



*Rewarding Learning*  
**ADVANCED SUBSIDIARY (AS)**  
General Certificate of Education  
2017

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# Economics

Assessment Unit AS 2  
The National Economy



AE121

**[AE121]**

**MONDAY 22 MAY, MORNING**

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#### 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.  
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.

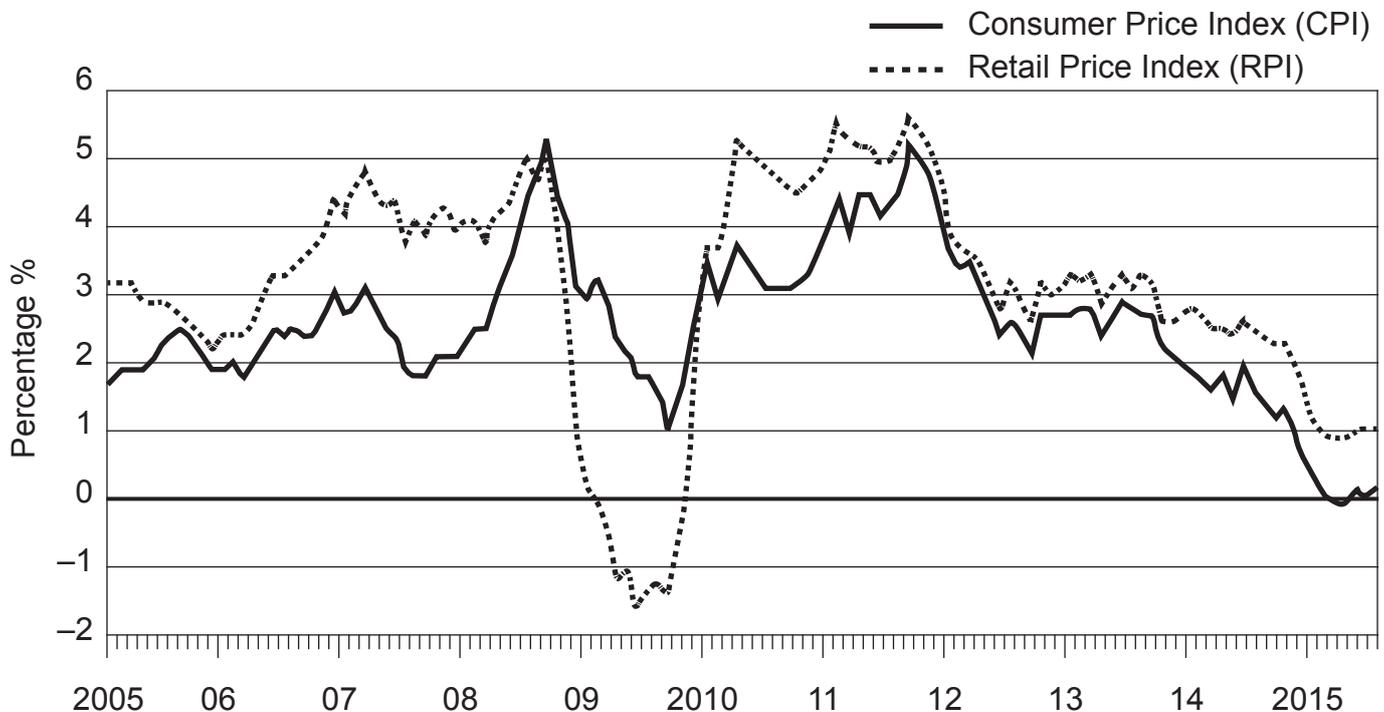
## Question 1: Data response

The following article was written in August 2015. Study it carefully and answer the questions which follow.

### Inflation at Historic Lows

#### Inflation March 2005–July 2015

Percentage change over 12 months



Adapted from *Consumer price inflation, UK: July 2015* from The Office for National Statistics.  
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Fig. 1

In 1975 the UK's official rate of inflation was 25 per cent. In April 2015 it was  $-0.1$  per cent. For many years Bank of England Governors have had to write letters to Chancellors of the Exchequer explaining why inflation was 1 per cent or more **above** the target of 2 per cent. Now a letter will have to be sent explaining why the rate of inflation is more than 1 per cent **below** target. 1

A number of factors lie behind this remarkable transformation. The first of these is the remarkable strength of the pound, especially against the euro. The pound/euro exchange rate has been as high as 1.43 euros to the pound, with many analysts predicting even higher levels. This is great news for UK holidaymakers and importers but is making life difficult for UK exporters. 2

A second factor is the fall in the world oil price. Brent crude oil is down from \$100 per barrel in September 2014 to under \$50 in September 2015. Since oil is a major cost of production a fall of this magnitude has a significant effect on the Consumer Price Index (CPI). 3

A third factor is the fall in world food prices. Recently the United Nations' global food price index has seen a year on year fall of around 24 per cent. Since food has a weighting of 11 per cent in the CPI the knock-on impact on the overall index is very significant. Indeed, as the UK is a major food importer, a strong pound significantly lowers the cost of the family shopping basket. 4

It is therefore surprising in the midst of this deflationary environment that the Bank of England should be considering a rise in interest rates. After all, higher rates are designed to deal with rising not falling prices. Bank of England Governor Mark Carney said in August 2015 that monetary policy normalisation (rises in the base rate of interest) was under serious consideration.

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The reason for this apparent paradox is that not all economic data points in the same direction. Yes, CPI inflation is close to zero and yes, manufacturing output fell by 0.5 per cent in July. In fact, output remains 5.2 per cent below its pre-crash peak achieved in the first quarter of 2008. However, underlying inflation which does not include items such as energy, food, alcohol and tobacco rose to 1.2 per cent in July 2015, its highest level in five months. Furthermore, consumer spending rose by an annualised rate of 1.4 per cent in the three months to June and the index of consumer confidence in June was at its highest level since January 2000.

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A further by-product of the ultra low interest rate of 0.5 per cent which was first introduced by the Bank of England in March 2009 is the creation of “asset price bubbles”. These occur when the prices of shares, London property, works of art and even fine wines have increased at a rapid and unsustainable rate. These bubbles have benefited extremely rich individuals but have disadvantaged lower income groups who find themselves priced out of the property market. Inequality in the distribution of wealth has soared.

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With so much conflicting economic data it is not surprising that the Bank of England is receiving a great deal of contradictory advice. Samuel Tombs of Capital Economics said, “raising rates could be postponed until the second quarter of 2016 as inflation is likely to turn negative again over the next few months”. However, it is the opinion of John Hawksworth of Price Waterhouse Cooper that the longer term inflationary outlook reinforces the case for interest rates to start rising sooner rather than later. The Bank of England’s Monetary Policy Committee is stuck between a rock and a hard place!

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*Adapted from © UK inflation rate rises to 0.1% by BBC News, 18 August 2015*

- 1 (a) Using the information in **Fig. 1**, compare the trend of the Retail Price Index with that of Consumer Price Index between March 2005 and July 2015. [6]
- (b) Explain how the Consumer Price Index is constructed. (Paragraph 4) [6]
- (c) Explain the impact of the strong pound on the UK’s rate of inflation. (Paragraph 2) [8]
- (d) Explain why an expansionary monetary policy can lead to “asset price bubbles”. (Paragraph 7) [8]
- (e) Critically examine the view that the Bank of England should significantly increase the level of UK interest rates. [12]

**Essays:**

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

**2 Economic growth may do as much harm as good**

- (a) Explain the difference between nominal and real gross domestic product (GDP). [10]
- (b) Analyse some of the main factors which might lead to a rightward shift in the long run aggregate supply curve. [15]
- (c) Evaluate the view that economic growth should no longer be an objective of government policy. [15]

**3 Balanced budgets promote stability**

- (a) Explain the main components of aggregate demand. [10]
- (b) Analyse why an economy's aggregate demand curve slopes downwards from left to right. [15]
- (c) Evaluate the view that a government should always maintain a balanced budget. [15]

**4 Government should create a fairer society**

- (a) Explain the main macroeconomic policy objectives of a government. [10]
- (b) Analyse why focusing on one macroeconomic policy objective may make it more difficult to achieve another. [15]
- (c) Evaluate the view that achieving greater equality in the distribution of income should be the government's top economic priority. [15]