GCE A level

375/01

ECONOMICS – EC5

P.M. FRIDAY, 6 June 2008

1½ hours

ADDITIONAL MATERIALS

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

INSTRUCTIONS TO CANDIDATES

Read the information in the case study carefully then answer the following questions.

Answer the questions in the separate answer book provided.

INFORMATION FOR CANDIDATES

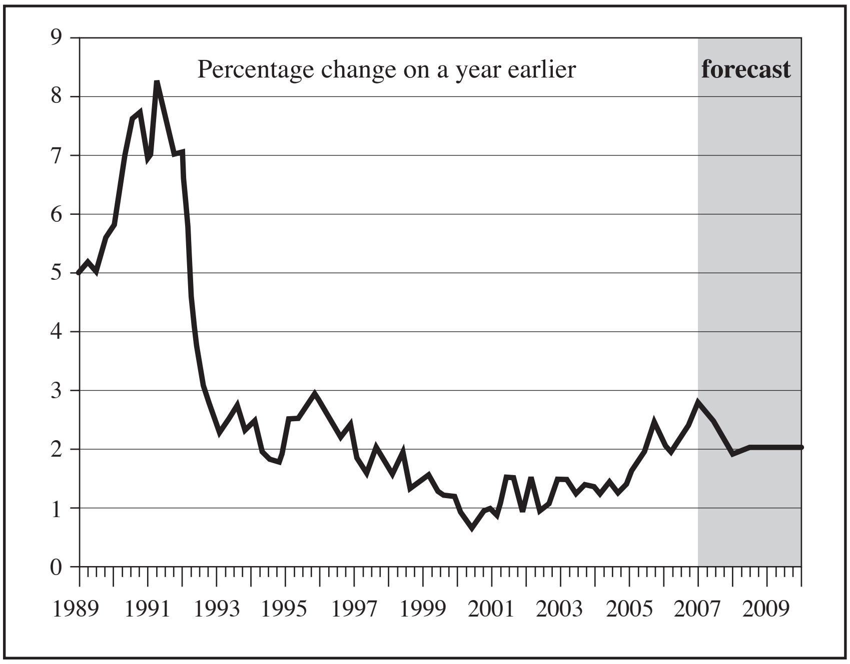
The number of marks is given in brackets at the end of each question.

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

Study the following information and then answer the questions which follow.

Article 1 - UK Inflation: far from a basket case

Figure 1 – CPI



When the Bank of England was granted independence 10 years ago, the expectation was that the Chancellor and the Bank's Governor would become at least fairly regular correspondents. A letter from the Governor explaining why inflation had moved more than a percentage point above or below target (and "above" was always thought more likely) was expected roughly every 15 months. As Mervyn King, the current Governor, wrote in the first such letter last week: "The chances of going almost 10 years without an open letter being triggered seems negligible."

One of the possibilities foreseen when the Bank was given independence was that a sharp rise in oil prices would push inflation up to 5%, 6% or even 8% and that the response would be to drive the economy into recession by jacking up interest rates.

The fact that inflation hit 3.1% last month was disappointing but no more, since it is likely to fall quickly back towards the 2% target because big increases last year will drop out of the year-on-year comparison.

Fathom Consulting, an independent firm, even using cautious assumptions about cuts in gas and electricity bills, and assuming further rises in petrol prices, says the Bank will be in possession of information showing an April drop in inflation to 2.8% when it meets next month, suggesting a fall to 2% in July and just 1.2% by December. RPI inflation, now 4.8%, will be 2.6% by the year-end.

As it is, the 10th anniversary will almost certainly coincide with a 0.25% interest-rate hike by the Bank to 5.5%. At least it will ensure plenty of headlines.

Could the Bank go for a 0.5% hike as some have been urging? Apart from the fact that it would look like a panic response to backward-looking news on inflation – 3.1% is history – it would require something extremely nasty to come out of the inflation-forecasting round.

But the financial press leapt on last week's average earnings figures showing annual growth of 3.6%, and ignored evidence of some softening in the labour market, with the broadest measure of unemployment up and employment down.

Why has Britain's inflation rate gone well above Europe's (1.9% on a comparable basis) after a long time below it? Gas and electricity bills here have risen much more, and are coming down more slowly than they should, thanks to a weak regulator.

The supermarkets, which dominate the food market, appear to have stopped competing on price. Rip-off Britain appears to be back, aided and abetted by "Rip-off Gordon Brown" – higher petrol and other excise duties, air-passenger duty and tuition fees. Take these out of the basket and inflation would still be below 2%.

The Bank has no need to panic and there is no need for interest rates to rise above 5.5%.

Where the pessimists about inflation may have a point, and where the Bank's finest minds will be occupying themselves this summer, is over the longer-term outlook. A 2% CPI inflation target is roughly equivalent to 2.75% retail price inflation. In the 1950s, RPI inflation averaged 4.3%, dropping to 3.5% in the 1960s, then 12.6% in the 1970s, 7.5% in the 1980s and 5.1% in the 1990s. Achieving inflation of less than 3% was, as the sports commentators say, "a big ask".

Strong growth in the money supply, currently nearly 13%, is not consistent with low inflation in the long term. Neither is current service-sector inflation of nearly 6%. Goods prices, even with the effect of cheap Chinese goods and the helpful impact of a strong pound, cannot keep on falling for ever. Food prices have gone up particularly in Britain – 5.1% over the past year – but they are also strong globally.

So the question the Bank should be asking itself as it enters its second decade of independence is whether it has done enough to cement low inflation in Britain. Firms have been taking advantage of strong demand to raise prices. Customers, it seems, have not been as resistant to price increases as they were.

Ensuring low inflation does not require sharp interest rate rises, though it probably does mean not cutting interest rates as inflation falls in the coming months. Mervyn King chose to let his letter speak for itself last week rather than pop up on radio and television to explain what the Bank was doing. But he and his monetary-policy committee colleagues have to do more to convince people and firms that low inflation will continue in the future.

Article 2 - Trade see-saw could leave sterling exposed

Figure 2 – Balance of payments current account

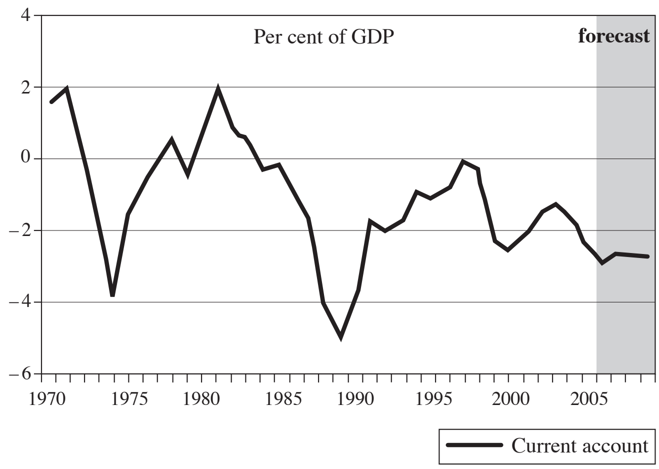


Figure 3 – Quarterly average effective exchange range of sterling against all currencies (Sterling January 2005 = 100)

31-Mar-04	101.6
30-Jun-04	102.4
30-Sep-04	102.1
31-Dec-04	100.3
31-Mar-05	100.7
30-Jun-05	101.6
30-Sep-05	99.8
31-Dec-05	99.6
31-Mar-06	98.8
30-Jun-06	100.3
30-Sep-06	102.2
31-Dec-06	103.6
31-Mar-07	104.6
30-Jun-07	104.1
30-Sep-07	104.6

Figures released a couple of weeks ago, showed that Britain ran a trade deficit in goods last year of no less than £84.3 billion. Let me pause for effect while that number sinks in.

Why is this not the cause of more comment? What does it say about the state of Britain's economy and competitiveness? How long can we go on like this? That £84.3 billion is a lot of money. It means, for every man, women and child in the UK, imports of goods exceed exports by more than £1,400. Not much of that was due to oil, which was in deficit last year but only by £3.7 billion.

Quite a lot of it was due to our appetite for manufactured products made abroad. Until 1982, Britain had never had a trade deficit in manufacturing, such was our status as the workshop to the world. Last year, however, the deficit was a fraction under £60 billion.

Once our ports sent "made in Britain" products to the four corners of the globe; the UK was the most powerful trading nation in the world. Now, the ports are busier handling imports. Britain exports more than it imports when it comes to services, where the UK's comparative advantage now lies. But even with a healthy surplus in services, the overall trade deficit last year was nearly £56 billion, not far short of £1,000 a head.

Disturbingly, there is no easy explanation for last year's deterioration. If consumer spending had been roaring away we could explain the deficit as being due to high spending sucking in imports. But spending has been subdued, up only 2% last year, while the deficit in goods rose from "only" £69 billion in 2005 and the total deficit increased from £45 billion. The trade deficit, which is "structural" (barely affected by the economic cycle) seems destined to rise by £10 billion a year. Soon it could top £100 billion.

We used to say, faced with much more modest trade deficits in the old days, that as a nation we were living beyond our means. In those days, the trade figures probably represented the single most important economic indicator. How come our present massive trade deficit excites relatively little comment?

One reason is that financial markets no longer move much in response to the trade figures. Compared with, say, inflation, pay, economic growth, retail sales or housing statistics, the trade numbers come well down the list of indicators, partly because neither the Bank of England nor the Treasury reacts to them by changing policy.

Nowadays it seems that many people think that a current account deficit is not particularly important for the UK economy.

Now, international trade flows are dwarfed by capital flows. Britain's trade deficit in goods is partly offset by a surplus in the service sector (in which 75 per cent of the British workforce is employed) and interest, profits and dividends from abroad, but it is mainly swamped by capital inflows. Long-term capital has been flooding into Britain, both for setting up new operations and foreign takeovers of UK businesses.

Last year Britain attracted nearly £90 billion of foreign direct investment, easily the largest of any country in Europe. There are also huge flows of portfolio investment – purchases of shares and government bonds – in and out of Britain each year.

This is why a gaping trade deficit has been associated not with a plunging pound but with a strong and stable exchange rate. Sterling has been a strong performer for more than a decade, enjoying a sustained run, the likes of which has not been seen for many decades, even as the trade figures have got worse. Capital inflows have kept the pound strong, even as an outflow of cash to pay for all those imports should have been pushing it down.

Indeed, there is a neat symmetry here, although it is not one any exporter would welcome. The balance of payments has to balance. Inflows of capital mean it balances at a high level for sterling, the consequence of which is to make life harder for exporters and easier for importers.

Is this how life will be from now on? Instead of nation paying its way by trade, does the UK make its way in the world by attracting foreign investment, even if that means selling our companies and other assets to foreign buyers?

We are some way from that point. UK assets overseas are broadly equal to foreign-owned assets in Britain, although British investors tend to get a higher return from their overseas holdings than foreigners do here.

Even so, dependence on capital inflows in the face of a growing trade deficit leaves Britain, and sterling, vulnerable. The Bank of England has warned that the sterling exchange rate will have to fall so that exports become more competitive and start making more of a contribution to growth.

Adapted from The Sunday Times, 25 February 2007

Article 3 - From The Chancellor of the Exchequer's Budget Report 2007

"Over the past ten years, the Government's macroeconomic framework has delivered more stability in terms of GDP growth and inflation rates than in any decade since the war. This historically low volatility puts the UK economy in a strong position to respond to the global economic challenges of the next *decade."

(A decade is a period of ten years.)

Figure 4 - Gross domestic product (GDP)

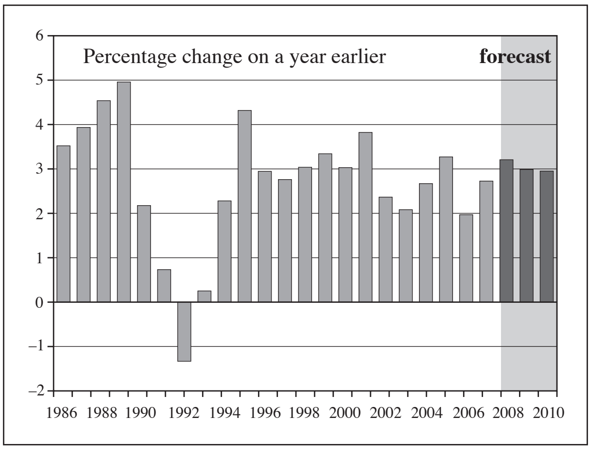


Figure 5 - UK employment and unemployment rates

Figure 6 - Releasing resources for priorities - real annual average growth rate in government spending, 1997-98 to 2007-08

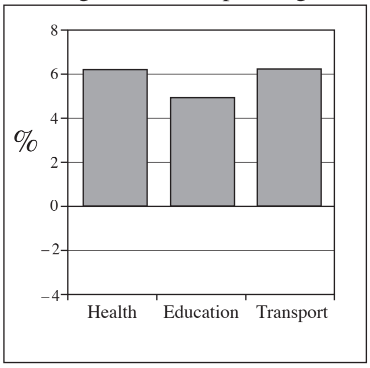


Figure 7 - International corporation tax (CT) rates (2007)

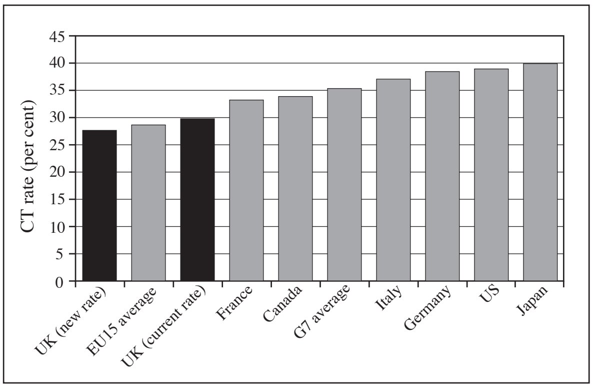
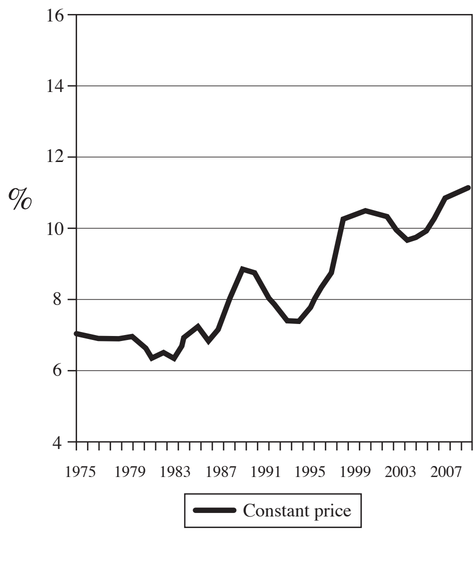


Figure 8 - Business investment as a % of GDP



(a) How far does it seem likely "that low inflation will continue in the future"? (Article 1 lines 50-51) [20]

(b) Discuss the view that "a current account deficit is not particularly important for the UK economy". (Article 2 lines 80-81) [20]

(c) Evaluate the Chancellor's claim in the Budget Report that "the UK economy is in a strong position to respond to the global economic challenges of the next decade". (Article 3 lines 110-111) [20]