

Answer TWO of the three questions in this paper.

Write your answers in the spaces provided.

If you answer this question put a cross in this box .

1. Managing the Economy

The Chancellor of the Exchequer gave a speech to Parliament in December 2006. He reported that the state of the UK economy was healthy. Economic growth was higher than he had predicted. The Chancellor pointed out that this was good news for jobs in the UK and that tax revenue would rise allowing the government to meet its spending plans. Environmental groups, however, have pointed out that economic growth can bring problems.

(a) Using an example, explain the term '*economic growth*'.

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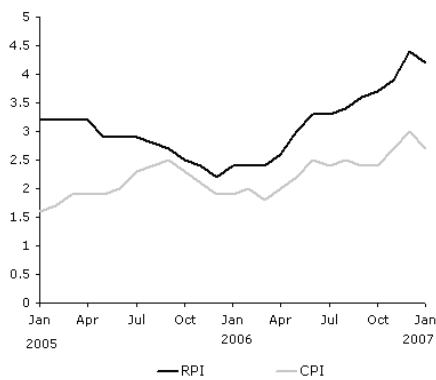
(b) Briefly analyse **one** cost and **one** benefit of economic growth to the UK economy.

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The rise in economic growth was not good news for everyone. Inflation rose to 3.1% in April 2007, way above the government's target of 2.0%. For businesses the increase in inflation creates uncertainty. How do they plan ahead if prices are rising? Do they increase their prices as well? What about firms trying to sell abroad? They might now be less competitive. Some firms are also likely to face increased demands for higher wages as employees try to keep up with inflation.

Annual Inflation Rate (%) in the UK

Source: ONS, Crown Copyright <http://www.statistics.gov.uk/cci/nugget.asp?id=19>

(c) Using an example, explain the meaning of the term '*inflation*'.

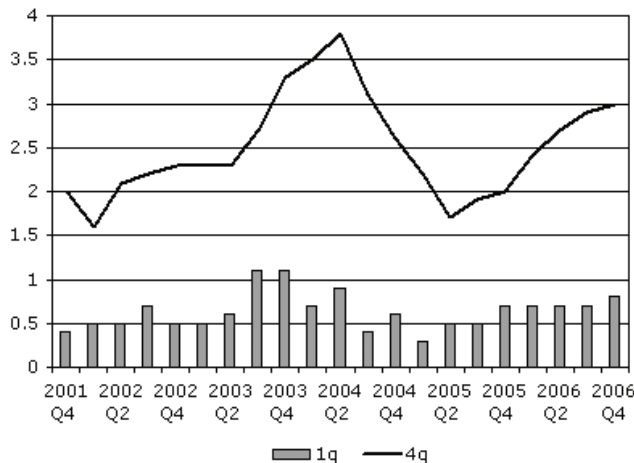
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The rise in economic growth in the UK might be part of a normal business cycle. Business cycles are influenced by changes in demand in the economy. An upturn in demand affects businesses in different ways.

UK Economic Growth as measured by Gross Domestic Product (GDP) 2004–2006. (% change)



Source: ONS Crown Copyright, <http://www.statistics.gov.uk/cci/nugget.asp?id=192>

Companies like Tesco and Sainsbury tend to be less affected by changes in the business cycle compared to companies that sell products like furniture, electrical goods and those in entertainment. People need food all the time!



When growth speeds up, companies like Dixons and Currys may have to think about making sure they have the goods to sell in their stores.

(d) Briefly explain how an upturn in the business cycle might affect a business like Dixons, the electrical retailer.

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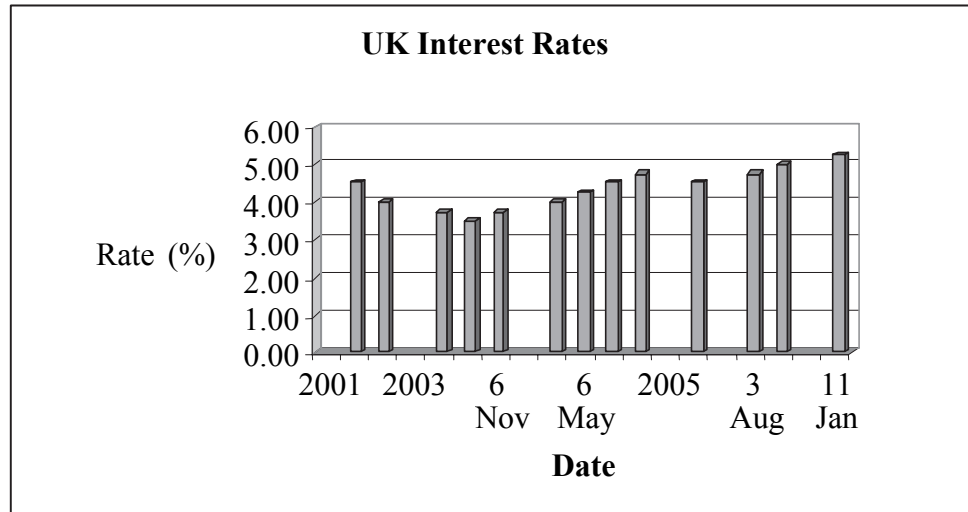
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Source of data: HM Treasury.

The Bank of England uses interest rates to influence the level of inflation. They increase interest rates when they want to bring inflation down. When the Bank of England increase interest rates, other banks increase their rates as well. This makes the cost of borrowing money for both businesses and individuals more expensive. Businesses might have to cut back on buying new equipment or machinery whilst individuals might think twice before taking out loans for a new car, a holiday or for new furniture or an extension to their house.

(e) Using an example, explain what you understand by the term the '*interest rate*'.

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The rise in interest rates affects different people and businesses in different ways.



“I have a large mortgage and every time interest rates rise my monthly mortgage payments increase. Every $\frac{1}{4}\%$ rise adds about £30 to my monthly payments. I have to think more carefully about what I am going to spend my money on. I may have to think about cutting back on some things that I used to do regularly like going to the cinema or eating out.”

<http://www.sxc.hu/photo/742936>

“I was thinking of buying a new car but the increase in interest rates has made me think twice. I have read in newspapers that this might not be the last rise in interest rates. I do not have a great deal of savings although my mother, who is now retired, does have some savings in a building society that she built up when she was working so she is pleased that interest rates are rising. At times like this I wish I had more savings too.”



<http://www.sxc.hu/photo/5281>



“I have had to borrow money to buy the premises and the equipment for my restaurant. Things have been going well and people have been visiting the restaurant regularly. Things might change now. The rise in interest rates might affect me in two different ways!”

<http://www.sxc.hu/photo/568287>



(f) Read the passages opposite carefully. Using your knowledge of business and economics, explain the points of view of the following people on a rise in interest rates.

(i) Householders with a mortgage.

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(ii) People with savings.

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(iii) A restaurant owner.

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Since 1997, the responsibility for controlling inflation has been given to the Bank of England. They monitor inflation and use interest rates as the main way of controlling inflation. Many people think that they have done a good job in keeping inflation low during this period and that the policy has been a success. This is not the only way to affect the business cycle and as a result inflation. The tax system could be used to influence the level of demand and help reduce the swings in the business cycle. In addition, government could use incentives and the benefits system to influence economic activity and this in turn affects the business cycle.

(g) Using your knowledge of economics and business, assess the strength of the case for the use of interest rates as the only chosen method of controlling inflation in the UK.

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If you answer this question put a cross in this box .

2. Big or Small?

Michael Ashwin runs a private limited company called Hill Farm Furniture. Michael employs 7 people and shares the ownership of the business with his ex-wife, Carolyn. Carolyn does most of the accounts and also the marketing. Michael does the design and planning work. Their staff all have their own jobs to do to help make the business a success.

(a) Using an example, explain what you understand by the term '*specialisation*'?

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(b) Explain how greater specialisation in the business might help Hill Farm Furniture improve productivity.

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(c) Consider **two** possible costs to Hill Farm Furniture of greater specialisation by the workers at the firm.

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Hill Farm Furniture has based its growing reputation on quality. It is something that Michael has to remind his staff of on a regular basis. When he first started he only had two people working for him and the business was a very close team. As the business has grown, more workers have been employed. Finding staff with the right skills is not easy. In addition, Michael has to make sure that he keeps them all motivated. As the business has

grown, communication becomes even more important.

Image source: www.hillfarmfurniture.co.uk

(d) Assess the value of bonuses and staff outings as methods of improving motivation at a firm like Hill Farm Furniture.

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Michael likes being part of a small business. He knows all of his staff well and each person knows what their job is and works as a team to get the job done. Companies like MFI, Magnet and B&Q, who also supply kitchen furniture, are much bigger. B&Q, for example, employs over 30,000 people. Michael knows that these companies have some advantages in being so big but he also thinks that they have some disadvantages which he does not have.

- (e) Explain **one** method that a large firm might use to try and reduce the effect of diseconomies of scale in the organisation.

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Big Business:

At the opposite end of the business scale to Hill Farm Furniture is a business like Mittal. Mittal is the world's largest steel firm and a multi-national business. In August 2005, it signed a deal with the government of Liberia in Africa.

The deal allowed Mittal access to about 1 billion metric tonnes of rich iron ore reserves in Western Liberia. Mittal Steel expected to invest \$900 million during the lifetime of the project. The investment would cover development of the mines, related railway and port infrastructure and provide community development projects. The deal would benefit Mittal's shareholders according to senior managers at the company.

(Source: adapted from www.mittalsteel.com)
<http://www.mittalsteel.com/NR/rdonlyres/4487DE25-EED7-4386-BAD4-ED2A6D1EE58B/591/2005AugLiberia.pdf>

A non-governmental organisation called Global Witness criticised the deal as not being in Liberia's interests. Some people in Liberia believed the deal was more in Mittal's interests than Liberia's. They thought that only around 2000 jobs would be created. Global Witness said the deal would have affected Liberia's control of the railways and its key port. It would also limit Liberia's capacity to regulate human rights, environment and taxation issues.

A new government was elected in January 2006 and re-negotiated the deal with Mittal. Mittal said the new agreement would involve investment now exceeding \$1bn and should generate 3 500 jobs directly and 15 000–20 000 jobs indirectly in Liberia.

Source: adapted from http://www.businessin africa.net/news/west_africa/541932.htm



(f) Read the passage opposite carefully. Using your knowledge of business and economics, explain the points of view of the following on multi-national businesses like Mittal.

(i) The new government of Liberia.

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(ii) Workers in Liberia.

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(iii) A Mittal shareholder.

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Intel, the US computer chip manufacturer, chose to set up a factory in the Central American country of Costa Rica. Since Intel opened the factory outside the capital, San Jose, in March 1998, Costa Rica's economy has been transformed.

The economy in Costa Rica grew by almost 8% in 1999 and there has been a big improvement in the country's export performance. Some Costa Ricans are worried. The central bank president, Eduardo do Lizano said, "Fifty years ago we depended on coffee and bananas; today we depend on Intel". The actual effect on the country's wealth will be reduced by the fact that some of the profits from computer chip manufacture will leave Costa Rica and go to the United States where Intel has its headquarters.

The government wants to keep growth going by seeking more foreign investment. Manufacturers who invest in Costa Rica can get tax benefits. Other Central American countries offer more generous incentives, but Costa Rica has other advantages, rare in the region. These include a sound legal system and a well-educated workforce. Such factors led Intel to choose Costa Rica for its only factory in Latin America.

Source: adapted from *The Economist* (US) 354.8152 (2000): p36. From Biz/ed Custom Journals.



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If you answer this question put a cross in this box .

3. Congestion and Externalities

The number of cars on Britain's roads is increasing. The market for new cars has been especially strong. In the UK in March 2007, new car sales rose by 3.1% according to figures from Just-auto. As sales of new cars have risen, it is having an effect on the prices of second hand cars.

(a) Using an example, explain what you understand by the term '*market*'.

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(b) Why might it be difficult to establish a market clearing price for **road use**?

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(c) Use supply and demand analysis to explain the effect on the price and quantity demanded of a rise in the demand for new cars. You may use a diagram to help illustrate your answer.

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Phil Goodwin, Professor of Transport Policy at University College London, has commented that more people are driving cars but the increase in the amount of road space available is not rising as fast. “This will continue to be the case unless steps are taken to reduce traffic. Building new roads is not an option. The cost of congestion to society is an annual cost of £20 billion. This would rise to £30 billion by 2010.”

Source: adapted from <http://eprints.ucl.ac.uk/archive/00001259/>

(d) Using an example, explain the meaning of the term ‘*externalities*’.

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(e) Explain **one** possible externality that might arise from congestion on the roads.

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“The idea of tracking every vehicle at all times is sinister and wrong. Road pricing is already here with the high level of taxation on fuel. The more you travel – the more tax you pay.

Road pricing will be unfair on those who live apart from families and poorer people who will not be able to afford the high monthly costs. Forget about road pricing and concentrate on improving our roads to reduce congestion.”

Peter Roberts – who led a petition to the government in 2007 to scrap the plans for road pricing. The petition gathered over 1.8 million signatures.

Source: adapted from <http://petitions.pm.gov.uk/traveltax/#detail>

The pressure group, Friends of the Earth has estimated that traffic congestion in London costs the average London household £675 per year. That is over £280 per Londoner per year. All in all, traffic congestion costs the capital almost £2 billion annually.

Roger Higman, Senior Transport Campaigner at Friends of the Earth said:

“Congestion is hitting every Londoner where it hurts – in their wallet.” Friends of the Earth want the government to find ways of reducing the number of vehicles on the road and support road pricing schemes.

Source: adapted from http://www.foe.co.uk/resource/press_releases/19970916141219.html

“Getting around Manchester in a car in the morning is not easy. I **have** to use my car as I am a salesperson but getting to see my clients in the early part of the day is really difficult. I have to leave extra early and even then I am often late for appointments because of the traffic. It only takes one accident to cause a major hold up. Sitting in the car not doing anything is really unproductive and being late can upset my clients although most are very understanding. Some of the clients I visit are not so happy about the prospect of road pricing as it will cost them more to get to work in the city centre in the morning. They also think that less traffic will mean less business for them. Something, though, has got to be done to reduce the traffic on the roads.”



(f) Read the passages on the previous page carefully. Explain the views of the following on the plans to introduce road pricing as a means of reducing congestion.

(i) Car user.

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(ii) Member of Friends of the Earth.

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(iii) Business person in Manchester.

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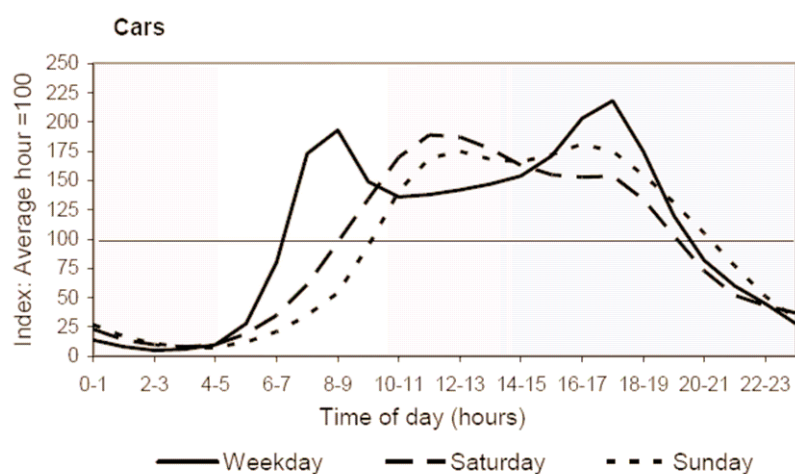
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In 2006, the government announced that it would be setting up some tests to see whether road pricing might work. The plans allow cities like Manchester and Birmingham to bring in a system to make drivers pay to use the roads. It was estimated that drivers might pay as much as £1.30 per mile if they chose to travel at peak times of the day. The aim of the scheme is to try and reduce the externalities that arise from the increase in the number of cars on Britain's roads.

Whilst road use has been rising, the pattern for road use at particular times of the day is quite different as shown by the chart below. If businesses were more flexible about when people went to work and allowed more people to work at home, where possible, congestion could be eased.

Distribution of traffic by time of day, period during the week and vehicle type: 2005



Source: http://www.dft.gov.uk/pgr/statistics/datatablespublications/roadtraffic/traffic/rtstatistics/coll_roadtrafficstatistics2005in/roadtrafficstatistics2005pdfdoc

“The UK transport system supports a staggering 61 billion journeys a year. Emissions from transport contributes about a quarter of the UK’s overall greenhouse gas emissions. Delays and unreliability on the roads have a cost to people and increases business costs and affects productivity and innovation.

Eliminating existing congestion on the road network would be worth some £7-8 billion of GDP per annum. If left unchecked, the rising cost of congestion will waste an extra £22 billion worth of time in England alone by 2025. My report argues that, for economic, social or environmental reasons, all transport users should meet all their external costs. Hence my strong backing for congestion-targeted road pricing.”

Sir Rod Eddington, Chair of the Eddington Transport Study.

Source: adapted from The Eddington Transport Study, December 2006
http://www.hm-treasury.gov.uk/media/39A/41/eddingon_execsum11206.pdf



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