Skoolumy

CAMBRIDGE A LEVEL ECONOMICS TOPICAL ESSAY QUESTIONS

POLICIES OF GOVERNMENT

PAST QUESTIONS

1. Explain what is meant by a transmissions mechanism of monetary policy and consider why it might not work in practice. [12]

2. Keynesians argue that increasing budget deficits will solve the problem of unemployment. Monetarists argue that supply side policies are more effective in reducing unemployment.

Consider which view is more likely to be correct. [25]

***3.* Public services – better or worse?**

A government usually has macroeconomic policy aims that it hopes will enable some success in raising the quality of life, or well-being, of the population. In doing this the government also hopes achieve efficiency in the use of resources.

Efficiency is measured by relating inputs to outputs. Inputs are relatively easy to count: they are financial costs of public services. Output can also be counted, but it is not necessarily a good measure of the outcome. The outcome is much harder to calculate. It is broader and more subjective – how do we assess whether a public service is 'better' or 'worse'?

This is where a knowledge of well-being makes an enormous difference. It could provide a much clearer view of the trade-offs that have to be made in allocating taxpayers' money to public services. Take the example of healthcare. To maximise the impact of expenditure on well-being, the budget may need to be adjusted to give more to mental health services and less to building general hospitals. For older people it could mean giving priority to programmes that would keep them out of hospital.

A focus on well-being should lead to better outcomes. This is where policymakers need a better understanding of behavioural economics. Governments have established Behavioural Insights teams, or Nudge Units. They have had some success. A small change in the wording of a letter to people who owed tax demonstrated how more behaviourally sensitive language sped up payments. The unit also found that jobseekers were nearly twice as likely to turn up for a job fair if the text message from the job centre used their names, and nearly three times as likely if the person sending the text message added ‘good luck’.

Do tax reliefs persuade people to save? No. So enrol them instead automatically in a pensions programme as a default position, with the possibility of opting out. Allowing people to learn from mistakes is good: it reduces dependency on the public sector and helps people make better decisions for themselves. But some errors, such as failing to save anything until you are too old to earn, cannot be reversed. Then an early ‘nudge’ is justified. It has proved successful in spreading the habit of saving for retirement into groups not persuaded by tax reliefs alone.

In the long term this, and similar behavioural changes, may well have more influence on well-being than can be represented by concentrating on a monetary calculation of GDP. Other economic indicators could be used to assess this change in well-being.

Source: RSA Issue 1, 2017

(a) The article refers to macroeconomic policy aims. Identify and explain two such macroeconomic policy aims. [4]

(b) Is there evidence in the article that a knowledge of behavioural economics can help public policy? [4]

4. (a) Distinguish between a country’s national debt and its public sector budget deficit and consider which is the more important. [12]

(b) Discuss the effectiveness of alternative macroeconomic policies used to reduce a public sector budget deficit. [13]

5. Monetary policy relies heavily on the theory of a monetary transmission mechanism.

Explain how a monetary transmission mechanism works and discuss its effectiveness. [13]

6. In pursuit of well-being

It has been said that the mark of success of a government is raising the quality of life or the well-being of the people in the country. This is sometimes measured by the Human Development Index (HDI). Table 1.1 shows the rank order of selected countries by the HDI and compares it with the rank by Gross Domestic Product (GDP) of that country.

In order to understand how people make decisions, governments in the United States (US), the United Kingdom (UK) and Australia established Behavioural Insights Teams. They came to be known as the Nudge Units as they used nudge theories from behavioural economics.

It was hoped that this approach would help to achieve an increase in well-being as well as in economic growth and GDP. Nudge policies were used, with some success, to get people back to work, encourage them to pay their taxes on time and give them good reasons to save for future pensions or to study for improved qualifications.

They were not, however, sufficient to eliminate government budget deficits which remained at a high level. There was an ever-rising demand for public services but this was not matched by an equal rise in tax revenues so the deficit increased.

Eliminating the government budget deficit continued to be a problem. One method of dealing with the problem was to increase taxation. However, tax rates were already high and even higher tax rates would not result in the increase in revenue that was needed. An alternative option was to increase government borrowing. There might be a strong case to support economic growth, but increasing the deficit in order to achieve this could risk causing another financial crisis.

A third option was to reduce government expenditure on public services. This could be achieved without causing a reduction in the quality of the service and a reduction in well-being if increases in productivity took place. Without continued increases in productivity, however, further cuts in spending could have serious long-term detrimental effects, especially in health provision and education.

Table 1.1 Rank of selected countries by HDI and GDP in 2017

	Rank	HDI		Rank	GDP (millions US$)	
Norway	1	0.89		29	391 959	
Australia	3	0.86		13	1 359 723	
Germany	5	0.85		4	3 423 287	
UK	13	0.83		5	2 496 757	
Thailand	70	0.58		26	432 898	
Botswana	103	0.43		115	15 564	
Pakistan	117	0.38		43	251 487	
Eswatini	121	0.36		157	3 938	

Sources: RSA Issue 1, 2017

(a) What is meant by nudge theory? [2]

(b) (b) Consider whether the information provides any evidence that nudge theory could increase an economy's GDP. [6]

(c) Distinguish between demand-side and supply-side policies and identify and explain one demand-side policy and one supply-side policy from the information. [6]

7. (a) Explain what economists mean by an inflationary gap and discuss why this is considered to be an economic problem. Use a diagram(s) to support your answer. [12]

(b) How far would you agree that the use of monetary policy is the most effective way to solve the problem of an inflationary gap? [13]

8. (a) Distinguish between the internal value of money and the external value of money and consider whether there is a link between these two values. [12]

(b) 'Policies which attempt to control the internal value of money will automatically make it difficult to control the external value of money.'

Discuss the view that this statement is only partially correct. [13]

9. 'The failure of the policy of quantitative easing (QE) to solve problems associated with an economic recession illustrates the weakness of monetary transmissions mechanisms in particular and monetary policy in general.'

Critically evaluate this statement. [25]

10. (a) Consider the extent to which the commercial banks can influence the money supply. [12]

(b) 'Quantitative easing has a limited effect on employment in the short run and is likely to cause inflation in the long run.'

Discuss whether there is any truth in this statement. [13]

11. Governments have a range of macroeconomic aims apart from economic growth.

(a) Explain the other main macroeconomic aims a government might have apart from economic growth. [12]

(b) Discuss whether there is always a consistent link between investment and economic growth. [13]

12. Governments sometimes aim to reduce the level of unemployment. Discuss whether this necessarily results in a conflict between this aim and other government macroeconomic aims. [13]

13. Macroeconomic decisions: microeconomic effects.

In 2011 many countries experienced a recession. Most industries, even monopolies, in those countries saw a decline in demand, consumer spending and profits. However the decline was less severe in some firms, for example those in the food and beverage industry, than for others, for example those in the leisure industry. This fall in consumer spending and in consumer confidence might have been caused by anticipated job losses as governments announced reductions in public sector expenditure.

Governments decided to reduce expenditure because they had very large budget deficits. Apart from public sector employment reductions the macroeconomic measures they introduced included fewer subsidies, tax increases and a more restrictive monetary policy. Tax increases did not help businesses. For example they made it more necessary for firms to make the control of any credit they gave a priority, and to monitor their cash flow very carefully. Increasing prices to match indirect tax increases in order to retain profit levels was not always possible when consumer demand was reduced. The alternative of reducing costs was also a problem. Some argued that firms operating with a high proportion of fixed costs found the market conditions increasingly difficult as their revenues failed to recover and the possibility for further cost reductions became more limited. Others thought that firms with a higher proportion of variable costs faced greater difficulties.

Some governments also reduced investment allowances and subsidies to firms. These tax-free allowances enabled firms to deduct some of the investment cost from what they had to pay in tax. However, a reduction in the allowances had no effect on those industries that did not invest in new equipment. It did harm small and medium-sized enterprises that wanted to buy new machinery, or undertake research in order to become more efficient, or improve their products.

The situation was not helped by increased restrictions imposed by the government on banks' ability to lend. These restrictions meant borrowing for house purchases was more difficult and this again reduced consumer expenditure.

(adapted from The Guardian)

Use the information to explain how macroeconomic changes can be linked to microeconomic decisions. [5]

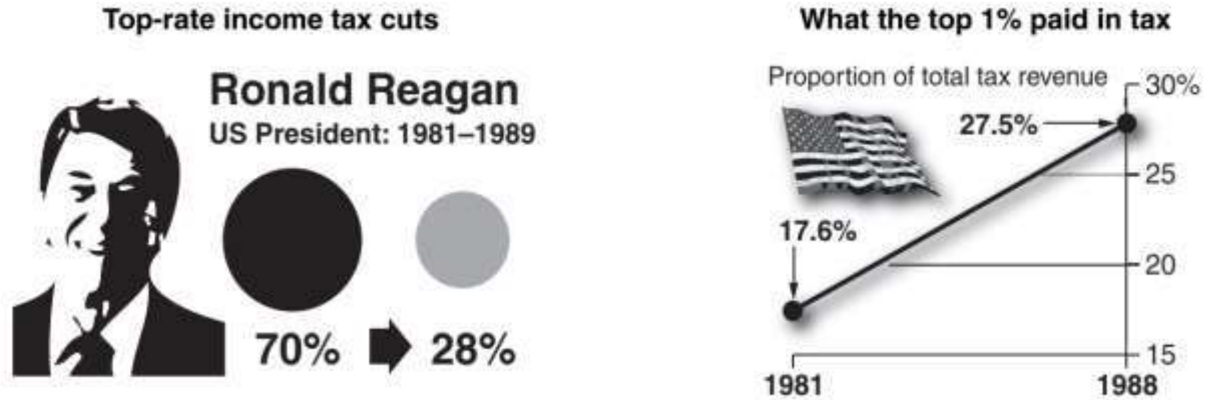
14. High taxes do not help in a recession

In 2009, there was an economic recession in many countries. One aspect of the recession was that unemployment rose. Governments paid large subsidies to a number of industries to try to stop the rise in unemployment. This increased the governments' debt and affected its other expenditure.

In an attempt to recover part of the extra expenditure, some governments had a policy of increased income tax rates on people who had high salaries.

However, critics of this policy argue that higher tax rates do not work. They say that the proportion of revenue received from top taxpayers falls and does not rise as taxes increase and the higher taxes cause damaging effects on the economy. It is better they say to decrease taxes. The decrease in taxes brings the government more revenue, not less revenue. Their opinion is supported by evidence from the past as is seen in the effect on tax receipts of changing tax rates in the US as shown in Fig. 1.

FIG. 1 CUTTING TAXES RAISES REVENUE



(Source: The Times, May 7 2009 p. 28.)

It is suggested that this opposite policy of reducing tax rates is better. Lower tax rates actually boost both the economy and tax revenues. For example, Russia, Latvia and Estonia reduced their highest tax rate and replaced a complicated system of taxes with a single income tax rate of 10%. They enjoyed a huge economic boost as a result.

Another aspect of the recession was that businesses found it difficult to borrow money from the commercial banks. In order to try and make borrowing easier and help businesses, some central banks lowered their interest rates. The central banks also bought government bonds in an attempt to increase the supply of money in the economy.

(***a) Explain what is meant by a recession. [3]***

(b) The article states that 'higher tax rates do not work'.

(i) What does the article mean by this statement? [3]

(ii) Is there enough evidence in the article to justify this statement? [6]

(c) Discuss why the actions of the central banks mentioned in the article might have been expected to ease the recession. [8]

15. The main way a developing country could become a developed country is for government policy to concentrate on the protection of domestic industry and investment in infrastructure.

Do you agree that this is the best policy? [25]

16. Interest rates, inflation and growth

Between 1 July and 1 October 2007, the GDP of the US rose at an annual equivalent rate of 4.0%. This was faster than the forecast rate of 3.1%. The rise was caused by an increase in consumer spending and by rising exports.

By November 2007, however, there were increased signs of a housing market slump, a rise in oil prices and a fall in the value of the US dollar. These changes presented the Federal Reserve (the US central bank) with a problem about interest rates.

The Federal Reserve had already cut interest rates in October 2007 and it reduced the interest rate again in November in order to help defend the US economy against the worsening housing market.

Further interest rate cuts were thought unlikely, as there was anxiety over the rising price of oil, which by November 2007 had reached a record level. The Federal Reserve said ‘recent increases in energy and commodity prices may result in further inflation’.

A difficult balance: conflicting policy objectives

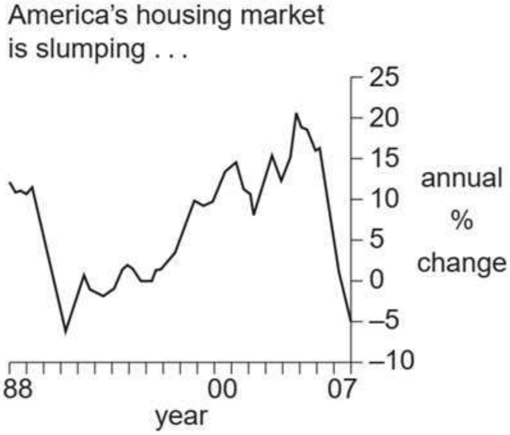


Fig. 1: House price index

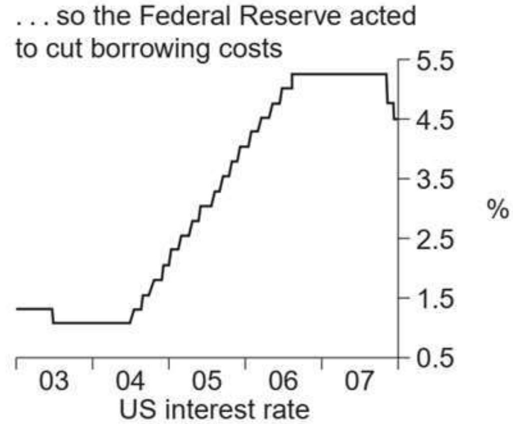


Fig. 2: US interest rate

Fig. 3: US crude oil price

Fig. 4: Dollars to the Euro

(a) Why does Fig. 4 refer to a 'falling dollar' when the trend of the line is upward? [2]

(b) Discuss the likely effectiveness of a reduction in interest rates as a solution to a housing market slump. [6]

(c) To what extent does the data support the view that the US economy was facing 'conflicting policy objectives'? [8]

17. Discuss the policies that a government might use to influence the level of investment in an economy. [13]

18. In 2006 it was reported that a country's unemployment rate had remained steady and that its central bank, through its interest rate policy, had prevented an increase in inflation despite a sharp rise in oil prices.

Discuss how interest rate policy might prevent a rise in inflation. [13]

19. In 2007 a report stated 'classrooms with teachers, clinics with nurses, clean water and working toilets are the key to ending global poverty. Only governments are in a position to provide these services on the scale required'.

Discuss whether governments should abandon their traditional macroeconomic aims in favour of the alternatives in the above statement. [25]

20. How far do you agree with the proposition that the main aims of economic government policy should be low unemployment and low tax rates? [25]

21. In 2002 there was a dangerous virus in China which caused many deaths. By July 2003 China had eliminated the virus and, as a result, there was a revival in tourism and consumer spending. Retail sales rose at the fastest pace for six months.

Why might a government wish to promote an increase in tourism? [13]

22. In August 2003 the US dollar rose in value against the euro as reports showed that Europe's economy failed to grow and Germany even fell into a recession.

(a) Explain what the above statement means. [12]

(b) Discuss what policies the German government might use to combat the recession. [13]

23. 'The rise in interest rates might not have the desired effect of curbing the existing inflation' reported a newspaper in 2002.

(a) Explain what effect a rise in interest rates might have on the level of total expenditure. [12]

(b) Discuss what policies apart from interest rate changes a government might use to control inflation. [13]

24. Most governments aim for full employment and stable prices. Which of those two aims should your government seek to achieve in the coming year and how might this choice affect the other aim? [25]

25. Discuss whether a budget deficit should necessarily be a source of concern. [13]

26. Discuss the ways in which a government might influence private investment in order to try to ensure sufficient economic growth in a country. [12]

27. An increase in a government's budget surplus will increase unemployment in the short run but it will make it easier to control a balance of payments deficit on the current account in the long run.

Evaluate this statement. [20]

28. With the help of a diagram, assess the effectiveness of government policies which might be used to reduce cost-push inflation. [20]

29. In periods of rising and persistent inflation, consumers and workers change their expectations of the future rate of inflation.

Evaluate, with the help of a diagram(s), the consequences of these changes of expectations for fiscal policy. [20]

30. With the help of a diagram, assess the effectiveness of using fiscal policy to close a negative output gap in an economy [20]

MARK SCHEME

1. Monetary transmissions mechanisms attempt to explain how changes in monetary policy might have an impact on key macroeconomic goals such as national income, output, employment and inflation.

Answers may explain either the Keynesian model or an alternative model based on a central bank changing the base rate of interest. Keynes suggested that an increase in the money supply might affect real variables such as output and employment because this would be transmitted by a fall in interest rates, leading to a rise in investment/aggregate monetary demand and ultimately an increase in GDP and employment. However, Keynes also identified a number of reasons why this approach might not work effectively in practice. Reasons might include: the existence of a liquidity trap; an interest inelastic investment; a relatively low multiplier effect; negative effect of a rise in income on interest rates.

A similar approach might be adopted in relation to the use of a central bank's mechanism to change interest rates to control the rate of inflation. Again, the success of this approach will rely heavily upon the strength of the links between a change in monetary policy and each of the variables which will determine the final outcome.

L4 (9–12 marks): For either approach an explanation of the meaning of monetary transmissions mechanism is required and supporting analysis should be fully developed and critically evaluated. In either approach, at least two evaluative comments should be provided. A reasoned conclusion should be provided which considers the extent to which the chosen monetary transmissions mechanism might work in practice.

L3 (7–8 marks): For accurate but only partially developed analysis based on either approach which provides at least one evaluative comment. Some attempt to draw upon the analysis and form a conclusion should be demonstrated.

L2 (5–6 marks): For a mainly descriptive comment which provides limited analysis and does not include any discursive comment. A conclusion will not be provided.

L1 (1–4 marks): For an answer that has some basic correct facts but includes irrelevancies and errors of theory.

2. Candidates should explain that a budget deficit will occur when government total expenditure is greater than its total income. It should also be explained that unemployment is considered to be a problem primarily because it represents a waste of valuable scarce resources.

Keynesians argue that an increased budget deficit will create additional expenditure/aggregate monetary demand which, in conjunction with the multiplier effect, will lead to an increase in output, income and employment. However, monetarists suggest that this approach might not be effective because: additional borrowing due to a budget deficit will lead to higher interest rates, lower investment and a countervailing fall in monetary demand; alternatively monetarists suggest it the financing of the deficit depends upon printing new money, this will ultimately lead to inflation; that it is the cause of unemployment which matters and Keynesian solutions would not be helpful regarding structural unemployment caused by changes in the pattern of demand and/or frictions in the labour market.

Therefore monetarists would argue that supply side policies, either based on direct government intervention, for example reducing corporation tax or by interfering with the price mechanism to reduce frictions in the labour market. For example introducing de-regulation and promoting privatisation. An attempt should be made to summarize the preceding argument and recognising that a key difference between the two approaches is closely linked to the type of unemployment under consideration.

L4 (18–25 marks): For an answer which explains what is meant by a budget deficit and which recognizes why unemployment constitutes a significant economic problem. Analysis of both the Keynesian and Monetarist proposed solutions will be provided. Analysis in both cases should be subject to at least one evaluative comment. A conclusion should recognize that a key difference between the two solutions advocated should relate to the specific type of unemployment under consideration.

L3 (14–17 marks): For analysis which addresses both the Keynesian and Monetarist approach to solving the problem of unemployment. A budget deficit and the reason why unemployment will also be explained in the process. However, there will be little evidence of evaluative comment with respect to either approach. A brief conclusion might be provided but it will not recognize the key explanation regarding the difference between the two approaches.

L2 (10–13 marks): For a less well developed comment which describes the meaning of a budget deficit and the problem of unemployment. Also some attempt will be made to distinguish between Keynesian demand side policies and Monetarist supply side policies but this will not be supported by any in-depth analysis. No attempt will be made to directly compare the effectiveness of the two policies.

L1 (1–9 marks): For an answer that shows some knowledge but does not indicate that the question has been fully grasped or where the answer is mostly irrelevant.

3. (a) Any two aims (2) explanation (2)

(b)

- evidence of possible reduction in unemployment
- evidence of possible increases in tax payments which could help reduce budget deficit
- evidence of persuasion to increase savings might help stop demand inflation

4. (a) Candidates should clearly distinguish between the national debt and the public sector budget deficit. The national is the cumulative amount of debt which consists of the total amount of money borrowed from the private sector and other purchases of government securities since the government began borrowing.

The public sector budget deficit occurs when a government spends more than its income in a particular time period, usually one year. Both are important due to their potential effects on the macro economy. Interest has to be paid on the national debt and this has an opportunity cost regarding the use of scarce public sector resources. The budget deficit has to be financed and this has important implications for the impact of this on key macroeconomic indicators.

L4 (9–12 marks) For an answer that provides a clear explanation of both terms and why each is important in relation to macroeconomic policy. An attempt should be made to evaluate the relative importance of each indicator and also an attempt should be made to show how both elements are linked. A conclusion should provide evidence of some consideration of why one indicator may or may not be more important than the other.

L3 (7–8 marks) For responses that demonstrate a good grasp of both indicators and why both indicators are important by linking each to macroeconomic management. No attempt will be made to examine the relative importance of each indicator and the conclusion will not be fully developed.

L2 (5–6 marks) For a description of both indicators but with a limited attempt to establish the importance of each indicator. There will be little reference to the potential links between the indicators and no discussion regarding their effect on key macroeconomic indicators. No conclusion will be provided.

L1 (1–4 marks) For an answer that has some basic correct facts but includes irrelevancies and errors of theory.

(b) Short run policy approaches can be divided into those based on increases in the level of taxation and those related to cuts in public expenditure. Longer term measures might relate to supply side policies used to achieve economic growth.

The effectiveness of each group of measures can be analysed by assessing their relative impact on the deficit in the short run and long run and considering costs associated with each policy alternative.

L4 (9–13 marks) For a discussion that refers to at least two groups of alternative macroeconomic measures and attempts to assess the costs/benefits associated with each approach. Good responses will identify the distinction between short run and long run approaches. A reasoned conclusion should be provided.

L3 (7–8 marks) For analysis of how different macroeconomic policies might be used to reduce a budget deficit but no attempt to distinguish between short run and long run approaches and no attempt to discuss which policy option might be the more effective.

L2 (5–6 marks) For an answer that describes how a budget deficit can be reduced but does not provide any supporting analysis of how each policy might work and only partially attempts to develop points raised. No conclusion will be provided.

L1 (1–4 marks) For an answer that has some basic correct facts but includes irrelevancies and errors of theory.

5. The monetary transmissions mechanism links changes in the money market to changes in the goods market. Changes in the money supply will change interest rates which will impact on the level of investment and ultimately this will change real variables such as output and employment.

Evaluative comment might refer to the liquidity trap, an inelastic MEC curve, the effect of negative expectations on investment, a possible weak multiplier effect or the negative feedback effect of an increase in income on the rate of interest.

L4 (9–13 marks) For a detailed explanation of the Keynesian monetary transmission supported by an accurate, clearly labelled diagram. Responses should identify at least two reasons why the link between the money market and goods market might be weak. Based on the preceding evaluation a conclusion should comment on the effectiveness of the theory.

L3 (7–8 marks) For clear analysis of the links between the money market and the goods market supported by an accurate, relevant diagram. Some evaluative comment will be provided but not fully developed. Conclusion will be brief.

L2 (5–6 marks) For a descriptive approach that does not support comment with an appropriate diagram with very little comment relating to the effectiveness of the process and no attempt to provide an appropriate conclusion.

L1 (1–4 marks) For an answer that has some basic correct facts but includes irrelevancies and errors of theory.

6. (a) Policies designed to influence behaviour by persuasion or example in order to achieve one of the main government economic policy aims.

(b)

- paying taxes increases revenue which might be spent on projects to increase GDP
- more people working reduces unemployment which increases income and might help economic growth
- increasing saving for education might increase skill levels in the economy and improve productivity.

(c) Distinction (2) identify (2) explain (2) demand side – changes in tax rates, supply side – improving infrastructure, training, productivity, borrowing could be used to stimulate either demand or supply.

7. (a) A clear definition of the meaning of the term ‘inflationary gap’ will be supported by an accurate, clearly labelled supporting diagram which identifies the inflationary gap. Some attempt should then be made to consider why this might cause economic problems. References might be made to the negative effect on expectations, private investment, the exchange rates, savers and debtors plus any other relevant effects.

L4 (9–12 marks): For an answer that explains the meaning of an inflationary gap and which refers to at least three potential negative effects. The relative importance of each identified effect should be considered.

L3 (7–8 marks): For an answer that identifies at least two negative effects associated with an inflationary gap and considers their relative importance or analyses three potential impacts on the economy associated with an inflationary gap.

L2 (5–6 marks): For an answer that describes what is meant by an inflationary gap and supports this with a reasonably accurate diagram and some brief comment regarding potential negative effects on the economy.

L1 (1–4 marks): For an answer that has some basic correct facts but includes irrelevancies and errors of theory.

(b) Responses should indicate a clear understanding of what is meant by monetary policy and alternative methods of monetary control should be explained. References should then be made to the problems associated with an inflationary gap and an attempt made to discuss the effectiveness of alternative monetary policies used to reduce an inflationary gap. The effectiveness of these polices should be evaluated and compared with alternative fiscal/supply side policies.

L4 (9–13 marks): For a detailed explanation of why monetary policies might solve problems associated with an inflationary gap. At least two types of monetary policy should be considered. Alternative policy measures should then be explained and discussed. A conclusion should then consider the relative effectiveness of monetary policy options compared to fiscal/supply side alternatives.

L3 (7–8 marks): For analysis of how monetary policy might work in order to reduce an inflationary gap. A clear diagram will be provided and problems associated with an inflationary gap will be identified. Only a brief comment will be provided regarding alternative policy approaches.

L2 (5–6 marks): For an answer that focuses upon explaining what is meant by an inflationary gap and describes alternative monetary policy options but does not discuss the effectiveness of either monetary policy or alternative policy options.

L1 (1–4 marks): For an answer that has some basic correct facts but includes irrelevancies and errors of theory.

8. (a) Answers should explain that the internal value of money will be determined by inflation and subsequent purchasing power and the external value will be determined by the foreign exchange value of the domestic currency. Links between the two values should be discussed. For example, an increase in inflation might lead to a fall in the exchange rate, therefore a fall in the internal value might be associated with a fall in the external value.

L4 (9–12 marks) For an answer which attempts to discuss how a change in the internal value of money might affect the external value and vice versa. Good responses will provide at least two examples and consider changes in both directions. Might also discuss the strength of the links.

L3 (7–8 marks) For an analysis of what might affect each of the two types of value and a limited attempt to identify why a change in one value might lead to a change in the other value.

L2 (5–6 marks) For an explanation of what is meant by internal and external value of money and establishing a clear distinction between the two.

L1 (1–4 marks) For an answer that shows some knowledge but does not indicate that the question has been fully grasped or where the answer is mostly irrelevant.

(b) Policies which attempt to control the internal value of money will include all policies used to control inflation. These might include monetarist, Keynesian demand pull and Keynesian cost push. Different policies would be expected to have a different impact on the external value of money. The response should use analysis to establish the links between the policies and their impact and make some attempt to discuss whether such policies automatically make it difficult to control the external value of money.

L4 (9–13 marks) For an answer which attempts to evaluate how far the statement under consideration can be described as 'only partially' correct. There should also be a discussion relating to whether these policies will 'automatically' make it difficult to control the external value of money. Examples and evidence should be provided to form a conclusion.

L3 (7–8 marks) For an answer which analyses why policies identified to control the internal value will have some impact on the external value. For example, an increase in interest rates to help control demand pull inflation might lead to an increase in exchange rates due to short term capital inflows.

L2 (5–6 marks) For an answer which explains alternative policies to control inflation and 23ecognizes that these policies will have an effect on the external value of money.

L1 (1–4 marks) For an answer that shows some knowledge but does not indicate that the question has been fully grasped or where the answer is mostly irrelevant.

9. Quantitative Easing should be explained and the problems generally associated with an economic recession should be clearly identified. The links between Quantitative Easing and the monetary transmissions mechanism should be established and these links should be further extended to allow a discussion of the effectiveness of monetary policy on real variables such as income, output and employment. Evaluative comment and a conclusion should be provided to assess the accuracy of the statement.

L4 (18–25 marks) For an answer which focuses upon each of the four elements referred to in the statement and makes an attempt to assess the extent to which problems associated with a recession might be solved by the use of Quantitative Easing. Evaluative comment should produce a conclusion/judgement regarding the success/failure of Quantitative Easing

L3 (14–17 marks) For an answer which attempts to link each element of the statement and provides some analysis of how/why these elements are linked. Diagrams might be used to illustrate how the monetary transmissions works and how this might address the problems associated with a recession

L2 (10–13 marks) For a correct explanation of each of the key elements of the statement but no attempt to link these elements to address the specific question

L1 (1–9 marks) For an answer that shows some knowledge but does not indicate that the question has been fully grasped or where the answer is mostly irrelevant.

10. (a) There are many definitions of the money supply. The narrow definition includes notes and coins in circulation and balances held by the commercial banks at the central bank. The more commonly used broad definition includes notes and coins in circulation and bank deposits. Bank deposits represent the largest part of the money supply. Commercial banks create new bank deposits every time they grant a loan. It is profitable for banks to create loans, so banks often have a significant effect on the broad definition of the money supply. However, there are limits to the ability of banks to create new deposits. These might include: the willingness of borrowers to borrow; leakages of funds (loans not re-deposited); the need for banks to maintain a safe amount of liquid assets; restrictions upon lending imposed by governments.

L4 (9–12): for an answer that 24ecognizes that there are a number of limitations to the ability of commercial banks to create new deposits. Should refer to at least two reasons why commercial banks' ability to influence the money supply might be limited

L3 (7–8): for an answer that analyses how banks can create money by granting loans and why banks have an incentive to do this. Might also refer to the importance of the bank credit multiplier

L2 (5–6): for an answer that 24ecognizes that there are different definitions of the money supply and that the most important measure includes bank deposits which also account for the biggest proportion of this measure

L1 (1–4): for an answer that shows some knowledge but does not indicate that the question has been fully grasped or where the answer is mostly irrelevant

(b) Candidates should explain what quantitative easing means and how it is used to influence interest rates and the money supply. Links should then be established between these changes and changes in the level of employment and the rate of inflation. Some discussion should then be applied to possible short-run effects on the economy and also some potential long-run effects. In each case candidates are expected to evaluate key relevant factors and draw a conclusion in relation to the statement under consideration.

L4 (9–13): for an answer that attempts to distinguish between short-run effects on the level of employment and the potential long-run effects on inflation. Evaluative comment should be used to decide how far the candidate agrees with the statement and a relevant conclusion should be provided

L3 (7–8): for an answer that critically analyses the way in which quantitative easing is supposed to work and how it might have worked in practice

L2 (5–6): for an answer that explains what quantitative easing means and how it can be used to influence interest rates and possibly the money supply

L1 (1–4): for an answer that shows some knowledge but does not indicate that the question has been fully grasped or where the answer is mostly irrelevant

11. (a) Description of macroeconomic aims with relation to price stability, balance of payments, employment, income distribution.

Level 4 (9–12 marks): for a sound description with good illustration and a clear understanding of all four aims.

Level 3 (7–8 marks): for an accurate but less developed description of four aims or a fuller description of three aims.

Level 2 (5–6 marks): for a correct but very brief description of the aims of a fuller description of two of the aims.

Level 1 (1–4 marks): for an answer that has some basic correct facts but includes irrelevancies and errors of theory.

(b) Discussion of link between investment and national income via multiplier, but also between income, demand and investment by the accelerator. Comment on possible differences due to differing injections, leakages, possible effect on prices rather than output of changes in investment.

Level 4 (9–13 marks): for a reasoned and clear discussion with accurate explanation of the theory with possible different outcomes together with a conclusion.

Level 3 (7–8 marks): for a fair but limited discussion with less recognition of the possible different outcomes.

Level 2 (5–6 marks): for a limited but acceptable attempt to consider part of the question, probably the multiplier effect, and with poor recognition of different outcomes.

Level 1 (1–4 marks): for an answer that has some basic correct facts but includes irrelevancies and errors of theory.

12. A discussion of the main aims of government policy, with a judgement as to whether there might be any conflict. Accept any relevant suggestion, for example, increased employment might increase spending, which might put pressure on prices and conflict with stable price aim. Non-conflict should also be mentioned, for example, increased employment might aid growth.

L4 (9–13) For a reasoned and clear discussion, logically presented, either one conflict fully presented, or two conflicts briefly presented together with non-conflict.

L3 (7–8) For a fair but undeveloped discussion, but with an accurate reference to the question. One conflict less fully presented together with non-conflict.

L2 (5–6) For a limited discussion with little comment, concentrating on one side only.

L1 (1–4) For an answer which has some basic correct facts, but includes irrelevancies and errors of theory.

13. 5 marks for effects. Those mentioned in the text of how public sector decisions have an impact on private sector firms include – reduced investment, lower profits, reduced demand, not possible to raise prices, public sector employment reduced causing a decline in confidence, fear of job losses, and possible reductions in expenditure, reduced research etc.

14. (a) Do not need a formal definition to gain 3 marks. Explanation of a recession in terms of a decline in output, a reduction in GDP, an increase in unemployment, decline in spending, decline in investment. [3]

(b) (i) The statement means that the rise in taxes does not increase the government's revenue as is anticipated and does not, therefore, increase the government's funds for expenditure. The distribution of the tax burden is not directed more to the higher income earners. [3]

(ii) Evidence in the charts: In the US during the 1980s the top rate was cut from 70% to 28% and the share of taxes paid by the top 1% rose from 17.6% to 27.5%.

– However, there is no evidence about what happened when tax rates were increased.

– there is also no statement about what the higher tax rates were intended to achieve.

– there is no statement about what happened to production and employment when taxes were high.

Up to 4 marks for evidence giving one side only.

(c) The bank lowered interest rates. Lower interest rates would mean a reduction in the cost of borrowing with a potential increase in investment which would stimulate the economy. Candidates can explain the effect of investment/injection increases. Lower rates are also hoped to encourage spending maybe by an increase in credit. Buying bonds also puts more money into the economy with the hope that this would stimulate demand. [8]

15. The candidates should present an argument which considers the criteria which distinguish developed from developing countries; which discusses the significance of the protection of domestic industry and the role of investment; and which comments on the proposition that governments should place an emphasis on protection and investment.

L4 For a thorough discussion of the range of distinguishing criteria, a competent discussion of the role of protection and investment and a reasoned conclusion. (18–25)

L3 For a competent discussion but with a more limited comment on the relative importance of protection and investment (to other alternatives). A conclusion should still be presented. (14–17)

L2 For an accurate though undeveloped discussion, limited attempt to mention the relative importance of protection and investment and no conclusion. (10–13)

L1 For an answer which shows some knowledge but does not indicate that the question has been fully grasped, or where the answer contains irrelevancies and errors of theory. (1–9)

16. (a) Shows $ against euro. More $ per euro, so dollar is worth less.

(b) Fall in interest rates makes borrowing easier, demand for houses increases, average price of houses rises, construction industry is more likely to make profits and be willing to increase supply of houses – presuming that banks are willing to lend to consumers up to 4 if no evaluation.

(c) Housing market slump could lead to increased unemployment – beginning in the construction industry but spreading to industries which supply contents for houses and materials for house building. The slump could be helped by lower interest rates. However, lower interest rates and the increase in oil prices might increase inflation. Falling interest rates could also increase spending and put further pressure on inflation. Value of dollar is declining and this causes further pressures on the balance of payments and exports.

17. The government might wish to influence the investment by using fiscal or monetary policy. It might also influence the investment of the private sector by regulation. It can use taxes or subsidies, interest rates, regulations or controls.

L4 For a reasoned discussion and clearly structured answer with several alternative policies. [9–13]

L3 For a competent discussion but with a more limited range of policies. [7–8]

L2 For a weaker attempt which may concentrate on only one type of policy, not present any drawbacks of that policy or not develop any wider analysis. [5–6]

L1 For an answer which has some basic correct facts but includes irrelevancies. Errors of theory or omissions of analysis will be substantial. [1–4]

18. Discussion of how changes in interest rates might influence spending, or saving, or investment and therefore might influence the pressure on resources and on inflation.

L4) For a sound discussion with good explanation of the analysis and a clear understanding with a conclusion. (9–13)

L3) For a competent comment but with limited development of the analysis and a weaker conclusion. (7–8)

L2) For a brief explanation and with a weak explanatory link between interest and inflation and with no conclusion. (5–6)

L1) For an answer which has some basic correct facts but includes irrelevancies. Errors of theory or omissions of analysis will be substantial. (1–4)

19. Candidates are asked to construct an argument. The elements in the argument must consist of (i) a statement of government macro-economic aims, (ii) a consideration of alternative aims mentioned, and (iii) whether governments have to abandon their macro aims in order to achieve the alternative.

L4) For an clear explanation of the macro aims, a clear statement about the assertion in the quote and a discussion of whether this implies the abandoning of other macro aims. A reasoned conclusion will be presented. (18–25)

L3) For a competent explanation which does not fully analyse the argument or clearly see the progression, or lack of progression in the argument. There will be some discussion but the evaluation will not be fully developed or extensive. (14–17)

L2) For an accurate though undeveloped explanation of some of the terms, probably mentioning some of the macro aims but not dealing with the link with the quote, with very limited evaluation and no real conclusion. (10–13)

L1) For an answer which shows some knowledge but does not indicate that the question has been fully grasped. The answer will have some correct facts but include irrelevancies. Errors of theory or omissions of analysis will be substantial. (1–9)

20. Candidates should discuss the aims of government policy and suggest which might be most important. Reasons should be given for their choice and they should come to a conclusion about the proposition in the question.

(L4) For a thorough explanation of the terms, a competent discussion of the proposition and a reasoned conclusion.

[18–25]

(L3) For a competent explanation but with a more limited and less developed discussion and conclusion.

[14–17]

(L2) For an accurate though undeveloped explanation with some attempt at analysis but only limited evaluation.

[10–13]

(L1) For an answer which shows some knowledge but does not indicate that the question has been fully grasped, or where the answer contains irrelevancies and errors of theory.

[1– 9]

21. Candidates can discuss the effect of an increase in tourism on employment in the country and on the international competitiveness of the economy. They could explain the effect of a rise in tourism on the balance of payments. They could also explain the possible effects of a rise in spending on tourism on the revenue of the government through indirect taxes.

L4 For a sound discussion with good explanation of the analysis and a clear understanding of the principles involved

9 – 13

L3 For a competent comment but with limited analysis

7 – 8

L2 For a correct explanation of part of the analysis. Candidates might explain either the employment effects, or balance of payments or government revenue

5 – 6

L1 For an answer which has some basic correct facts but includes irrelevancies. Errors of theory or omissions of analysis will be substantial

1 – 4

22. (a) Candidates should explain what is meant by 'US dollar rose against the Euro', 'Europe's economy failed to grow and Germany fell into a recession'.

L4 For a sound explanation of each part and a clear understanding of the principles involved

9 – 12

L3 For a competent comment but with limited elaboration of the analysis

7 – 8

L2 For a correct explanation of part of the analysis. Candidates might explain only two of the parts of the statement

5 – 6

L1 For an answer which has some basic correct facts but includes irrelevancies. Errors of theory or omissions of analysis will be substantial

1 – 4

(b) Discussion of fiscal and monetary or regulative policies to deal with recession. Strictly, the policy of the German government is restricted by the EU but answers which ignore this should be accepted.

L4 For a reasoned and clear discussion with accurate development of theory

9 – 13

L3 For a clear discussion but with limited elaboration of the analysis or may discuss only two types of policy

7 – 8

L2 For a correct discussion of part of the analysis. Candidates might discuss either fiscal or monetary or regulative policies

5 – 6

L1 For an answer which has some basic correct facts but includes irrelevancies. Errors of theory or omissions of analysis will be substantial

1 – 4

23. (a) Explanation of effect of interest rate changes on investment, on saving, and on spending. Effect on possible changes in production, employment, income levels, but also effect on any existing inflationary tendencies.

Level 4) For a sound explanation with good illustrations and a clear understanding of the principles involved.

9 - 12

Level 3) For a competent comment with limited critical comment.

7 - 8

Level 2) For a correct description but undeveloped comment with limited attempt to elaborate the description.

5 - 6

Level 1) For an answer that has some basic correct facts but includes irrelevancies and errors of theory.

1 – 4

(b) Discussion of the types of inflation and, therefore, of the policies possible which might include restricting imports, curbing spending, taxation policies, directives about wages.

L4) For a reasoned discussion and clear analysis.

9 - 13

L3) For a fair but undeveloped analysis.

7 - 8

L2) For a limited but acceptable attempt to consider the possible results of policies.

5 - 6

L1) For an answer which has some basic correct facts but includes irrelevancies and errors of theory.

1 - 4

24. Discussion of the two policy aims. Candidates should give a reasoned account of how the aim chosen would affect and link to the alternative aim.

L4 For a thorough explanation of the terms, a clear analysis of the link between different issues, a discussion of the possible outcome of government policy with a balance of alternative views and a reasoned conclusion (18-25)

L3 For a competent explanation which does not fully analyse the effects of government policy, does not fully develop a discussion on possible links but makes some attempt at evaluation (14-17)

L2 For an accurate though undeveloped explanation with some attempt at analysis but only limited evaluation (10-13)

L1 For an answer which shows some knowledge but does not indicate that the question has been fully grasped, or where the answer contains irrelevancies and errors of theory (1-9)

25. Discussion of meaning of budget deficit with comment on possible effect on incomes, employment, growth, imports.

(L4) For a sound discussion with clear understanding of the principles involved and a reasoned conclusion. [9–13]

(L3) For a competent discussion but with limited development and limited conclusion. [7–8]

(L2) For a correct explanation but without concluding comment. [5–6]

(L1) For an answer which has some basic correct facts but includes irrelevancies. Errors of theory or omissions of analysis will be substantial. [1–4]

26. Discussion of fiscal and monetary incentives together with particular subsidies or regulative controls.

L4 For a sound discussion with clear understanding of the principles involved (9-12)

L3 For an accurate reference to the question but with a more limited explanation (7-8)

L2 For an explanation which contains minor errors or an undeveloped comment, not necessarily logically presented (5-6)

L1 For an answer which has some basic correct facts but includes irrelevancies and errors of theory (1-4)

27. AO1 and AO2 out of 14 marks. AO3 out of 6 marks.

Indicative content

Responses may include:

AO1 Knowledge and understanding and AO2 Analysis

• Knowledge of what is meant by a budget surplus, in relation to the difference between government expenditure and government income.

• Reference to links between a government surplus, aggregate monetary demand and unemployment.

• Explanation of the specific type of unemployment that might relate to an increase in a governments budget surplus.

• Analysis of the links between changes in interest rates and unemployment in the short run.

• Explanation of some of the key elements of the balance of payments accounts and how they might be influenced by changes in fiscal policy.

• Analysis of the links between a budget surplus and the control of a balance of payments in the long run.

AO3 Evaluation

• The impact of a budget surplus in the short run on the level of unemployment will depend upon the main cause of the existing level of unemployment.

• A budget surplus is more likely to have a negative effect on unemployment when an economy has a lot of existing spare capacity.

• If structural factors are responsible for unemployment, supply side policies might be more effective.

• A budget surplus might lead to lower interest rates and cause problems for specific industries within an economy. For example, low interest rates might cause a boom in the housing market.

• If a budget surplus leads to a subsequent fall in interest rate, this might ultimately make it more difficult to control a balance of payments in the long run.

• A conclusion should make an attempt to make an overall comparison between the use of monetary policy and alternative fiscal or supply side policies. A judgement should be made which directly addresses the statement in question.

Accept all valid responses.

AO1 Knowledge and understanding and AO2 Analysis 14

AO3 Evaluation 6

28. AO1 and AO2 out of 14 marks. AO3 out of 6 marks.

Indicative content

AO1 Knowledge and understanding and AO2 Analysis

• A clear outline of different causes inflation and why inflation might cause problems.

• A more detailed explanation of the causes of cost push inflation, supported by an accurately labelled diagram

• A description of alternative policies that a government might use to reduce cost push inflation

• Analysis can be used to show how a government will be able to increase aggregate supply, in the long term, by increasing productivity through direct investment. For example, by increasing expenditure on education/infrastructure. This analysis might also be supported by a relevant diagram

• In the short term, a government might focus on attempting to reduce the cost of producing goods and services by introducing widespread subsidies, reducing indirect taxation, removing tariffs on key imports or the use of incomes policies.

L2 maximum if no accurate diagram provided

Must refer to some supply side polices to gain L3 marks

AO3 Evaluation

• Increasing the use of subsidies and/or decreasing the use of indirect taxation is likely to have a negative effect on a government's budget. For example, increasing the budget deficit and subsequently increasing the need for more government borrowing.

• Removing tariffs is likely to have a negative effect on the incomes and output of domestic producers and possibly lead to an increase in unemployment

• The introduction of incomes policies is likely to lead to opposition from trade Unions and the possibility of industrial disruption.

• Long run supply-side policies are likely to focus on attempts to increase productivity. This frequently involves significant investment in new technology which will lead to a rise in unemployment in the short run

• Other policies which might be used in the long run might include immediate investment in skills training and improving the quality of the infrastructure. Skills training is expensive and hence has a high initial opportunity cost. While the immediate effect of an increase in expenditure on improving the infrastructure is likely to increase aggregate demand and add to the inflationary pressure

• A conclusion should attempt to assess the relative effectiveness of each type of policy approach and consider which approach is likely to be the most effective in the short run and then compare this with possible outcomes that might be achieved in the long run.

Accept evaluation relating to demand side policies.

AO1 Knowledge and understanding and AO2 Analysis 14

AO3 Evaluation 6

29. AO1 and AO2 out of 14 marks. AO3 out of 6 marks.

Indicative content

AO1 Knowledge and understanding and AO2 Analysis

• Definition of inflation, non-accelerating inflation rate of unemployment.

• Expectations mean consumers and workers change their view on the future rate of inflation based upon their experience of past inflation rates.

• Use of AD, AS analysis to show how inflation occurs. This may be referred to as cost push/demand pull inflation.

• Explanation of Phillips curve in terms of the trade-off between wage growth/inflation and employment. This becomes a cost-push view of inflation as workers pursue higher wages to compensate for higher prices (the wage/cost spiral).

• Analysis of Fiscal policy on changing unemployment/inflation.

• Impact of changing expectations on the fall in unemployment and the rate of inflation

Note: Maximum L2 if no diagram

AO3 Evaluation

• Changing expectations means that the anticipated fall in unemployment is temporary as consumers and workers negotiate higher wages to offset the past inflation.

• Fiscal policy can no longer be used to reduce unemployment.

• The shape of the AS curve – whether it is horizontal or vertical in the short-run. Keynesians argue AS is more elastic in the SR

• Expansionary fiscal and monetary should not be used as they only create higher inflation.

•Phillips curve relationship may no longer be valid. In the 1970s there was high inflation and high unemployment, in the 2000s there was low unemployment and low inflation.

• In the 1960s/1970s there was more structural strength between wages and inflation as there was a larger proportion of unionised labour and the ability of workers to negotiate higher wages was stronger.

• Since the 1950s when the Phillips curve relationship was determined, there has been a significant increase in world trade and development of MNC the supply of labour is no longer limited by national borders.

• To achieve low inflation and low unemployment policies which stimulate economic growth and supply-side policies which reduce capacity restraints are `needed.

Accept all valid responses.

30. AO1 and AO2 out of 14 marks. AO3 out of 6 marks.

Indicative content

Responses may include:

AO1 Knowledge and understanding and AO2 Analysis

• Fiscal policy would require a government to use taxation and government expenditure changes to influence key macroeconomic goals such as inflation, economic growth and the level of employment.

• An output gap will show the difference between the actual output of an economy and its potential output.

• A negative output will indicate that there is spare capacity in an economy which will be primarily due to insufficient aggregate monetary demand. A relevant diagram can be used to illustrate this gap.

• Analysis can be used to show how a government will be able to significantly influence aggregate demand by either increase its expenditure or reducing the overall level of taxation.

• A budget deficit will inject additional demand into an economy which will have a magnified effect on output, income and employment due to the positive contribution of a multiplier effect.

AO3 Evaluation

• Fiscal policy could help to close a negative output gap by increasing a government's budget deficit but this may lead to higher interest rates and crowding out in the private sector.

• It is difficult for a government to produce an accurate forecast of the magnitude of the output gap.

• Although a budget deficit might help to reduce a negative output gap in the short run, if the deficit is financed by increasing the money supply, this might lead to inflation in the long run.

• Alternative policies such as supply-side policies might be more effective by closing the output gap while avoiding the risk of inflation in the long run.

• Expansionary fiscal policies used to close an output gap might lead to an increase in the demand for imports and subsequently, a negative impact on the country's balance of payments.

• While the long-run impact on the current account is dependent upon respective export/import price elasticities of demand, it is also important to recognise that if raw materials such as oil constitute a significant proportion of the value of imports then the price elasticity of demand for imports is likely to be low.

• The long-run impact on inflation will be influenced by the current state of the economy when the devaluation takes place. For example, if there is a significant amount of spare capacity, the effect on Aggregate Demand of a lower price of exports might be limited.

• It could also be noted that a government which chooses to use a policy of devaluation is perhaps prioritising the need to correct a balance of payments disequilibrium at the possible expense of other key macroeconomic goals such as controlling inflation.

• Based on the evidence/analysis provided, it is not clear whether a devaluation of the currency will solve a persistent current account deficit in either the short run or the long run. Similarly, the impact on the general price level will depend on a number of variables which are difficult to predict or measure accurately.

Accept all valid responses.

AO1 Knowledge and understanding and AO2 Analysis 14

AO3 Evaluation 6