



ADVANCED GCE
ECONOMICS
 The UK Economy

2887

Candidates answer on the Answer Booklet

OCR Supplied Materials:

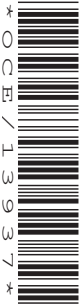
- 8 page Answer Booklet

Other Materials Required:

None

Tuesday 2 February 2010
Afternoon

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.

Section A

Answer **this** question.

1

Bank of England Inflation Report May 2008

The short-term outlook for inflation has deteriorated markedly over the past three months. CPI inflation was 3% in April, and rising energy and import prices will almost certainly push up the inflation rate further. As those increased prices feed through to household bills, they will lead to a squeeze on real take-home pay which will slow consumer spending and output growth.

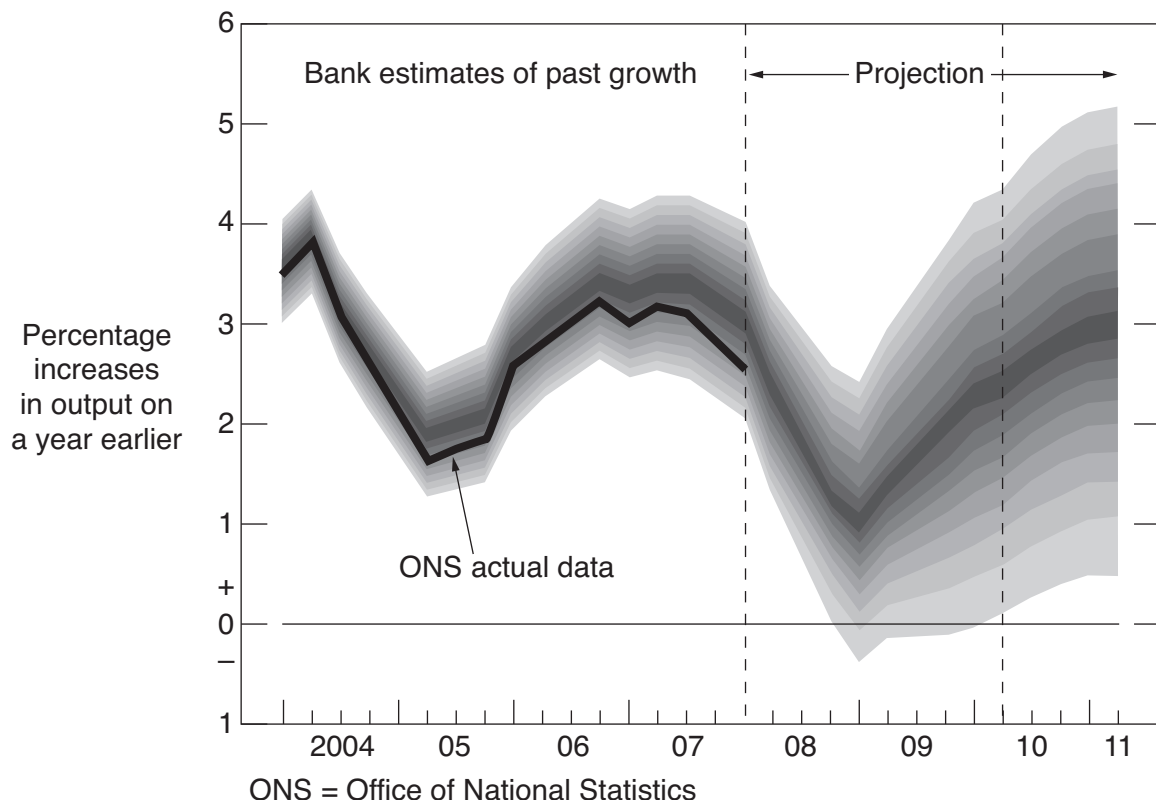
5

Financial market conditions remain fragile. Banks continue to lower the supply of credit to the economy, the impact of which is most clear in property markets. Commercial property prices have fallen 16% since the summer of 2007 and house prices are now falling too.

In these circumstances, the household savings rate is likely to rise. This is part of a rebalancing of the UK economy, away from spending and importing, towards saving and exporting; a change that will be supported by the depreciation of sterling which is now 12% below where it was in August 2007.

10

Fig. 1 GDP projection May 2008

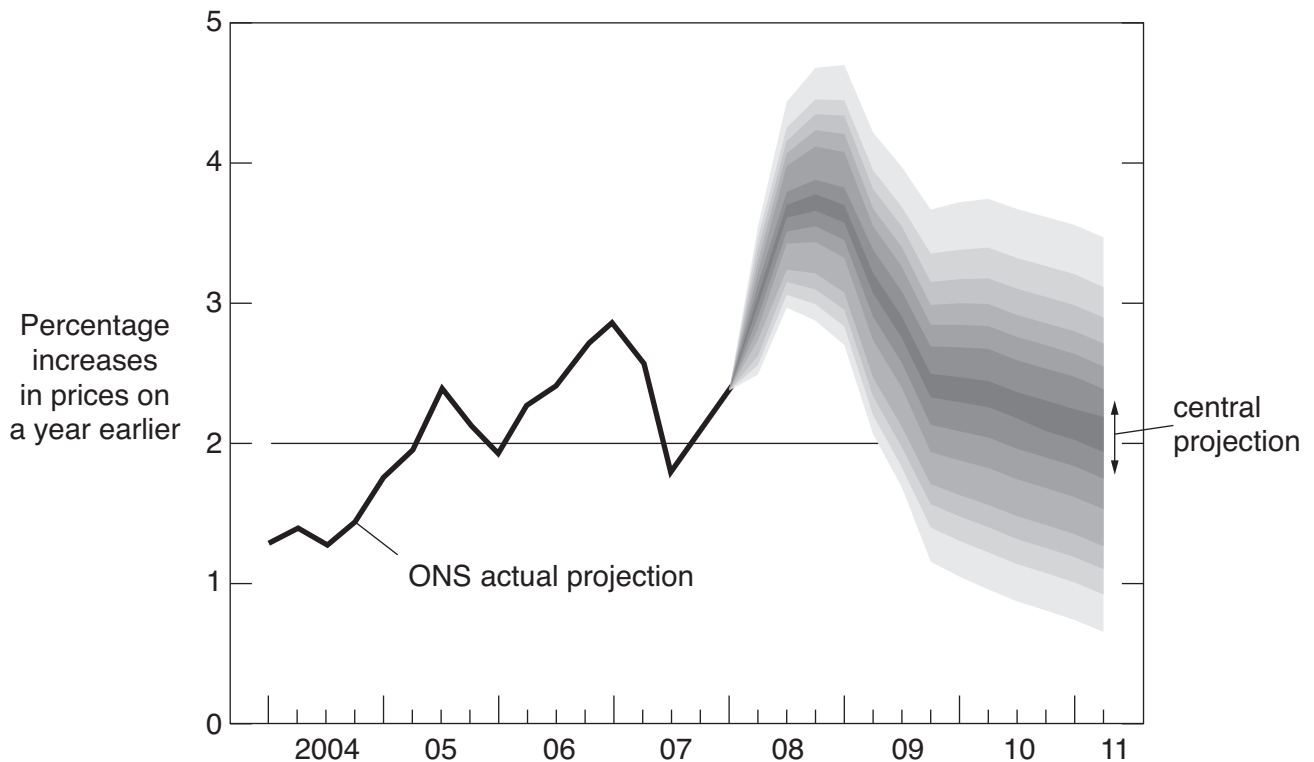


The Monetary Policy Committee (MPC) expects growth to slow sharply in the short-term, reflecting the squeeze on real incomes, before recovering again as credit conditions begin to ease and the depreciation of sterling boosts exports and reduces imports.

15

The Committee's latest projection for inflation is shown in Fig. 2.

Fig. 2 CPI inflation projection May 2008



Higher prices for domestic energy, food and imports will push inflation above target this year, and there is considerable uncertainty about the future. This has led the Governor of the Bank of England, Mervyn King, to state “I will have to write a number of letters to the Chancellor over the next year”. However, the MPC thinks that to bring inflation back in line quickly will result in an undesirable degree of volatility in output, so it is aiming to make the correction over a longer period.

20

Answer **all** parts.

(a) Explain what is meant by:

(i) ‘real take-home pay’ (line 4);

[2]

(ii) ‘the household savings rate’ (line 9).

[2]

(b) Explain in what circumstances the Governor of the Bank of England has to write a letter to the Chancellor.

[2]

(c) Explain how a 12% depreciation of sterling should support the move away from importing and towards exporting.

[4]

(d) Using the information provided, comment on the view that most of the inflationary pressure reported on was of a supply side nature.

[4]

(e) Discuss the problems of forecasting the rate of inflation in the short and medium term.

[6]

Section B

Answer **one** question.

- 2 (a) Explain the role of rates of interest and why there are different rates of interest in an economy. [10]
- (b) Discuss the extent to which monetary policy can be considered the best way to achieve the main macroeconomic policy objectives. [15]
- 3 (a) Explain the impact that discretionary fiscal policy could have on the UK economy. [10]
- (b) Discuss the limitations of fiscal policy as a policy instrument. [15]
- 4 (a) Explain the main potential causes of a UK balance of payments deficit on the current account. [10]
- (b) Discuss the extent to which a balance of payments current account deficit is a problem for the UK economy. [15]

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