THIS IS A LEGACY SPECIFICATION

OCR
RECOGNISING ACHIEVEMENT

ADVANCED GCE
ECONOMICS 2887
The UK Economy

Candidates answer on the Answer Booklet

OCR Supplied Materials:
- 8 page Answer Booklet

Other Materials Required:
None

Friday 30 January 2009
Morning

Duration: 1 hour 30 minutes

INSTRUCTIONS TO CANDIDATES

- Write your name clearly in capital letters, your Centre Number and Candidate Number in the spaces provided on the Answer Booklet.
- Use black ink. Pencil may be used for graphs and diagrams only.
- Read each question carefully and make sure that you know what you have to do before starting your answer.
- Answer Question 1 and **one** question from Section B.
- If you need to use additional answer sheets, fasten these sheets securely to the Answer Booklet.
- Do **not** write in the bar codes.

INFORMATION FOR CANDIDATES

- The number of marks is given in brackets **[ ]** at the end of each question or part question.
- The total number of marks for this paper is **45**.
- The quality of your written communication will be taken into account in the marking of your answer to Section B.
- This document consists of **4** pages. Any blank pages are indicated.

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Section A

Answer **this** question.

1 **How Monetary Policy Works**

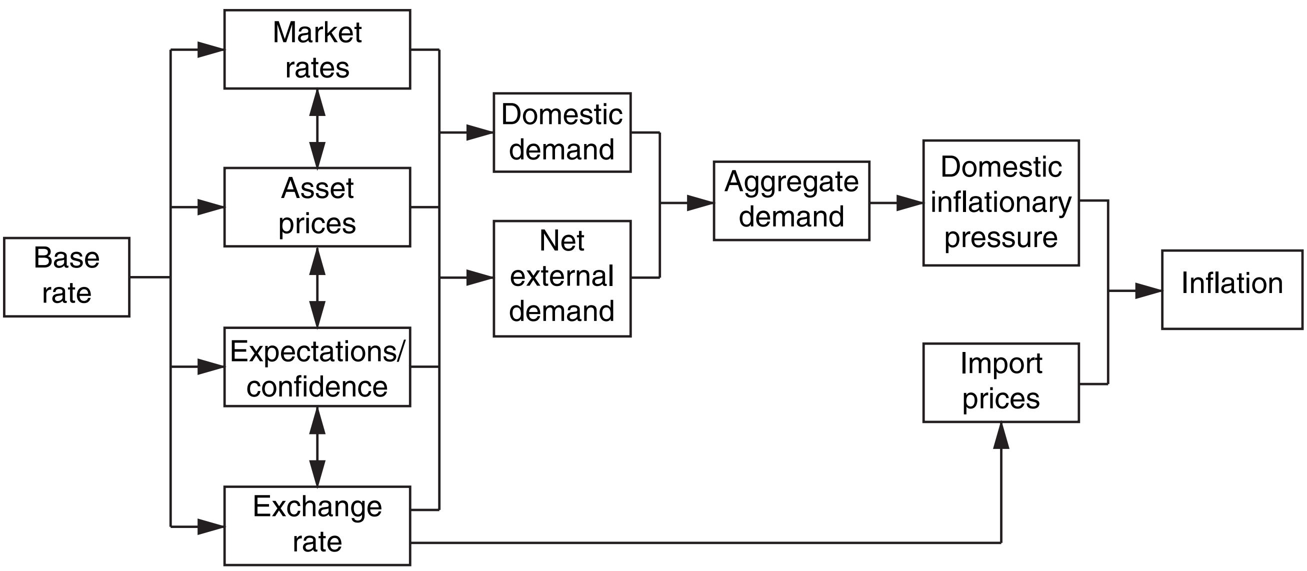
When the Monetary Policy Committee (MPC) of the Bank of England changes the official interest rate, known as the bank rate, it is attempting to influence the overall level of expenditure and the money supply in the economy. When the amount of money spent grows more quickly than the volume of output produced, inflation results.

The MPC sets the bank rate at which the Bank of England is prepared to lend to financial institutions. This rate then affects the whole range of interest rates set by commercial banks, building societies and other institutions for their own customers. It also tends to have an impact on the price of financial assets, such as bonds and shares, and the exchange rate.

Changes in interest rates, the price of bonds, shares and the exchange rate influence consumer and business demand. In turn, changes in aggregate demand feed through into output and employment. These effects alter the relative balance of demand and supply of workers and expectations of inflation.

This sequence of events is shown in Fig. 1 below.

Fig. 1 From interest rates to inflation – the transmission mechanism of monetary policy



Source: Adapted from *'How Monetary Policy Works'*, www.bankofengland.co.uk

The effectiveness of monetary policy depends significantly on its predictability and the time it takes to work through the economy. For instance, the impact of interest rates on the exchange rate can be uncertain. In practice, there are time lags before changes in interest rates affect spending and saving decisions and even longer time lags before they affect consumer prices.

Economists cannot be precise about the size or timing of all these impacts. The maximum effect on output is estimated to take up to about a year, and the maximum impact of a change in interest rates on inflation takes about two years. So the MPC has to set the base rate using judgments about what inflation might be over the coming few years, not what it is today.

Answer **all** parts.

(a) Define the term 'rate of interest'. **[2]**

(b) With reference to Fig. 1:

(i) state what is meant by net external demand; **[2]**

(ii) explain how import prices can affect inflation. **[2]**

(c) **(i)** Explain how an increase in the base rate would, in theory, influence the sterling exchange rate. **[4]**

(ii) Comment on the statement that 'the impact of interest rates on the exchange rate can be uncertain' (lines 16-17). **[4]**

(d) Discuss whether the MPC has been the most significant influence on the UK's inflation rate in recent years. **[6]**

Section B

Answer **one** question.

2 **(a)** Explain how economists demonstrate the gains from free trade between nations. **[10]**

(b) Discuss whether there is any justification for the UK to use protectionist policies in the global economy of the 21st century. **[15]**

3 **(a)** Explain how fiscal policy can be used to reduce the level of unemployment in the UK economy. **[10]**

(b) Discuss the extent to which fiscal policy alone can be used to solve the unemployment problems of the UK economy. **[15]**

4 **(a)** Explain **one** macro-economic policy conflict that could arise in the UK economy. **[10]**

(b) Discuss the extent to which government economic policy can achieve a successful balance between its macro-economic objectives. **[15]**

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Source: Adapted from '*How Monetary Policy Works',* www.bankofengland.co.uk

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