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 20 May 2024

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 In 2019 the average annual percentage increase in real Gross Domestic Product (GDP) was 1.7% in developed countries and it was 4.6% in developing countries.

(Source: adapted from IMF, World Economic Outlook 2019)

(a) Which **one** of the following best describes an increase in real GDP?

(1)

☒ **A** Actual economic growth

☐ **B** Negative output gap

☐ **C** Positive output gap

☐ **D** Potential economic growth

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(b) Explain **one** limitation of using GDP data to compare living standards between developed and developing countries.

(3)

One limitation is that GDP data does not take account of the informal and unpaid economy, such as subsistence farming, barter and the hidden economy, which are much larger in developing countries.

Real GDP grew by 4.6% in developing countries compared with 1.7% in developed countries, a difference of 2.9 percentage points. However, because so much output in developing countries is unrecorded, GDP undervalues their real output, so the data may give a misleading comparison of living standards between the two groups of countries.

(Total for Question 1 = 4 marks)

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2 In 2019 the marginal propensity to consume in the UK was estimated to be 0.8.

(a) Define the term 'marginal propensity to consume'.

(1)

The marginal propensity to consume is the proportion of an increase in income that is spent on consumption, i.e. MPC = ΔC / ΔY (in the UK 0.8 of each extra £1).

(b) Explain **one** likely factor that could increase the level of consumption of UK households.

(2)

A fall in interest rates would reduce the cost of borrowing, for example on loans, credit cards and mortgages, and reduce the reward for saving.

As a result households have more disposable income and an incentive to borrow and spend rather than save, so UK household consumption increases.

(c) Using the above data, which **one** of the following represents the value of the multiplier?

(1)

- ☒ **A** 0.2
- ☒ **B** 0.8
- ☒ **C** 1.3
- ☒ **D** 5.0

(Total for Question 2 = 4 marks)

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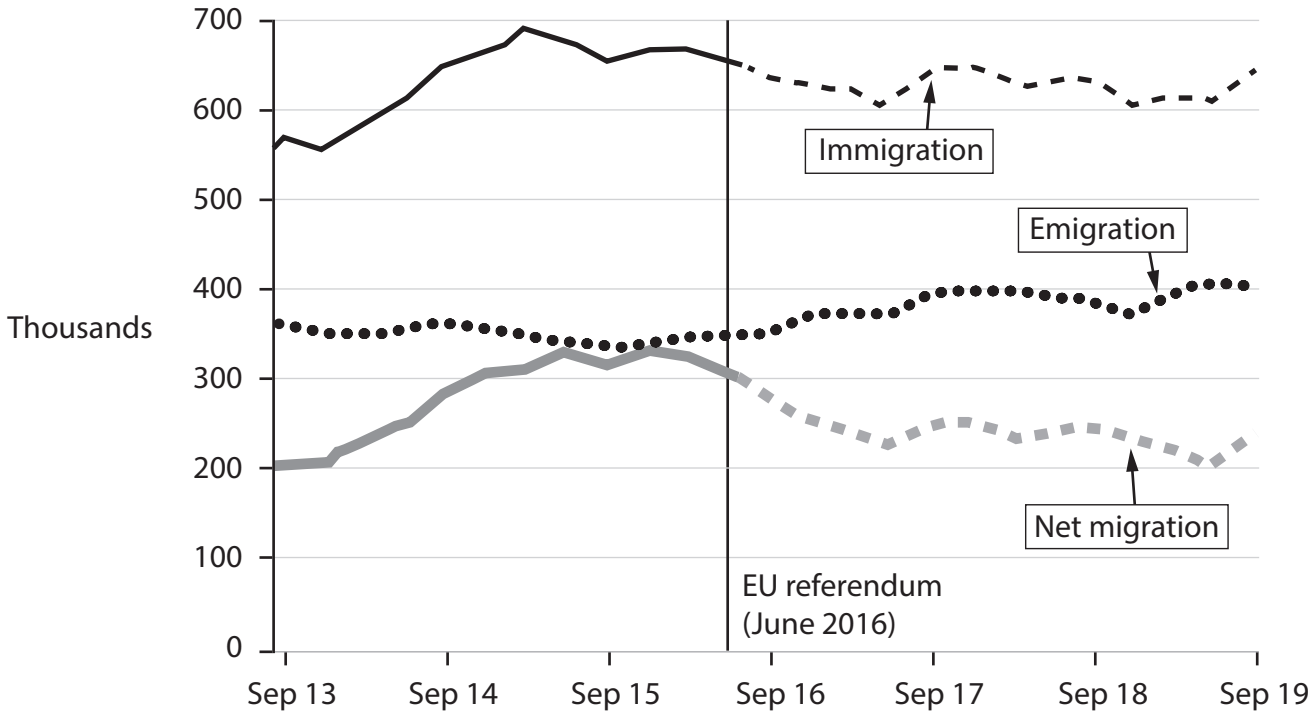
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3 The graph below shows UK long-term migration trends, September 2013 to September 2019. Immigration refers to the number of people entering the country to live there and emigration refers to the number of people leaving the country.



(Source: adapted from https://www.ons.gov.uk)

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

(1)

- ☐ **A** Between September 2013 and September 2016, there were nearly 100 000 more people leaving the UK than entering the UK
- ☐ **B** Immigration to the UK is likely to decrease the short-run AS curve
- ☒ **C** Since the EU referendum, net migration has fallen by around 80 000
- ☐ **D** There has been a significant decrease in emigration throughout the given period

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(b) With reference to the above chart, explain **one** likely effect of migration on employment in the UK.

(3)

Immigration increases the supply of labour in the UK. The chart shows immigration rose from about 560 000 in Sep 13 to a peak of nearly 690 000 in early 2015, so net migration rose to over 300 000 before falling after the EU referendum.

These migrants increase the size of the population and fill job vacancies that domestic workers are unable or unwilling to fill. They also spend their income on goods and services, raising consumer spending and the demand for labour, which creates more jobs, so employment in the UK is likely to increase.

(Total for Question 3 = 4 marks)

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4 Business investment fell by 0.5% between Quarter 3 2019 and Quarter 4 2019.

(Source: adapted from https://www.ons.gov.uk)

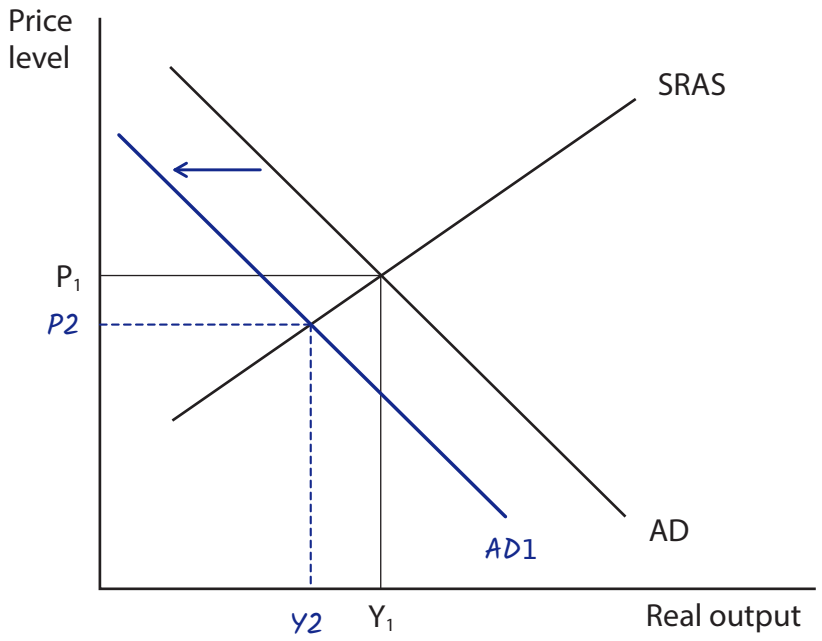
(a) Define the term 'investment'.

(1)

Investment is spending by firms on capital goods, such as machinery and buildings, which increases the capital stock of the economy.

(b) Annotate the aggregate demand (AD) and short-run aggregate supply (SRAS) 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)



(c) Which **one** of the following factors might have caused business investment in the UK to fall?

(1)

- ☒ **A** A decrease in business expectations
- ☐ **B** A decrease in government regulations
- ☐ **C** An increase in the demand for exports
- ☐ **D** An increase in the rate of economic growth

(Total for Question 4 = 4 marks)

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5 The table below shows the UK's budget deficit between March 2016 and March 2019.

Year	Budget deficit (£ billion)
2016	83.6
2017	56.3
2018	56.0
2019	38.7

(Source: adapted from https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicspending/bulletins/ukgovernmentdebtanddeficitforeurostatmaast/september2019)

(a) Define the term 'budget deficit'.

(1)

A budget deficit is when government spending is greater than taxation (government revenue) in a given year.

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(b) Using the above table, calculate the percentage decrease in budget deficit between March 2016 and March 2019. You are advised to show your working.

(2)

Decrease = 83.6 − 38.7 = £44.9 billion

% decrease = (44.9 ÷ 83.6) × 100

= 0.53708... × 100 = 53.71%

Answer: the budget deficit fell by 53.71% (about 54%).

(c) Which **one** of the following will most likely lead to a reduction in the budget deficit?

(1)

- ☐ **A** An increase in government spending and a decrease in taxation
- ☒ **B** An increase in taxation and a decrease in government spending
- ☐ **C** An increase in the value of exports and a decrease in the value of imports
- ☐ **D** An increase in the value of imports and a decrease in the value of exports

(Total for Question 5 = 4 marks)

TOTAL FOR SECTION A = 20 MARKS

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SECTION B

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

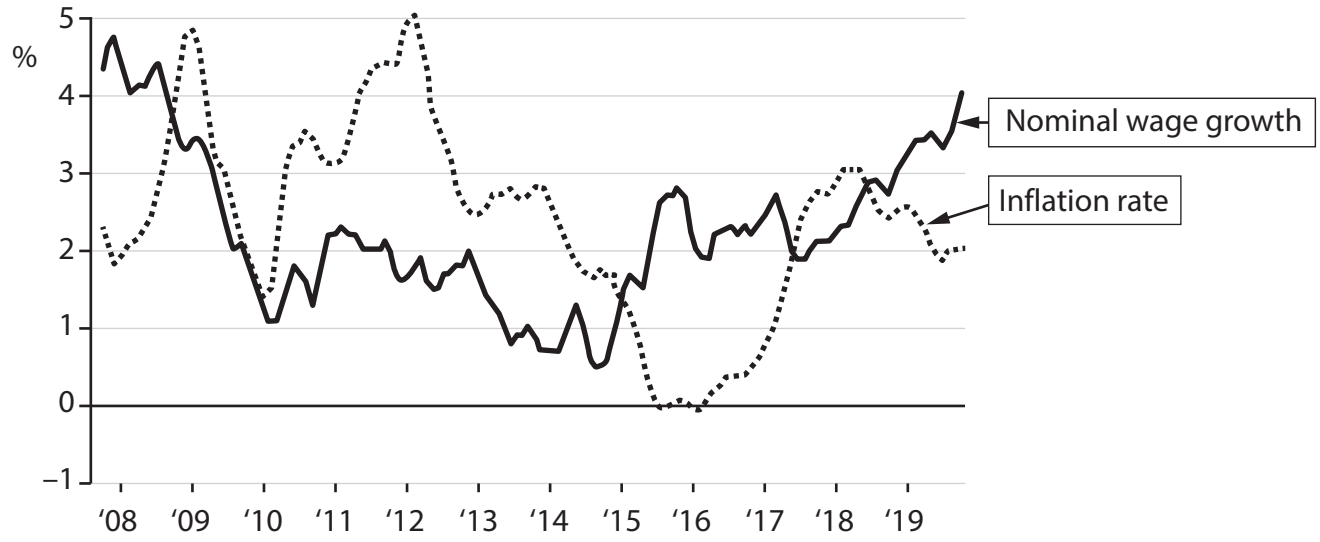
Answer ALL Questions 6(a) to 6(e) and EITHER Question 6(f) OR Question 6(g).

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

Question 6

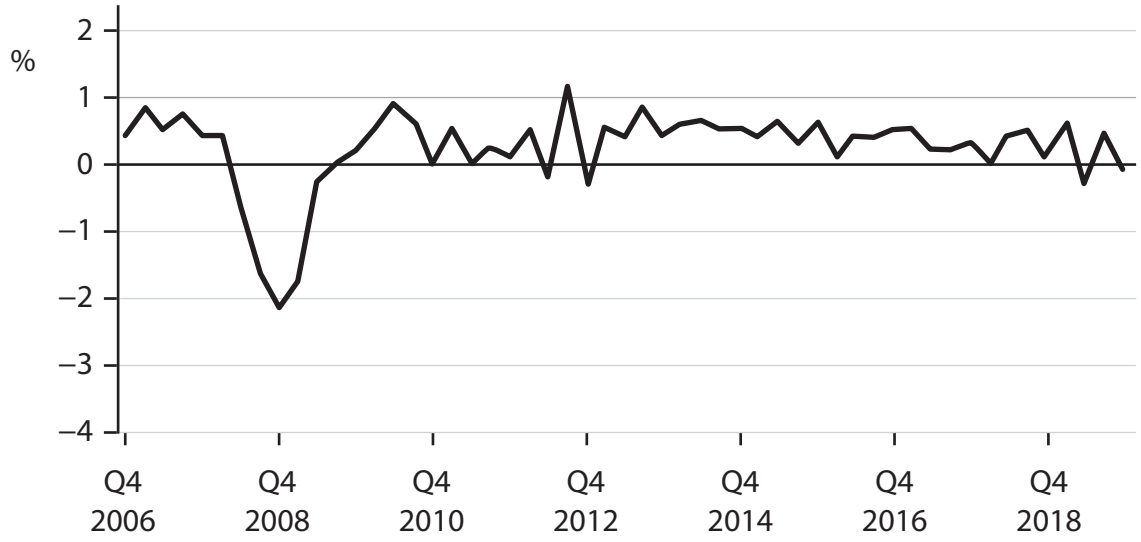
UK monetary policy since the Global Financial Crisis of 2008

Figure 1: UK inflation rate (as measured by the Consumer Prices Index) and UK nominal wage growth, annual percentage change, 2008 to 2019



(Source: adapted from ONS)

Figure 2: UK real GDP, annual percentage change, Q4 2006 to Q4 2019



(Source: adapted from https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/ihyq/qna)

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Extract A

Has monetary policy worked?

Between 2008 and 2009, financial markets around the world were crashing and many UK banks were adversely affected by the collapse of the housing market. This reduced access to credit for UK households and businesses.

Faced with these large risks, the Monetary Policy Committee (MPC) of the Bank of England reduced the base interest rate from 5.25% in February 2008 to 0.5% in March 2009.

The MPC had known that reducing the base interest rate was not enough alone. It drafted the use of a new idea: quantitative easing (QE). It had bought assets worth £200 billion by November 2009. This QE was later implemented by the USA's Federal Reserve, and was claimed to be a success. In July 2012 the total spent on QE in the UK amounted to £375 billion.

This decision has been credited with preventing the recession, caused by the Global Financial Crisis of 2008, turning into another Great Depression. The UK's unemployment rate peaked at 8.5% in 2009 but had fallen to 4% in 2019, the lowest since the mid-1970s.

In 2016 the MPC further expanded its QE programme by £60 billion and reduced the base interest rate to 0.25%. Households with mortgages benefitted from the low interest rate, enabling them to continue consumption and therefore helping economic recovery. Nevertheless, this has resulted in a rise in household debts. Borrowing on credit cards and personal loans has increased above the levels seen before 2008.

Inflation caused by the fall in the exchange rate of the British pound, higher employment levels and nominal wage growth has since directed the MPC to increase base interest rates. It increased the base interest rate to 0.5% in November 2017, and then to 0.75% in March 2018. However, the uncertainty around the UK's future trade relationship with the EU has meant that increases in the base interest rate were only marginal.

Many economists believe that if the UK and the EU are unable to form a trade agreement, base interest rates would need to be decreased again and QE expanded. Conversely, a few economists have argued that QE is no longer effective as a monetary policy instrument. They indicated that the base interest rate was usually reduced by as much as 5% during previous recessions. This is more than the UK can currently manage. Therefore it would also require the government to implement a fiscal policy to deal with any future economic downturn.

The Bank of England is, nonetheless, preparing for the worst-case scenario of a recession deeper than the downturn after the Global Financial Crisis of 2008.

(Source: adapted from 'The verdict on 10 years of quantitative easing', Richard Partington, The Guardian, https://www.theguardian.com/business/2019/mar/08/the-verdict-on-10-years-of-quantitative-easing)

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

(4)

(b) Assess the likely impact of an increase in real wages on the UK economy.

Use an aggregate demand and aggregate supply diagram in your answer.

(10)

(c) With reference to the information provided, explain **two** characteristics of a recession.

(6)

(d) Explain **one** reason why 'the fall in the exchange rate of the British pound' (Extract A, line 21) is likely to increase inflation.

(5)

(e) Discuss factors, **apart from** changes in real wages, which the MPC may have considered when changing the base interest rate.

(15)

EITHER

(f) Evaluate whether expansionary demand-side policies lead to conflicts between macroeconomic objectives.

(20)

OR

(g) Evaluate whether the MPC has been successful in meeting the UK's macroeconomic objectives between 2008 and 2019.

(20)

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

(4)

The inflation rate is the percentage change in the average price level of goods and services in an economy over a period of time, usually a year. In the UK it is measured by the Consumer Prices Index (CPI).

Figure 1 shows that the highest rate of inflation was in 2012 at about 5%. Inflation then fell to around 0% in 2016, so prices were hardly rising at all. Between 2016 and 2017 the rate of inflation increased by nearly two percentage points, meaning the average price level was rising at a faster rate.

There was also disinflation between 2009 and 2010, where the inflation rate fell from nearly 5% to about 1.5%: the average price level was still increasing, but at a slower rate.

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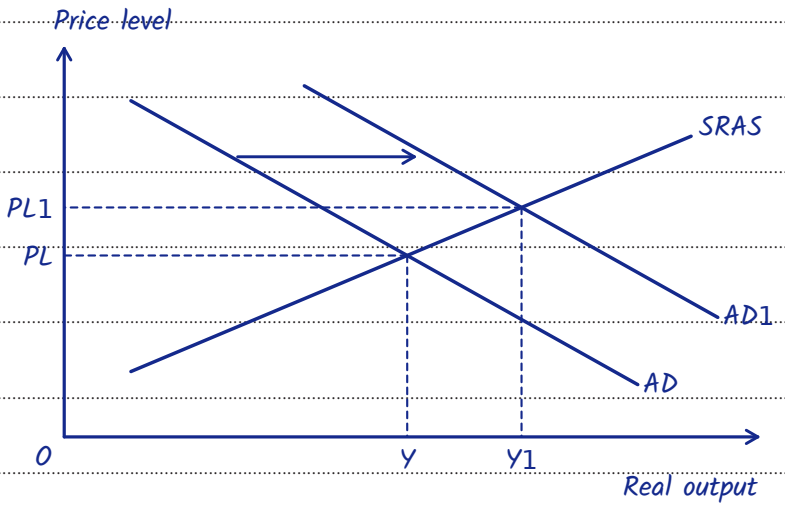
(b) Assess the likely impact of an increase in real wages on the UK economy.

Use an aggregate demand and aggregate supply diagram in your answer.

(10)

Real wages are nominal wages adjusted for inflation. Figure 1 shows that in 2019 nominal wage growth was about 4% while inflation was about 2%, so real wages grew by around 2%.

An increase in real wages raises the purchasing power of households, so consumer expenditure increases. Consumption is a component of aggregate demand (AD = C + I + G + (X – M)), so AD shifts right from AD to AD1 in my diagram. The price level rises from PL to PL1, increasing inflationary pressure, and real output increases from Y to Y1, so there is economic growth. As firms produce more output, they demand more labour (a derived demand), so unemployment decreases. There may also be a multiplier effect, as extra spending becomes other people's income, so the final rise in real output is larger than the initial increase in consumption.



However, the size of the impact depends on the elasticity of the AS curve and the state of the UK economy. If the economy is close to full capacity, with unemployment at only 4% in 2019, the AS curve is steep, so the rise in AD will mainly cause inflation rather than higher real output. If there is spare capacity, real output can rise with little inflation.

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Consumption is the largest component of AD, at around 60% of UK GDP, so a rise in real wages is likely to have a significant impact. On the other hand, UK consumers have financed much of their spending by borrowing: 'borrowing on credit cards and personal loans has increased above the levels seen before 2008'. Households may use higher real wages to repay debts or save, so consumption may rise by less than expected, and spending based on borrowing creates an unstable and unbalanced economy.

The impact also depends on other factors in the economy, such as net trade and investment. If uncertainty over the UK's trade relationship with the EU reduces investment and exports, AD may not increase overall. Some extra spending may also leak out of the circular flow on imports. Furthermore, nominal wage growth may be more significant than real wages in determining consumption, as many people do not adjust for inflation, and higher wages may raise firms' costs, shifting SRAS left.

Overall, an increase in real wages is likely to increase AD, real output and employment, but with some inflation. The size of the impact depends mainly on how close the UK is to full capacity and on whether households spend, save or use the extra income to repay debts.

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(c) With reference to the information provided, explain **two** characteristics of a recession.

(6)

A recession is when there are two consecutive quarters of negative economic growth (falling real GDP).

One characteristic of a recession is rising unemployment. Figure 2 shows real GDP growth was negative from Q2 2008 to Q3 2009, falling to about −2%. As real output falls, firms need fewer workers because labour is a derived demand, so they lay workers off and cut recruitment. Extract A shows that the UK unemployment rate peaked at 8.5% in 2009.

A second characteristic is falling inflation. Figure 1 shows that inflation fell by around 3.3 percentage points between 2009 and 2010, from nearly 5% to about 1.5%. This is because lower consumer confidence and rising unemployment cause a reduction in consumer expenditure, so AD falls and there is less demand-pull pressure on prices. Firms may also cut prices to sell unsold stock.

A further characteristic is a reduction in the base interest rate: the Bank of England reduced it from 5.25% in February 2008 to 0.5% in March 2009 to encourage borrowing, consumption and investment.

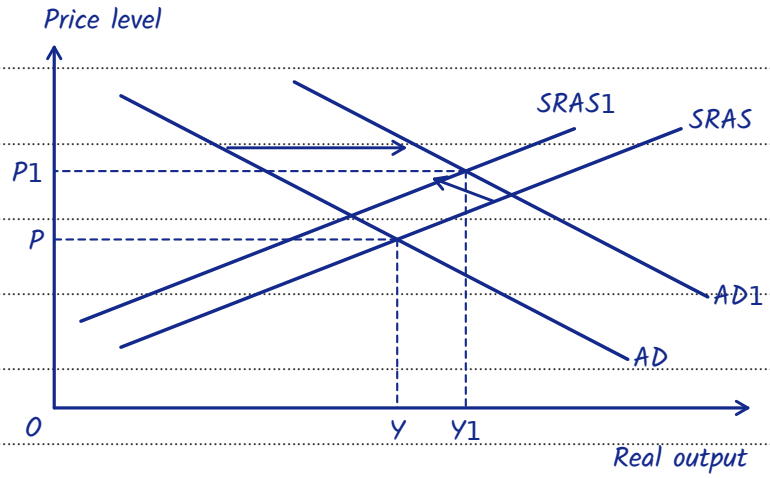
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(d) Explain **one** reason why 'the fall in the exchange rate of the British pound' (Extract A, line 21) is likely to increase inflation.

(5)

Inflation is a sustained rise in the average price level. The pound weakened largely due to a lack of confidence as a result of the UK's decision to leave the EU.

A fall in the exchange rate means UK exports become relatively cheaper in foreign currency, while imports become relatively more expensive in pounds. Demand for UK exports rises and demand for imports falls, so net exports (X – M), a component of AD, increase: there are more injections and fewer leakages from the circular flow. AD shifts



right from AD to AD1 in my diagram, causing demand-pull inflation.

In addition, imported raw materials and components such as oil become more expensive, raising firms' costs of production, so SRAS shifts left to SRAS1, causing cost-push inflation. Together the price level rises from P to P1.

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(e) Discuss factors, **apart from** changes in real wages, which the MPC may have considered when changing the base interest rate.

(15)

The MPC sets the base interest rate to meet the government's inflation target of 2% CPI (plus or minus 1%) while supporting growth and employment. When deciding on the rate it considers a range of factors.

Firstly, the MPC considers the rate of economic growth and the size of the output gap. Figure 2 shows real GDP fell sharply, to about −2%, in the 2008 to 2009 recession, creating a large negative output gap with spare capacity. This meant low demand-pull inflation was expected, so the MPC cut the base rate from 5.25% to 0.5% to boost consumption and investment. The MPC aims to ensure AD grows in line with productive potential: if AD grows faster, a positive output gap will lead to inflation.

Secondly, the MPC considers current and forecast inflation and inflation expectations. Figure 1 shows inflation rose to about 5% in 2012, above the target, but fell to around 0% in 2016, which allowed the MPC to cut the base rate to 0.25%. When inflation rose to around 3% in 2017, caused by 'the fall in the exchange rate of the British pound', the MPC increased the base rate to 0.5% in November 2017 and 0.75% in March 2018. If people expect higher inflation they demand higher wages, so expectations matter as much as current inflation.

Thirdly, the MPC considers unemployment and the labour market. The UK unemployment rate 'peaked at 8.5% in 2009 but had fallen to 4% in 2019, the lowest since the mid-1970s'. A tight labour market with low unemployment and nominal wage growth of around 4% in 2019 suggests future demand-pull and wage-cost inflation, which supports raising interest rates.

The MPC also considers business and consumer confidence. 'The uncertainty around the UK's future trade relationship with the EU' meant increases in the base rate were only marginal, because low confidence reduces investment and consumption and could indicate

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a turning point in the business cycle. It also looks at the exchange rate: a weaker pound raises import prices, while higher interest rates attract hot money inflows and raise the pound, reducing inflation. Finally, house prices matter: the 'collapse of the housing market' reduced household wealth, borrowing and spending, so lower rates were needed. Other factors include oil and commodity prices, access to credit, savings rates and economic performance in other countries.

However, the reliability of these indicators is limited. Many statistics, such as GDP, are revised later, so the MPC may be responding to inaccurate data, and UK growth may not have been as low as first estimated. It is also very difficult to estimate the size of the output gap or spare capacity in the economy.

In addition, some indicators are lagging: unemployment is a lagging indicator, so it may be of little use in forecasting future inflation. Oil and commodity prices are very volatile, so a rise may be temporary, which is why using the current inflation rate alone to guide decisions is a problem. Monetary policy itself has a time lag of around 18 to 24 months, so the MPC has to rely on forecasts, and economic shocks such as Brexit or a global health crisis can change the global economic landscape and make forecasts wrong.

Overall, the MPC is likely to consider a combination of factors rather than one alone. The most significant are probably forecast inflation and the output gap, since they relate directly to the inflation target, but the weight given to each factor depends on the circumstances: in 2008 to 2009 growth and confidence dominated, whereas in 2017 the exchange rate and inflation were the main concern.

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EITHER

(f) Evaluate whether expansionary demand-side policies lead to conflicts between macroeconomic objectives.

(20)

OR

(g) Evaluate whether the MPC has been successful in meeting the UK's macroeconomic objectives between 2008 and 2019.

(20)

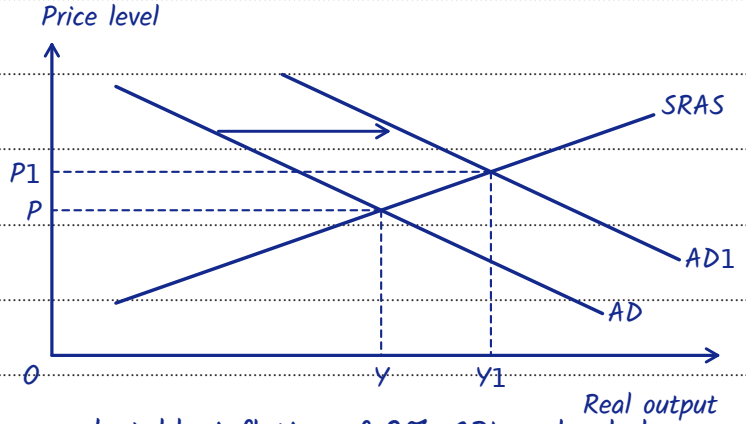
Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

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

Write your answer here:

Question 6(f)

Expansionary demand-side policies aim to increase aggregate demand, using fiscal policy (higher government spending or lower taxation) or monetary policy (lower interest rates or quantitative easing). The UK's macroeconomic objectives include economic growth, low



unemployment, low and stable inflation of 2% CPI and a balance on the current account, as in my diagram.

An increase in government spending, for example on infrastructure or benefits, directly increases AD from AD to AD1. Real output rises from Y to Y1, so there is economic growth, and since labour is a derived demand, unemployment falls. However, the price level rises from P to P1, so there is a conflict between growth and employment on the one hand and low inflation on the other. Higher output may also conflict with protection of

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the environment, through more pollution and congestion.

A reduction in taxation, such as a cut in income tax, raises disposable income and lowers the tax burden, increasing consumption, AD, growth and employment. However, lower tax revenue together with higher spending widens the budget deficit and increases national debt, conflicting with a balanced budget. If the cut is mainly to higher-rate taxpayers, it may also widen income inequality.

Monetary policy creates similar conflicts. The MPC cut the base rate from 5.25% in 2008 to 0.5% in 2009 and spent £375 billion on QE by 2012. Lower interest rates reduce the cost of borrowing and the reward for saving, increasing consumption and investment, so growth and employment rise; unemployment fell from a peak of 8.5% in 2009 to 4% in 2019. However, rising AD causes demand-pull inflation, and lower rates reduce hot money inflows, weakening the pound. A weaker exchange rate makes exports cheaper and imports dearer, which may improve the current account, but higher import prices cause cost-push inflation, as Extract A shows with inflation 'caused by the fall in the exchange rate of the British pound'. Higher incomes also suck in more imports, which can worsen the current account, and low interest rates have led to 'a rise in household debts'.

However, conflicts do not always occur. If government spending is on health, education or infrastructure, it also increases LRAS, raising productive capacity, so there is no inflationary pressure in the long run. Similarly, lower interest rates may increase investment in capital, which increases AS and reduces inflationary pressures. If higher spending increases growth, this will raise tax revenues and cut spending on benefits, so the budget deficit may not worsen.

The extent of any conflict also depends on the elasticity of the LRAS curve and the amount of spare capacity. In 2009 there was a large negative output gap, so expansionary policy raised output with little inflation; inflation fell to around 0% in 2016 despite

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record low rates. Close to full capacity, as in 2019 with unemployment at 4%, the same policy would mainly cause inflation.

Furthermore, the policies may be ineffective. Tax cuts will have little effect if households use them to increase savings or repay debts, and cuts in the Bank of England's interest rate will be ineffective if banks are unwilling to lend or do not pass lower rates on to customers, as after 2008 when access to credit fell. There is also a time lag of around 18 to 24 months before policies take full effect, so the conflicts may not appear immediately.

In conclusion, expansionary demand-side policies are likely to lead to conflicts between growth and employment and inflation, the budget deficit and the current account, especially when the economy is near full capacity. However, the conflicts are much smaller when there is spare capacity or when spending raises long-run aggregate supply, so the significance of the conflict depends on the state of the economy and the type of policy used.

Question 6(g)

Expansionary monetary policy involves reducing interest rates or increasing the money supply, through QE, to increase aggregate demand. The MPC of the Bank of England sets the base rate to meet the 2% CPI inflation target, while supporting the government's other objectives of growth, low unemployment and a balanced current account.

The MPC has been successful in many ways. It cut the base rate by 4.75 percentage points, from 5.25% in 2008 to 0.5% in 2009, and increased QE to £375 billion by July 2012. This reduced the cost of borrowing and increased consumption and investment, so AD rose and real GDP growth recovered from about −2% in 2009 to positive growth from 2010 onwards (Figure 2). This decision has been credited with 'preventing the recession, caused by the Global Financial Crisis of 2008, turning into another Great Depression'.

The increase in AD also led to falling unemployment, which 'had fallen to 4% in 2019,

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the lowest since the mid-1970s'. Inflation has been mostly under control and largely within the target range of 1% to 3% (Figure 1), so the main objective of the MPC has been met. Lower interest rates also reduce hot money flows, leading to a weaker currency, as shown by the 'fall in the exchange rate of the British pound', which makes exports more competitive and should improve the current account of the balance of payments as net exports rise. Since 2014 nominal wage growth has generally been above inflation, so real incomes and living standards have risen, and 'households with mortgages benefitted from the low interest rate, enabling them to continue consumption'.

However, there is evidence that the MPC has not been fully successful. The increase in real GDP since the crisis has only been modest: Figure 2 shows that between 2010 and 2018 growth was mostly less than 1%. Inflation has also been out of tolerance at times, reaching about 5% in 2011 to 2012 and falling to around 0% in 2015 to 2016, outside the 1% to 3% range. This suggests inflation was mostly affected by cost-push factors, such as oil prices and the exchange rate, that are not under the MPC's control. Real incomes were falling for much of the period between 2008 and 2014, as inflation was above nominal wage growth (Figure 1), which reduced the standard of living and quality of life. Low interest rates have also 'led to a rise in household debts', with borrowing on credit cards and loans above pre-2008 levels, and QE raised asset prices such as houses and shares, benefiting wealthier households, which could lead to a rise in income inequality. There is little clear evidence that QE has worked in the UK: the MPC needed additional rounds of asset purchases, for example it 'further expanded its QE programme by £60 billion' in 2016, and some economists argue QE is no longer effective. In addition, with the base rate at only 0.75% in 2018, the MPC has little room to cut rates in a future recession, when rates were usually reduced by as much as 5%, so the government would also need fiscal policy. The current account also remained in deficit, so not all objectives were met.

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In conclusion, the MPC has been largely successful between 2008 and 2019 in its main objective of keeping inflation close to target and in preventing a deeper recession, with unemployment falling to 4%. However, it has been less successful in achieving strong growth and rising real incomes, partly because many shocks were outside its control. Its success depends on which objective is prioritised: judged against price stability and employment it succeeded, but monetary policy alone was not enough to deliver a strong recovery.

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(Total for Question 6 = 60 marks)

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

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