

**ADVANCED GCE UNIT  
ECONOMICS**

THE UK ECONOMY

**WEDNESDAY 13 JUNE 2007**

**2887**

Morning

Time: 1 hour 30 minutes

Additional materials: Answer Booklet (8 pages)



**INSTRUCTIONS TO CANDIDATES**

- Write your name, Centre number and candidate number in the spaces provided on the answer booklet.
- Answer Question 1 and **one** question from Section B.
- Write all your answers on the separate answer booklet provided.
- If you need to use additional answer sheets, fasten these sheets securely to the answer booklet.

**INFORMATION FOR CANDIDATES**

- The number of marks is given in brackets [ ] at the end of each question or part question.
- The quality of your written communication will be taken into account in the marking of your answer to Section B.

This document consists of **4** printed pages.

## Section A

Answer **this** question.

1

## The UK's productivity gap

At a macroeconomic level, there is a 'productivity gap' between the UK and other major industrialised countries. Closing this 'gap' is central to improving the UK's international trade competitiveness and economic performance. Irrespective of what happens to domestic demand and GDP (Fig. 1), continuous improvement in living standards depends ultimately on continuous improvement in productivity.

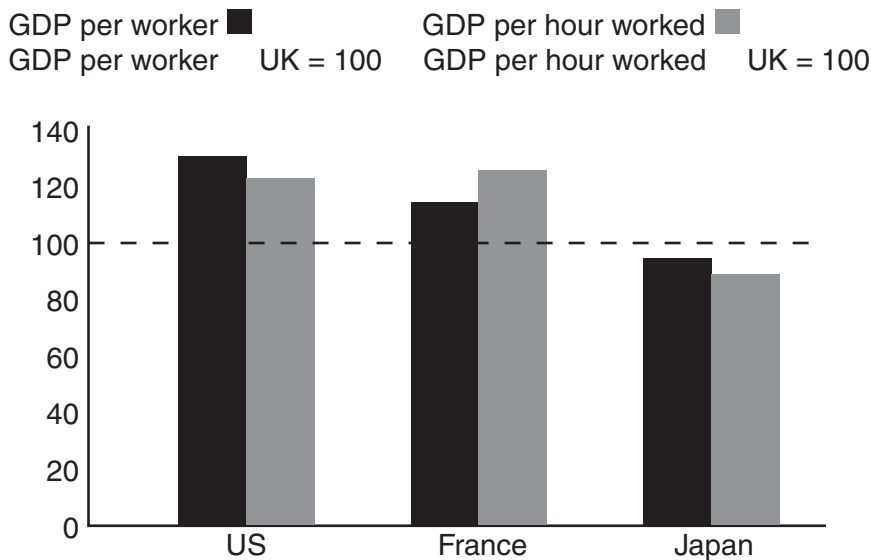
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**Fig. 1 UK economy – Domestic demand in real terms and real GDP**  
% changes on the previous year

	2004	2005
<b>Domestic demand (in real terms)</b>	3.75	1.75
<b>Real GDP</b>	3.00	1.75

Fig. 2 illustrates the 'productivity gaps' between the UK and three other major economies. The size of the 'gap' depends partly on the measure of productivity that is used.

**Fig. 2 An international comparison of productivity in 2002**



Some explanations for the 'productivity gap' are relatively straightforward. For example, giving employees more and better equipment enables them to produce more output for every hour worked. Unsurprisingly, capital per worker is significantly higher in countries such as France than it is in the UK. Policy should therefore, in part, be aimed at increasing capital investment spending by UK companies.

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Answer **all** parts.

- (a) (i) Apart from investment spending, identify the **two** other components of domestic demand. [2]
- (ii) With reference to Fig. 1, explain what happened to domestic demand in real terms and real GDP from 2004 to 2005. [2]
- (iii) In 2004, the percentage changes in real GDP and domestic demand in real terms were not the same. Explain **one** possible reason for this. [2]
- (b) (i) With reference to Fig. 2, compare the UK's productivity in 2002 with that of the USA and France. [3]
- (ii) Comment on the extent to which relatively low productivity may reduce the international trade competitiveness of 'UK companies'. [5]
- (c) Discuss whether policy 'aimed at increasing capital investment spending by UK companies' will close the 'productivity gap'. (lines 11–12) [6]

**Section B**

Answer **one** question.

- 2** Most Central Banks hold reserves of foreign currencies in case they need to intervene to prevent large fluctuations in the foreign exchange value of their currency. Records show that, during 2004-2005, the Bank of England chose not to intervene in the foreign exchange market in this particular way.
- (a)** With the use of a diagram, explain how the Bank of England could prevent large fluctuations in the sterling exchange rate. [10]
- (b)** Discuss the extent to which the foreign exchange value of a currency should be determined solely by market forces. [15]
- 3** Between 2000 and 2004, the faster growing major industrialised economies including the UK had relatively low savings rates. The slower growing comparable economies over this period such as Germany had relatively high savings rates.
- (a)** Explain the factors that affect the level of savings in the UK economy. [10]
- (b)** Discuss whether an increase in the UK's savings rate will lower the country's rate of economic growth. [15]
- 4** In general, poorer UK households enjoyed greater real income growth in 2003-2004 than richer ones. This was the third successive year in which income inequality had fallen and was due, in part, to a large package of redistributive measures by the government.
- (a)** Explain how changes in income inequality can be measured. [10]
- (b)** Discuss whether 'greater real income growth' will necessarily lead to a higher standard of living in the UK. [15]

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