

Mark Scheme (Results) Summer 2007

GCE

GCE Economic (6353) Paper 1

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Question 1

- (a) (i) With reference to Figure 1, explain how inflation is measured in the UK. (3)

Reserve 1 mark for reference to CPI/RPIX or raw figures from Figure 1.
Basket of goods (1 mark) Family Expenditure Survey (1 mark) weighting (1 mark) price survey (1 mark) construction of index (1 mark)

- (ii) Outline how the Bank of England's Monetary Policy Committee (MPC) attempts to keep inflation 'within one percentage point of the inflation target' (line 5). (4)

Concept of target, i.e. 2% or 2.5% (1 mark)
Explanation of ceiling and floor (must have both) (1 mark)
Use of interest rates to achieve this (1 mark):
If inflation goes too high then interest rates must rise (1 mark);
If inflation goes too low then interest rates must fall (1 mark)
If transmission mechanism given of AD shift then award up to (2 marks)

- Look at a range of indicators
- Take a long term view
- Sole objective - i.e. without the constraints of government, or apolitical.

- (iii) Outline two possible costs for the economy experiencing 'interest rates higher than they needed to be' (line 14). (6)

1 mark for identification of a factor, 1 mark for explanation of transmission mechanism, 1 mark for why it is a cost

Costs (2 x 3 marks) might include:

- Economic growth is hindered, or recession
- Less spending cause reduction in confidence
- less investment
- Less foreign direct investment
- Unemployment
- Exchange rate might be too high therefore lower exports or higher imports (i.e. balance of payments issues)
- Housing market
- Widening income distribution

Don't allow the following as costs *unless linked to a cost in the economy e.g. employment/ lower consumer living standards*:

- More saving
- Borrowing falls
- Spending decreased

- (b) (i) Using an appropriate diagram, evaluate how 'significant increases in share and house prices' (line 12) are likely to affect the price level and equilibrium real output level in the UK.

(8)

Either

Diagram showing AD shift to the right (1 mark) and changes in the equilibrium points (1 mark) Diagram must have a macro feel.

Increase in wealth (or equivalent terminology) (1 mark)

People spend more as a result, i.e. C rises (1 mark)

The reason why people spend more (mortgage equity withdrawal, confidence, feel-good factor) (1 mark)

Increase in price level (1 mark)

Increase in equilibrium real output (1 mark)

Multiplier (1 mark)

Maximum 4/6 analysis marks if no mention of wealth effects or other transmission mechanism

Maximum of 4/6 mark if no valid diagram

OR

Allow a well-reasoned analysis based on falling AD if based on negative impact of higher mortgages for people taking out a new mortgage, and white goods arguments. NO MARKS for fall in AD diagram unless linked to this specific analysis. (Up to 6 marks)

Do not allow arguments based on people buying fewer houses or shares because they are expensive.

Evaluation (2 marks) might include:

- Speculative boom can lead to spectacular crashes
- there are many other determinants of AD e.g. exchange rates might change
- short run/long run effects
- there might be changes in AS
- elasticity of AS/spare capacity argument
- size of the multiplier e.g. the extent of the change will depend on how much is spent in imports
- increase in debt might have long term contradictory effects
- relative importance of shares and house ownership
- AD might shift either way, and if both sides are considered accurately they this can be awarded as evaluation marks.

(ii) Outline two sources of information, apart from share and house prices, used by the MPC when it makes its interest rate decision.

(4)

Identification (2 x 1 mark) and explanation of inflationary pressures (2 x 1 mark).
If no mention of the price level then do not award explanation marks.

Factors might include:

- Consumer spending
- Export and import levels
- Government spending
- Unemployment/employment levels
- Debt
- Savings
- Change in retail sales
- Exogenous shocks
- Regional data
- Exchange rate
- The fiscal stance
- Money supply growth
- Commodity prices
- Skills shortages
- Inflation (for explanation mark there must be reference to expected rates or pattern of inflation)
- Performance in other countries
- Economic growth figures
- Consumer confidence survey
- Business confidence survey

Do not allow share and house prices, or changes in interest rates (the bank or repo rate)

(c) Assess the implications for the UK economy of the cut in interest rate, 'down from 4.75% to 4.5%'. (Extract 1 line 3).

(15)

1 mark - implicit understanding of interest rate cut, e.g. it's cheaper to borrow money

2 marks - diagram showing AD shifts to the right or equivalent verbal analysis of how price level and real output are affected, or other macro implications for the economy e.g. Balance of Payments

Transmission mechanisms (award 3 x 2 marks or 2 x 3 marks), with at least one that is not via consumption

Maximum analysis mark of 7/9 if only Consumption used as transmission mechanism.

Evaluation (award 3 x 2 marks or 2 x 3 marks) points might include:

- the size of the interest rate cut is very small (0.25%)
- there is also an impact on AS
- externalities arguments
- there are many other determinants of AD e.g. exchange rates might change
- short run/long run effects
- elasticity of AS/spare capacity argument
- size of the multiplier e.g. the extent of the change will depend on how much is spent in imports
- increase in debt might have long term contradictory effects
- lower interest rates could mean house prices rise so first-buyers have less to spend

Question 2

- a) (i) What is meant by a *budget deficit* (Extract 1, line 13)? (2)

Reference to data e.g. £37bn (1 mark);

Government spending is too high, it has overspent, or government has to borrow (1 mark)

Government spending is more than revenue/taxation (2 marks)

No marks are available if there is reference to trade or Balance of Payments, as this illustrates fundamental misunderstanding

- (ii) From Figure 1, calculate the percentage change in total spending on health and education from 2004-05 to 2007-08. (2)

$26/83 \times 100$ for health = 31.3% (accept 31%) (1 mark)

$10/65 \times 100$ for education = 15.4% (accept 15%) (1 mark)

$(£109 \text{ bn} + £75 \text{ bn}) \times 100 / (£83 \text{ bn} + £65 \text{ bn}) = 124\%$ therefore 24.3% increase (accept 24%) (2 marks)

Special case for subtraction of correct data:

If all the correct data is selected and subtracted (i.e. change but not percentage change) (1 mark) *i.e. if health and education are selected separately and the subtraction is done correctly for both then award 1 mark*

Award 1 mark for 124% (shows some understanding of the formula)

(iii) Using aggregate demand and supply analysis, assess the likely long run impact on the UK economy of the planned increase in health and education spending.

(8)

Diagram showing AD shift to the right and/ or AS shift to the right (1 mark) and changes in the equilibrium points (1 mark). Diagram must have a macro feel.

AD analysis up to three marks, including diagram., for example increase in G, as a component of AD; cut in T as a factor in the multiplier; expansionary impact - output or price level or both;

AS analysis up to six marks, including diagram. Must mention both health and education for full marks on this section with links to macroeconomic effects.

*Maximum mark of 3/6 analysis marks if only referring to AD
Maximum mark of 5/6 if only health OR education*

Evaluation (2 marks). might include:

- multiplier effects
- the spending might not affect quality of output - e.g. managerial expenses absorb costs?
- short/long run effects
- the effects depend on the shape of the AS curve
- reduction in government spending elsewhere
- how is it going to be paid for? Increase in taxation elsewhere, and effect on incentives
- there are many other determinants of AD e.g. exchange rates might change

b) (i) Outline one reason why it might be necessary to revise the estimates for changes in GDP (extract 1 lines 3 and 4).

(2)

1 mark for identification, and/or

1 mark explanation of why the factor will affect estimates of GDP, or examples to illustrate the link, and/or

1 mark for data observation that it was too high

Reasons might include:

- deliberately over-optimistic forecasts (political reasons);
- migration;
- unreliable data;
- exogenous (outside) shocks; e.g. 9/11
- miscalculation;
- incompetence;
- slowdown unpredictable or other unexpected development

Do not accept reasons why GDP figures are changed, e.g. economic growth, it's not GDP per head, inflation hasn't been taken into account

ii) Analyse one possible implication for government policy of the inaccuracy of growth figures.

(4)

1 mark for implication,
up to 2 marks for explanation of process
up to 2 marks for policy

For example: unemployment levels may rise (1 mark) which might mean there is a need to run a larger budget deficit (financial crowding out) (2 marks) ; fiscal policy will be tighter in the future (2 marks)

Maximum mark of 3/4 if no reference to government policy

c) Analyse the likely impact of the expected rise in exports of 5% on GDP growth and the UK Balance of Payments (lines 7 and 8)

(7)

Award up to 5 marks for the effect on GDP growth
Award up to 5 marks for the effect on UK Balance of Payments

Diagram showing AD shift to the right (1 mark) and changes in the equilibrium points (1 mark) Diagram must have a macro feel. Award only once.

Growth:

- Increase in AD (1 mark)
- via (X-M) (1 mark)
- multiplier effects (1 mark).
- Significance of export led growth (1 mark)
- Further analytical marks for consequences for growth e.g. through damaging effects of inflation (2 marks)

Balance of Payments:

- Rise in X likely to mean an improvement (1 mark) or Balance of Payments (implicit understanding that there are increase inflows) (1 mark)
- multiplier effects (1 mark)
- Hard to say as we don't know what is happening to imports (1 mark)
- Significance of export led growth - not likely to worsen B of P
- Balance of payments could worsen if the increase in GDP causes inflation and therefore the UK finds exports are relatively expensive/imports relatively cheap
- Further analytical marks for consequences for Balance of Payments e.g. through exchange rates (2 marks)

Maximum mark of 5/7 if only growth or Balance of Payments are considered.

d) Assess the relative merits of demand side and supply side policies as measures to improve UK living standards. (15)

1 mark - implicit understanding of rising living standards, e.g. higher levels of consumption, not just growth per se

2 marks - diagram showing AD shift or AS shift to the right or equivalent verbal analysis of how price level and real output are affected

Policies (award 3 x 2 marks or 2 x 3 marks), with at least one that demand and one that is supply side.

Subsidies only accepted as supply-side policy if given with clear justification of impact on aggregate supply.

Maximum mark of 7/9 if only demand or only supply side policies considered.

Evaluation (3 x 2 marks or 2 x 3 marks) points might include

- identification of **common elements** of both policies - e.g. cutting taxes as a demand management policy as well as an improvement to incentives (3 marks)
- that the policies might work together or otherwise
- contrast between monetary and fiscal policy
- short/long run implications
- depends on elasticity of AS
- depends on magnitude of multiplier
- other things might not be equal
- relative merits of policies, with justified prioritisation

