Please check the examination details below before entering your candidate information

Candidate surname	Other names
StemUp Model Solution	

Pearson Edexcel
Level 3 GCE

Centre Number	Candidate Number

Thursday 14 May 2020

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 October 2019 the annual rate of inflation in the UK was 1.5%, as measured by the Consumer Prices Index (CPI), and 2.1%, as measured by the Retail Prices Index (RPI).

(a) Define the term 'inflation'.

(1)

Inflation is a sustained increase in the general price level over a period of time, which causes a fall in the purchasing power of money.

(b) Explain **one** likely cause of inflation.

(2)

One cause is demand-pull inflation, where aggregate demand rises faster than the economy's capacity to produce. For example, a fall in interest rates makes borrowing cheaper, so consumption and investment increase. With little spare capacity, firms respond to the excess demand by raising prices, so the general price level rises.

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(c) From the above data, it can be deduced that the percentage point difference between CPI and RPI was:

(1)

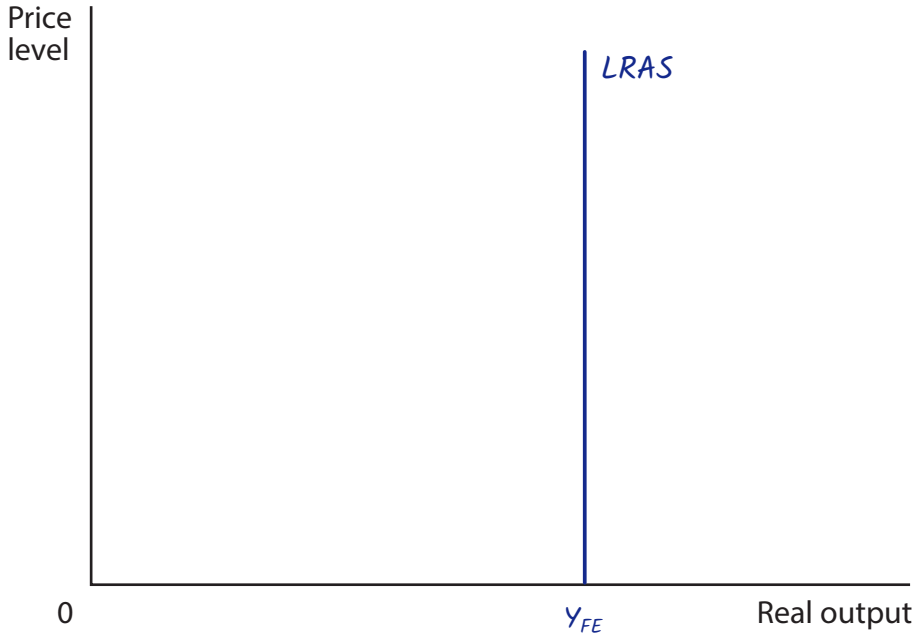
- ☐ **A** 0.0
- ☐ **B** 0.2
- ☐ **C** 0.4
- ☒ **D** 0.6

(Total for Question 1 = 4 marks)

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2 (a) Illustrate the shape of the **Classical** long-run aggregate supply (AS) curve on the diagram below.

(1)



(b) Explain the reason for the shape of the Classical long-run AS curve.

(2)

The Classical LRAS curve is vertical at the full employment level of output (Y_{FE}). In the long run wages and prices are fully flexible and markets are efficient, so the labour market clears and all factors of production are fully employed. The economy is at full capacity with no spare resources, so a rise in AD only raises the price level, not real output.

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(c) Which **one** of the following is an example of a market-based supply-side policy?

(1)

- ☒ **A** A reduction in unemployment benefits
- ☐ **B** Construction of new transportation links
- ☐ **C** Government-funded apprenticeship schemes
- ☐ **D** Increased government spending on healthcare

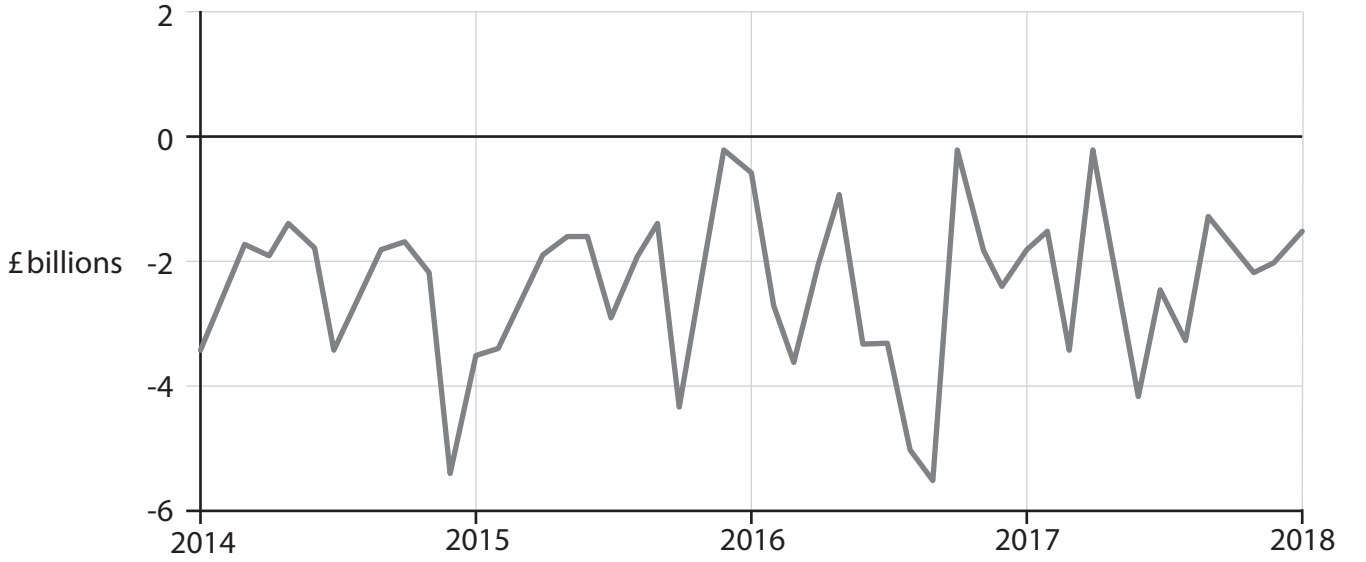
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3 The UK's net monthly balance of trade in goods and services, by value, January 2014 to January 2018, is shown in the chart below.



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

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

(1)

- ☒ **A** The government was spending more than it received in taxation
- ☒ **B** The UK's balance of trade, by value, was always in equilibrium
- ☒ **C** The value of imports was greater than the value of exports
- ☒ **D** The value of inflows was greater than the value of outflows

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(b) Explain **one** likely reason for the UK's balance of trade in goods and services over the period shown. Refer to the chart on page 6 in your answer.

(3)

The chart shows the UK's balance of trade in goods and services was in deficit throughout, mostly between about −£1bn and −£4bn a month, with a low of about −£5.5bn in early 2015, and still in a deficit of just under £2bn at the end of 2017. This means the value of imports was greater than the value of exports.

One likely reason is rising real incomes. As UK incomes grew after the recession, consumers spent more, and because the UK has a high marginal propensity to import, a large share of this extra spending went on imported goods and services, such as cars and electronics. Imports therefore rose faster than exports, keeping the trade balance in deficit.

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4 In August 2018 the Monetary Policy Committee of the Bank of England raised the UK's base interest rate from 0.5% to 0.75%.

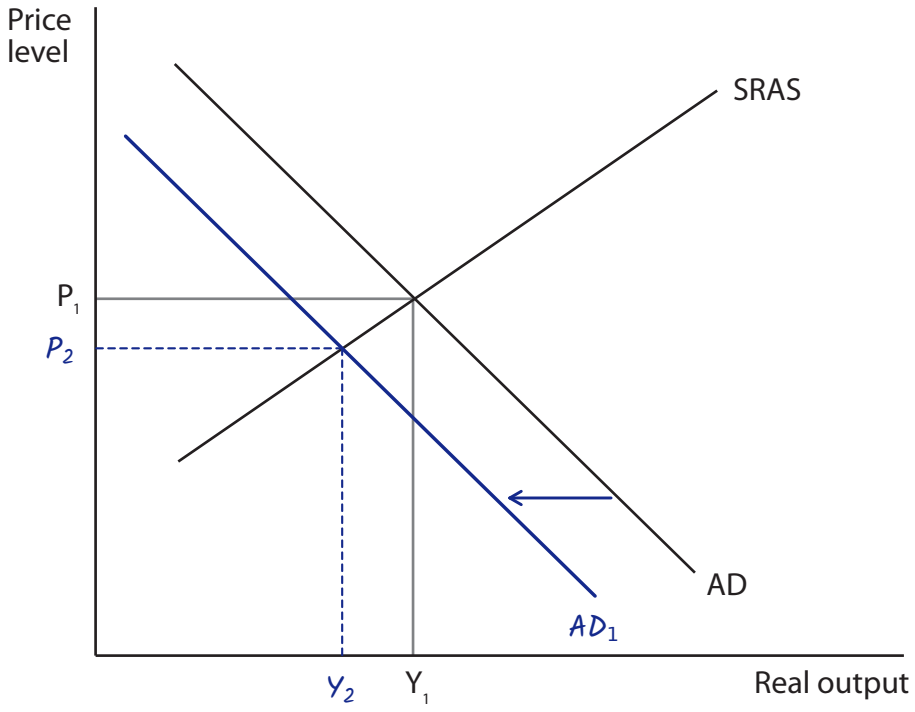
(a) Define the term 'interest rate'.

(1)

The interest rate is the cost of borrowing money and the reward for saving, expressed as a percentage.

(b) Annotate the aggregate demand (AD) and short-run aggregate supply (SRAS) diagram below to show the possible impact of a rise in the base interest rate on the equilibrium level of real output and the price level.

(2)



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(c) Which **one** of the following demand-side policies best explains a rise in the base interest rate?

(1)

- ☐ **A** Contractionary fiscal policy
- ☒ **B** Contractionary monetary policy
- ☐ **C** Expansionary fiscal policy
- ☐ **D** Expansionary monetary policy

(Total for Question 4 = 4 marks)

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5 The table below shows the UK's Gross National Income (GNI) between 2014 and 2017.

Year	Gross National Income (£ million)
2014	1 806 468
2015	1 852 845
2016	1 920 116
2017	2 008 593

(Source: adapted from www.ons.gov.uk/economy/ © Crown Copyright)

(a) Define the term 'Gross National Income'.

(1)

GNI is the total income earned by a country's residents: GDP plus net income from abroad, such as interest, profits and dividends.

(b) Which **one** of the following represents the ratio of Gross National Income in 2015 to Gross National Income in 2017?

(1)

- ☒ **A** 1 : 1.03
- ☒ **B** 1 : 1.05
- ☒ **C** 1 : 1.08
- ☒ **D** 1 : 1.11

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(c) Using 2014 as the base year, calculate the index number for 2016. You are advised to show your working.

(2)

Index = (2016 value ÷ 2014 value) × 100, where 2014 = 100

= (1 920 116 ÷ 1 806 468) × 100

= 1.0629 × 100 = 106.29

Index number for 2016 = 106.3

(Total for Question 5 = 4 marks)

TOTAL FOR SECTION A = 20 MARKS

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SECTION B

Read Figures 1 and 2 and extracts (A and B) before answering Question 6.

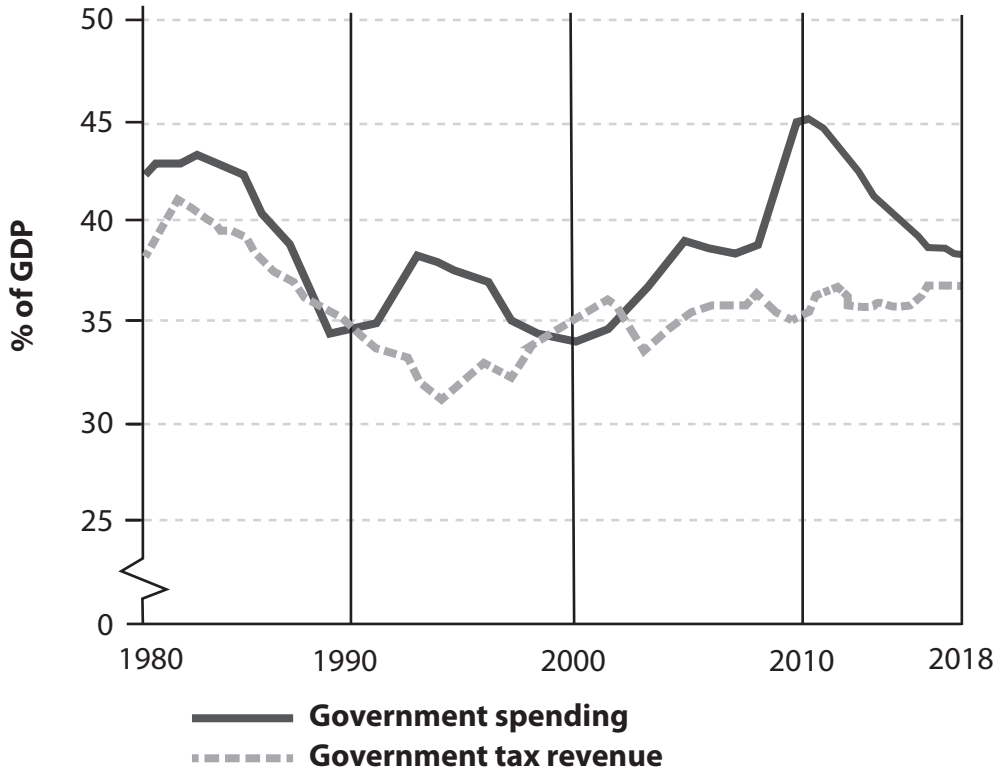
Answer ALL Questions 6(a) to 6(e) and EITHER Question 6(f) OR Question 6(g).

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

Question 6

UK government budget and household consumption

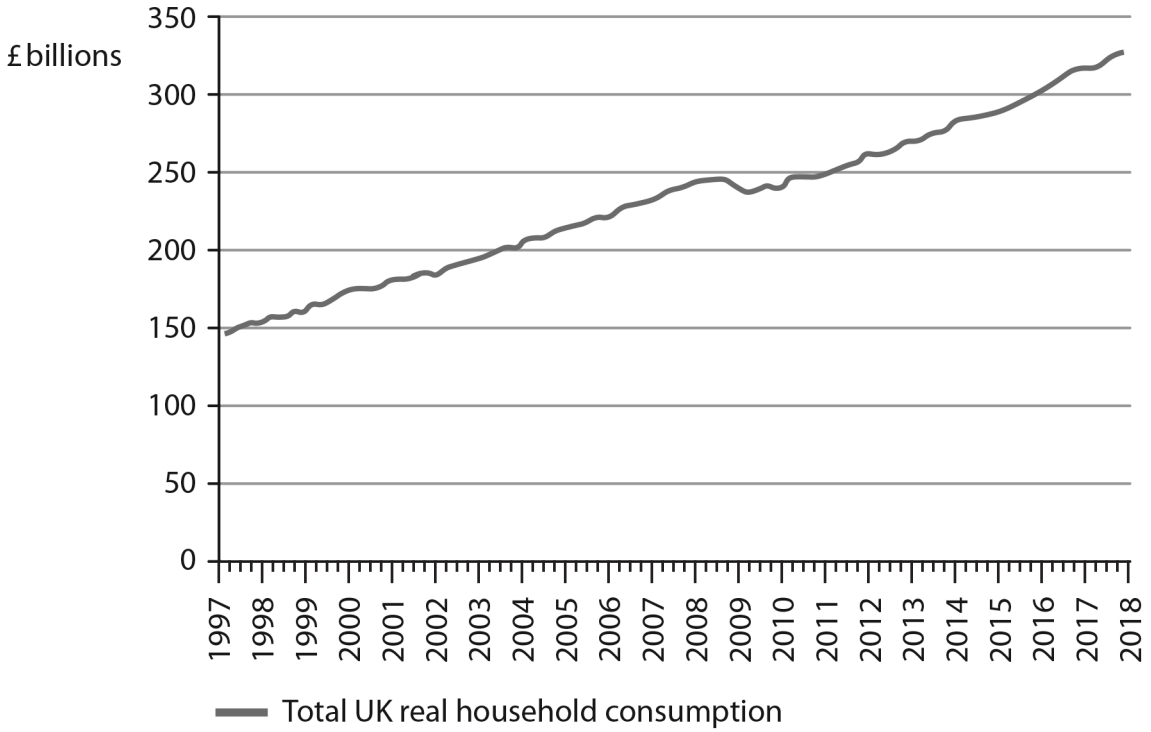
Figure 1: UK government spending and tax revenue as % of GDP, 1980–2018



(Source: adapted from Office for Budget Responsibility (OBR), http://cdn.obr.uk/EFO-MaRch_2018.pdf © Crown copyright 2018)

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Figure 2: UK real household consumption, quarterly, £ billions, 1997 to 2018



(Source: adapted from ONS, www.ons.gov.uk/economy/nationalaccounts/satelliteaccounts/bulletins/consumertrends/apriltojune2018)

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Extract A

UK household consumption

Despite the slow growth in real household disposable incomes, consumer spending rose in 2017. Annual spending per person increased by £589, when compared with 2016. This may have reflected UK households' delay in adjusting to the increase in inflation that was associated with the fall in the exchange rate of the British pound. The increase in consumption has also been driven by low interest rates. In 2017 UK house prices increased by an average of 5.1%.

UK consumers have financed most of their spending by borrowing on credit cards in order to maintain their living standards. In 2017 borrowing on credit cards rose by 9.6%, the second-highest level since before the financial crisis. This has increased the Bank of England's concerns about the sustainability of borrowing, given the slow growth in real incomes. The Bank has also indicated that the base interest rate was likely to rise faster than previously expected. More expensive credit could therefore constrain the ability of households to spend.

(Source: adapted from 'Consumer Trends UK', ONS, https://www.ons.gov.uk/economy/ nationalaccounts/ satelliteaccounts/bulletins/consumertrends/octobertodecember2017 and © Crown copyright 2018)

Extract B

Reduction of the UK's budget deficit

Since 2010 many economists have believed that the biggest problem facing the government was the rising budget deficit. In late 2017, the UK's Chancellor of the Exchequer announced that the government would continue with its plans to decrease its budget deficit. To address this issue, the government further reduced welfare payments and introduced extra spending cuts in the public sector.

The UK government had estimated that the fall in UK productivity since the financial crisis was only temporary. However, it has now accepted that this fall in the level of productivity is a long-term issue. Subsequently, the UK's forecast long-term trend rate of growth was reduced. Slower growth means lower tax receipts, higher spending and a bigger budget deficit.

Some economists have suggested that the government should not pursue additional reductions in the budget deficit. They have also claimed that the responsibility of the government is not to balance the budget but to balance the economy by moving it to full employment.

(Source: adapted from 'Philip Hammond must ditch deficit reduction and invest. But will he?', The Guardian, https:// www.theguardian.com/politics/2017/nov/19/philip-hammond-must-ditch-deficit-reduction-and-invest-but-will-he')

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6 (a) With reference to Figure 1, explain the term 'balanced government budget'.

(4)

(b) Explain the likely effect of a fall in the exchange rate of the British pound on aggregate demand. Refer to Extract A in your answer.

(5)

(c) With reference to Figure 2 and Extract A, explain **two** likely influences on the level of UK real household consumption.

(6)

(d) Assess the likely impact on the UK economy of an 'increase in consumption' (Extract A, lines 5–6). Use an aggregate demand and aggregate supply diagram in your answer.

(10)

(e) Discuss the factors that might explain why 'the UK's forecast long-term trend rate of growth was reduced' (Extract B lines 9–10).

(15)

EITHER

(f) Evaluate supply-side policies that could be used to increase the UK's rate of economic growth.

(20)

OR

(g) Evaluate the likely macroeconomic effects of the UK government pursuing a policy of reducing its budget deficit.

(20)

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6 (a) With reference to Figure 1, explain the term 'balanced government budget'.

(4)

A balanced government budget is when government spending equals government tax revenue in a given year, so there is neither a budget deficit (spending greater than revenue) nor a budget surplus (revenue greater than spending).

Figure 1 shows the UK had a balanced budget in about 1990, when spending and tax revenue were both nearly 35% of GDP, and again around 2000 at about 35% of GDP. For most of the period, however, the budget was in deficit: for example, in 2010 spending was about 45% of GDP while tax revenue was only about 35%, and in 2018 spending (about 38%) was still above tax revenue (about 37%).

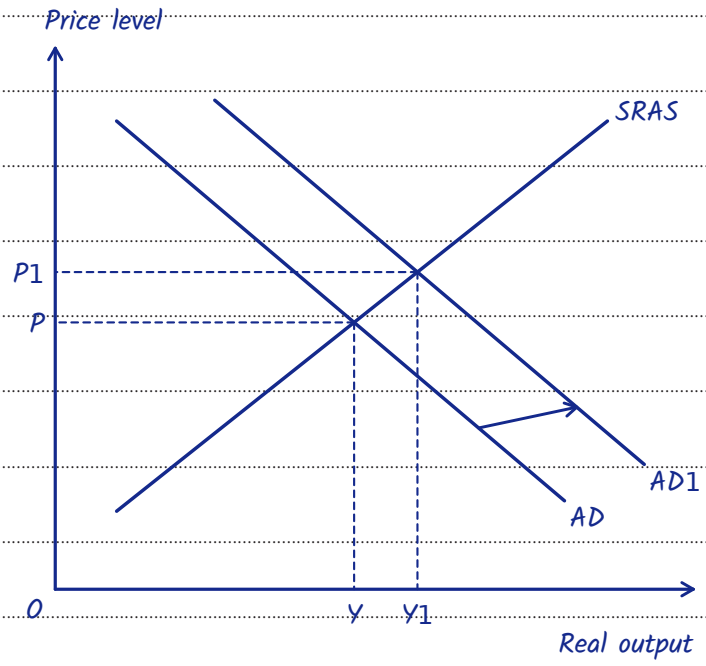
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(b) Explain the likely effect of a fall in the exchange rate of the British pound on aggregate demand. Refer to Extract A in your answer.

(5)

Aggregate demand is the total planned spending on goods and services in an economy: AD = C + I + G + (X − M). A fall in the exchange rate (depreciation) means one pound buys less foreign currency. Extract A links the inflation of 2017 to the fall in the pound, which followed the uncertainty and lack of confidence caused by the UK's decision to leave the EU, along with low interest rates reducing hot money inflows.

A weaker pound makes UK exports relatively cheaper for foreign buyers, so demand for exports rises. At the same time imports become relatively more expensive in pounds, so UK consumers switch to domestically produced goods and spending on imports falls. Net exports (X − M) therefore increase, so AD increases, shifting from AD to AD1 in the diagram, raising real output from Y to Y1 and the price level from P to P1.



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(c) With reference to Figure 2 and Extract A, explain **two** likely influences on the level of UK real household consumption.

(6)

Real household consumption is the spending by households on goods and services, adjusted for inflation. Figure 2 shows it rose from about £148bn in 1997 to about £325bn in 2018, with only a brief fall in 2008 to 2009, and it grew by approximately 1.7% between 2016 and 2017. Extract A states that annual spending per person increased by £589 in 2017 compared with 2016.

One influence is interest rates. Extract A says the increase in consumption has been driven by low interest rates. A low interest rate means a low reward for saving, so households save less and spend more, and a low cost of borrowing, so it is cheaper to finance spending on credit. This explains why borrowing on credit cards rose by 9.6% in 2017 and consumption kept rising despite slow growth in real incomes.

A second influence is the wealth effect. In 2017 UK house prices increased by an average of 5.1%. As the value of their assets rises, homeowners feel wealthier and more confident, so they are willing to spend a larger share of their income and to borrow against the value of their homes. High consumer confidence means households make purchases they believe they can pay for in the future, so real consumption increases.

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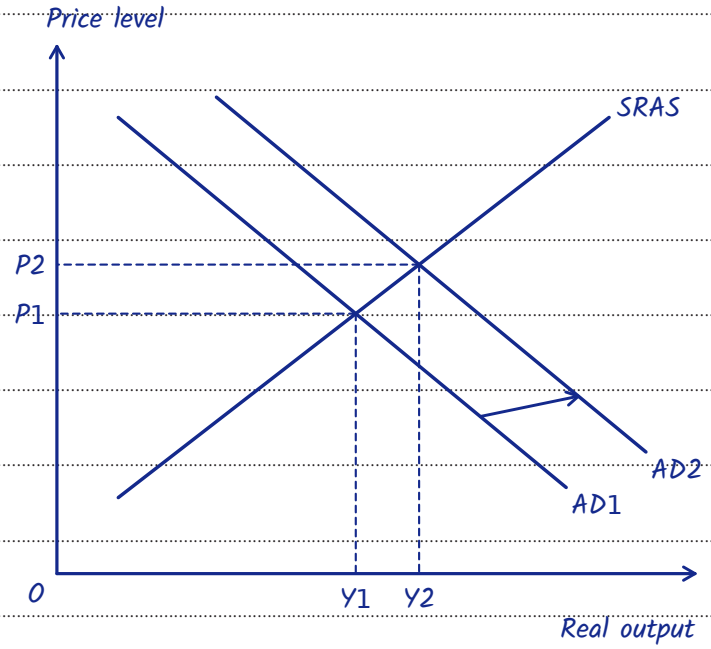
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(d) Assess the likely impact on the UK economy of an 'increase in consumption' (Extract A, lines 5–6). Use an aggregate demand and aggregate supply diagram in your answer.

(10)

Consumption is household expenditure on consumer goods and services. It is the largest component of aggregate demand (AD = C + I + G + (X – M)), so an increase in consumption shifts AD to the right from AD1 to AD2, as shown in my diagram.

As AD increases, firms respond to higher demand by increasing output, so real



output rises from Y1 to Y2, which means higher economic growth. To produce more, firms need more workers, so the demand for labour rises and unemployment falls. However, as the economy moves closer to full capacity, firms face rising costs and are able to raise prices, so the price level rises from P1 to P2, increasing inflationary pressure. The data supports this: Figure 2 shows real household consumption rose by nearly 117% between 1998 and 2018, from about £150bn to about £325bn, and Extract A shows spending per person increased by £589 in 2017. There may also be a multiplier effect, as extra spending becomes income for others who then spend part of it, so the final rise in real output is

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larger than the initial rise in consumption.

However, the size of the impact depends on the elasticity of the SRAS curve and the state of the UK economy. If there is spare capacity, as after the financial crisis, the increase in consumption mainly raises real output and employment with little inflation. If the economy is close to full capacity, the curve is steep and the main effect is higher inflation rather than growth.

The increase is also built on borrowing. Extract A states that consumers financed most of their spending by borrowing on credit cards, which rose by 9.6% in 2017, while real incomes grew slowly. This creates an unstable and unbalanced economy, dependent on debt rather than on investment and exports. It may not be sustainable: the Bank of England indicated the base rate was likely to rise faster than expected, and more expensive credit could constrain the ability of households to spend, so the rise in AD may be short-lived.

Finally, the overall impact depends on other components of AD. Some extra spending goes on imports, worsening the trade deficit and reducing the effect on UK output. If investment or net trade fall, for example due to uncertainty over leaving the EU, the rise in consumption may only offset these falls.

Overall, an increase in consumption has a significant short-run effect on growth and employment because consumption is around 60% of AD, but as it is financed by credit and interest rates are rising, the long-run benefit is likely to be limited.

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(e) Discuss the factors that might explain why 'the UK's forecast long-term trend rate of growth was reduced' (Extract B lines 9–10).

(15)

The long-term trend rate of growth is the average rate at which real output can increase over a long period without generating inflation. It depends on the growth of productive capacity, that is the quantity and quality of the factors of production, shown by a rightward shift of the LRAS curve. Extract B says the UK's forecast was reduced because the government accepted that the fall in productivity since the financial crisis is a long-term issue.

The first factor is a fall in relative productivity, output per worker per hour. If UK productivity stays low, the economy produces less output from its resources, so potential output grows more slowly. Low productivity also raises costs per unit, which makes UK exports relatively expensive compared with those of trading partners such as the US and EU, so exports fall, further slowing growth. As Extract B explains, slower growth means lower tax receipts, higher spending and a bigger budget deficit.

A second factor is slow growth in investment in capital goods since the financial crisis. Low business confidence and uncertainty, including over the UK's decision to leave the EU, mean firms have delayed investment in new machinery and technology. With a smaller and older capital stock, workers have less capital to work with, so labour productivity and productive capacity grow slowly.

A third factor is a lack of technological advances and innovation. If firms spend less on research and development, there are fewer new products and production methods, so efficiency improves slowly and the cost of supplying goods and services remains high.

A fourth factor is the quality and quantity of the labour force. Extract B shows the government made extra spending cuts in the public sector to reduce the

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deficit. Lower government spending on education and training reduces the skills of the workforce, reducing human capital and productivity. In addition, slower immigration following the decision to leave the EU means fewer workers coming into the country, which slows the growth of the active labour force and hence the rate of output produced. An ageing population has a similar effect.

Other factors include stricter government regulation, which makes markets less flexible and reduces competition, and external factors such as slow global growth, which reduces demand for UK exports and discourages investment. Demand-side factors can also matter: weak AD after the crisis, with slow growth in real incomes, reduced the incentive for firms to invest.

However, the most significant factor is likely to be productivity, since Extract B states directly that productivity is a long-term issue, and low investment, R&D and skills all work through productivity. Its importance depends on the size of the fall in UK productivity and on how UK productivity compares with that of its main trading partners: if their productivity has also slowed, the UK's competitiveness is less affected.

The financial crisis was over ten years ago, so its direct effects should have faded. Uncertainty over the UK's decision to leave the EU may now be more important, and as the effects of lower investment take time to appear, they may not yet be fully seen, meaning the forecast could be cut further. On the other hand, forecasts are based on estimates, and inaccuracies or inadequacies in the data, for example difficulty measuring output in the service and digital sectors, may mean productivity and long-term growth are not as low as estimated. The world economy is also uncertain, so external shocks could change the forecast in either direction.

In conclusion, the main reason for the reduced forecast is the long-term fall in

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productivity, caused mainly by low investment in capital, technology and skills. Other factors such as lower immigration and slow global growth add to this, but the extent of the reduction depends on whether Brexit uncertainty is resolved and how quickly investment recovers.

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EITHER

(f) Evaluate supply-side policies that could be used to increase the UK's rate of economic growth.

(20)

OR

(g) Evaluate the likely macroeconomic effects of the UK government pursuing a policy of reducing its budget deficit.

(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 6(f)

Supply-side policies are government policies designed to increase the productive capacity of the economy by improving the quantity and quality of the factors of production and the efficiency of markets. Economic growth is an increase in real output (real GDP) over time. Supply-side policies shift the LRAS curve to the right from LRAS1 to LRAS2, raising potential output from Y1 to Y2 while reducing the price level from P1 to P2, so growth can be sustained without inflation.

Interventionist supply-side policies involve government spending. Increased government spending on education and training raises the skills of the workforce, increasing human capital and labour productivity, so more output is produced from the same resources. This directly addresses the problem in Extract B, where the fall in UK productivity is a long-term issue. Increased spending on healthcare reduces the number of days absent from work, raising output per worker.

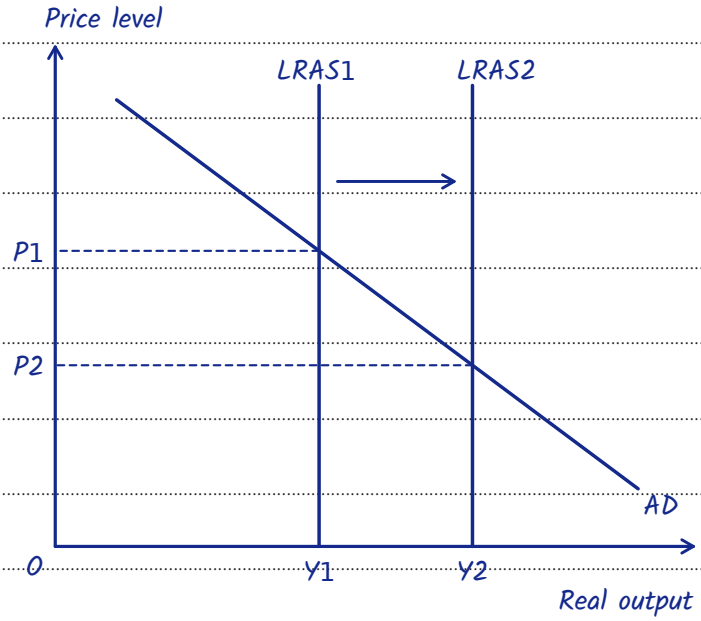
Government schemes to improve childcare provision allow more parents to return to work, increasing the size of the labour force.

Spending on infrastructure investment, such as broadband, rail and roads, reduces

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transport and communication costs for firms and improves access to markets.

Financial support for investment in economically deprived regions can help



overcome structural unemployment, using idle resources and increasing the UK's total output.

Market-based supply-side policies aim to free up markets. Reducing the level of benefits and income tax increases the incentive to work, which increases the number of people in work and their output per worker. Reducing corporation tax raises post-tax profits, increasing funds for investment and making the UK more internationally competitive for foreign direct investment. Cutting bureaucracy and regulation reduces firms' costs, raising productivity, while privatisation and deregulation increase competition, innovation and efficiency. Policies to increase the flexibility and mobility of labour, such as reducing trade union power, help the labour market adjust.

However, there are significant time lags. Education and infrastructure projects can take ten years or more before they raise productivity, so they do not help growth in the short run, while the government is also trying to reduce its budget deficit, as in Extract B, which limits the money available for interventionist policies. The

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effectiveness of spending on infrastructure, education and healthcare at delivering sustainable growth also depends on how well it is targeted; poorly chosen projects may waste resources.

Market-based policies have problems too. A cut in income tax may be ineffective if workers use it as an opportunity to work less for the same income, since the income effect can outweigh the substitution effect. A cut in corporation tax will not raise growth if companies use it to boost short-term profits and dividends rather than investment. If taxes are increased elsewhere to pay for the cuts, incentives to work may fall. Privatisation may simply create private monopolies with less efficiency and lower economic growth. Cutting benefits may also increase inequality and poverty.

Supply-side policies only raise actual growth if there is enough aggregate demand: if AD is weak, the extra capacity remains unused.

In conclusion, the most effective policies are likely to be investment in education, training and infrastructure, as they directly raise productivity, the key cause of the UK's low trend growth. However, they are slow and costly, so a combination with market-based policies such as targeted corporation tax allowances for investment is best in the short run.

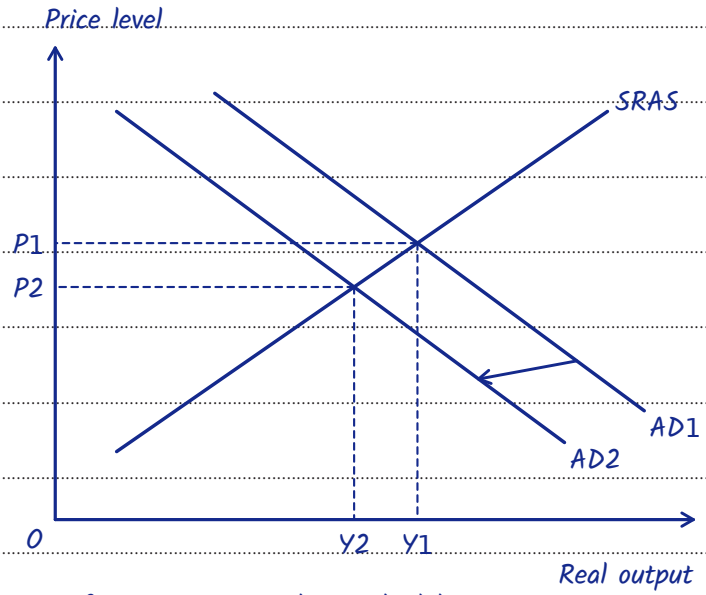
Option 6(g)

A budget deficit occurs when government spending is greater than tax revenue in a year. Reducing it means fiscal austerity: in late 2017 the Chancellor announced the government would continue with plans to decrease the deficit by further reducing welfare payments and introducing extra spending cuts in the public sector (Extract B). Lower G and higher taxes reduce aggregate demand, shifting AD left from AD1 to AD2, so real output falls from Y1 to Y2 and the price level falls from P1 to P2.

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Firstly, there is a reduction in real output and economic growth. The fall in government spending is a withdrawal from the circular flow of income, and through the negative multiplier effect the final fall in national income is larger than the cut. Secondly, as output falls firms need fewer workers, so unemployment rises, particularly in the public sector where departmental spending cuts lead to job losses and falling real wages.

Thirdly, there is a deflationary effect, reducing inflationary pressure, which helps the Bank of England meet its 2% target. Fourthly, lower welfare payments reduce



the disposable income of the poorest households, increasing inequality and reducing real incomes and living standards, alongside the slow growth in real household disposable incomes in Extract A. Lower incomes also reduce spending on imports, improving the current account of the balance of payments as net exports rise.

Lower spending and output may also reduce pollution, although cuts to environmental programmes could harm the environment.

In the long run, cuts to public investment in infrastructure, education and health can reduce productive capacity, lowering the trend rate of growth. As Extract B notes, slower growth means lower tax receipts and higher spending, so the deficit may not fall at all. Some economists argue the government should not pursue

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further reductions, but invest to balance the economy at full employment.

However, the effects depend on the size of the multiplier: if the economy is open and the marginal propensity to import is high, the fall in output is smaller. They depend on the shape of the AS curve and spare capacity: near full capacity, the main effect is lower inflation rather than lower output. Reducing transfer payments may reduce frictional and voluntary unemployment, as people have a greater incentive to find work. The effects depend on how far private sector spending and employment can replace public sector spending, for example if lower borrowing reduces interest rates and crowds in private investment. They also depend on which areas of spending or taxes are changed: cutting current spending harms growth less than cutting capital spending. Higher taxes may also lead to a rise in the hidden economy, such as cash in hand work.

In conclusion, reducing the deficit is likely to reduce growth and employment and increase inequality in the short run, but it may improve confidence and lower interest rates in the long run. The overall effect depends on the multiplier and on whether public investment is protected.

(Total for Question 6 = 60 marks)

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

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