Please check the examination details below before entering your candidate information

Candidate surname	Other names
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Pearson Edexcel Level 3 GCE

Centre Number	Candidate Number

Thursday 16 May 2019

Morning (Time: 1 hour 30 minutes) | Paper Reference **8EC0/02**

Economics A

Advanced Subsidiary

Paper 2: The UK Economy – Performance and Policies

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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P 5 7 1 9 5 A 0 1 3 2

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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 It is estimated that building a second runway at Gatwick airport will require an investment of £9.3 billion.

The total increase in UK GDP as a result of this injection is expected to be around £44.1 billion.

(Source: adapted from www.gov.uk/government/uploads/system/uploads/attachment_data/file/ 452267/AC01_tagged_amend_25_11.pdf © Crown Copyright)

(a) Define the term 'injection' in this context.

(1)

An injection is an addition of spending into the circular flow of income that does not come from the consumption of domestic households, i.e. investment, government spending or exports. Here the injection is the £9.3 billion of investment spending on building the second runway.

(b) Calculate the value of the multiplier based on the data given. You are advised to show your working.

(2)

Multiplier = final increase in GDP ÷ initial injection

= £44.1 billion ÷ £9.3 billion

= 4.7419...

Multiplier = 4.74

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(c) Which **one** of the following is a likely cause of a decrease in the value of the UK's multiplier?

(1)

- ☒ **A** A decrease in the marginal propensity to save
- ☒ **B** A decrease in the marginal propensity to tax
- ☒ **C** An increase in the marginal propensity to consume
- ☒ **D** An increase in the marginal propensity to import

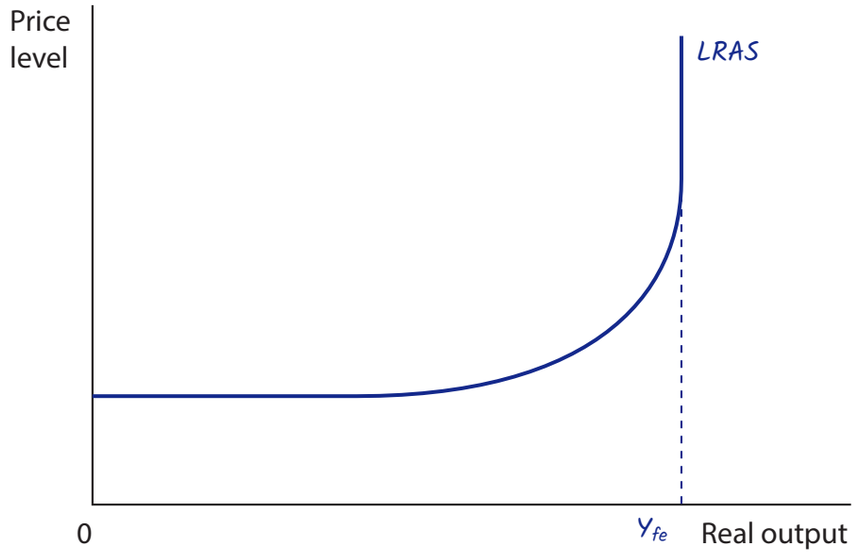
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2 (a) Illustrate the shape of the Keynesian long-run AS curve on the diagram below.

(1)



(b) Explain what is meant by spare capacity in an economy.

(2)

Spare capacity exists when an economy is producing below its maximum potential (full employment) level of output, so factors of production such as labour and capital are under-utilised, e.g. unemployed workers and idle machinery. There is a negative output gap: the economy is operating inside its PPF, on the elastic section of the LRAS, so there is room to increase real output without much increase in the price level.

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(c) Which **one** of the following is most likely to cause a movement along the AS curve?

Changes in:

(1)

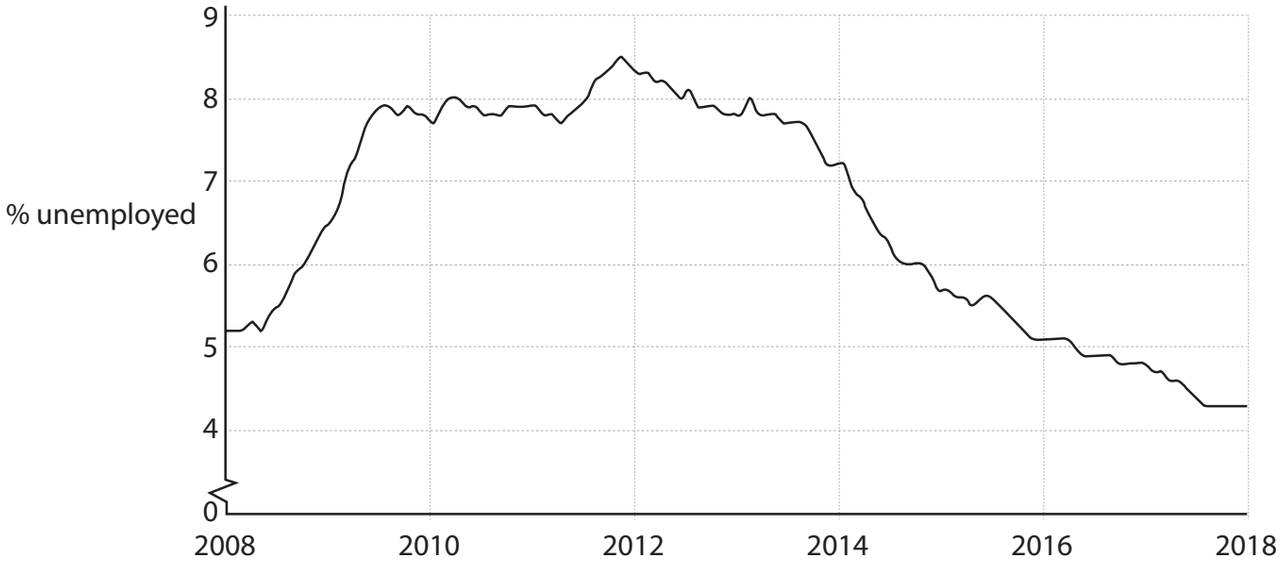
- ☒ **A** competition policy
- ☒ **B** relative productivity
- ☒ **C** the cost of raw materials
- ☒ **D** the level of aggregate demand

(Total for Question 2 = 4 marks)

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3 UK unemployment rate as a % of all those economically active, seasonally adjusted, from 2008 to 2018



(Source: adapted from https://www.ons.gov.uk/employmentandlabourmarket/peoplenotinwork/ unemployment/timeseries/mgsx Crown Copyright)

(a) With reference to the chart above, explain **one** likely economic effect of the change in the UK unemployment rate between 2012 and 2018.

(3)

The chart shows that the UK unemployment rate fell from about 8.3% in 2012 to about 4.3% in 2018, a fall of around 4 percentage points.

One likely effect is an improvement in the government's finances. As more people move into work, they pay income tax and National Insurance and spend more, raising VAT receipts, while fewer people claim unemployment benefits, so welfare spending falls.

With higher tax revenue and lower welfare payments, the budget deficit would decrease, giving the government more scope to spend on public services such as health and education or to cut taxes. Fewer scarce resources are also wasted, as less potential output is lost.

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(b) Which **one** of the following policies is most likely to reduce the unemployment rate in the UK?

(1)

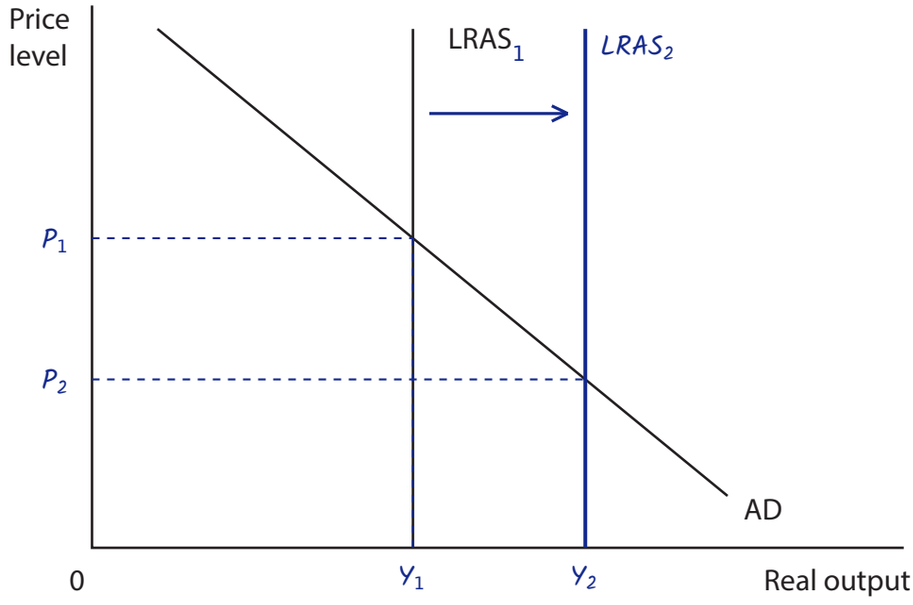
- ☒ **A** A decrease in direct taxes on company profits
- ☐ **B** A decrease in quantitative easing
- ☐ **C** An increase in government payments to the unemployed
- ☐ **D** An increase in the UK base interest rate

(Total for Question 3 = 4 marks)

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4 The diagram below shows the aggregate demand (AD) and a possible long-run aggregate supply (LRAS) for the UK.



(a) Define the term 'price level'.

(1)

The price level is the average level of prices of goods and services in the economy at a given time, measured by a price index such as the CPI.

(b) Annotate the diagram above to show the likely impact of government policy to promote business competition on the equilibrium level of real output and price level.

(2)

Policy to promote competition raises efficiency and productivity, so LRAS shifts right from $LRAS_1$ to $LRAS_2$; the price level falls from P_1 to P_2 and real output rises from Y_1 to Y_2.

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(c) Which **one** of the following is an interventionist supply-side policy?

(1)

- ☒ **A** An improvement in infrastructure
- ☐ **B** An increase in indirect taxation
- ☐ **C** An increase in interest rates
- ☐ **D** An increase in the regulation of markets

(Total for Question 4 = 4 marks)

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5 The table below shows average UK house prices between July 2014 and July 2017.

Year	Average house prices (£)	Index numbers of average UK house prices (2014 is the base year)
2014	189 709	100
2015	200 141	105.5
2016	215 127	113.4
2017	226 185	119.2

(Source: adapted from http://landregistry.data.gov.uk/app/ukhpi/explore - Crown Copyright)

(a) Which **one** of the following is the most likely impact of an increase in average UK house prices on existing homeowners?

(1)

- ☒ **A** Greater confidence
- ☐ **B** Higher income
- ☐ **C** Lower consumption
- ☐ **D** Negative wealth effect

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(b) Using 2014 as the base year, calculate the index number for

(2)

(i) 2015

Index number = (200 141 ÷ 189 709) × 100

= 105.4989...

2015 index number = 105.5

(ii) 2016.

Index number = (215 127 ÷ 189 709) × 100

= 113.3984...

2016 index number = 113.4

(c) Define the term 'index number'.

(1)

An index number is a figure that shows the value of a variable, such as a price or quantity, relative to its value in a base year which is given the value 100, so it shows the percentage change from the base year.

(Total for Question 5 = 4 marks)

TOTAL FOR SECTION A = 20 MARKS

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SECTION B

Read Figures 1 to 4 and extracts (A and B) before answering Question 6.

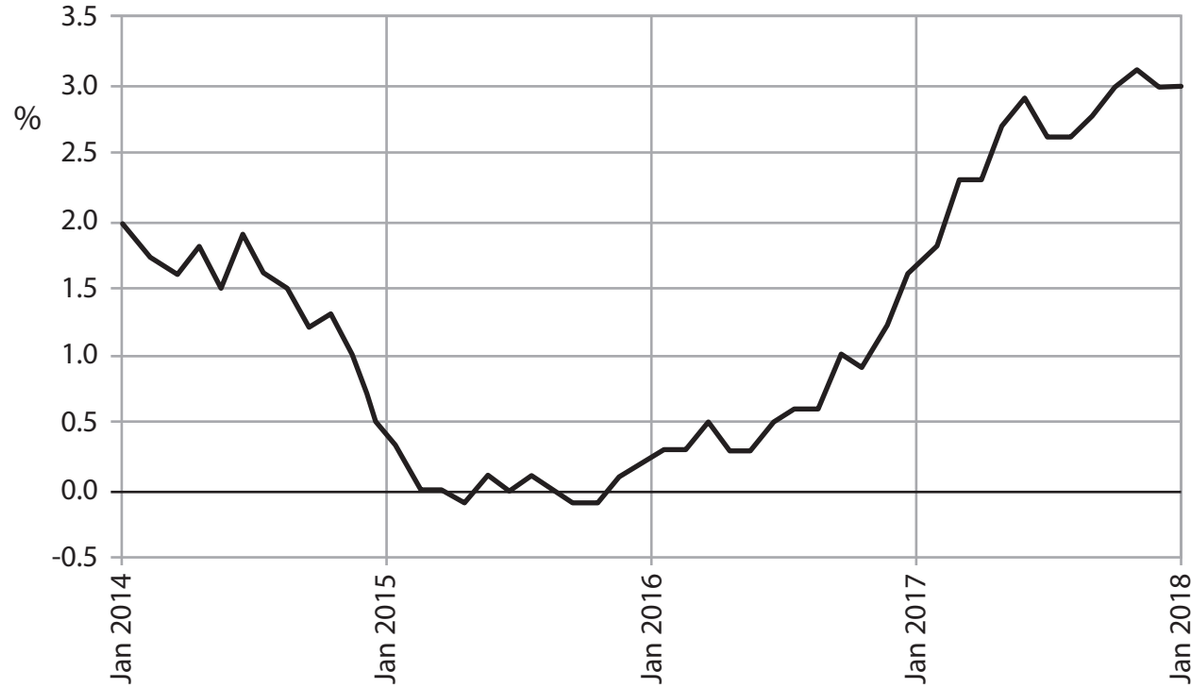
Answer ALL Questions 6(a) to 6(e) and EITHER Question 6(f) OR Question 6(g).

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

Question 6

UK 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)

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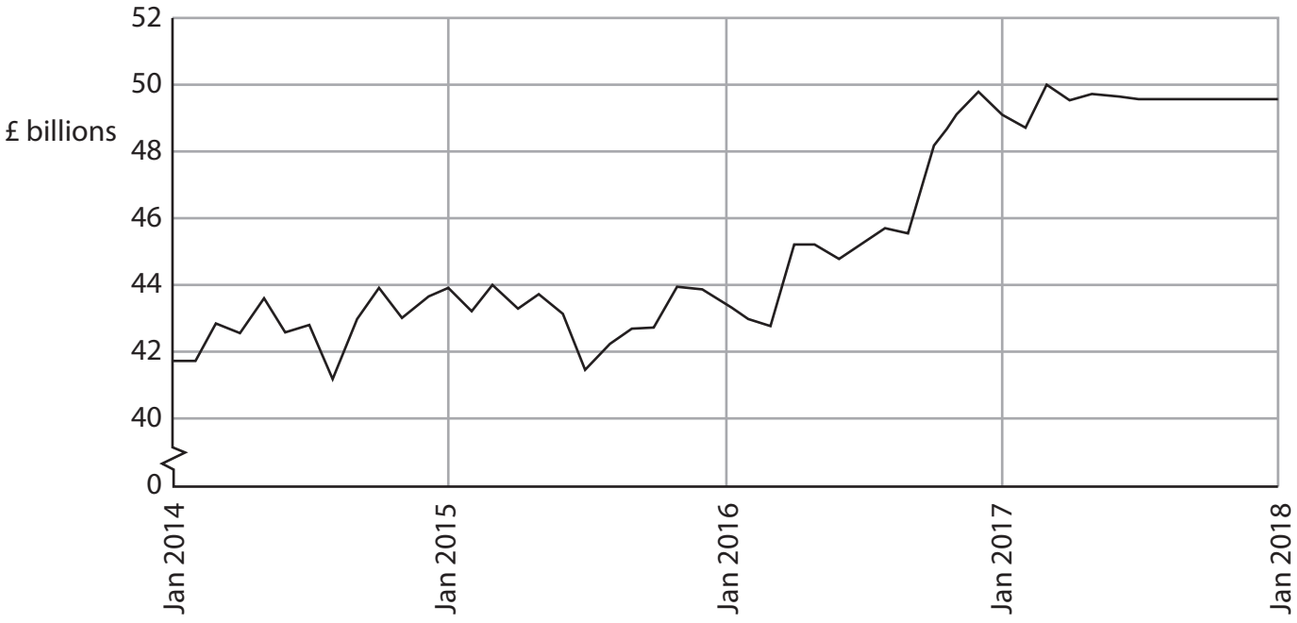
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Figure 2: Selected changes to the CPI basket of goods and services, 2017

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)

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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)

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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/)

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6 (a) With reference to the first paragraph of Extract A and Figure 1, explain how the change in the exchange rate of the pound has 'contributed to rising inflation' (Extract A, line 4).

(4)

(b) With reference to Extract A, explain **two** likely economic effects of the higher rate of UK inflation.

(6)

(c) With reference to the last paragraph of Extract A and Figure 2, explain **one** reason why it is necessary to regularly update the CPI basket of goods and services.

(5)

(d) With reference to Figure 3, assess the likely impact of the change in the value of exports, since mid-2016, on the economic growth of the UK. Use an aggregate demand and aggregate supply diagram in your answer.

(10)

(e) With reference to Figure 4, Extract B and your own knowledge, discuss the limitations of using GDP data to compare living standards between the UK and developing countries.

(15)

EITHER

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

(20)

OR

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

(20)

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6 (a) With reference to the first paragraph of Extract A and Figure 1, explain how the change in the exchange rate of the pound has 'contributed to rising inflation' (Extract A, line 4).

(4)

The value of the pound fell sharply after the EU referendum in June 2016. A weaker pound means imports become relatively more expensive in sterling terms.

The UK is a net importer of food, and demand for food is relatively price inelastic, so the higher import costs are passed on to consumers. Extract A states that food prices increased by 3.5 percentage points between January and September 2017. Higher prices of imported raw materials, fuel and components also raise firms' costs of production, shifting SRAS to the left and causing cost-push inflation.

In addition, a weaker pound makes UK exports relatively cheaper abroad, so demand for exports rises. This increases AD, adding demand-pull inflationary pressure.

As a result, Figure 1 shows CPI inflation rising from below 1% in mid-2016 to over 3% at the end of 2017, an increase of about 1 percentage point since the start of 2017, so inflation has exceeded the Bank of England's 2% target since January 2017.

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(b) With reference to Extract A, explain **two** likely economic effects of the higher rate of UK inflation.

(6)

One effect is a fall in real wages and purchasing power. Inflation rose to over 3% at the end of 2017, while basic wage increases are expected to be only around 1%, so wage growth is lagging behind price rises and real wages are falling by around 2%. Each pound of income buys fewer goods and services. People on low fixed incomes are affected most, as they spend a larger proportion of their income on necessities such as food, leaving them with very little money to spend on relatively more expensive items. This lowers their standard of living, widens income inequality and reduces consumer confidence and consumption. Extract A shows many are using credit cards and short-term loans to maintain their standard of living, so personal debt relative to income has risen.

A second effect is that the Monetary Policy Committee raised the base rate of interest by 0.25 percentage points to 0.5% in November 2017 in response to inflation above the 2% target. This increases the cost of borrowing and the reward for saving, so households cut consumption and firms reduce investment, slowing the growth of AD. Households who have borrowed on credit cards, short-term loans and variable-rate mortgages face higher repayments, reducing their discretionary income further, although inflation does reduce the real value of their existing debts over time.

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(c) With reference to the last paragraph of Extract A and Figure 2, explain **one** reason why it is necessary to regularly update the CPI basket of goods and services.

(5)

The CPI basket must be updated regularly to ensure that inflation and the cost of living are accurately measured, by reflecting current consumer spending patterns. Consumer tastes and technology change over time. Extract A explains a move towards health, fitness and gluten-free products, so non-dairy milk and cycling helmets were added to the basket in 2017, while menthol cigarettes were removed. Technological advancements mean consumers have switched from basic mobile phones to smartphones, so basic mobile phones were taken out, and child scooters replaced child swings.

If the basket was not updated, it would include goods that households no longer buy, such as apple cider, and changes in their prices would distort the index, while price changes of newly popular goods such as non-dairy milk would be missed. Consumers may also have switched away from goods whose prices have increased. The weightings would then not reflect actual spending, so the CPI would overstate or understate the true rate of inflation.

This matters because the CPI is used for the Bank of England's 2% inflation target and for uprating benefits, pensions and wage negotiations, so an inaccurate basket could lead to the wrong interest rate decisions. As consumer tastes change frequently, the basket is reviewed every year.

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(d) With reference to Figure 3, assess the likely impact of the change in the value of exports, since mid-2016, on the economic growth of the UK. Use an aggregate demand and aggregate supply diagram in your answer.

(10)

Economic growth is an increase in real GDP. Exports are a component of aggregate demand, where AD = C + I + G + (X − M), and they are an injection into the circular flow of income.

Figure 3 shows that since mid-2016 UK exports rose from about £45.5 billion per month to around £50 billion per month in early 2017, an increase of about £4.5 billion per month, or almost 10%. This was largely due to the fall in the exchange rate of the pound after the EU referendum, which made UK goods cheaper abroad, and to rising foreign demand from the global economic recovery (Extract B).

As shown in my diagram below, the increase in exports shifts AD to the right from AD_1 to AD_2. Real output rises from Y_1 to Y_2, so there is economic growth, with the price level rising from P_1 to P_2. The effect is increased by the multiplier: exporting firms earn more revenue and pay their workers more, who spend part of their extra income, creating further rounds of spending. Firms may also invest to expand capacity to meet higher export orders, which would increase LRAS and potential growth. Extract B suggests exports are expected to be the most significant driver of UK growth.

However, the impact may be limited. Since early 2017, Figure 3 shows exports have levelled off at around £49.5 billion per month, so this boost to growth has not continued. Figure 3 shows nominal values, so some of the rise reflects higher sterling prices after the depreciation rather than higher volumes. The weaker pound also makes imports more expensive, and as the UK has a relatively price inelastic demand for imports such as food, spending on imports may rise, so net exports (X − M) increase by less than exports. Exports are only one component of AD; consumption is much larger, and Extract A shows real wages falling as inflation exceeds wage growth, which

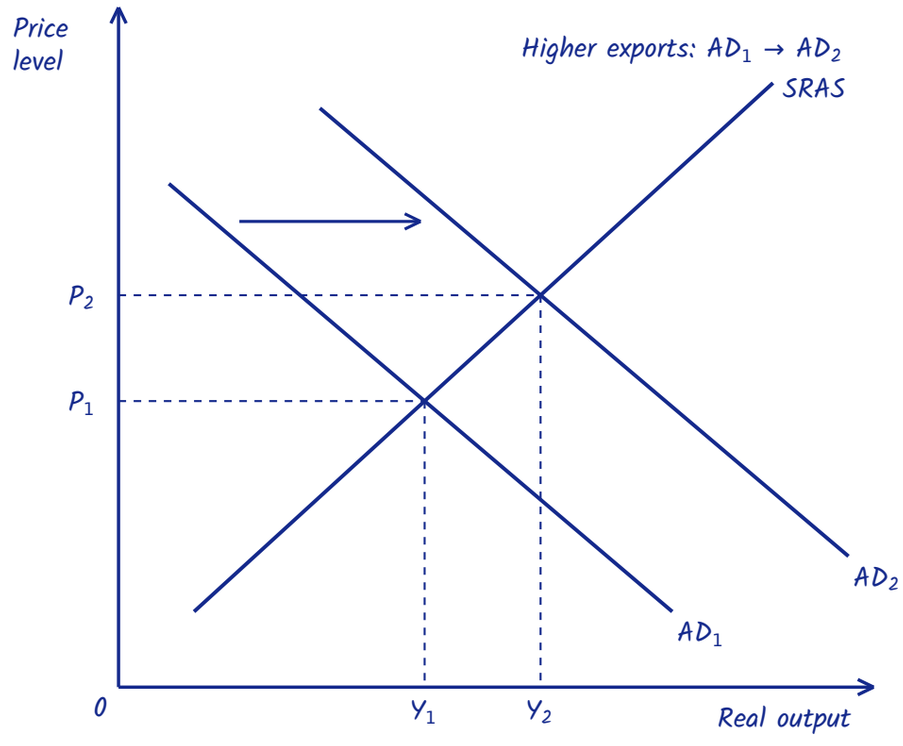
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reduces consumption and offsets the rise in exports. Indeed, Figure 4 shows UK growth was only 1.8% in 2016 and 2.0% in 2017.

The effect also depends on spare capacity: with unemployment at about 4.3%, the economy may be close to full capacity, so the rise in AD may cause more inflation than real growth. Exporters are also vulnerable to changes in demand abroad and exchange rates, which are out of the UK's control. Overall, the rise in exports gave a significant short-run boost to UK growth in 2016 to 2017, but its long-term impact is likely to be small unless it leads to higher investment and productivity.

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(e) With reference to Figure 4, Extract B and your own knowledge, discuss the limitations of using GDP data to compare living standards between the UK and developing countries.

(15)

GDP is the total value of goods and services produced in an economy in a year; real GDP is adjusted for inflation. Living standards refer to the material welfare and quality of life of the population, including income, consumption, health and education. Figure 4 shows that real GDP growth in developing countries (4.5% in 2017) was more than double that of the UK (2.0%), but this does not mean living standards are higher or rising faster there.

Firstly, Figure 4 only shows percentage changes. Developing countries start from a much lower level of GDP, so 4.5% growth of a small GDP may add far less output than 2.0% growth of the UK's GDP of around £2 trillion. Total GDP is also misleading without considering population size: GDP per capita is a better indicator of average incomes. Many developing countries have rapid population growth, so much of their GDP growth may be absorbed by more people, leaving GDP per head growing slowly.

Secondly, the informal economy. Extract B states that the relative size of the informal economy of developing countries is nearly five times greater than that of the UK. Subsistence farming, barter and unrecorded cash work are not bought and sold through official markets, so no income is recorded. GDP therefore undervalues real output and income in developing countries far more than in the UK, so comparisons understate their true living standards.

Thirdly, the distribution of income. GDP is a total and says nothing about how income is shared. Extract B notes that growth varies across the country, with jobs and wages distributed unevenly. Developing countries often have high income inequality, so rapid GDP growth may mainly benefit a rich minority while many people remain in poverty.

Two countries with the same GDP per head can have very different living standards.

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Fourthly, quality of life. GDP does not measure leisure time, working conditions, life expectancy, education, pollution or the quality of public services such as healthcare. Rapid industrial growth in developing countries may involve pollution and long working hours that reduce welfare. This is why economists in Extract B argue that the quality of growth, not just the quantity, needs to be measured. GDP also includes spending on investment goods, which may raise future living standards at the expense of current ones.

Finally, comparisons require converting GDP into a common currency, usually US dollars, at market exchange rates. These do not reflect differences in purchasing power: the cost of living is much lower in most developing countries, so a dollar buys more there. Without purchasing power parity (PPP) adjustment, their living standards are understated. The methods of calculation and reliability of data in developing countries may also be weaker.

However, GDP data still has value. It is a standard, internationally recognised and well understood measure, calculated using agreed methods, and data is readily available for nearly all countries over time, so it is still possibly the best single measure available for comparison. Higher real GDP per capita is strongly linked to higher average incomes, which allow more spending on health and education, so it is a key determinant of material living standards. Many limitations can be reduced by using GDP per capita at PPP, or by combining GDP with other indicators such as the Human Development Index, which includes life expectancy and education. On the other hand, the standard of living is partly subjective, so it cannot be measured accurately by any single indicator.

Overall, GDP data alone is a limited measure for comparing living standards between the UK and developing countries, mainly because of the much larger informal economy, differences in purchasing power and inequality. The faster growth rates in Figure 4 tell us little on their own; GDP per capita at PPP used alongside measures of quality of life

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such as the HDI gives a far more accurate comparison.

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EITHER

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

(20)

OR

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

(20)

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:

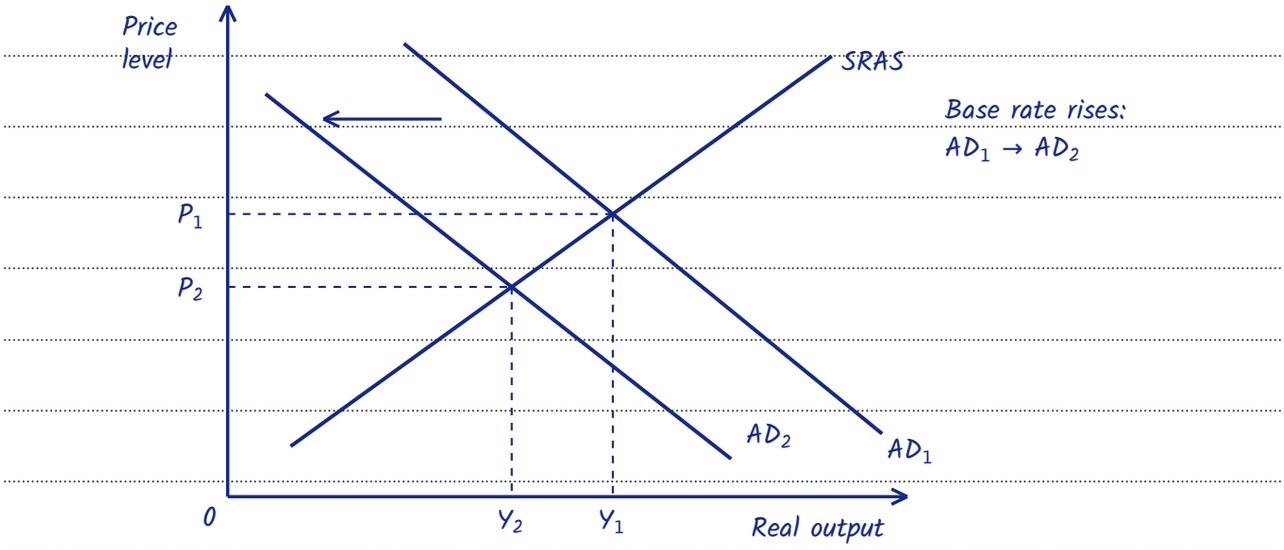
Option (f)

Interest rate changes are a tool of monetary policy. The Monetary Policy Committee (MPC) of the Bank of England sets the base rate to meet the government's inflation target of 2% CPI, plus or minus 1 percentage point. To reduce inflation the MPC raises the base rate (contractionary policy); when inflation is below target it can cut the rate (expansionary policy). Figure 1 shows inflation fell to around 0% in 2015, well below target, which justified keeping the base rate at a record low, but after January 2017 inflation exceeded 2%, rising to over 3% at the end of 2017, so in November 2017 the MPC raised the base rate by 0.25 percentage points to 0.5%.

A higher base rate leads commercial banks to raise the rates on loans, credit cards and mortgages. This increases the cost of borrowing for households, so spending on credit and on consumer durables falls. Homeowners on variable-rate mortgages face higher repayments, reducing their effective disposable income, and higher mortgage costs reduce demand in the housing market. Higher rates also increase the reward for saving, raising the opportunity cost of spending, so consumption, the largest component of AD, falls.

Business investment also falls because the cost of borrowing funds rises and some planned projects become unprofitable. In addition, higher UK rates attract hot money flows, increasing demand for the pound and raising the exchange rate. Exports become

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less price competitive and imports cheaper, so (X – M) falls, and cheaper imports directly reduce cost-push pressure, which matters as Extract A shows the weak pound pushed up food prices.

As shown in the diagram above, falls in C, I and (X – M) shift AD left from AD_1 to AD_2, so the price level falls from P_1 to P_2, reducing demand-pull inflationary pressure. The effect is magnified by the multiplier, as lower spending reduces other people's incomes.

However, the effectiveness of interest rate changes is limited. Firstly, it depends on the magnitude of the change: a 0.25 percentage point rise to 0.5% is still historically very low and is unlikely to reduce spending significantly. Secondly, there are time lags of up to two years before a change feeds through to inflation, so the MPC must rely on forecasts that may be wrong. Thirdly, many mortgages and loans are on fixed rates, so a change in the base rate has little immediate impact, and commercial banks may not pass on the full change.

Fourthly, the effect depends on confidence: if consumers and firms are optimistic (animal spirits), they may continue to borrow and spend despite higher rates. Extract A shows households on low fixed incomes are borrowing to maintain their living standards, so higher rates may push them into financial difficulty rather than reduce spending.

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Most importantly, the cause of inflation matters. Extract A suggests inflation in 2017 was largely cost-push, caused by rising food and import prices after the fall in the exchange rate of the pound. These external factors are beyond the Bank of England's control. Raising rates reduces AD but does not tackle the cause, so it may reduce output and raise unemployment while inflation stays high, especially as wage growth of only 1% suggests demand is already weak. The impact also depends on the position on the LRAS curve: with spare capacity, a fall in AD mainly lowers real output rather than the price level. Higher rates may also reduce investment and so the growth of LRAS, increasing inflationary pressure in the long run, and a stronger pound worsens the current account, conflicting with other objectives.

In conclusion, interest rates are flexible and quick to change, and are effective at controlling demand-pull inflation, especially as the independent Bank of England is credible, keeping inflation expectations close to 2%. However, they are much less effective against cost-push inflation caused by external shocks such as the 2016 to 2017 depreciation. Their effectiveness depends on the size of the change, time lags, fixed-rate loans and confidence, so they work best alongside supply-side policies that raise productivity.

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Option (g)

Economic growth is an increase in real GDP (actual growth) or in the productive potential of the economy (potential growth). The UK's macroeconomic objectives include sustained economic growth, low and stable inflation (the 2% CPI target), low unemployment, a sustainable current account on the balance of payments, a fairer distribution of income and protection of the environment. Figure 4 shows UK real GDP growth of 1.8% in 2016 and 2.0% in 2017. I will evaluate the conflicts between growth and low inflation, and between growth and the current account.

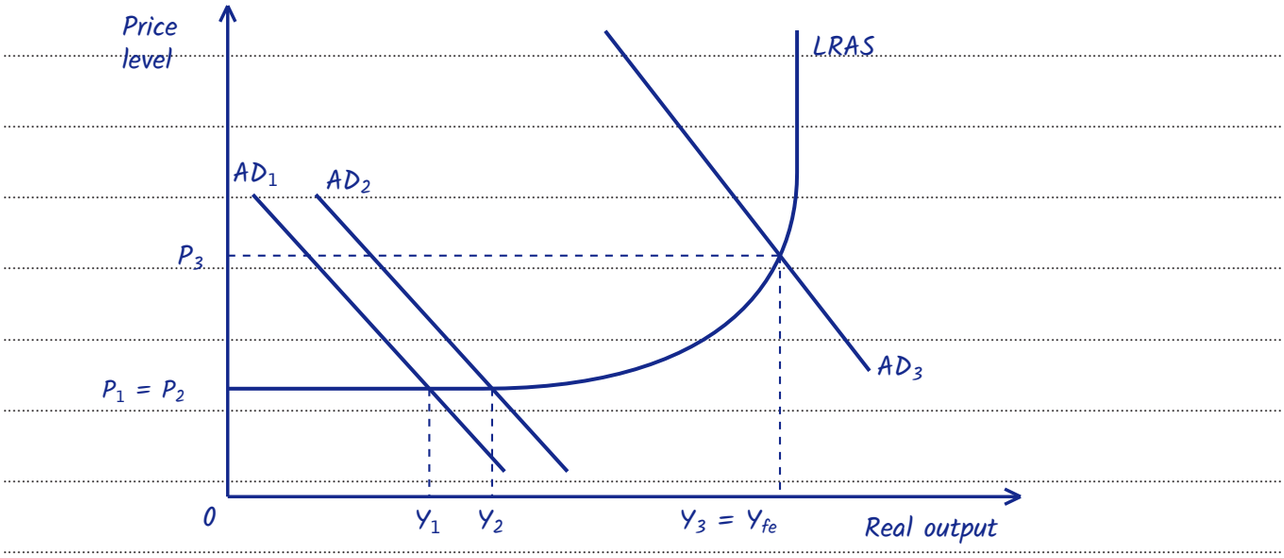
Growth and inflation: if growth is driven by rising AD, such as the increase in exports since mid-2016 shown in Figure 3, then as the economy approaches full capacity firms face shortages of skilled labour and bottlenecks in the supply chain. Firms compete for scarce resources, so wages and costs rise and are passed on as higher prices. As the diagram shows, an increase from AD_1 to AD_2 on the elastic section of the LRAS raises real output with little inflation, but a further increase from AD_2 to AD_3 near full employment output (Y_{fe}) mainly causes demand-pull inflation, raising the price level from P_2 to P_3. With unemployment at about 4.3% in 2018 and inflation above 3% at the end of 2017, further demand-led growth would risk pushing inflation further above target.

Growth and the current account: as real incomes rise, consumers spend more, and because the UK has a high marginal propensity to import, a large share of extra spending goes on imported goods such as food, cars and electronics. Strong domestic demand may also divert output from export markets to the home market. Imports therefore grow faster than exports, worsening the UK's current account deficit, which is already large. Consumer-led growth financed by rising personal debt, as described in Extract A, is especially likely to suck in imports.

However, the extent of these conflicts depends on several factors. Firstly, the type of

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growth: if it comes from increases in LRAS, through investment, higher productivity, training or new technology, then capacity expands and real output rises while the price level stays stable or even falls, so there is no conflict with low inflation. Supply-side growth also improves international competitiveness, which helps the current account.

Secondly, the stage of the economic cycle and the amount of spare capacity. With a negative output gap, as in 2010 to 2013 when unemployment was around 8%, AD can rise with little inflation; the conflict only becomes serious when actual growth exceeds the growth of productive capacity. The initial rate of inflation also matters: Figure 1 shows inflation close to 0% in 2015, so faster growth then would have helped bring inflation back towards the 2% target rather than conflicting with it.

Thirdly, the source of demand matters for the current account. Extract B suggests UK growth is expected to be export-led, driven by the fall in the pound and the global recovery. Export-led growth raises X relative to M, so it would improve rather than worsen the current account. The effect also depends on whether domestic firms can meet rising demand and on how competitive UK firms are internationally. Growth also raises tax revenue, giving the government more scope to fund policies that reduce other costs of growth.

In conclusion, there are real conflicts between growth and both low inflation and the

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current account, particularly in the short run when growth is driven by consumer spending and the economy is close to full capacity, as in the UK in 2017 to 2018. However, they are not inevitable: if growth is sustainable, supply-side and export-led, so that productive capacity grows at least as fast as AD, the UK can achieve growth alongside low inflation and an improving current account. The most significant conflict is likely to be with the current account, given the UK's high marginal propensity to import.

(Total for Question 6 = 60 marks)

TOTAL FOR SECTION B = 60 MARKS
TOTAL FOR PAPER = 80 MARKS

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