A-LEVEL STUDENT GUIDE 2

AQA

Economics

The national and international economy

Ray Powell
James Powell
George Vlachonikolis

HODDER EDUCATION
AN HACHETTE UK COMPANY

Contents

Content Guidance

The measurement of macroeconomic performance

How the macroeconomy works

Economic performance

Financial markets and monetary policy

Fiscal policy and supply-side policies

The international economy

Questions & Answers

Getting the most from this book

Exam tips

Advice on key points in the text to help you learn and recall content, avoid pitfalls, and polish your exam technique in order to boost your grade.

Knowledge check

Rapid-fire questions throughout the Content Guidance section to check your understanding.

Knowledge check answers

1 Turn to the back of the book for the Knowledge check answers.

Summaries

- Each core topic is rounded off by a bullet-list summary for quick-check reference of what you need to know.

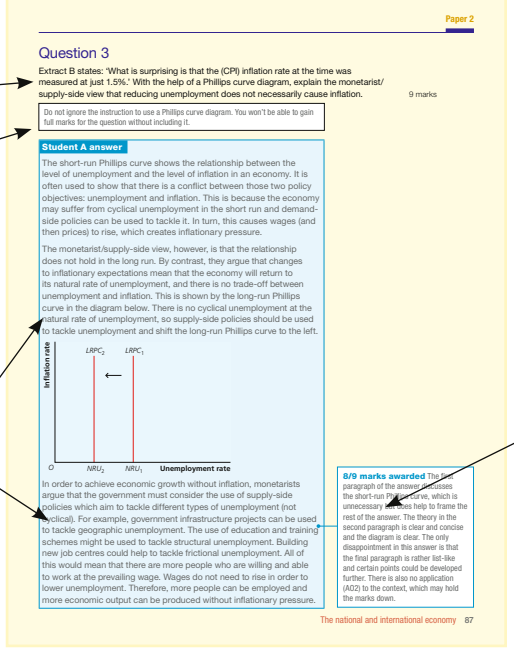
Exam-style questions

Commentary on the questions

Tips on what you need to do to gain full marks.

Sample student answers

Practise the questions, then look at the student answers that follow.



Paper 2

Question 3

Extract B states: 'What is surprising is that the (CPI) inflation rate at the time was measured at just 1.5%.' With the help of a Phillips curve diagram, explain the monetarist/supply-side view that reducing unemployment does not necessarily cause inflation. 9 marks

Do not ignore the instruction to use a Phillips curve diagram. You won't be able to gain full marks for the question without including it.

Student A answer

The short-run Phillips curve shows the relationship between the level of unemployment and the level of inflation in an economy. It is often used to show that there is a conflict between those two policy objectives: unemployment and inflation. This is because the economy may suffer from cyclical unemployment in the short run and demand-side policies can be used to tackle it. In turn, this causes wages (and then prices) to rise, which creates inflationary pressure.

The monetarist/supply-side view, however, is that the relationship does not hold in the long run. By contrast, they argue that changes to inflationary expectations mean that the economy will return to its natural rate of unemployment, and there is no trade-off between unemployment and inflation. This is shown by the long-run Phillips curve in the diagram below. There is no cyclical unemployment at the natural rate of unemployment, so supply-side policies should be used to tackle unemployment and shift the long-run Phillips curve to the left.

In order to achieve economic growth without inflation, monetarists argue that the government must consider the use of supply-side policies which aim to tackle different types of unemployment (not cyclical). For example, government infrastructure projects can be used to tackle geographic unemployment. The use of education and training schemes might be used to tackle structural unemployment. Building new job centres could help to tackle frictional unemployment. All of this would mean that there are more people who are willing and able to work at the prevailing wage. Wages do not need to rise in order to lower unemployment. Therefore, more people can be employed and more economic output can be produced without inflationary pressure.

8/9 marks awarded The first paragraph of the answer discusses the short-run Phillips curve, which is unnecessary. It does help to frame the rest of the answer. The theory in the second paragraph is clear and concise and the diagram is clear. The only disappointment in this answer is that the final paragraph is rather list-like and certain points could be developed further. There is also no application (AO2) to the context, which may hold the marks down.

The national and international economy 87

Commentary on sample student answers

Read the comments showing how many marks each answer would be awarded in the exam and exactly where marks are gained or lost.

Financial markets and monetary policy

The structure of financial markets and financial assets

The characteristics and functions of money

Money is best defined by focusing on the two principal functions it performs in the economy. The two main functions of money are as a medium of exchange (or means of payment) and as a store of value (or store of wealth). Money has two other functions, which are less important for you to know. It serves as a standard of deferred payment; and it is the unit in which the prices of goods are quoted and in which accounts are kept.

Definitions of the money supply and the distinction between narrow money and broad money

Over the years, the Bank of England has used more than one definition of the **money supply**. These divide into measures of narrow money and broad money.

- Narrow money restricts the measure of money to cash and bank and building society deposits (current account deposits), and reflects the medium-of-exchange function of money, namely money functioning as a means of payment.
- Broad money also includes other financial assets which, although stores of value, are too illiquid, at least for the time being, to function as mediums of exchange.

The difference between the money market, the capital market and the foreign exchange market

A **financial market** is a market in financial assets or securities. Financial markets can be classified in a number of ways, but one of the most fruitful is as markets for short-dated financial assets (often called **money markets**) and markets for long-dated and undated financial assets (often called **capital markets**). There are also **foreign exchange markets**, and markets for commodity futures and insurance products.

Exam tip

Make sure you understand the similarities of, and the differences between, money markets and capital markets.

Knowledge check 19

What is meant by a standard of deferred payment?

Money Primarily a medium of exchange, but also a store of value.

Money supply The total amount of money in an economy, including cash in circulation and bank deposits.

Financial market A market in financial assets or securities.

Money markets A means for lenders and borrowers to satisfy their short-term financial needs.

Capital markets A means for lenders and borrowers to satisfy their long-term financial needs.

Foreign exchange markets Global, decentralised markets for the trading of currencies.

The role of financial markets in the wider economy

Without the existence of financial markets, which of course include **banking markets**, modern economies would not be able to function. If financial markets did not exist, the supply of **liquidity** necessary to finance economic transactions would dry up. The fundamental purpose of financial markets is to act as intermediaries which channel funds from those who have surplus funds to those who have a shortage of funds. And without foreign exchange markets, it would become very difficult, if not impossible, for international trade and tourism to take place.

Banking markets Markets for banking services.

Liquidity The ease with which an asset can be converted into cash without loss of value. Cash is the most liquid of all assets.

The difference between debt and equity

Debt is what people owe; **equity** is what they own. To explain this, consider a company which needs to raise money to finance its expansion. If it borrows, the company is increasing its debt. To avoid accumulating debt, the company may decide to sell new shares, in which case it is selling ownership in itself. The new shareholders, who have become part-owners of the company, have increased their equity stakes in the company.

Debt What people owe.

Equity What people own.

The inverse relationship between market interest rates and bond prices

When companies borrow, they may sell a form of company debt known as **corporate bonds**. Likewise, government bonds are a form of government debt. In the UK these are called **gilt-edge securities**, or gilts.

Consider a £100.00 government bond which pays the bond holder a guaranteed £5.00 a year in interest. If the bond price remains at £100.00, the bond holder earns a 5% annual interest payment. Suppose, however, that the long-term interest rate increases to 10%. In this situation, the second-hand price of the £100.00 bond must fall on the stock exchange to £50.00 to convert the £5.00 guaranteed annual interest payment into a yield of 10%. There is thus an inverse or negative relationship between the bond's price and the rate of interest the bond earns if it is sold second-hand on the stock exchange.

Corporate bonds Long-dated borrowing by private sector companies.

Gilt-edged securities Long-dated borrowing by the UK central government.

Commercial banks and investment banks

The difference between a commercial bank and an investment bank

Commercial banks, which are often called retail banks and 'high street' banks, are commercially run financial institutions that deal with ordinary members of the general public and businesses.

Although they are also profit-making and commercially run institutions, **investment banks**, such as the US-owned Goldman Sachs, are mainly involved in helping companies, other financial institutions and other organisations (such as the government and its agencies) to raise finance by selling shares or bonds to investors and to hedge against risks. Goldman Sachs has recently begun to accept online

Commercial banks Financial institutions which make profits by selling banking services to their customers. Also known as retail banks and 'high street' banks.

Investment banks Financial institutions which until recently did not generally accept deposits from ordinary members of the public. They provide financial advice to private sector companies and to the government.

deposits from the general public, though it is still primarily an investment bank dealing with companies.

The main functions of a commercial bank

The main function of a commercial bank, acting as an intermediary between households and firms, is to accept deposits from the general public that can be transferred by cheque, by debit card or through an online transfer of funds undertaken on the internet, and to create deposits which are lent to customers who wish to borrow from their banks. Commercial banks do have other functions, such as buying and selling foreign exchange, but these are less important.

The structure of a commercial bank's balance sheet and its need to maintain liquidity, profitability and security

Prudent retail banking requires a commercial bank to operate on a ratio of cash and other liquid assets to advances that maintains customers' confidence in the bank, while generating acceptable profits for the bank. In other words, prudent banking involves trading off liquidity against profitability.

Besides trading off between liquidity and profitability, banks also have to make choices with regard to the security of their assets. The profitability for banks of loans granted to customers depends to a significant extent on the degree of risk attached to the loans. Non-secured loans are risky because if a customer defaults on the loan, the bank cannot recover any money. Because of the risk of non-repayment of unsecured loans, banks charge higher interest rates and hence make more profit than is the case with secured loans such as mortgage loans.

Knowledge check 20

What is meant by trading off profitability against liquidity?

Potential conflicts between these objectives

The asset structure shown in Table 1 illustrates the conflict between liquidity and profitability facing a commercial bank.

Table 1 The asset structure of a commercial bank

Liquidity ↕ Profitability	Cash [notes and coins] Balances at the Bank of England Money at short and call notice [money lent to other banks via the interbank market] Bills [commercial bills and Treasury bills]	**Liquid assets**
	Investments [e.g. holdings of government bonds – gilts – and corporate bonds] Advances [e.g. credit or loans and mortgages extended to the bank's customers]	**Illiquid assets**

If a bank kept all its assets in the most liquid form of cash, it would not really be a bank at all, but a safe-deposit institution. The bank's profits would come largely from the fees it charged customers for guarding their valuables. The bank's cash would be completely liquid, but not very profitable.

Knowledge check 21

Why is cash, which is the most liquid of all assets, not very profitable?

The cash a bank holds allows it to make profitable advances or loans to its customers. The rates of interest that retail banks charge on the loans are a major source of profits. Imprudent or greedy banks might be tempted to create far too many profitable advances — imprudent in the sense that the banks possess insufficient cash to meet

customers' possible cash withdrawals. These banks would be operating on too low a ratio of cash and other liquid assets to the advances they have created. If a run on the banks occurred, the banks would crash.

A conflict stemming from a lack of security of bank assets is illustrated by events which happened in the American financial crisis in 2007 and 2008. American banks sought profit through providing sub-prime mortgage loans to high-risk customers. These loans turned into bad debts when customers could not repay the loans. Saddled with bad debts, a number of banks went out of business, the most notable being Lehmann Brothers in the USA in 2008.

How banks create credit and bank deposits

In a modern monetary economy, bank deposits, which are created by commercial banks, form by far the largest part of the money supply or stock of money in an economy. Cash acts as the 'small change' of the total money stock. To illustrate the credit- and bank-deposit-creating process, we shall assume that there is only one commercial bank in the economy, possessing only one reserve asset (cash) and that, to maintain confidence, the bank must always possess cash equal to 10% of total customer deposits.

A member of the general public deposits £1,000 cash in the bank. From the bank's point of view, both its assets and its liabilities increase by £1,000. The cash is the bank's asset, but the £1,000 deposit credited in the customer's name is the bank's liability, since the bank is liable to honour any cash withdrawals made by the customer. The £1,000 is recorded in the bank's balance sheet in the following way:

Assets	Liabilities
£1,000	£1,000
Total assets: £1,000	**Total liabilities: £1,000**

As things stand, all the bank's deposit liabilities are backed with cash (that is, the bank's cash ratio is 100%). But at the next stage, the bank uses the cash as a monetary base from which to launch the profitable loans it grants to customers. Unlike the customer depositing the £1,000, other customers may need to borrow from the bank. The 10% cash ratio the bank has chosen to work with means that the bank is in a position to lend exactly £9,000 to these customers. This takes the form of an interest-earning advance on the assets side of the bank's balance sheet, which is matched by a £9,000 created deposit on the liabilities side:

Assets	Liabilities
£1,000	£1,000
Advances: £9,000	Created deposits: £9,000
Total assets: £10,000	**Total liabilities: £10,000**

Both the customer who made the initial deposit of £1,000 and the customers in receipt of the advances can draw cheques or make payments equal to £10,000 in total on their deposits. The initial £1,000 cash deposit has enabled total deposits to be increased to £10,000. The bank has created new credit and bank deposits to the tune of £9,000.

Exam tip

It is important to understand that most of the money supply or stock of money in the economy is deposit money rather than cash.

Central banks and monetary policy

The main functions of a central bank

A **central bank** such as the Bank of England has two key functions: to help the government maintain macroeconomic stability and to bring about financial stability in the monetary system. With regard to macroeconomic stability, the Bank of England's remit is to deliver price stability and, subject to that, to support the government's economic objectives, including those for growth and employment.

Financial stability can be achieved, in part, through the central bank acting as lender of last resort to the banking system, and also, in part, by the central bank's monitoring and regulation of the financial system. The lender-of-last-resort function can be defined as the readiness of the central bank to extend loans to banks that are solvent but have short-term liquidity problems.

Central banks also carry out other related functions such as controlling the note issue, acting as the bankers' bank, acting as the government's bank, buying and selling currencies to influence the exchange rate, and liaising with overseas central banks and international organisations.

Central bank A national bank that implements the government's monetary policy and issues currency. The Bank of England is the UK's central bank.

Knowledge check 22

What is the difference between monetary policy and fiscal policy?

Monetary policy and its objectives

Monetary policy is any deliberate action undertaken by the government or its agents, such as the country's central bank, to achieve economic objectives by using monetary instruments such as **Bank Rate**, **quantitative easing (QE)** and controls over bank lending.

The main function of the Bank of England is to implement monetary policy on behalf of the UK government. For over 30 years, control of inflation has been the main objective of UK monetary policy. The government, in the person of the chancellor of the exchequer, sets the inflation rate target, which since 2003 has been 2% CPI inflation, and instructs the Bank of England to operate monetary policy so as to 'hit' this target.

However, in the 2008/09 recession, negative economic growth and growing unemployment led to a situation in which controlling inflation as the main monetary policy objective was temporarily placed on the back burner, with monetary policy being used instead to try and increase aggregate demand and bring about recovery. Although the Bank's primary objective is price stability, it must also support the government's economic policy objectives, including those for growth and employment. History repeated itself from 2020 onwards when monetary policy was once again used to increase aggregate demand to try to induce recovery from the Covid-19 recession.

Monetary policy 'The action that a country's central bank or government can take to influence how much money is in the economy and how much it costs to borrow.'

Bank Rate The rate of interest which a central bank charges on its loans to a commercial bank.

Quantitative easing (QE) A form of unconventional monetary policy in which a central bank purchases long-dated securities on the open market in order to increase the money supply and encourage lending and investment. Also known as Asset Purchase Scheme.

Using *AD/AS* diagrams to show how monetary policy affects the price level and real output

Monetary policy is generally used to manage the level of aggregate demand in the economy. It is an example of **demand-side economic policy**. To understand how monetary policy is used in this way, it is worth repeating the aggregate demand equation:

$$AD = C + I + G + (X - M)$$

Demand-side economic policy Aims to change the aggregate demand in the economy.

Expansionary monetary policy brought about by a cut in Bank Rate and/or quantitative easing shifts the *AD* curve to the right. What happens next depends first on the extent of the rightward shift of the *AD* curve, and second on the slope of the *SRAS* curve.

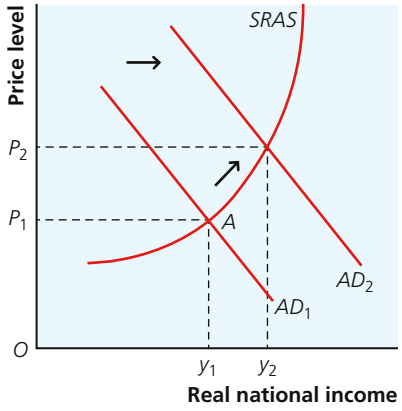


Figure 26 The effect of an expansionary monetary policy on real output and the price level

Figure 26 illustrates one possible outcome. Because the *SRAS* curve is relatively steep to the right of the original macroeconomic equilibrium at point *A*, the expansionary monetary policy leads to a greater increase in the price level than increase in real income.

The factors considered by the MPC when setting Bank Rate

Before the members of the **Monetary Policy Committee (MPC)** decide what action to take on Bank Rate, they hold several meetings to look at how the economy is working. It can take around 2 years for monetary policy to have its full effect on the economy. So MPC members need to consider what inflation and growth in the economy are likely to be in the next few years. The Bank explains the reasons behind monetary policy decisions (for example, to raise or lower Bank Rate) in its quarterly Monetary Policy Report.

Indicators that are of interest to the MPC before any Bank Rate decision include: the unemployment rate; the level of saving; changes in retail sales; the effect of adverse external shocks, such as the Covid-19 pandemic; the state of consumer and/or business confidence; the state of the housing market and the market for mortgages; and movements in the pound's exchange rate.

How changes in the exchange rate affect aggregate demand and macroeconomic policy objectives

A fall in the exchange rate increases the prices of imports and reduces the overseas prices of the country's exports. This switches demand towards domestically produced goods within the country, which in turn increases aggregate demand for the country's output. What happens next depends on how close the economy is to full employment before the change in the exchange rate. If there was plenty of spare capacity, economic growth and employment should increase. However, if the economy was producing at full capacity, the main effect may be an increasing rate of inflation.

Knowledge check 23

This analysis considers only the *SRAS* curve and not the economy's *LRAS* curve. Extend the analysis to consider the effect of a vertical *LRAS* curve on the eventual outcome.

Knowledge check 24

Draw an *AD/AS* diagram to illustrate contractionary monetary policy.

Monetary Policy Committee (MPC)
Committee of the Bank of England, which meets eight times a year to decide the rate at which Bank Rate is set. It is also responsible for directing other aspects of the government's monetary policy framework. The Committee is responsible primarily for keeping the consumer price index (CPI) measure of inflation close to a target set by the government (currently 2%). Its secondary aim is to support growth and employment.

Knowledge check 25

How may an increase in the exchange rate affect aggregate demand and macroeconomic objectives?

The monetary policy transmission mechanism

The Bank of England believes that interest rate policy affects aggregate demand and inflation through a number of channels, which form the transmission mechanism of monetary policy. The flow chart in Figure 27 shows the routes through which changes in Bank Rate (the instrument of monetary policy), shown at point 1 in the diagram, eventually affect inflation (the objective of monetary policy), shown at point 11.

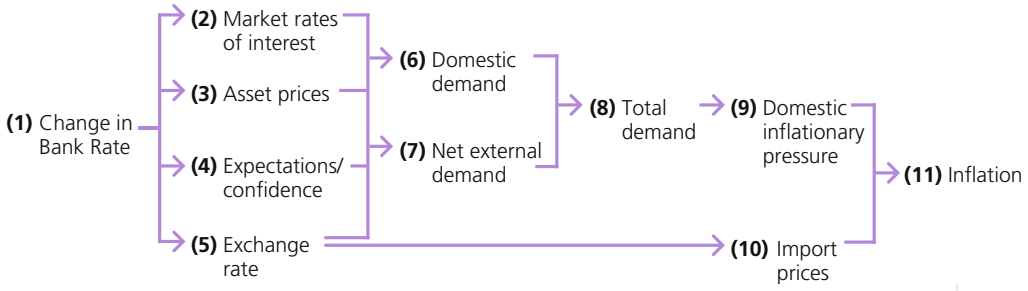


Figure 27 The transmission mechanism of interest rate policy

How the Bank of England can influence the growth of the money supply

For many decades, the Bank of England has been operating an **accommodating monetary policy**, in which it allows the money supply to increase or decrease so that the stock of money in the economy equals the amount of money that people wish to hold at current market interest rates. This means that the Bank of England influences the growth of money supply, primarily through changing Bank Rate. But given that Bank Rate was set at 0.5% in 2009 and then at 0.1% at the onset of the Covid-19 recession in 2020, other monetary policy instruments have been introduced which have influenced the growth of the money supply. The main one has been quantitative easing (QE). QE, also known as the Asset Purchase Scheme, is an unconventional form of monetary policy through which the Bank of England creates new money electronically which it then uses to buy financial assets, such as government bonds, on the country's financial markets.

Accommodating monetary policy A policy of allowing the money supply to rise in line with national income and the demand for money.

The regulation of the financial system

Regulation of the financial system in the UK

Financial regulation involves limiting the freedom of banks and other financial institutions, and of the people they employ, to behave as they otherwise might wish to do. Financial regulation is undertaken by the Financial Policy Committee (FPC) at the Bank of England, by the Prudential Regulation Authority (PRA) — itself a part of the Bank of England — and by the Financial Conduct Authority (FCA), which is not part of the Bank. Through the FPC, the Bank of England has responsibility for the Bank's second key function: maintaining financial stability.

The FPC is primarily responsible for **macroprudential regulation**, whereas the PRA and FCA are mainly responsible for **microprudential regulation**.

- Macroprudential regulation is concerned with identifying, monitoring and acting to remove risks that affect the stability of the financial system as a whole.
- Microprudential regulation focuses on ensuring the stability of individual banks and other financial institutions. It involves identifying, monitoring and managing risks that relate to individual firms.

Macroprudential regulation Focuses on the financial system as a whole, aiming to limit the build-up of system-wide financial risk.

Microprudential regulation The regulation and supervision of individual financial institutions to ensure that each bank has a balance sheet that can withstand economic and financial shocks.

Bank failures

Bank failures occur because banks are financial institutions which 'borrow short but lend long'. Much of the assets that commercial banks possess results from the creation of deposit liabilities which customers can instantly withdraw. However, the banks' assets are largely long term, often in the form of 25-year mortgages granted to finance house purchase. Banks can also fall victim to rogue bank workers who steal huge amounts of money from the banks that employ them.

Liquidity ratios and capital ratios

Over time, banks have failed or have required government assistance either because they lacked liquidity or because they had inadequate capital, or through a combination of both of these contributory factors.

A bank's **liquidity ratio** is the ratio of cash and other liquid assets owned by the bank to its deposit liabilities. Liquidity is a measure of the ability and ease with which assets can be converted to cash. To remain viable, a bank must have enough liquid assets to meet its near-term obligations, such as withdrawals of cash by depositors.

Liquidity ratio The ratio of a bank's cash and other liquid assets to its total deposits.

A bank's **capital ratio** is the amount of capital on the bank's balance sheet as a proportion of its loans. While insufficient liquidity makes a bank vulnerable to a run on the bank, insufficient capital exposes the bank to the risk of a fall in the value of its assets.

Capital ratio The amount of capital on a bank's balance sheet as a proportion of its loans.

Moral hazard

As the 2007/08 financial crisis showed, banks are sometimes tempted to take too many risks in pursuing the huge profits that lending long allows. They do this because they believe that the Bank of England, in its role as lender of last resort, and the government, through its bailouts, will not allow banks to fail.

Moral hazard exists when a bank pursues profit and takes on too much risk in the knowledge that, if things go wrong, someone else will bear a significant portion of the cost. Investing in high-risk assets can lead to high profits, but unless there is the possibility that financial institutions will be allowed to fail, there is insufficient incentive for them to act prudently.

Moral hazard The lack of incentive to guard against risk where a financial institution is protected from the consequences of the risk.

Systemic risk and the impact of problems that arise in financial markets upon the real economy

It is important to distinguish between **systemic risk** and one-off risks. In contrast to a one-off shock, which affects only a single bank without rippling into the rest of the banking system, systemic risk affects the entire banking system and other financial

Systemic risk In a financial context, the risk of a breakdown of the entire financial system, caused by inter-linkages within the system rather than the failure of an individual bank or financial institution.

institutions as well. For example, the collapse in the UK of the Northern Rock bank in 2012 triggered a one-off shock to the UK monetary system, partly because Northern Rock was quite small, but largely because the collapse was caused by a bad business plan chosen by Northern Rock's owners, which other banks had not adopted. By contrast, the collapse of Lehmann Brothers in the USA in 2008 adversely affected the whole of the American banking system. Lehman Brothers' size and integration into the US economy made it a source of systemic risk. When the bank collapsed, it created problems throughout the financial system and the economy. Capital markets froze up while businesses and consumers could not get loans, or could only get loans if they were extremely creditworthy and posed minimal risk to the lender. As the Lehmann Brothers collapse showed, the consequences of a systemic financial crisis can be devastating because of the role that banks and finance play in the wider economy.

Summary

- Money markets, capital markets and foreign exchange markets are the main financial markets.
- Money is defined by its medium-of-exchange and store-of-value functions.
- The commercial banking system creates bank deposits and credit, which are a multiple of the cash deposited in the system.
- Commercial banks divide into high street banks such as Barclays and investment banks such as JP Morgan.
- Investment banks are financial institutions that provide services such as underwriting of new share issues, assisting in mergers and acquisitions, and brokering. In general, an investment bank's clients are institutional investors. Investment banks rarely provide retail banking services, though Goldman Sachs has introduced the Marcus savings account to attract savings from the general public.
- Monetary policy is the part of macroeconomic policy which uses policy instruments such as Bank Rate and quantitative easing to achieve objectives such as the control of inflation.
- As bank deposits are the main form of money, to be successful monetary policy must aim to control the rate of growth of bank deposits.
- Bank Rate has generally been the most important monetary policy instrument, though recently quantitative easing has temporarily been used.
- Since the 1990s, the rate of inflation has been the main monetary policy objective, but since the 2008/09 recession and the 2020 Covid-19 recession, achieving 2% inflation has been subordinated to stimulating aggregate demand to promote economic recovery.

Questions & Answers

The A-level examination

A-level Paper 2

The A-level Paper 2, 'National and international economy', is 2 hours long and has a maximum mark of 80. The exam paper contains two sections, A and B, both of which must be answered. Section A, which accounts for 40 marks (50% of the total), comprises two data-response questions (DRQs), labelled Context 1 and Context 2, of which you should answer one. Section B, which also accounts for 40 marks (50% of the total), contains three essay questions (EQs), of which you should answer one. Each essay question has two parts and you should answer both parts.

This Student Guide contains one context for Section A and one essay question for Section B.

A-level Paper 3

Paper 3, 'Economic principles and issues', also carries a maximum of 80 marks. Section A (30 marks) has 30 multiple-choice questions (MCQs), of which roughly half are on microeconomics and roughly half on macroeconomics.

The MCQs that follow in this Student Guide are similar to the sorts of themed questions that you might see in the A-level Paper 3 exam.

In Section B of Paper 3, worth 50 marks, there are three extended-response questions based on a case study or investigation which require you to draw together different areas of the specification. An 'extended response' is evidence generated by you that is of sufficient length to allow you to demonstrate the ability to construct and develop a sustained line of reasoning which is coherent, relevant, substantiated and logically structured. The case study in Part B is not pre-released.

This Student Guide provides one such case study with questions.

Assessment objectives

Assessment objectives (AOs) are set by the government agency Ofqual and are the same across the A-level Economics papers. The exams measure how you have achieved the following assessment objectives:

- AO1: Demonstrate knowledge of terms/concepts and theories/models to show an understanding of the behaviour of economic agents (consumers, workers and firms) and how they are affected by and respond to economic issues.
- AO2: Apply knowledge and understanding to various economic contexts to show how economic agents are affected by and respond to economic issues.
- AO3: Analyse issues within economics, showing an understanding of their impact on economic agents.
- AO4: Evaluate economic arguments and use qualitative and quantitative evidence to support informed judgements relating to economic issues.

Assessment objectives 1 and 2 are testing 'lower-order' skills, whereas objectives 3 and 4 test 'higher-order' skills.

Weighting of assessment objectives for A-level Economics

Assessment objectives (AOs)	Component weightings (approx. %) Paper 1	Paper 2	Paper 3	Overall weighting (approx. %)
AO1	5–8	5–8	7–10	20–23
AO2	7–10	7–10	9–12	26–29
AO3	9–11	9–11	6–9	26–29
AO4	7–10	7–10	5–8	22–25
Overall weighting of components	33.3	33.3	33.3	100

The exam questions in this guide

This guide includes 19 examination-style questions designed to be a key learning, revision and exam preparation resource.

In Paper 2, Section A, there are four data-response questions. Then in Section B there are two essay questions (one worth 15 marks; one worth 25 marks).

In Paper 3, Section A, there are ten MCQs. Then in Section B there are three data-response questions (worth 10 marks, 15 marks and 25 marks). Section B is called the Investigation and all questions refer to the context given in the Scenario.

All the questions in this guide can be used 'en bloc' as part of a short trial or mock exam near the end of your course. Alternatively, as you study a topic in the Content Guidance section of this guide, you could refer selectively to particular questions in this section that assess aspects of the topic.

Note: No past-paper questions, nor students' answers to past-paper questions, have been included in this guide.

This section of the guide also contains:

- correct answers for the MCQs and a brief explanation of the correct answer
- comments on the MCQs, explaining particular features of each question
- student answers of grade-A standard (or sometimes A* standard) and grade-C standard for each DRQ and essay question
- comments on each student's answer, explaining, where relevant, how the answer could be improved

Paper 2

Section A

Total for this context: 40 marks

Context 1: Wage growth in the UK

Study Extracts A, B and C and then answer all parts of Context 1 which follow.

Extract A UK unemployment in the Covid-19 recession

By July 2020, the number of people claiming unemployment benefits had more than doubled since the Covid-19 crisis began in March 2020, increasing dramatically from 1.2 million to 2.7 million over that period, according to official figures. The number of employees on UK payrolls fell by 730,000 over the same period.

The Office for Budget Responsibility has given an official view of what might happen to unemployment in the next few years. In its optimistic scenario, the unemployment rate peaks at 9.7% in 2020, and returns to pre-crisis levels in 2022. In its 'downside' scenario, it peaks at 13.2% in 2021 — with 4 million people out of work. It is still at 6.3% by the end of this scenario in 2024 — well above pre-crisis levels.

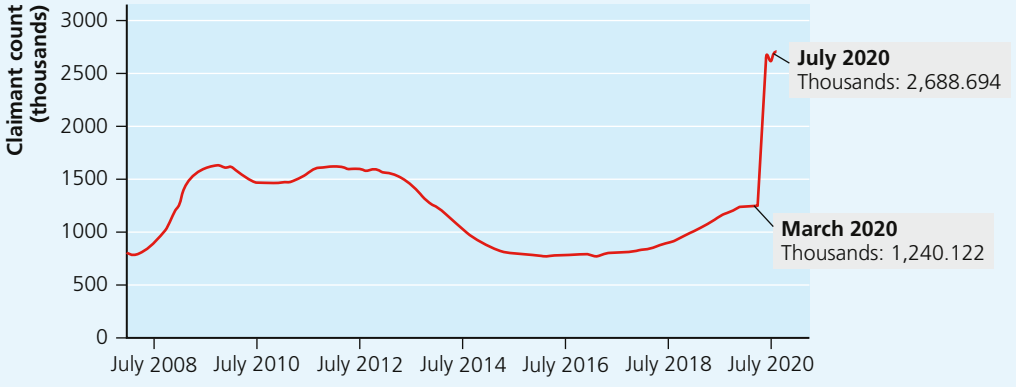


Figure 1 UK unemployment measured by the Claimant Count, January 2008 to July 2020
Source: ONS Labour market overview, UK: August 2020

Extract B UK wage growth

News of wage growth is often celebrated by front-page newspaper headlines. It is a sign that living standards are improving. Thus, in April 2019, when the ONS reported that median weekly earnings for full-time employees reached £585, an increase of 2.9% since April 2018, cue positive headlines. But the report came with the caveat that median weekly earnings in real terms were still 2.9% lower (£18 lower) than the peak in 2008 of £603 in 2019 prices. This fact was curiously overlooked by the media.

By the end of January 2019, UK wage growth was still strong at 2.2%. This was no real surprise since the figures were published in the same month that the unemployment rate

was recorded at 3.8%, the lowest level since the mid-1970s. What is surprising is that the (CPI) inflation rate at the time was measured at just 1.5%. Standard economic theory posits that low unemployment and an expansion of the economy will result in inflation. This does not seem to be the case in the UK. The ONS even reported on the issue: 'Based on the relationship between unemployment and pay growth between 2001 and 2007, nominal wage growth should currently lie somewhere between 3% and 5%.' The report concludes with a prediction that there will be significant wage growth in the UK in 2020.

Source: ONS report

Extract C UK exports

Table 1 UK export market by size and % of total, 2019

Exports	£ billions	% of total
USA	120.9	18.8
Germany	56.0	8.7
Netherlands	44.3	6.9
France	41.7	6.5
Ireland	35.1	5.5
China	**22.6**	**3.5**
Italy	20.7	3.2
Switzerland	20.2	3.1
Belgium	19.1	3.0
Spain	18.0	2.8
EU	291.0	45.3
World	**642.2**	**100.0**

Source: ONS Pink Book

Table 2 UK goods and services exported to China by type, 2018

UK goods exported to China by type, 2018			UK services exported to China by type, 2018		
Good	**£bn**	**% of total**	**Services**	**£bn**	**% of total**
Gold	4.3	20.9%	Travel	0.95	20.6%
Road vehicles	3.9	18.8%	Transportation	0.91	19.8%
Petroleum (and petroleum products)	3.9	18.8%	Intellectual property	0.44	9.6%
Machinery	2.1	10.2%	Finance	0.36	7.8%
Metal ores (and scrap metal)	0.9	4.2%	Government	0.12	2.5%

Source: https://researchbriefings.files.parliament.uk/documents/CBP-7379/CBP-7379.pdf

Question 1

Extract A states that by July 2020 the number of people claiming unemployment benefits had more than doubled since the Covid-19 crisis began in March 2020. Using the data from Extract A, calculate the percentage increase in unemployment to two decimal places between March and July 2020.

2 marks

The question is asking you to select data from Extract A and perform a simple percentage calculation to two decimal places.

Student A answer

According to Figure 1 in Extract A, Claimant Count unemployment increased from 1,240,122 in March 2020 to 2,688,694 in July 2020. This is an absolute increase of 1,448,572. It is a percentage increase of (1,448,572 / 1,240,122) × 100, which is an increase of **116,808830098%**.

To two decimal places this is **116.81%**.

2/2 marks awarded This is the correct answer and the working makes it clear how the answer was derived.

Student B answer

UK unemployment measured by the Claimant Count rose from 750,000 in July 2008 to about 1.5 million in March 2020, fluctuating over the years in between. Then Claimant Count unemployment more than doubled to peak at around 2.7 million in July 2020. This growth reflected the Covid-19 recession which hit the UK and world economies in 2020.

0/2 marks awarded The student has not answered the question, so no marks have been awarded. Kindness marks are never awarded for wrong and irrelevant answers.

Question 2

Extract B states that 'median weekly earnings in real terms were still 2.9% lower (£18 lower) than the peak in 2008'. Explain how median weekly earnings in 2008 can be lower in nominal terms but higher in real terms than median weekly earnings in 2019. 4 marks

Make sure you explain the difference between real and nominal income.

Student A answer

Nominal income is income that is not adjusted for inflation. It must be the case that the median weekly earnings in 2008 were lower than the median weekly earnings in 2019, recorded at £585. The % change between the two figures is known as wage growth.

Real income is adjusted for the inflation rate between two dates (in this case, 2008 and 2019). It must be the case that the inflation rate in those 11 years was higher than the wage growth in the period. As a result, the inflation-adjusted 'real' wage is higher than £585. Extract B says the real wage (of 2008) is £603 because it had more purchasing power in 2008 than the current median wage in 2019.

4/4 marks are awarded This is a tricky question but the answer is articulate and clear. It uses the data from Extract B to great effect.

Student B answer

Real wages are adjusted for inflation.

Extract B states that 'median weekly earnings in real terms were still 2.9% lower than the peak in 2008'. This means that wage growth between 2008 and 2019 was lower than the inflation rate over the same time period.

2/4 marks awarded The answer is correct but it is lacking any explanation. Often, it is not enough to know the right answer — you must explain *why* it is the right answer. This answer could be improved by using concepts such as purchasing power or deflator adjustments.

Question 3

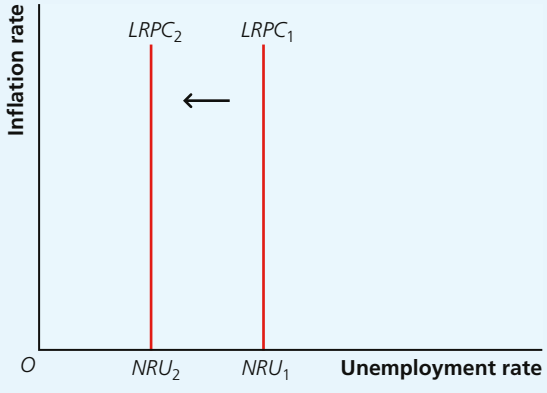
Extract B states: 'What is surprising is that the (CPI) inflation rate at the time was measured at just 1.5%.' With the help of a Phillips curve diagram, explain the monetarist/supply-side view that reducing unemployment does not necessarily cause inflation. 9 marks

Do not ignore the instruction to use a Phillips curve diagram. You won't be able to gain full marks for the question without including it.

Student A answer

The short-run Phillips curve shows the relationship between the level of unemployment and the level of inflation in an economy. It is often used to show that there is a conflict between those two policy objectives: unemployment and inflation. This is because the economy may suffer from cyclical unemployment in the short run and demand-side policies can be used to tackle it. In turn, this causes wages (and then prices) to rise, which creates inflationary pressure.

The monetarist/supply-side view, however, is that the relationship does not hold in the long run. By contrast, they argue that changes to inflationary expectations mean that the economy will return to its natural rate of unemployment, and there is no trade-off between unemployment and inflation. This is shown by the long-run Phillips curve in the diagram below. There is no cyclical unemployment at the natural rate of unemployment, so supply-side policies should be used to tackle unemployment and shift the long-run Phillips curve to the left.



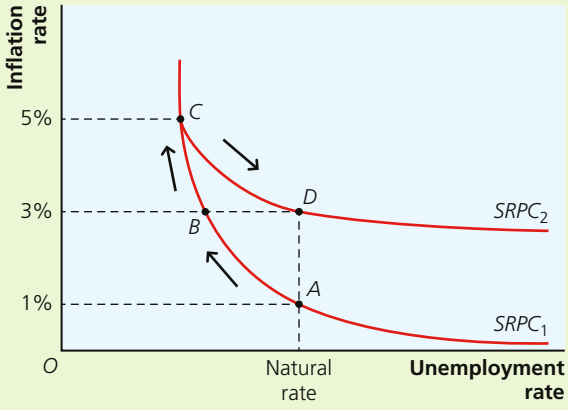
In order to achieve economic growth without inflation, monetarists argue that the government must consider the use of supply-side policies which aim to tackle different types of unemployment (not cyclical). For example, government infrastructure projects can be used to tackle geographic unemployment. The use of education and training schemes might be used to tackle structural unemployment. Building new job centres could help to tackle frictional unemployment. All of this would mean that there are more people who are willing and able to work at the prevailing wage. Wages do not need to rise in order to lower unemployment. Therefore, more people can be employed and more economic output can be produced without inflationary pressure.

8/9 marks awarded The first paragraph of the answer discusses the short-run Phillips curve, which is unnecessary but does help to frame the rest of the answer. The theory in the second paragraph is clear and concise and the diagram is clear. The only disappointment in this answer is that the final paragraph is rather list-like and certain points could be developed further. There is also no application (AO2) to the context, which may hold the marks down.

Student B answer

The Phillips curve shows the relationship between the inflation rate and the unemployment rate in a country. It shows that as unemployment falls below the natural rate, inflation starts to accelerate.

The monetarist/supply-side view, however, is that the relationship does not hold in the long run. By contrast, they argue that changes to inflationary expectations mean that the economy will return to its natural rate of unemployment, and there is no trade-off between unemployment and inflation.



This is shown by self-stabilisation of the model at the natural rate of unemployment (NRU), as shown in the diagram.

Demand-side policies reduced unemployment from *A* to *B* below the natural rate. This creates inflationary pressure (1% to 3% inflation). However, additional workers will demand higher-than-inflation wage rises (they ask for 5%). This creates a wage–price spiral (*B* to *C*) which only stops when firms cannot sustain continual wage increases. People are laid off (*C* to *D*) and the economy returns to the natural rate but at a new 'higher' inflation rate of 3%.

Therefore, in order to grow without inflation, a government must use supply-side policies. These are policies like infrastructure, education/training, decreasing corporation tax and decreasing unemployment benefits.

The answer spends too long analysing the theory of the Phillips curve without really answering the question. Here, the only point being made is that the economy returns to the natural rate but it doesn't say anything about reducing unemployment.

The final paragraph is where the emphasis of this answer should be but it is only two sentences long and reads like a list.

4/9 marks awarded The answer shows a very strong understanding of the Phillips curve theory. However, there is almost no application (A02) to the context and, more importantly, the answer is too unbalanced. There is too much emphasis on the mechanics of the short-run Phillips curve adjustments. Instead the answer should be more focused on why the long-run Phillips curve shifts.