Edexcel (A) Economics A-level

AS-level Paper 2: The UK Economy

Example answers

June 2016

6a) With reference to Figure 1, explain the term 'real income' (4)

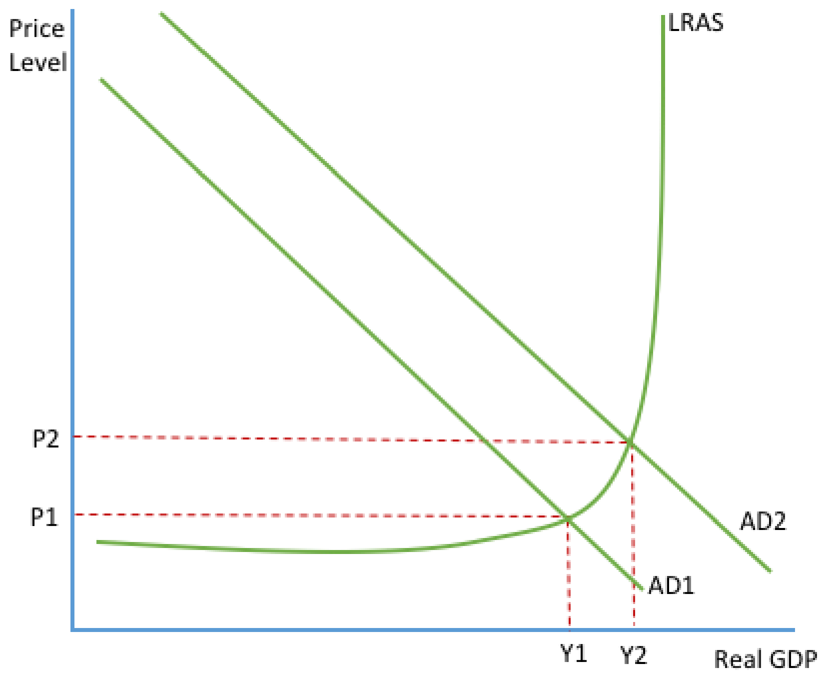
Real income is the amount of money people earn, whether this be from their job, interest on savings, rent on land etc., adjusted for inflation. Real income was highest in 2008 at £676 and lowest at £610 in 2012. This does not necessarily mean that nominal income fell, but inflation may have meant prices rose and if nominal income did not rise at the same amount, real income would have fell. Real income means the value of the income at prices in that year.

Teacher's comments: 4/4

b) Assess the likely impact of falling real incomes on UK consumers. (10)

One effect of falling real income will be lower spending. This is because consumers have less income and so have less to spend and therefore spend less. Also, it will mean that they have less confidence about their future income and so will save more, meaning even less is spent. On the whole this will cause a fall in consumption.

The fall in consumption is likely to mean that AD will fall (ceteris paribus) and therefore this will cause a fall in unemployment causing consumer's real income to fall even further. This will also mean some businesses close down and so therefore consumes have less choice. This will be a particular problem in areas where the fall in AD has caused local unemployment and so many shops and businesses have to close down, meaning consumers have to travel long distances.



On the other hand, one positive effect may be that businesses put on sales and lower prices in order to encourage people to buy. As a result, consumers will be able to get goods and services cheaper than before.

Another effect on consumers may be that they buy different goods. It may have a microeconomic effect as consumers switch to goods with a negative YED.

The impact on consumers may depend on government decisions. For example, the government may decide to lower tax and so therefore, real disposable income may rise, meaning consumers can buy more goods. The MPC may decide to lower interest rates in order to prevent deflation and unemployment. As a result, consumers may have increased confidence and spend more, particularly on durable goods which are often bought on credit. They could also benefit from positive wealth effects when the value of their assets rises.

The impact will also depend on the size of the fall in income and who is most hit. If rich individuals with a lower marginal propensity to consume, are most affected, t is likely to make no difference to them as they have lots of excess income.

Overall, it is likely to have mainly negative effects on the consumers as they have less to spend and less choice.

Teacher's comments: 7/10

Be careful with the phrase "consumers have less income"- they do not have less income, they can simply buy less with it. Refer to the diagram. Stress fall in living standards.

c) With reference to Extract A, explain the likely effect of a rise in the value of the pound on aggregate demand. (5)

A rise in the value of the pound is likely to mean AD will fall. A strong pound makes imports cheap and exports dear. As a result, more people will buy imports and less people will buy UK exports, causing net trade to fall. Net trade is a component of AD and so a fall in net trade will cause AD to fall. Extract A shows how a rise in the value of the pound can be caused by a rise in interest rates and so therefore the effect of a rise in interest rates will cause AD to fall even further.

Teacher's comments: 5/5

d) With reference to the data, explain two likely reasons for the UK's falling inflation rate. (6)

Inflation peaked at 5.2% in October 2011 and since then has fallen to 0.5% in October 2014. One cause of this fall in inflation may be due to lower levels of demand, reducing the problems of demand-pull inflation. Demand is likely to have fallen due to the Global Financial Crisis since consumption will have fallen due to a fall in consumer confidence and real incomes (Extract A shows it fell by about £65 in 2008 to 2012) and investment would have fallen due to lower business confidence.

Moreover, it may be due to lower rises in costs. The main business cost in the UK is wages and so therefore a fall in real wages (shown in Extract A) would have led to lower costs for businesses. Therefore, there is a reduction in cost push inflation and so businesses do not have to keep putting up prices to match rising wages in order to maintain profit. Instead, they can keep prices low and so inflation is lower.

Teacher's comments: 4/6

Articles do not talk about a fall in wages but they do talk about a fall in oil prices and shipping costs etc.- the last point is not valid, use what is mentioned in the text.

e) With reference to Extracts A and B and your own knowledge, discuss whether the MPC should be concerned about the risk of deflation in the UK economy. (15)

Deflation is the general fall of prices. If it occurs, it can cause major problems as consumers continue to put off spending and so demand falls even further and therefore prices continue to fall. It is also often associated with negative economic growth and rising unemployment as businesses have to sack workers as sales are too low.

One reason the MPC should be concerned because if it does occur, they have few tools they can use in order to fix the problem. Once it has started, it is difficult to get rid of, seen in Japan which had deflation in 9 years between 1999 and 2012. Therefore, they should be concerned as if the UK experience deflation, there is likely to be high unemployment etc for a long period of time.

Moreover, they should be concerned because inflation has fallen by almost 5% in 2011 and 2014 and is now below 1%, already much lower than the UK's target of 2%. This is despite the policies of quantitative easing and extremely low interest rates, at 0.5%, which have been attempting to rise AD. There is little more they can do in order to raise inflation and so they should be concerned as the threat is quite possible. Extract A says deflation is expected.

However, some may argue they shouldn't be concenred as the Bank of England governor, Mark Carney, said that in the "medium term" there is likely to be higher inflation in the UK and so the MPC shouldn't be concerned about deflation as it will only be short term. Forbes argue that the pound is likely to get weaker, which will increase exports and decrease imports, causing a rise in AD. Imports will be more expensive and so if people still have to buy them, it will cause inflation. Therefore, they should not be concerned as experts argue that, whilst there may be deflation in the short term, in the long/medium term there will even be inflation. This increased inflation will even warrant a possible rise in interest rates.

Also, they should not be concerned because, even though inflation has been falling since 2011, there has still been increased economic growth. This could mean that deflation may not even have its usual negative consequences and it may just lead to a further reduction in prices, which helps to make UK exports more competitive and could improve the balance of payments.

Overall, the MPC should be concerned about deflation as it is quite probable that it will occur and there is little action they can take if it does.

Teacher's comments: 12/15

Also stress that fall in oil prices etc. are not in MPC control- also could lead to shift in AS right

f) Evaluate whether the MPC has been successful in controlling the UK's inflation rate since 2011. (20)

The MPC's main aim is to ensure a target of 2% inflation is met. If inflation is above 3% or below 1%, then the head of the Bank of England has to write a letter to the prime minister explaining why it happened and what action is being taken.

From the data, the MPC has not been successful as inflation peaked at 5.2%, 3.2% above target but it is now 1.5% below target. Therefore, some would argue that the MPC is unsuccessful as they are way off target. The threat of deflation also suggests that the committee is unsuccessful as this is definitely not part of the aim.

Moreover, it can be argued that they are unsuccessful as inflation has been falling consistently since October 2011 and the bank has done nothing successful at stopping this. They are unable to cut interest rates any further and quantitative easing is still not have a strong enough effect to increase inflation. If the MPC was successful, it would have prevented inflation from continuing to fall, particularly at such a rapid rate.

However, when the economic situation is taken into account, the MPC has been successful. Firstly, despite the Global Financial Crisis in 2009, there has not yet been any deflation. This can been seen as a success as it is very likely this could have occurred. The bank's decision to drop interest rates to 0.5% encouraged AD and prevented this from occurring. The decreased rate has made borrowing cheaper, ensuring consumers spent and businesses invested, as most rates in the economy are dependent on the bank's rates. It has also caused a fall in the value of the pound, since less people want to store their money in British banks and so therefore exports would have been more competitive which increases net trade and increases AD.

Also, the MPC have been successful as they have managed to use quantitative easing without causing high inflation, which many believed would happen. Quantitative easing is when the central bank buys assets from other institutions which pushes the price of these up and causes an increase in AD due to a positive wealth effect. It will also mean that banks can lend more money, if the assets are bought from a bank, and so therefore increase consumption and investment as it is cheaper to borrow. Inflation was high in October 2011 (5.1%) so the Bank decide to reduce quantitative easing, and this has allowed inflation to fall.

They have also been successful as it has not been done at a cost to other policies. For example, inflation is still falling but the economy is growing (which is unusual, as seen in the Phillips curve). They have been successful in preventing extremely high or extremely low inflation.

Overall, the MPC has been successful given the situation the economy was in. Although normal targets have not been met, the MPC has ensured that there has not been extreme inflation on either ends of the scale.

Teacher's comments: 15/20

You could make more comment on the supply side factors that have affected the economy and over which they have no control.