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

Monday 7 June 2010
Afternoon

Duration: 1 hour 30 minutes

2887

OCE/13940

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.

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.

Turn over

Section A

Answer **this** question.

1 **The Spectre of Stagflation**

As the film 'Mamma Mia!' evokes nostalgia for the 1970s, more ominous echoes of that stagflationary decade are ringing louder and louder in 2008. The economy looks set for recession as the housing market slides and the banking trauma refuses to go away. At the same time the inflation rate is rising steeply. This toxic combination is what has been previously described as stagflation.

The scale of the oil price shock hitting the UK economy is similar to that of the 1970s. Indeed the prices paid by manufacturers for their fuel and materials soared by 30.3% in the year to June 2008, the biggest jump since November 1974. This suggests the prices these firms charge to retailers will in due course rise even higher than the 10% annual increase in June. This was the highest rate of factory-gate inflation since 1982. Unless retailers absorb the cost increases they are experiencing, this will cause more pain for hard-pressed households. Consumer price inflation (CPI) is moving even farther away from the 2% target. In just two months it has climbed by almost a percentage point, from 3.0% in the year to April, to 3.3% in May and then 3.8% in June, the highest for 16 years.

As far as most shoppers are concerned the CPI is merely starting to catch up with their daily experience. The CPI may be used for the inflation target but it commands little confidence because it excludes owner-occupier housing costs. The older Retail Price Index, excluding mortgage interest payments, (RPIX), rose 4.8% in June 2008 – again the highest for 16 years.

Whatever index is used tends to understate people's inflationary alarm, which is coloured by the fact that the prices of everyday essentials are rising so fast. Road fuel costs, for example, leapt by 24% in the year to June 2008. Annual food price inflation accelerated from 8.7% in May to 10.6% in June. These are the increases that impact upon households.

At the same time the figures for those claiming unemployment benefits showed a rise of 15 500 in June 2008, the biggest monthly increase since 1992. Since the release of this data a number of homebuilders have announced big layoffs. In the months ahead unemployment, which lags the economic cycle, looks set to rise, although this may be tempered by migrants returning to eastern Europe as jobs in the UK become scarce.

If the trend towards a 1970s style stagflation continues, then households, the government and the Bank of England are set to face some very difficult decisions. Households will see their real incomes falling and their expectations about future price rises will impact on their wage demands, even though job losses are on the increase. Falling levels of aggregate demand and an increase in unemployment benefit claims will impact upon the government's budget. The Bank may face the dilemma of having to raise the rate of interest to fight inflation while the number of redundancies climbs each month. Echoes of the 70s mean much more to economists than Pink Floyd and flared trousers; they pose the toughest policy decisions for decades.

Answer **all** parts.

(a) Explain what is meant by:

(i) stagflation (line 5); **[2]**

(ii) factory-gate inflation (line 10). **[2]**

(b) Explain what is meant by 'Unless retailers absorb the cost increases they are experiencing, this will cause more pain for hard-pressed households' (lines 10–12). **[2]**

(c) With the aid of a diagram, explain the impact of a significant increase in the price of oil on the UK economy. **[4]**

(d) Comment on the view that 'Households will see their real incomes falling and their expectations about future price rises will impact on their wage demands' (lines 30–32). **[4]**

(e) Discuss the extent to which a rise in unemployment in the UK may be reduced by a return of migrants to eastern Europe. **[6]**

Section B

Answer **one** question.

2 **(a)** Explain how, in theory, changes in the Bank of England base rate will influence 'hot money' flows and the value of sterling. **[10]**

(b) Discuss the extent to which international financial flows can impact on the sterling exchange rate. **[15]**

3 **(a)** Explain the main determinants of the size of the credit creation multiplier. **[10]**

(b) Discuss how significant a major expansion of the money supply may be to the performance of the UK economy. **[15]**

4 **(a)** Explain the most significant influences on the rate of economic growth in the UK economy. **[10]**

(b) Discuss to what extent the government's main policy instruments can be used to achieve a high and sustainable economic growth rate. **[15]**