



2015 specification
First exams in 2017 (2016 for AS)

Data Response Case Studies

For AS/A level Year 1 AQA Economics

Macroeconomics: The national economy in a global context

zigageducation.co.uk

POD
7090

Publish your own work... Write to a brief...
Register at publishmenow.co.uk

Contents

INSPECTION COPY

Thank You for Choosing ZigZag Education

Teacher Feedback Opportunity.....

Terms and Conditions of Use

Teacher’s Introduction

Economic Growth in the UK – Back to Business as Usual?

 Case Study

 Questions.....

UK Inflation in the 1970s

 Case Study

 Questions.....

Venezuela’s Inflation Problem

 Case Study

 Questions.....

UK Unemployment – Successes and Challenges

 Case Study

 Questions.....

Should We Be Worried about the UK’s Current Account Deficit?

 Case Study

 Questions.....

The UK’s Slump in Consumption During the Recession

 Case Study

 Questions.....

The Economics of Immigration

 Case Study

 Questions.....

Investigating the Multiplier Effect.....

 Case Study

 Questions.....

Patterns in the Business Cycle

 Case Study

 Question

Monetary and Fiscal Policy in the Great Depression

 Case Study

 Questions.....

Supply-side Policies – Privatisation in the UK

 Case Study

 Questions.....

When will the UK raise interest rates?

 Case Study

 Questions.....

Answers.....

**COPYRIGHT
PROTECTED**



Teacher's Introduction

This resource is designed to be used for teaching AQA AS/A Level Economics. The Response Case Studies intended for students to complete as homework tasks.

The case studies are presented in specification order, collectively covering each specification. Each case study contains detailed information (including diagrams and questions).

The 'Use the data' tasks focus particularly on quantitative skills, and the 'Test your knowledge and application skills'. The extended-response questions are an opportunity for higher-level analysis and evaluation skills. Most of the questions given are in exam-style questions to this style except in the case of the extended-response questions provided for all tasks and questions.

Reading through each study and answering the questions is expected to take 20-30 minutes. Extended-response questions at the end of each case study. One option for using this resource is to read through the case study in class and set the exam-style evaluation question as homework.

This resource will help prepare students for the Paper 2 component of the AS/A Level Economics. It is of interest in the real-world applications of macroeconomics. Each case study uses a scenario to present a student to a fascinating array of contemporary and historical issues relating to the UK economy.

I hope this resource helps you to bring economics to life for your students.

Case Study	Specification
1. Economic growth in the UK – back to business as usual?	3.2.1 – the measurement of national income
2. UK inflation in the 1970s	3.2.1 – the measurement of national income 3.2.3.3 – inflation and deflation
3. Venezuela's inflation problem	3.2.1 – the measurement of national income 3.2.3.3 – inflation and deflation <i>Note: all indications are for the UK economy, not another national context</i>
4. UK unemployment – successes and challenges	3.2.1 – the measurement of national income 3.2.3.2 – employment and unemployment
5. Should we be worried about the UK's current account deficit?	3.2.1. – the measurement of national income 3.2.3.4 – the balance of payments
6. The UK's slump in consumption during the recession	3.2.2 – how the macroeconomy is affected by changes in aggregate demand
7. The economics of immigration	3.2.2.5 – determinants of short-run aggregate demand determinants of long-run aggregate demand
8. Investigating the multiplier effect	3.2.2.4 – aggregate demand and the multiplier
9. Patterns in the business cycle	3.2.3.1 – economic growth and the business cycle
10. Monetary and fiscal policy in the Great Depression	3.2.4 – macroeconomic policy
11. Supply-side policies – privatisation in the UK	3.2.4.3 – supply-side policies
12. When will the UK raise interest rates?	Multiple topics

Remember!

Always check the exam board website for new information, including changes to the specification and sample assessment material.

Free Update

Register your email address to receive updates to this resource or other Economics resources purchased, and details of any price changes.

* resulting from minor specification changes, and peer reviews, or occasional errors.

Go to zzed.uk/free

INSPECTION COPY

**COPYRIGHT
PROTECTED**



Economic Growth in the UK – Back to Business

This case study requires knowledge of Section 3.2.1 – the measurement of national income

The financial crisis of 2008 saw the UK experience the worst recession since the Great Depression. The recession saw rising unemployment, a dramatic fall in bank lending (credit), and unprecedented stimulus measures from the UK government and Bank of England to try to steer the economy back towards positive growth.

Now that the worst of the crisis seems to be over, many commentators and external organisations (such as the IMF) are optimistic about the future of the UK economy – not least since economic growth in 2014 topped that of all the other 'G7' countries (see Figure 2).



INSPECTION COPY

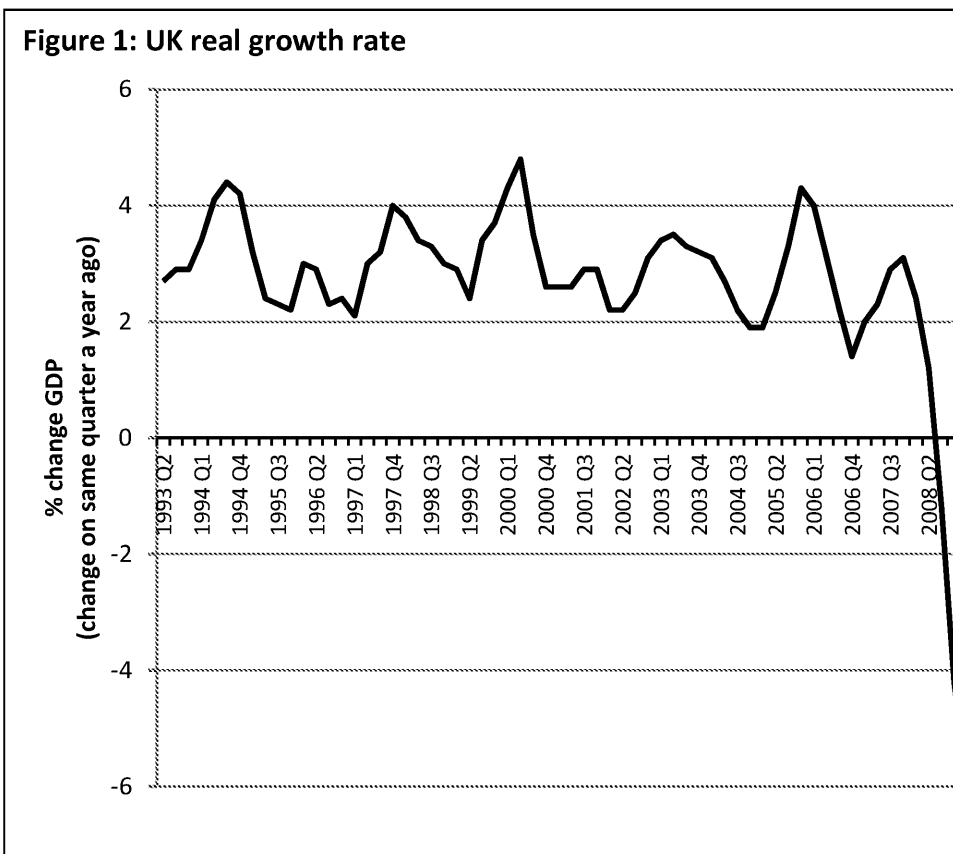


Figure 2

G7 Country	UK	Canada	USA	Germany	France
2014 annual real GDP growth rate	2.9	2.4	2.4	1.6	0.0

Many other economic indicators also seem to be showing signs of health – budget deficit is slowly narrowing (although not as quickly as the Chancellor would like), wages are rising for the first time in several years (particularly notable since 2008). Some attribute this to sensible economics on the Chancellor's part – strong responsibility seem to have boosted market confidence (the costs of borrowing have fallen).

**COPYRIGHT
PROTECTED**



have remained low – unlike imperilled economies such as Greece). Other government spending more gradually would have led to more reliable growth more to do with the revival of the world economy than any policy of the G oil has also been an unexpected bonus for the UK as a net importer of oil.

In the 2015 Autumn Statement, the Chancellor announced relatively expansion designed to boost economic growth, rather than lower the national debt) as economic growth predictions by the Office for Budget Responsibility (OBR) included postponing cuts to tax credits, and increasing the police budget as

Critics argue that predicting economic growth rates is notoriously difficult on forecasts is a risky move. There are some clear threats to the UK and this including a slowdown of economic growth in China, and a chronic shortage market. Hopefully the forecasters are right to predict that the UK will return can't know for sure.

Use the data

1. Estimate the average annual rate of GDP growth in the UK from 1993 to 2008.
2. Briefly describe how Figure 1 would change if nominal GDP figures were used.
3. Suppose the USA's real GDP at the start of 2014 was \$17 trillion. What would the figures in the extract?

Test your knowledge...

1. Define real GDP.
2. Give two reasons from the passage why the UK's growth rate was relatively

Extended-response question

1. 'Once population size and inflation are accounted for, GDP is a good measure of an economy is.' Evaluate this claim.

**COPYRIGHT
PROTECTED**

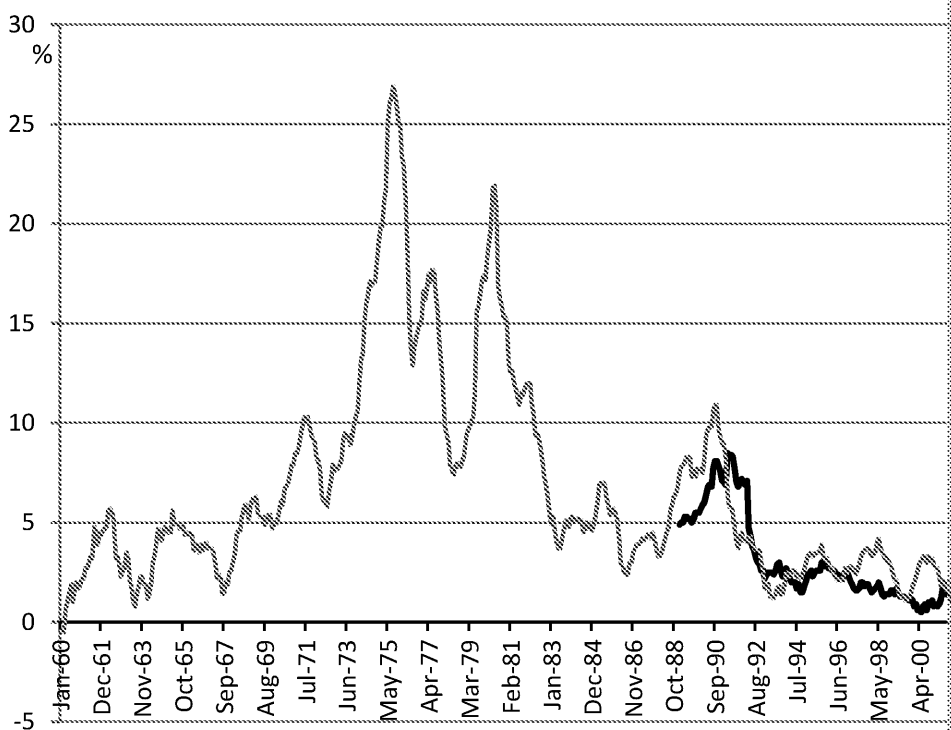


UK Inflation in the 1970s

This case study requires knowledge of Section 3.2.1 – the measurement of macroeconomic indicators and 3.2.3.3 – inflation and deflation.

Inflation figures in the UK tend to be buried in the financial sections of newspapers. Inflation has been very modest over the past few decades (hovering close to the Bank of England target of 2%) although the near-zero rate in 2015 piqued some interest. However, in the 1970s (and the 1980s) inflation was a serious concern.

Figure 1: UK inflation 1960–2013



Inflation data is calculated each month as the percentage change in prices from the same month in the previous year.

High inflation is often associated with high economic growth – inflation a sign of ‘overheating’. In the 1970s, however, economists in the UK and US were faced with a combination of high inflation and low economic growth. This came to be known as ‘stagflation’.

One of the causes of this was a succession of oil price ‘shocks’ in the world economy – i.e. unexpected increases in the price of oil. This caused a slowdown in the UK manufacturing industry (as oil is a key cost of production) as well as an outflow of money from the UK to foreign oil producers (since the use of cars had become highly popular). These are examples of cost-push and demand-pull inflation, respectively.

It has also been observed that the government’s policy response worsened stagflation. Interest rates were kept too low. Low interest rates lead to inflation if economic activity is kept at a high enough level. Unfortunately, the government had inaccurate data on the economy and thought it had a greater capacity to grow than it actually did (they overestimated the output gap). In retrospect, it would have made more sense to increase interest rates to reduce inflation.



**COPYRIGHT
PROTECTED**



INSPECTION COPY

Following this episode, policymakers tended to become more 'hawkish' – emphasis on controlling inflation, possibly at the expense of economic growth. When the UK entered a period of relatively stable inflation in the 1980s, policymakers have been more concerned with promoting economic growth than worrying about high inflation.

Use the data

1. Using Figure 1, what was the highest inflation rate experienced by the UK in the 1970s?
2. (a) In percentage points, what was the approximate change in the rate of inflation between July 1982 and July 1983?
(b) What term describes this kind of change?
3. Describe the trend in the inflation rate during the 1970s.

Test your knowledge...

1. State one reason why inflation increased in the 1970s.
2. Explain the difference between deflation and inflation.

Extended-response question

1. Discuss the costs of inflation for an economy.

**COPYRIGHT
PROTECTED**



Venezuela's Inflation Problem

This case study requires knowledge of Section 4.1 – International Trade. There is a particular focus on inflation, so this case study could also be used in a course on macroeconomics.

In the West, inflation figures don't make headline news very often. We are used to inflation fluctuating around a modest 0–5% – not the sort of levels that people tend to worry about. The UK hasn't seen double-digit inflation since the 1970s.

In other parts of the world, however, high inflation can be a persistent economic woe, often a symptom of underlying economic weakness. Figure 1 shows economic data for Venezuela, along with other Western hemisphere economies. Note the exceptionally high consumer price figure for Venezuela!

Figure 1: Western Hemisphere Economies: Real GDP (annual percentage change), Current Account Balance (% of GDP)

	Real GDP			Consumer prices		
	2014	2015	2016	2014	2015	2016
North America	2.4	3.0	3.0	1.0	0.5	1.7
United States	2.4	3.1	3.1	1.6	0.1	1.5
Canada	2.5	2.2	2.0	1.9	0.9	2.0
Mexico	2.1	3.0	3.3	4.0	3.2	3.0
South America	0.7	-0.2	1.3	-	-	-
Brazil	0.1	-1.0	1.0	6.3	7.8	5.9
Argentina	0.5	-0.3	0.1	-	18.6	23.3
Colombia	4.6	3.4	3.7	2.9	3.4	3.0
Venezuela	-4.0	-7.0	-4.0	62.2	96.8	83.3
Chile	1.8	2.7	3.3	4.4	3.0	3.0
Peru	2.4	3.8	5.0	3.2	2.5	2.0
Ecuador	3.6	1.9	3.6	3.6	3.2	3.0
Bolivia	5.4	4.3	4.3	5.8	5.1	5.0
Uruguay	3.3	2.8	2.9	8.9	7.9	7.5
Paraguay	4.4	4.0	4.0	5.0	3.6	4.5
Central America	4.0	4.2	4.3	3.4	2.6	3.3
Caribbean	4.7	3.7	3.5	4.0	3.3	4.2

Source: IMF World Economic Outlook

Figures for 2015 and 2016 are projected.

A key source of Venezuela's problems has been the low world price of oil (Venezuela is highly reliant on oil exports as a source of income. The fall in oil price has caused the bolivar to plunge in value. This makes it particularly expensive for it to import supplies: a severe worsening of the terms of trade. This is a rare example of over-specialisation!

INSPECTION COPY

**COPYRIGHT
PROTECTED**



Low oil prices are only part of the story: misguided economic policies must be corrected. A system of price controls has distorted the market, causing inefficiencies. Firms do not have incentives to produce the goods needed in the economy. Attempts to solve the problem by fixing the rate have failed: corrupt officials can game the system. The gap between the favourable, official exchange rate and the real, black-market exchange rate is large. The government has tried to help the situation by printing more currency, but this has only led to higher inflation. Official inflation statistics have been hard to come by. The central bank seems to have stopped collecting data after the December 2014 figure was released.

In a dramatic turn of events in early January 2016, Nicolas Maduro, the president, was removed from the central bank from the legislature (which elected a majority opposition) and the government expressed concerns that the country may end up experiencing hyperinflation.

It is well known that high rates of inflation can be crippling for an economy. Shortages have meant that some shop owners have stopped updating their prices because they cannot keep up with the constant price changes. Many consumers have turned to a black market for their goods.

Use the data

- Using the data from Figure 1:
 - Which South American country has the lowest projected inflation rate in 2016?
 - What is the projected annual inflation rate in North America in 2016?
 - Name two countries which are expected to experience consistent inflation in 2016.

Test your knowledge...

- Explain the difference between inflation and the price level.
- Name one cause of inflation identified in the text.
 - Explain one other possible cause of inflation.
- Explain the relationship between inflation and the exchange rate.

Extended-response question

- The effects of inflation in Venezuela have been overwhelmingly negative. Are there any situations where a positive inflation rate can be good for the economy?

**COPYRIGHT
PROTECTED**



UK Unemployment – Successes and

This case study requires knowledge of Section 3.2.1 – the measurement of macroeconomics and 3.2.3.2 – employment and unemployment.

Unemployment can be one of the most persistent and damaging economic problems. Some Eurozone countries such as Spain and Italy have experienced eye-watering levels of youth unemployment since the financial crisis of 2008 – leading to fears of a ‘lost generation’.

The UK was also buffeted by a spike in unemployment following the crash, as Figures 1 and 2 show, but since 2013 the situation seems to have improved dramatically.



INSPECTION COPY

Figure 1: Measures of total unemployment (age 16+)

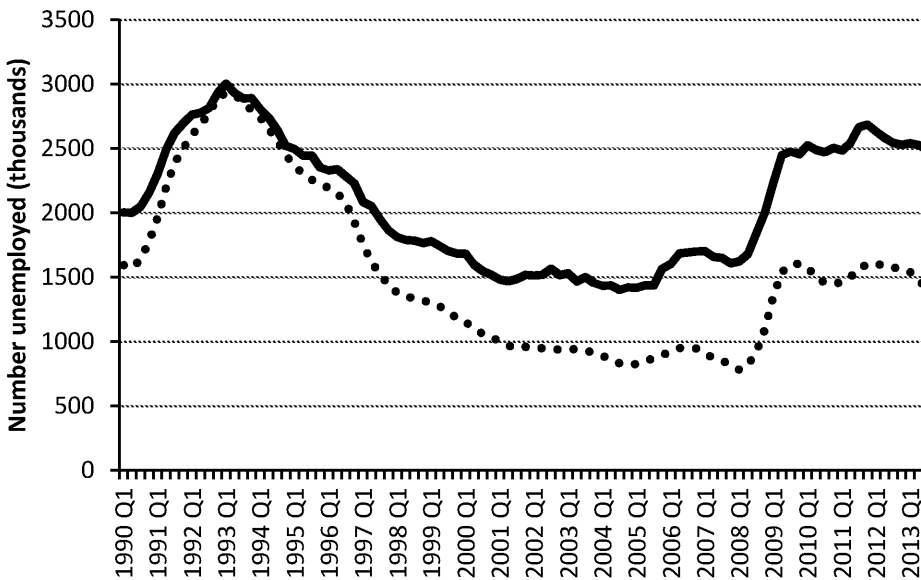
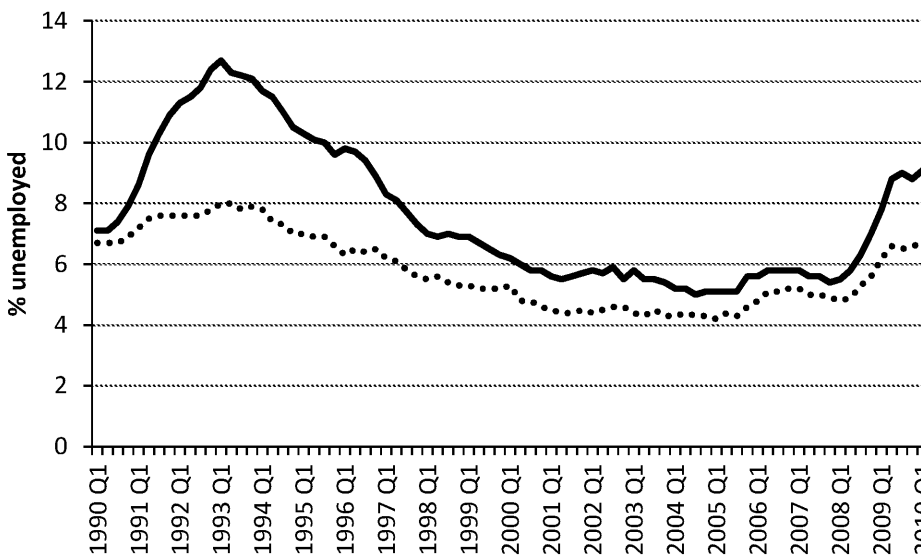


Figure 2: Unemployment rates (male/female)



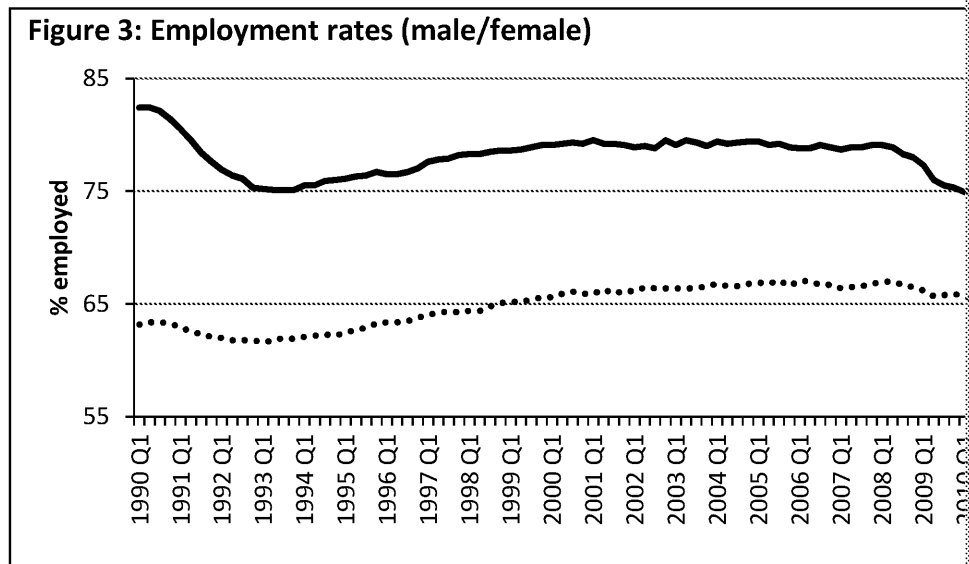
**COPYRIGHT
PROTECTED**



The UK is not out of the water just yet, however. There have been heavy j industry, as competition from abroad proved too fierce to make the indus could try to prop up the industry via increased subsidies, but unless the u issues are tackled, it is feared that this would amount to signing a 'blank c

There have also been concerns that the unemployment figures only appea emergence of 'zero-hours contracts' – but hard evidence on this is difficult

Figure 3: Employment rates (male/female)



Another perplexing pattern has been observed since the crisis: even though risen and unemployment figures have fallen, wage growth has been stagn wages to rise when unemployment is low).

One reason might be that inflation has been very low – if inflation were high demanding nominal wage increases. Another is that more people are hav time, as their employers cannot afford to have them work longer. A more sluggish wage growth is that the proliferation of cheap capital goods has r (e.g. the introduction of self-service machines at McDonald's). Whether th remains to be seen.

Use the data

1. Looking at Figure 1, explain why the Claimant Count measure of unemployment Labour Force Survey measure.
2. Suppose that in 2000 Q1 (quarter 1) the population of the UK was 60 million consisted of 55% of the total population, use Figure 2 to estimate the numb economy.
3. Look at Figure 3. What can you observe about the difference between male Can you think of any reasons behind the differences shown in the graph?

Test your knowledge...

1. Define the term 'economically active'.
2. Figure 1 shows a rise in unemployment numbers during the financial crisis c unemployment that is likely to have taken effect during this time.

Extended-response question

1. Discuss the consequences of unemployment for the economy and society.

**COPYRIGHT
PROTECTED**



Should We Be Worried about the UK's Current Account Deficit?

This case study requires knowledge of Section 3.2.1. – the measurement of macroeconomic indicators, 3.2.3.4 – the balance of payments on current account. It would also be helpful to know how exchange rates work.

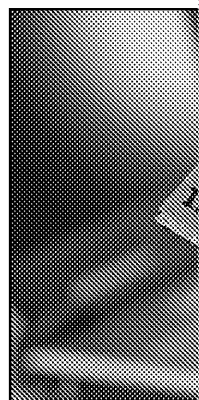
In the UK there has been much talk about the budget deficit – but less about the current account deficit. The budget deficit (which was £142 billion in 2010) seems to be falling steadily (it was £100 billion in 2014). However, the story is quite different for the current account. In the last period it jumped from £41 billion to around £92 billion.

Figure 1: UK Current Account Balances as a percentage of GDP

Quarter	Total	Trade	Primary
Q3 2012	-3.1	-1.7	-0.4
Q4 2012	-4.2	-2.5	-0.7
Q1 2013	-4.2	-1.7	-0.4
Q2 2013	-3.2	-1.6	0.1
Q3 2013	-4.6	-1.6	-1.0
Q4 2013	-6	-2.9	-1.1
Q1 2014	-4.5	-2.2	-1.3
Q2 2014	-4.2	-1.3	-1.1
Q3 2014	-5.4	-2	-2.2
Q4 2014	-6.3	-2.1	-2.2
Q1 2015	-5.2	-2.3	-1.9
Q2 2015	-3.6	-0.7	-1.9

The last columns of Figure 1 show the three components of the current account balance (exports minus imports), net investment income (or 'primary income') and net interest income (or 'secondary income'). The sum of these gives the total current account balance.

Current account deficits are not inherently 'bad' in the same way that running current account surpluses is not inherently 'good'. Developing countries may wish to run a current account deficit to import capital goods, with a view to improving their productivity in the future. Countries that rely too heavily on their exports may run into trouble if the price of their commodity falls unexpectedly (as with oil-producing countries in 2015/16).



Running a current account deficit is nothing new for the UK: there hasn't been a current account surplus since 1992. But some economists are concerned about the size of the deficit: the figure for Q4 2014 is the largest ever deficit in peacetime.

One of the worries about current account deficits is that they have to be funded by borrowing. If this persists over time, interest payments become a burden on the economy. They can also be funded by foreign investment in the domestic country. A recent example is the investment in building nuclear power stations in the UK. Some fear that this investment by foreign countries could compromise an economy's long-run growth potential.

INSPECTION COPY

**COPYRIGHT
PROTECTED**



Others argue that if the deficit grows too large, the exchange rate will depreciate to improve the current account balance. They also argue that investors have a lot of confidence in the UK because of many other measures it is performing strongly. Therefore, investors will invest in the UK in the near future. Furthermore, now that the UK is a net importer of oil, the low price of oil will reduce the deficit from worsening (so long as prices stay low).

It remains to be seen whether the UK government or the Bank of England will intervene to reduce the current account deficit, or whether market forces could solve the problem.

Use the data

1. Look at the data in Figure 1.
 - (a) Which of the three components of the current account appears to be stable over time?
 - (b) Which of the three components seems to have worsened over time (i.e. increased in deficit)?
2.
 - (a) Suppose UK GDP in 2012 was £1,600 billion (or £1.6 trillion). Using the data, calculate the size of the current account deficit in Q3 (quarter 3) 2012.
 - (b) If UK GDP in 2014 was £1,750 billion (or £1.75 trillion), calculate the size of the current account deficit in Q3 (quarter 3) 2014.

Test your knowledge...

1. Based on the article:
 - (a) Explain the effect on the current account balance if the value of UK investment in the rest of the world increases.
 - (b) Explain the effect on the UK's current account balance of an increase in the value of UK investment in the rest of the world.

Extended-response question

1. Assess the effectiveness of investing in one of the UK's export sectors as a way of reducing the current account deficit.

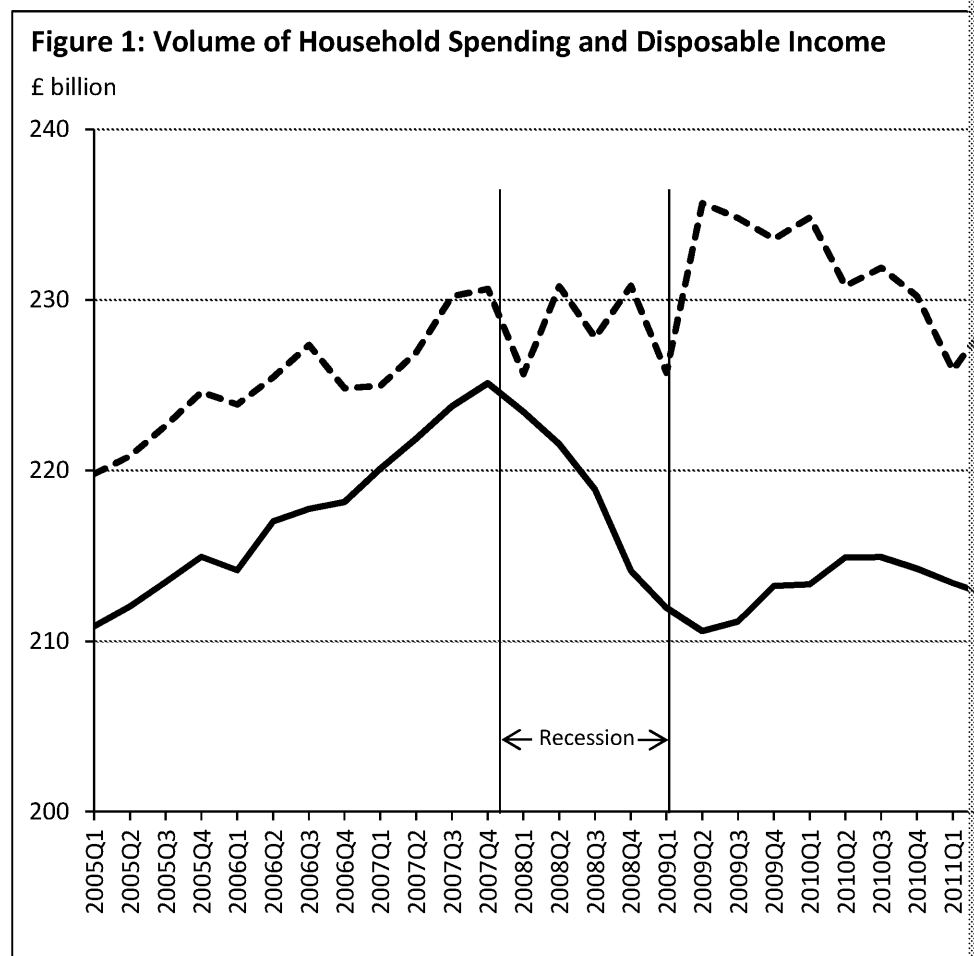
**COPYRIGHT
PROTECTED**



The UK's Slump in Consumption During

This case study requires knowledge of Section 3.2.2 – how the macroeconomy works, the components of aggregate demand and the influences on these components.

The 2008 global financial crisis had a pronounced effect on aggregate demand. The largest component of aggregate demand is consumption – accounting for 60% of GDP. Figure 1 shows how household spending (which is equivalent to consumption) fell during the recession:



The Labour government at the time attempted to reverse the trend using many tools, such as adjusting taxes (e.g. lowering VAT and increasing the income tax threshold), bailing out the financial sector, and relying on the Bank of England to lower interest rates (interest rates fell steadily from 5.75% in 2007 Q3 down to 0.5% by 2009 Q2).

It is interesting to compare the trend in disposable income with the trend in household spending. Even though disposable income remained fairly constant (even increasing in 2009), household spending fell sharply. This is despite the fact that disposable income is usually believed to be the main factor affecting consumption.

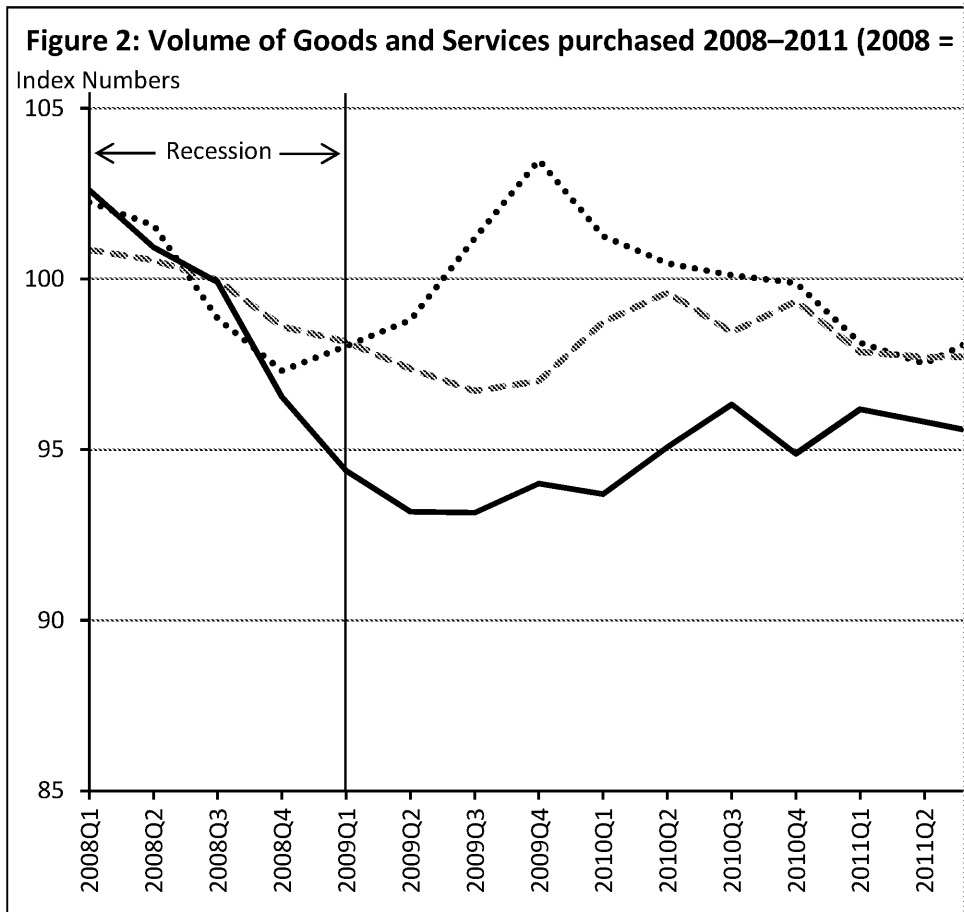
The main explanation for this is that household saving increased in the same period. Many households chose to pay off their debts that they had accumulated during the mid 2000s. In economic terms, paying down debts is classed as saving.

INSPECTION COPY

**COPYRIGHT
PROTECTED**



Figure 2 shows how consumer spending on different types of goods was affected by the recession.



Non-discretionary goods and services are essential products, such as staple food. Discretionary goods and services are desirable, but not necessary. Examples include luxury goods and leisure activities.

Since 2011, consumption seems to have grown slowly but steadily as the global economy and household finances improved.

Use the data

1. Is the data in Figure 1 in real or nominal terms?
2. Looking at Figure 2, estimate (in percentage terms) how much discretionary goods and services spending fell between its highest point (quarter 3) and 2009 Q3.
3. In 2009 Q1 (quarter 1), was spending on discretionary goods and services higher or lower than spending on non-discretionary goods and services?

Test your knowledge...

1. What is the formula for aggregate demand?
2. By approximately how much did household spending fall between its highest point (quarter 3) and 2009 Q3 in Figure 1?
3. Using an AD curve, show the effect of a fall in the rate of VAT.

Extended-response question

1. Discuss the relative importance of interest rates and consumer confidence in determining aggregate demand.

INSPECTION COPY

**COPYRIGHT
PROTECTED**

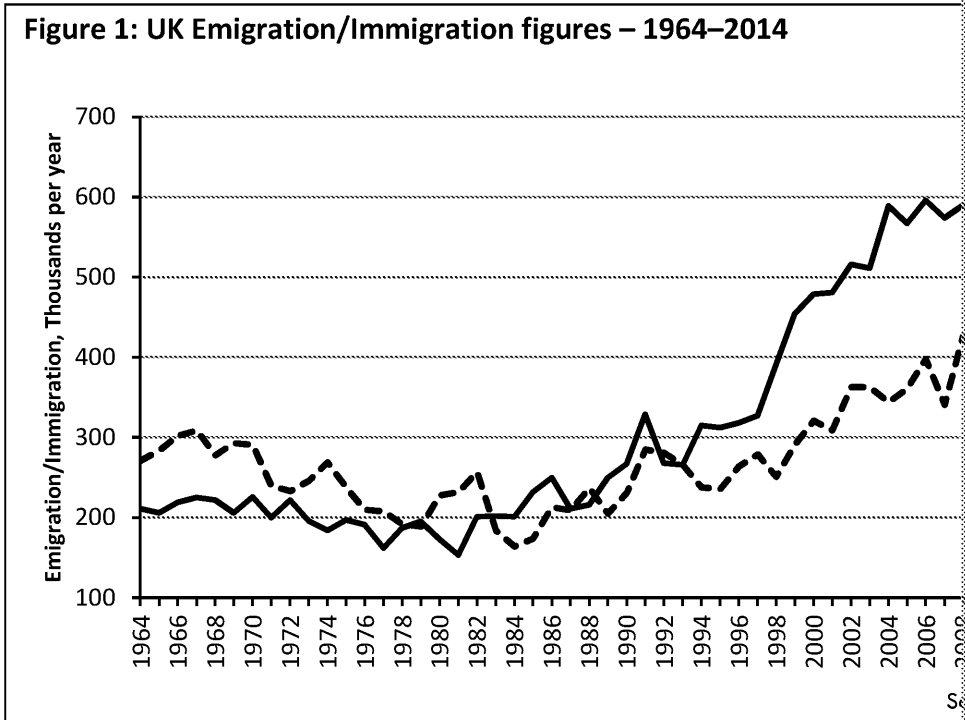


The Economics of Immigration

This case study requires knowledge of Section 3.2.2.5 – determinants of short-run determinants of long-run aggregate supply.

The humanitarian crisis in Syria has revived old debates about the effects of migration on 'host' nations. There are a plethora of arguments related to the *social* consequences of migration, but information on the *economic* effects of migration is relatively scarce.

Figure 1: UK Emigration/Immigration figures – 1964–2014



There are several different areas of the economy that migration studies may examine (one area is the effect of migration on the wages and employment rates of natives belonging to the host nation). The concern is that the influx of labour depresses employment (using a simple demand and supply diagram, immigration is an increase in the supply of labour).

Others counter that this argument falls foul of the 'lump of labour' fallacy (the idea of a fixed number of jobs to go around in the economy). Since migrants also consume for goods and services, the negative effect on employment and wages may be offset.

Evidence on this is mixed. In the US, some studies have found evidence of a decrease in native wages, but European studies have tended to produce 'statistically insignificant' results. That is, the estimates of the effects of migration on EU wages are probably close to zero. On the other hand, there is some evidence from European studies that immigration increases the employment levels of natives (people drop out of the labour force due to the greater competition).

The differences in results may be because labour protection laws in Europe mean that wages tend to be quite inflexible (or 'sticky'), but the labour market in the US is more *laissez-faire* (free market). Another observation is that the effect on natives depends on whether the migrants are skilled or unskilled. Unsurprisingly, skilled migrants seem to benefit host nations more.

INSPECTION COPY

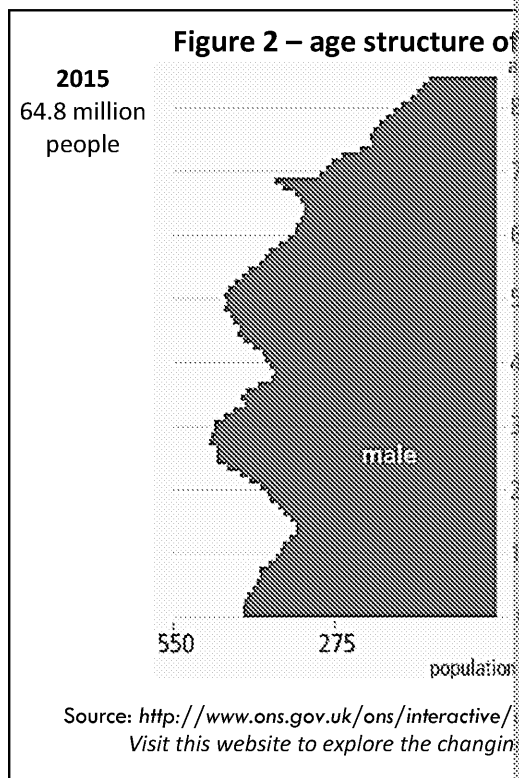
COPYRIGHT
PROTECTED



One of the benefits supporters of migration point to is that it boosts the size of the population – since migrants tend to be young people looking for work. This increases the size of the labour force as a proportion of the total population. Figure 2 shows the UK's 'population pyramid' in 2015. The bulges show the effect of 'baby booms'.

One of the counterarguments to this is that migration simply delays the 'demographic time bomb' facing developed countries – there will still be the problem of an ageing population in the future even after migration levels tail off.

The economic arguments around migration are highly complex and often country-specific – as a discipline in economics is a long way off from resolving all the nuances.



Use the data

'Net migration' is the difference between immigration and emigration – an annual net migration of 100,000 indicates that 100,000 more people immigrated into a country than emigrated.

1. When did immigration figures begin to consistently overtake emigration figures?
2. Estimate net migration into the UK in the years (using a ruler might be helpful)
 - (a) 2006
 - (b) 1979

The working age population consists of those people aged 16–64. Looking at Figure 2, estimate the working age population in 2015.

3. Suppose one million migrants aged 20–29 came to the UK and gained employment. What would be the effect on the labour force participation rate?
4. Now suppose that the birth rate and death rate remains constant, and no more migrants come to the UK. What would the labour force participation rate be like after 50 years?

Test your knowledge...

'Net migration' is the difference between immigration and emigration – an annual net migration of 100,000 indicates that 100,000 more people immigrated into a country than emigrated.

1. Estimate net migration into the UK in 2010.
2. Briefly describe the trend in net migration from 1964–2014.
3. State and explain two other factors that can increase LRAS, aside from demographic change.

Extended-response question

1. Using information from the extract and your own knowledge, evaluate the extent to which migration is an effective way of encouraging higher levels of migrant workers.

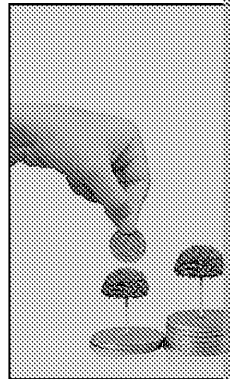
**COPYRIGHT
PROTECTED**



Investigating the Multiplier Effect

This case study requires knowledge of Section 3.2.2.4 – aggregate demand and the multiplier. You should be familiar with the idea of withdrawals and injections from the circular flow of income. You may also have looked at fiscal policy as well.

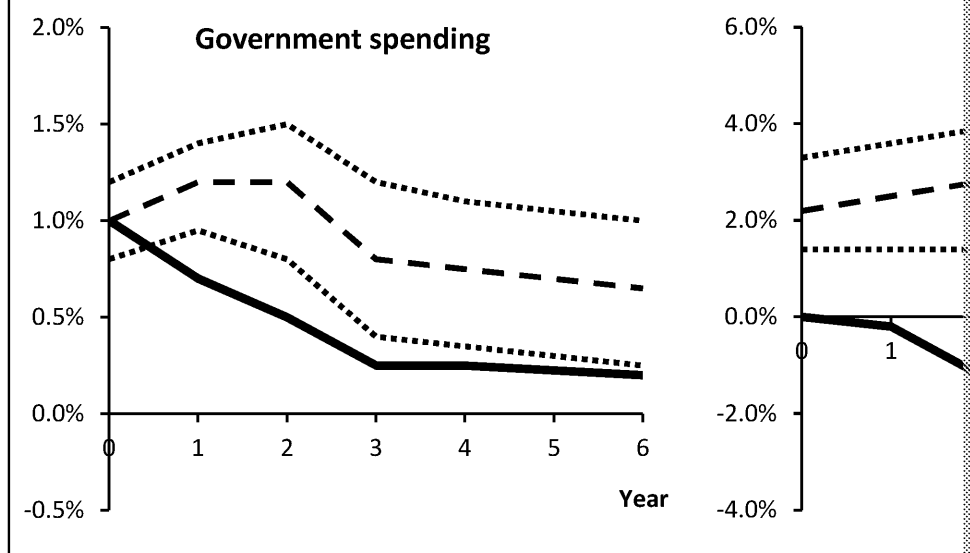
The idea of the multiplier effect in economics is quite simple in theory. When there is an injection of money into the economy (such as through government spending, or through spending by foreign tourists), the overall effect on the economy can be greater than the size of the initial injection. This is because when one person's income increases, they then spend that money, which increases the income of others, and so on, until the money is withdrawn.



Since the financial crisis, there has been a renewed interest in estimating the multiplier. It is not clear whether large fiscal expansions could be a good solution to the crisis. In particular, the size of the multiplier has proven to be very difficult to estimate. Many studies over the years have tried to quantify the size of the multiplier – but they often produce very different results. Recent research suggests that the size of the multiplier depends crucially on whether the economy is in a recession or not.

The following graphs, from IMF research, show the effect of a 1% increase in government spending on several key macroeconomic variables over time. The bold line represents the effect on output, accounting for the state of the economy. The middle dashed line shows the effect on investment, and the other two dotted curves show the 'upper and lower bound' estimates of the effect in a recession, so we can be confident that the actual effect is somewhere between these lines.

Figure 1: the multiplier effect: change in variable after a 1% increase in government spending

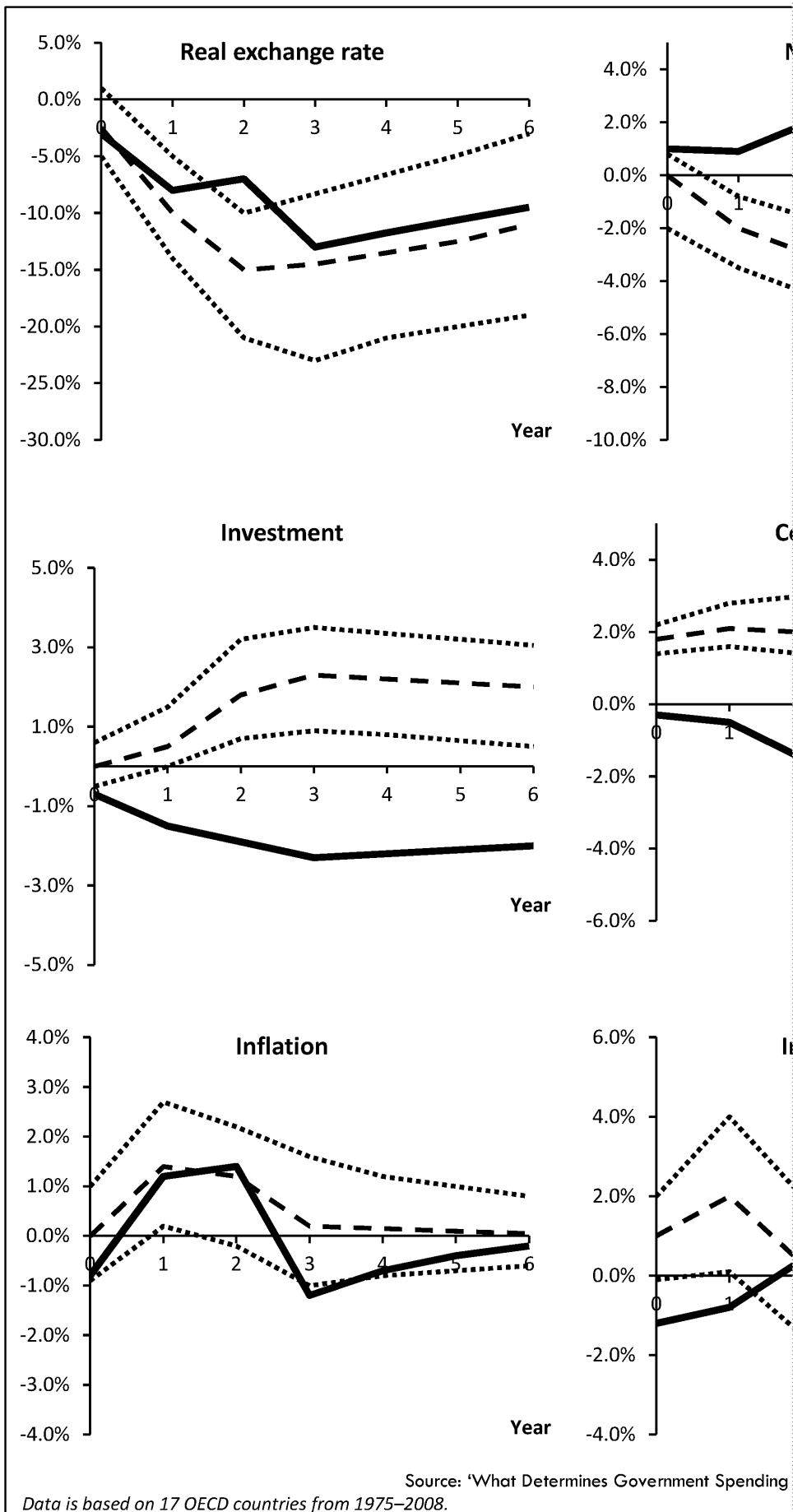


INSPECTION COPY

**COPYRIGHT
PROTECTED**



**COPYRIGHT
PROTECTED**



So, for example, the output (or GDP) graph indicates that when the economy increases in government spending will increase output by around 2%. Thus, in the baseline case, the multiplier is estimated to be 0: this means that government spending has no effect on output!

The results seem to confirm that governments should seek to inject money during a recession. Part of the problem in the recent recession was that banks were short of 'liquidity' – so more government spending could help to alleviate this. A counterargument to this is that it increases the amount that the government has to spend, which is unsustainable. This suggests that it would be a good idea for governments to spend more during economic booms, so they can afford to spend more during recessions.

Use the data

1. Look at Figure 1. Suppose government spending increased by £1.5 billion. What is the predicted change in consumption after two years, under the following?
 - (a) The standard recession scenario
 - (b) The higher estimate of the recession scenario
 - (c) The lower estimate of the recession scenario
 - (d) The baseline case
2. Can you think of one reason why the real exchange rate falls (depreciates) as government spending increases? (Hint: look at the effect on inflation.)
3. Can you explain why, in the baseline case, investment is expected to fall?

Test your knowledge...

1. Use a diagram to explain why an increase in government spending is expected to increase output in the short run.
2. Look at the graph showing the change in output. Compare the trend for the recession case with the trend for the expansion case.
3. Explain what is meant by the accelerator process.

Extended-response question

1. Suppose a government wanted to help the economy out of recession by raising government spending. Using your knowledge of injections, withdrawals and the multiplier, explain the effectiveness of this policy.

**COPYRIGHT
PROTECTED**



Patterns in the Business Cycle

This case study requires knowledge of Section 3.2.3.1 – economic growth

Virtually all modern economies experience fluctuations in GDP growth around trend growth, known as business cycles (or trade/economic cycles). This is where the economy follows a pattern of boom, downturn, boom, downturn, and so on. Numerous possible explanations for this phenomenon have been posited, including:

- Bubbles in markets (e.g. housing markets)
- The multiplier effect
- The accelerator effect (this is the idea that changes in national income result in greater than proportional changes in investment)
- External shocks from innovation
- Economic policies by governments
- Stock/inventory cycle – companies accumulate stocks of goods during booms, then scale back their production, amplifying the business cycle

Economists still disagree about the exact causes of business cycles, and how to manage them (or, indeed, whether they should try to affect them at all or just let them run their course). Gordon Brown, as Labour chancellor, famously promised to tackle 'boom and bust' but was unable to prevent the recession following the 2008 financial crisis.

It is worth noting that slumps in the business cycle (or downturns) usually result in a fall in GDP growth, rather than actual negative growth (recession – two consecutive years of negative GDP growth). As Figure's 1 and 2 show, negative GDP growth is relative to the previous year. Figure 1 shows that the actual pattern of business cycles is quite variable: they aren't always the same. Figure 2 shows that the actual pattern of business cycles is quite variable: they aren't always the same. Figures 1 and 2 are sometimes presented to be in textbooks!

Some economists argue that the effect of 'automatic stabilisers' is sufficient to dampen economic growth. In booms, tax revenues go up and welfare spending falls, dampening economic growth. In downturns, tax revenues fall and welfare spending rises, which occurs during slumps, prompting the government to fund expenditure by borrowing. These effects occur automatically, without additional government interference.

Other economists argue that automatic stabilisers are insufficient, particularly during a recession. Expansionary fiscal and monetary policy is needed in these situations. These policies are sometimes referred to as 'Keynesian', as John Maynard Keynes advocated in certain cases to help return an economy to full employment.

INSPECTION COPY

**COPYRIGHT
PROTECTED**



Figure 1: UK's annual growth rates of GDP

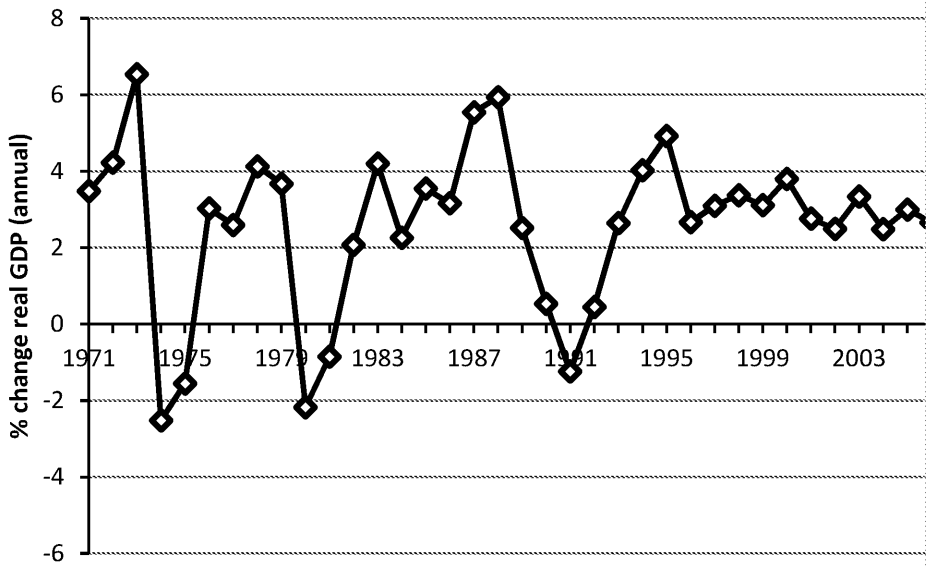
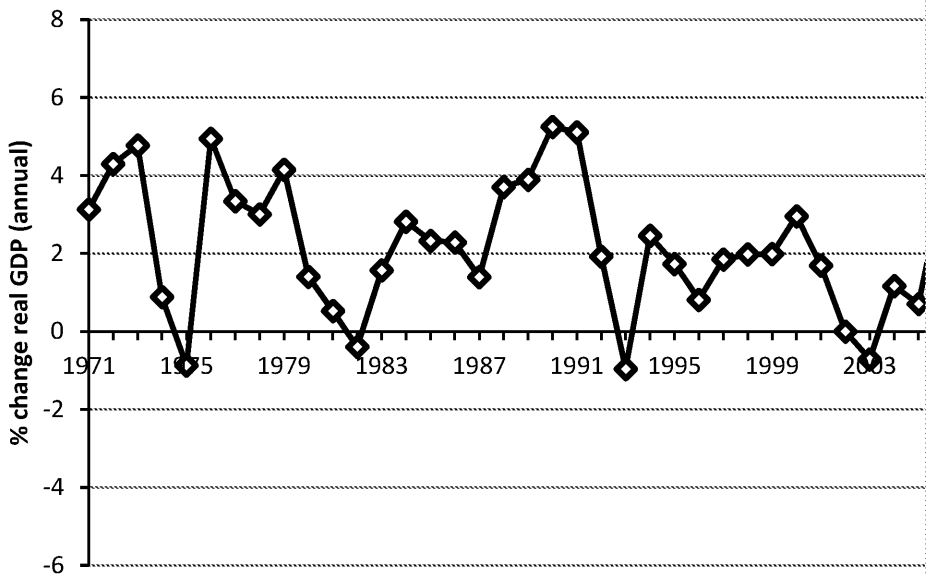


Figure 2: Germany's annual growth rates of GDP



Use the data

1. Identify a period during which GDP growth was fairly stable for both the UK and Germany.
2. Using Figure 1, estimate the average annual GDP growth rate of the UK over the period 1971-2003.

Test your knowledge...

1. Describe the trend in GDP growth in the UK during the 1980s.
2. Use a classical AD/AS diagram, with a SRAS, to illustrate the type of output gap that exists:
 - (a) At the peak of a boom
 - (b) At the trough of a downturn
3. Explain the difference between short-run and long-run economic growth.

Extended-response question

1. Assess the costs and benefits of economic booms.

**COPYRIGHT
PROTECTED**



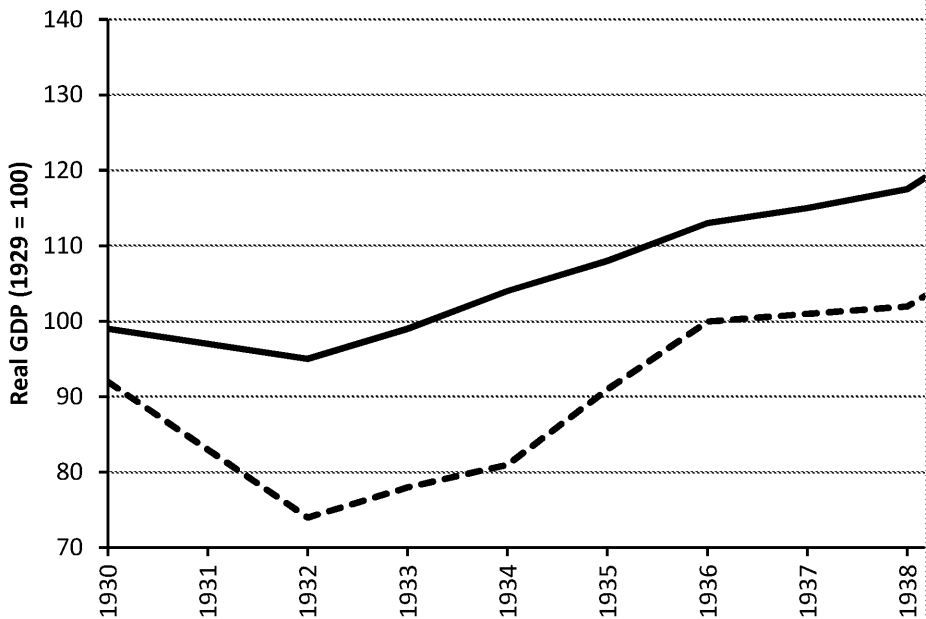
Monetary and Fiscal Policy in the Great Depression

This case study requires knowledge of Section 3.2.4 – macroeconomics

The Financial Crisis of 2008 was a global economic disaster, but it is still dwarfed by the Great Depression of 1929. The Great Depression was particularly damaging for the UK, which also had its fair share of economic misery. The episode provides a unique opportunity to study the effects of demand-side policies in an economic downturn. Figure 1 shows real GDP in the UK and US during the Depression:

INSPECTION COPY

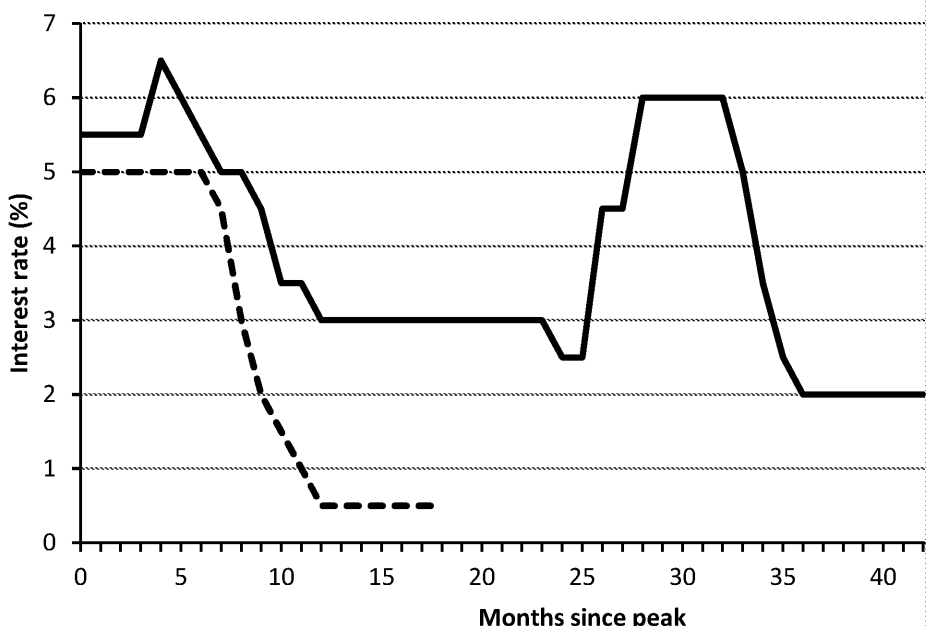
Figure 1: UK and US real GDP 1929–1940



Source: Middleton, (2010), 'British monetary and fiscal policy in the 1930s'

So what was the UK's monetary policy response to the Depression? Figure 2 shows the Bank of England's monetary policy: the interest rate.

Figure 2: Bank of England interest rates in the Great Depression (1929) as a percentage of the 1929 level



Source: Almunia et al. (2009), 'From Great Depression to Great Credit Crisis'

**COPYRIGHT
PROTECTED**



It is interesting to note that interest rates were cut much more rapidly during the 2008 crisis than in the Great Depression (this is *expansionary* monetary policy – lowering interest rates should boost aggregate demand). In fact, the central bank increased interest rates in 1931. The reason for this was that the UK was trying to protect the value of its exchange rate, which at the time was tied to the Gold Standard. Decreasing interest rates in this environment would have meant that the pound would depreciate, so more pounds would have been needed to buy the same amount of gold (which would put the UK at a disadvantage with its neighbours). When the UK finally abandoned the Gold Standard in late 1931, the interest rate could safely be cut. This led to a depreciation of the pound, boosting the UK's competitiveness and hence aggregate demand.



In terms of fiscal policy, the government sought to correct the budget deficit by cutting unemployment benefits and raising taxes. These are *contractionary* policies that slow down the economy. Nevertheless, the economy did recover quite quickly. One theory is that because these policies were accepted at the time as 'the right thing to do', people were able to restore confidence in the markets. Another possibility is that the monetary policy was enough to counteract the contractionary effects of fiscal policy. There are similarities to be drawn between the UK's response here and the response to the Financial Crisis.

However, economists should be cautious of drawing too many conclusions from the experience of the Great Depression. The complexity of the situation and the effect of any one policy on economic growth is almost impossible to measure. The economy was structured quite differently back then. For example, the budget deficit in 1931 was small relative to the budget deficit seen in 2007. Failing to learn from history and drawing false analogies could be just as bad.

Use the data

1. In which year did the US economy recover to its 1929 levels of GDP?
2. What is the (technical) definition of a recession? Was the UK in a recession during the 2008 Financial Crisis?
3. From Figure 2, how long did it take for the UK interest rate to fall from 5% to 1% during the 2008 Financial Crisis?

Test your knowledge...

1. Approximately how much larger (in percentage terms) was the UK economy in 2008 compared to 1929?
2. (a) Show the effect of a fall in the interest rate on AD using an AD/AS diagram.
(b) Explain two reasons why the fall in interest rates has this effect on AD.

Extended-response question

1. Evaluate the effectiveness of using demand-side policies to stimulate economic growth during the 2008 Financial Crisis.

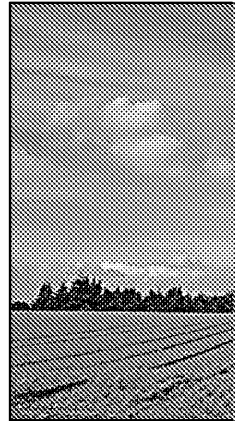
**COPYRIGHT
PROTECTED**



Supply-side Policies – Privatisation

This case study requires knowledge of Section 3.2.4.3 – supply-side policies

Supply-side policies, such as improving health and education, aim to increase the productive capacity of the economy. This allows for greater long-term economic growth. One of the larger (and more controversial) supply-side projects in the UK was the privatisation of nationalised industries in the 1980s and 90s.



The idea behind privatisation is that it enhances competition in the market, increasing efficiency, as private firms (motivated by profit) run themselves more efficiently than the government can. In the UK, examples of industries that have been privatised include the steel, telecoms, electricity and gas industries (and more recently, water and rail).

Figure 1 charts labour productivity in the electricity sector before and after a UK-wide industry index:

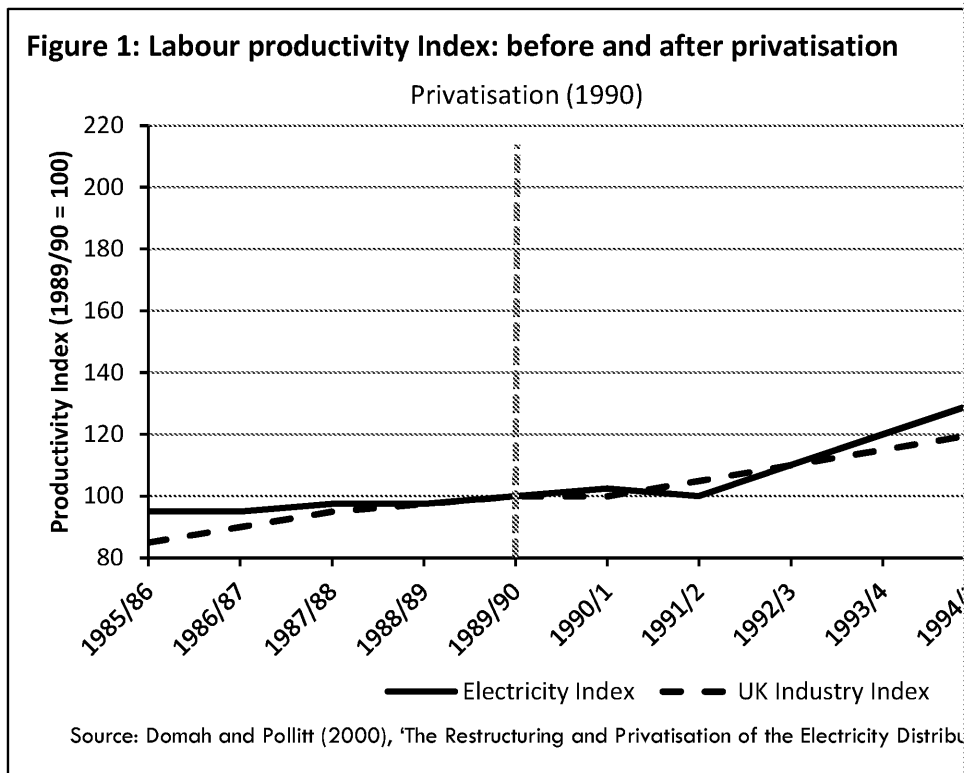


Figure 1 does seem to indicate that privatisation had a positive effect on labour productivity in the electricity sector. Some argue that this is due to reductions in employment following privatisation (as private firms automatically increase labour productivity, ceteris paribus). Supporters of privatisation argue that the loss of employment in specific industries is offset by gains in employment in other sectors.

There was fierce opposition to privatisation at the time, causing deep divisions in the Labour Party. Critics argue that privatisation has failed, because market power has become concentrated in a few hands, undoing any initial efficiency gains from competition (critics argue that the electricity sector in particular, where a small number of firms dominate the market).

INSPECTION COPY

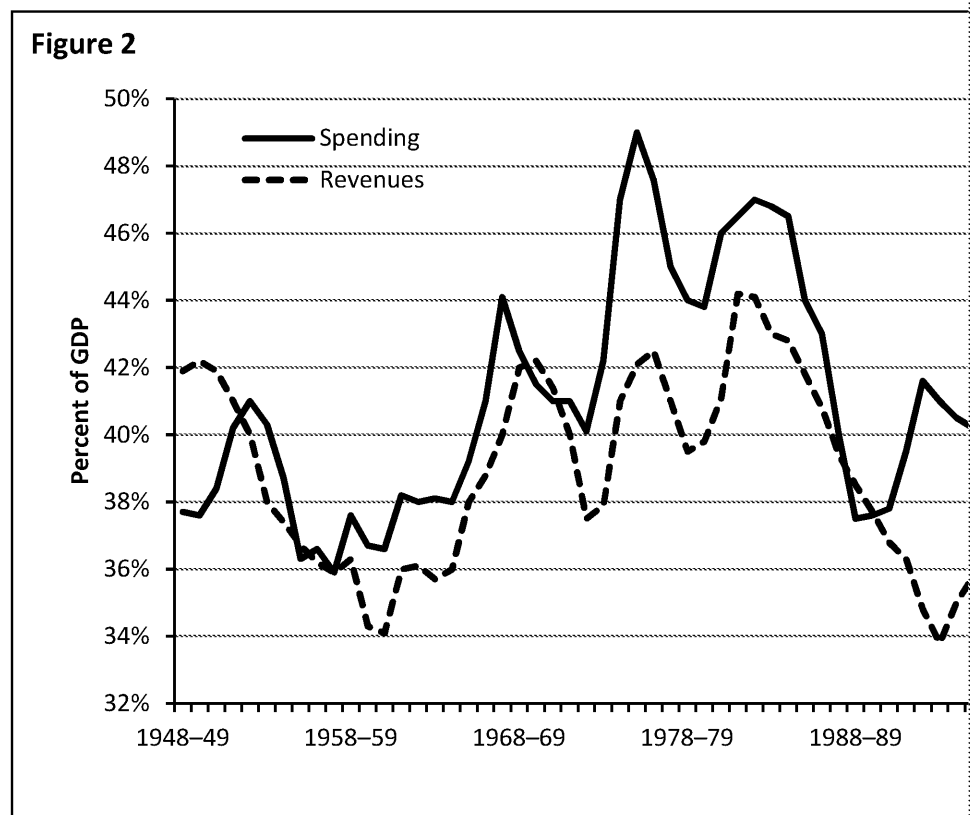
**COPYRIGHT
PROTECTED**



Studying the effects of privatisation is difficult, because it's hard to tell whether downturns in industries would have happened anyway if there had been no privatisation was the cause of these changes! Most economists agree, though, that privatisations are maximised when there is a genuine competition in the industry.

The next question on this issue will be how far the NHS will move toward privatisation to depend on whether the current system can continue to support an ageing population and whether supporters of privatisation can persuade the public that it won't be profiting from people's ill health.

Figure 2 shows the pattern of government spending and tax revenues over the period 1948–89.



Use the data

1. How much higher was the productivity of labour in the electricity sector in 1991 than in 1981, when privatisation was first introduced?
2. Look at the pattern of government spending during the 1980s in Figure 2. Is it increasing or decreasing? Why?
3. Look at Figure 2. What can you infer about the UK's tax rates during the 1980s?

Test your knowledge...

1. From the passage, identify one potential benefit and one potential cost of privatisation.
2. Show the effect of a successful supply-side policy on an AD/AS diagram.

Extended-response question

1. 'Governments should focus more on supply-side policies than demand-side policies'. Discuss this statement. How do you think supply-side policies can increase long-term economic growth?

**COPYRIGHT
PROTECTED**



When will the UK raise interest

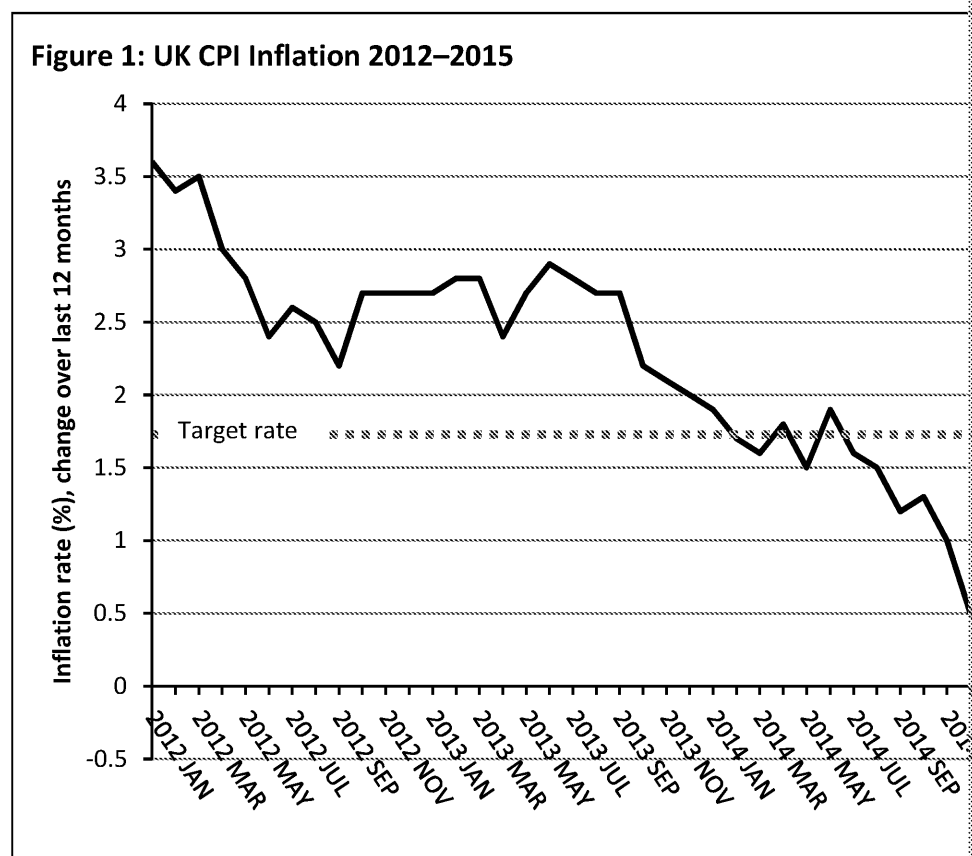
This case study covers a range of AS Macro topics

Interest rates are one of the key tools central banks use to guide the economy in the right direction. The Bank of England's Monetary Policy Committee meets every month to decide whether or not to change interest rates. In the UK, interest rates have been at a historic low of 0.5% since March 2009. Financial commentators have been continually pushing back their predictions of when rates will finally go up again.

In Japan, interest rates fell to -0.1% in January 2016 to try to stimulate growth, but the US seems more optimistic: the Federal Reserve inched up the US's interest rate in December 2015. The UK seems to have recovered from the recession, so why haven't interest rates gone up here as well? Mark Carney – the Canadian-born go – is concerned about an array of economic risks facing the country in 2016

The main worry is that a combination of low oil prices and a fall in China's that the global economy will have a weak year. The UK is highly integrated (more so than the US), so it will certainly be affected by an economic slow

Another factor is the inflation rate. Traditionally, monetary policy is designed to target a stable, positive rate. As Figure 1 shows, the UK has seen unusually low in years.



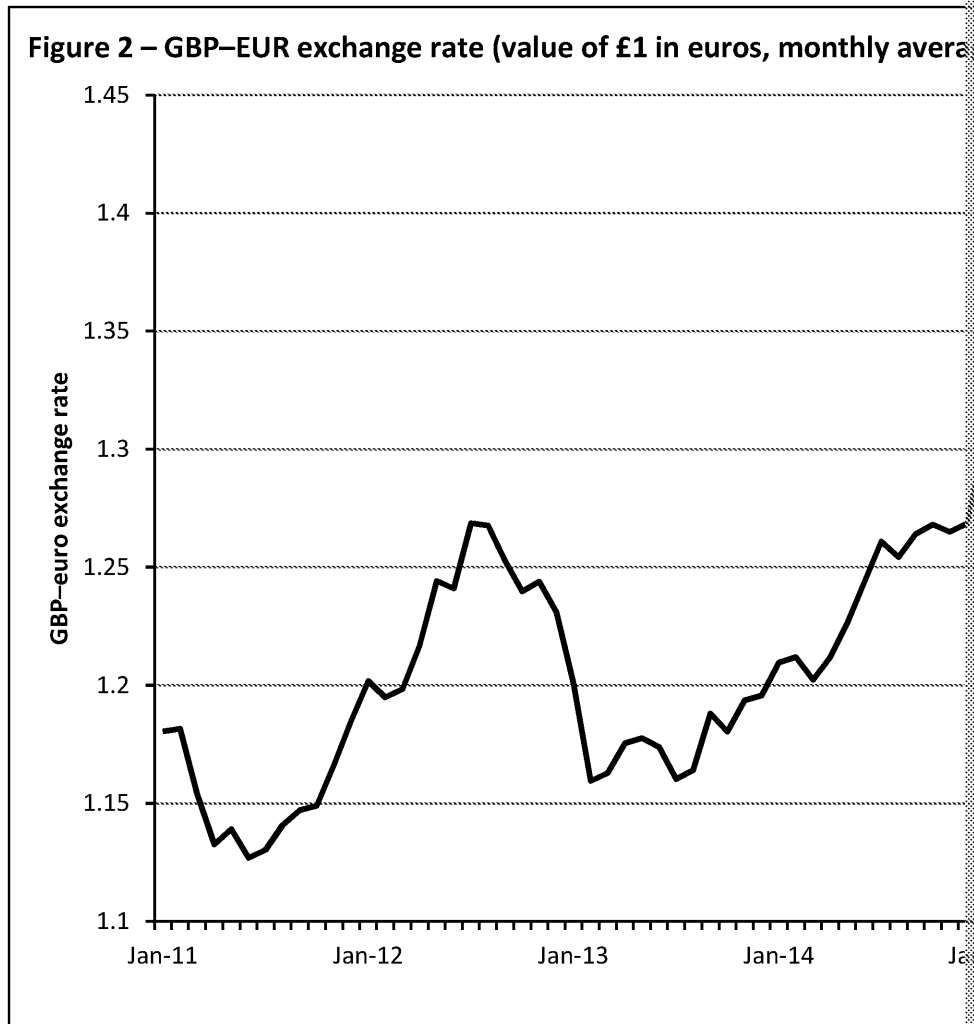
It is feared that if interest rates are hiked too soon, the result could be defl

INSPECTION COPY

**COPYRIGHT
PROTECTED**



Related to this is the UK exchange rate (see Figure 2). The pound was relatively stable until 2012, but it has been falling because of uncertainty about the UK's referendum on EU membership.



There is another difference between the UK and US economies that may affect exchange rates: fiscal policy. In the UK, the government is pursuing contractionary fiscal policy, which has led to a large budget deficit. The US, in contrast, has relatively expansionary fiscal policy, which has led to a large budget deficit.

Use the data

- Which of the following terms best describes the trend in Figure 1: (a) disinflation, (b) stagflation, or (c) deflation?
- Explain why deflation might be damaging for an economy.
- Suppose the GBP–EUR exchange rate is 1.15 (as in early 2013). In this case, how many euros can you buy with one pound?

Test your knowledge...

- Give two reasons why the UK inflation rate might have been falling (Figure 1).
- Explain how an increase in the interest rate would be expected to affect the exchange rate.
 - Explain the main consequences of the change in the exchange rate for the UK economy.

Extended-response question

- Assess the effectiveness of lowering interest rates to stimulate economic growth.

INSPECTION COPY

**COPYRIGHT
PROTECTED**



Answers

Mark scheme: extended-response questions

10 marks

Knowledge (2), application (2) and analysis (2)		
	0	No relevant answer given.
Level 1	1–2	A few concepts may be identified correctly, but inconsistently, and with little thought behind the causes and effects.
Level 2	3–4	Some knowledge of economic concepts is shown, partially linked to the relevant reasoning skills, but may focus too much on one side of an argument.
Level 3	5–6	Knowledge of the economic concepts is very accurate. Links to the question are provided with relevant examples. Analysis is well reasoned and logical, and appropriate for the question.
Evaluation (4)		
	0	No evaluation.
Level 1	1–2	Limited attempt at evaluation – may be only loosely related to the question.
Level 2	3–4	Accurate, balanced evaluative comments are made, supporting a rounded argument directly to the question.

15 marks

Knowledge (3), application (3) and analysis (3)		
	0	No relevant answer given.
Level 1	1–3	A few concepts may be identified correctly, but inconsistently, and with little thought behind the causes and effects.
Level 2	4–6	Some knowledge of economic concepts is shown, partially linked to the relevant reasoning skills, but may focus too much on one side of an argument.
Level 3	7–9	Knowledge of the economic concepts is very accurate. Links to the question are provided with relevant examples. Analysis is well reasoned and logical, and appropriate for the question.
Evaluation (6)		
	0	No evaluation.
Level 1	1–2	Limited attempt at evaluation – may be only loosely related to the question.
Level 2	3–4	Clear evidence of evaluative comments, though they may be unfairly weighted. Reasoning / supporting evidence is provided but may be incomplete.
Level 3	5–6	Accurate, balanced evaluative comments are made, supporting a rounded argument directly to the question.

20 marks

Knowledge (4), application (4) and analysis (6)		
	0	No relevant answer given.
Level 1	1–3	A few concepts may be identified correctly, but inconsistently, and with little thought behind the causes and effects.
Level 2	4–6	Some knowledge of economic concepts is shown, partially linked to the relevant reasoning skills, or basic reasoning skills.
Level 3	7–10	Good knowledge of the relevant economic concepts is displayed, linked to the relevant evidence to support the main arguments. Analysis is well developed on one side of an argument.
Level 4	11–14	Knowledge of the economic concepts is very accurate. Links to the question are provided with relevant examples. Analysis is well reasoned and logical, and appropriate for the question.
Evaluation (6)		
	0	No evaluation.
Level 1	1–2	Limited attempt at evaluation – may be only loosely related to the question.
Level 2	3–4	Clear evidence of evaluative comments, though they may be unfairly weighted. Reasoning / supporting evidence is provided but may be incomplete.
Level 3	5–6	Accurate, balanced evaluative comments are made, supporting a rounded argument directly to the question.

INSPECTION COPY

**COPYRIGHT
PROTECTED**



Case Study 1: Economic growth in the UK – back to business as usual?*Use the data*

1. 2.5% (accept 2–4%)
2. Nominal GDP figures do not account for the effect of inflation, so GDP figures appear positive in the UK). Therefore, the GDP growth figures would be higher (also the reverse). Visually, the graph would appear to have shifted up.
3. USA's GDP growth is given as 2.4% in the text, so from a starting point of \$17 trillion (17×102.4) / 100 = \$17.408 trillion.

Test your knowledge...

1. GDP is the total value of output (or goods and services) produced in an economy (with the effect of inflation removed) (1).
2. Possible answers include: market confidence, low borrowing costs, low oil price, revenue. 1 mark for each identified factor. You cannot have the expansionary monetary policy. Statement (since this was after 2014).

Extended-response question

1. GDP measures the total value of output in an economy. When you adjust for population and inflation (real GDP) this can give a good impression of the *size* of an economy. However, to compare the *success* of different economies, many important factors are omitted:
 - **Living standards.** It can be more informative to adjust GDP using the concept of PPP to account for different living standards in different countries (PPP should be clearly explained). Accounting for living standards tends to narrow the perceived gap between rich and poor. Rich countries are usually relatively cheap in poorer countries.
 - **Inequality.** Even per capita GDP figures give no indication of the distribution of income. A country can experience rapid economic growth, but this would not benefit the general population if the benefits go to a small elite.
 - **Negative externalities.** GDP only measures the total value of output, it doesn't account for 'bad' output. Economic growth may come hand in hand with environmental damage, such as loss of land for commercial purposes.
 - **Happiness.** Having a higher average standard of living does not guarantee that people are happy. People may end up working excessively long hours and spend less time with their families. While wealth increases happiness up to a point – but increasing wealth beyond that point has little effect. This is notoriously difficult to measure, however.

In your answer you could also make reference to 'composite' indicators such as the Human Development Index (HDI) or the Quality of Life Index (QoL). These take into account a range of factors before comparing countries' performance (with respect to economic development). However, GDP does not account for the size of the 'black economy' (unrecorded or illicit activity) which can vary greatly between countries. A good answer should explain at least two or three of these factors.

Case Study 2: UK inflation in the 1970s*Use the data*

1. Around 27% (in 1975). Accept 26–28%.
2. (a) Inflation fell from around 22% to around 5%, a fall of 17 percentage points (any fall of 15–19 percentage points is acceptable).
(b) This is known as disinflation – a reduction in the rate of inflation (not to be confused with deflation).
3. Inflation in 1970 was around 5%, but increased rapidly to a peak in the middle of the decade of around 7–8% before climbing again towards the end of the decade to around 22%.

Test your knowledge...

1. The passage notes the increase in oil prices and low interest rates (also known as stagflation). The fact that the rate of inflation is high and these factors are present earns 1 mark.
2. Deflation is when the inflation rate is negative, i.e. when prices are falling (1). Inflation is when the inflation rate is positive, i.e. when prices are rising (1).

**COPYRIGHT
PROTECTED**

Extended-response question

- Your answer should explain clearly several costs of inflation, before assessing their (whether inflation can be beneficial in some ways). Possible costs of a high rate of inflation are:
 - Uncertainty.** Consumers might postpone economic activity, given how rapidly prices are changing. Businesses will be unclear about their costs of production, and may have difficulty setting prices (**menu costs**).
 - Shoe-leather costs** (cost to consumers of having to compare prices more often).
 - Reduces value of savings / fixed incomes.** Inflation creates winners and losers. Those who suffer a fall in their wealth, as will those whose incomes do not automatically rise.
 - Possible **wage-price spiral** (if inflation is high, it leads to workers negotiating for higher wages, higher inflation, and so on)
 - Fall in international competitiveness** (inflation is a sign of economic weakness, which reduces investment, and the price of exports appears inflated)

An evaluative point you could make is that the costs depend on how high the rate of inflation is (higher and more prolonged periods of inflation are more damaging).

As another evaluative point you could explain that a low and stable rate of inflation is good since it acts as a gentle encouragement for people to spend money (which boosts economic growth).

Case Study 3: Venezuela's inflation problem*Use the data*

- Peru
 - 1.7%
 - Correct answers include Mexico, Peru, Ecuador, Bolivia and Uruguay. By consistently having a lower rate of inflation in each year than the last.

Test your knowledge

- Inflation is the rate of change of (or a sustained increase in) the price level. (1)
- An increase in the money supply by the government / central bank. (1)
 - Causes of inflation are usually divided into 'demand-pull' and 'cost-push' factors. Demand-pull factors include an increase in any of the components of AD (consumption, investment, government spending, exports). Cost-push factors could include increases in wage costs or input costs, or a fall in aggregate supply (if the population loses confidence in the currency).
1 mark for each identified factor (plus brief explanation, e.g. increase in consumption leads to an increase in demand, which leads to inflation)
- One way to look at this is that high inflation is expected to lead to a depreciation of the domestic currency. Domestic goods become less competitive (fall in demand for the currency), and foreign goods become more competitive (increase in supply of the currency): this leads to a fall in the exchange rate. (1)
In a similar way, a depreciation of the currency is expected to lead to inflation, because domestic goods become more expensive (imported inflation). (1)

The relationship between inflation and exchange rates is complex, because both depend on many factors. You should at least be aware that high inflation is associated with depreciation.

Extended-response question

- Benefits of inflation** – When inflation is controlled and stable, it can be argued that there are several benefits. One argument is that it erodes the cost of repaying debts – so it could be beneficial to consumers (e.g. if I owe you £100, then there is high inflation, then when I pay you back £100 it is worth less). Another could be argued that low, but positive inflation helps wages to adjust, encourages saving, and is important – avoids the risk of deflation (which can be very damaging). A stable rate of inflation also helps confidence in the stability of an economy and its currency, which can increase economic growth and higher investment from abroad.

**COPYRIGHT
PROTECTED**

Case Study 4: UK unemployment – successes and challenges

Use the data

1. The main explanation is that the claimant count ignores those who are unemployed but do not claim unemployment benefit for various reasons (e.g. too much hassle to claim, don't like the stigma of claiming unemployment benefit).
2. 55% of 60 million is 33 million (size of the labour force). Figure 2 tells us that the male unemployment rate was around 6%, so that means that 1.98 million men were unemployed (6% of 33 million).
3. The graph shows that male employment rates are higher than female employment rates, with the gap narrowing over time (the gap in 1990 was roughly 20 percentage points, in 2015 the gap was roughly 10 percentage points). The gap could be explained, for example, by the fact that women are more likely to be employed in part-time or care for children. The narrowing of the gap seems to be down to greater employment opportunities for women, while male employment has remained fairly steady, perhaps due to a shift in societal attitudes.

Test your knowledge...

1. Economically active people are those that are either working (employed) (1) or looking for work (unemployed) (1). The number of economically active people is the same as the size of the labour force. You need to mention both people counts as economically active to get the full two marks.
2. Possible answers include: structural unemployment, demand deficiency / cyclical unemployment, frictional unemployment. 1 mark for explaining how it works.

Extended-response question

1. Your answer should discuss the significance of several consequences of unemployment and economic costs.

Possible **economic** consequences include:

- Fall in tax revenue and/or increase in unemployment benefit spending (which increases the budget deficit). This has knock-on effects on the economy: it could lead to a rise in government spending in other areas.
- Loss of economic growth (lower output/GDP due to less work, plus fall in consumption).
- Costs to the unemployed themselves: economic costs (lower living standards, loss of skills). Could mention that the longer someone is out of work, the more difficult it is to get back into work. There are fears in countries such as Spain and Italy of a 'lost generation', since young people are not gaining the skills and experience they need to get back into work.

Social costs include crime and various health problems.

Case Study 5: Should we be worried about the UK's current account deficit?

Use the data

1. (a) Secondary income (or net international transfers)
(b) Primary income (or net investment income). Despite the fall in the deficit in 2015, the current account balance has been clearly downwards.
2. (a) £49.6 billion (3.1% of 1,600 billion)
(b) £94.5 billion (5.4% of 1,750 billion)

Test your knowledge...

1. (a) This would represent an improvement in the net investment income balance – the current account balance would improve (i.e. become closer to a surplus). 1 mark for improvement in net investment income, 1 mark for current account balance improvement.
(b) Since the extract states that the UK is a net importer of oil, an increase in oil prices would be worsening the net trade component of the current account balance (i.e. greater cost of imports, 1 mark for worsening of current account balance).

An alternative answer could be: rising oil prices may reduce the demand for oil imports (1), which may lead to no effect on the current account (or a small improvement). However, this may not be the case since oil is a necessity in most countries (1) and the inelasticity of demand.

**COPYRIGHT
PROTECTED**



Extended-response question

- The main benefit of this strategy is that it should boost the amount of exports from (ceteris paribus). This strategy is likely to be more successful if it focuses on an industry that is well in. A good answer should explain this clearly, before discussing some of the potential costs:
 - Opportunity cost involved
 - Possible x-inefficiency (from micro-problems with subsidies reducing the efficiency of production)
 - If other countries are more competitive in these markets, this strategy may not allow the UK to compete with countries such as China, which benefit from low unit labour costs.

Other evaluation points you could mention include: success depends on the world economy and the initial size of the export sector receiving the investment.

You should come to a conclusion as to whether you think the policy would be successful (and if so, which it would / would not be successful). You can be for or against the idea, providing reasons.

Case Study 6: The UK's slump in consumption during the recession*Use the data*

- This data is in real terms – you can tell because 2008 is used as the base year (this means that 2008 = 100 relative to 2008).
- The index in 2009 Q3 is at about 93 – this indicates a fall of 7% from 2008 Q3. 6–8% is acceptable.
- This is a bit of a trick question – you can't tell from the graph which type of spending was most affected. The actual amounts of spending involved – only the percentage changes (Note: questions about the graph are not asked).

Test your knowledge...

- $AD = C + I + G + (X - M)$. Answers in symbols or words are both acceptable.
- Household spending fell from a peak of around £225 billion in 2007 Q4 to a low of around £211 billion in 2009 Q2, a fall of about £14 billion. Answers between £13 and £15 billion are acceptable.
- Diagram should show a shift to the right in aggregate demand: this is because a fall in VAT (which is a tax on consumer goods) encourages consumption (the main component of AD). Up to 2 marks for correct labelling, up to 2 marks for showing the shift correctly.

Price
Level
(£)


Extended-response question

- A good answer must explain how both interest rates and consumer confidence can be used to boost consumption.

Interest rates: A fall in the interest rate makes saving less attractive and borrowing more attractive, which increases consumer spending. You could also explain how it increases investment (businesses invest in interest-bearing assets), and potentially how it affects net trade (low exchange rate, since it becomes less attractive for foreign investors to save here. This means exports rise – boosting aggregate demand).

Consumer confidence: If consumers are confident about the outlook for the economy, they will spend more, leading to healthy levels of spending. The same goes for business confidence and investment.

Both are clearly important elements of a strategy to boost consumption. However, there are several points that can be made:

- Interest rates (usually) can't go below zero. Since the current rate of 0.5% is so low, there are limited options for further rate cuts.
- Consumers may want to save no matter how low interest rates are if they believe the economy is in a long-term slump.
- Changes in interest rates have a delayed effect on aggregate demand (time lag).
- Consumer/market confidence cannot be directly controlled by the government. It depends on public perceptions of how well the economy is doing, and how competent the government is.

A good conclusion should note that both of these factors are important in determining the success of a strategy to boost consumption. It is part of a wider approach to tackling the problem (i.e. they won't be nearly as effective if used in isolation). You should make an argument that one factor is more important than another, as long as it is valid.

**COPYRIGHT
PROTECTED**



Case Study 7: The economics of immigration*Use the data*

1. Around 1983 (emigration exceeded immigration in one or two years after that, but rule).
2. (a) Around 200,000 (accept 175,000–225,000)
(b) Around 0. (accept –25,000–25,000)
3. The labour force participation rate would increase.
4. The labour force participation rate would worsen, as the ‘bulge’ from the migration (retire).

Test your knowledge...

1. Immigration was roughly 590,000 and emigration was roughly 340,000, so net migration answer between 225,000 and 275,000 is acceptable for 1 mark.
2. Between 1964 and the mid 1980s, net migration was usually small and negative. Did to climb at a faster rate than emigration, and net migration became positive and large period of negative net migration, 1 mark for identifying period of positive net migration.
3. Possible answers include:
 - Technological advance
 - Improvements in productivity
 - Improvements in education and skills (human capital)
 - Regulatory changes / competition policy changes

Other answers are possible so long as they are well justified: 1 mark for stating each can increase LRAS.

Extended-response question

1. There are several points in the article that you can mention, both for and against that include:
 - Increasing size of the labour force (evaluation point: more effective in countries more of a problem, e.g. Japan)
 - Bring broader range of skills (e.g. technical skills, language skills) – boost to human capital depends on skill composition of migrants)
 - Migrants may be harder workers or contribute disproportionately towards income of native workers (e.g. NHS. Evaluation point here is that migration is more beneficial to fill shortages either generally, or in specific sectors.)
 - Potential to foster better trade relations between sending/host countries

Points against could include:

- Overcrowding / undesirable population growth (evaluation point: particularly in countries with shortage of housing supply such as the UK)
- Diminish labour market opportunities for native workers through lower wages (evaluation points: only applies when there is a shortage of jobs to begin with, could be mitigated by migrants)
- ‘Brain drain’ effect from sending countries (when countries lose their best and brightest and remittance payments back to families)

Although they are not direct economic issues, you could also point out potential social issues that could arise from migration. This could be mitigated by government policies to integrate migrants. You can draw an AD/AS diagram to show the increase in AS from migration (and a possible decrease in AD). You can be either for or against the policy in your conclusion, but for Level 3 evaluation you need to provide contexts in which the policy could be successful/unsuccessful.

**COPYRIGHT
PROTECTED**

Case Study 8: Investigating the multiplier effect*Use the data*

- Answers can be within £0.5 billion of the answers stated here:
 - $1.5 * 2 =$ increase of £3 billion
 - $1.5 * 3 =$ increase of £4.5 billion
 - $1.5 * 1 =$ increase of £1.5 billion
 - $1.5 * -1.8 =$ decrease of £2.7 billion
- Increasing government spending is predicted to cause inflation due to a shift to the cheaper and exports more expensive, reducing the demand for domestic goods (the domestic currency) which causes the exchange rate to depreciate.
Another possible reason is that government spending crowds out private investment abroad, depreciating the exchange rate.
- The idea here is that government spending ‘crowds out’ private investment (i.e. reduces investment opportunities available to the private sector), decreasing investment.

Test your knowledge...

- Government spending increases the G component of AD, shifting AD to the right. This should lead to inflation using the standard AD/AS framework. Note that using a Keynesian LRAS curve is equally valid. 2 marks for correct labelling, 2 marks for showing shift in AD and resulting increase in inflation. Price Level
- The trend for the baseline case is that output falls over the first two years, before slowly reverting back to normal. The trend for the recession case is the complete opposite: output increases (initially at 2%), before gradually falling after two years. 1 mark for correction description of each trend.
- The accelerator process is when an increase in GDP leads to a greater than proportionate increase in investment. (1) Remember, this is a different concept to the multiplier effect.

Extended-response question

- Taxes represent a withdrawal from the national flow of income, so raising taxes is like a multiplier. So, even if government spending increases, the total effect on the economy could use an AD/AS diagram to show that raising taxes is likely to shift AD to the left (investment, depending on the type of tax).

On the plus side, you could argue that the boost from government spending would be particularly if the higher taxes were well targeted, or increased only slightly (so that not so dramatically). If the national debt or budget deficit was particularly high, you could see this as a sensible policy, inspiring market confidence.

Evaluative points could be that there is a time lag between raising taxes and seeing the effect. This policy wouldn't help fix the recession until further into the future (it may worsen the recession) that it might make more sense for the government to borrow the money, and repay it later (since borrowing money is likely to withdraw less from the economy than extending the loans).

You can conclude that the policy would be successful or unsuccessful, so long as it is consistent with the article and standard theory, the evidence seems to suggest that it would be unsuccessful.

Interestingly, raising taxes in a recession was one of the policies implemented by the US during the Depression in the 1930s – and the general consensus is that the policy was disastrous.

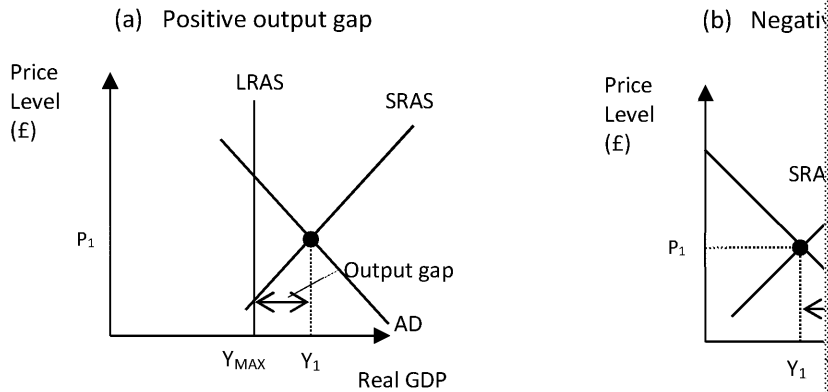
Case Study 9: Patterns in the business cycle*Use the data*

- The mid 1990s to early 2000s seems to be the most stable (continuing into the mid 2000s) period of stability in the USA, leading to some economists speculating that the natural rate of interest had changed. They seem to have been proved wrong by the volatility seen in the late 2000s.
- The average annual growth rate is 2.3%. This is hard to estimate visually from the graph, but 2% and 3% is a good guess.

**COPYRIGHT
PROTECTED**

Test your knowledge...

- The 1980s was a very volatile decade for growth in the UK (1), with GDP growth sw... 2% in the space of one year in the early part of the decade. Following a recession, (1988 (1) before falling rapidly again.
- In case (a) the economy may be experiencing a positive output gap (it is also accept... maximum, i.e. output gap of zero). In case (b) the economy is likely to be experienc... diagram, 1 mark is for labelling, 1 mark is for drawing the curves in the right places, correct type of output gap. Note that this scenario can also be drawn using a Keyne...



- Short-run economic growth is a temporary increase in output, usually associated with... run growth refers to the trend rate of growth in the economy over a longer period of...

Extended-response question

- The main benefit from economic booms is higher rates of economic growth. Econo... living standards. Booms are also associated with low unemployment, avoiding the... Economic growth should also improve the government's finances as tax revenues in... automatically improving a budget deficit. The country may also benefit from inflow... if interest rates are high.

There are several potential downsides to economic booms, however. Firstly there r... which can have a variety of negative effects on the economy. Furthermore there m... certain markets (e.g. housing). When these bubbles burst, the subsequent recessio... booms may also be associated with environmental damage, depending on which in... To get higher marks you must assess both the benefits and the costs of economic b...

Case Study 10: Monetary and fiscal policy in the Great Depression

Use the data

- 1936 (since the index has returned to 100)
- A recession is defined as two consecutive quarters of negative GDP growth. Figure... recession, as GDP fell consistently from 1930–1932.
- 6 months

Test your knowledge...

- Around 34% larger (index number of 134). 32–26% acceptable.
- (a) Your graph should show a shift to the right in AD. 2 marks for correct labelling (you should show the new price level). 2 marks for showing the shift correctly.
(b) Possible reasons include: higher consumer spending, higher investment, higher net exports. 1 mark for stating the reason, 1 mark for explanation of how it works (e.g. higher consumption and investment because saving is less worthwhile, higher net exports because exchange rate depreciates as fewer people choose to save pounds).

Price Level

COPYRIGHT PROTECTED



Extended-response question

- Your answer should explain how at least two or three demand-side policies can increase economic growth (at least one monetary policy and at least one fiscal policy). You could include an AD/AS diagram to refer to the diagram you drew in Question 2. You should also note some of the drawbacks of each policy. For example:
 - Lowering interest rates should increase economic growth, since it increases the money supply (as explained in Question 2). Evaluation: this is only effective up to a point (in the long run, it will lead to zero), and there may be a time lag between changing the rate and seeing an effect. It may also depreciate the currency, which could be damaging for countries which rely on exports.
 - You could also mention increasing the money supply, which has similar effects to lowering interest rates. However, this could lead to inflation (this is a general criticism of demand-side policies). It could also depreciate the currency.
 - Government spending is an example of fiscal policy that can stimulate growth. Its success may depend on the size of the multiplier. However, this spending may also lead to a rise in the budget deficit / national debt. There may also be a substitution effect. Another potential evaluative point is that government spending could 'crowd out' private investment.
 - Lowering taxes is an expansionary fiscal policy, as it encourages greater economic growth. It depends on the nature of the tax cut (some taxes target particular types of activities). Also, lowering taxes could reduce tax revenues, leading to a worsening of the budget deficit. However, you could argue that it would actually increase tax revenues: Laffer curve).

A general criticism you should mention is that demand-side policies can lead to inflation in the long term. Here, you could note that the rate of inflation may be high if the money supply is increasing or not. You may reason that demand-side policies are best used in normal economic times, since there is more likely to be an output gap.

You don't need to mention all these points to reach a high-level answer. You should mention the most important points in good detail.

Case Study 11: Supply-side policies – privatisation in the UK*Use the data*

- The index shows about 200 compared to 100, so labour productivity is twice as high as in 1970.
- Figure 2 shows a sharp fall in government spending, which is exactly what you would expect from privatisations (since the government is no longer funding these industries). The fall in government spending could be due to the need to do with this, or perhaps to do with the tax cuts under the Conservative government in the 1980s.
- The 1970s shows very high spending and tax revenues as a percentage of GDP. One of the reasons for this during this period (particularly income tax) were significantly higher than they are today.

Test your knowledge...

- The main benefit is any gains from competition (efficiency) (1). The costs identified are the loss of jobs (1), and the divisions in society caused by privatisation.
- Your graph should show a shift to the right by LRAS: 2 marks for correct labelling (including new price level and real GDP levels), 2 marks for showing shift correctly. Keynesian LRAS diagrams are equally acceptable. Price Level

Extended-response question

- Your answer should identify the purpose of each type of policy. For example:

Demand-side policies: used to influence AD, contribute more to short-run economic growth than long-run economic growth, particularly useful in recessions.

Supply-side policies: used to influence AS, essential for long-run economic growth, but often have a long time lag and high short-term opportunity cost.

A good answer should probably reason that it's not a question of choosing one type of policy, but that different types of policies serve different functions, so both are important for economic growth (and that policies are changed all the time). In your answer you could use an AD/AS diagram to illustrate the effects of each type of policy. You could also point out some advantages and disadvantages of specific types of policy (e.g. the effects of tax cuts on the supply side, or the arguments around changing tax rates on the demand side).

**COPYRIGHT
PROTECTED**

Case Study 12: When will the UK raise interest rates?

Use the data

1. The answer is (a) disinflation. This is a reduction (fall) in the rate of inflation. Although deflation (e.g. April 2015), this does not describe the majority of the period.
2. Deflation can reduce economic growth, since the value of money is increasing rather than decreasing. People are encouraged to hold onto money, reducing demand, and potentially leading to further deflation. As a result, GDP growth falls, unemployment increases and tax revenues fall: all of these can contribute to a recession.
3. If £1 = €1.15, then €1 = (1 / 1.15) = £0.87 (rounded to nearest penny). Therefore, €43.50 = £43.48 – £43.50 to allow for rounding.)

Test your knowledge...

1. Possible reasons could include: low aggregate demand (or low components of AD, e.g. falling oil/energy prices, slow wage growth, strong exchange rate (which leads to lower net exports) etc.
2. (a) An increase in the interest rate would be expected to appreciate (strengthen) the pound because it becomes more attractive to save in pounds (1).
(b) An appreciation of the exchange rate would be expected to reduce exports (1). It would also be expected to increase imports (1), since the purchasing power parity effect of this is a worsening of trade balance (or widening of the trade deficit) which could lead to a recession (1). (Mention that this could result in higher unemployment.)

Extended-response question

1. Your answer should first explain how lowering interest rates can stimulate growth (e.g. via increased investment, increase in net exports via depreciation of currency, etc.). You should then discuss the limitations of lowering interest rates alone, based on the passage and your own knowledge. Possible points include:
 - Time lag between changing interest rates and change in other economic variables
 - Zero-lower bound for interest rates (although Japan has broken this unwritten rule)
 - There are situations when lowering interest rates is not enough to kick-start growth, and governments may use other instruments such as quantitative easing, or fiscal policy such as government spending
 - Low interest rates are supposed to discourage saving, but if households and firms are worried about the future (e.g. due to high unemployment), they may reduce their debts, then they may end up saving anyway. This was the case in the early 2000s.

**COPYRIGHT
PROTECTED**

