EZY ECONOMICS

# Sample Papers – Set 1

# AQA A Level – Paper 2 (National and International Economy)

# Answer Guide

This document is intended to support paper 2 of the first set of the EzyEconomics sample exam papers.

The answer guide provides a commentary on possible effective approaches to answer the sample exam questions.

# Note from the Editors

This answer guide has been created by EzyEducation Ltd. It has not been ratified by the exam board. The main purpose of this material is to provide schools with an additional source of material to help teachers prepare students for their examinations. The guide aims to indicate to students what EzyEducation Ltd consider to be good exam technique. It also indicates the content that students might use to answer specific questions.

Although it has been influenced by the specification and sample mark schemes published by examination boards, it is not possible to guarantee that this document will accurately reflect the way examinations are actually marked. This is subject to uncertainty due to the subjective nature of the marking process.

# Contents

## Section A

### Context 1



### Context 2



## Section B

### Essay 1



### Essay 2



### Essay 3

# AQA Macro Answer Guide

## Question 1

Using the data in **Extract A**, calculate, to 1 decimal place, the percentage change in the average annual Pound to Dollar exchange rate from 2008 to 2016.

**[2 marks]**

There are two key steps to this question.

### Step 1: Identify the important pieces of data from Extract A

The question asks about the average annual Pound to Dollar exchange rate from 2007 to 2013. Extract A provides you with a table showing the average annual exchange rate values of the Pound against the Dollar from 2008 up to the forecast of 2017. Identifying the correct column allows us to pick out the values we need to answer the question.

**EXTRACT A**

| Year | Pound to Dollar Exchange Rate | UK Current Account Balance (£m) | UK Inflation Rate (CPI) |
|---|---|---|---|
| 2007 | $2.00 | -37,490 | 2.32% |
| 2008 | $1.85 | -55,002 | 3.61% |
| 2009 | $1.57 | -44,831 | 2.17% |
| 2010 | $1.55 | -43,062 | 3.29% |
| 2011 | $1.60 | -29,088 | 4.48% |
| 2012 | $1.58 | -61,433 | 2.83% |
| 2013 | $1.56 | -76,442 | 2.53% |
| 2014 | $1.65 | -84,998 | 1.47% |
| 2015 | $1.53 | -80,233 | 0.05% |
| 2016 | $1.36 | -94,185 | 0.64% |
| 2017 | $1.23 | -94,860 | 2.7% |

We are looking for the percentage change between 2008 and 2016, therefore we need to only pick out those two values from the column we are focusing on.

**Correct Figures:**

**2008:** The average annual exchange rate of the Pound against the Dollar was \$1.85.

**2016:** The average annual exchange rate of the Pound against the Dollar was \$1.36.

## Step 2: Accurately perform percentage change calculation

Begin with the correct formula for calculating a percentage change.

$$Percentage\ Change = \frac{New\ Value - Original\ Value}{Original\ Value} \times 100$$

We are asked to calculate the percentage change **from** 2008, so that is the original value, **to** 2016, so that is the new value.

$$Percentage\ Change = \frac{2016\ ER - 2008\ ER}{2008\ ER} \times 100$$

$$Percentage\ Change = \frac{\$1.36 - \$1.85}{\$1.85} \times 100$$

$$Percentage\ Change = -0.26486 \ldots \times 100$$

$$Percentage\ Change = -26.486\%$$

$$Percentage\ Change = -26.5\%$$

It is important to provide the answer accurately. The question asks for the answer to be given to **1 decimal place**. As it is a percentage change, a % sign is required.

Producing the correct answer will earn 1 mark.

Producing the correct answer **and** giving it to 1 decimal place with a % sign will earn 2 marks.

A summary sentence can often be useful to highlight the answer you have given. For example:

*"The value of the average annual exchange rate of the Pound against the Dollar decreased by 26.5% between the years 2008 and 2016."*

**Question 2**

Explain how the data in **Extract A** show a decline in investor confidence in the UK economy following the UK's decision to leave the European Union on the 23rd of June.

**[4 marks]**

A good answer needs to include two key elements.

Evidence (data) from Extract A

A clear explanation why that evidence shows investor confidence has declined

## Step 1: Include some evidence

The best example of evidence from Extract A is to look at the exchange rate between 2016 and 2017. It is important to specifically quote data from the extract. The following example does not achieve this:

*"Extract A shows that the exchange rate of the Pound against the Dollar fell during 2016 because of the UK's decision to leave the European Union."*

A far better example of providing evidence is:

*"Extract A shows that the average annual exchange rate of the Pound against the Dollar fell in 2016 compared to 2015's rate from $1.53 to $1.36. This shows that the Pound weakened against the Dollar over this period. It can also be shown that the weaker Pound is set to continue with the exchange rate forecast to continue to fall in 2017 compared to 2016's level to $1.23."*

## Step 2: Provide a clear explanation

Having provided some evidence, your answer needs to explain why this evidence shows that investors lost confidence in the UK economy. To achieve top marks, this explanation needs to be clear and logical.

If your evidence has effectively identified the significant fall in the exchange rate shown by Extract A, then an effective explanatory chain of reasoning might look like:

*"The weakened exchange rate can be explained by the loss of investor confidence in the UK economy brought about by the UK's decision to leave the European Union. An exchange rate is determined by the supply and demand of that currency on the foreign exchange market. If an economic shock such as Brexit hits an economy it creates instability and uncertainty, which investors are averse to, as uncertainty often brings extra risks in terms of the return on assets.*

*The lower the confidence that investors have in the currency, the weaker the currency becomes as investors sell the Pound reducing the demand for Pounds. This explains why since 2016 the exchange rate has fallen significantly from $1.53."*

This is a good (but not the only) way of answering this question. Your focus within the question should be why investors wish to hold fewer pounds in the uncertain environment created by Brexit.

It is important to be aware that the command word in this question is **'Explain'** and therefore detailed analysis and evaluation is not required. This question should take no longer than **6 minutes** to answer.

Providing accurate evidence is essential for earning marks on this question.

Once this has been provided, the mark awarded depends upon the quality and clarity of the explanation.

**Question 3**

**Extract B, (lines 26-28)** explains that following the UK's decision to leave the European Union, the Pound fell from $1.50 to $1.32 overnight.

With the help of a diagram, explain how the decision of the UK to leave the European Union has resulted in a weaker pound.

**[9 marks]**

There are two key elements required within this answer:

An accurate and appropriate diagram

Written explanation inclduing knowledge, application and analysis

A good (but not the only) approach to this question is:

## Step 1: Introduction

Beginning by introducing the context and setting the scene for the diagram to follow allows you to display important knowledge and application skills alongside.

The example below makes a clear reference to the context (UK economy), provides an appropriate and applied definition (UK Exchange Rate) and sets up the answer for the diagram by describing what we are trying to analyse (Fall in the exchange rate).

*"Extract B states that Brexit caused the "pound to slump overnight by 10% to $1.32, a 30-year low". The UK exchange rate of the pound against the dollar is the rate at which the pound trades against the dollar on the foreign exchange market i.e. how many dollars a trader receives when exchanging £1 on the market. In this case, the value of the pound immediately fell against the dollar during the night of the referendum result and this has continued after the referendum result was announced. Therefore, the fall in the value of Sterling can be attributed to a change in the supply/demand for Pounds because of the*

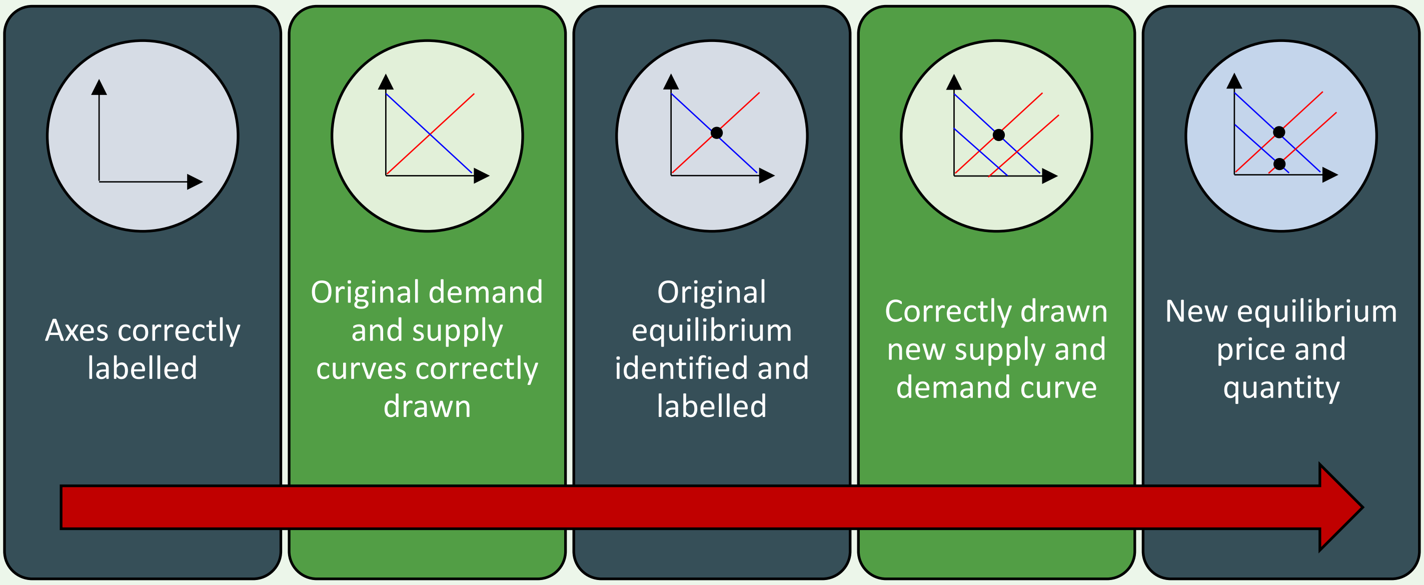
*relative attractiveness of the UK currency falling due to increased uncertainty over the future trading relationship between the UK and the EU."*

This explanation above sets up introduction of an exchange rate diagram which can explain using demand and supply analysis why the value of the pound fell against the dollar after the economic shock of Brexit.

## Step 2: Diagram

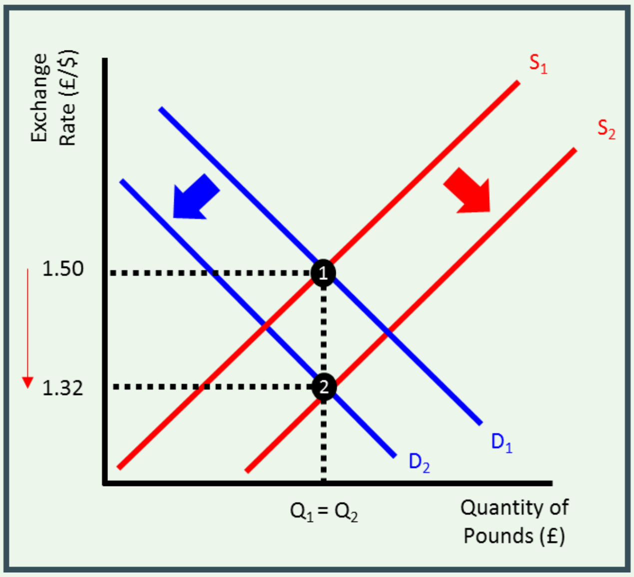
Here the question revolves around a fall in the exchange rate. Therefore, the appropriate diagram is one which shows the determination of an exchange rate through the interaction of the demand and supply of pounds

In this case, for the diagram to be completed accurately, the following features have to be present:




**Use a ruler and ensure the diagram is neat and tidy.**

## Pound to Dollar Exchange Rate (£/$)




## Step 3: Written Explanation

The first thing your written explanation needs to do is to clearly explain what your diagram shows. To assist clarity, it helps to refer to the labels you have given on your diagram. Where possible, the results of the diagram should be applied to the context of the question. For example:

*"In the diagram above, the floating exchange rate of the pound against the dollar is represented, where the value of the pound is determined solely by the interaction of the demand for, and supply of pounds. The initial value of the exchange rate is at $1.50 and this is determined by the intersection of the original demand curve for pounds ($D_1$) and the original supply curve of pounds ($S_1$). The Brexit vote creates two curve shifts in the following exchange rate diagram. The demand curve for pounds shifts inwards to $D_2$ because the extra uncertainty caused by Brexit leads to fewer potential investors wanting to hold UK based assets. This is because when investors wish to purchase UK assets they have to do so using pounds, therefore if the demand for UK assets increases so does the demand for pounds. The political and economic uncertainty deters them from investing in the UK and instead, they may put their holdings into a 'safe haven' currency i.e. a currency traded in a country*

*which has very little risk and political upheaval. The return may be lower in this country but investors are compensated by taking on less risk.*

*However, there is also a shift in the supply curve of pounds as well. This is because Brexit will also cause existing UK asset holders to sell their assets and purchase safer and higher yielding foreign assets, due to the heightened economic risk surrounding Brexit. When this form of capital flight occurs, the supply of pounds increases, represented by the expansion of the supply of pounds curve to ($S_2$). This is because investors must sell their UK assets in pounds, increasing the number of pounds available in the foreign exchange market at any one time.*

*Taken separately, the demand curve contraction and supply curve expansion both exert downward pressure on the exchange rate to fall. However, when considering both curve shifts simultaneously, the exchange rate fall is more prominent. This explains why the new equilibrium exchange rate settles at $1.32, which signals that the pound has depreciated against the dollar i.e. each pound now buys fewer dollars compared to before the referendum vote."*

It is important that you read and understand the context provided in extract B as this alludes to the fact that there are two curve shifts, a joint demand and supply curve shift in this question results in the large drop in the value of the pound against the dollar.

To achieve maximum marks, your answer may need to expand a little (but only a little) further than the accurate analysis thus far offered. There are a variety of relevant issues which can be analysed including:

## Size of Curve Shifts

- The diagram shows the impact that the two curve shifts have on the pound to dollar exchange rate but the exact impact will depend on how large the curve shifts are.

## Ceteris Paribus

- This logical chain of reasoning all runs on the asuumption that we are only considering the impact of Brexit on the exchange rate but there may be other factors that we could take into account which could affect the outcome of this e.g. the monetary policy reaction from the central bank.

## Determinants of an Exchange Rate

- In your initial analysis you could have expanded upon the determinants of an exchange rate to make the chain of reasoning behind Brexit's impact on the UK exchange rate clearer and simpler to follow such as hot money flows, expectations, confidence and any other valid determinant.

## Economic Shock

- The chain of reasoning behind the diagram can be improved with an applied statement relating to the relative importance of the UK and EU relationship i.e. more than 50% of UK exports are exported to EU countries.
- Also the fact that the vote to leave the EU came as a shock to the country explains why the demand for pounds, and supply of pounds curves shifted to the extent explained in the analysis section.

In your answer, you would not be expected to discuss many of these issues. A good strategy might be to attempt to introduce one issue with a clear chain of reasoning. This question does not examine your skills of evaluation, so you should focus upon using these issues **briefly** to push your analysis up to the top end! Your answer should take you no longer than **14 minutes.**

| |
|---|
| This question is marked on a levels basis. The overall quality of your response, including your diagram will be considered when deciding upon which level the answer is. |
| Level 1 [1 – 3 Marks] – Poor or no diagram alongside a brief and/or incoherent written explanation. |
| Level 2 [4 – 6 Marks] – Reasonable response which may include a diagram |
| Level 3 [7 – 9 Marks] – Organised and coherent response with an accurate and appropriate diagram. |

**Question 4**

In **Extract C**, **(lines )** states that the 'long-term outlook for the UK economy is weak in a post-Brexit world' despite the improved short-term performance of the UK economy.

Using the data in the extracts and your own economic knowledge, evaluate the macroeconomic consequences of a fall in the value of the pound for the UK economy.

**[25 marks]**

To access top marks in any economics essay, it is important to focus on two key elements:

The different assessment objectives → Essay Structure

As essay structure is a more general skill, we will focus on showcasing how to hit the different assessment objectives required for this specific question. However, hopefully, the following discourse will provide some assistance with regards to essay structure.

In this question, you need to briefly explain what is meant by an exchange rate and describe the macroeconomic criteria by which consequences of a change in the exchange rate can be measured, before presenting a coherent discussion of the potential impact of a fall (depreciation) in the exchange rate on the UK economy and arriving at a final judgement.

## AO1: Knowledge

Being able to display accurate knowledge is judged to be the most basic requirement. It is still important to be able to demonstrate accurate knowledge throughout your essay. You can signpost this by including accurate definitions. For example, in your introduction, you might want to describe what is meant by a fall in the value of a currency. For example:

*"An exchange rate represents the rate at which one currency can be exchanged for another. For instance, the pound to dollar exchange rate represents the price at which one pound can be exchanged for in terms of dollars. Under a floating exchange rate regime, the value is determined by the interaction of the supply of and demand for pounds, with little intervention from the government. Exchange rate movements on the foreign exchange market result in significant changes in the performance of an economy due to trillions of dollars of cash transactions being made every day. Therefore, it is important for the government of a country to use a decided upon criteria for measuring and weighing up the macroeconomic consequences that result from exchange rate movements, as exchange rate movements create positive and negative economic consequences for an economy."*

## AO2: Application

Being able to apply your knowledge is particularly important for essays within data response questions. In this case, the question particularly asks about the macroeconomic consequences of a fall (depreciation) in the exchange rate. Utilising the data extracts can provide some helpful angles to use to demonstrate that you are applying economic theory to this particular context. Some examples are:

## Extract A and Extract B - Lines 26-28

- The data on the UK exchange rate shows that the pound has been gradually depreciating since the 2008 Financial Crisis, but the rate of depreciation has increased since 2016 after the vote to leave the EU.
- This could be used to show the impact that a large economic shock - both globally and nationally - has on the strength of an economy's exchange rate.

## Extract A

- The data taken from the UK economy suggests that as the exchange rate falls, the deficit on the current account of the balance of payments has increased and the UK inflation rate has declined since 2007.
- This could be used as a slight rebuttal against the economic theory, by pointing to evidence that a weaker exchange rate may in fact cause the trade performance of a country to worsen and the inflation rate to weaken.

## Extract B - Lines 1-8

- This describes the dollar to pound exchange rate as a floating exchange rate and signals that the value of the pound is determined by market forces.
- This can be used to support your analsis when talking about the macroeconomic consequences of a fall in a country's exchange rate.

## Extract C - Lines 3-7

- This provides an explanation of the theorised impact that a weaker exchange rate has on the trade performance of a country.
- This can be used to support the conventional theory that a lower exchange rate provides a country with a competitive boost to their exports.

## Extract C - Lines 26 - 34

- This describes the impact that imported inflation may have on offsetting the competitive boost to a country's exports from an initial fall in the exchange rate.
- This can be used as a possible evaluation point when discussing the impact that a lower exchange rate has on the trade performance of a country.

You are only expected to use some of these application examples in your essay.

This is a question asking you about the macroeconomic consequences of a fall in the exchange for the **UK economy**, so your answer would benefit from being able to introduce some application points that specifically refer to the performance of the UK economy which is either from the data or from your own economic knowledge. Some examples are:

## Trade of Goods and Services

- Trade is important for the UK as 28% of the goods and services produced domestically are exported abroad, whilst the value of goods and services imported into the UK from the rest of the world represents 30% of GDP.
- As the value of goods and services exported and imported represents a large share of UK GDP, changes in the exchange rate will significantly impact the UK economy. This is because an exchange rate affects the relative prices of these goods.

## Employment in Exporting Industries

- It is estimated that three million UK jobs are supported by industries that export goods and services to the EU.
- This figure can be used to show that the change in the exchange rate will have implications for people that work in these exporting industries. But this does not necessarily mean that these jobs depend on the UK being a member of the EU.

## EU Single Market

- When goods and services are sold abroad they can face trade barriers including tariffs (taxes applied only to imports), quotas, and product standards that are different from those in the domestic market. This all results in an increase in the cost of trade.
- Being a part of the EU's single market means greater economic integration and cooperation and trade barriers are reduced and in some cases eliminated. This means it is relatively easy for British firms to sell goods and services to the rest of the EU.

## Foreign Investment

- The UK runs a current account deficit of nearly 7% of GDP on the balance of payments which means it needs to run a surplus on the financial/capital account to balance their international accounts. Therefore, the UK receives the third largest amount of foreign investment, behind the US and China. This means infrastructure projects within the UK are often funded by foreign investment such as the builiding of Hinkley Power Plant funded by China. The reliance on foreign investment may become a problem if the exchange rate falls, as it may reduce the amount of investment into the UK economy as investors lose confidence.

## Low Interest Rates

- The UK base rate was reduced to 0.5% in 2009 and was reduced in 2016 to 0.25% to help deal with the impact of Brexit. Therefore, when talking about the impact of a fall in the exchange rate it is important to consider that this may be an alternative way of stimulating the economy when the Central Bank has interest rates close to the zero lower bound.

## UK Full Employment

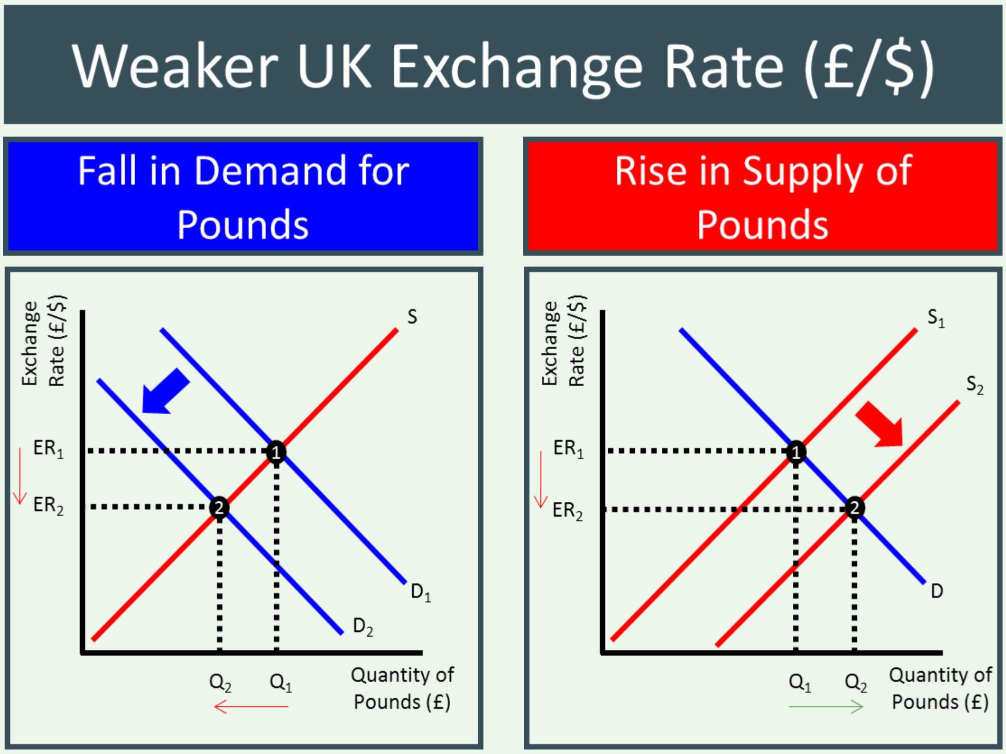
- In 2016, the UK has consistently displayed the signs of a strong labour market. The employment rate reached a record high of 74% and the unemployment rate fell to a 10-year low of 4.8%. This suggests that the UK is close to or at full employment. Therefore, if a fall in the exchange rate boosts growth it may lead to sharp inflationary effects as a result of a positive output gap being created.

As ever, you only need to include some of these issues. Indeed, some of these application examples are quite specific and would only be expected of sophisticated answers.

## AO3: Analysis

The core of top-level essays consists of well-constructed, relevant analysis of the topic. This should be presented using logical chains of reasoning, and where appropriate, clear diagrams.

There are lots of analytical routes you could go down with a question like this. The core analysis will involve an explanation of the macroeconomic consequences of a fall in the exchange rate. A good way to start might be to explain what is meant by a ‘fall in the exchange rate’. However, be careful not to spend too much time on this as you need to focus on the consequences of this fall.




*"When the demand for pounds falls and/or the supply of pounds increases, it exerts downward pressure on the exchange rate to fall, and this represents a depreciation of a country's currency as each pound when exchanged on the foreign exchange market will now result in fewer dollars. This results in the value of the pound weakening against the dollar. The opposite case holds for an appreciation of a currency."*

Now that you have set the scene regarding what is meant by a fall in the value of a country's exchange rate, you can now proceed with the effects this has on the UK economy.

A good (but not only) way to approach this part of the question is to analyse the impact that a falling exchange rate has on the four main macroeconomic objectives of a country. This allows you to isolate the impact that the exchange rate movement has on the trade performance, inflation rate, economic growth rate and unemployment rate of a country. These effects can then be evaluated and a final judgement can be made based on your viewpoint over the relative importance of these objectives from the perspective of the UK economy. A good example of introducing this approach into your essay is:

*"When analysing and evaluating the main macroeconomic consequences of a change in the exchange rate on the UK economy, the ability of the UK government to achieve their main macroeconomic objectives needs to be considered under the weaker exchange rate. This is because, in order for a country to achieve economic stability, the government of most developed countries have four main macroeconomic objectives. These objectives ensure that the government of a country can track their progress over time and identify the policies that they need to adopt to target higher growth and living standards in the future. These macroeconomic objectives represent strong and sustainable economic growth, a stable price level, low and consistent unemployment and a sustainable balance of payments position with the rest of the world."*

This clearly signals the four main performance areas of the economy you will use as an internal criterion for the consequences of a weaker pound on the UK economy. Note: some economists will also consider the impact on the distribution of income.

## Trade Performance

When considering the impact of exchange rate movements on the performance of an economy, the biggest discussion point revolves around the change in the trade performance and competitiveness of a country relative to the rest of the trading world.

As the exchange rate represents the relative value of a currency against another and goods around the world are priced in their own domestic currency, exchange rate movements will affect the relative attractiveness of these goods around the world. The key focus here to explain the theoretical impact of a fall in the exchange rate on the trade performance of a country is

### Fall in the Exchange Rate (£/$)

| | Relative Price |
|---|---|
| Domestic Exports | Decrease **(Rest of World)** ▼ |
| Foreign Imports | Increase **(UK Consumers)** ▲ |

to look at the change in the relative price of domestic exports and foreign imports. The table below summarises these effects:

*"A fall in the exchange rate causes the rate at which pounds' exchange for dollars on the foreign exchange market to fall. In essence, this means that after the fall in the exchange rate, each pound sold on the market can be exchanged for fewer dollars in return, as the pound has weakened against the dollar. However, bilateral exchange rates such as the pound to dollar exchange rate hold reciprocal values. This just means if the pound weakens against the dollar then the dollar must strengthen against the pound. Therefore, when each dollar is sold on the foreign exchange market for pounds, more pounds are returned than before the exchange rate movement."*

The reciprocity of bilateral exchange rates is important to establish before assessing the impact on the trade performance. This is because UK produced goods are priced in pounds when sold on the world market and foreign produced goods will be priced in the respective foreign currency of the producing nation. Therefore, if the value of the pound falls against other leading currencies, foreign consumers need to exchange less of their foreign currency holdings to get the right number of pounds required to purchase the UK exported good, assuming there is no change in the relative inflation rate of the UK. This effectively means that the relative price of UK exports is lower to foreign consumers and UK exports will become relatively more competitive on the world stage.

However, foreign produced goods or services imported into the UK will now appear relatively more expensive, because of the fact that UK consumers will now need to exchange more pounds to get the right amount of the foreign currency required to purchase the foreign import. This effectively means that the relative price of foreign-produced imports into the UK is higher to UK consumers and foreign imports will become relatively less competitive in the UK market for countries that now enjoy a stronger domestic currency against the pound.

This all means that economic theory suggests that, assuming ceteris paribus, the impact of a fall in the exchange rate on the trade performance of a country should be positive:

"The Balance of Payments is a record of the financial transactions over a period of time between a country and its trading partners. A section of the balance of payments is responsible for measuring the trade balance of the UK. It records the trade flows between the UK and the rest of the world and is a signal of how competitive the UK economy and the industries within the UK are.

If the UK exchange rate falls, the theoretical impact this will have on the trade performance of the country is positive assuming all other things being held equal. This is because the relative price of UK produced exports will fall and this will increase the demand for these goods from foreign consumers, boosting the value of exported goods and services sold by the UK to the rest of the world. At the same time, the relative price of foreign imports heading to the UK will rise and this will reduce the UK's demand for these goods as the law of demand states that as goods become more expensive less is demanded at that higher price. This will lead to the value of UK imported goods and services from the rest of the world to improve.

As both fo these effects are working in the same direction, the trade balance of the UK will improve. This signals a competitive boost has been granted to the UK economy from the subsequent weakening of the pound and as the trade balance makes up part of the current account on the balance of payments it will help reduce the heavy reliance of the UK economy on foreign investment flows which are currently needed for the UK to live within its means."

This describes the economic theory behind why the trade performance of a country will improve under a weaker exchange rate but it's also important to discuss the reasons why these theorised predictions may not conform to economic reality:

## Cyclical Trade Flows

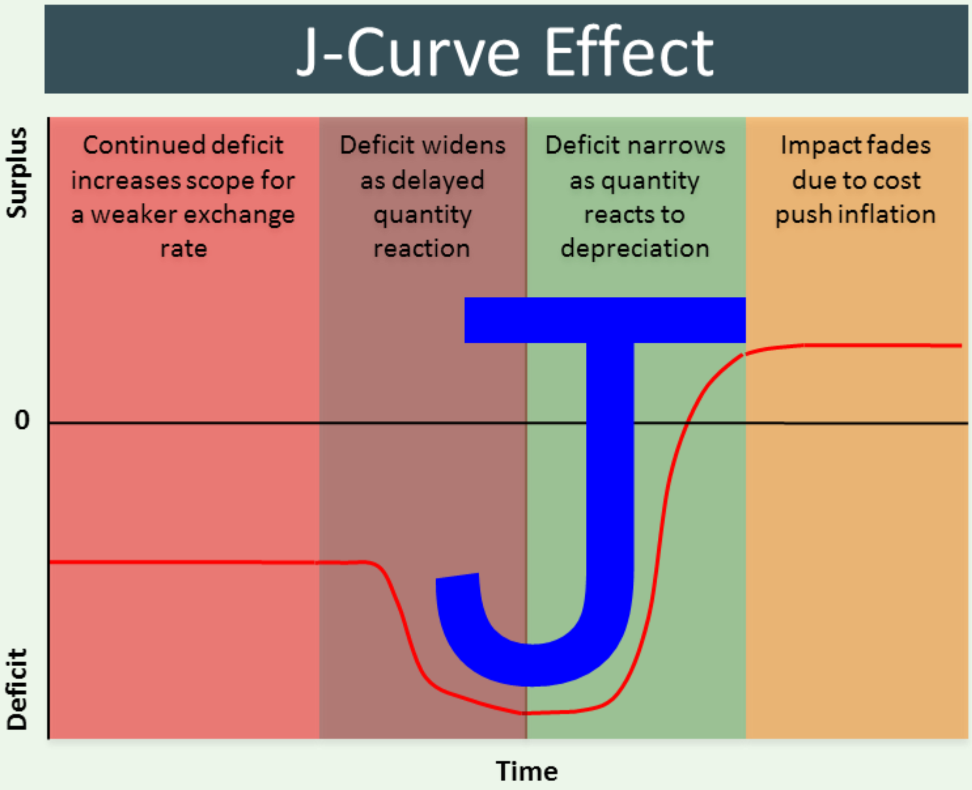
- Despite the exchange rate weakening in the short-term, the impact on a country's trade performance could also lead to a stronger pound in the long-term reversing these competitive gains and improvements in the sustainability of the balance of payments position.
- This is because a depreciation today could mean in an appreciation in the future as demand for exports will increase causing an increase in the demand for pounds and an increase in the value of Sterling.

## Marshall-Lerner Condition

- The Marshall-Lerner Condition is an advanced trade theory that aims to show that a weakening of a country's currency will only cause the deficit on the current account of the balance of payments to improve if the sum of the price elasticity of demand values for exports and imports are greater than 1 i.e. **($E_X + E_M > 1$).**
- This is because if demand is inelastic for these goods then the exchange rate movement will not create a significant enough change in demand, as they may represent essential goods that consumers need to buy regardless of the price. This explains their price insensitivity to the goods.

## J-Curve Effect

- The J Curve effect says a trade deficit can initially worsen after a weakening in the domestic currency, but will improve in the medium term if the Marshall-Lerner condition holds.
- The higher exchange rate first corresponds to more costly imports and less valuable exports, leading to a bigger initial deficit or a smaller surplus. Due to the competitive, relatively low-priced exports, the affected country's exports of the goods in question start to increase as outside demand for the lower-priced option increases. Local consumers also purchase less of the more expensive imports and focus on local goods as the exchange rate makes certain locally produced items more affordable than the imported counterpart. The trade balance eventually improves to better levels compared to before devaluation.
- Therefore, the movement in the trade deficit described by this effect traces out the letter 'J' which is where the name for the theory stems from.




## Relative UK Inflation Rate

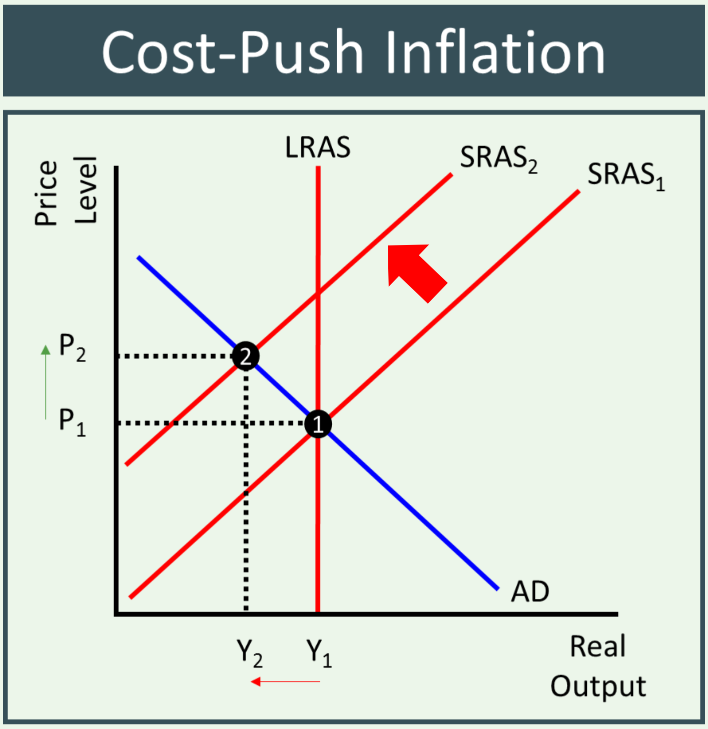
- When considering the theoretical impact of a fall in the value of the pound on the trade performance of the UK economy the assumption of ceteris paribus was maintained. Therefore, no consideration was given to the relative inflation rate of the UK to the rest of the world. If the UK experiences an increase in its inflation rate quicker than the rest of its trading partners, that will go some distance towards reducing the competitive boost that a weaker currency gives the UK. It might not stop the trade deficit from reducing but it may slow down the pace of this deficit reduction.

## Relative Currency Strength

- The trade performance will only theoretically improve for the UK against countries who have witnessed a reciprocal rise in their own exchange rate. Despite the pound falling, other countries currencies may have fallen by an even greater amount, giving the UK effectively no competitive advantage over those countries from the fall in the exchange rate.

## Inflation

When the exchange rate for a country changes it has a direct impact on the consumer prices index – the central measure of inflation for a country - as many UK-produced goods and services require raw materials, commodities and resources that are priced in a foreign currency that have to be imported in from the rest of the world. Therefore, when an exchange rate changes it affects the production costs of UK exporting firms which have an impact on the prices that UK consumer's face. It is also important to show a diagram here to accompany your analysis as this will help you describe the form of inflation that is created in an economy as a result of the fall of the exchange rate:




*"A fall in the exchange rate increases the relative price of goods and services which are imported into the UK from the rest of the world. From a consumer's point of view, this increases the price that UK consumers have to pay in order to acquire foreign produced goods. However, the main inflationary impacts of a fall in the exchange rate are created by the impact of the exchange rate on the relative price of goods that UK firms have to use in the production process of domestically produced goods.*

*This is because many of the raw materials and commodities that firms use to produce their final goods are priced in a foreign currency. For instance, crude oil, one of the most important commodities used in the global economy, is denominated in dollar terms. Therefore, if the pound weakens against the dollar it raises the price of a barrel of oil for firms in the UK. Therefore, this means that the production costs will increase for all goods which involve the use of oil in the production process.*

*If firms' production costs increase it means, all other things being equal, that the profit margin on each good produced by firms will fall and therefore firms will have less incentive to supply the good and if less is supplied, the aggregate supply curve will shift inwards from $SRAS_1$ to $SRAS_2$. The excess demand this creates across the economy for these affected goods, forces a new macroeconomic equilibrium in the short-run to settle at point 2 with a higher overall price level of $P_2$. The higher price level represents an increase in the rate of price increases and therefore cost-push inflation in an economy."*

Once you have analysed the cause of higher inflation, you then need to explain the wider impact that a higher rate of inflation will have on economic agents within the economy.

*"A higher rate of inflation in the UK signals the average price of goods in the UK is increasing over time. This has a significant impact on consumers' ability to purchase goods and services. When the average price of goods and services increase, assuming no change in a consumer's disposable income, the real purchasing power of this income is going to fall as consumers cannot purchase as many goods that they perhaps desire to. As consumption contributes to two thirds of the total expenditure of the UK, the fall in consumption may negatively impact the growth rate of an economy. Over a longer time frame, if the initial inflation creates an inflationary spiral, then the reduced consumption may have a significant effect on individuals' living standards"*

This provides one example of the damaging consequences of a higher inflation rate on the UK economy. You could also have discussed here:

1. The impact that a higher inflation rate has on the competitiveness of UK exports relative to the rest of the world. If the UK inflation rate increases quicker than trading partner's inflation rate, then potentially the fall in the currency may not cause the expected improvement in a country's balance of payments position.

2. The effect on employment of fewer goods being supplied by firms in the UK economy. If production costs increase, firms' profitability falls and therefore firms need to produce fewer goods. If this is the case, then they will demand less labour, possibly increasing unemployment.

This describes the economic theory behind why a country's inflation rate may increase with a weaker currency but it's also important to discuss the reasons why these theorised predictions may not conform to economic reality:

## Firm Behaviour

- Economic theory assumes that if firms' face higher production costs they will try to pass at least some of these higher production costs onto the consumer through the form of higher prices. However, some firms may decide to absorb higher production costs, in order to keep prices low and retain market share. In the UK, many grocery firms have chosen to asorb higher costs or have adopted alternative strategies such as reducing the amount of product sold in each packet (shrinkflation!).

## Hedging Contracts

- Many firms avoid the higher costs that come from a weaker exchange rate by hedging against currency risk. This is done by firms agreeing contracts in advance for the price at which they can exchange a currency for another. This means that despite the nominal exchange rate weakening, the exchange rate that firms use when importing production components for their goods is likely to be higher initially. This results in a more gradual increase in the inflation rate rather than a one-off surge as firms' contracts slowly start to expire.

## Sustainability

- A rise in the inflation rate created by a weakening in the exchange rate is likely to be a short-term problem as theoretically there is only so far the pound can fall against a particular currency.
- You could also argue that inflation may not always be perceived as a problem as long as it remains within the central bank's inflation target range, as it may prevent consumers from delaying their purchases if they realise that prices are on the rise.

## Money Illusion

- The real puchasing power of consumers will only fall if workers suffer from money illusion. This is the idea that when nominal wages increase in an environment of higher inflation, workers believe their real incomes have increased, when in fact they have not and this causes workers not to push for higher wages to prevent real incomes from falling.

Only a couple of these points need to be raised to provide a contrarian view to the expected theoretical impact of a weaker exchange rate on the macroeconomic objective.

## Unemployment

It is important for an economy to maintain a low unemployment rate to ensure that an economy is productively efficient and making the best use of its resources, but also to ensure that from the government's perspective the welfare state does not grow too large. A weaker exchange rate will theoretically have two main consequences for the level of employment in an economy. A good (but not the only) way to explain this point is provided in the example below:

*"If the value of the pound weakens, the relative price of UK exports will reduce and therefore the competitiveness of UK-produced goods will increase. If foreign consumers demand more of these UK exports, because of the relative price fall, then the firms operating in the UK's exporting industries such as manufacturing firms and institutions in the financial sector will need to employ more workers. This will result in employment within these industries increasing, whilst also preventing some existing workers from being made unemployed, as the UK's declining export industries may be given a competitive boost through the weaker pound. This prevents the long-term decline of certain UK industries and the possible structural unemployment that could result from this.*

*However, this is not the only employment boost that the UK could benefit from because the higher relative price of foreign imports into the UK will cause UK consumers to switch away from consuming foreign imports towards consuming domestically produced goods, instead of imports. This may help raise domestic employment in these industries as UK firms no longer have to compete on such low-cost terms with foreign competitors."*

This provides an example of just one approach towards discussing the economic consequences of a weaker exchange rate on employment in the UK. You could also have discussed here:

1. The effect that a weaker pound has on the tourism industry for the UK i.e. if the pound weakens it makes foreign holidays more expensive for UK families and therefore they may decide to cancel foreign holidays and enjoy a 'staycation' which means that income which would previously have been spent in a foreign country will now be spent in the UK. The weaker exchange rate also makes UK holidays more attractive to foreign holidaymakers, providing a boost to growth and jobs in an expanding sector of the economy.
2. May help to protect sunset industries which cannot cope with the threat of low-cost foreign competition and therefore boosting employment.

This describes the economic theory behind why a country's inflation rate may increase with a weaker currency but it's also important to discuss the reasons why these theorised predictions may not conform to economic reality:

## Depends on Cause of Exchange Rate Movement

- It may be the case that the exchange rate weakened because of the onset of an economic shock. A shock creates instability and uncertainty which is not welcomed by firms or/and investors. Therefore, if a firm is unsure of the impact that a shock may have on their profitability it may cause them to become more cautious and hold back on hiring decisions, until the economic ramifications of the shock on the firms finances is more certain. This explains why there is often a time lag between the business cycle and the employment cycle.

## Cost Reductions

- In light of higher production costs brought about by imported inflation, firms may decide to lay off workers in order to control their production costs. This is a likely scenario as labour costs often make up the largest expense as a proportion of total production costs.

## Relative Size of Protected Industries

- The employment boost may not be significant for an economy if the size and value of the exporting industries is small relative to the total size of the economy.

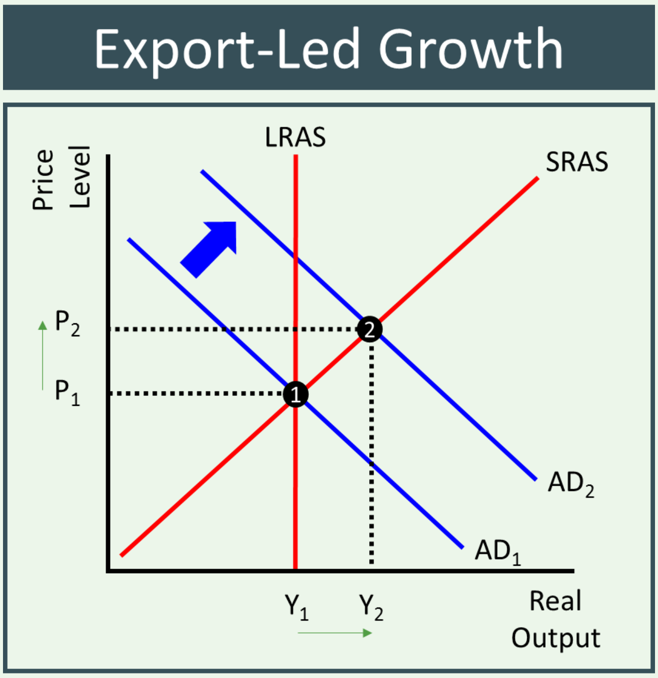
## Full Employment

- If an economy is already close to full employment, the increase in employment across the economy is likely to be small and unsustainable as inflation erodes away the gains in employment in the long-run.

Only a couple of these points need to be raised to provide a contrarian view to the expected theoretical impact of a weaker exchange rate on the macroeconomic objective.

## Economic Growth

A weaker exchange rate can provide an economy with an export boost which theoretically should create export-led growth as the value of a country's exports increase under a weaker exchange rate. Including a diagram alongside your logical chain of reasoning will aid your analysis:




*"The weaker pound causes the relative price of exports to fall for foreign consumers, which assuming all other things being equal, will cause demand for UK exports to increase. The relative price of foreign imports into the UK increases and therefore the demand for foreign imports fall, resulting in a fall in the value of imported goods and services. As net exports (X-M) is a component*

*of aggregate demand. If the value of exports (X) increases and the value of imports (M) decreases, then the value of net exports will increase (X-M). This means aggregate demand will increase at every possible price level and this is represented by a positive AD expansion from $AD_1$ to $AD_2$ on an AD/AS diagram.*

*This creates a positive output gap as output at the new macroeconomic equilibrium ($Y_2$) is higher than the full employment output level ($Y_1$) and this also signals that employment is also higher as firms demand more labour when more goods and services are required to be produced. This extra demand from the economy creates pressure for the general price level in the economy to increase from $P_1$ to $P_2$."*

This means effectively the fall in the currency has the same impact on the economy as an expansionary monetary policy because it is used to counter any slowdown in the economy to stimulate demand, profits, output and jobs. This perhaps explains the logic behind why countries that have a fixed exchange rate devalue their currency when their economy slows down.

This describes the economic theory behind how a country's growth rate may increase with a weaker currency but it's also important to discuss the reasons why these theoretical predictions may not conform to economic reality:

## Offsetting Factors

- It has already been mentioned that a weaker currency is likely to cause inflation to be imported into a country, which may offset the benefits to growth from export-led growth. For instance, if consumption falls because of higher prices in the economy this may result in growth being stunted in the long-run.

## Sustainability?

- The type of growth predominantly created by a weaker exchange rate is likely to only create short-run growth which ultimately turns into an inflationary move up the LRAS curve as the economy adjusts back to a new long-run macroeconomic equilibrium at the full employment level.
- However, it could be argued that a weaker exchange rate may increase the relative attractiveness of investor holdings in the UK as each unit of foreign currency can now be exchanged for more pounds. If inward invstment into the UK increases, then this could create an LRAS curve expansion and long-run sustainable economic growth.

## Multiplier and Accelerator Effects

- A fall in the exchange rate creates export-led growth because of a rise in demand for exports and a fall in the demand for imports. However, the effect on demand and output may create additional gains in employment, as firms require more workers to produce more goods and services. These job gains may be of a permanent nature if imports take up a permanently higher share of the domestic market. If this is the case, the gain in output will be larger than the initial increase in net exports, resulting in a positive multiplier effect.
- It may also be the case that industries that benefit from a weaker exchange rate may provide additional benefits that spillover to the wider supply chain.

Only a couple of these points need to be raised to provide a contrarian view to the expected theoretical impact of a weaker exchange rate on the macroeconomic objective.

## AO4: Evaluation

Including accurate and relevant evaluation in your essay is the most important thing to ensure you achieve top marks. Evaluation is the art of making supported judgements, of deciding which factors are most important and examining the scenario in which factors assume greater or lesser importance..

There a huge number of evaluative angles you could take within this essay. Here we will showcase some useful examples that you could apply to any of the main macroeconomic objectives. You would not be expected to include all of these examples – there simply is not enough time!

## The Magnitude of Exchange Rate Fall

- It is important to discuss the size and significance of the exchange rate movement when analysing the impact of a fall in the exchange rate on the performance of the economy. The greater the fall in the exchange rate, the more amplified the effects outlined in the analysis section of the essay become. For instance, the expansion in the AD curve will be greater for a larger fall in the exchange rate, amplifying the effect on jobs, output and growth.
- It is is also important to take into the account the external value which the exchange rate fell from. For instance, if the pound was already at a historically weak level compared to foreign currencies, then a fall in the exchange rate is unlikley to boost the competitiveness of exporting industries significantly. If the exchange rate falls from a relatively strong level to a weak level relative to the rest of the world then the competitive boost to the economy will be far greater.

## Elasticity Conditions

- Elasticity conditions for exports and imports affect the strength of the competitive boost that an economy receives as a result of a currency depreciation. For example, some industries are more exposed than others to currency fluctuations due to the fact that demand is price elastic. In this case, a small fall in the exchange rate will provide exporting industries with a large competitive boost. However, if demand is inelastic it will take a significant fall to impact the value of exported goods and services traded.

## Size and Importance of Exporting Industry

- Industries where a high percentage of total goods produced are exported are more exposed than others to currency fluctuations because the reliance on revenue from exported goods is far greater for these industries compared to others. Therefore, if a country exports relatively few goods to the rest of the world the liklihood is that the exchange rate fall will damage the economy.
- It is also important to consider whether the competitive boost given to an economy can be solely attributed to the weaker currency or whether in fact there are other factors influencing this.

## Time Frame of Exchange Rate Movement

- A currency can gradually weaken over a long period of time or fall sharply as a result of an unexpected economic shock. This is important to consider as an unexpected shock is likely to affect an economy over a short period of time as often the shock creates fear and uncertainty over the future course of direction of an economy, whilst a continued depreciation is a sign that the economy is structurally weakening and therefore the weakened currency may be signalling a long-term decline in certain industries.

## Corrective Market Mechanisms

- It may be the case that the government of a country may introduce corrective measures if the weaker currency negatively impacts the economy too significantly from their persepctive. For instance, this is why many countries run a 'dirty float' exchange rate as it permits the government to intervene when there is evidence that large currency fluctuations are damaging the economy. This may alter the impact that a weaker exchage rate has on an economy.

## State of the World Economy

- If global demand is weak, if the relative price of exports falls this may not cause the value of exports sold by a country to increase by as much as theoretically predicted from a fall in the exchange rate because foreign consumers may not be incentivised to increase their consumption of the exported goods due to perhaps declining disposable incomes in their home country.

Overall, it is important to provide in your essay, a reasoned judgement; an argument which makes a decision about whether a fall in the exchange rate would, overall, be good or bad for an economy. It doesn’t matter which side of the argument you make the case for – you will be examined on how effectively you structure that argument and how well you support it with economic theory.

The concluding paragraph of your essay is often a very good place to make clear what your overall reasoned judgement of the question is. Some people also like to include a similar judgement in their introduction, to signpost clearly to the examiner that they will be making an evaluative judgement in their essay.

Here is a good example of an attempt to, in one paragraph, argue that a fall in the exchange rate will overall benefit the UK economy:

*"Overall, the economic case and arguments for a fall in the exchange rate boosting the macroeconomic performance of the economy is persuasive. Despite the fact that the arguments regarding the potential inflationary impacts of this exchange rate movement deserve consideration, the competitive boost that a weak currency provides a country in a possibly uncertain economic and political time such as Brexit should take priority. This is especially so because a weak currency can help curb and change the pattern of world trade in a favourable way for the UK to help protect and energise declining sunset industries where long-suffering workers have had continually weak pay growth over the years and a lack of assurances provided from their employer regarding their job security. Therefore, a weaker pound should be welcomed by the UK economy."*

Alternatively, it would be just as valid to argue that a weaker pound may be detrimental to growth, output, inflation and jobs:

*"On balance, the macroeconomic consequences of a weaker pound in the UK are likely to hamper the growth prospects and living standards of the UK population. The allure of a weaker pound revolves around providing important economically deep-rooted industries with a competitive boost which helps provide a greater stimulus boost to the economy in the here and now. Despite the importance of these factors, the most pressing issue for the UK economy is the ability to sustainably grow over time and wrestle away the comparative advantage of producing certain goods from low-cost producing nations. A weaker pound only provides a short-term solution to a more permanent and systemic problem in the UK economy because any short-term gains in output and employment will be eroded away by the inevitable wave of inflation imported into the UK from the rest of the world due to the fall in the value of the pound."*

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| Essays are marked on a levels basis. The overall quality of your essay will be considered when deciding upon which level the answer is. |
| Level 1 [1 – 5 Marks] – Very weak response which includes little relevant content. |
| Level 2 [6 – 10 Marks] – Weak response which shows some understanding but undeveloped analysis. |
| Level 3 [11 – 15 Marks] – Reasonable analysis but poor evaluation, which is usually unsupported. |
| Level 4 [16 – 20 Marks] – A well organised response with good analysis and some reasonable evaluation. |
| Level 5 [21 – 25 Marks] – A well organised response with good analysis and supported evaluation throughout |