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General Certificate of Education
January 2010

Economics

Assessment Unit AS 2

The National Economy

[AE121]

AE121

THURSDAY 21 JANUARY, MORNING

TIME

1 hour 30 minutes.

INSTRUCTIONS TO CANDIDATES

Write your Centre Number and Candidate Number on the Answer Booklet provided.
Answer **Question 1** and **one** question from **Questions 2**, **3 or 4**.

INFORMATION FOR CANDIDATES

The total mark for this paper is 80.
Quality of written communication will be assessed in all questions **except 1(a)**.
Figures in brackets printed down the right-hand side of pages indicate the marks awarded to each question or part question.

ADVICE TO CANDIDATES

You are advised to take account of the marks for each part question in allocating the available examination time.

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Question 1: Data Response

The passage below was written in **autumn 2007**.

Study the passage carefully and answer the questions which follow.

"Inflation Above Target"

The UK's annual inflation rate for the year ending October 2007 was 2.1%, just above the Bank of England's target rate of 2%. Most UK consumers will have no difficulty in identifying how this has occurred! Every trip to the petrol station or the supermarket shows them that food and petrol are becoming much more expensive. **1**

Food prices are increasing at their highest rate for more than a decade. Increased raw material costs meant that food factories are having to pay six per cent more for their ingredients. These surging costs will inevitably be passed on to consumers and retail food prices are expected to rise by 10.3% in the coming year. **2**

Rising food prices have a knock-on effect on the UK's official measure of inflation, the index of consumer prices, (CPI). With food prices having a weighting of approximately 10%, this alone will add around 1% to the value of the index. The story at the petrol pumps is much the same. In November 2007 a litre of unleaded petrol cost £1.02, a rise of 18% on its price 12 months before. Faced with these inflationary pressures, it would be expected that the Bank of England would be considering a rise in interest rates. **3**

However, the Bank of England's Monetary Policy Committee must also take account of the serious deflationary pressures in the economy. Families are already beginning to suffer the effects of the world financial crisis, known as the "credit crunch". This has caused many financial institutions to cut back on lending and to increase interest rates on mortgages and other forms of borrowing. The Bank of England had already increased interest rates 5 times in the past 15 months and the "credit crunch" has simply added to the misery of home buyers. House prices have started to fall and this is likely to have a serious knock-on impact on consumer spending. **4**

Not surprisingly, economists are divided about the prospects for the economy and also about what action the Bank of England should take. Some of their views are given below:

- David Kerr, economic adviser to the British Chamber of Commerce, said, "We believe there is still a case for a small cut in interest rates to stimulate consumer spending".
- Alan Monks of investment bank J. P. Morgan saw little prospect of an immediate reduction in inflation which he expected to be above the Bank of England's target in every month until the end of 2008.
- Ben Broadbent of investment bank Goldman Sachs argued that the rise in inflation should be discouraging the Bank of England from responding to weak aggregate demand by cutting interest rates.

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- Anatole Kaletsky, Times columnist, wrote on October 22nd, “For the fir 15 years I am seriously worried about the prospects for the British econo housing market and the value of sterling. I believe that all the risks in the yea ahead – from economic activity, employment, house prices and the value of ste – are now clearly on the downside”.

- The International Monetary Fund (IMF) has cut its growth forecasts for the UK economy from 3% to 2.3% and for the USA it has cut predicted growth from 2.8% **5**
to 1.9%.

So the members of the Bank of England’s Monetary Policy Committee face a dilemma. Should they raise the rate of interest to squeeze inflationary pressures out of the economy **6**
or cut it to prevent a possible recession?

(a) Explain what is meant by inflation. [3]

(b) Show how the Consumer Price Index (CPI) is used to calculate the UK rate of inflation. [9]

(c) Using aggregate demand and supply analysis, show the probable impact on the UK economy of rising oil and fuel prices. [9]

(d) Paragraph 4 states that falling house prices would have a knock-on impact upon consumer spending. Analyse the impact of falling house prices upon consumer spending. [9]

(e) As an economic advisor to the Bank of England in **November 2007**, write a short report to the Monetary Policy Committee, advising it whether the rate of interest should be raised, lowered or left unchanged. [10]

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Essays:

Answer **one** from **Questions 2, 3 or 4**.

2 **"Dramatic rise in UK unemployment"**

(a) Outline the **two** methods by which unemployment is measured in the UK. [10]

(b) Explain the main causes of unemployment. [15]

(c) Evaluate the view that a low rate of economic activity, rather than a high rate of unemployment, is the main problem in the UK labour market. [15]

3 **"Fiscal and monetary policy must work together to ensure economic viability"**

(a) Explain what is meant by fiscal policy. [10]

(b) Show how fiscal policy might contribute to macroeconomic stability. [15]

(c) Evaluate the likely effectiveness of relying exclusively upon monetary policy to maintain macroeconomic stability. [15]

4 **"GDP figures ignore environmental costs"**

(a) Explain the circular flow of income and expenditure for an open economy with a government. [10]

(b) Explain **two** of the methods by which an economy's gross domestic product (GDP) may be measured. [15]

(c) Evaluate the view that GDP should cease to be the basis for measuring economic growth because it makes no allowance for the environmental costs of increased economic activity. [15]

THIS IS THE END OF THE QUESTION PAPER

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