Write your name here

Surname	Other names

Pearson Edexcel GCE

Centre Number

Candidate Number

Economics

Advanced Subsidiary
Unit 2: Managing the Economy

Wednesday 21 May 2014 – Afternoon
Time: 1 hour 30 minutes

Paper Reference
6EC02/01R

You do not need any other materials.

Total Marks

Instructions

- Use **black** ink or ball-point pen.
- **Fill in the boxes** at the top of this page with your name, centre number and candidate number.
- Answer EITHER Question 1 or Question 2.
- Answer the questions in the spaces provided – *there may be more space than you need.*

Information

- The total mark for this paper is 80.
- The marks for **each** question are shown in brackets – *use this as a guide as to how much time to spend on each question.*
- Questions labelled with an **asterisk** (*) are ones where the quality of your written communication will be assessed – *you should take particular care on these questions with your spelling, punctuation and grammar, as well as the clarity of expression.*
- Calculators may be used.

Advice

- Read each question carefully before you start to answer it.
- Check your answers if you have time at the end.

Turn over ▶

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Answer EITHER Question 1 or Question 2.

If you answer Question 1, put a cross in this box ☒ .

1 Growth

Extract 1 Stagnation in the UK economy

After the Great Recession comes the Great Stagnation. The United States, Japan and the euro area have all suffered very limited growth since the crash in 2008, yet Britain has under-performed them all. The economy has had almost no growth since the coalition Government took office in 2010, leaving gross domestic product more than 4% below its pre-crisis peak and the UK in a negative output gap.

For the moment all politicians are focusing on infrastructure as the solution to growth. Larry Summers, the former US Treasury Secretary, warned that unless the UK Government stimulates construction, it will face a re-run of America's fate in the Great Depression.

Yet the experience of Japan's extended stagnation offers a cautionary lesson. The country embarked on 15 stimulus packages between 1992 and 2008, including many massive infrastructure investment projects. But nearly 20 years after its financial bubble burst, the country is still stagnating. All those extra bullet (high-speed) trains failed to generate a period of growth in the economy's output. Investment projects need to be carefully chosen to have a real impact. Many of the ideas that we hear – a motorway connecting Oxford and Cambridge, for example – sound unlikely to generate long-term growth. Britain invested vast amounts of money in commercial property in the 2000s; it was not needed. Economists at a financial consultancy argue that there is a surplus of infrastructure in the UK following the collapse in GDP. Returns on private sector infrastructure investment are likely to be low or even negative. Encouraging banks to lend billions to finance more of it may provide a short-term boost but, in the long run, it will only increase Britain's debt problem.

Masaaki Shirakawa, the Governor of the Bank of Japan, argued in a speech last week that policy in Japan had to go beyond short-term fiscal and monetary policies, and focus on the longer term. That means lifting the economy's growth potential. In Britain, spending needs to be increased on the development of assets other than physical capital. The country needs to invest more in innovation, "intangible" assets such as intellectual property, software, design and patents, not just apartment blocks. Yet calculations published by Nesta, a charity, show that spending on research and innovation by British companies fell by as much as £24 billion in 2011. The governments of America, France, Germany and South Korea have committed more to research and innovation than the UK since the crisis began, according to the Nesta report.

UK Government policies are making the situation worse. It is difficult to understand why the Government is including students in its restrictions on immigration, given the critical role Britain's universities will play in the pursuit of growth. Instead of holding universities back with greater regulation and bureaucracy, it should be trying to help them to attract the top brains in global academia. The Government argues that it is just reducing the numbers of students coming to learn English at language schools and that overseas student numbers studying at British universities are slightly up on previous years.

The Government's innovation strategy relies partly on a policy that cuts the corporation tax rate on income generated from UK patents. Yet, as the Institute for Fiscal Studies, a think-tank, has pointed out repeatedly, this costly incentive is poorly targeted: the companies that benefit are able to carry out the research outside the UK economy and then apply for a UK patent.

George Osborne, the Chancellor, has centred his growth strategy on low interest rates, but, as Spencer Dale of the Bank of England has pointed out, this comes at a cost. Extended periods of low rates can simply delay economic restructuring by covering up bad debts as weak companies are kept going. Here again, the Japanese experience is relevant. Mr Shirakawa admits that Japan's unwillingness to deal quickly with the bad debts of its failing companies played a significant part in condemning the country to lengthy stagnation.

The UK boom of the 1990s and 2000s did not create long-term growth. It was mainly generated by short-term, demand-side factors such as rising asset prices, easy finance and an unsustainable increase in the number of public sector employees. Growth was also stimulated by cheap imports from China, which are no longer falling in price. The Government has a critical role in leading the search for long-term supply-side growth. If it fails, the Great Stagnation could be with us for years to come.

(Source: The Times Newspapers Ltd, 10 Sept 2012)

(a) (i) With the aid of a diagram and reference to Extract 1, explain what is meant by "output gap" (Extract 1, line 5).

(6)

(ii) With reference to the third paragraph of Extract 1, define investment. (Extract 1, line 14).

(4)

(iii) Explain **two** likely causes, other than monetary policy, of the fall in investment in research and innovation by British companies (Extract 1, lines 29–30).

(8)

(b) (i) Assess the effects that **increasing** numbers of overseas students could have on the UK economy. Use an aggregate demand and aggregate supply diagram in your answer.

(12)

(ii) Outline **two** mechanisms by which "low interest rates" (Extract 1, lines 47–48) can lead to economic growth.

(8)

*(iii) Evaluate the impact of the "increase in the number of public sector employees" (Extract 1, line 56) on the UK economy.

(12)

*(c) Evaluate the merits of using supply-side policies to overcome 'the Great Stagnation' (Extract 1, line 1).

(30)

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(Total for Question 1 = 80 marks)

If you answer Question 2, put a cross in this box ☒ .

2 UK economic performance and monetary policy

Figure 1 UK macroeconomic indicators

	Real GDP	Consumer Price Index (CPI)	ILO Unemployment	Balance of Payments on Current Account
	Annual % change	Annual % change	% of labour force	% of GDP
2005	2.8	1.9	4.9	–2.1
2006	2.6	3.0	5.4	–2.9
2007	3.6	2.1	5.3	–2.3
2008	–1.0	3.1	5.7	–1.0
2009	–4.0	2.9	7.7	–1.3
2010	1.8	3.7	7.8	–2.5
2011	0.9	4.2	8.1	–1.3
2012	0.2	2.7	8.0	–3.7

(Source: adapted from data from the Office for National Statistics licensed under the Open Government Licence v.1.0.)

Extract 1 Domestic demand, exports and exchange rates

Since 2008 domestic demand has been fragile in the UK and the savings ratio (percentage of household disposable income saved) has risen from –0.9% at the end of the boom in the first quarter of 2008 to around 6% in 2012.

Despite the weaker sterling exchange rate, imports have remained high and exports have been lower than hoped for. Lee Hopley, Chief Economist of the EEF manufacturers' organisation, said there were fewer UK suppliers than in the past, so while a weak pound makes export sales cheaper, it raises the cost of components and raw materials, which now have to be imported. Also, many exports are of niche products, which are less price-sensitive in demand. "Large aircraft manufacturers are not going to go somewhere else to buy aircraft landing gear because the exchange rate has moved," Ms Hopley said.

David Kern, Chief Economist at the British Chambers of Commerce, warned that a further depreciation in sterling would be damaging. "We have … reached the point where the benefits of a weaker pound for UK exports will be very small, while the potential damage to the economy because of high inflation and the squeeze it imposes on businesses and consumers is much bigger."

(Source: © The Financial Times Ltd 2013)

Extract 2 UK inflation and interest rates

In February 2013, the Bank of England's Monetary Policy Committee (MPC) announced that the UK's inflation rate for January 2013 remained steady at 2.7% and its interest rate would remain at 0.5%. This means the interest rate has been at the same historically low level for four years since it was rapidly reduced in 2008 from over 5%.

Members of the MPC were split on whether to change interest rates. Inflationary pressure was evident in the service sector and from a weakening sterling exchange rate. However, on the other side, domestic consumption remained low and unemployment persisted.

(Source: © Bank of England)

(a) (i) Outline **two** main components of the Balance of Payments on Current Account.
(4)

(ii) Explain **two** possible problems for the UK economy of its persistent current account deficit as shown in Figure 1.
(8)

(iii) With reference to the information provided, assess the effect of a weakening of the sterling exchange rate on the UK Balance of Payments on Current Account.
(12)

*(b) With reference to the information and your own knowledge, examine **two** factors that might explain the change in the UK unemployment rate since 2008.
(12)

(c) (i) Explain how the rate of inflation is measured in the UK. Refer to the concept of weights in your answer.
(6)

(ii) With reference to Extract 1, explain how a rise in the "percentage of household disposable income saved" (Extract 1, line 2) may affect real output in the UK economy.
(8)

*(iii) With reference to the data and your own knowledge, discuss the issues that the Monetary Policy Committee of the Bank of England might consider when seeking to achieve its inflation target.
(30)

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(Total for Question 2 = 80 marks)

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