WELSH JOINT EDUCATION COMMITTEE
General Certificate of Education
Advanced Subsidiary/Advanced

CYD-BWYLLGOR ADDYSG CYMRU
Tystysgrif Addysg Gyffredinol
Uwch Gyfrannol/Uwch

372/01

ECONOMICS – EC2

A.M. THURSDAY, 18 January 2007

(1 hour)

ADDITIONAL MATERIALS

In addition to this examination paper, you will need an 8 page answer book.

INSTRUCTIONS TO CANDIDATES

This paper contains **one** compulsory question.

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.

VP*(372-01)

Study the information below and then answer the questions that follow.

DEAR TONY, I'M AFRAID WE HAVE RUN OUT OF STEAM

. . . and the rest of the economy is faring little better

Figure 1

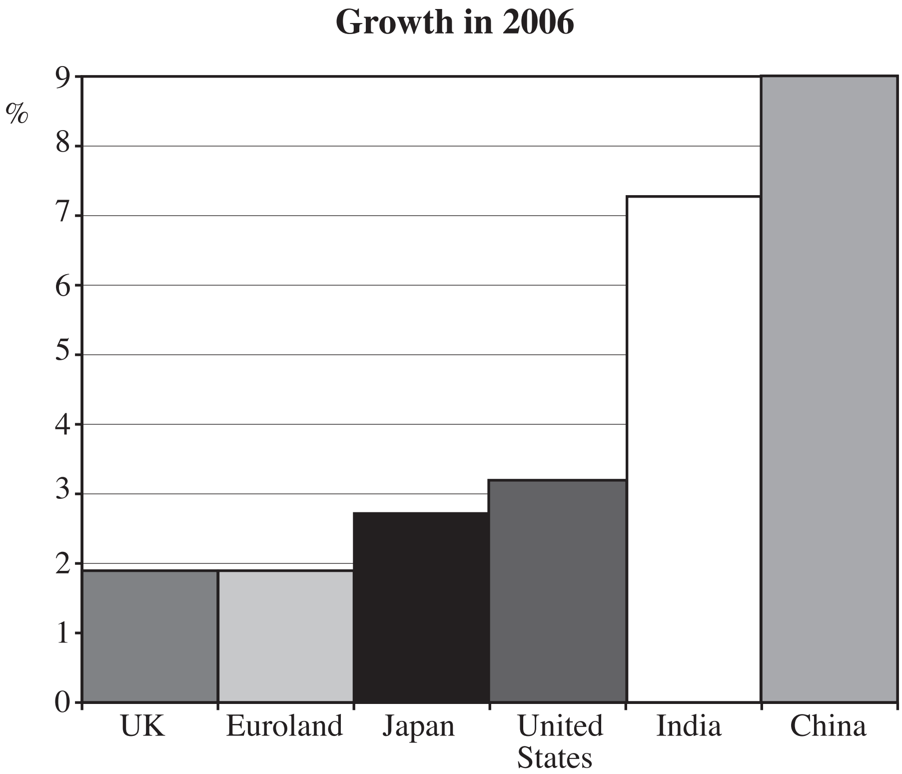
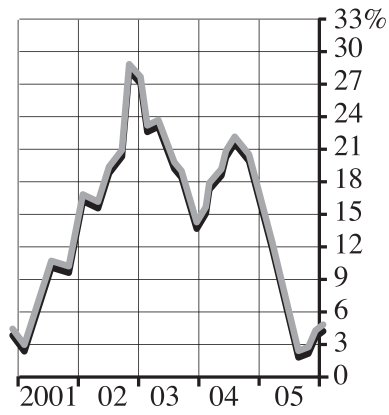


Figure 2

UK HOUSE PRICES
Annual percentage change



Source: Halifax

Economically Britain appears to have reached a turning point. Either the disappointing growth in 2005 was a blip, in which case things need to speed up soon, or it's the shape of things to come. Plenty are starting to think the latter. For the first time in years Britain may no longer be able to claim economic superiority over Europe. The HSBC bank has predicted that Britain's GDP will grow by 1.8% in 2006, well behind Japan (2.7%) and the USA (3.3%).

Why is this happening? The main reason is that Britain has lost the economic 'motor' of consumer spending that has powered us through the Blair-Brown era. When consumer spending is not growing strongly the British economy looks very ordinary indeed. As recently as 2003/04 consumer spending was growing by nearly 4%, helped by a booming housing market, but in 2005 the spell was broken. The indebted consumers, worried about pensions and seeing their tax burden rising, could not be blamed for saying enough is enough. The consequences, while not an outright recession, were a slowdown in the growth of consumer spending to 2.5% with a small rise in the level of unemployment.

What can be done? In a paper for Lombard Street Research, 'Time for a New Economic Policy', Christopher Smallwood proposes a radical solution. The current approach to policy, he says, has run out of steam. Consumers have reached the limits of their indebtedness and another growth factor – the £50 billion swing from a £12 billion surplus to a £38 billion deficit on the Government's finances since 1997 – cannot go any further. Government spending rose to 42% of GDP in 2005.

Smallwood proposes reviving a policy that worked well in the 1990s, when interest rates were cut sharply, taxes rose to slash the budget deficit and the pound fell against other major currencies. The result was strong and balanced economic growth of 4.5%. This economic growth was led by a rise in both exports and investment. This could be quite timely for the UK balance of payments with a trade deficit on goods and services at 3.4% of GDP in the third quarter of 2005.

Could history repeat itself? Smallwood argues that cutting interest rates dramatically and raising taxes to cut the budget deficit would kill two birds with one stone and restore economic growth, based on exports and investment rather than consumer spending and government expenditure. Boosting investment from near-record lows in 2005 might help to improve the poor productivity growth under this Government – a full percentage point weaker on an annual basis than in 1990-96.

Adapted from David Smith, Sunday Times, 8 January 2006

(a) (i) Using **Figure 2**, describe the trend in house prices over the period shown. [4]

(ii) Using economic analysis, explain how rises in consumer spending in 2003/04 were 'helped by a booming housing market'. (Line 10.) [4]

(b) Using the data, explain what was happening to the components of aggregate demand in 2005. [8]

(c) Explain **two** factors, **other than** changes in house prices, which might have caused the slowdown in the growth of consumer spending in 2005. [6]

(d) Discuss the view that 'boosting investment' is enough to 'improve poor productivity growth'. (Lines 26-27.) [6]

(e) Using the data and appropriate economic analysis, assess the extent to which Christopher Smallwood's polices of 'cutting interest rates dramatically and raising taxes' (line 24) should enable the UK Government to achieve its macroeconomic objectives. [12]