Please check the examination details below before entering your candidate information

Candidate surname: StemUp Model Solution

Other names:

Pearson Edexcel Level 3 GCE

Centre Number:

Candidate Number:

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.
- Good luck with your examination.

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 In March 2020 the Monetary Policy Committee (MPC) of the Bank of England reintroduced its quantitative easing programme.

(a) Which **one** of the following is the most likely effect of this quantitative easing?

(1)

- ☐ **A** A fall in economic growth
- ☐ **B** A fall in the rate of inflation
- ☒ **C** An increase in the money supply
- ☐ **D** An increase in unemployment

The MPC of the Bank of England also cut the UK's base interest rate from 0.75% to 0.1% in March 2020.

(b) Explain **one** likely impact of a decrease in the base interest rate on inflation.

(3)

A lower base rate decreases the cost of borrowing for households and firms, and decreases the reward for saving.

The MPC cut the base rate from 0.75% to 0.1% in March 2020, a fall of 0.65 percentage points, so mortgages and loans become cheaper.

Households have more disposable income after mortgage repayments and borrow more, so consumption rises, and firms find investment cheaper. Since C and I are components of AD, AD shifts right and demand-pull inflation rises. Lower rates also reduce hot money inflows, so the pound depreciates, (X – M) rises and import prices rise, adding further to inflation.

(Total for Question 1 = 4 marks)

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2 The table below shows the UK's nominal Gross Domestic Product (GDP) and population, 2016 to 2018.

Year	GDP (£ millions)	Population (millions)
2016	1 995 478	65.6
2017	2 033 234	66.0
2018	2 061 408	66.4

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

(a) Define the term 'nominal'.

(1)

Nominal means a value measured at current prices, i.e. not adjusted for inflation.

(b) Using the above GDP data, which **one** of the following represents the index number for 2016, if 2017 is the base year?

(1)

- ☐ **A** 96.8
- ☒ **B** 98.1
- ☐ **C** 101.9
- ☐ **D** 103.3

(c) Calculate the UK's nominal GDP per capita in 2018. You are advised to show your working.

(2)

GDP per capita = nominal GDP ÷ population

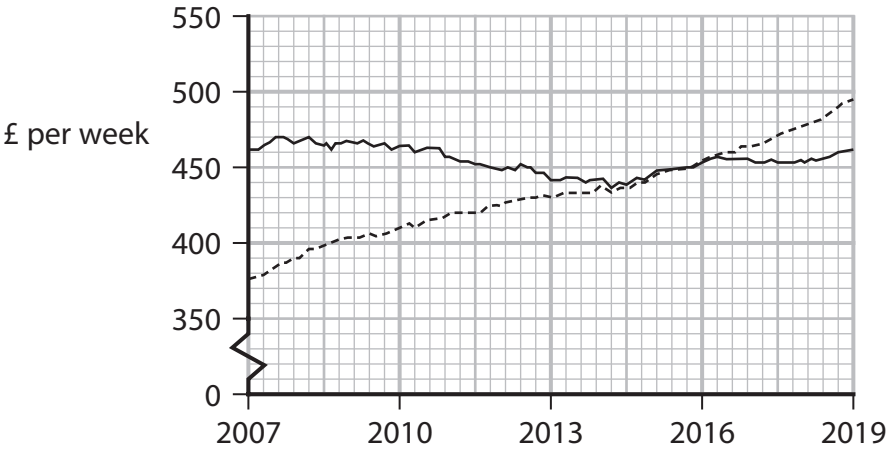
= £2 061 408 million ÷ 66.4 million

= £31 045.30 per person

Nominal GDP per capita in 2018 = £31 045.30

(Total for Question 2 = 4 marks)

3 UK average weekly earnings, January 2007 to January 2019



(Source adapted from: https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/averageweeklyearningsingreatbritain/march2019)

(a) Which **one** of the following can be inferred from the above chart?
Between 2007 and 2019,

(1)

☒ **A** earnings adjusted for interest rates were lower than earnings not adjusted for interest rates

☒ **B** nominal earnings increased by nearly 125 percentage points

☒ **C** the increase in earnings not adjusted for inflation was greater than earnings adjusted for inflation

☒ **D** there were significant increases in real earnings each year

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(b) With reference to the chart, explain the likely relationship between real incomes and subjective happiness.

(3)

Subjective happiness is a person's own judgement of their wellbeing, which may differ between individuals. As real incomes increase, happiness is likely to increase, because higher real earnings increase a person's ability to afford and buy more goods and services.

The chart shows that, although nominal earnings rose by nearly £125 per week between 2007 and 2019, real earnings stayed roughly constant at about £450 to £460 per week, and even dipped to about £440 around 2014.

As real earnings have not increased, people have no more purchasing power than in 2007, so they are unlikely to have experienced a big improvement in their living standards or happiness. The rise in nominal pay is a money illusion, as it was cancelled out by inflation.

(Total for Question 3 = 4 marks)

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4 The UK exchange rate changed from £1 = $1.53 in January 2015 to £1 = $1.22 in October 2019.

(a) Define the term 'exchange rate'.

(1)

The exchange rate is the value (price) of one currency in terms of another currency, e.g. £1 = $1.22 in October 2019.

(b) Which **one** of the following represents the percentage change in the £ sterling and US$ exchange rate?

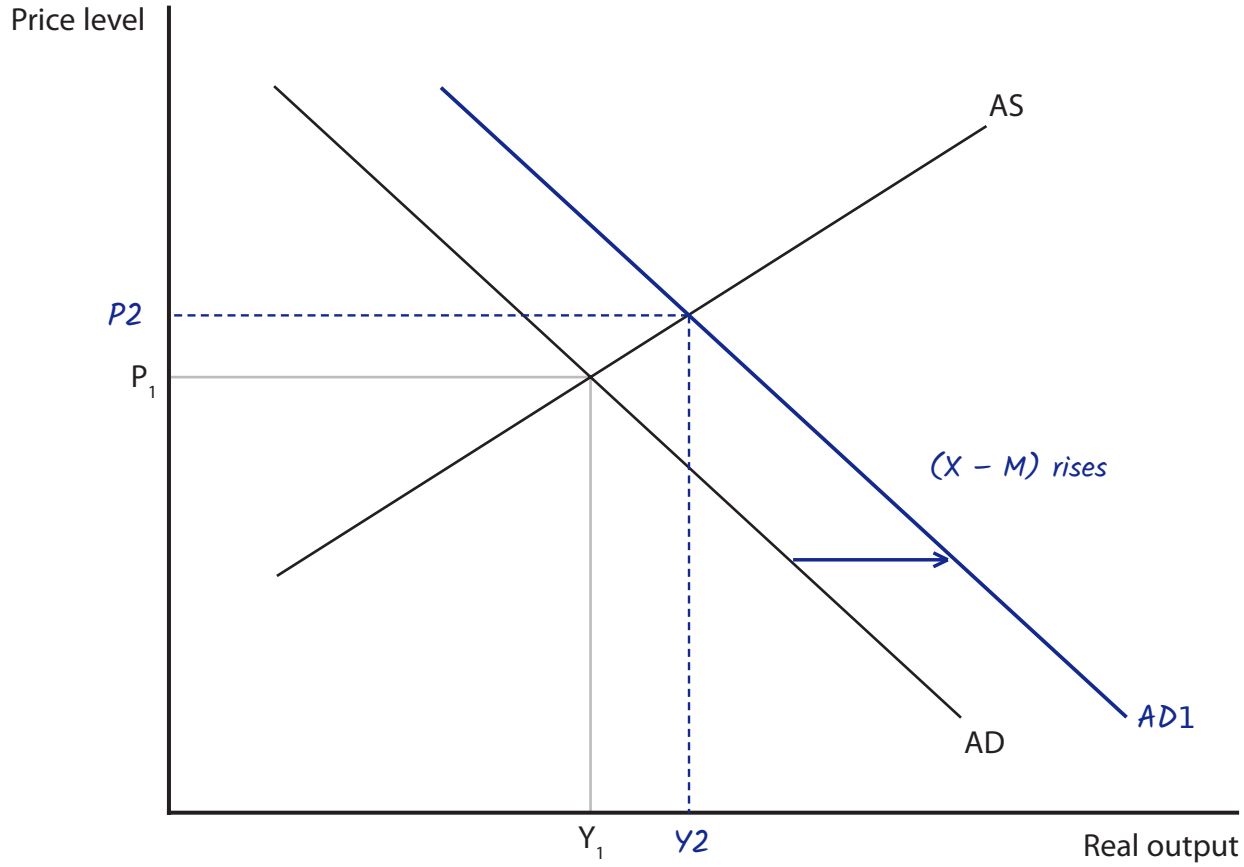
(1)

- ☒ **A** 0.31%
- ☒ **B** 20.26%
- ☒ **C** 25.41%
- ☒ **D** 79.74%

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(c) Annotate the aggregate demand (AD) and aggregate supply (AS) diagram below to show the likely impact of an improvement in net trade on the equilibrium level of real output and the price level.

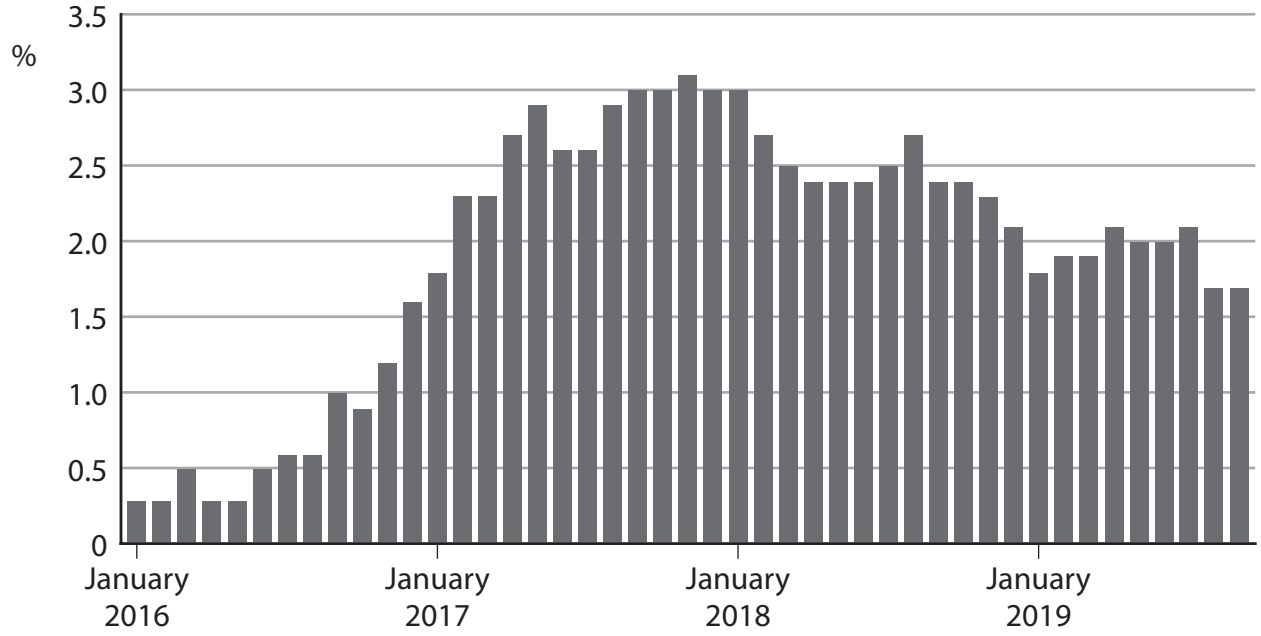
(2)



(Total for Question 4 = 4 marks)

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5 Annual rate of UK inflation, as measured by the Consumer Prices Index (CPI), January 2016 to September 2019.



(Source adapted from: https://tradingeconomics.com/united-kingdom/inflation-cpi)

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

(1)

☒ **A** The average price level was lower in January 2018 than in January 2019

☒ **B** The average price level was unchanged between January 2017 and January 2019

☒ **C** There was deflation from January 2018 to January 2019

☒ **D** There was disinflation from January 2016 to January 2017

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(b) Explain **one** limitation of CPI in measuring the rate of inflation.

(3)

One limitation is that CPI does not include most housing costs, such as mortgage interest payments and council tax.

The chart shows CPI inflation of about 1.7% in September 2019, just below the 2% (+/– 1%) target.

Monthly rent or mortgage interest repayments form a large part of consumer spending. If housing costs are rising faster than other prices, CPI understates the true rise in the cost of living for many households, so actual inflation faced by homeowners may be well above 1.7%. CPI also only measures the cost of living for an average household, so it may not reflect the inflation faced by pensioners or low income households.

(Total for Question 5 = 4 marks)

TOTAL FOR SECTION A = 20 MARKS

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SECTION B

Read Figures 1 and 2 below and Extract A before answering Question 6.

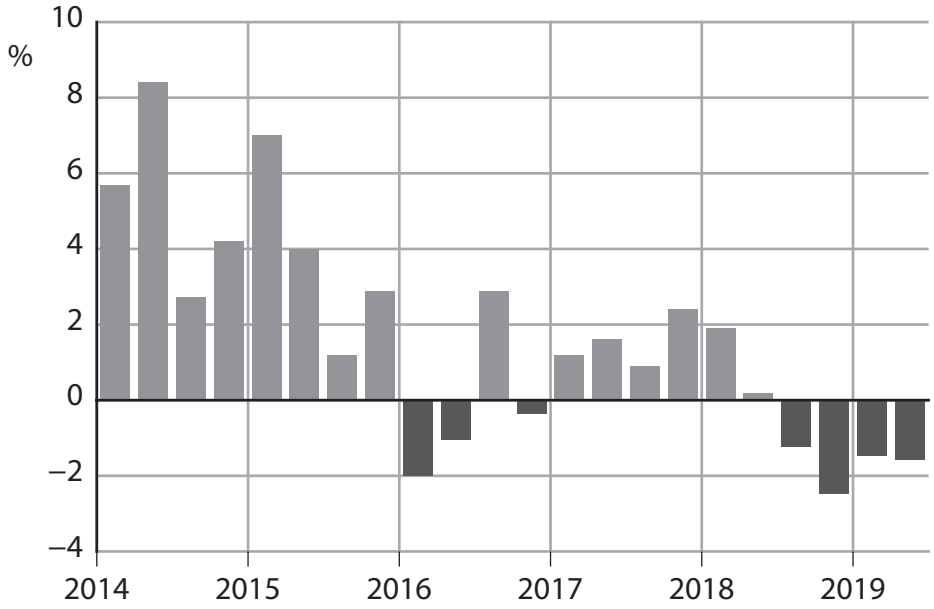
Answer ALL Questions 6(a) to 6(e) and EITHER Question 6(f) OR Question 6(g).

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

Question 6

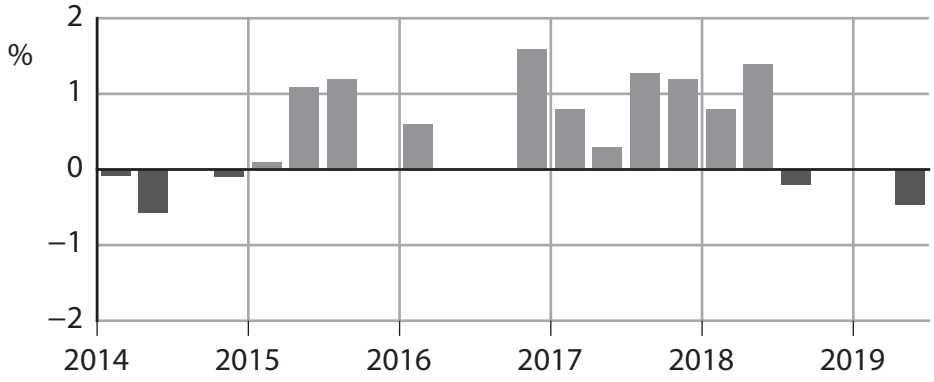
UK investment and productivity

Figure 1: UK investment, annual percentage change, 2014 to 2019



(Source adapted from: https://www.ft.com/content/5e12351e-baaf-11e9-96bd-8e884d3ea203)

Figure 2: UK labour productivity, annual percentage change, 2014 to 2019



(Source adapted from: https://www.theguardian.com/business/2019/oct/08/uk-productivity-brexit-boris-johnson-labour)

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Extract A

Another recession?

For the first time in nearly seven years, the UK economy contracted by 0.2% in the second quarter of 2019. This was as a result of a significantly weaker than expected performance in almost every part of the UK economy.

Business investment has been weak across the world, but it is particularly low in the UK. Firms are reluctant to commit to capital spending while there is economic uncertainty. Growth in investment, in areas such as transport and machinery, has slowed. Global trade tensions are also affecting investment decisions.

Labour productivity decreased by 0.5% in the second quarter of 2019, the worst performance since mid-2014. Declining productivity is a concern especially as it comes at a time when the unemployment rate has been one of the lowest. The rate of unemployment decreased from 6% in July 2014 to 3.8% in July 2019.

The UK's economic growth has been held back by low investment and productivity since the Global Financial Crisis of 2008. Moreover, the uncertainty over the UK's future trade relationship with the EU has discouraged companies from investing in productivity-boosting technology. This has decreased the prospects for increases in workers' pay. Without business investment and improvements in productivity, short-term growth in real GDP is likely to slow further and reduce living standards.

However, the UK Government expects the UK economy to perform better than Germany and Italy. These export-focused countries are highly exposed to the slowdown in world trade and the fall in average global incomes.

The UK economy is seeing continued strength in consumer spending. Consumption will support growth, provided there is no sudden shock to the UK labour market. Household incomes are strong, primarily due to high employment. Government expenditure has also been rising since the end of 2018. The UK Government has promised more money for schools and infrastructure improvements.

Despite this, some economists believe that the UK economy is likely to experience another recession. They claim that low income households cannot cope with a new downturn. The overall picture for the UK economy does not look promising because most businesses are reluctant to invest, productivity is low and economic growth relies on continued consumption.

(Source adapted from: 'On the brink: Britain's economy braced for Brexit shock', FT, https://www.ft.com/ content/40c604d2-c01c-11e9-89e2-41e555e96722; 'Recession threat hangs over UK economy ahead of Brexit, FT, https://www.ft.com/content/5e12351e-baaf-11e9-96bd-8e884d3ea203; 'UK productivity falls at fastest pace in five years as Brexit dents investment, The Guardian, https://www.theguardian.com/ business/2019/oct/08/uk-productivity-brexit-boris-johnson-labour)

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6 (a) With reference to Figure 1, explain the term 'investment'.

(4)

(b) With reference to Extract A, explain **two** influences on the level of UK investment.

(6)

(c) With reference to the fourth paragraph of Extract A, assess the limitations of using GDP to compare living standards over time.

(10)

(d) Explain **one** likely reason why 'the UK Government expects the UK economy to perform better than Germany and Italy' (Extract A, lines 19–20).

(5)

(e) With reference to the information provided, discuss the likely impact of a recession on the UK economy.

(15)

EITHER

(f) Evaluate the fiscal policies the UK Government could use if it believes that 'the UK economy is likely to experience another recession' (Extract A, lines 27–28).

(20)

OR

(g) Evaluate the supply-side policies the UK Government could use to increase the UK's productivity.

(20)

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(a) With reference to Figure 1, explain the term 'investment'.

(4)

Investment is spending by firms on capital goods, such as machinery, factories and transport equipment, which adds to the capital stock of the economy. It raises productivity and productive capacity (LRAS), and it is an injection into the circular flow of income and a component of AD.

Figure 1 shows that UK investment growth was strong in 2014, peaking at about 8% (annual change), but in early 2016 investment decreased by about 2%. From the end of 2018 to mid 2019 investment fell every quarter, with the largest fall of about 2.5% at the end of 2018.

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(b) With reference to Extract A, explain **two** influences on the level of UK investment.

(6)

The first influence is business confidence and expectations (animal spirits). Extract A states that firms are reluctant to commit to capital spending while there is economic uncertainty, and that uncertainty over the UK's future trade relationship with the EU has discouraged companies from investing. Firms will only invest if they are confident about future costs, revenues and sales. If they are unsure whether Brexit will bring tariffs or disrupt supply chains, the expected rate of return on new capital becomes risky, so they delay or cancel investment projects, as shown by the falls in investment from late 2018.

The second influence is the rate of economic growth (the accelerator). Extract A shows that the UK economy contracted by 0.2% in the second quarter of 2019, raising fears of another recession. A fall in GDP means lower demand for goods and services, so firms already have enough spare capacity and do not need to buy new capital goods. Lower sales also reduce retained profits, which are a key source of funds for investment.

Global trade tensions also reduce the demand for exports, so firms that export have less reason to expand capacity, which further reduces UK investment.

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(c) With reference to the fourth paragraph of Extract A, assess the limitations of using GDP to compare living standards over time.

(10)

GDP is the total value of goods and services produced in an economy over a period of time. Living standards refer to the material welfare and quality of life of the population. The fourth paragraph of Extract A suggests that slower growth in real GDP will reduce living standards, but there are limitations in using GDP to compare living standards over time.

Firstly, nominal GDP must be adjusted for inflation, as a rise in nominal GDP may only reflect higher prices. Even real GDP can be misleading if the population is growing: the UK population grew from 65.6 million in 2016 to 66.4 million in 2018, so total GDP growth overstates the rise in output per person. Percentage changes are also misleading without reference to the size of total GDP.

Secondly, GDP says nothing about the distribution of income. Growth may be unevenly spread across regions, with jobs and wages concentrated in some areas. Extract A notes that low income households cannot cope with a new downturn, so an average figure can hide falling living standards for many people, even when GDP is rising.

Thirdly, GDP excludes the informal, hidden and unpaid economy, such as housework, volunteering and cash-in-hand work, because it is not bought or sold and there is no recorded income. If the size of this economy changes over time, comparisons become unreliable.

Fourthly, GDP ignores quality of life issues such as working hours, leisure, health, education and pollution. Higher output may come with longer hours, stress and environmental damage. The composition of GDP also matters: spending on investment goods raises future living standards at the expense of current consumption, so the low investment described in Extract A may raise living standards now but reduce them later. Data is also revised and may be unreliable.

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However, GDP remains a useful measure for comparing living standards over time. It is a standard, well understood and internationally recognised measure, data is easy to obtain quarterly, and it is collected in the same way each year, so comparisons over time within the UK are more reliable than comparisons between countries. Using real GDP per capita overcomes the problems of inflation and population growth and gives a good indication of average incomes, which are a key determinant of living standards. Since the size of the hidden economy changes only slowly, its effect on trends is small. Furthermore, standard of living is subjective and cannot be measured accurately. Alternative measures such as the HDI or happiness surveys have their own weaknesses, so GDP may still be the best measure available.

In conclusion, GDP is limited because it ignores distribution, non-market activity and quality of life, but real GDP per capita, used alongside other indicators, is still a reasonable guide to changes in UK living standards over time.

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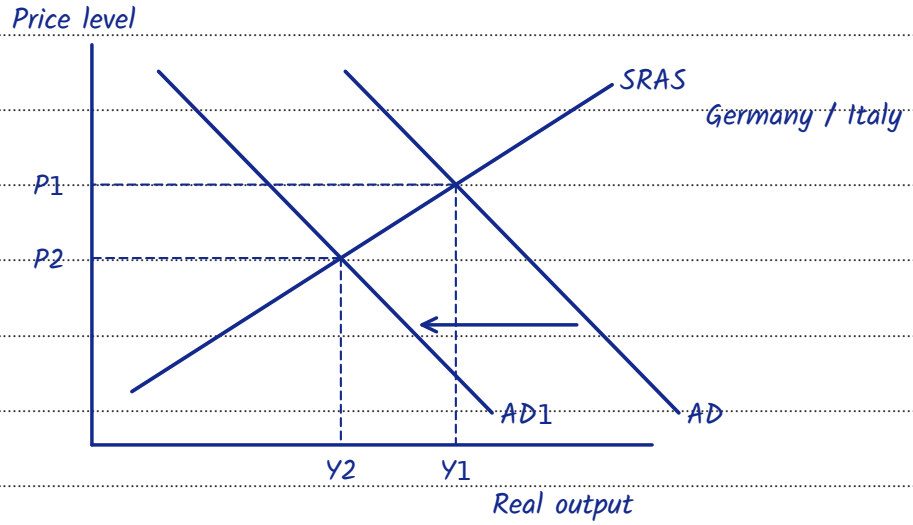
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(d) Explain **one** likely reason why 'the UK Government expects the UK economy to perform better than Germany and Italy' (Extract A, lines 19–20).

(5)

One likely reason is that Germany and Italy are export-focused economies (export-led growth), so they are much more reliant on international trade than the UK. Extract A states that they are highly exposed to the slowdown in world trade and the fall in average global incomes. As incomes in trading partners fall, there is a lack of demand for German and Italian exports, so the net trade (X – M) component of their AD falls. AD shifts left from AD to AD1, leading to lower real output (Y1 to Y2) and lower economic growth, and possibly higher unemployment.

In contrast, the UK economy is consumption driven, with continued strength in consumer spending and rising government expenditure, so the contribution of exports to UK GDP is smaller and the UK is less affected.



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(e) With reference to the information provided, discuss the likely impact of a recession on the UK economy.

(15)

A recession is a period of at least two consecutive quarters of negative economic growth (falling real GDP). Extract A reports that the UK economy contracted by 0.2% in the second quarter of 2019, and some economists believe that another recession is likely.

The first likely impact is higher unemployment. With lower real GDP and falling demand, firms need fewer workers, since labour is a derived demand, so cyclical unemployment rises from its low rate of 3.8% in July 2019. Households lose income and cannot afford as many goods and services, so living standards fall and poverty rates could rise. Extract A warns that low income households cannot cope with a new downturn, so inequality is likely to widen. Since UK growth relies on continued consumption, falling incomes and confidence reduce consumer spending further, and the negative multiplier effect makes the fall in AD larger than the initial shock.

Secondly, firms are likely to make less profit as consumer spending falls. Business investment is already weak, as Figure 1 shows falls in investment in every quarter from late 2018, and a recession would cut it further through the accelerator effect. Less investment in R&D and productivity-boosting technology means labour productivity, which already fell by 0.5% in Q2 2019, would stay low. This could reduce the growth of LRAS and cause long-term damage (hysteresis), as unemployed workers lose skills.

Thirdly, government finances would worsen. Tax revenues from income tax, VAT and corporation tax fall, while spending on unemployment and welfare benefits rises through the automatic stabilisers. The budget deficit and the debt to GDP ratio would rise, which may make it harder to fund the promised extra money for schools and infrastructure. A recession can also bring social costs such as stress, worse health and higher crime, and fewer resources can be devoted to renewable energy.

However, a recession may also bring some benefits. Lower demand reduces demand-pull

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and cost-push inflationary pressures; CPI inflation was already only about 1.7% in September 2019, so this is less of a concern, although the risk of deflation could rise. Spending on imports falls as incomes fall, which would improve the current account deficit of the balance of payments. Less production by firms means lower external costs such as pollution and less depletion of non-renewable resources, and depressed house prices may make houses more affordable for first-time buyers.

The size of the impact depends on the depth and length of the recession. The contraction in Q2 2019 was only 0.2%, and this was not technically a recession, as there were not two consecutive quarters of negative growth, so the impact may be relatively small. Extract A shows that household incomes are strong due to high employment, consumer spending is continuing and government expenditure has been rising since the end of 2018, all of which would cushion a fall in AD. The UK is also expected to perform better than Germany and Italy, which are more exposed to the slowdown in world trade.

The impact also depends on the policy response. The Bank of England could cut interest rates, but with the base rate at only 0.75% (then 0.1% in March 2020), there is little room for monetary policy, so fiscal policy may be needed, which would add to government borrowing.

In conclusion, a recession would be likely to harm the UK economy mainly through higher unemployment, lower investment and productivity, and worse public finances, with low income households hit hardest. The benefits, such as lower inflation and a smaller current account deficit, are relatively minor. However, if the downturn is short and shallow, and supported by strong consumption and government spending, the overall impact may be limited.

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EITHER

(f) Evaluate the fiscal policies the UK Government could use if it believes that 'the UK economy is likely to experience another recession' (Extract A, lines 27–28).

(20)

OR

(g) Evaluate the supply-side policies the UK Government could use to increase the UK's productivity.

(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)** ☒

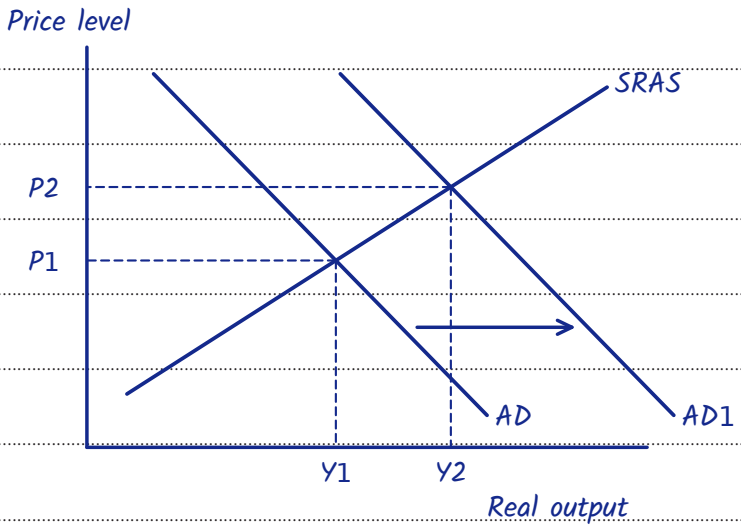
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Answer to 6(f)

Expansionary fiscal policy is the use of increased government spending and/or lower taxation to increase aggregate demand, usually financed by a larger budget deficit. If the government believes that the UK economy is likely to experience another recession, after it contracted by 0.2% in Q2 2019, it could use several fiscal policies.

Firstly, it could increase government expenditure, for example on infrastructure, schools and housing, as it has already promised more money for schools and infrastructure improvements. Since G is a component of AD, AD shifts right from AD to AD1 in the diagram, raising real output from Y1 to Y2 and the price level from P1 to P2. Through the multiplier effect, the extra spending creates incomes for construction workers and suppliers, who spend part of it, so the final rise in real GDP is greater than the initial injection, and unemployment is kept low. Infrastructure spending also raises LRAS in the long run.

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Secondly, it could cut the rate of income tax, raise the income tax threshold or decrease national insurance contributions. This increases households' disposable income and purchasing power, which leads to greater consumption and promotes economic growth. Since UK growth relies on continued consumption, supporting household incomes directly targets the main driver of AD and helps the low income households that Extract A says cannot cope with a downturn. Lower indirect taxes, such as a temporary cut in VAT, would reduce prices and boost spending quickly. The government could also relax austerity measures and increase unemployment benefits, which go to people with a high marginal propensity to consume.

Fiscal policy is particularly significant because monetary policy may be ineffective: the base rate was only 0.75% and was cut to 0.1% in March 2020, so interest rates are already historically low, leaving little room to cut them further.

However, there are limitations. There are long time lags: infrastructure projects can take 18 to 24 months or more to plan and implement, so the spending may arrive after the recession has ended. The effect depends on the value of the multiplier in the UK; with high leakages into savings, taxes and imports, the multiplier may be small. If consumer and business confidence is low, households may save tax cuts rather than spend them, so the effect on AD may not be as large or significant.

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The impact also depends on the level of spare capacity in the economy. With unemployment at only 3.8%, the economy may be close to full capacity, so if LRAS is inelastic, extra AD may mainly raise the price level rather than real output. There is also a conflict with other objectives, such as reducing the budget deficit and national debt. Higher borrowing can lead to higher bond yields, increasing the cost of debt repayments and crowding out private sector investment. Raising benefits may reduce the incentive to find employment, and free market economists argue that higher spending will be wasted on inefficient projects.

In conclusion, fiscal policy is likely to be the most effective tool against a recession because monetary policy has little room left. The best approach would be timely, targeted and temporary measures, such as tax cuts for low income households with a high propensity to consume, together with infrastructure spending that also raises long-run productivity. However, its success depends on the size of the multiplier, the level of confidence and the government's willingness to accept higher borrowing.

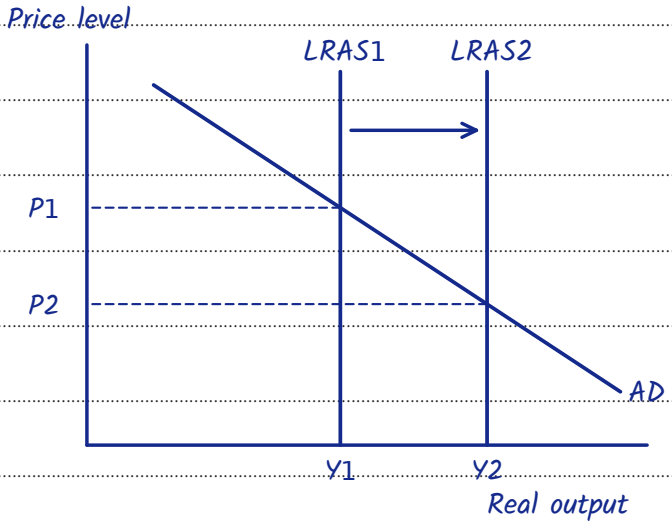
Answer to 6(g)

Productivity is output per worker per hour. Supply-side policies are government policies that aim to increase the productive capacity of the economy (LRAS) by improving the quantity and quality of the factors of production. They can be market-based or interventionist. UK productivity is a concern: labour productivity decreased by 0.5% in Q2 2019, the worst performance since mid-2014, and Figure 2 shows it fell below zero in late 2018 and 2019.

Firstly, the government could increase spending on education and training, such as apprenticeships and bursaries for university courses. This raises human capital, so each worker can produce more output per hour, which increases productivity. As shown in the diagram, LRAS shifts right from LRAS1 to LRAS2, increasing real output from Y1 to

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Y2 and reducing the price level from P1 to P2, so growth is non-inflationary. Increased spending on healthcare would also reduce the number of days absent from work.



Secondly, the government could increase spending on infrastructure investment, such as transport, broadband and roads, as it has promised. Better infrastructure reduces industry costs, cuts travel times and improves access to markets, so firms can produce more with the same inputs, raising productivity.

Thirdly, it could reduce corporation tax or offer investment allowances. Extract A states that uncertainty has discouraged companies from investing in productivity-boosting technology. Lower taxes increase post-tax profits and the return on investment, which encourages firms to buy new capital, giving workers better machinery and raising output per worker. This would also increase international competitiveness for foreign direct investment.

Other policies include cutting bureaucracy and regulation, competition policy for inefficient industries, privatisation to increase competition, innovation and efficiency, better childcare provision and policies to increase the flexibility and mobility of labour. However, supply-side policies have a significant time lag. Education and training may

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take years before workers enter the labour force, and infrastructure projects take many years to complete, so they cannot quickly reverse the fall in productivity. They also have an opportunity cost and require higher government spending, which may increase the budget deficit, or an increase in taxation elsewhere, which may have an effect on incentives to work.

A cut in corporation tax may be ineffective if companies use it to boost their short-term profits and dividends rather than invest in productivity-boosting technology, particularly while Brexit uncertainty remains, which supply-side policy cannot remove. Similarly, a cut in income tax may lead some workers to work less for the same income. Privatisation may create private monopolies with less efficiency. There is also a risk of government failure, as the government may invest in the wrong projects.

In addition, productivity is difficult to measure accurately, especially in services. The low unemployment rate of 3.8% suggests that some less productive workers have been brought into employment, which reduces average output per worker, so the fall in productivity is partly a result of labour market success rather than a failure.

In conclusion, the most effective supply-side policies are likely to be spending on education, training and infrastructure, because they directly raise the quality of labour and capital, although they work only in the long run. Tax incentives for investment may help, but they depend on business confidence, so reducing uncertainty over the UK's future trading relationship may be a necessary first step for supply-side policies to raise UK productivity.

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