Rewarding Learning

ADVANCED SUBSIDIARY (AS)
General Certificate of Education
January 2013

Economics

Assessment Unit AS 2

The National Economy

[AE121]

AE121

MONDAY 28 JANUARY, AFTERNOON

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(d)**.
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.

Question 1: Data response

The passage below was written in **October 2011**.

Study the passage carefully and answer the questions which follow.

UK inflation remains above target

United Kingdom Inflation Rate
Annual Change in Consumer Price Index

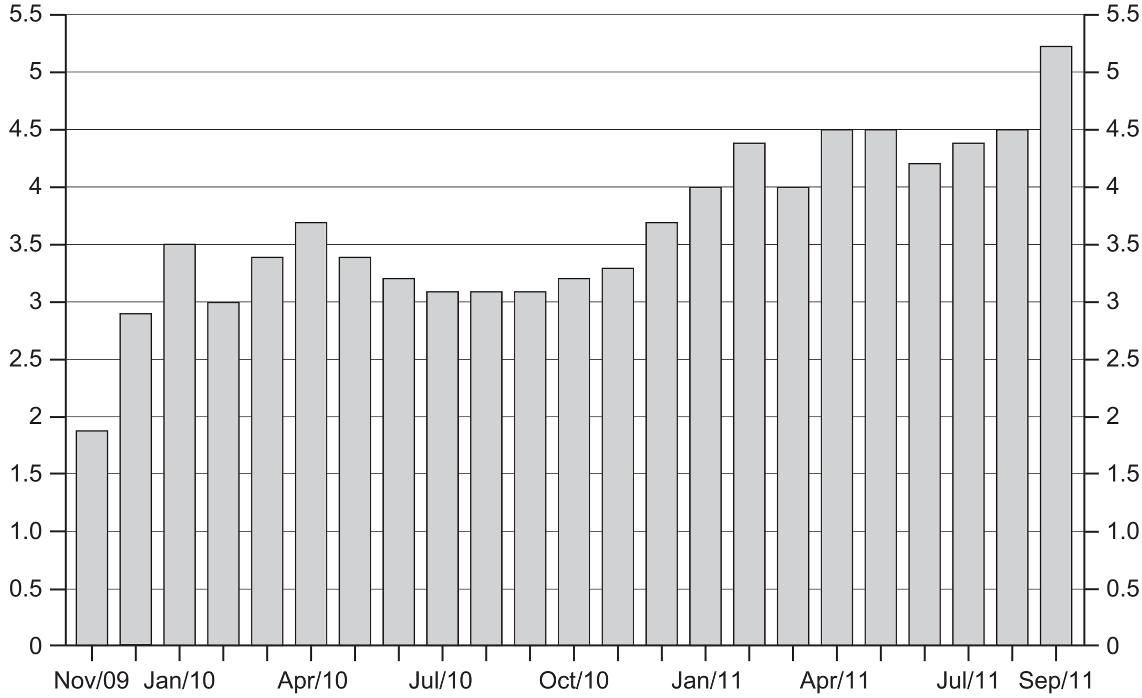

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Fig. 1

Food Prices Drive Inflation

Economy	**Annual Food Price Increase (%) Year to March 2011**
UK	4.9
Germany	3.6
USA	1.9
France	1.4
Italy	1.1
Irish Republic	1.0
Euro Area (Average)	1.8

Fig. 2

UK inflation continues to exceed the government's target of a 2 per cent per an
the Consumer Price Index (CPI). The figures for September 2011 show inflation ru
5.2 per cent. The target rate has not been achieved since November 2009. 1

Much of the reason for this lies in the escalating cost of food with the UK experiencing food price inflation of 4.9 per cent in the year ending March 2011. Food has a weighting of around 12 per cent in the CPI which makes it a significant driver of the overall rate of inflation. The UK has one of the highest rates of food price inflation in the EU as it is highly dependent on food imports. The price of these imports is affected by the value of the pound and by world food prices which are increasing due to demand from growing economies such as India and China. 2

Under normal circumstances the Bank of England would be expected to respond to high inflation by putting up interest rates. However, the UK economy is experiencing a very weak recovery from recession. Sluggish growth and high unemployment have led the Bank of England to keep the official bank interest rate at an all-time low of 0.5 per cent. The rate has been kept at this level since March 2009 in spite of a persistent failure to meet the inflation target. 3

Many economists argue that interest rate increases would be ineffective in dealing with this bout of inflation as many of the price increases are international in origin and largely beyond the control of the UK monetary authorities. 4

However, a very different strategy has been adopted by the European Central Bank (ECB) which has a similar inflation target to the Bank of England. When in April 2011 Eurozone inflation reached 2.8 per cent it raised its key rate to 1.25 per cent, meaning that the Eurozone has higher interest rates and lower inflation than the UK. 5

This combination of relatively high inflation and a historically low rate of interest means that the UK is facing negative real interest rates. Moneyfacts magazine reports that the best annual rate available to savers is 2.75 per cent at a time when the CPI is rising by 4 per cent. The real value of savings is therefore falling. At the same time many households with mortgages are paying less than 2 per cent in interest. 6

Indeed, it is not just savers who are suffering because of inflation. The Institute for Fiscal Studies estimates that the combination of stagnant wages and high inflation has reduced the living standards of the typical UK family by £500 over the last 12 months. Average income in real terms has returned to 2005 levels. 7

The Bank of England has attracted considerable criticism for its failure to meet its inflation target. One commentator said "Bank of England Governor Mervyn King is living in a dream world when he describes the current high level of inflation as 'temporary'. It is hardly temporary when it has lasted continuously since November 2009." The Daily Telegraph in an editorial (15 February 2011) simply described the Bank of England's performance in controlling inflation as "inept"! 8

1 **(a)** Using the data in **Fig. 1**, describe the changes in the UK rate of inflation between November 2009 and September 2011. [6]

(b) Explain why food price inflation is higher in the UK than the Eurozone.

(c) Explain the impact of a rise in food prices on the C.P.I. (Paragraph 2) [6]

(d) Explain what is meant by the term "negative real interest rates". (Paragraph 6) [4]

(e) Analyse the causes of falling living standards in the UK referred to in paragraph 7. [6]

(f) Critically examine the Bank of England's decision to leave its official bank rate unchanged at 0.5 per cent since March 2009. [12]

Essays:

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

2 Aggregate demand resistant to fiscal stimulus

(a) Describe the main components of aggregate demand in an economy. [10]

(b) Explain why an economy's aggregate demand curve slopes downwards from left to right. [15]

(c) Critically examine the view that fiscal policy is the most effective means of controlling aggregate demand. [15]

3 GDP statistics overstate economic welfare

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

(b) Explain the main factors which determine an economy's rate of economic growth. [15]

(c) Evaluate the view that GDP statistics should not be used as an indicator of economic welfare. [15]

4 Reducing unemployment essential for the economy

(a) Explain the difference between unemployment and economic inactivity. [10]

(b) Analyse the likely impact of supply side policies upon a country's rate of unemployment. [15]

(c) Evaluate the view that reducing unemployment should be the UK Government's main economic objective. [15]