Centre No.						Paper Reference	Surname	Initial(s)
Candidate No.						6 3 5 3 / 0 1	Signature	

Paper Reference(s)

6353/01

Edexcel GCE

Economics

Advanced Subsidiary

Unit 3 – Managing the Economy

Thursday 17 January 2008 – Morning

Time: 1 hour

Examiner's use only

Team Leader's use only

Question Number	Leave Blank
1	
2	
Total	

Materials required for examination	Items included with question papers
Nil	Nil

Instructions to Candidates

In the boxes above, write your centre number, candidate number, your surname, initial(s) and signature.
Check that you have the correct question paper.
Write your answers in the spaces provided in this question paper.
Answer EITHER Question 1 OR Question 2. Indicate which question you are answering by marking the box (☒). If you change your mind, put a line through the box (☒) and then indicate your new question with a cross (☒).

Information for Candidates

The marks for individual questions and the parts of questions are shown in round brackets: e.g. **(2)**.
There are 2 questions in this question paper. The total mark for this paper is 40.
There are 24 pages in this question paper. Any blank pages are indicated.

Advice to Candidates

You will be assessed on your ability to organise and present information, ideas, descriptions and arguments clearly and logically, including your use of grammar, punctuation and spelling.
You are advised to spend the first 5 minutes reading the paper. In calculations you are advised to show all the steps in your working.

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Answer EITHER Question 1 OR Question 2.

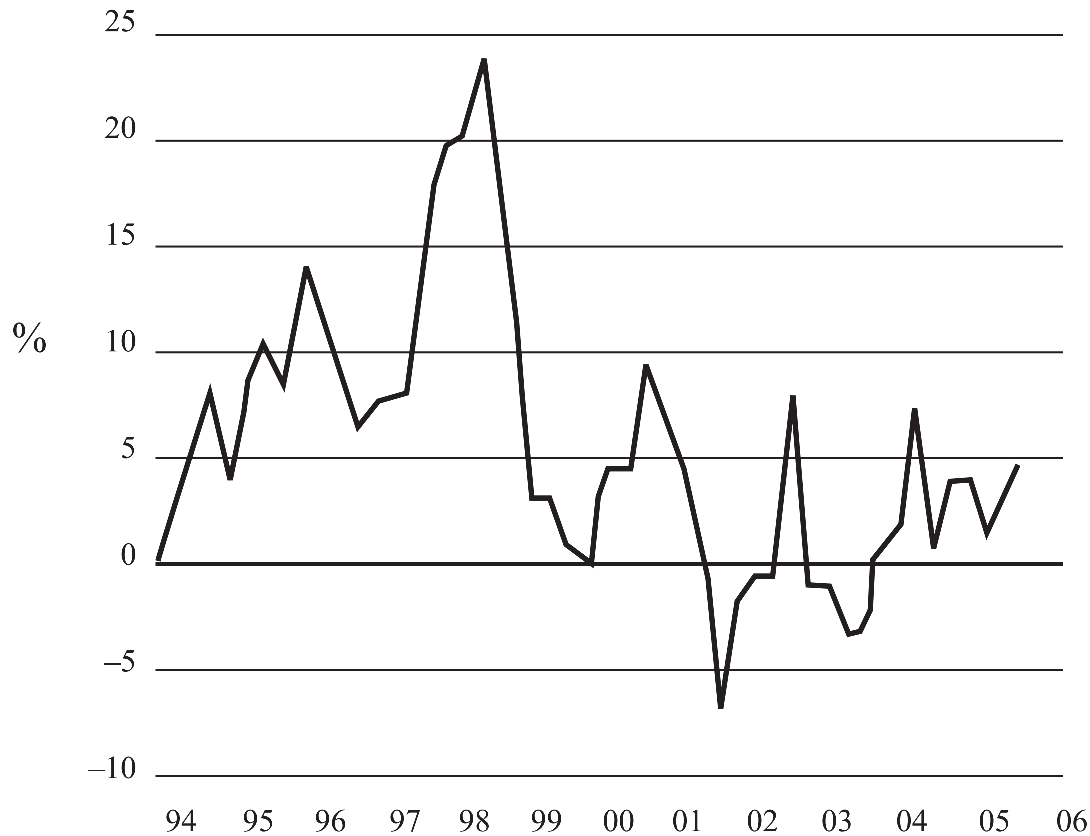
If you answer Question 1 put a cross in this box ☒ .

Question 1 **Investment, productivity and trade**

Extract 1 **UK Investment**

The investment boom of the 1990s left many sectors in the UK with spare capacity, a situation made more significant to the UK economy by the rapid build-up of productive capacity in China. Despite high and rising profits between 2001 and 2004 investment was sluggish. However, the good news is that business investment grew by 4.6% between 2005 and 2006, three times as strong as consumer spending.

Figure 1 **Business investment, % change on a year earlier (2003 prices)**



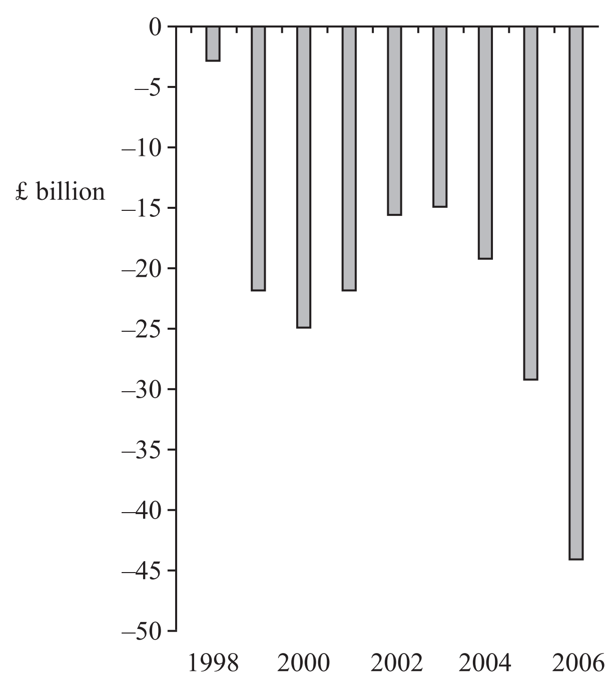
Source of Extract 1 and Figure 1: David Smith, *The Sunday Times*, 9 July 2006

Extract 2 **UK Productivity**

Gordon Brown has described productivity as the 'fundamental measure of economic performance'. Productivity has risen by only 1.7% a year over the past four years, its slowest level of growth for 15 years. Nevertheless, the productivity gap with France is closing. Despite tax incentives to stimulate more research and development by firms and measures designed to increase competition, productivity growth is still held back by increased regulation and tax burdens. Problems in education, innovation and transport are holding back productivity growth. This is reflected in the negative trade balance over the past decade. Although this is partly explained by the strong pound, it also reflects a structural problem, that of failed supply side policies.

Source: adapted from 'Gordon Brown and the Economy – Lustre Lost' *The Economist* 23 March 2006, and *The Financial Times*, 23 March 2006

Figure 2 **The UK current account of the Balance of Payments**



Source: *HM Treasury*

Leave blank

(a) With reference to Extract 1 and Figure 1,

(i) Define *investment*.

(2)

(ii) Contrast the rate of growth in investment in **1998** with that of **2001**.

(2)

Leave blank

(iii) Using an aggregate demand and supply diagram, illustrate the likely impact on real output and the price level of the change of business investment between 2005 and 2006 (*Extract 1*, *lines 4–5*).

(6)

Leave blank

(b) (i) Explain **one** reason why productivity growth is a 'fundamental measure of economic performance' (*Extract 2*, *lines 1–2*).

(3)

(ii) With reference to Extract 2 and Figure 2, assess the likely impact on the current account of the Balance of Payments of the changes in UK productivity.

(6)

Leave blank

(iii) **Apart from productivity changes**, outline **two** reasons which might explain the deficit in the current account of the Balance of Payments.

(6)

Leave blank

(c) With reference to the information provided and your own knowledge, evaluate the use of supply side policies as a means to reduce a Balance of Payments deficit on the current account.

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(15) **Q1**

(Total 40 marks)

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If you answer Question 2 put a cross in this box ☒.

Question 2 Monetary Policy in the UK

Extract 1 Bank raises interest rates

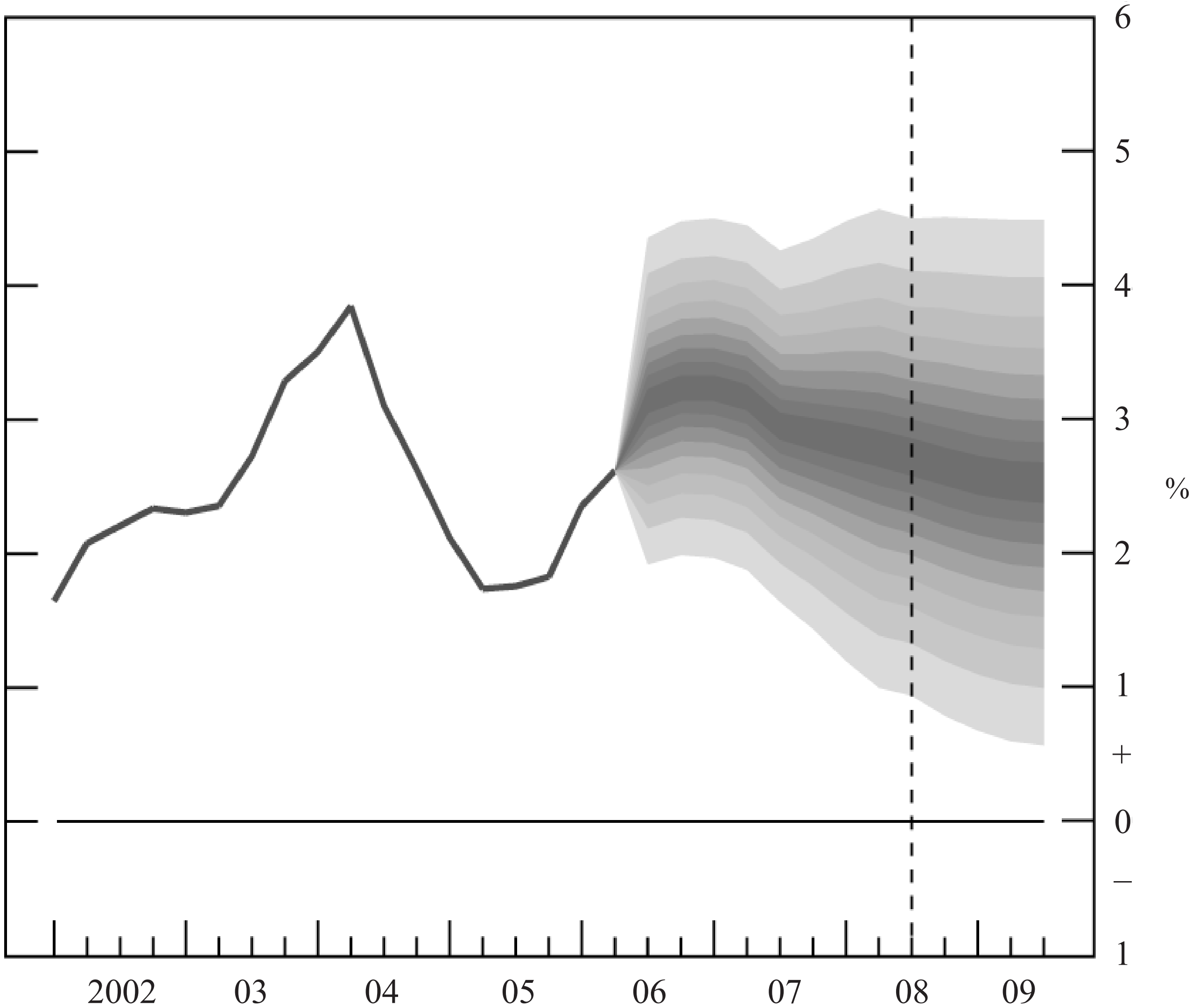
Householders were left anxious today after the Bank of England's Monetary Policy Committee (MPC) raised interest rates to 4.75 per cent, which will cost homeowners with an average £80,000 mortgage over £12 a month more. House price rises have not returned to the growth seen in recent years, and major high street banks reported increasing problems with bad debt levels, mainly on personal loans.

It is the first time that interest rates have moved after a year of inactivity and the MPC decision was a surprise for many. In a statement, the Bank of England said that the rise was necessary to bring inflation back to target (see Figure 1). The UK economy grew by more than expected, and retail sales were robust. Gas and electricity bills have contributed to the jump to 2.5 per cent in the rate of inflation (as measured by the Consumer Prices Index, CPI) up from 2.2 per cent in May. Wage pressure is likely to increase in line with fuel price rises. The MPC governor Mervyn King said that there was a '50-50 chance' that the inflation rate would move above 3% over the next six months.

However, there are signs that the interest rate rise was unnecessary. Unemployment is at its highest for six years, and taken together with slow wage growth this suggests there is significant spare capacity. The American-led world economic slowdown may worsen. David Kern, economic adviser at the British Chamber of Commerce, said he thought the rise in the rate of interest was unnecessary. 'We appreciate that it must make difficult choices but the correct decision by the MPC would have been to keep interest rates on hold.'

Source: adapted from *www.independent.co.uk/business* 3 August 2006 and *The Sunday Times*, 13 August 2006

Figure 1 **Current CPI inflation projection based on market interest rate expectations**



The fan chart shows the likelihood of various outcomes for CPI information in the future. The darkest central band represents the most likely outcome.

Source: *Bank of England* inflation report, August 2006, *www.bankofengland.co.uk*

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(a) (i) Explain how inflation is measured in the UK. Refer to the concept of weights in your answer.

(4)

(ii) Explain **one** reason why a rise in the rate of inflation above 3% might be a cause for concern.

(3)

Leave blank

(b) (i) Analyse the likely impact on house prices of an increase in interest rates (*Extract 1*, *line 2*).

(4)

Leave blank

(ii) Using an aggregate demand and supply diagram, analyse the likely impact on the price level and the equilibrium real level of output which may result from the rise in interest rates, as outlined in Extract 1.

Leave blank

(8)

Leave blank

(c) (i) Explain what is meant by *spare capacity* (*Extract 1*, *line 16*).

(2)

(ii) Examine why 'significant spare capacity' (*Extract 1*, *line 16*) in the economy is a factor that the MPC considers when making its interest rate decision.

(4)

Leave blank

(d) With reference to the information provided and your own knowledge, assess the view that 'the correct decision by the MPC would have been to keep interest rates on hold'. (*Extract 1*, *lines 19–20*).

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(15) **Q2**

(Total 40 marks)

TOTAL FOR PAPER: 40 MARKS

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