

**ADVANCED GCE
ECONOMICS**

The UK Economy

THURSDAY 31 JANUARY 2008

2887

Afternoon

Time: 1 hour 30 minutes

Additional materials: Answer Booklet (8 pages)



INSTRUCTIONS TO CANDIDATES

- Write your name in capital letters, your Centre Number and Candidate Number in the spaces provided on the Answer Booklet.
- Read each question carefully and make sure you know what you have to do before starting your answer.
- Answer Question 1 and **one** question from Section B.
- Write all your answers in the separate answer booklet provided.
- If you need to use additional answer sheets, fasten these sheets securely to the answer booklet.

INFORMATION FOR CANDIDATES

- The number of marks for each question is given in brackets [] at the end of each question or part question.
- The quality of your written communication will be taken into account in the marking of your answer to Section B.
- The total number of marks for this paper is **45**.

This document consists of **4** printed pages.

Section A

Answer **this** question.

1

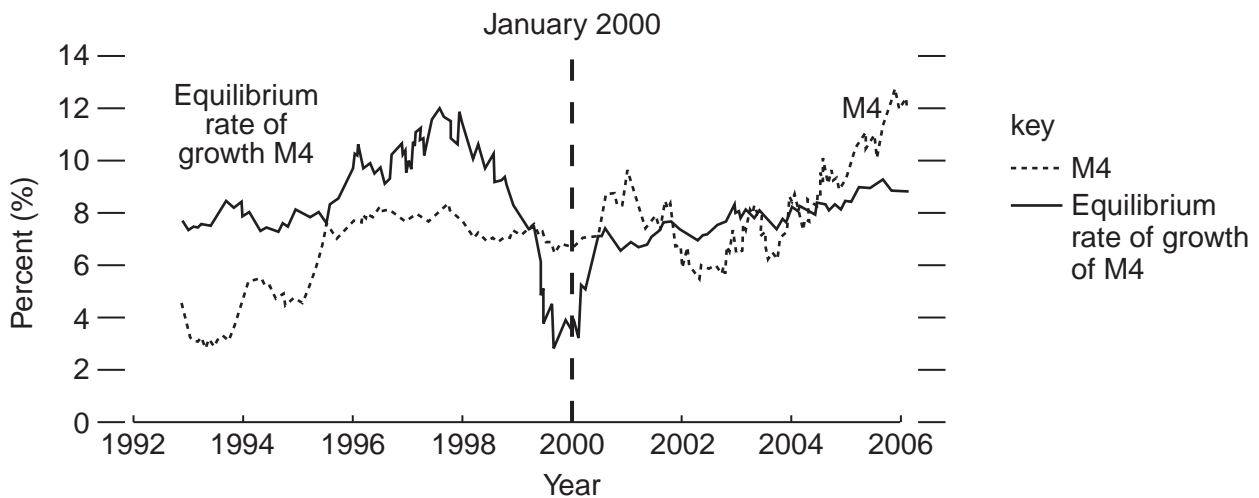
Money and inflation in the UK

Since 1997, the Bank of England has been responsible for achieving the UK government's inflation target. The aim is to meet the target on average over time¹ – inflation much below or much above the target is viewed as undesirable. The independent nine-member Monetary Policy Committee (MPC) sets interest rates each month at a level it believes is consistent with achieving this target. To guide decision making, the MPC monitors a range of economic data, including information on monetary growth in the UK. 5

Narrow money (mainly cash) is useful as a guide to the current spending patterns of consumers. In the early part of 2006, growth in narrow money accelerated to 5.4% per annum. It is, however, the growth in broad money (M4) which provides more helpful clues about future changes in aggregate demand and, hence, inflationary pressures in the medium term. The annual growth rate of M4 in April 2006 was over 12%. 10

Fig. 1 shows the actual growth of M4 in relation to its 'equilibrium rate of growth' – the rate which is thought to be consistent with stable inflation. Fig. 2 shows the UK inflation record before and after 1997.

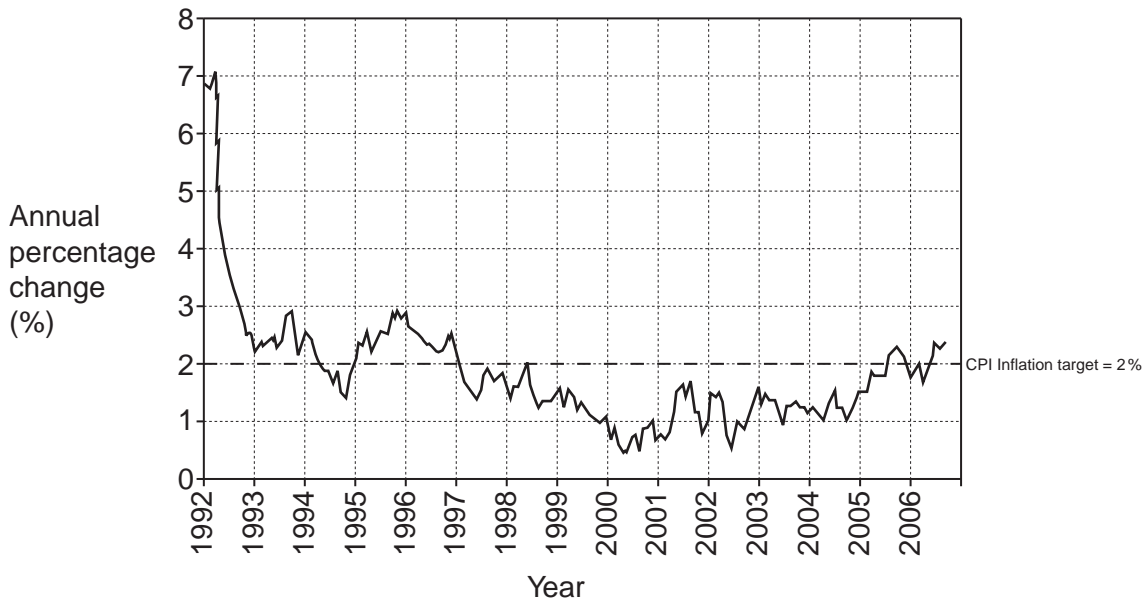
Fig. 1 Annual M4 growth in the UK and an estimate of its equilibrium rate of growth



¹ The original inflation target in 1997 was based on the Retail Price Index, excluding mortgage interest payments (RPIX) at a central rate of 2.5%. In December 2003, it was announced that the Consumer Price Index (CPI) would replace the RPIX as the measure on which the inflation target would be based. The target then became 2% ± one percentage point. The CPI is available from January 1996 onwards and estimates are available from 1988.

Fig. 2 Consumer price inflation in the UK

Annual percentage change in the Consumer Price Index. The inflation target is 2%



Source: HM Treasury, www.hm-treasury.gov.uk

- (a) State **two** functions of money. [2]
- (b) (i) Using Fig. 1, describe the trend in broad money (M4) growth in relation to the 'equilibrium rate of growth of M4' between 2000 and 2006. [2]
- (ii) Explain how the behaviour of banks and building societies could contribute to a rapid growth in broad money (M4). [2]
- (c) Using the Quantity Theory of Money, comment on the significance for UK inflation if broad money (M4) growth persistently exceeds its 'equilibrium rate of growth'. [4]
- (d) (i) State and explain **two** reasons why inflation 'much above' the 2% target would be viewed as undesirable (line 3). [4]
- (ii) Using Fig. 2, discuss the performance of the Bank of England since 1997 in meeting the government's inflation target. [6]

Section B

Answer **one** question.

- 2** In 2005, GDP per worker in the UK was over 20% lower than in the USA, about the same as in Germany, and over 10% higher than in Japan. UK policy aims to raise labour productivity through maintaining macroeconomic stability and initiating microeconomic reforms to the supply side of the economy.
- (a) Explain why labour productivity may vary between countries. [10]
- (b) Discuss the likely effectiveness of using supply-side policies to increase productivity in the UK. [15]
- 3** In 2006, estimates suggested that for nearly a decade the average value of sterling in the foreign exchange markets had been overvalued by over 10%. The harm this imposed on the UK economy was particularly severe for the UK manufacturing sector.
- (a) With the aid of a diagram, explain how the exchange rate is determined in a free market. [10]
- (b) Discuss the extent to which an overvalued currency may harm the performance of the UK economy. [15]
- 4** The UK's tax revenues as a share of GDP rose to 37.2% in 2005, according to the Organisation for Economic Cooperation and Development (OECD). This increase, from 36% in 2004, was the third biggest of any OECD member. The UK's 'tax burden' became slightly higher than the OECD average.
- (a) Explain how growth in GDP can lead to a rise in direct and indirect tax revenues. [10]
- (b) Discuss the consequences for the UK economy of a rising 'tax burden'. [15]

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 Fig. 2 Source: HM Treasury, www.hm-treasury.gov.uk. Crown copyright material is reproduced with the permission of the Controller of HMSO and the Queen's Printer for Scotland.

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