Rewarding Learning

ADVANCED
General Certificate of Education
January 2014

Economics

Assessment Unit A2 2

The Global Economy

[AE221]

MONDAY 27 JANUARY, MORNING

AE221

TIME

2 hours.

INSTRUCTIONS TO CANDIDATES

Write your Centre Number and Candidate Number on the Answer Booklet provided.
Answer **Question 1** and **one** question from **Questions 2**, **3** or **4**.

INFORMATION FOR CANDIDATES

The total mark for this paper is 80.
Quality of written communication will be assessed in all parts of **all** questions **except 1(a)**.
Figures in brackets printed down the right-hand side of pages indicate the marks awarded to each question or part question.

ADVICE TO CANDIDATES

You are advised to take account of the marks allocated for each part question in allocating the available examination time.

Question 1

The following passages were written in September 2012. Please read them carefully answer the questions which follow.

Case Study: The UK Economy falling behind

Source 1: Contrasting performance of UK and German economies

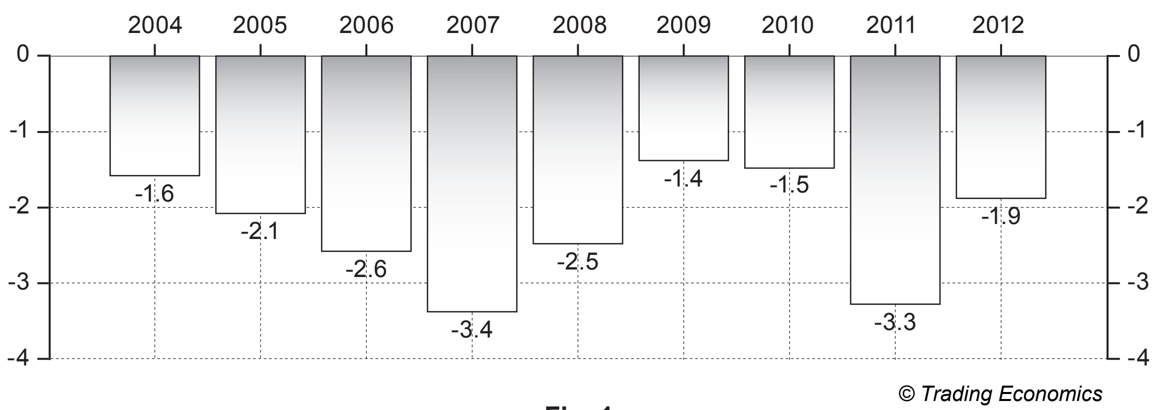

Fig. 1

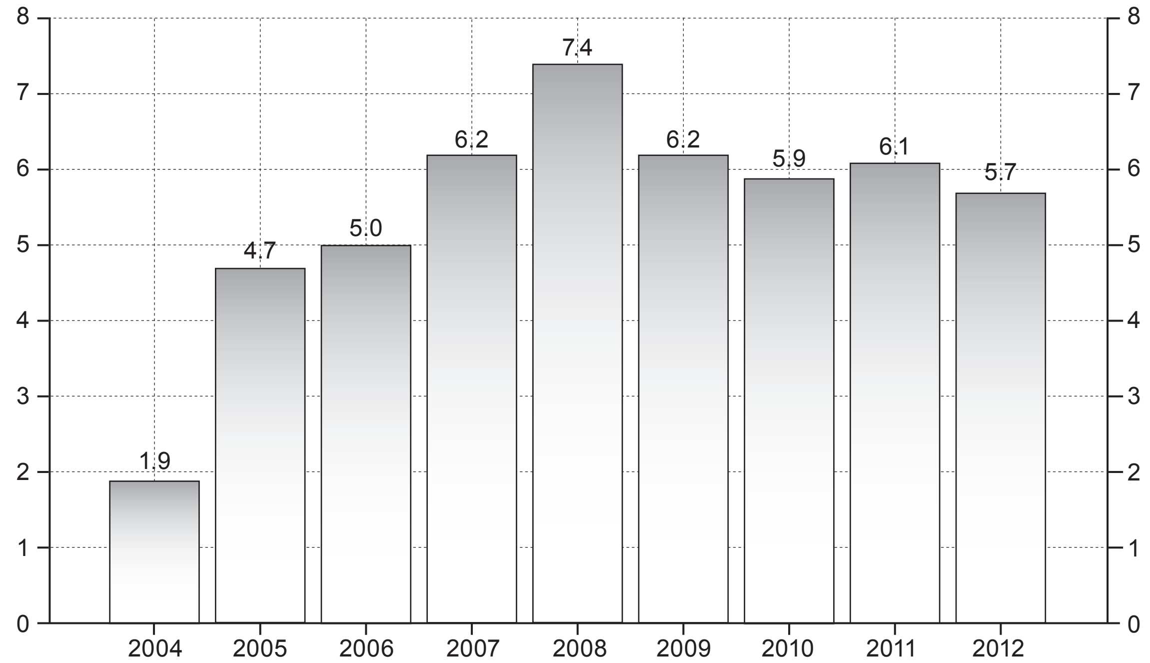

Fig. 2

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Source 2: Deindustrialisation is the main problem!

The fact that the UK is running a massive current account deficit even while unemploy high is a worrying sign that our long-term growth prospects have deteriorated.

In the second quarter of 2012 the UK's trade in goods showed a deficit of £28.3 bn. That is a record both as an absolute amount and as a share of GDP. This is odd because a big deficit is normally associated with an economic boom and low unemployment. Obviously the UK economy is not booming which means that the relationship between trade and the state of the domestic economy has changed.

Between 1997 and 2006 there was a strong correlation between trade and the unemployment rate; low unemployment was associated with large deficits and high unemployment was accompanied by low deficits. If this relationship had continued, the 8% unemployment rate we have today would be accompanied by a small surplus. Instead, we have a huge deficit.

A similar thing is true if we look at the overall current account deficit. The 1997–2006 relationship between that deficit and unemployment predicts that we should have a surplus now, rather than a deficit of almost 2 per cent of GDP.

The trade-off between the external balance and the state of the domestic economy has worsened. No longer can a stagnant economy and high unemployment guarantee a reduction in the UK's current account deficit. Possible explanations include the weakness of the Eurozone economies and the strength of the pound.

In addition, something more fundamental is happening which the recession has exacerbated – there has been a relative decline in UK manufacturing and export capacity. This is commonly referred to as deindustrialisation.

The problem is that a lot of low-skilled manufacturing work has migrated to the Far East. This means that if low-wage jobs are to be created – a precondition for high employment – they must be in the services sector. But this means that higher employment will be associated with larger trade in goods deficits. It also means that deflating the economy in order to improve this balance would require a recession of such magnitude that it could be politically unacceptable.

Source 3: More workers. Less output!

For much of 2012, UK GDP has been stagnant or falling, yet more people are in emp
This can only mean one thing: that those in employment are producing less. This is con
by the figures for UK productivity for the first quarter of 2012. These show:

- UK labour productivity fell by 1.3 per cent *in the first quarter of 2012 on an output per hour basis*.
- Labour productivity in the services sector fell by 0.4 per cent in Q1.
- Labour productivity in manufacturing fell by 2.6 per cent in Q1, the steepest drop since 2008 Q4.
- UK unit labour costs increased by 1.4 per cent in Q1. Manufacturing unit wage costs increased by 2.1 per cent over this period.

Of course if this were just a one-off then it would be unimportant. However these figures confirm a trend which has been apparent for a number of years: that the UK is losing its comparative advantage in a range of products.

Official figures show that the productivity gap with the US soared by nine percentage points between 2006 and 2010 to leave the gap the largest since 1994. US productivity per hour was 23 percentage points higher than the UK while Germany and France were ahead by 18 and 16 percentage points respectively. The Republic of Ireland produced 32 per cent more per worker hour than the UK.

Howard Archer, chief UK economist at IHS Global Insight, said, “A number of factors appear to have limited UK productivity in recent years. These include relatively low research and development expenditure; past increases in the size of the public sector (which is generally considered to be less productive); infrastructure bottlenecks; and education inefficiencies”.

One Tory MP attributed the UK’s dismal productivity record to over-regulation of industry; a culture of welfare dependency; and a powerful environmental lobby blocking major infrastructural improvements such as motorways and a third runway at Heathrow. He pointed out that less regulated economies such as the USA sacked millions of workers in the wake of the banking crash but were now reaping the benefits as firms were leaner and more efficient.

Adapted from a variety of sources September 2012

Source 4: Does the current account balance really matter?

On this, as on many other issues, economists, are divided. A writer in the Investors C believes the answer is definitely yes. Chris Dillow wrote "A current account deficit mean definition – that we are borrowing from overseas. A poor trade-off between this balance an unemployment therefore means that we cannot pay our way in the world unless we have eith high enough unemployment to depress imports or unless the overseas demand for our exports rises strongly. Fortunately this is not an immediate problem. Our relatively healthy international investment position means we will be able borrow from overseas for some time; our net external liabilities are only just over 8 per cent of GDP. But, of course, we cannot borrow from overseas forever. This means that the UK's long-run growth prospects are poor and we may face decades of falling living standards".

However a prominent trade unionist believes that the answer is definitely no. He argued, "The current account deficit is merely a statistical blip with no relevance to the real economy. The government should expand demand in the economy irrespective of the impact on the Balance of Payments. Why should jobs and living standards be sacrificed in order to change a statistic which is of no economic significance?"

From: Britain's Trade Trouble by Chris Dillow, Investors Chronicle, 4 September 2014 © The Financial Times Limited 2014. All Rights Reserved

(a) Using the data in **Figs 1** and **2** compare the UK and Germany's current account balances as percentages of their GDPs. [5]

(b) Analyse the main reasons for the UK's persistent balance of payments deficit. [10]

(c) Examine some of the reasons why the USA has significantly higher productivity than the UK. [10]

(d) Evaluate the view that a current account deficit is of no economic significance. [15]

Essays: Answer **one** question from **Questions 2**, **3** or **4**.

2 Globalisation has made life harder for UK firms and workers

(a) Explain the main features of globalisation.

(b) Critically examine the impact of globalisation upon the UK economy. [25]

3 Less Developed Countries (LDCs) need free trade

(a) Explain some of the ways in which economic development can be measured. [15]

(b) Critically examine the view that removing trade barriers is a more effective way of promoting economic development in LDCs than extensive foreign aid programmes. [25]

4 Not all members can survive in a common currency

(a) Explain the role of the European Central Bank. [15]

(b) Critically examine the view that the European common currency (euro) cannot survive with all its current members. [25]

THIS IS THE END OF THE QUESTION PAPER