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Other names:

**Pearson Edexcel Level 3 GCE**

Centre Number

Candidate Number

# Economics A

## Advanced Subsidiary

## Paper 2: The UK Economy – Performance and Policies

Monday 22 May 2017 – Morning

**Time: 1 hour 30 minutes**

Paper Reference

**8EC0/02**

**You do not need any other materials.**

Total Marks

### Instructions

- Use **black** ink or ball-point pen.
- **Fill in the boxes** at the top of this page with your name, centre number and candidate number.
- There are two sections in this question paper.
- Answer **all** questions in Section A.
- In Section B, answer **all** of questions 6(a) to 6(e) and **one** question from 6(f) or 6(g).
- Answer the questions in the spaces provided – *there may be more space than you need.*

### Information

- The total mark for this paper is 80.
- The marks for **each** question are shown in brackets – *use this as a guide as to how much time to spend on each question.*
- Calculators may be used.

### Advice

- Read each question carefully before you start to answer it.
- Check your answers if you have time at the end.

*Turn over* ▶

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## SECTION A

**Answer ALL questions. Write your answers in the spaces provided.**

**Some questions must be answered with a cross in a box ☒. If you change your mind about an answer, put a line through the box ☒ and then mark your new answer with a cross ☒.**

**You are advised to spend 25 minutes on this section.**

**Use the data to support your answers where relevant. You may annotate and include diagrams in your answers.**

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

| | |
|---|---|
| September 2013 | 126.8 |
| September 2014 | 128.4 |
| September 2015 | 128.2 |

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

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

**(2)**

% change = (128.2 − 128.4) ÷ 128.4 × 100

= (−0.2 ÷ 128.4) × 100 = −0.156...

= −0.16% (CPI fell by about 0.16%)

(b) Define the term 'deflation'.

**(1)**

Deflation is a sustained fall in the general (average) level of prices in an economy, i.e. a negative rate of inflation.

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

**(1)**

☒ **A** oil prices

☐ **B** unemployment

☐ **C** income tax rates

☐ **D** interest rates

**(Total for Question 1 = 4 marks)**

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**2** Between 2008 and 2014 the number of people in the UK looking to work longer hours and therefore receive more total pay increased from 76 482 to 142 788. Over the same period the unemployment rate fell to 5.7%.

(Sources: https://www.gov.uk/government/statistics/numbers-of-part-timers-seeking-full-time-employment and http://www.ons.gov.uk/ons/taxonomy/index.html?nscl=Unemployment+Rates#tab-data-tables)

(a) With reference to the statement above, explain the term 'under-employment'.

**(3)**

*Under-employment is when people are in work but work fewer hours than they would like to (e.g. part-time when they want a full-time job), or are in jobs that under-utilise their skills and qualifications.*

*The statement shows that between 2008 and 2014 the number of UK workers looking to work longer hours nearly doubled from 76 482 to 142 788, a rise of 66 306 (about 87%), even though the unemployment rate fell to 5.7%.*

*This is likely to be because, after the recession, a lack of demand led employers to offer more part-time, flexible and zero-hours contracts instead of full-time jobs. As a result the unemployment rate makes the labour market look healthier than it really is, and under-employed workers receive lower total pay, which reduces their standard of living.*

(b) Which **one** of the following is the most likely reason for a fall in the unemployment rate?

**(1)**

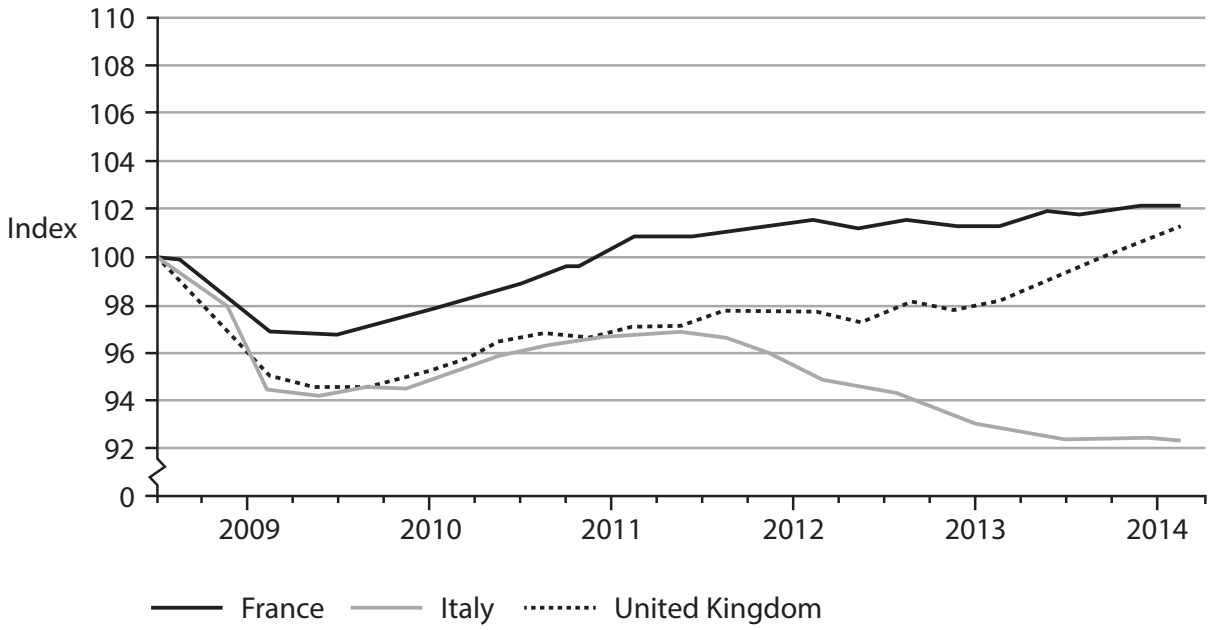
- ☐ **A** Increasing unemployment benefit payments
- ☐ **B** Decreasing real GDP
- ☐ **C** Decreasing funding for apprenticeships
- ☒ **D** Increasing consumer spending

**(Total for Question 2 = 4 marks)**



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**3 Real GDP in selected economies (the base year 2008=100)**




(Source: http://www.ons.gov.uk/ons/rel/elmr/gdp-and-the-labour-market/q1-2014--may-gdp-update/sty-gdp-g7-economies.html?format=print)

(a) Which **one** of the following can be inferred from the chart?

**(1)**

- ☒ **A** The UK's real GDP is smaller in 2014 than it was in 2008
- ☒ **B** Between 2008 and 2014 France's real GDP growth rate was higher than Italy's
- ☒ **C** Between 2008 and 2014 inflation was lower in France than in the UK
- ☒ **D** France experienced a greater fall in real GDP than the UK in 2014

(b) Define the term 'real GDP'.

**(2)**

*Real GDP is the total value of all final goods and services produced in an economy over a period of time (usually a year), adjusted for inflation, i.e. measured at constant prices so that changes in the price level are removed.*

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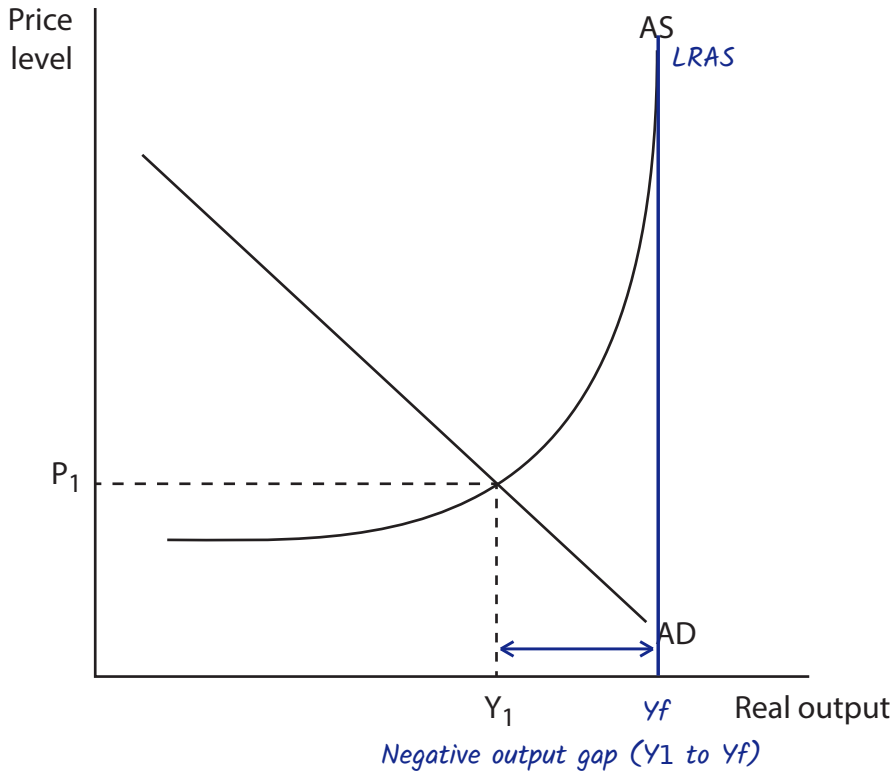




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(c) Illustrate a negative output gap on the diagram below.

**(1)**




**(Total for Question 3 = 4 marks)**

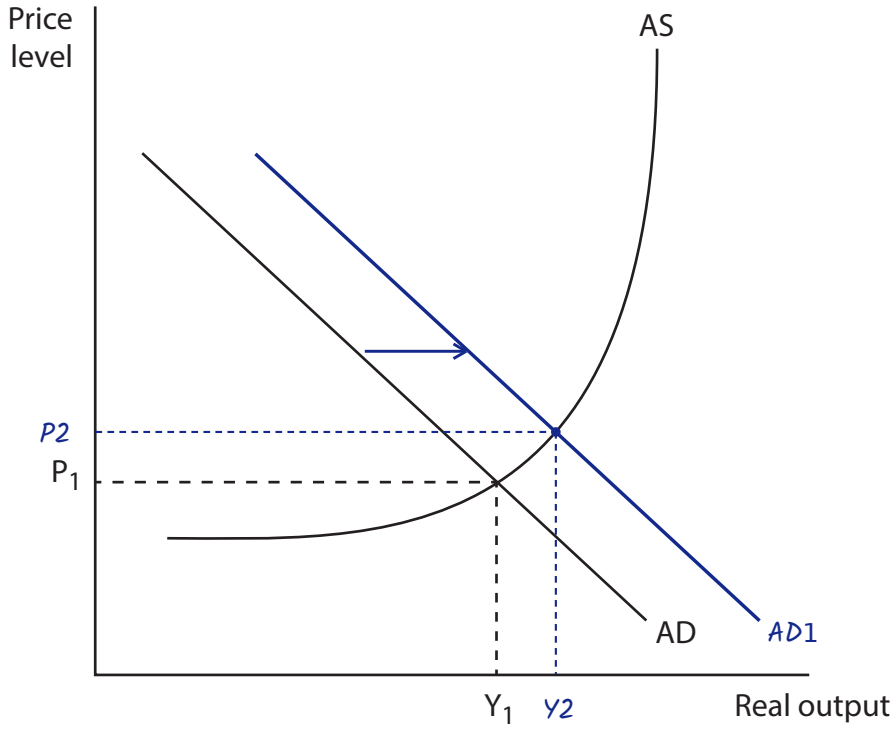
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**4** The Chancellor announced in the 2015 Budget that the personal allowance (the annual income that can be earned before starting to pay income tax) would increase from £10 600 to £11 000 in April 2016. This means most consumers will pay less income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

*A direct tax is a tax on income, wealth or profits, paid directly to the government, e.g. income tax.*

(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)**

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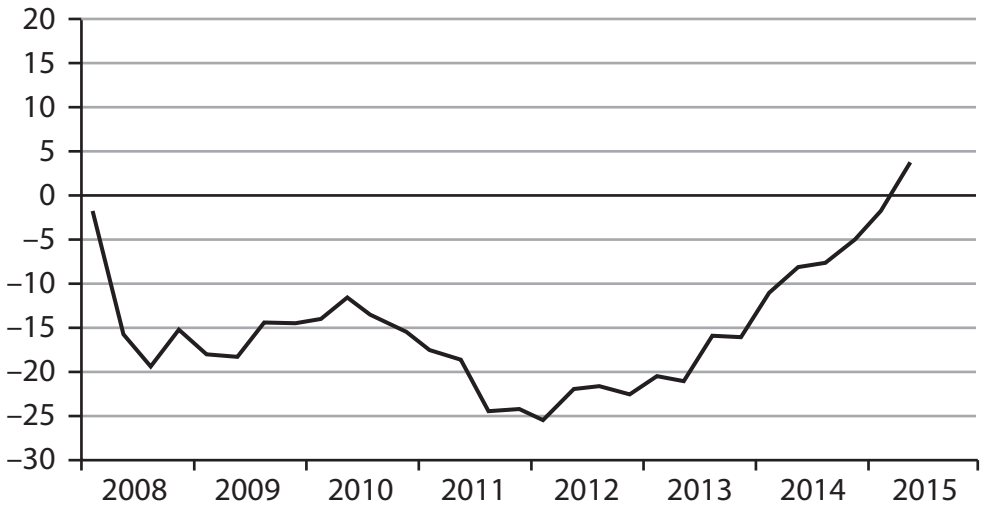




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**5** The chart below shows the results from a survey of UK consumers' confidence in their financial situation. A negative balance means that, on average, consumers reported their financial situation got worse, a positive balance means they reported it improved and a zero balance indicates no change. This is recorded on a scale from –100 to +100.

**UK consumer confidence**




(Source: http://www.ons.gov.uk/ons/dcp171778_418064.pdf)

(a) Explain **one** likely reason for the change in consumer confidence between 2012 and 2015.

**(3)**

*Consumer confidence improved sharply from a low balance of about –25 in 2012 to a positive balance of about +4 in 2015, its highest level since before 2008.*

*One likely reason is falling unemployment as the UK economy recovered and real GDP grew. As more people found jobs and job security became more predictable, households expected their incomes to rise, so more of them reported that their financial situation had improved.*

*This was reinforced by inflation falling to almost zero by 2015, so real incomes and purchasing power rose, further increasing consumers' confidence.*

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(b) Which **one** of the following is most likely to result from an improvement in UK consumer confidence? A decrease in the marginal propensity to:

**(1)**

- ☒ **A** consume
- ☒ **B** tax
- ☒ **C** import
- ☒ **D** save

**(Total for Question 5 = 4 marks)**

**TOTAL FOR SECTION A = 20 MARKS**

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**QUESTION 6 BEGINS ON THE NEXT PAGE.**

## SECTION B

**Read Figures 1 and 2 and extract A before answering Question 6.**

**Answer ALL Questions 6(a) to 6(e), and EITHER Question 6(f) OR Question 6(g).**

**You are advised to spend 1 hour and 5 minutes on this section.**

**Question 6**

**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)

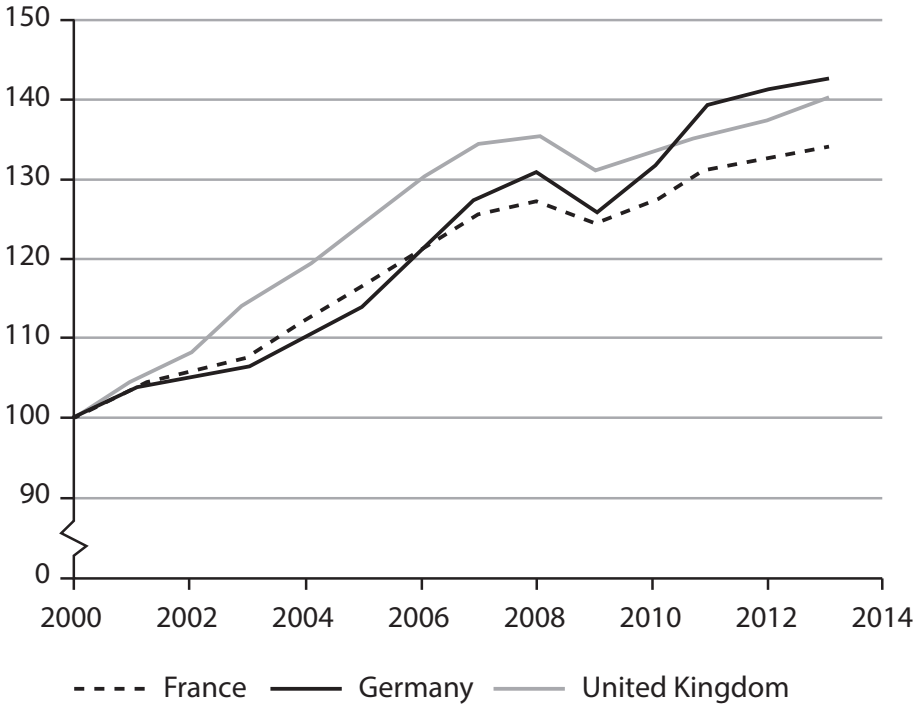
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**Figure 2: Nominal GDP per capita at Purchasing Power Parities (PPPs) (the base year 2000=100)**




(Source: https://www.imf.org)

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**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)

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**6** (a) With reference to Figure 1, explain the term 'net trade'.

**(4)**

(b) With reference to the information provided and your own knowledge, assess the likely causes of the UK's trade deficit.

**(10)**

(c) With reference to Extract A, paragraph 2, explain **one** likely influence on UK investment.

**(5)**

(d) With reference to Figure 2 and Extract A, explain **two** likely reasons why the growth of the UK's nominal GDP per capita at PPPs was slower than that of Germany after 2010.

**(6)**

(e) Evaluate policies the government could use to increase the UK's productivity.

**(15)**

**EITHER**

(f) Evaluate the benefits of economic growth to the UK given that 'a number of concerns remain' in the UK economy (Extract A, line 7).

**(20)**

**OR**

(g) Evaluate the view that another recession is 'inevitable' in the UK (Extract A, line 24).

**(20)**

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**6** (a) With reference to Figure 1, explain the term 'net trade'.

**(4)**

Net trade is the difference between the total value of a country's exports and the total value of its imports of goods and services (exports – imports, X – M).

If the value of exports is greater than imports there is a trade surplus; if imports exceed exports there is a trade deficit and net trade reduces aggregate demand.

Figure 1 shows that in 2014 UK net trade was –2% of aggregate demand, so the UK had a trade deficit, the same as France (–2%). In contrast Germany had a trade surplus, with net trade of +6%, and China had a trade surplus of +3%.

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(b) With reference to the information provided and your own knowledge, assess the likely causes of the UK's trade deficit.

**(10)**

A trade deficit occurs when the value of imports of goods and services exceeds the value of exports. Figure 1 shows UK net trade was −2% of aggregate demand in 2014, compared with a 6% surplus in Germany, and Extract A states that low export growth meant the UK's trade deficit persisted, with exports growing at just 2.7% a year against the 8% needed to reach the £1 trillion target.

One likely cause is the UK's low productivity, which is around 20 percentage points below the average for the rest of the G7. Low output per worker raises unit labour costs, so UK goods are less price competitive than German or Chinese goods. Foreign demand for UK exports falls and UK consumers switch to cheaper imports, widening the deficit, especially in goods industries such as manufacturing, where output is still 6.3% below its pre-recession peak.

A second cause is the strong value of the pound. A high exchange rate makes UK exports more expensive in foreign currencies and imports cheaper in pounds. If demand for exports and imports is price elastic, export revenue falls and spending on imports rises, worsening net trade.

Third, rising real incomes and consumer-driven growth: consumption is 66% of UK aggregate demand, much higher than 57% in Germany and France. The UK has a high marginal propensity to import, so as real incomes and confidence rise, much of the extra spending goes on imported goods. Finally, slow growth in the world economy, especially in the Eurozone, the UK's main trading partner, reduces demand for UK exports.

However, the importance of these causes can be questioned. Extract A shows that exports of services continued to grow in 2015, so the deficit is mainly in goods; the UK's comparative advantage in services such as finance partly offsets weak manufacturing. Productivity is also difficult to measure, especially in the large service sector, so the 20 percentage point gap may overstate the problem. Moreover, business investment grew by 5%, which should raise productivity and competitiveness in the future, so this cause may weaken over time.

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The time period also matters: the pound has since been weakening against various currencies, which makes UK exports cheaper and imports dearer, although because of time lags (the J-curve effect) the trade balance may worsen before it improves, and it will only improve if demand is price elastic enough.

Overall, the most significant cause is probably low productivity, because it is a long-term structural problem that a weaker pound cannot solve on its own, whereas the effects of the exchange rate and slow world growth are more temporary and cyclical.

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(c) With reference to Extract A, paragraph 2, explain **one** likely influence on UK investment.

**(5)**

One likely influence on UK investment is business confidence. Extract A, paragraph 2 states that GDP growth has remained strong, with output rising at the highest rate in the G7, and that unemployment continued to drop.

When firms see strong and sustained economic growth they expect demand, sales and profits to keep rising, so they are more willing to invest in new capital such as machinery, equipment and factories to expand capacity and meet future demand (the accelerator effect). This helps explain why business investment grew by 5%.

In addition, interest rates were at a record low of 0.5%, which reduces the cost of borrowing and increases the expected return on investment projects, giving firms a further incentive to invest.

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(d) With reference to Figure 2 and Extract A, explain **two** likely reasons why the growth of the UK's nominal GDP per capita at PPPs was slower than that of Germany after 2010.

**(6)**

*Figure 2 shows that between 2010 and 2013 UK nominal GDP per capita at PPPs rose by only about 7 index points (from about 133 to 140), whereas Germany's rose by about 11 points (from about 132 to 143), so Germany overtook the UK in 2011.*

*One reason is the UK's low productivity, which Extract A says is around 20 percentage points below the average for the rest of the G7. Low output per worker means that output and incomes per person grow slowly. It also raises the average cost of UK exports, making them more expensive relative to Germany's, so UK growth could not be export-led.*

*A second reason is the UK's lack of exports and rising imports. The current account deficit reached a record 6% of GDP in the third quarter of 2014 and UK export growth was only 2.7% a year, while Germany had a trade surplus of 6% of aggregate demand (Figure 1). Imports, largely due to increased domestic consumption, are a withdrawal from the circular flow of income, whereas strong German exports are an injection that raised German GDP faster. The UK's population has also grown faster than Germany's, so UK GDP is shared between more people.*

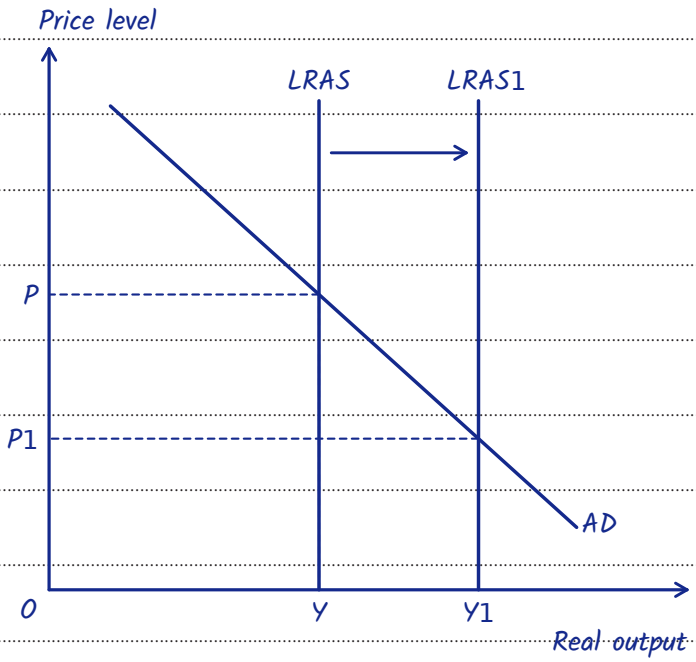
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(e) Evaluate policies the government could use to increase the UK's productivity.

**(15)**

*Productivity is output per worker (or per hour worked). Extract A states that UK productivity is around 20 percentage points below the average for the rest of the G7, so policies must raise the amount each worker produces, not simply total output.*

*Policies that raise productivity are supply-side policies: they increase the productive capacity of the economy, shifting LRAS to the right from LRAS to LRAS1 (diagram), increasing real output from Y to Y1 and lowering the price level from P to P1.*




*Firstly, the government could improve education and training, for example by reforming apprenticeships to rapidly improve skills in construction, manufacturing and technology, as Extract A suggests. Better-skilled workers complete tasks faster, make fewer mistakes and can use more advanced capital, so output per worker rises. This would be especially valuable in manufacturing, where output remains 6.3% below its pre-recession peak.*

*However, education and training policies have long time lags: it may take several years before trainees enter the workforce, so productivity will not rise in the short run. There is also an*

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opportunity cost, since money spent on apprenticeships could have been spent on healthcare, and the extra spending has fiscal implications when the government is trying to reduce its budget deficit. The policy only works if apprenticeships are high quality and match the skills firms need.

Secondly, the government could invest in infrastructure such as roads, railways, ports, airports and faster broadband. Less congestion and fewer delays in transporting goods mean workers and firms can produce more in the same time, and better telecommunications let businesses work more quickly and communicate with foreign firms, raising output per worker across many sectors. On the other hand, infrastructure projects are very expensive and slow to complete, and the magnitude of their impact may be limited or concentrated in one region: for example, Crossrail mainly benefits London. There may also be conflicts with environmental objectives, such as damage to habitats and higher emissions during construction.

Thirdly, the government could relax the planning system to promote more house-building. More housing, especially in high-productivity cities, improves the geographical mobility of labour, so workers can move to jobs where their skills are most productive, and it raises efficiency in the construction industry. Removing burdens on manufacturers such as carbon taxes, and allowing shale gas exploration, would lower firms' costs and could encourage investment in new capital, which raises labour productivity.

Yet relaxing planning rules and removing carbon taxes conflict with environmental objectives: carbon taxes correct the negative externality of pollution, and shale gas exploration (fracking) is unpopular with local communities, so there is a trade-off between productivity and sustainability. Lower costs may also simply raise profits or dividends rather than lead to more investment, so productivity may not rise at all. Improving healthcare could also help, as healthier workers take less time off, but this is costly and slow.

Overall, the most effective policy is probably improving education and apprenticeships, because higher skills raise productivity across the whole economy and the gains are long-lasting, even

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though the time lag is long. Infrastructure is also important, but its impact depends on where it is built. In practice a combination of policies is needed, and their success will depend on the size and targeting of the spending, the state of public finances, and whether firms also keep increasing investment, which grew by 5% according to Extract A.

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**EITHER**

(f) Evaluate the benefits of economic growth to the UK given that 'a number of concerns remain' in the UK economy (Extract A, line 7).

**(20)**

**OR**

(g) Evaluate the view that another recession is 'inevitable' in the UK (Extract A, line 24).

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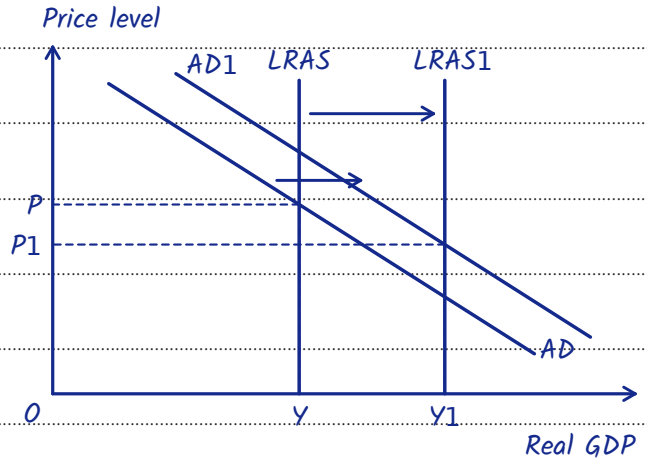
**Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.**

Chosen question number: **Question 6(f)** ☒ **Question 6(g)** ☒

Write your answer here:

*Question 6(f)*

*Economic growth is an increase in real GDP (or real GDP per head) over time; long-run growth is an increase in the productive potential of the economy.*




*AD shifts right to AD1 and LRAS shifts right to LRAS1, so real GDP rises from Y to Y1 with little extra inflation.*

*Growth brings several benefits. Higher incomes and employment raise living standards, as consumers can afford more goods and services, and with unemployment continuing to drop more people have jobs. Rising incomes and spending increase tax revenues and reduce spending on benefits, so the government can improve public services such as health and education or redistribute income, while also reducing the budget deficit. Firms earn higher profits, which can be reinvested to improve quality, develop new products and raise productivity, and growing business confidence encourages more investment, as shown by the 5% growth in business investment in Extract A. If growth comes from supply-side improvements (LRAS shifting right),*

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it can also reduce inflationary pressure, and investment in sustainable technology can bring environmental benefits.

However, the benefits are limited because 'a number of concerns remain'. First, the current account deficit reached a record 6% of GDP in Q3 2014 and export growth is just 2.7% a year, far below the 8% needed for the £1 trillion target. Because the UK has a high marginal propensity to import, growth based on rising incomes sucks in imports, so the balance of payments deteriorates further, which may be unsustainable.

Second, the growth is unbalanced and consumer-driven: consumption is 66% of aggregate demand (Figure 1) and the household gross debt to income ratio is projected to rise by 26 percentage points by 2020, back to pre-crisis levels. Growth financed by borrowing is fragile, because if interest rates rise households will cut spending sharply and the benefits of growth could be reversed in a recession.

Third, the goods sectors are struggling: output in manufacturing and construction is falling, with manufacturing 6.3% below its pre-recession peak, and productivity is around 20 percentage points below the G7 average, with skills and housing shortages. If AD grows faster than LRAS, growth leads to demand-pull inflation (AD shifting right along a steep AS curve) rather than higher real output. Growth may also widen inequality if firms pay higher profits to shareholders rather than invest, and the gains may go mainly to London and the South East and to the service sector.

There are also wider costs: growth can deplete natural resources and create negative externalities such as pollution and congestion, so it may be unsustainable; and technological change may cause structural unemployment in the short run, while longer working hours may harm work-life balance.

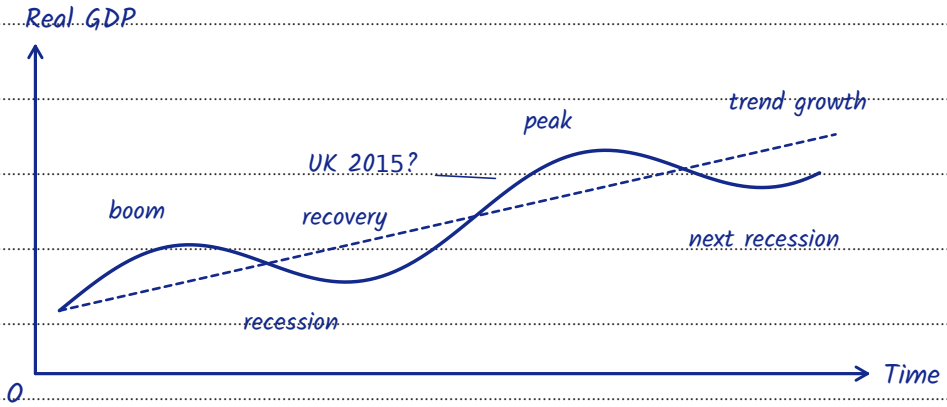
In conclusion, economic growth does bring real benefits to the UK in higher living standards, employment and tax revenue, but given the concerns in Extract A these benefits are smaller and less secure than headline growth suggests. The benefits will be greatest and longest-lasting

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if growth becomes more balanced, led by investment, productivity and exports rather than consumer debt; otherwise, in the long run, the current account deficit and household debt could turn growth into another recession.

Question 6(g)

A recession is usually defined as two consecutive quarters of negative economic growth (falling real GDP). The trade cycle diagram shows how the economy fluctuates around its trend growth rate: after a boom and a peak, a downturn leads to recession.




There are strong reasons to think another recession is likely. Growth is heavily dependent on consumption, which is 66% of UK aggregate demand compared with 57% in Germany and France (Figure 1). Households are set to become even more indebted, with the gross debt to income ratio projected to rise by 26 percentage points between 2015 and 2020, back to levels last seen before the Global Financial Crisis. Much consumer confidence also depends on rising house prices, which may not be sustainable. If interest rates rise from their record low, debt repayments increase, consumers cut spending and, through the negative multiplier, AD and real GDP fall.

Moreover, the economy has not rebalanced towards export-led growth. UK export growth is only 2.7% a year against the 8% needed for the £1 trillion target, so the target is unrealistic given weak global demand, and the current account deficit reached a record 6% of GDP, partly because of a sharp fall in the rate of return on UK investments overseas. Low productivity, around 20 percentage points below the G7 average, and falling output in manufacturing and

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construction mean the supply side is weak. The large government budget deficit and national debt also limit the scope for fiscal stimulus if a downturn starts, and a fall in real incomes would reduce consumption further.

On the other hand, a recession is not 'inevitable'. The UK has always been a consumer-driven economy and has had persistent current account and trade deficits for decades while continuing to grow. Business investment rose by 5%, which adds to AD and raises productive capacity, and exports of services continued to grow. Financial reforms and increased oversight by the Bank of England make another banking crisis less likely, and falling commodity prices and low inflation benefit the UK as a net importer by raising real incomes. Well-timed macroeconomic policy, such as cutting interest rates or quantitative easing by the Bank of England, could prevent a downturn, and the government's plan to control debt in the long term increases lenders' confidence. Since 2016 the fall in the pound after the Brexit vote has made UK exports cheaper, and stronger global growth would boost service sector exports.

In conclusion, the risk of a recession is significant because growth is unbalanced and based on rising household debt, so a rise in interest rates or an external shock could trigger one. However, 'inevitable' is too strong: the timing and depth depend on policy responses, global growth and the exchange rate. In the long run, the trade cycle means a downturn will happen at some point, but it is not certain in the next few years.

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**(Total for Question 6 = 60 marks)**

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