AQA A-LEVEL ECONOMICS · 7136

ECONOMICS



EXAM QUESTION PACK

3.2.2.3 THE DETERMINANTS OF AGGREGATE DEMAND

SCORE	PERCENTAGE
/177	%

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1. In the past few years, CPI inflation has often differed by more than 1% from its 2% target. In the winter of 2015 the UK experienced a brief period of deflation but, more recently, inflation has been over 3%.

Explain the main causes of a rise in inflation.

[15 marks]

2. **The Global Context Extract B** (lines 13 −15) refers to the possible benefit to the UK and other economies if countries hosting major sports competitions become more open to investment in the long term.

Explain the term 'investment' **and** analyse **two** possible economic benefits for the UK when it is investing overseas.

[9 marks]

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3.

THE GLOBAL CONTEXT

Extract B: Winners and losers

The debate over the consequences of globalisation for individual countries continues. Inevitably, there will be benefits and costs, winners and losers. For example, whilst the UK has experienced deindustrialisation, its service sector has been successful in world markets.

As the debate continues, one aspect of globalisation cannot be disputed: that the greater integration of economies has meant that major events occurring in one part of the world will have an impact not just on the affected country or region but are now much more likely to have global significance.

Some events are known about well in advance of them actually happening. Major sports competitions are an example. In 2012, for instance, the UK will host the Olympic Games. Similarly, Russia and Qatar will host the football World Cup in 2018 and 2022 respectively. The economic impact of such events on host countries is likely to be positive. For other countries, the immediate impact is likely to be more limited. However, the UK and other economies could benefit if these events make the host countries more open to trade and investment in the long term.

Other events are far less predictable or are completely unpredictable. For example, how might the UK cope with a disruption to gas and oil supplies if relations with Russia deteriorate or political turbulence in the Middle East escalates? What path to recovery will the UK take following the devastating effects of the 2008 US financial crisis?

Generalisations about the economic impact of natural disasters are often unhelpful. Hurricane Katrina in 2006, which caused billions of dollars of damage in the New Orleans area of the USA, had minimal economic impact on the rest of the world. However, the Japanese earthquake and tsunami in 2011 are on a different scale. Japan accounts for 7% of world GDP. There are fears that the scale of the damage may lead to a return to recession in Japan, as fearful Japanese consumers spend less and save more. Global supply chains originating in Japan, such as car components supplied to the rest of the world, have been severely disrupted. The UK, as well as Japan's other trading partners, will struggle to maintain exports to the Japanese market until stability is restored.

Like any other country, the UK needs to have a strong economy to be able to respond successfully to all types of global event and to secure sustained economic growth. Important factors include high productivity, resource mobility, innovation, skilled labour, a strong infrastructure in its widest sense and general flexibility in the economy. The ability to make use of these supply-side qualities will, however, also depend on aggregate demand. The impact of major global events on UK aggregate demand will inevitably vary considerably, positively or negatively, with unknown consequences for macroeconomic performance.

Source: news reports, 2010/11

4.

The Europena Union Context Extract D (lines 22−23) argues that government spending 'can initiate a powerful stimulus to an economy through the multiplier process'.

Explain 'the multiplier process' **and** analyse its possible impact on an economy's unemployment **and** economic growth.

[9 marks]

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5. THE EUROPEAN UNION CONTEXT

Extract D: Is EU unity threatened?

Europe, and indeed much of the world, was shaken by the depth of the economic downturn from 2008. Many countries, including the UK, saw the solution to be a return to Keynesian economics and, therefore, tolerance of large budget deficits. This was coupled with significant monetary expansion, so that, in the UK for example, the Bank of England Bank Rate was cut to 0.5% in 2009, accompanied by a policy of 'quantitative easing' (increases in the money supply).

The UK pressed other EU governments to embark on fiscal expansion. Not all shared the UK's enthusiasm and, at best, wanted only a much more modest fiscal stimulus than was the case in the UK. However, events sometimes overtook such wishes. Ironically, given the scale of the UK fiscal stimulus, until the latter part of 2009 the UK was the only major economy to remain in recession. This may reflect the greater significance of the housing and financial sectors in the UK compared to other EU countries.

The fiscal position of many EU countries has given rise to concern. Italy, for example, now has a national debt (the total outstanding debt of central government) of around 120% of GDP, even though its annual budget deficit is not exceptionally large. Some countries have shown a greater determination than Italy to cut their deficits. In December 2009, for example, Ireland announced sharp cuts in public sector wages. But it is certainly not just Italy which has shown complacency. The EU's Stability and Growth Pact limits annual borrowing to 3% of GDP. EU governments are under increasing pressure to return to this target by 2014.

The short- to medium-term benefits of fiscal expansion during downturns cannot be denied. Government spending can initiate a powerful stimulus to an economy through the multiplier process. Aggregate demand therefore rises. The UK Pre-Budget Report put government spending at £676 billion. Tax cuts will give households more spending power. Coupled with cheap credit and retail price discounts, recovery can therefore be helped through increased consumption.

However, the impact of increased government borrowing arising from budget deficits across the EU is of concern amongst some economists. It may eventually force the authorities to increase interest rates, lead to 'crowding-out' of private sector activity and make public spending cuts and tax increases an inevitability. In the UK, for example, a VAT rate of 17.5% was restored in January 2010 following a temporary cut to 15%. Equally, the 2009 Pre-Budget Report announced an increase in National Insurance contributions.

The problem in trying to assess the impact of fiscal expansion is, of course, not knowing what might have happened without it. Certainly, some economists are quick to attribute the end of recession in France and Germany in 2009 to such fiscal loosening. Indeed, it is difficult to argue that, for any country in the EU, economic growth and employment cannot be beneficial to some extent at a time when business and consumer confidence are both at a low level.

Whether such a policy eventually causes inflation to make an unwelcome return remains to be seen. At that point, EU members may experience a greater urgency to balance budgets and reduce monetary expansion.

Source: various sources, 2010

6. **The European Union Context Extract E** (lines 8–9) states: 'There's a lack of concern about international competitiveness in France.'

Explain what is meant by 'international competitiveness' **and** analyse how the international competitiveness of France might be improved.

[9 marks]

7. **THE EUROPEAN UNION CONTEXT**

Extract E: The French economy faces problems

The International Monetary Fund (IMF) has warned the French government that, unless it makes major economic reforms to lower its labour costs and avoid tax rises, the economy is likely to experience reduced growth. This view was echoed in a recent survey of bankers, in which France was identified as the most serious threat to Europe's recovery from the debt crisis which has crippled growth and driven unemployment to record highs. The outlook for France, the Eurozone's second largest economy, is more worrying than that for Italy, Spain or Germany.

The Chief Executive officer of the Institute of International Finance said: 'There's a lack of concern about international competitiveness in France.' French President, François Hollande, is failing to revive business investment in the face of one of the world's highest tax burdens. Such investment could generate greater efficiency and higher productivity, especially important if the euro's exchange rate does not always work in France's favour.

An IMF spokesperson, Edward Gardner, also said that French unemployment, which currently stands at 11%, would continue to rise, despite President Hollande's vow to reduce it by the end of the year. 'It reflects in large part a general phenomenon in Europe that the recovery is slower in coming than we had expected.' The euro area's recovery almost came to a halt as the French economy unexpectedly shrank and German growth slowed.

The failure of the French economy to improve is in contrast to the overall success of the German economy and the stronger signs of recovery in the UK. President Hollande now faces difficult choices in reducing government spending to reach European budget deficit commitments. Furthermore, a recent announcement that VAT will rise, despite previous claims that there would be no significant tax rises, may cause further problems for the economy.

Source: News reports, 2013

8. In May 2014, the European Central Bank (ECB) President, Mario Draghi, warned that there was a risk of deflation across economies in Europe.

Explain why deflation may occur in an economy.

[15 marks]

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9. Which one of the following is an injection into the circular flow of income of the UK?

A UK households buying goods from UK firms out of their current income ⬭

B The purchase of raw materials by UK firms from abroad ⬭

C UK firms retaining some of their income as profit ⬭

D The government spending money on old age pensions ⬭

[1 mark]

10. **The Balance of Payments Extract E** (lines 8−10) states that: 'The hope was that with sterling having lost about a quarter of its value since the financial crash five years previously, this depreciation would have boosted exports …'
With the help of a diagram, explain how a boost to exports would help the recovery of the UK economy.

[9 marks]

11. It is now nearly a decade since the financial crisis caused a recession in the UK. In March 2009, the Monetary Policy Committee (MPC) set the UK Bank Rate at 0.5%, which was a record low, in order to stimulate economic growth.

Explain the main features of a recession.

[15 marks]

12. Explain how the data in **The Balance of Payments Extract D** show that increasing growth in real GDP frequently leads to an increased deficit in the balance of trade in goods and services.

[4 marks]

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13. The Balance of Payments

Extract E: Re-balancing the UK economy

The UK government wants to re-balance the economy more towards investment, manufacturing and exports, and away from consumption and government spending. Manufacturing only accounts for around 11% of what is produced in Britain, while the service sector accounts for over three-quarters of UK GDP.

Britain, which until recently exported more to Ireland than to the combined BRIC economies (Brazil, Russia, India, and China), wants to export more to emerging economies and help its companies access the fastest-growing markets in the world.

In 2012, Britain's trade deficit hit its highest level since 2007. The hope was that with sterling having lost about a quarter of its value since the financial crash five years previously, this depreciation would have boosted exports in the same way that it did during the early 1990s, when the pound depreciated after a sterling crisis. The last time that Britain had a trade surplus was towards the end of that decade, in 1997.

Source: news reports, February 2014

14. The Balance of Payments

Extract D: UK trade figures and real GDP growth 2006 - 2012

	UK trade balance			Real GDP (% change on previous year)
	Trade in goods (£ million)	Trade in services (£ million)	Balance of trade in goods and services (£ million)	
2006	-76 842	41 643	-35 199	2.8
2007	-90 535	53 802	-36 733	3.4
2008	-94 261	61 689	-32 572	-0.8
2009	-82 933	59 560	-23 373	-5.2
2010	-98 585	65 733	-32 852	1.7
2011	-100 092	76 832	-23 260	1.1
2012	-108 700	75 319	-33 381	0.3

Source: news reports 2014

15. **Economic Growth and Development in Africa Extract B** (lines 4−5) states: 'Economists can generally agree on the causes of economic growth such as investment, innovation and improvements in productivity'.

With the help of a diagram, explain why investment can lead to increased economic growth.

[9 marks]

16. Explain the term 'upturn in the economic cycle' (**Extract E**, line 1) **and**, with the help of a diagram, analyse why this may have caused Spain's unemployment rate to fall.

[9 marks]

17. **Economic growth and development in Africa**

Extract B: Living standards

Economic growth in Africa is expected to accelerate in 2014 and 2015. However, this growth is failing to translate into job creation and the broad-based development that is needed to reduce high poverty and rising inequality rates in many countries, the UN has said.

Economists can generally agree on the causes of economic growth such as investment, innovation and improvements in productivity. There is greater disagreement over the consequences. An important part of the debate is the impact of economic growth on economic development and living standards. The debate has become more complex as measurement of economic development has become more sophisticated. However, real GDP per capita (income per head) remains one of the basic measures. Various indices, such as the Human Development Index, incorporate a number of factors into their calculations in order to give as comprehensive a view of living standards as possible and to allow more accurate international comparisons. Factors include life expectancy, infant mortality and nutritional levels.

Supporters of continued economic growth point to increased employment, greater welfare, more support for the disadvantaged and more resources for health, education and infrastructure. Opponents of unconstrained economic growth point to the rapid depletion of exhaustible natural resources, environmental deterioration and a widening inequality in the distribution of income and wealth.

Source: News reports 2013

18. Explain the phrase 'devaluation of the exchange rate' (**Extract B**, line 12) **and**, with the help of a diagram, analyse how a devaluation of the Chinese currency (the yuan) may affect economic growth in the UK.

[9 marks]

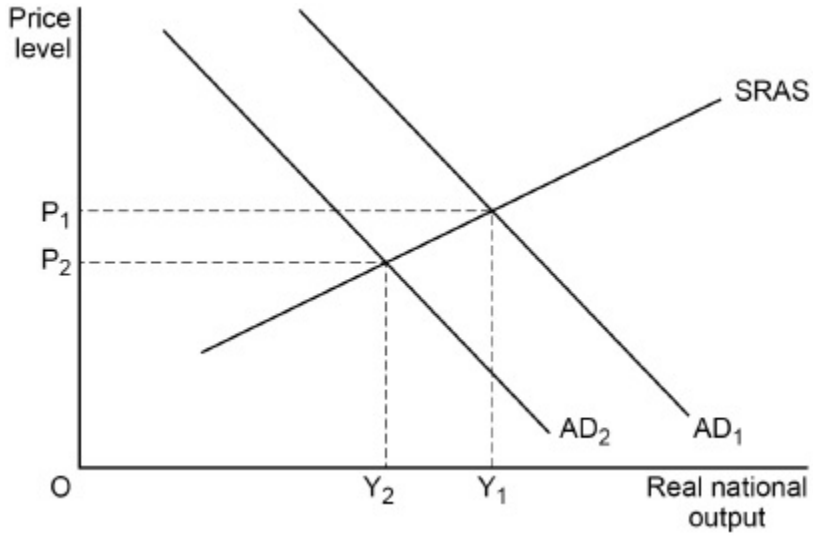
19. The Government has ruled out the possibility of a rise in VAT before 2020 but other indirect taxes may increase. It has also stated that the personal income tax allowance will be increased from £10 800 in 2015/16 to £12 500 by 2020, and plans to cut the main rate of corporation tax from 20% to 17%.

Explain how changes in both government spending **and** taxation might affect the level of economic activity.

[15 marks]

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20. The diagram below shows two aggregate demand (AD) curves and the short-run aggregate supply (SRAS) curve for an economy.



All other things being equal, the change in real national output from Y_1 to Y_2 is most likely to have been caused by an increase in the

A government's budget deficit. ⬭

B level of interest rates. ⬭

C size of the labour force. ⬭

D volume of exports. ⬭

[1 mark]

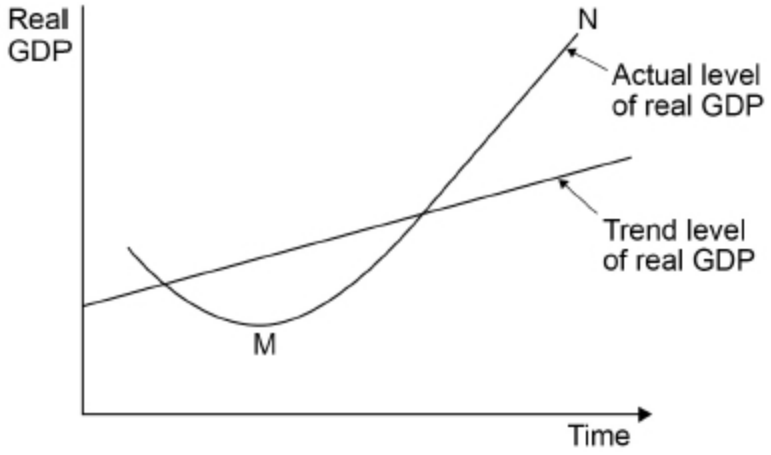
21. The UK has seen significant changes in its pattern of trade with the rest of the world in terms of what we trade and with whom. The UK's current account deficit widened from £29.1bn in 2011 to £100.2bn in 2015. The deficit in 2015 was 5.4% of GDP, the largest annual deficit as a percentage of GDP since records began in 1948.

Evaluate the measures that might be taken to reduce a deficit on the current account of the UK's balance of payments.

[25 marks]

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22. The diagram below shows the actual level of real GDP and the trend level of real GDP over time for an economy. The economy starts its recovery from recession at point M.
After several years of growth the economy reaches point N.



All other things being equal, which one of the following is the most likely consequence of the economy's growth path between points M and N?

A A decrease in the level of interest rates due to deflation. ⬭

B A decrease in the rate of inflation due to increased output. ⬭

C An increase in investment due to the accelerator process. ⬭

D An increase in the value of the multiplier due to a rise in the savings ratio. ⬭

[1 mark]

23. An African Development Bank report showed that Angola received more direct foreign investment than any other African country in 2015. Angola is a less economically developed country (LEDC) that has had fluctuating economic growth in the past. Despite having suffered from a long civil war which ended in 2002, many multinational corporations (MNCs) are now investing heavily in Angola's growing economy.

Explain the main barriers that LEDCs face when attempting to achieve stable, long-term economic growth.

[15 marks]

24. Explain how the data in **Extract D (Figures 1 and 2)** show that consumer confidence may have risen since 2014.

[4 marks]

25. Using the data in **Extract D (Figure 2)**, calculate the average amount saved per household in 2016 if average household income was £26 300. Give your answer to the nearest pound.

[2 marks]

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26. The marginal propensity to consume (MPC) in an economy is 0.5. If the MPC increases by 20% the new value of its multiplier will be

A 2.0 ⬭

B 2.5 ⬭

C 5.0 ⬭

D 10.0 ⬭

[1 mark]

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