

AS Economics Managing the Economy 03 Jan Mark Scheme

1.(a) Outline how fiscal policy can be used to raise the level of aggregate demand.

Fiscal policy refers to changes in the government's budget, candidates must mention either changes in government spending or taxation (1 mark)

Aggregate demand is the total demand for goods and services produced in the UK, or total expenditure, or  $C+I+G+X-M$  (1 mark).

Rise in government spending (1 mark) and cut in taxes (1 mark) will raise AD via  $C+I+G+X-M$ , or illustrated on diagram (1 mark).

Also reward further analysis such as multiplier effects, incentive effects etc. 5

(b) Using aggregate demand and supply analysis, outline the effect of each of the following on the level of real GDP and the price level in the UK:

(i) a fall in GDP in the rest of Europe

A fall in GDP in the rest of Europe will reduce their demand for UK goods. Resulting fall in UK exports (1 mark).

This will tend to reduce UK AD (1 mark)

Appropriate AD/AS diagram, or equivalent written analysis, showing fall in level of GDP and fall in the price level (2 marks)

Further development, such as implied multiplied consequences, exchange rates changes etc. (1 mark)

Also award relevant discussion elasticities, lags, other things not remaining the same etc. Also allow relevant arguments based on the fall in EU output causing deflation. 5

(ii) a rise in UK consumer confidence

A rise in consumer confidence will, other things being equal, raise consumption. (1 mark)

Likely rise in aggregate demand (1 mark).

Consequent rise in the price level and rise in real output indicated on appropriate AD/AS diagram, or equivalent written explanation (2 marks).

Further development, such as implied multiplied consequences, investment effects etc. (1 mark).

Also award relevant discussion of elasticities, lags, other things not remaining the same. 5

(c) Using aggregate demand and supply analysis, assess the relative merits of monetary policy and fiscal policy in an economy experiencing rapid inflation.

Understanding of inflation (1 mark).

Explanation of the use of these policies to reduce the rapid inflation indicated by the question. Explanation of the use of tax rises or reductions in government spending to reduce AD (3 marks)

Explanation of the meaning of the term monetary policy in terms of raising interest rates (3 marks)

illustration of effect on AD in appropriate AD/AS diagram or equivalent written analysis (2 marks).

For the evaluation marks: consideration of the relative appropriateness of monetary policy and fiscal policy in terms of timing, adverse effects of changes in interest rates or taxes, opportunity cost issues, multiplier and other lag issues, the independence of policy making, flexibility of

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response, long term effects of cuts in government spending, effects of changes in interest rates on capital mobility. Also reward a critique of both monetary and fiscal policy in the light of the potential effectiveness of supply side policies. Also any discussion based on the appropriateness of policy relative to the cause of the inflation and likely conflicts with other objectives. Award any two evaluative points up to (3 marks) each.

If the candidate has mixed up the names of monetary and fiscal policy but their analysis and evaluation of changes in interest rates and government spending/taxation is correct then award a maximum of 10 marks: 4 marks for analysis, six marks for evaluation.

(Total 30 marks)

15

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2 (a) Explain what is meant by a balance of payments disequilibrium

The balance of payments is a record of international transactions (this may be implicit in references to imports and exports) (1 mark) divided broadly into current account and capital account (1 mark).

A disequilibrium refers to a current account deficit (or surplus), or where the values of imports are not equal to the value of exports, or where there are net outflows or inflows of sterling (3 marks). 5

(b) For each of the following, outline two causes of: (i) a fall in the level of unemployment

Award up to 3 marks to a maximum total of five, for identification and explanation of each of two possible causes of falls in the level of unemployment. Candidates may select any appropriate improvements from either the demand side or the supply side or both.

5

(b) (ii) decreasing inequality of income distribution

Award up to 3 marks to a maximum total of five, for each of two possible causes of falling income inequality. e.g.

changes in human capital,

levels of unionisation,

employment laws,

tax changes,

benefit system changes,

effect of the minimum wage.

Also award appropriate discussions of the impact of macroeconomic changes such as changes in the business cycle or inflation. 5

(c) Discuss the extent to which the use of demand side policies to achieve full employment might conflict with balance of payments equilibrium and concern for the environment.

Understanding of demand side policies (1 mark)

Explanation of how demand side policy might raise the level of GDP and hence move the economy to full employment, which may include a diagram (4 marks).

The impact of these policies on the balance of payments: rise in imports as incomes increase. (2 marks)

The impact of these policies on the environment - e.g. a rise in negative externalities (2 marks).

A further 6 marks for evaluation of each conflict.

Extent to which full employment policies might conflict with balance of payments equilibrium: consideration of lags, income elasticity of demand for imports, exchange rate consequences, position on AS curve, other countries' macroeconomic position, etc. (3 marks)

Extent to which full employment policies might conflict with the environment: elaboration and assessment of the many potential adverse effects, possible recognition that higher income levels may make it possible to afford remedies (3 marks)

Also award evaluation marks if the candidates has made a judgement about the relative significance of these two potential conflicts.

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(c) (i)

(i) With reference to Figure 1:

identify what happened to the cost of living as measured by RPIX during 1999.

Figure 1 shows a fall in the inflation rate, or a rise in the cost of living (1 mark) although the rate at which the cost of living increased slowed during the year (1 mark) 2

3 (a) (ii) explain why the RPIX rate of inflation was higher than the headline rate in 1999.

RPIX is the same as the RPI but excludes mortgage interest repayments - accept excludes 'mortgages', 'interest repayments' (1 mark) Cuts in interest rates reduce the headline rate but not the RPIX (1 mark).

2

(b) Outline one reason why the Retail Price Index may tend to overestimate changes in the cost of living.

Reasons might include, consumers switching their spending patterns to cheaper goods before the weights are revised, the failure of the RPI to accommodate changes in technology or other changes in quality of goods, biasing data collection problems etc. Also appropriate discussion of 'average household' issues, such as people without mortgages when interest rates are rising, vegetarians, etc. Identification and explanation of one reason ( 3 marks ).

3

With reference to Figure 2:

define the term investment

The purchase by firms of plant or machinery. Accept capital goods, factories, fixed assets, stock accumulation. Do not accept increases in savings, purchases of equities.

2

outline two possible factors that could account for the increase in household consumption

Award any two factors (2 marks) each: one mark each for identification and explanation. For example, cuts in interest rates, rise in incomes, redistribution of income e.g. through the minimum wage, house price increases and other wealth changes, multiplied effects from the increase in investment, rise in consumer confidence from the fall in inflation etc.

4

23 (Hi)

using aggregate demand and supply analysis, examine the possible implications of the data for the UK price level and the level of real output

Award 4 marks for a discussion of the effect of the changes in AD from the changes in consumption and investment and 4 marks for a discussion of the change in house prices. Within each section allow (2 marks) for explanation of impact on AD or AS (1 mark) for an appropriate diagram showing change in price level and change in output, or other written explanation, and (1 mark) for evaluation: e.g. relative size, elasticities etc. If the candidate looks only at C and I, or other combinations, then award a maximum of 6 marks, including 2

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marks for evaluation.

8

(d) With reference to Figure 3:

(i) What are the main components of the UK balance of payments on current account?

Trade in goods (or visibles) (1 mark), trade in services (or invisibles) (1 mark) and (1 mark) for either investment income or transfers.

Award only one mark if answer is 'exports and imports'.

3

(e) Discuss the extent to which the current account data might influence interest rate decisions of the Monetary Policy Committee of the Bank of England

The graph shows a deterioration in the current account of the balance of payments (1 mark). Effect of this on AD through X-M, other things being equal and therefore on prices (possibly illustrated on a diagram) (1 mark). Evaluation: this is a dramatic change in the data suggesting some overheating or structural imbalance in the UK economy, potential importance for the exchange rate and thus the inflation target. However, not enough data here for the MPC to make a decision, (lack of) reliability of the figures, other things not equal, elasticities, relative (lack?) of importance of the balance of payments in the MPC's basket of indicators, emphasis that the MPC targets inflation not the balance of payments (4 marks).

(Total 30 marks)

24

4 (a)

With reference to Figure 1 and Extract 1:

(i) define labour productivity

Labour productivity: output per worker.

2

(ii)

how might you account for the difference in labour productivity in the UK and US?

Identifying that US productivity is higher than UK productivity (1 mark) and specific reference to the fact that this is a wide gap (1 mark).

Award two possible reasons (2 marks) each: 1 mark for identification and one mark for explanation. Perhaps the effect of earlier supply side policies e.g. relative levels of deregulation, union legislation, differences in tax structure, brain drains, differences in investment in technology, human capital, attitudes to work, management styles, research and development, consequences of the UK's adherence to the social chapter.

6

(b) Examine why demand side policies may be thought to be ineffective in 'raising Britain's long-term rate of economic growth' (Extract 1, lines 2-3)

Explanation of use of demand side policies (2 marks) Explanation and evaluation that shifts in the AD curve may only move an economy up an already inelastic AS curve, possibly including diagram (4 marks - 2 marks for explanation, 2 marks for evaluation, e.g. the degree of the inelasticity.). Also reward other evaluative development of the limitations of Demand Side policies in terms of expectations of future policy reversals, inflationary effects or a defence of demand side

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policies into the longer run in terms of confidence on investment etc.

6

(c) In the light of the data in Figure 1 and Extract 1, assess the importance of supply side policies to the UK economy.

Explicit reference to data (2 marks). Understanding of supply side policies in terms of shifts in the AS curve, or identification of specific policies e.g. union reform, privatisation, reforms to tax and benefit system, training and education etc. (2 marks). Evaluation of at least two specific supply side policies in terms of likely effectiveness, lags, relative importance of those discussed etc. (4 marks)

8

25