Extract A: The sterling exchange rate

In June 2016 just before Britain voted to leave the EU, the pound sterling was trading at $1.48 and at €1.32. The immediate aftermath of the referendum saw sterling decline sharply in value. Continued uncertainty around Brexit kept the pound weak for many months, providing a much needed injection into the UK’s circular flow of income. The full impact of the multiplier effect is difficult to calculate as many of Britain’s exporters are importers themselves. For example, cars made in Britain may be exported all over the world, but raw materials used in their manufacture, such as oil and copper, are imported. In addition, uncertainty has reduced the marginal propensity to import and increased the desire to save. Furthermore, currency traders and speculators are increasingly being influenced by politics rather than economic forces, making the foreign exchange markets react quickly, leading to a faster pace of change in the price of sterling. After the general election in December 2019, sterling rallied briefly as a Brexit deal seemed more likely. However, the forecast for 2020 seems to be further depreciations against the dollar and the euro.

Source: https://www.bbc.co.uk/news/business-46862790

Extract B: UK monetary policy

In 2008, just ahead of the full recognition of the significance of the global financial crisis, the Bank of England’s Monetary Policy Committee (MPC) had set a base interest rate of 5%. In the six months that followed, six rate reductions occurred and by March 2009 the official base rate of interest was just 0.5%. However, the MPC realised that more action was needed, and they undertook a programme of quantitative easing, spending a total of £435bn on QE over the past decade. Despite these actions being initially an emergency measure, the interest rate was still only 0.75% in December 2019, and the proceeds from any maturing bonds are still used to fund more QE purchases. The measures meant the recession of 2009 did not turn into a depression and unemployment peaked at 8.5%, well below that of the US or the eurozone. However, wealth inequality soared in the aftermath: the wealthiest 10% saw their real wealth rise by £350,000 whereas the least wealthy 10% saw their real wealth rise by just £3,000.

Inflation generated by the weak pound since the Brexit vote as well as record employment levels and rising pay growth have led the MPC to lift interest rates to 0.75%. However, the forecast for 2020 is that it is likely to be lowered by 0.25 percentage points in the light of very sluggish growth in the economy and worryingly low investment levels.

Sources: https://www.theguardian.com/business/2019/mar/08/the-verdict-on-10-years-of-quantitative-easing
https://www.which.co.uk/news/2019/12/what-will-brexit-mean-for-interest-rates/
(a) With reference to Extract A, explain what is shown by the circular flow of income model. 

(5 marks)

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(b) With reference to Extract A, examine two effects of the depreciation in sterling on the UK’s current account balance. 

(8 marks)

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(c) With reference to the information provided, discuss the factors that influence the size of the multiplier.

(12 marks)
(d) With reference to the information provided, evaluate the policies the MPC could undertake to create growth and encourage investment in the UK.

(15 marks)
[Total Marks available = 40 marks]

End of Questions