Please check the examination details below before entering your candidate information

Candidate surname	Other names
StemUp Model Solution	

Centre Number | Candidate Number

Pearson Edexcel Level 3 GCE

Monday 22 May 2023

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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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 Between 2019 and 2020 the UK Government increased its expenditure on healthcare from £175.1 billion to £219.9 billion.

(a) Explain **one** likely impact of this interventionist supply-side policy on aggregate supply in the UK.

(3)

Aggregate supply is likely to increase, shifting the LRAS curve to the right. Between 2019 and 2020 government expenditure on healthcare increased by £44.8 billion (£219.9bn – £175.1bn), which is a 25.6% increase ((44.8 ÷ 175.1) × 100). This spending means people will be healthier, so fewer working days are lost to illness and more people attend work rather than missing it. A healthier workforce is more efficient, increasing labour productivity and the quality of labour, so the productive capacity of the UK economy rises. AS shifts right, leading to higher real output and a lower price level.

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

(1)

- ☐ **A** A decrease in the level of unemployment benefits
- ☐ **B** A decrease in the regulation of product markets
- ☒ **C** An increase in the provision of training programmes
- ☐ **D** An increase in the rate of corporation tax

(Total for Question 1 = 4 marks)

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2 The table below shows the UK's real GDP per capita, in US dollars, measured at Purchasing Power Parities, 2018 to 2020.

Year	GDP per capita, US$
2018	46 853
2019	47 369
2020	42 536

(Source: https://data.worldbank.org/indicator/NY.GDP.PCAP.PP.KD?locations=GB)

(a) Define the term 'GDP per capita'.

(1)

GDP per capita is real GDP divided by the population, i.e. the average output (income) per person in the country.

(b) Which **one** of the following is the most likely effect of the change in real GDP per capita between 2019 and 2020?

(1)

- ☒ **A** Decrease in living standards
- ☒ **B** Decrease in unemployment
- ☒ **C** Higher consumer confidence
- ☒ **D** Higher price level

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(c) Explain **one** reason why Purchasing Power Parities (PPPs) are used.

(2)

PPPs are used to improve accuracy when comparing data, such as GDP per capita, between different countries. A PPP exchange rate is calculated by comparing the price of a basket of comparable goods and services in different countries, so it compares the cost of living and buying power in each country. This removes distortions caused by market exchange rates and different price levels, so it gives a truer comparison of living standards.

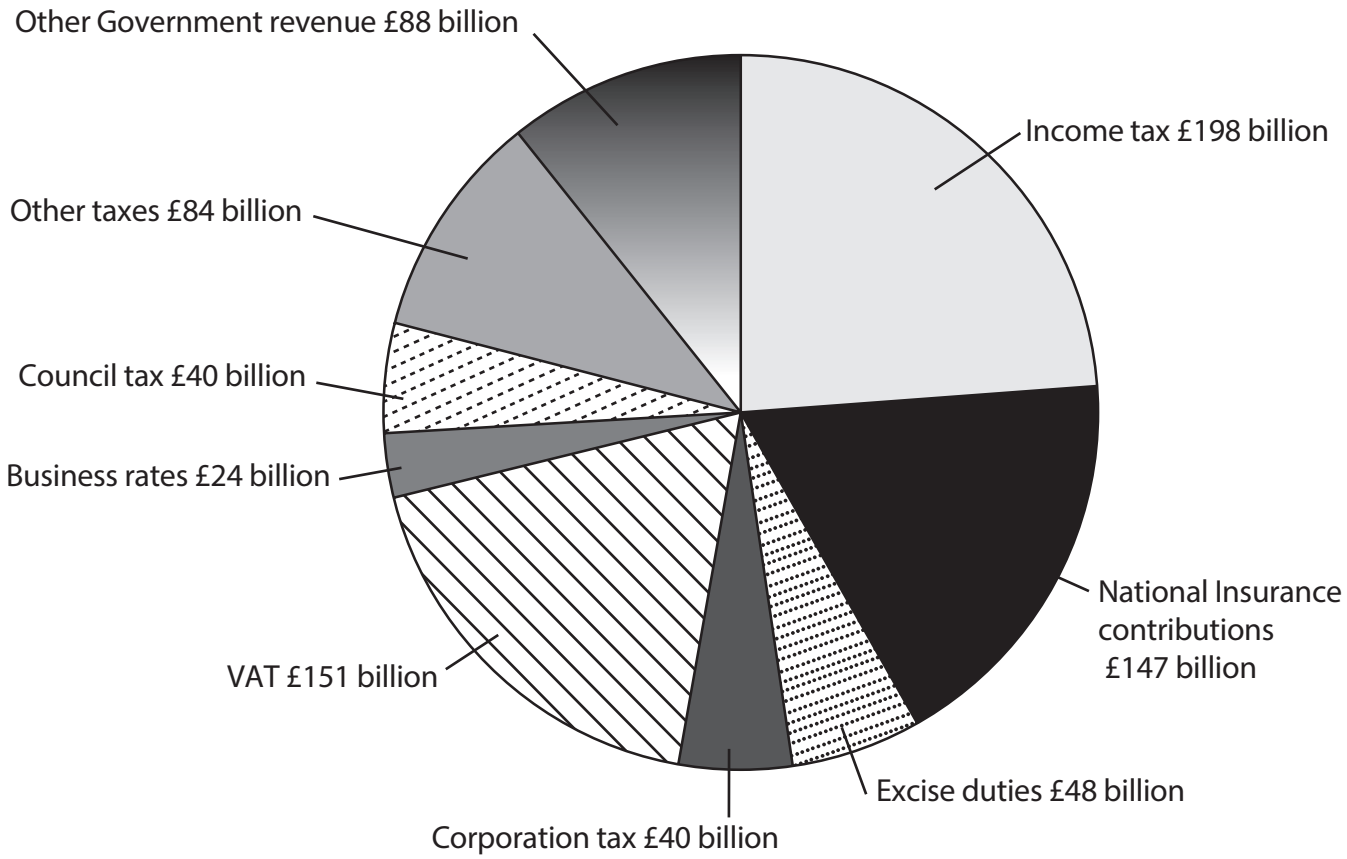
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3 The chart below shows areas of UK Government tax revenues for 2021–22. The total tax revenue for the year was £820 billion.



(Source adapted from: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/966868/BUDGET_2021_-_web.pdf)

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

(1)

- ☒ **A** Corporation tax revenue is higher than excise duties
- ☒ **B** Income tax raises less revenue than Value Added Tax (VAT)
- ☒ **C** Tax revenue from business rates contributes to approximately 3% of the overall government tax revenue
- ☒ **D** Tax revenue from National Insurance contributions is five times greater than the tax revenue from council tax

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(b) Total UK Government tax revenue for 2021–22: £820 billion.
Total UK Government expenditure for 2021–22: £1 053 billion.

Using these figures, explain the likely impact of the above data on the UK Government's budget balance.

(3)

The UK Government has a budget (fiscal) deficit.

Budget balance = tax revenue – government expenditure = £820bn – £1 053bn = –£233 billion, so there was a budget deficit of £233 billion in 2021-22.

This is because UK Government expenditure is greater than the revenue it receives from taxation. To finance the gap the Government will have to borrow more funds, for example by selling gilts, which adds to the national debt and increases future debt interest payments.

(Total for Question 3 = 4 marks)

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4 The table below shows the UK business investment, in £ billions, 2019 and 2020.

Year	Business investment (£ billions)
2019	226
2020	204

(a) Define the term 'investment'.

(1)

Investment is spending on capital goods, such as machinery and factories, which increases the capital stock of the economy; it is an injection into the circular flow of income.

(b) Assume 2019 is the base year. Which **one** of the following represents the index number for 2020?

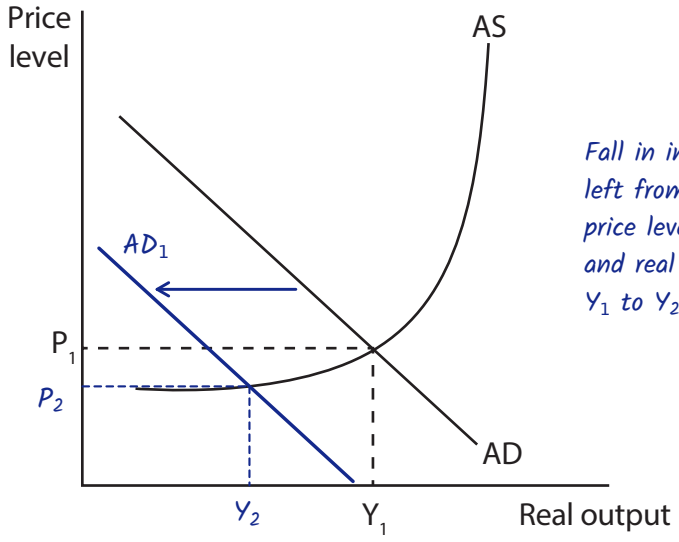
(1)

- ☒ **A** 9.7
- ☒ **B** 90.3
- ☒ **C** 109.7
- ☒ **D** 110.8

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(c) Annotate the aggregate demand (AD) and aggregate supply (AS) diagram below to show the likely impact of a fall in business investment on the equilibrium level of real output and the price level.

(2)



Fall in investment: AD shifts left from AD to AD_1, so the price level falls from P_1 to P_2 and real output falls from Y_1 to Y_2.

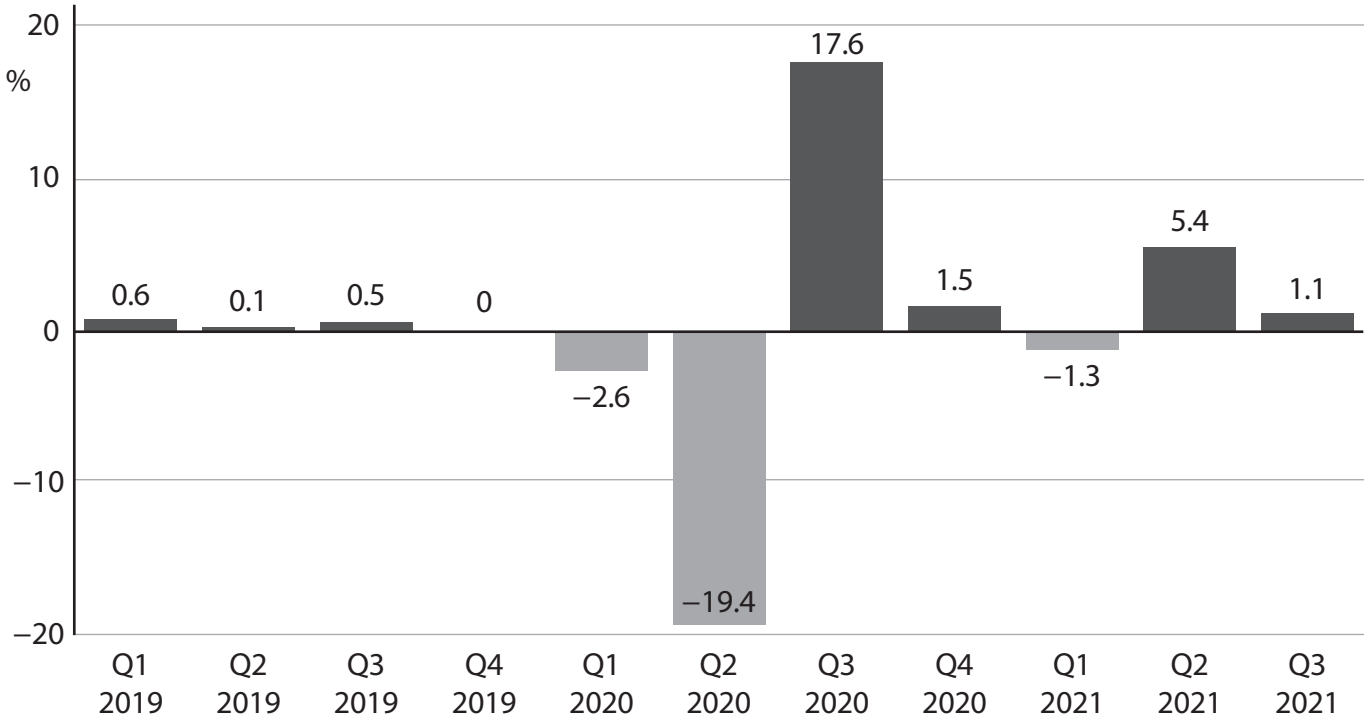
(Total for Question 4 = 4 marks)

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5 The chart below shows UK real GDP growth rate (%), Quarter 1 (Q1) 2019 to Quarter 3 (Q3) 2021.



(Source adapted from: https://tradingeconomics.com/united-kingdom/gdp-growth)

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

(1)

- ☒ **A** In Q4 2020 the level of real GDP fell by 16.1 percentage points
- ☒ **B** The price level was rising at a slower rate between Q1 2019 and Q2 2019
- ☒ **C** The UK economy experienced a boom between Q3 2019 and Q1 2020
- ☒ **D** The UK economy experienced a recession in the first six months of 2020

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(b) With reference to the chart, explain **one** likely benefit of economic growth to firms.

(3)

Economic growth increases the revenue and profits of firms.

The chart shows UK real GDP grew by 5.4% in Q2 2021 and by 1.1% in Q3 2021, recovering after the fall of −19.4% in Q2 2020.

As real GDP rises, consumers will have greater incomes and will increase their demand for firms' goods and services. Firms' sales are therefore likely to increase as a result of higher consumer demand, raising sales revenue and profit, which firms can reinvest to expand capacity, employ more workers and invest in new technology.

(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 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

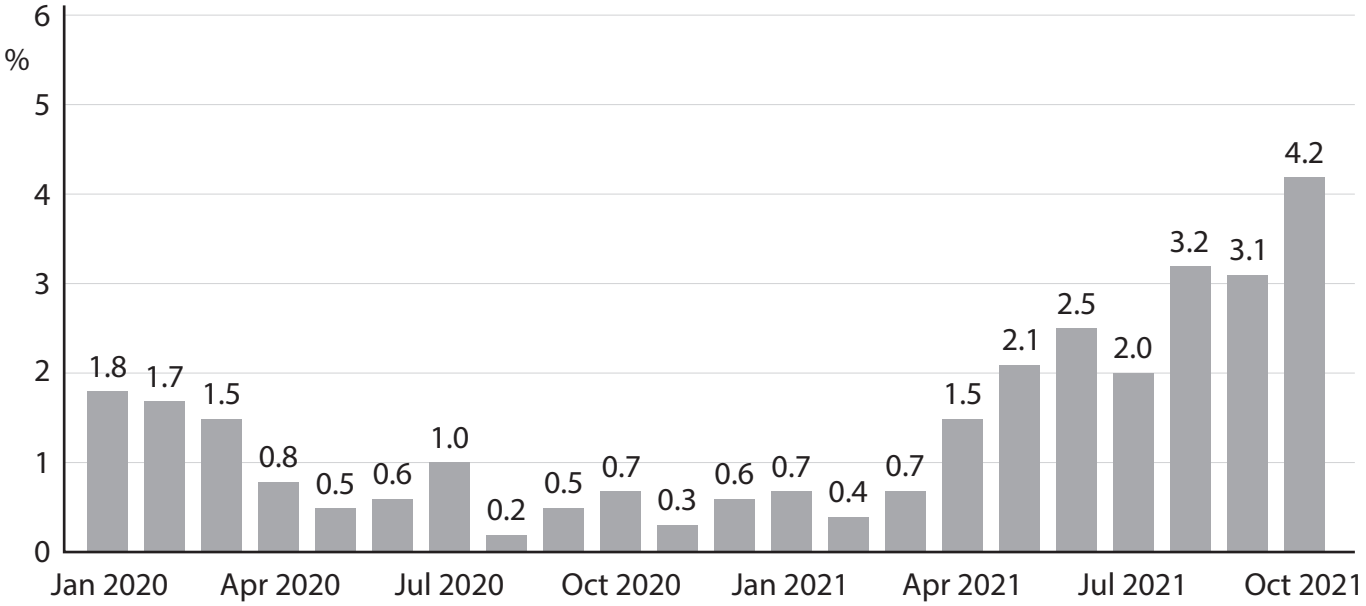
UK balance of trade and inflation

Figure 1: UK balance of trade in goods and services, January 2020 to October 2021



(Source adapted from: https://tradingeconomics.com/united-kingdom/balance-of-trade)

Figure 2: UK inflation rate as measured by annual percentage changes in the Consumer Prices Index (CPI), January 2020 to October 2021



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

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Extract A

Balance of trade in goods and services

Rising imports from non-EU countries have increased the UK's trade deficit in the third quarter of 2021. This was as a result of the UK strengthening its trading relationships with countries outside the EU. An 11.2% increase in imports from non-EU countries has increased the UK's trade deficit to nearly £7 billion. Moreover, exports to non-EU countries were £0.8 billion lower than exports to EU countries.

Despite the overall trade balance being in deficit, the UK services trade balance is in surplus, reflecting the economy's heavy reliance on services. The trade in services surplus increased by £2.2 billion to £35.6 billion. This was mostly as a result of an increase in the export of financial services.

(Source: adapted from https://www.cityam.com/swelling-non-eu-imports-widens-uk-trade-deficit)

Extract B

Inflation

In December 2021 the rate of inflation in the UK rose to 5.4%, its highest rate in 30 years. The speed of increase has taken economists by surprise. The Bank of England expected inflation to peak at this rate, but not until April 2022. The rate was more than two-and-a-half times its 2% inflation target.

Transport costs were the biggest contributor to rising inflation, with petrol prices increasing by over 5%. Moreover, supply chain bottlenecks constrained access to raw materials and limited the number of new products being sold in the market. At the same time, economists warned that the demand for goods and services in the UK economy was quickly increasing. This was a result of the easing of the restrictions associated with the global health crisis.

The high rate of inflation would normally be enough to prompt a significant increase in the base rate of interest by the Bank of England's Monetary Policy Committee (MPC). Despite the lower rates of economic growth, the MPC increased the base interest rate from 0.1% to 0.5% in February 2022.

(Source: adapted from 'UK inflation hits highest level in a decade', FT, https://www.ft.com/content/dd5edcd1-2e70-4910-b642-269574b4bcdd; 'What does the UK's soaring inflation rate mean for you?', The Guardian, https://www.theguardian.com/business/2021/dec/15/what-does-uk-soaring-inflation-rate-mean)

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(a) With reference to Figure 1, explain the term 'balance of trade in goods and services'.

(4)

(b) With reference to Figure 2, explain how the CPI inflation rate is measured. Refer to the concept of weights in your answer.

(5)

(c) With reference to Extract A, assess the likely impact of a rise in the value of exports on the UK economy.

(10)

(d) With reference to Extract B, explain **two** reasons for the increase in the rate of UK inflation.

(6)

(e) Discuss the likely economic effects of the high rate of UK inflation on consumers **and** workers.

(15)

EITHER

(f) Evaluate the main influences on the UK's net trade balance.

(20)

OR

(g) Evaluate how interest rates are used to control UK inflation.

(20)

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(a) With reference to Figure 1, explain the term 'balance of trade in goods and services'.

(4)

The balance of trade in goods and services is the value of exports of goods and services minus the value of imports of goods and services, i.e. net trade (X–M). The balance is zero when the value of imports equals the value of exports. When the value of exports is greater than imports there is a trade surplus, and when imports exceed exports there is a trade deficit.

Figure 1 shows that the UK had a trade surplus of £8 billion in May 2020. However, the balance worsened from December 2020, with a deficit of about £6 billion, and the trend has worsened again since May 2021: the UK has had a trade deficit every month since June 2021, of around £2 billion in October 2021.

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(b) With reference to Figure 2, explain how the CPI inflation rate is measured. Refer to the concept of weights in your answer.

(5)

The CPI is a weighted price index that measures the average change in the prices of a representative basket of goods and services bought by a typical UK household.

Each year an annual survey of household spending (the Living Costs and Food Survey) is used to choose the contents of the basket, around 700 items, and to set the weights. Weights are assigned in proportion to the amount of money spent on each item, so items on which households spend a larger proportion of their income, such as transport or food, have a larger weight and a bigger effect on the index than items such as matches.

Every month price surveys are undertaken to collect the prices of the items in the basket from shops across the UK and online. Each price change is multiplied by its weight and the results are added to find a weighted average. Within each year, the index represents the changing cost of a basket of fixed composition, quantity and quality. In the base year the index number is set at 100.

The inflation rate is the annual percentage change in the CPI. Figure 2 shows the UK inflation rate has been increasing, from 0.4% in February 2021 to 4.2% in October 2021, whereas there was disinflation between January 2020 (1.8%) and May 2020 (0.5%), when prices still rose but more slowly.

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(c) With reference to Extract A, assess the likely impact of a rise in the value of exports on the UK economy.

(10)

Exports are goods and services produced in the UK and sold abroad. They are an injection into the circular flow of income. Extract A shows that the UK services trade surplus increased by £2.2 billion to £35.6 billion, mostly as a result of an increase in the export of financial services.

A rise in the value of exports increases net exports (X–M), a component of aggregate demand (AD = C + I + G + (X–M)). As shown in my diagram, AD shifts right from AD to AD_1, so real output rises from Y_1 to Y_2 and the average price level rises from P_1 to P_2. Net injections increase, creating a positive multiplier effect: export firms such as banks pay more wages and buy from suppliers, and this income is spent again, further increasing AD and real output.

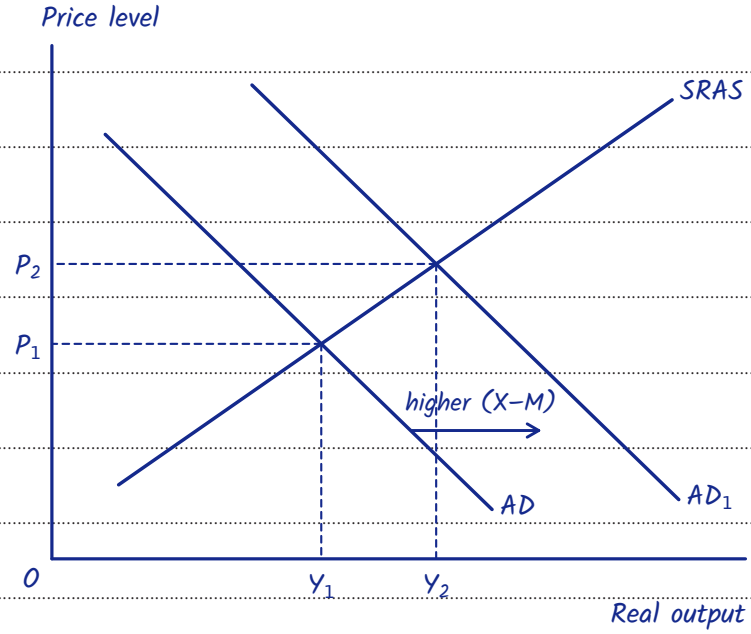
Rising real output means firms need more workers, so unemployment is likely to fall. This reduces government spending on welfare benefits and raises tax revenue, improving the government's finances. Nominal wages could rise, and real wages too if wage growth is above the inflation rate, increasing living standards and so domestic consumption. Higher demand may also encourage firms to invest, raising long-term growth, and the current account could improve if the value of exports becomes greater than the value of imports.

However, the impact on AD and real output depends on the size of the increase in exports relative to imports. Extract A shows an 11.2% increase in imports from non-EU countries increased the UK's trade deficit to nearly £7 billion, and exports to non-EU countries were £0.8 billion lower than exports to EU countries. A rise in exports may be offset by an increase in imports, so net injections may be small. The data also only gives information on exports of services: the overall impact depends on how high exports of goods are relative to exports of services.

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The effect also depends on the level of spare capacity and the elasticity of the LRAS curve. If the economy is close to full capacity, higher AD mainly causes inflation rather than higher output; Figure 2 shows inflation already rising to 4.2% in October 2021, and higher inflation creates uncertainty for firms, reducing investment. The size of the multiplier also matters, as the UK has a high marginal propensity to import. In the long run, higher UK prices may make exports less price competitive, reducing demand for them.

Overall, a rise in exports, especially of financial services, is likely to boost AD, growth and employment, but the size of the benefit depends on the size of the rise, the multiplier, spare capacity and whether imports rise as well.



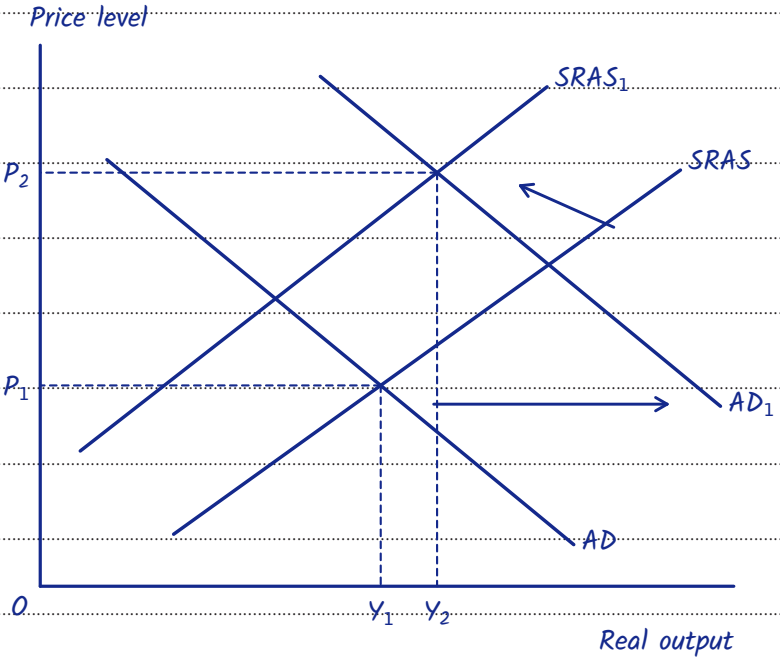
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(d) With reference to Extract B, explain **two** reasons for the increase in the rate of UK inflation.

(6)

One reason is cost-push inflation. Extract B states that transport costs were the biggest contributor to rising inflation, with petrol prices increasing by over 5%, and supply chain bottlenecks constrained access to raw materials. Higher petrol prices and rising costs of raw materials increase firms' costs of production, so SRAS shifts left from SRAS to $SRAS_1$, raising the price level, as firms pass higher costs on to consumers.

A second reason is demand-pull inflation. Demand for goods and services in the UK was quickly increasing as a result of the easing of the restrictions associated with the global health crisis. Increasing domestic demand raises consumption, as households spend savings built up in lockdown, so AD shifts right from AD to AD_1. With supply constrained, the price level rises from P_1 to P_2, so inflation reached 5.4% in December 2021.



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(e) Discuss the likely economic effects of the high rate of UK inflation on consumers **and** workers.

(15)

Inflation is a sustained increase in the general price level. UK inflation is high: Figure 2 shows CPI inflation rose from 0.4% in February 2021 to 4.2% in October 2021, and Extract B states it reached 5.4% in December 2021, its highest rate in 30 years and more than two-and-a-half times the 2% inflation target.

For consumers, high inflation reduces purchasing power. If prices rise faster than incomes, real incomes fall, so each pound buys fewer goods and services. This causes a fall in living standards, especially for low-income households, as necessities such as petrol, which rose by over 5%, food and energy take a larger share of their income. Falling real incomes lead to a loss of consumer confidence, so consumers cut spending, reducing consumption, AD and economic growth.

Savers also lose, because the real value of savings falls when the rate of inflation is higher than the rate of interest. The base rate was only 0.1% throughout the period in Figure 2, while inflation was 4.2% in October 2021, so savers earned a negative real interest rate of about −4%. This discourages saving and redistributes wealth away from savers, such as many pensioners.

For workers, if nominal wages rise more slowly than prices, real wages fall, reducing their standard of living. As workers get used to higher inflation, inflation expectations rise and they demand higher wages to protect the buying power of their incomes. If firms agree, their costs rise and SRAS shifts left, causing a wage-price spiral, so inflation becomes self-reinforcing. Higher costs and uncertainty may lead firms to cut investment and jobs, so unemployment in the UK may rise through inefficiency, and with the lower rates of economic growth mentioned in Extract B the UK risks stagflation. UK goods also become less internationally price competitive, reducing exports and jobs in exporting industries.

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However, the effects depend on the cause of inflation. Rising petrol prices and supply chain bottlenecks indicate cost-push inflation, which cannot be directly controlled by the UK, but may be temporary once supply chains recover. Part of the inflation is demand-pull, caused by rising spending as restrictions eased; this reflects recovering incomes and jobs, so the negative effects on workers may be smaller.

The effects also depend on the magnitude and duration of inflation. Inflation increased from 0.7% in January 2021 to 4.2% in October 2021, a rise of 3.5 percentage points, so the impact is likely to be quite significant. Inflation has been rising since February 2021 (Figure 2); the longer it lasts, the more expectations rise. If it is temporary, as the Bank of England expected with a peak in April 2022, the long-term impact will be limited.

Not all consumers lose. Those with a high level of personal debt benefit, as the real value of debt falls; for example, the value of a mortgage loan relative to income is likely to decrease, especially with interest rates at 0.1%. Workers with strong bargaining power, for example trade union members or those in sectors with labour shortages, may gain pay rises above inflation, and if there is high wage inflation it is easier to find work, as firms are raising wages because they cannot choose other workers at lower wages. However, much of the UK workforce has low bargaining power, so wage demands may not be met and real wages are likely to fall.

Overall, high inflation is likely to harm most consumers and workers by reducing real incomes, real savings and confidence. The severity depends on how long inflation remains high and whether wages keep up, with borrowers and workers with strong bargaining power affected least.

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EITHER

(f) Evaluate the main influences on the UK's net trade balance.

(20)

OR

(g) Evaluate how interest rates are used to control UK inflation.

(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)

The net trade balance is the value of exports minus the value of imports of goods and services (X–M). Extract A shows that the UK's trade deficit widened to nearly £7 billion in Q3 2021, as imports from non-EU countries increased by 11.2%, and Figure 1 shows a trade deficit in every month since June 2021.

A key influence is the exchange rate. If the external value of the pound rises, UK exports become more expensive in foreign currencies while imports become cheaper in pounds. Assuming demand for exports and imports is price elastic, the value of exports falls and the value of imports rises, so the UK's trade balance worsens. A depreciation of the pound does the opposite, making UK goods more price competitive.

However, this depends on the size of the change in the value of the currency and how long it is maintained for. The exchange rate is likely to be more significant in the long run than the short run because of pre-agreed contracts for imports and exports. It also depends on how sensitive consumers are to price changes for imports and exports, which depends on non-price issues and the degree of competition in the market. Firms may also respond by changing prices: UK exporters may lower their sterling prices when the pound rises to keep the price constant in the importer's currency, so export volumes change little.

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A second influence is real income in the UK. An increase in real income causes consumer spending to rise, and part of this is spent on imports, as the UK has a high marginal propensity to import. Extract B states demand was quickly increasing as health restrictions eased, which helps explain rising imports and the worsening trade balance in 2021. However, the impact depends on how sensitive consumers are to changes in income: if imports are essential goods, such as food and fuel, or inferior goods, demand for them will not rise much as income rises.

The state of the world economy is also important. If the UK's main trading partners, such as the EU, enter a recession, their incomes fall and they buy fewer UK goods and services, so exports fall and the trade balance worsens. In contrast, global recovery raises demand for UK exports; the increase in exports of financial services helped the services surplus rise by £2.2 billion to £35.6 billion.

The degree of protectionism also matters. If the UK's trading partners impose tariffs, quotas or non-tariff barriers on UK goods and services, the value of exports and net exports falls. Leaving the EU single market has added paperwork and border checks for UK exporters, and Extract A notes exports to non-EU countries were £0.8 billion lower than to EU countries, while the UK has strengthened trading relationships outside the EU, raising imports.

The relative inflation rate affects price competitiveness. If the rate of inflation is higher in the UK than in its trading partners, UK exports become relatively more expensive and imports relatively cheaper, so the value of exports falls and the trade balance worsens. UK inflation of 4.2% in October 2021, rising to 5.4% in December 2021, could therefore worsen the deficit if it is higher than abroad.

Finally, non-price factors such as quality, design, reliability, branding and after-sales service influence demand. If UK exports are of relatively lower quality, demand for them will fall and the trade balance worsens. The UK's strength in high-quality financial

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services explains its services surplus, whereas low productivity and investment in manufacturing help explain the large deficit in goods.

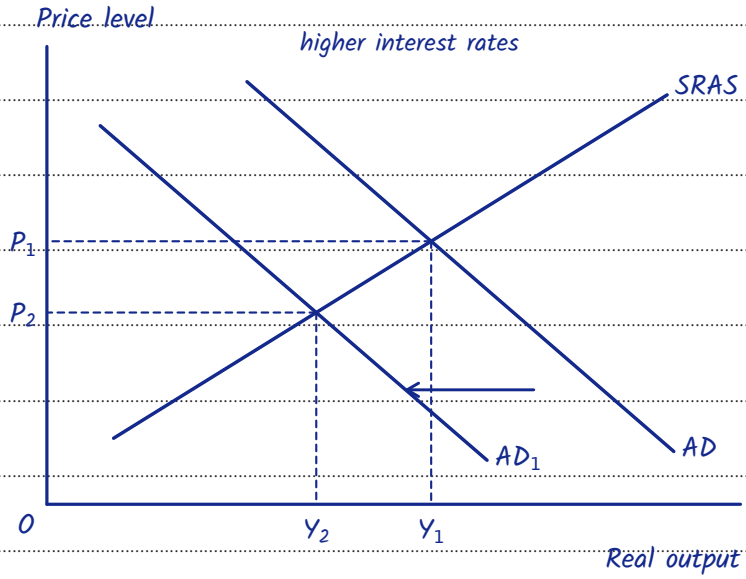
Evaluation: these influences act together, and a combination of influences, such as a strong pound alongside rising UK incomes and high inflation, has a larger impact on the net trade balance than any one factor. In the short run, changes in real income and the exchange rate are likely to be the main influences, as seen when the trade balance moved from a surplus of £8 billion in May 2020 to deficits as UK demand recovered. In the long run, non-price competitiveness and productivity are the most significant influences, because they explain the UK's persistent deficit in goods. Overall, the main influence on the UK's net trade balance depends on the time period, but structural factors such as competitiveness matter most in the long run.

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Option (g)

Interest rates are set by the Monetary Policy Committee (MPC) of the Bank of England to meet the Government's inflation target of 2% CPI inflation, as low and stable inflation is a key macroeconomic objective. With inflation at 4.2% in October 2021 (Figure 2) and 5.4% in December 2021, the MPC used contractionary monetary policy, increasing the base rate from 0.1% to 0.5% in February 2022.

Higher interest rates discourage borrowing by both households and firms, as they increase the cost of borrowing, so spending on credit falls. They also increase the rate



of saving, as the opportunity cost of spending has risen. Both reduce consumption, so AD shifts left from AD to AD_1, as shown in my diagram. The price level falls from P_1 to P_2 and real output from Y_1 to Y_2, reducing inflationary pressures.

A rise in mortgage interest repayments will reduce homeowners' real effective disposable income, so they spend less. Higher mortgage costs also reduce demand in the housing market, so house prices rise more slowly, reducing the wealth effect and inflation.

Business investment may also fall, as the cost of borrowing funds rises; planned investment projects become unprofitable, so AD falls further and inflationary pressures fall.

In addition, a higher interest rate increases the value of the pound due to hot money

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flows into UK banks. UK exports become more expensive and imports cheaper, so the (X–M) component of AD falls, reducing inflationary pressures. Cheaper imported raw materials and fuel also lower firms' costs, helping to reduce cost-push inflation.

However, the impact depends on the magnitude of the change in the interest rate. The base rate was only increased by 0.4 percentage points to 0.5%, which is still very low when inflation is 5.4%, so real interest rates remain negative and the impact may not be large. There are also time lags: changes in interest rates may take 18 months to 2 years to feed through into inflation, so policy must be based on forecasts, and the Bank of England's forecast was wrong, as inflation rose faster than expected.

Many mortgages and loans are on a fixed rate, so a change in the base rate may have little impact on their repayments in the short run, and commercial banks may not change their own rates fully in line with the base rate. The impact also depends on consumer and business confidence (animal spirits): if confidence is high as the economy reopens, households and firms may keep borrowing despite higher rates, and the size of the multiplier affects how far AD falls.

Interest rates also work mainly on demand, while external factors are beyond the Bank of England's control. Extract B suggests the higher rate of inflation has been caused by rising petrol prices and supply chain bottlenecks, which is cost-push inflation. Raising rates cannot increase the supply of raw materials, so it would reduce inflation only by reducing output and jobs. The effect of lower AD depends on the position on the LRAS curve and the level of spare capacity: with spare capacity the fall in AD mainly reduces real output rather than prices.

There may be conflicts with other macroeconomic objectives and policies. Extract B notes lower rates of economic growth, so higher rates risk a recession and higher unemployment, and they raise the cost of government borrowing. Higher rates may also mean lower investment, which reduces LRAS in the long run, increasing inflationary

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pressures in the future. A stronger pound may also worsen the trade deficit.

In conclusion, interest rates are the main tool used to control UK inflation and they are effective against demand-pull inflation, such as the surge in demand as restrictions eased. However, their success depends on the size of the rise, time lags, the share of fixed-rate loans and confidence, and they are weak against cost-push inflation from petrol prices and supply bottlenecks, where they may cause a recession. The small rise to 0.5% suggests the MPC judged that much of the inflation was temporary and cost-push, so interest rates are only partly effective and work best alongside supply-side policies.

(Total for Question 6 = 60 marks)

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

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