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# Economics

**Advanced Subsidiary**

**Unit 2: Managing the Economy**

Monday 22 May 2017 – Morning

**Time: 1 hour 30 minutes**

Paper Reference

**6EC02/01**

**You do not need any other materials.**

Total Marks

## Instructions

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

## Information

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

## Advice

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

Turn over ►

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Pearson

Answer EITHER Question 1 OR Question 2.

If you answer Question 1 put a cross in the box  .

1 UK inflation

Figure 1 UK Consumer Prices Index (CPI) inflation, year on year



(Source: [http://www.ons.gov.uk/ons/dcp171780\\_427182.pdf](http://www.ons.gov.uk/ons/dcp171780_427182.pdf))

Figure 2 Oil price (\$) per barrel



(Source: <https://www.tradingview.com/chart/?symbol=FX:USOIL>)

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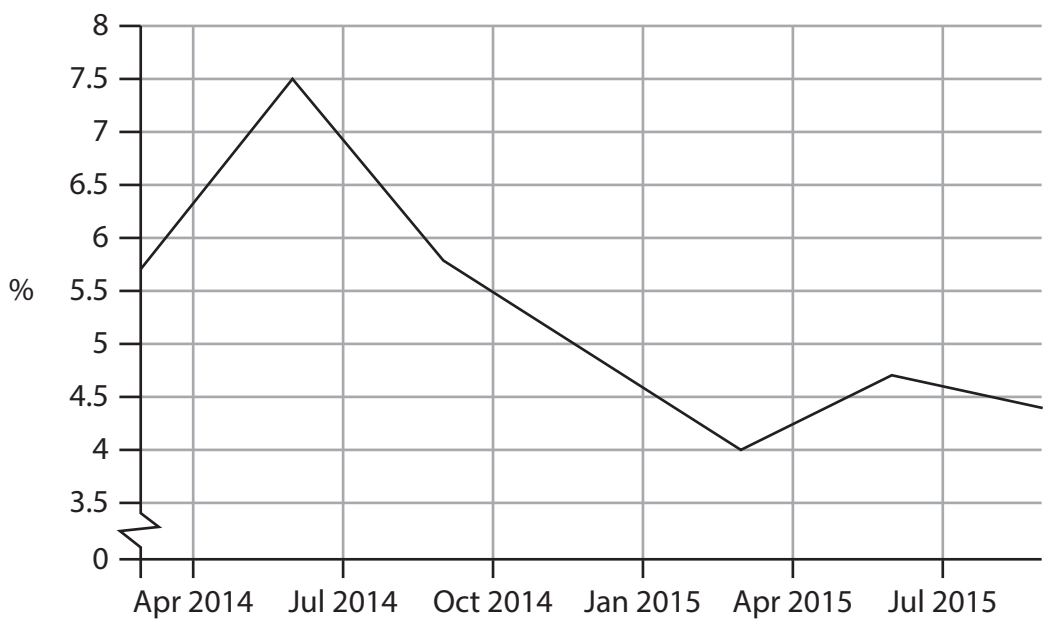


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**Figure 3 UK savings ratio (percentage of disposable income saved by households)**



(Source: <http://www.tradingeconomics.com/united-kingdom/personal-savings>)



## Extract 1 UK prices

Deflation (fall in average price level) can cause concern. For the second time in 2015, the UK economy has slipped into deflation. But it is nothing to worry about. This is 'good' deflation, not bad.

Deflation is bad when it is the result of less money in the economy, meaning consumers are buying fewer products and services and firms are cutting prices in a bid to stimulate demand. This can lead to worsening company performances, cost cutting and redundancies. Less spending means lower demand, which damages economic growth. 5

Worse still is the potential for a deflationary spiral – where people hold on to their money rather than spend it because they think it will be worth more in the future. This reduces aggregate demand, in turn pushing prices down further, so people hang on to their money for longer. Breaking this spiral can be difficult to achieve. 10

But we do not have to worry about that yet. Here is why the UK is experiencing good deflation.

- **Falling commodity prices**

An excess supply of oil has driven down its price. This has had a positive knock-on effect on many businesses in the form of lower costs. In the retail sector in particular, prices are lower because goods are cheaper to manufacture and transport. Also lower petrol prices have eased the pressure on drivers' wallets. Many commodity prices have fallen, from oil to agricultural produce to metals. Often, these lower prices are passed on to the consumer – which pulls down inflation. 15 20

Falling food and fuel prices have boosted the spending power of households across the country and businesses can spend less on moving goods and people across the world and more on paying down debt, investing in equipment, hiring staff or offering pay rises.

- **Real wage growth is stronger and consumers are still spending money** 25

For much of 2015, CPI inflation has been at or very close to 0%. At the same time, wage growth excluding bonuses, rose to 2.9% over the year, according to the ONS. Previously, real wages had been in decline, so this is a welcome reversal. If consumers were not spending, we would be worried. But amid record high employment levels and real wage increases, consumer spending is on the rise while the household savings ratio is falling. 30

- **Inflation has been stable and is set to rise soon**

Investec Economics, an investment bank, reported: "The inflation rate has remained remarkably stable in recent months: today's data marks the eighth month running where the inflation rate has remained fairly steady within the -0.1% to +0.1% range. During this period, we have not seen a worrying change in inflation expectations." 35

- **It gives the Bank of England breathing space on interest rates**

Policymakers at the Bank of England are juggling when best to raise the base rate from its all-time low of 0.5% as the economy recovers from the financial crisis. This is to stop people taking excessive advantage of cheap credit in a booming economy, which would carry substantial financial risks. But the Bank of England must target 40



a 2% inflation rate over the medium term. So if it raises interest rates, it will cost more to borrow money – so less of it will make its way into the economy.

Most households and businesses have debts. When interest rates rise, repayment costs on these debts will also go up, leaving less to spend or save.

45

(Source: adapted from <http://www.ibtimes.co.uk/uk-inflation-why-this-good-deflation-1523810>)

- (a) (i) Explain how the UK rate of inflation as measured by the CPI is calculated. Refer to the concept of weights in your answer. (4)
- (ii) With reference to the information provided, explain **two** causes of the fall in the UK's rate of inflation since 2012. (8)
- (b) With reference to the information provided, discuss **two** likely effects of a fall in the average price level on the UK economy. (12)
- (c) Analyse **two** potential problems for the UK economy of an increase in the base rate of interest. (8)
- \*(d) Examine the impact of the fall in the price of oil on the UK's price level and real output. Illustrate your answer with an aggregate demand and aggregate supply diagram. (12)
- (e) With reference to Figure 3, explain **two** likely reasons for the fall in the UK savings ratio since July 2014. (6)
- \*(f) Evaluate policies that could be used to return the UK's inflation rate to its 2% target. (30)



(a) (i) Explain how the UK rate of inflation as measured by the CPI is calculated. Refer to the concept of weights in your answer.

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(ii) With reference to the information provided, explain **two** causes of the fall in the UK's rate of inflation since 2012.

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(b) With reference to the information provided, discuss **two** likely effects of a fall in the average price level on the UK economy.

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(c) Analyse **two** potential problems for the UK economy of an increase in the base rate of interest.

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\***(d)** Examine the impact of the fall in the price of oil on the UK's price level and real output. Illustrate your answer with an aggregate demand and aggregate supply diagram.

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(e) With reference to Figure 3, explain **two** likely reasons for the fall in the UK savings ratio since July 2014.

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\*f) Evaluate policies that could be used to return the UK's inflation rate to its 2% target.

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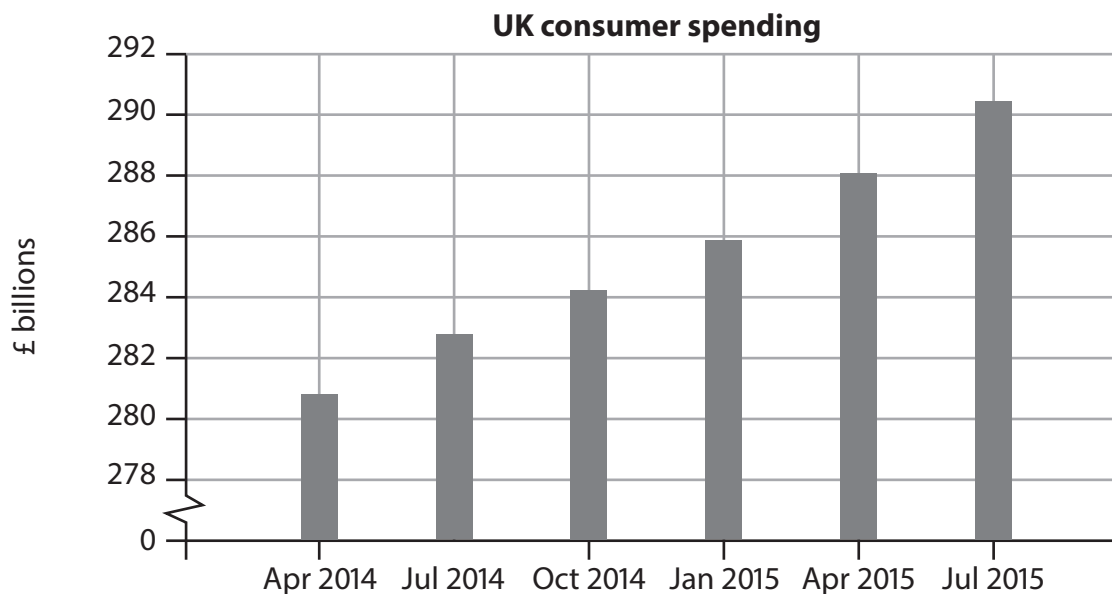
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If you answer Question 2 put a cross in the box  .

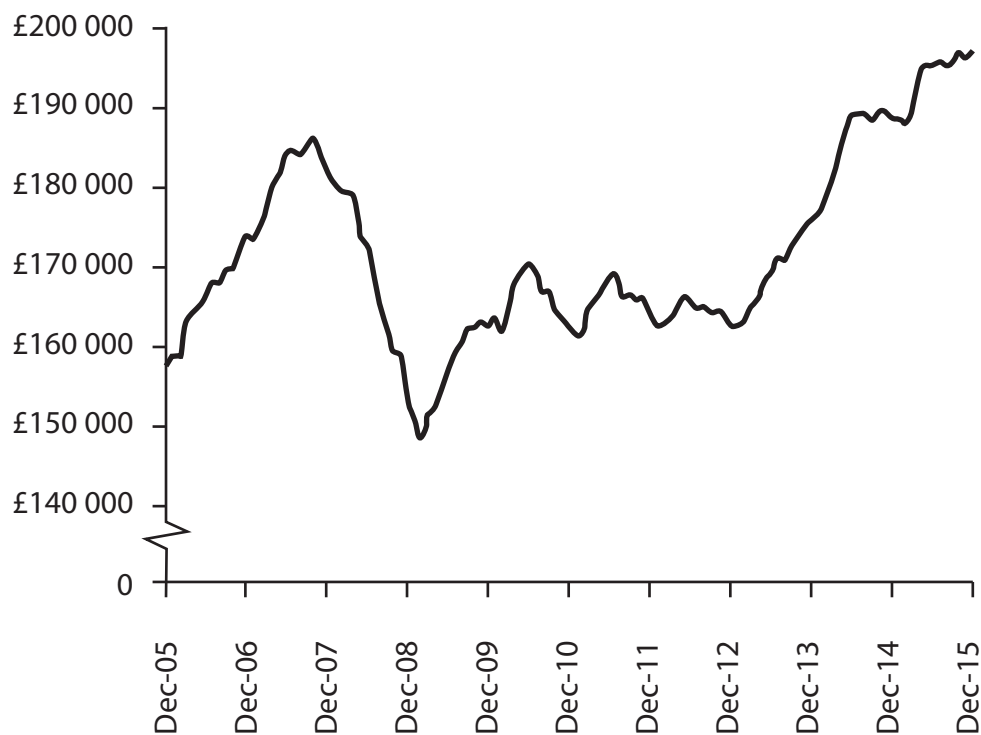
## 2 Stability of the UK economy

Figure 1 UK nominal consumer spending by quarter (£ billions)



(Source: <http://www.tradingeconomics.com>)

Figure 2 Average UK house prices December 2005 - December 2015



(Source: <http://www.nationwide.co.uk/~media/MainSite/documents/about/house-price-index/Dec-Q4-2015.pdf>)



### Extract 1 Warning over rising household debt

Britain risks becoming dependent on rising consumption fuelled by household debt as factory output and exports fall, MPs have been told. SNP economics spokesman Stewart Hosie issued the warning after figures showed that household debt has increased substantially since summer 2015 while manufacturing output turned in its worst performance since 2013.

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Mr Hosie said Chancellor George Osborne was failing to keep his promise to make exports a significant contributor to growth in order to rebalance the economy away from household consumption.

The rising debt figures, with average family debt now at £13 520, are inconsistent with a rebalanced economy, he suggested. These figures are being further fuelled by low interest rates and rising incomes.

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Mr Hosie said: "The key thing about the impact of trade and exports on GDP is that it is negative. As we saw in the reports yesterday, because industrial output is down and exports are likely to continue to fall, we are going to continue to see or need a dependence on household consumption and a rise in household debt which would be inconsistent with a properly rebalanced economy."

15

Mr Hosie said that many jobs depend on thriving manufacturing exports and he criticised the Chancellor for setting an "unachievable" target of doubling exports to £1 trillion by 2020. Instead, exports fell from £521 billion in 2013 to £513 billion the following year, and the independent Office for Budget Responsibility said Mr Osborne's target would be missed by £350 billion.

20

Mr Hosie said encouraging more innovation would prove key in boosting manufacturing – which still accounts for 44% of all UK exports. "That is as much a part of building a larger, more productive and faster growing manufacturing base as it is important in its own right."

25

Mr Hosie criticised plans to change the funding model of the Government's innovation agency, Innovation UK. He said £165 million of grants for innovation will now be turned into loans, which may suppress innovation even further. He argued that it was important to encourage innovation because as it had declined, so had manufacturing output, exports and employment.

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Labour Party spokesman Bill Esterson commented that the UK spent less on research as a share of GDP than France, Germany, the US and China. There was also, he said, "slow progress" in infrastructure projects and the quality of infrastructure was now the second worst in the G7, the group of leading industrialised nations, adding "capital spending has more than halved as a proportion of GDP since 2010".

35

The problem of UK exports, he added, was made worse by low productivity. ONS statistics showed that, in 2014, productivity measured as output per hour worked in the UK was 21% lower than the average for the rest of the G7 countries.





Mr Esterson proposed encouraging small businesses, looking to export for the first time, to work together with other firms who are already successfully exporting. "I think that that would be really helpful because I think... having to deal with all the VAT, National Insurance, marketing, manufacturing – that is actually quite frightening for a small company and I think that is what is so off-putting."

40

(Source: adapted from: <http://www.heraldsotland.com/news/homenews/14201611>.  
Stewart\_Hosie\_issues\_warning\_over\_rise\_of\_household\_debt/)

- (a) (i) With reference to Figure 1, explain the term 'nominal consumer spending'. (4)
- (ii) With reference to the information provided and your own knowledge, explain **two** benefits of an expanding manufacturing sector for the UK economy. (6)
- (iii) Evaluate the likely impact of the increase in house prices on the UK's price level and real output. Illustrate your answer with an aggregate demand and aggregate supply diagram. (12)
- (b) (i) With reference to Figure 1, explain **two** likely reasons, apart from house prices, why UK consumer spending is increasing. (8)
- (ii) Analyse **two** reasons why the UK Government may be concerned about rising household debt. (8)
- \* (c) With reference to the information provided and your own knowledge, evaluate the likely impact of a fall in the value of exports on the UK economy. (12)
- \* (d) Discuss policies that could be used to improve the productivity of the UK economy. (30)



(a) (i) With reference to Figure 1, explain the term 'nominal consumer spending'.

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(ii) With reference to the information provided and your own knowledge, explain **two** benefits of an expanding manufacturing sector for the UK economy.

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(iii) Evaluate the likely impact of the increase in house prices on the UK's price level and real output. Illustrate your answer with an aggregate demand and aggregate supply diagram.

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(b) (i) With reference to Figure 1, explain **two** likely reasons, apart from house prices, why UK consumer spending is increasing.

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(ii) Analyse **two** reasons why the UK Government may be concerned about rising household debt.

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\* (c) With reference to the information provided and your own knowledge, evaluate the likely impact of a fall in the value of exports on the UK economy.

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\*(d) Discuss policies that could be used to improve the productivity of the UK economy.

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**TOTAL FOR PAPER = 80 MARKS**



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