AQA

AS
ECONOMICS

Paper 2 The National Economy in a Global Context

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DO NOT WRITE ANY ANSWERS IN THIS INSERT. YOU MUST ANSWER THE QUESTIONS IN THE ANSWER BOOKLET PROVIDED.

CONTEXT 1: INFLATION

Questions 21 to 26

- **Extract A:** **UK inflation rate (%), measured by CPI, January 2018 to December 2020**
- **Extract B:** **Achieving the inflation target of 2%**
- **Extract C:** **Are very low interest rates good for the economy?**

CONTEXT 2: INTERNATIONAL TRADE

Questions 27 to 32

- **Extract D:** **UK monthly balance of trade in goods and services (£million), November 2017 to October 2020**
- **Extract E:** **The trade balance: an overlooked objective of government macroeconomic policy?**
- **Extract F:** **Should the trade balance receive more attention?**

Context 1 **Total for this context: 50 marks**

INFLATION

Extract A: UK inflation rate (%), measured by CPI, January 2018 to December 2020

Source: ons.gov.uk, February 2021

Extract B: Achieving the inflation target of 2%

For over 40 years, the control of inflation has been one of the main objectives of government macroeconomic policy. It is widely believed that price stability helps to create the conditions for all the other objectives to be achieved. Stable prices mean firms and individuals have more confidence. Consequently, there is likely to be more investment and consumption, more jobs are created, and everyone benefits as the economy grows. On the other hand, high inflation can be disruptive. Firms may postpone expansion plans, workers may ask for large wage increases, and already-high inflation can quickly get out of control. With this in mind, the government sets the target rate of inflation that the Bank of England's Monetary Policy Committee (MPC) has to achieve. The MPC uses monetary policy to control inflation. Given that the price level is affected by demand-side and supply-side factors, both domestically and from all over the world, this is not an easy task.

In 2020, the pandemic caused long periods of reduced economic activity. As expected, unemployment increased and inflation fell. Oil prices tumbled in response to falling global demand and this helped to reduce firms' costs of production. In the UK, government policy, such as the temporary reduction in VAT, an indirect tax, from 20% to 5%, also helped to reduce inflation.

Source: News reports, December 2020

Extract C: Are very low interest rates good for the economy?

The 2% inflation target is not only designed to protect the economy from the harmful effects of high inflation but also to prevent the economy from experiencing a period of deflation. As 2020 drew to a close, there was evidence of some inflationary pressures. It was reported that the average UK house price had risen by 7.6% in the year to November 2020. The completion of a UK–EU trade deal provided a confidence boost, and the FTSE 100 Index of leading shares reached its highest value since March 2020. However, deflationary factors were also in evidence. The UK pound sterling appreciated to its highest level against the US dollar since April 2018. Overall, output was not expected to recover to its previous peak until 2022.

The MPC has continued to implement very loose monetary policy to support the economy. Bank Rate remained at an all-time low of 0.1%, and there were further injections of money via the quantitative easing scheme. This should encourage consumption and much needed investment. In addition, the cost of government borrowing remained low, crucial at a time when the budget deficit and national debt were increasing considerably.

However, there are disadvantages of low interest rates. They have the potential to create inflationary pressure. Pensioners and others who rely on their savings to provide a source of income may lose out. Low interest rates encourage more consumer debt which might lead to instability in the future. Tempted by cheaper borrowing, some firms might make poor investment decisions, leading to a misallocation of resources. It remains to be seen whether very low interest rates are good for the economy.

Source: News reports, December 2020

Turn over for Context 1 questions

Context 1: – Questions 21 to 26

2 1 Define 'deflation' **Extract C** (line 2).

[3 marks]

2 2 The original price of an overnight stay in a hotel room is £180 including VAT. Calculate the new price of an overnight stay, following the reduction in VAT referred to in **Extract B** (line 15).

[4 marks]

2 3 Use **Extract A** to identify **two** significant features of the inflation rate over the period shown.

[4 marks]

2 4 **Extract B** (lines 14–15) states: 'In the UK, government policy, such as the temporary reduction in VAT, an indirect tax, from 20% to 5%, also helped to reduce inflation.'

Draw an AD/AS diagram to show the impact of a reduction in indirect taxation on real national income and the price level in an economy.

[4 marks]

2 5 **Extract B** (lines 7–9) states: 'With this in mind, the government sets the target rate of inflation that the Bank of England's Monetary Policy Committee (MPC) has to achieve.'

Explain **two** factors considered by the Bank of England's MPC when setting Bank Rate.

[10 marks]

2 6 **Extract C** (lines 18–19) states: 'It remains to be seen whether very low interest rates are good for the economy.'

Use the extracts and your knowledge of economics to assess the view that very low interest rates are good for the UK economy.

[25 marks]

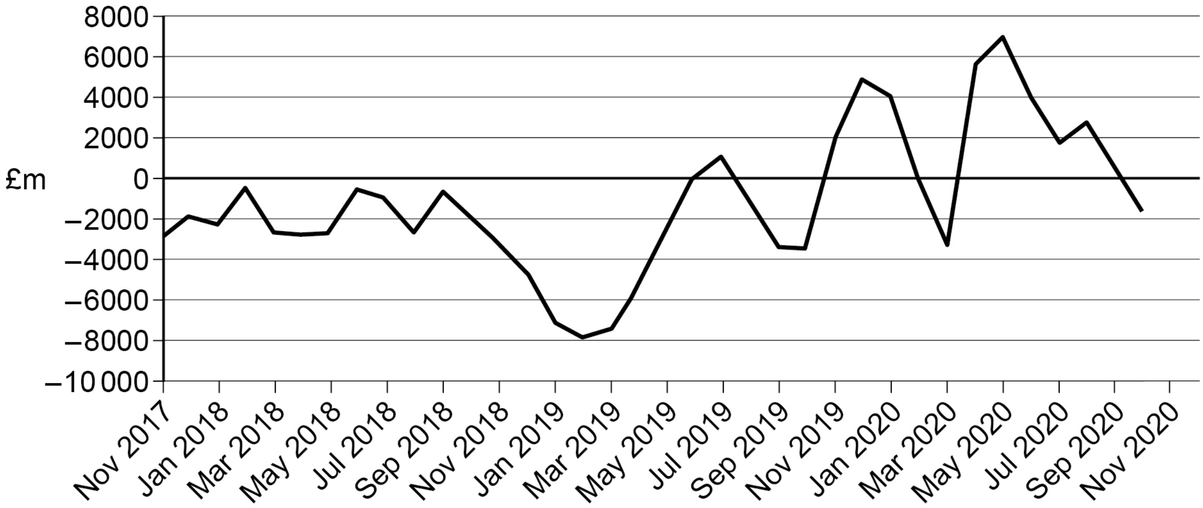
There are no extracts printed on this page

Turn over for Context 2

Context 2 **Total for this context: 50 marks**

INTERNATIONAL TRADE

Extract D: UK monthly balance of trade in goods and services (£million), November 2017 to October 2020



Source: ons.gov.uk, February 2021

Extract E: The trade balance: an overlooked objective of government macroeconomic policy?

The importance that governments attach to the various objectives of macroeconomic policy varies over time. However, the achievement of a satisfactory balance of trade in goods and services is often the one that receives the least attention. Governments and media headlines tend to focus on unemployment, inflation and economic growth. Recent favourable trade balances, such as the £8.2 billion surplus achieved in the 12 months to October 2020, have largely been overlooked.

But why? An improving trade balance could signal good news for an economy. An increase in exports should help to reduce unemployment. There is likely to be a positive multiplier effect and economic growth should increase. An increase in output will reduce spare capacity, firms feel more confident, and the accelerator theory suggests that investment should rise.

However, this is not always the case. Changes in the trade balance are often linked to changes in the economic cycle. For example, in the year to July 2020 the balance of trade in goods deficit improved. This was not because the value of exports increased, but because the value of exports fell by a smaller amount than the fall in the value of imports. The value of exports fell by £31.6 billion to £321.6 billion. The larger decrease in the value of imports was mainly due to falling demand for machinery, transport equipment and fuels due to the inactivity caused by the pandemic. As the economic recovery gets underway, the balance of trade in goods might deteriorate again.

Source: News reports, December 2020

Extract F: Should the trade balance receive more attention?

Many economists believe that the trade balance reflects the strength or weakness of a country's international competitiveness in terms of the price and quality of the goods and services exported. International trade is also affected by fluctuations in the exchange rate, the rate of inflation and the level of economic activity in other economies. Some of these factors can be beyond the government's control.

However, there is a great deal that can be done to improve the balance of trade in goods and services. Government supply-side policy can have a direct influence, via changes to corporation tax and industrial policy, to provide incentives for exporting firms to increase investment. Increased and better-targeted spending on education and training should help to improve human capital. Highly skilled workers are capable of producing cutting-edge, high-quality goods and services which are sought after in the global marketplace. Firms themselves have a role to play, by being dynamic, innovative and constantly seeking productivity improvements. If the inflation rate remains low, and appropriate policies are adopted, the UK economy should reap the benefits from an improvement in its balance of trade in goods and services.

Source: News reports, December 2020

Turn over for Context 2 questions

Context 2: – Questions 27 to 32

2 7 Define 'economic recovery' **Extract E** (line 17).

[3 marks]

2 8 In the year to July 2020, the deficit in the balance of trade in goods was £105 billion. Calculate the value of imports of goods for the year to July 2020, using the information in **Extract E** (lines 12–15) to help you.

[4 marks]

2 9 Use **Extract D** to identify **two** significant features of the balance of trade in goods and services over the period shown.

[4 marks]

3 0 **Extract E** (lines 4–6) states: 'Recent favourable trade balances, such as the £8.2 billion surplus achieved in the 12 months to October 2020, have largely been overlooked.'

Draw an AD/AS diagram to show the effect of an improvement in the balance of trade in goods and services on real national income and the price level in an economy.

[4 marks]

3 1 **Extract F** (lines 1–2) states: 'Many economists believe that the trade balance reflects the strength or weakness of a country's international competitiveness'.

Explain how a fall in a country's international competitiveness may affect economic growth in the economy.

[10 marks]

3 2 **Extract F** (lines 6–7) states: 'However, there is a great deal that can be done to improve the balance of trade in goods and services.'

Use the extracts and your knowledge of economics to evaluate policies that may be used to achieve a sustained improvement in the UK's balance of trade in goods and services.

[25 marks]

END OF QUESTIONS