-9195-00144feab49a.html

Extract 2 Unemployment Headlines from the Guardian, March 2010

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

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

Figure 2 UK Inflation and Unemployment 1980–2010*



*The 2010 figure is predicted

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

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

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

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

(a) Assess the usefulness of the information provided in Extracts 1 and 2 and Figure 3 to the MPC when making interest rate decisions.

(12)

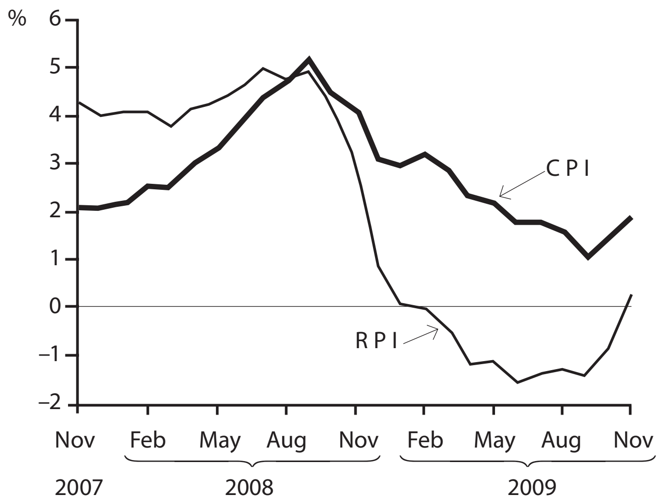
*(b) Discuss the fiscal and supply side policies the UK Government could pursue to reduce the rate of unemployment. Refer to Extract 2 and Figure 3 in your answer.

(30)

(Total for Question 23 = 42 marks)

24 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.

24 With reference to Figure 1, and your own knowledge, to what extent has monetary policy, as conducted by the Monetary Policy Committee, been a success?

(12)

(Total for Question 24 = 12 marks)

25 Economic Growth and Unemployment

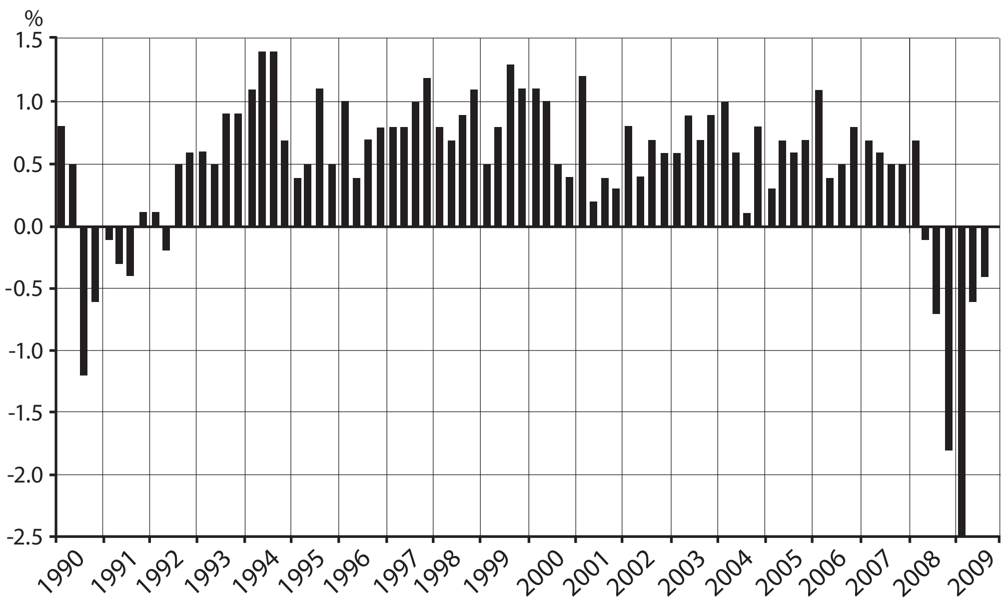
Extract 1 The World Economy – a glimmer of hope?

The worst of the economic downturn is over only in the sense that the pace of global decline has peaked. Thanks to expansionary – and unsustainable – fiscal and monetary policies, output growth will eventually become positive again. However, growth, when it comes, will be too feeble to stop unemployment and spare capacity rising. The increasing output gap will keep many individuals and firms dependant on the government.

Consider what that means. Much of the rich world will see unemployment rates that reach double figures, and then stay there. Inflation will become negative thanks to falling fuel costs and record economic spare capacity, pushing down prices and wages. Government borrowing will soar because of falling growth, prolonged fiscal spending and the growing costs of bailing out the banks and other firms. Continuing high unemployment, years of falling investment and higher government borrowing will limit economies' underlying potential. It is clear that rates of economic growth will be lower than the long-term trend for years to come.

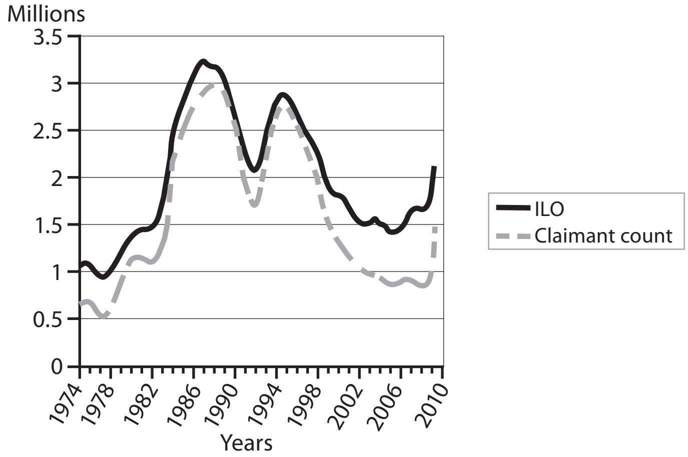
Source: adapted from *The Economist* 24 April 2009
http://www.economist.com/opinion/displaystory.cfm?story_id=13527685.

Figure 1 UK Growth rates at a 30-year low



Source: statistics.gov.uk

Figure 2 Unemployment: ILO and the Claimant Count



Source: www.statistics.gov.uk

Extract 2 Unemployment: ILO and the Claimant Count

ILO unemployment is now 6.7% (2.1 million). In some regions it is much higher, for example the West Midlands (8.4%) and the North East of England (8.3%). While ILO unemployment is still much lower, so far, than in the recent recessions of the 1980s and 1990s, it is forecast that the level will go above 3 million in 2010. The employment rate for people of working age is 73.8% as measured by the International Labour Organisation (ILO).

The claimant count has now increased continuously for 14 months. The claimant count rate in March 2009 was 4.5% (1.5 million), up 0.2% on the previous month and 2.1% higher than in March 2008.

Source: adapted from 'First Release labour market statistics' April 2009 ONS

Figure 3 Total immigration into the UK 1998 to 2007

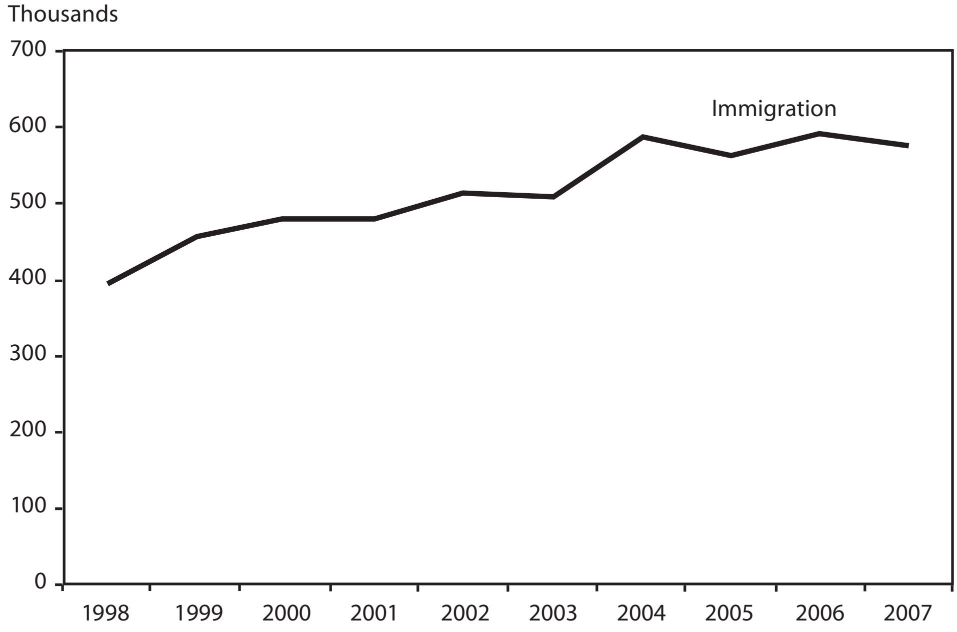
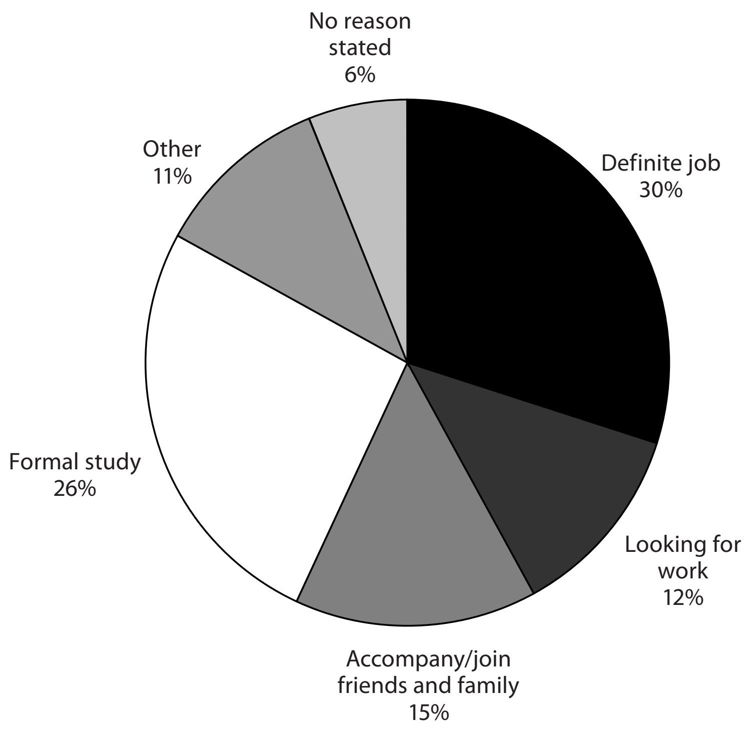


Figure 4 Estimates for the main reason for immigration to the UK, 2007



Source: http://www.statistics.gov.uk/pdfdir/tim1108/pdf

(a) With reference to Figure 1 and Extract 1, distinguish between *fiscal policy* and *monetary policy*.

(6)

*(b) discuss the likely effectiveness of 'expansionary... fiscal and monetary policies' (*Extract 1, lines 2 to 3*) as means of closing the output gap.

(16)

(Total for Question 25 = 22 marks)

26 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.

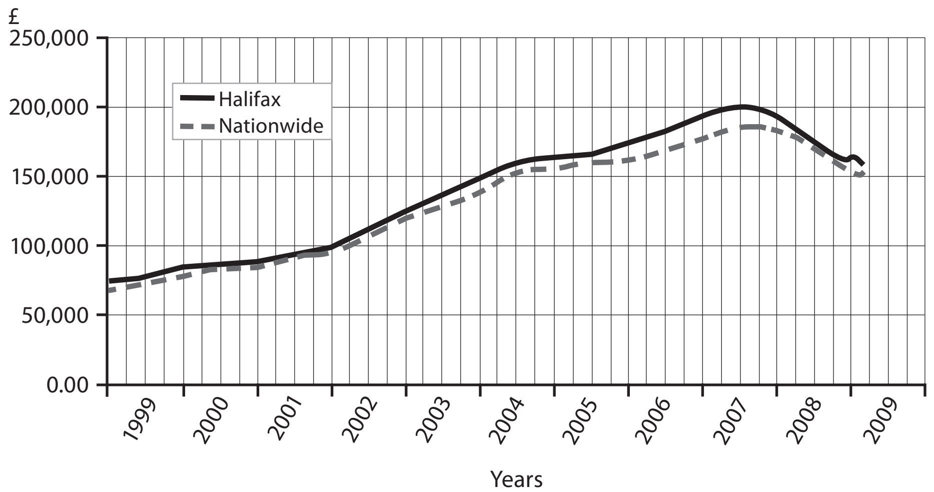
Policy makers noted that the prospect of households holding back on spending was probably the biggest risk to an economic recovery. Household consumption fell by 1 per cent in the fourth quarter of 2008 and the ratio of savings to disposable income was higher than expected.

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.

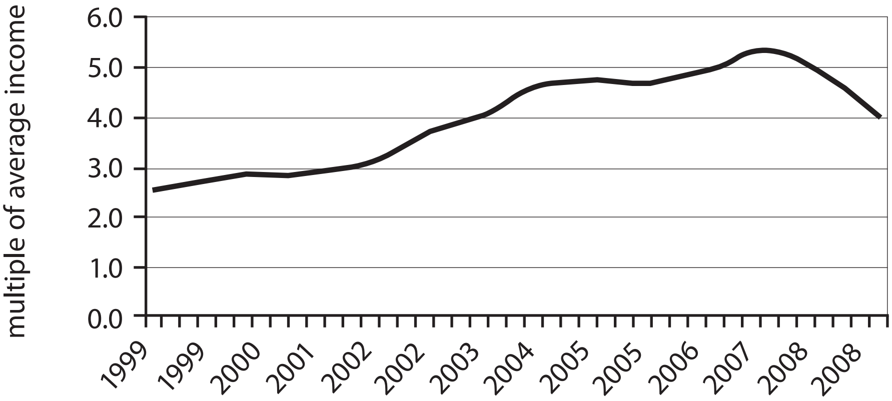
Source: adapted from *The Times* Online April 22, 2009.

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

(a) examine how interest rate decisions may be used to achieve the government's inflation target.

(14)

*(b) Evaluate three ways in which economic policy can be used to 'stimulate UK economic growth' (*Extract 1, lines 4 to 5*).

(30)

(Total for Question 26 = 44 marks)

Question 27 Demand management

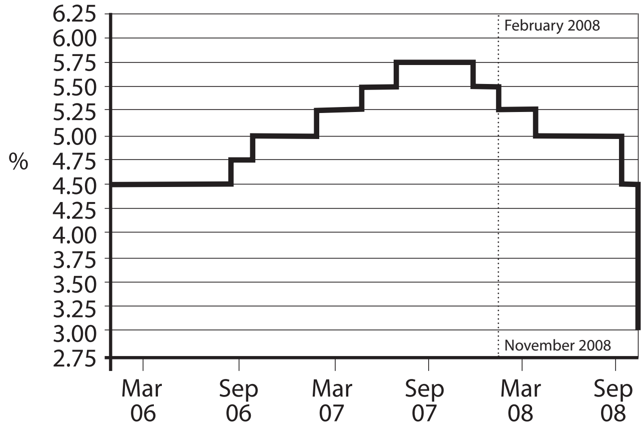
Extract 1 Bank of England cuts interest rates again

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.

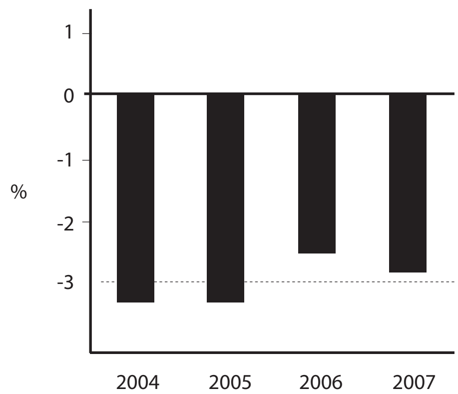
Source: Adapted from press release February 2008 www.bankofengland.co.uk

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



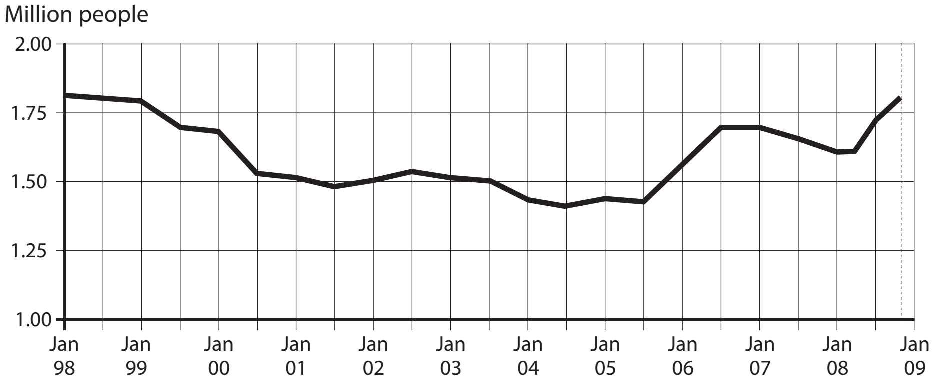
Source: www.statistics.gov.uk 7 April 2008

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

With reference to Extract 2 and Figure 2,

27 Evaluate why a change in the government budget deficit may lead to a more than proportional change in aggregate demand. Use an aggregate demand and supply diagram to illustrate your answer. **(14)**

END OF SECTION B **(Total for Question 27 = 14 marks)**

SECTION C

Write your answers in the spaces provided.

28 The European Central Bank introduced a new round of quantitative easing (QE) in March 2020, purchasing up to €750 billion of assets. The objective of this QE was to reduce the serious risks to the effectiveness of monetary policy resulting from a significant recession. The European Central Bank's target for inflation remains at 'below but close to 2%'.

(Source adapted from: https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html)

Evaluate the effectiveness of quantitative easing during 'a significant recession'. **(25)**

(Total for Question 28 = 25 marks)

29 In 2018, the United States Government cut the corporation tax rate (tax on company profits) from 35% to 21%. Income tax rates for US citizens were also reduced: for example, the top rate of income tax was cut from 39.6% to 37%.

(Source adapted from: https://www.nytimes.com/)

Evaluate the likely impact of cutting tax rates as a policy to increase economic growth. **(25)**

(Total for Question 29 = 25 marks)

30 In 2016 the UK Chancellor of the Exchequer announced that the government would spend an extra £23 billion on innovation and infrastructure over the following five years.

Evaluate the likely economic effects of this planned increase in government expenditure. **(25)**

END OF SECTION C **(Total for Question 30 = 25 marks)**