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# A-LEVEL ECONOMICS

7136/3: Economic Principles and Issues  
Report on the Examination

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## Section A

### General

The overall standard of the students' responses to the 30 MCQ's in Section A of this paper indicate that the demands of the test were slightly easier those of the 2018 test. Sixteen questions were easy, with facilities of 65% or more, compared with twelve in last year's test. There was only one very demanding question with a facility of less than 35%. All the questions performed in a manner consistent with the requirements of the subject and produced results within the statistically acceptable range. None of the questions were rejected from the test.

The sixteen easy questions were 1, 4, 5, 8, 10, 13, 14, 15, 16, 17, 20, 25, 26, 27, 29 and 30. Questions 16, 17, and 30 were exceptionally easy with facilities of 80% or higher. The easiest of these was Question 16 with a facility of 87%, followed by Question 17 with a facility of 88% and Question 30 with a facility of 89%.

Question 21 was the most demanding question in the test with a facility of only 33%. The majority of students also found Question 9 and 22, with facilities of 36% and 39% respectively, quite difficult.

Another indication of the slightly easier nature of this test in comparison with that of last year is that no question had a distractor which was more popular than the correct response. However, six questions did have a one distractor which attracted a disproportionately large number of responses. These, and the other questions which the majority of students found challenging, are considered below.

### Question 3

This was a relatively demanding question with only around 48% of students selecting the Key, B, and almost as many, about 42%, selecting distractor A. This result implies that more than 40% of students did not understand the difference between complete market failure and market failure. Distractor A is an example of market failure due to negative externalities in production and consumption. Externalities in production and consumption result in a sub-optimal level of production and/or consumption. However, the resultant market failure does not lead to zero production and consumption. In contrast, complete market failure implies zero production and consumption of a good or service. The complete absence of a market results from the unwillingness of firms to produce due to non-excludability in consumption and/or the absence of enforceable property rights.

### Question 4

The Key, A, was only selected by only around 45% of students. This was a surprisingly poor response for a standard aggregate demand and aggregate supply curve diagram question, made even more so by the choice of distractor C by about 36% of students.

The question involved a straightforward test of students understanding of the variables determining the position of a short-run aggregate supply curve. The position of a short-run aggregate supply curve is determined by costs of production in an economy and the price of imports. The price of all imports is affected by the exchange rate and, for some imports, by the level of tariffs. All other things being equal, a decrease in the level of tariffs on imports will lead to a reduction in the cost of imports and a consequent reduction in the price level in an economy. This is shown by a shift to the right in the position of the short-run aggregate supply curve.

Response B is a distractor because the productivity of capital is a determinant of the position of the long-run aggregate supply curve and not that of the short-run aggregate supply curve.

The level of money wage rates is an important determinant of the position of the short-run aggregate supply curve. However, around 36% of students who selected distractor C made the error of confusing a decrease in the rate of wage inflation with a decrease in the level of money wages. A decrease in the rate of wage inflation simply means a slowdown in the rate at which wages are increasing and still involves an increase in the level of wages. An increase in the level of wages shifts the short-run aggregate supply curve to the left not to the right, as shown in the diagram.

A reduction in the value of government subsidies to farmers, distractor D, would result in an increase in market prices and a shift to the left in the position of the short-run aggregate supply curve.

### Question 7

There is a very close similarity in terms of the pattern of responses, but not the topic area, between this question and Question 4. The Key, B, was also selected by about 45% of students and one of the distractors was selected by around 36% of students. The question tested students' knowledge and understanding of the role of utility theory in explaining consumer behaviour. Specifically, their understanding of how the hypothesis of diminishing marginal utility can be used to help explain why a demand curve is downward sloping.

Students selecting distractor A made the mistake of confusing diminishing marginal utility with diminishing returns in production. Response C was a very weak distractor. The majority of students recognized that diminishing marginal utility did not provide an explanation for why firms try to maximise profit.

Distractor D was selected by around 36% of students and indicated they had an inadequate understanding of the relationship between total and marginal utility. The total utility from consuming an additional unit of a good or service continues to increase, albeit at a diminishing rate, as long as the marginal utility from consuming an additional unit is positive.

### Question 9

This was the second most demanding question in the test with a facility of only 36%, Key B. The approximately equal number of students selecting each of the distractors indicates that the majority of students had to guess for the correct response. The implication of this is that the quantity theory of money and, more specifically, the Fisher equation of exchange must have been a neglected part of the specification for many students. In the Fisher equation,  $MV = PQ$ , the right hand side of the equation is the nominal value of national income. If the velocity of circulation,  $V$ , is constant, an  $x\%$  increase in the supply of money must result in an  $x\%$  increase in  $MV$ , and an equivalent increase in  $PQ$  or nominal national income.

Students choosing distractor A, lacked understanding, or had no knowledge and understanding, of the quantity theory, and related incorrectly an  $x\%$  increase in the money supply to an  $x\%$  decrease in the rate of interest. Likewise, students choosing distractors C and D demonstrated their lack of knowledge and understanding of the quantity theory, based on the Fisher equation of exchange. There is nothing in this version of the quantity theory of money to link an increase in the supply of money to a proportional increase in either real national income or the rate of economic growth.

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**Question 11**

The pattern of responses indicates that students found this to be a somewhat challenging question. The Key, A, was chosen by around 47% of students while distractor D attracted around 38% of students. The reason why more than half of students failed to select the key, and over a third selected the same distractor, is not the quantitative nature of the question but weak understanding of the difference between fixed, variable and total costs.

The question required students to calculate the average fixed cost of providing 3,000 handbags per month. Fixed costs are the costs incurred when output is zero. The data provided gave the total cost of producing a zero output as £45,000 per month. The average fixed cost of producing 3,000 handbags per month is thus simply calculated by dividing £45,000 by 3,000, and equals £15.

The answer given for Distractor D was £120. Approximately 38% of students selected this figure, and they demonstrated a confused understanding of the difference between fixed and variable costs. Total cost is the sum of fixed and variable costs. The data gave £360,000 as the total cost of producing 3,000 handbags per month. Dividing £360,000 by 3,000 yields a figure of £120. This figure is obviously the average total cost not the average fixed cost of producing 3,000 handbags per month.

Distractor B, £105, is the average variable cost of producing 3,000 handbags per month. While distractor C, the least popular of the four responses, is the marginal cost of increasing production from 2,000 to 3,000 handbags per month.

**Question 21**

This was the most demanding question in the test with only around 33% of students selecting the Key, C. Despite its low facility, the question discriminated effectively between the more and less able students sitting the paper. The majority of students appeared to have a poor understanding of the use of quantitative easing, (QE), and role of forward guidance for the conduct of monetary policy. This weakness is evidenced by the almost equal distribution of the remaining responses between the three distractors.

Given the state of the economy detailed in the stem of the question, a central bank is most unlikely to pursue a policy leading to an appreciation of the exchange rate, response A. Such a policy would reduce the demand for exports, leading to an increase in unemployment. It would also reduce the cost of imports and move the inflation further away from the target rate set by the government.

Likewise, given the state of the economy and the government's policy target for inflation, a policy of increasing the base rate of interest and reversing the QE policy, distractor B, would worsen unemployment and increase deflationary pressure. In consequence the rate of inflation would fall further below the target set by the government.

Selling some of the central bank's stock of government bonds to other financial institutions, distractor D, implies a reversal of its QE policy. A reversal of the central bank's QE policy, after several years, would be deflationary and have a negative effect on expectations regarding the future stance of monetary policy. Such a change in the stance of monetary policy would have all the consequences outlined above in relation to distractor B.

To avoid such a scenario and the consequential adverse effect on the state of inflationary expectations, central banks issue forward guidance regarding the future stance of monetary policy to manage expectations in a direction which supports rather than works against their desired policy outcomes.

### Question 22

This was another unexpectedly difficult question. The majority of students were expected to be familiar with the basic concepts of substitute goods and joint supply. They were also expected to have had a good grounding in the application of demand and supply curve diagrams to different contexts. Less than 40% of students chose the Key, A. Distractor B was chosen by around 34% of students, which came close to making it a prominent distractor.

Joint supply arises when the same production process results in the simultaneous output of two separate products. Substitute goods are interchangeable in consumption or use and have a positive cross-price elasticity of demand. The degree of substitutability is measured by the magnitude of their cross-price elasticity of demand.

Beef and leather are an example of joint supply. The hide of cattle is a by-product of beef production and is used to make leather. Beef and chicken are substitutes in consumption. Because they are substitutes, with a positive cross-price elasticity of demand, a fall in the price of chicken will lead to a fall in the demand for beef and a subsequent fall in the number of cattle required for beef production. A fall in the number of cattle will result in a reduction in the available supply of leather.

Based on the information in the stem of the question, the fall in the supply of leather will shift the market supply curve to the left but have no effect on the position of the demand curve. This change in the market for leather is shown in diagram A. The demand for leather is unaffected by the increased demand for chicken and consequent fall in the demand for beef. Diagram B illustrates a shift to the left in the position of the demand curve for leather not beef and is consequently incorrect.

Diagram C illustrates an increase in the market demand for leather. This cannot possibly result from any of the changes referred to in the stem of the question. Likewise, the shift to the right in the market supply curve for leather, Diagram D, implies an increase in the number of cattle and supply of beef, which is the opposite scenario detailed in the question.

### Question 24

The Key, B, was selected by half the students. The question discriminated very effectively between the more and less able students in the test. Data interpretation questions typically provide more of a challenge to students than simple calculation questions or tests of knowledge and understanding of concepts. The question was no exception in this respect. It is included here because it illustrates clearly the consequence of failing to relate the data in the stem in a meaningful way to the four possible responses.

The stem contains insufficient information to calculate the value of the Human Development Index for the economy detailed in the question. Response A is thus a distractor. Likewise, responses C and D are distractors because no data is provided in the stem on money wages and unemployment. Data is provided for the rate of inflation but, without equivalent data for money wages, no inference can be drawn regarding the implications of inflation for the change in real wages. Data is also given for the rate of population growth but this fact alone does not necessarily

imply an increase in unemployment. Without information on the demand for labour and the real wage rate, no inference can be made regarding the number of unemployed people.

Response B, on the other hand, can be inferred unambiguously from the data provided. The 3% increase in real GDP combined with the 2.5% rate of inflation exceed the 5% increase in the population over the same period resulting in an increase in nominal GDP per capita.

### **Question 28**

The Key, A, was selected by half of the students. Although not identified as a demanding question it is considered here because the relationship between the balance of payments and the exchange rate is an area of the specification which many students find difficult.

A net capital outflow arises when investors increase the supply of domestic currency on the foreign exchange market by more than the demand by investors for the domestic currency on the foreign exchange market. Such a change in the supply and demand for the domestic currency could result from domestic investors increasing their demand for overseas assets relative to foreign investors demand for domestic assets. The result of the excess supply of the domestic currency on the foreign exchange market is a decrease in the exchange rate, response A.

Response B is incorrect because a decrease in the exchange rate would result in an increase in the value, in terms of the domestic currency, of the unchanged income in foreign currency from overseas investments.

Response C is incorrect because an increased demand for foreign assets relative to domestic assets will lead to a fall in the price of domestic assets and increase in their yield. This, in turn, will lead to an increase in the rate of interest. Further, depending upon the exchange rate regime and any target for the rate of inflation, downward pressure on the exchange rate is more likely to cause the central bank to increase and not decrease the rate of interest.

Response D is incorrect because the decrease in the exchange rate resulting from a large net capital outflow will, in the short run, increase the domestic currency value of imports without any immediate change in the domestic currency value of exports.

### **Section B: General**

The overall standard of the responses showed an improvement from last year. The mean mark was higher for all three questions. However, the spread of marks was also greater and whilst there were some excellent answers, some responses were disappointing.

Many students were able to demonstrate good knowledge of the concepts and principles tested on the paper, but some answers showed significant problems. Knowledge and understanding is the foundation upon which other skills are based, and issues with a student's grasp of the terminology, concepts and theories outlined in the specification will inevitably lead to a lower performance on this paper.

Students are also assessed on their ability to apply their knowledge and understanding to the context, in this case the UK housing market. They need to select relevant concepts and theories and use them effectively to answer the questions set. For example, they should have recognised that the demand and supply model was a fundamental theory to employ when attempting to explain fluctuations in house prices. Some students applied the model well when answering

question B32, but some only considered either demand-side or supply-side influences. Others didn't recognise its importance. It was surprising how many students used macro AD/AS diagrams or hybrid macro/micro diagrams to represent the housing market in questions B32 and B33. Similar problems have been noticed in previous years. Centres could improve the performance of their students by devoting some time to helping them to distinguish between situations where individual markets should be represented by microeconomic diagrams and when diagrams representing the economy as a whole are appropriate.

The extracts in the case study provide background information and also include clues that students can use to help them answer the questions. Students who make little or no use of the extracts will put themselves at a significant disadvantage. The numerical and textual data will help students to identify important issues that should be developed and may include evidence that can be used to help support or refute arguments. The most able students made extensive use of the extracts, whereas some students' responses largely ignored them. However, some less effective answers just copied statements from the extracts and failed to develop the material effectively. Students would benefit from practising how the use of both numerical and textual data can be used to enhance the quality of their responses to questions. Centres now have three past papers that they can use with their students, as well as two sets of sample assessment materials that were written at the same time as the current specification.

The ability to analyse issues and problems is an important skill that students should try to develop through their study of economics. More able students started by identifying relevant issues and developed them in a methodical and systematic manner, presenting a clear, logical chain of reasoning. The attempted analysis in less effective answers omitted important steps or lacked clarity and precision. Effective use of diagrams can help to support analysis. The more able students used diagrams to help them construct a logical argument. Less effective answers made only a perfunctory reference to their diagrams or didn't refer to them at all. Making use of diagrams provides students with an opportunity to demonstrate their analytical ability. It is an opportunity that some failed to grasp.

When answering questions B31 and B33, the overwhelming majority of students made judgements, but they were not always very well supported or convincing. When assessing the quality of the evaluation, examiners take into account the extent to which judgements are supported by both qualitative and quantitative evidence. Supporting evidence might include material taken from the extracts, relevant use of the student's own knowledge and sound, well-developed analysis. The most able students demonstrated their ability to evaluate arguments effectively as they progressed through their response and to provide a well-supported conclusion or recommendation.

On the whole, students' answers were legible but, as mentioned last year, credit cannot be given if it is impossible to read the response. Similarly, poor or inappropriate diagrams cannot be rewarded. Students should be reminded that poor presentation can affect their ability to communicate with the reader and hence the mark they achieve.

### **Question 31**

The overall quality of students' responses to this type of question continues to improve but some students did not appreciate how they should approach answering such questions. The most effective answers demonstrated a clear understanding of what is meant by affordability, but it was disappointing that only a small minority of students started by attempting to explain this key concept. Most quoted the figures accurately and were able to use them to support basic

judgements. Some less effective responses, digressed into discussing issues that had little bearing on the question set, or deliberated on what they expected to happen to affordability after 2017, sometimes considering the impact of Brexit.

All four Figures in Extract C were relevant, but some answers were limited in that they only considered one or two sets of data. The more effective answers quoted the figures and then analysed how they were relevant before drawing a conclusion. For example, Figure 1 showed that the standard variable mortgage interest rates had fallen; more able students explained that this would lead to a reduction in monthly mortgage repayments for many people, making housing more affordable. A few students also appreciated that this may not be the case since house prices have risen and hence the amount borrowed may have increased.

Some students failed to use Figure 4 and others used it badly. More able students calculated the percentage change in house prices and compared this to the overall percentage change in weekly earnings. The difference was less than 1% but nonetheless, some boldly concluded that it meant houses were more affordable, the more able students were more nuanced in their judgements. A fairly common error was to compare the difference between the changes in house prices and earnings in 2007 with the difference between house prices and earnings in 2017. Students who did this mistakenly alleged that because the difference was smaller in 2017 than 2007, houses had become more affordable.

Many students attempted to identify limitations in the data that might affect the reliability of judgements based on the data available. However, this was not always done well. Examples of issues often raised by the more able students included: Figures 2 and 3 only related to first-time buyers; there was no information about regional differences in house prices and earnings; and that averages may be distorted by extremes and can be misleading. It was quite common for students to assert that it would have been helpful if figures on inflation had been given, but only rarely were they able to provide a valid explanation of why data showing inflation may have helped.

Most students attempted a final judgement, but some did not. However, many of those who provided an overall judgement did not pay much attention to 'the extent to which' houses were more affordable.

### **Question 32**

As stated in previous reports, this question is only testing three of the four assessment objectives: knowledge and understanding, application and analysis. Evaluation is not being assessed. The extracts were included to help students, but some made little use of the source material. This often meant that application was limited. However, it was the quality of the analysis that distinguished most effectively between very effective and more modest answers.

More able students provided a convincing explanation of why house prices fell significantly in 2008 but rose over the whole period. The more able students recognised that the forces of demand and supply are the key determinants of changes in house prices and they analysed the impact of both demand-side and supply-side influences over the period. Some students only attempted to explain the overall rise in house prices between 2007 and 2017. Those who did this well were able to gain high marks. A few students just attempted to explain why house prices fell in 2008. This often resulted in a very limited answer that focused primarily on causes of the financial crisis rather than its impact on house prices.

There were some very effective responses that explained the reason for the drop in house prices in 2008 in terms of the financial crisis and its impact on confidence, incomes and employment, which then fed through to the housing market by reducing the demand for houses. However, many students who recognised that the financial crisis contributed to the fall in house prices were unable to provide a convincing explanation of how it affected house prices in the UK. A few students recognised that speculative bubbles might be relevant but only a small minority was able to explain how speculation may have contributed to the fall in UK house prices in 2008.

The subsequent rise in house prices was explained in terms of demand outstripping supply. Many cited population growth as the main driver of rising demand and planning restrictions as the reason for inadequate supply. Some of the more able students analysed the impact of improved macroeconomic conditions on the demand for houses and some also considered the effect of low interest rates. A few students considered the impact of the Help to Buy Scheme and improved credit conditions.

It was disappointing that a lot of students thought they should represent the housing market using an AD/AS diagram. Others put price and quantity on the axes but labelled the curves AD/AS. When there was a linked explanation of the diagram, it was often unclear whether they were referring to the housing market or the macroeconomy. On the other hand, there were some very effective answers that used an AD/AS diagram to show developments in the macroeconomy and then linked this to a demand and supply diagram to help them analyse the impact of developments in the macroeconomy upon the housing market.

Some of the least effective answers identified a few relevant points from the extracts but included little, if any, economic analysis to explain the causes of the changes in house prices.

### **Question 33**

The most effective answers often started by briefly identifying some of the problems in the UK housing market, drawing on the extracts, and outlining the case for government intervention. Common arguments related to housing as a merit good and inequality as potential sources of market failure. The more able students included a merit good diagram, illustrating the effect of positive externalities in consumption on market outcomes. The analysis linked to the diagram was then used to provide an argument in favour of some form of government intervention. A fairly common error was to present a diagram showing positive externalities in production. Some credit was allowed provided the associated explanation was reasonable. Only the more able students presented a convincing, measured explanation of the positive externalities that may result from good quality housing. Most students recognised that intervention in the housing market can help to reduce inequality and based their arguments for intervention on eliminating the worst effects of inequality, including homelessness.

Despite the clues in the extracts, relatively few students distinguished between the different types of government spending on housing. Those that did, were able to analyse and assess the various consequences of providing financial support for those on low incomes and, for example, financing or subsidising the provision of more social housing.

Many students recognised that when deciding whether they should recommend that the government increase its spending in housing, they ought to consider other policy options. Relaxing planning regulations and the imposition of rent controls were often identified as alternatives. Less effective answers failed to include detailed analysis of the possible consequences of such policies and hence the evaluation was, at best, superficial and relied on copying snippets from the extracts.

More effective answers included diagrams illustrating the effects of relaxing planning regulations on the housing market. For example, some included a demand and supply diagram showing the effect of an increase in supply of houses, others included a diagram illustrating negative externalities resulting from building houses. Some of the more able students included diagrams to support their analysis and evaluation of rent controls.

The extracts hinted at the budgetary consequences of an increase in government spending on housing. Most students recognised that it would probably lead to an increase in the budget deficit, cuts in other programmes or higher taxes. However, only a minority developed their arguments. Some considered the consequences of an increase in government spending on aggregate demand, employment and growth. When present, the analysis was generally sound and fairly well developed. The inclusion of an AD/AS diagram and discussion of possible multiplier effects enhanced the quality of some answers. A few considered the consequences of financing more spending on houses by raising taxes. Some of these students asserted that higher taxes would reduce aggregated demand without considering the expansionary effect of the increase in government spending.

More able students used the prompts in the extracts to help them identify key issues. They used their knowledge and understanding of relevant economic theory to support their analysis of the likely effects of different ways in which the government might attempt to correct the problems in the housing market. They assessed the relative merits of each of the policies considered as they worked their way through their answer. Finally, they included a supported recommendation. Some more effective responses recommended that the government should increase spending on housing; others concluded that it was unnecessary and recommended a different approach. What mattered was how well they were able to justify their recommendation.

## **Mark Ranges and Award of Grades**

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