AQA A-LEVEL ECONOMICS · 7136

ECONOMICS



EXAM QUESTION PACK

3.2.2.6 DETERMINANTS OF LONG-RUN AGGREGATE SUPPLY

SCORE	PERCENTAGE
/591	%

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1.

The European Union Context Extract F (lines 14−18) states: 'The EU introduced the Stability and Growth Pact …in order to prevent individual economies from creating instability across the EU. However, EU member countries have struggled to keep to the pact, with only four member countries not breaking the rules.'

Using the data and your knowledge of economics, evaluate the likely impact on the UK economy of other EU countries attempting to reduce their public sector debt at the same time.

[25 marks]

2.

Weaknesses in the UK balance of trade in goods persist, with a deficit of £27.6 bn in the third quarter of 2011, compared, for example, to £23.3 bn in the same quarter in 2010.

Discuss the possible contribution of supply-side reforms to achieving an improvement in the UK balance of trade in goods.

[25 marks]

3.

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]

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4. **THE GLOBAL CONTEXT**

Extract C: Incentives and economic performance

Could inequality be adversely affecting economic performance? According to some economists, capitalism is not working effectively. Reducing trade union power and creating more flexible labour markets have created greater income inequality. Successive governments have also reduced taxation on companies and high earners (such as the cut in income tax for those earning over £150 000 from 50% to 45%) in order to promote incentives and wealth generation, as well as focusing much of the UK's hopes on the financial services industry. These policies, however, have created greater divides in terms of the 'haves' and 'have nots' which may have consequences for the UK's macroeconomic performance.

There has been a shift, over the last generation, in the share of GDP from the workforce to shareholders of between 5% −7%, with many low earners finding it difficult to get onto the property ladder. Neo-classical economists cite the trickle-down effect as a way of improving the living standards of all by cutting taxes for upper income groups and business, stating that economic progress depends on saving and innovation which, in turn, depends on the ability to make high profits. However, research by the Tax Justice Network claims that, when there are high levels of inequality, to avoid tax, financial capital often leaves the country, rather than staying in the domestic economy.

It has been argued that other policies such as public sector pay rise limits of 1%, benefits rising at 1% rather than inflation-linked increases, and the removal of some housing benefit, as well as the culture of bankers' bonuses, have all contributed to growing inequality. This is likely to have consequences for consumer spending power, but may also help to contribute to reduced inflationary expectations. There has also been criticism of the UK banking system, in that it has been too focused on making quick financial returns rather than long-run investment. Ultimately, these factors may damage the UK's ability to achieve its macroeconomic targets.

Source: News reports, 2013

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

Evaluate the view that the UK government should give higher priority to preventing deflation rather than controlling inflation.

[25 marks]

6. 'It is better to do everything you can to prevent deflation before it begins, even if there is only a small chance of it occurring.'

Assess the impact on UK macroeconomic performance of a prolonged period of deflation.

[25 marks]

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7. **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]

8. 'The UK economy has recently been in the grip of its worst recession for 60 years.'

Assess the contribution which supply-side reforms might make in helping avoid major recessions.

[25 marks]

9. **THE GLOBAL CONTEXT**

Extract B: Will growing inequality damage the US economy?

Some economists are predicting that the US will play a leading role in driving world economic growth and, as the country which is the UK's main export partner, this may provide an injection into the UK's circular flow of income. However, since the 2008 financial crash, there has been debate in the US over whether or not economic growth can be strengthened and, if so, how best to achieve this. Within this debate, there are growing concerns about the specific issue of income inequality. The top 1% of earners have received 95% of the increase in income since the financial crisis. Since 2009, the top 1% have seen their incomes rise on average by 31.4%, whereas the rest of the population has seen a rise of only 0.4%.

The economist, Joseph Stiglitz, has highlighted inequality as one of the prime reasons why the US has continued to struggle to recover. His basic argument is that the rich have a lower marginal propensity to consume (the proportion of any increase in income spent) and a higher marginal propensity to save (the proportion of any increase in income not spent) than the poor.

Such inequality also creates unsustainable 'property-price bubbles' as wealthy individuals increase the demand for property to let out on the rental market which further fuels inflation. Tax receipts, which could be injected into the economy, also end up being reduced, as the rich are able to exploit loopholes to avoid payment of tax. For this reason, Stiglitz argues that it is necessary for the US Government to intervene to deal with inequality. If the incomes of the poor were raised, increased consumption would occur. This argument is refuted by Paul Krugman, who states that there are some European economies with much lower income inequality which are also in a mess.

Source: News reports, 2013

10. **The Global Context Extract B** (lines 5–8) argues: "It now seems unlikely that economic 'powerhouses' such as India and China will provide support for the global economy through trade and investment. Such support might have helped avoid world recession and restored economic growth."

Explain the term 'world recession' **and** analyse how **both** trade **and** investment can help to bring about economic growth.

[9 marks]

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11. **The Global Context Extract C** (lines 7−9) states: ‘These policies, however, have created greater divides in terms of the ‘haves’ and ‘have nots’ which may have consequences for the UK’s macroeconomic performance.’

Using the data and your knowledge of economics, assess the importance for UK macroeconomic performance of increasing income inequality, **both** domestically **and** in other economies.

[25 marks]

12. The Budget Report of April 2009 estimated that UK government borrowing for 2009-10 would be £175 billion, or about 12% of GDP.

To what extent should government borrowing be a cause for concern?

[25 marks]

13. **THE EUROPEAN UNION CONTEXT**

Extract F: Ireland emerges from bailout

Whilst many of the Eurozone members still face instability in their own economies, Ireland became the first economy to emerge from its bailout since the Eurozone crisis began. In its final report on Ireland’s progress under the rescue scheme, the European Commission said: ‘With public sector debt at 122% of GDP in 2013, Ireland needs to continue with its fiscal reduction programmes, reduce private-sector debt and improve bank profitability to revive lending.’

Of the UK’s top ten European trading partners, Ireland is the only one with which the UK has a current account surplus. The importance of trade with Ireland is therefore of great significance. The Irish and UK economies are highly integrated and it is not yet clear how further cuts in Ireland might impact on the UK’s macroeconomic performance.

Public sector debt across many European nations is still at very dangerous levels and Ireland’s debt to GDP ratio is the second highest in the EU. Higher national debts may lead to problems such as crowding out, where private sector investment is reduced due to increased public sector borrowing. The EU introduced the Stability and Growth Pact (limiting total debt as a percentage of GDP to 60% and annual deficits to 3% of GDP) in order to prevent individual economies from creating instability across the EU. However, EU member countries have struggled to keep to the pact, with only four member countries not breaking the rules. Both Ireland and the UK have breached the pact since 2008. No doubt more problems lie ahead for the Eurozone.

Source: News reports, 2013

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14.

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

15.

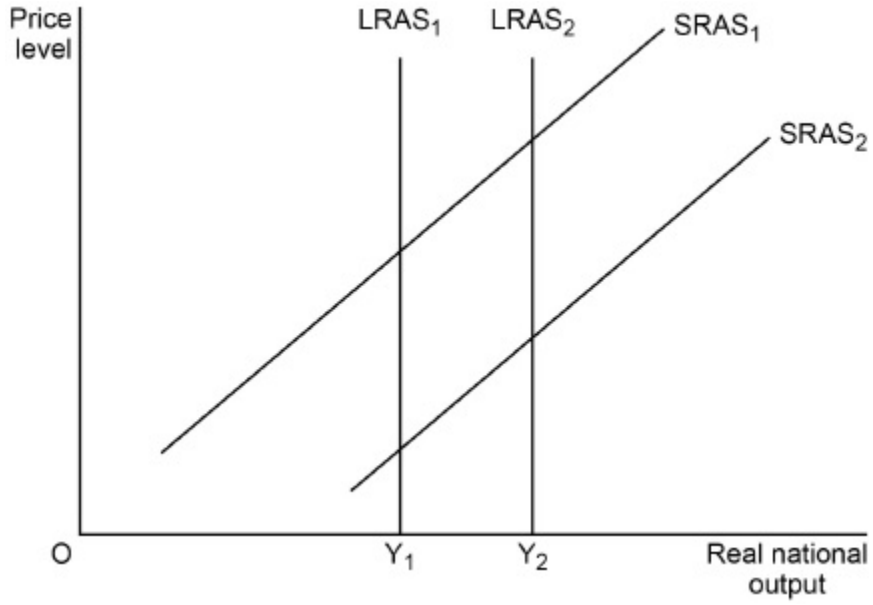
The Global Context Extract B (lines 1−3) states: 'some economists are predicting that the US will play a leading role in driving world economic growth and, as the country which is the UK's main export partner, this may provide an injection into the UK's circular flow of income.'

Explain the term 'circular flow of income' **and** analyse how economic growth in the US may lead to increased national income in the UK.

[9 marks]

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1. The diagram below shows two long-run aggregate supply (LRAS) and two short-run aggregate supply (SRAS) curves for an economy.



All other things being equal, which one of the following is most likely to explain the movement to the right of both the short-run and long-run aggregate supply curves?

A A large increase in the availability of renewable energy within the economy ⬭

B An increase in employment and a depreciation of the exchange rate ⬭

C An increase in the natural rate of unemployment and the level of money wage rates ⬭

D A supply-side shock to the economy which increases the rate of inflation ⬭

[1 mark]

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2.

THE GLOBAL CONTEXT

Extract B: Will growing inequality damage the US economy?

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The economist, Joseph Stiglitz, has highlighted inequality as one of the prime reasons why the US has continued to struggle to recover. His basic argument is that the rich have a lower marginal propensity to consume (the proportion of any increase in income spent) and a higher marginal propensity to save (the proportion of any increase in income not spent) than the poor.

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Source: News reports, 2013

3.

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]

4.

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

Evaluate the view that the UK government should give higher priority to preventing deflation rather than controlling inflation.

[25 marks]

5.

Taking into account the news report, **Brazil: The Hot 'BRIC' Extract D** and the original evidence, do you recommend that the company should invest in Brazil? Justify your recommendation.

[25 marks]

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6.

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

7.

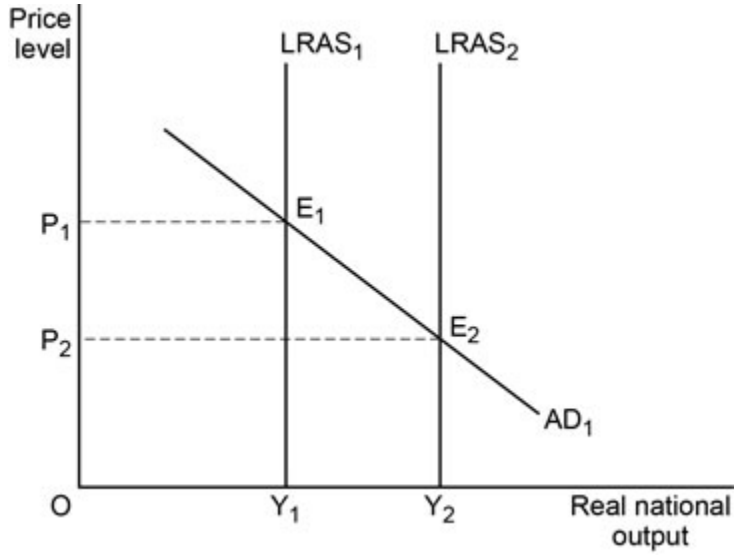
After a period of inflation below the target rate, the Consumer Price Index (CPI) inflation rate was recorded as −0.1% in early 2015. The Governor of the Bank of England wrote: ‘A temporary period of falling prices, driven by large adjustments in a few specific components of the CPI, is a fundamentally distinct phenomenon from ‘deflation’...The UK is not experiencing ‘deflation’.’

Explain the possible causes of deflation in an economy.

[15 marks]

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8. The diagram below depicts an aggregate demand (AD) curve and two long-run aggregate supply (LRAS) curves for an economy. The economy's initial equilibrium is at E_1.



All other things being equal, the movement of the economy from its initial equilibrium at E_1 to E_2 is most likely to be caused by an increase in

A government borrowing. ⬭

B labour productivity. ⬭

C the rate of deflation. ⬭

D money wage rates. ⬭

[1 mark]

9. The Office for Budget Responsibility (OBR) forecast that government spending would account for 36% of GDP by 2020 compared to 45% of GDP in 2010.

Explain the economic reasons for government spending.

[15 marks]

10. In January 2009, £1 could buy approximately 1.04 euros on the foreign exchange market. By July 2015, £1 could buy approximately 1.44 euros.

Explain the factors that may lead to a rise in the exchange rate of a currency.

[15 marks]

11. **Extract F** (line 21) asks: 'Why are productivity rates in other economies important for the UK?'

Using the data and your knowledge of economics, evaluate the significance of productivity improvements in the UK **and** in other EU economies for the performance of the UK economy.

[25 marks]

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12. Explain the term 'foreign direct investment' (**Extract E**, line 7) **and**, with the help of a diagram, analyse how foreign direct investment **and** improvements to infrastructure may boost productivity.

[9 marks]

13. Using the data in **Extract D**, calculate to one decimal place, how much greater in percentage terms German output was per hour compared to Italian output per hour in 2014.

[2 marks]

14. **Extract C** (lines 21 – 22) states: 'Any kind of deal between the EU and ASEAN economies is still a long way off, and the UK must wait to see how new trade deals affect its macroeconomic performance.'

Using the data and your knowledge of economics, evaluate the extent to which international agreements to increase free trade are likely to be beneficial to the UK's macroeconomic performance.

[25 marks]

15. Explain the term 'comparative advantage' (**Extract B**, line 17) **and**, with the help of a diagram, analyse **two** causes of increased globalisation in the world.

[9 marks]

16. 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%.

Evaluate the economic consequences for the UK economy of a significant shift in the burden of taxation from direct taxes to indirect taxes.

[25 marks]

17. **Extract F** (lines 19–20) states 'What is not clear is what should be done if low inflation turns to bad deflation.'

Using the data in the extracts and your knowledge of economics, evaluate the view that monetary policy is the most effective way of tackling deflation in developed economies such as the UK and Japan.

[25 marks]

18. 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]

19. 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]

20. Between 2011 and 2016, UK unemployment fell from a high of 8.5% to 4.8%. Some argue that government attempts to reduce unemployment inevitably lead to trade-offs with other macroeconomic policy objectives.

Explain how government policies can reduce the natural rate of unemployment.

[15 marks]

21. **Extract C** (lines 2–3) states 'More recently, India has begun to use more market-based strategies to help its development, including liberalising trade and privatisation.'

Using the data in the extracts and your knowledge of economics, evaluate the view that greater use of market-based strategies is the best way to improve the economic development of India.

[25 marks]

22. **Extract E** (lines 9–10) states 'Improvements in productivity on the supply side of the economy could actually lead to more deflation.'

With the help of a diagram, explain how improvements in productivity could cause deflation.

[9 marks]

23. 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%.

Evaluate the view that inflation is always preferable to deflation.

[25 marks]

24. 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.

Evaluate the view that MNCs play a positive role in the development of LEDCs.

[25 marks]

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25. 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]

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