WELSH JOINT EDUCATION COMMITTEE
General Certificate of Education
Advanced

CYD-BWYLLGOR ADDYSG CYMRU
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Uwch

374/01

ECONOMICS EC4

A.M. WEDNESDAY, 14 June 2006

($1\frac{1}{4}$ hours)

ADDITIONAL MATERIALS

In addition to this examination paper, you will need a 12 page answer book.

INSTRUCTIONS TO CANDIDATES

Answer **one** of the questions.

INFORMATION FOR CANDIDATES

The number of marks is given in brackets at the end of each question.

You are reminded of the necessity for good written communication and orderly presentation in your answers.

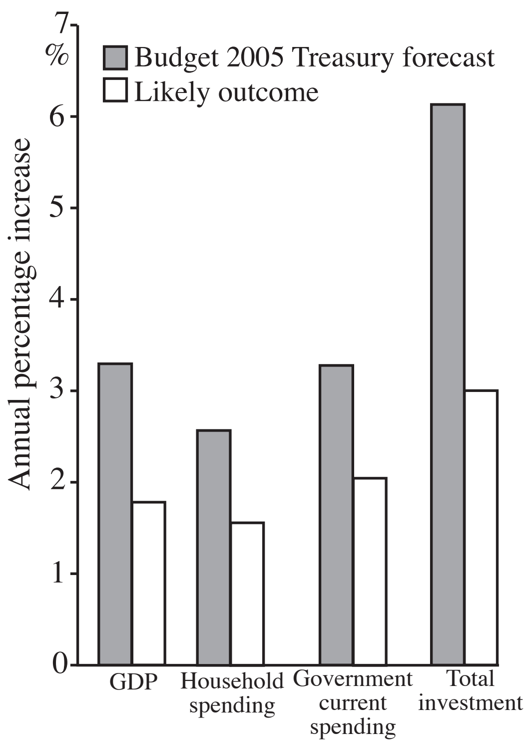
Answer **one** *question.*

1. Study the following information and then answer the questions that follow.

Sorry Gordon, you know you had it coming

Figure 1 - Treasury and independent economic forecasts

How the Treasury's forecast for 2005 went wrong – the growth rate of GDP and its domestic components.



How Treasury and independent forecasts have changed for UK GDP growth in 2005. (Consensus and Capital Economics are independent forecasters)

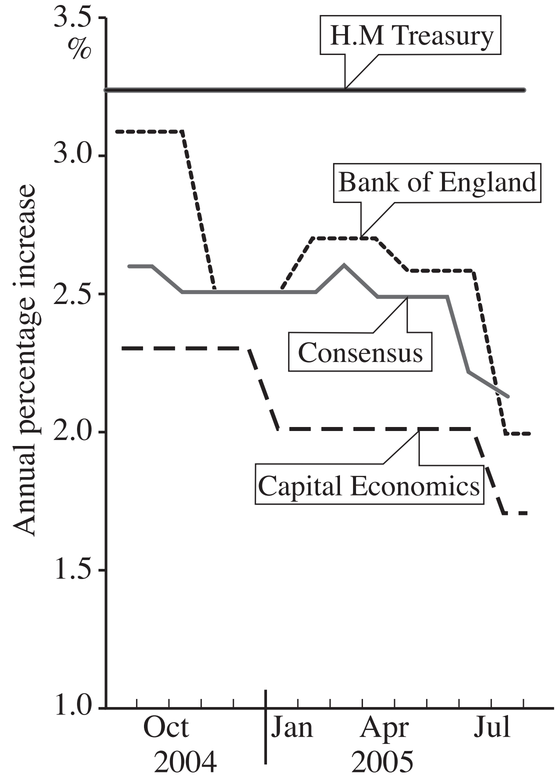
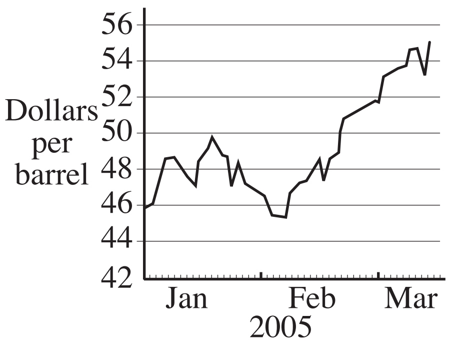


Figure 2 - World oil price (dollars per barrel)



On Friday Gordon Brown acknowledged that his forecast for UK growth would not be met. He said that growth would be at, or slightly below, 2.5% for 2005, and there was a strong hint that it could be only 2%.

All year the Treasury's view of the economy has been under attack from independent forecasters who have thought it much too optimistic. As 2005 has worn on they have revised their forecasts down.

So the always-right Chancellor has had to admit that he was wrong. He has sought to pin the blame for the shortfall on the rise in oil prices, against which he is powerless. He warned that the effects of higher oil prices are "more considerable than previously thought because of the scale of the rise" and added: "That is something that is obviously having an effect on costs."

Why the slowdown?

Does the oil price explanation stack up? Clearly it has been a major factor behind the weakness of consumer spending - and not only because of higher petrol prices. It is also a major driver behind the huge increase in gas and electricity prices which have also squeezed real income growth.

The flow of oil from the North Sea has also made the country almost self-sufficient. Indeed, the Treasury benefits in the short term from higher petroleum tax revenues, higher VAT payments and higher corporation tax on the oil companies, although the Chancellor said he saw no net gain.

John Butler, an economist at HSBC, said oil could not be blamed for the slowdown so far this year. "The reason growth has been slower is because consumers have reacted to slower house price rises and higher levels of debt."

However, by the end of 2005, he predicts higher oil prices and the knock-on effects, in the form of higher electricity and gas bills, will chop around 1% off the spending power of households. He also said high oil prices would hit corporate profits and slow investment, and that the high profits being earned by BP and Shell, which are then repatriated into the UK from abroad, are helping to keep sterling strong and will hit the trade balance.

But the price of energy is hardly the only factor at work. Consumers have also had to contend with high debt levels, the delayed effects of previous interest rate increases, rising taxes and a slowing housing market. The collapse of spending on the High Street and a recession in the manufacturing sector - which is shedding 7,000 jobs a month - have dragged growth down to the annual rate of 1.7%.

As regards the effect of public spending on the rest of the economy, the extra money poured into public sector salaries has continued to support aggregate demand. In the year to June 2005 public sector investment has risen by about 30% while private sector business investment has crawled along. So in both respects growth of public spending has been a considerable support.

But there is a price to pay for this support. Although tax revenue has been rising, it has not closed the gap between government spending and tax receipts, so tax rates will have to rise.

Prospects

The economic slowdown may have major consequences for the UK economy. It will increase government borrowing and pose an acute dilemma - either accept an embarrassingly high public sector deficit or raise taxes in a downturn.

However, this may not be the end of it. The news from the High Street is dire. Whilst poor retail performance was concentrated on stores, pubs and restaurants were doing well - perhaps as people decided to drown their sorrows. But now the downturn looks to be spreading there also.

Households are saving more. The savings ratio is now 5%, up from 4.5% in the previous quarter, as consumers tuck away cash.

Many are taking comfort from the idea that the housing market has stabilised but the tax rises are yet to come. So things could easily turn out much worse for the UK economy.

There are, however, still signs of strength in the economy. Household incomes are still rising and though unemployment has started to rise it has not yet started to affect people's confidence.

Adapted from the Daily Telegraph September 24 2005

(a) Using Figure 1, explain how forecasts of GDP growth by the Treasury and independent forecasters changed during 2005. [8]

(b) Explain why lower economic growth may "have major consequences for the UK economy". (Line 38) [8]

(c) Discuss whether Gordon Brown was right to describe the rising price of oil as the main cause of reduced growth in 2005. [12]

(d) Evaluate the view that "things could easily turn out much worse for the UK economy". (Line 47) [12]

2. Study the following information and then answer the questions that follow.

Brazil's economy - 1945 to the present day

Import-substitution policies 1945-1990

After the second world war, Brazil's economic development was based on import-substitution, helped by a large domestic market. Tariff and non-tariff barriers aimed to discourage imports and huge capital funds were invested in infrastructure and establishing state-owned public corporations in areas where private investment was not occurring. For three-and-a-half decades the economy expanded rapidly and a large and diversified industrial sector was developed.

The industrialisation process from the 1950s to the 1970s led to the expansion of important sectors of the economy such as the automobile industry, petrochemicals, and steel, as well as the completion of large infrastructure projects. In the decades after World War II, the annual growth rate for Brazil was among the highest in the world averaging, until 1974, 7.4%.

Liberalisation in the 1990s

In the late 1970s import-substitution policies began to show signs of exhaustion. Protectionist policies had made the economy inward-looking and inefficient, causing a steady decline in the country's current balance.

In the early l990s Brazil was engaged in a series of far-reaching economic reforms. They encompassed trade liberalization, deregulation, privatisation, and the establishment of a legal and structural framework to promote foreign investment.

In four years almost all non-tariff barriers were removed and import tariffs were slashed. Lower import tariffs reduced the cost of inputs and machinery, promoting production and investment in the consumer-goods sector. This reinforced Brazil's comparative advantage in agriculture and livestock, in addition to stimulating expansion of the domestic durable-goods sector and services such as telecommunications, commerce, transport and public utilities. Furthermore, external competition led to a sharp rise in labour productivity.

Economic reforms continued through the 1990s and included such measures as the abolition of state monopolies, reduction or elimination of trade barriers in goods and services as well as export subsidies, in line with Brazil's obligations as member of the World Trade Organisation (WTO). The average tariff came down from 32 percent in 1990 to 14 percent as of 1999.

Tough economic policies for the 2000s

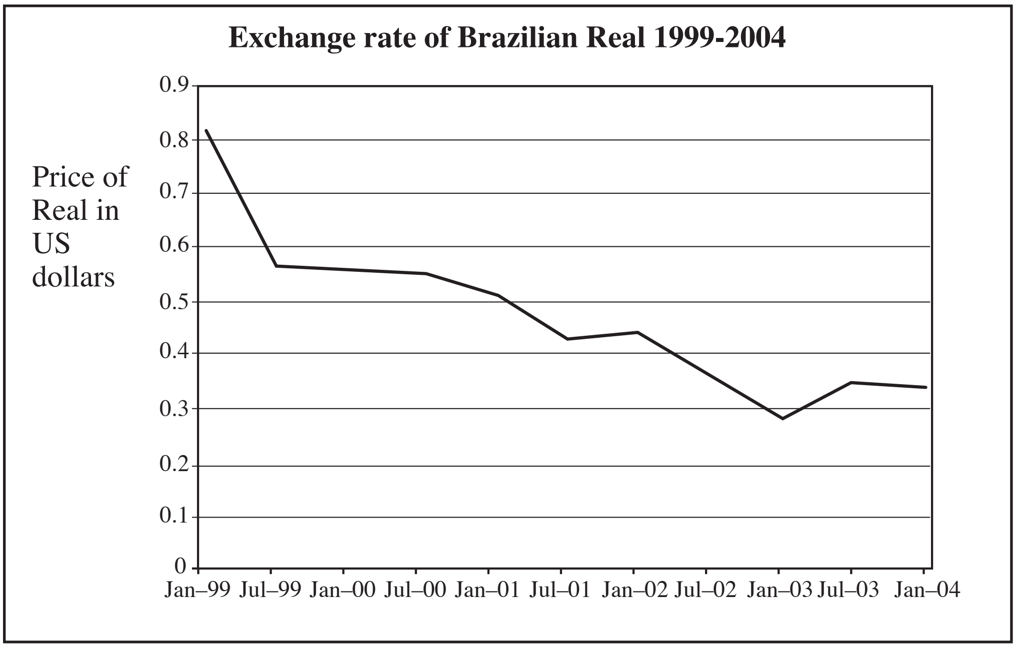
Brazilians learned last week that their economy shrank 0.2% in 2003, the worst performance in 11 years. President Lula and his economic team promised that the tight fiscal and monetary policies of 2003 (such as high taxes and interest rates) would lead to renewed growth and more jobs in 2004.

The pain is obvious enough: in 2003 average wages fell 6.2% in real terms, while unemployment in the big cities rose to 11.7%, from 11.2%. Household consumption fell a record 3.3% in 2003, while interest payments on the public debt were almost 10% of GDP.

So when will the gains come? Real interest rates are among the highest of any large economy. But the economy is in better shape than it looks. Last year's policies choked an inflationary spiral, restored investors' confidence in Brazil and should allow interest rates to fall further. Most economists still expect growth of 3-4% in 2004, spreading out from booming exports to domestic consumption and investment.

The devaluation of the Brazilian currency, the *Real*, of January 1999 encouraged export growth, lifting the export/GDP ratio to 10.6% in 1999 and 12% in 2000, narrowing the trade deficit. In 2001 exports continued to expand, growing by 5.7% year on year, though the growth was mainly concentrated in lower-value-added primary products, with industrial exports barely rising. Reduced demand from Brazil's largest regional trading partner, Argentina, was among the reasons for the slow recovery in manufactured exports.

Figure 1 - Exchange rate of the Brazilian Real (the Real is the Brazilian currency)



Long-term underinvestment, particularly in infrastructure, has led to high costs and inefficiencies in services such as transport, energy provision and communications. Export industries have also suffered from a heavy corporate tax burden, and small and medium-sized enterprises have found it difficult to acquire financing and technical assistance to support their export activities.

Figure 2 - Brazil economic indicators 2000-2003

	2000	**2001**	**2002**	**2003**
GDP per head ($ at purchasing power parities)	7,283	7,480	7,640	7,710
GDP (annual % change)	4.32	1.29	1.91	0.40
Budget deficit (% of GDP)	3.41	3.25	9.80	4.90
Consumer prices (annual % change)	7.04	6.84	8.45	14.72
Public debt (% of GDP)	49.44	52.57	55.93	57.40
Labour costs per hour (US dollars)	3.58	3.02	2.58	2.69
Recorded unemployment (%)	13.33	11.27	11.68	12.32
Current-account balance as % of GDP	-4.03	-4.55	-1.67	0.90

Looking outward to the world

Figure 3 - Brazil's major trade partners 2004

Exports	% of total exports	Imports	% of total imports
US	21.1	US	18.3
Argentina	7.6	Argentina	8.9
Netherlands	6.1	Germany	8.1
China	5.6	China	5.9

In recent years Brazil has increasingly looked to world markets as a source of prosperity. It is part of Mercosur, a free trade area with its neighbours Argentina, Uruguay and Paraguay which is eventually intended to be a full common market. Lula's other hope is for a free trade area for the whole of North and South America, and he has been negotiating free trade agreements to reduce trade barriers with the European Union and China.

Adapted from The Economist March 4 2004

(a) Explain the reasons for Brazil's import-substitution policies between 1945 and 1990. [8]

(b) How were the 'far-reaching economic reforms' (line 15) in the 1990s intended to benefit Brazil's economy? [8]

(c) Discuss whether the 'tough economic policies for the 2000s' (line 28) were successful. [12]

(d) Evaluate the possible effects on the Brazilian economy of membership of Mercosur and other international free trade agreements. [12]