



Rewarding Learning

ADVANCED

General Certificate of Education

Economics

Assessment Unit A2 2

assessing

Managing the Economy in a Global World



AEC21

[AEC21]

Assessment

TIME

2 hours.

Assessment Level of Control:

Tick the relevant box (✓)

Controlled Conditions	
Other	

INSTRUCTIONS TO CANDIDATES

Write your Centre Number and Candidate Number on the Answer Booklet provided.
Answer **all** questions in Section **A** and **B** and **one** question in Section **C**.

INFORMATION FOR CANDIDATES

The total mark for this paper is 90.

- Section A: 20 marks
- Section B: 40 marks
- Section C: 30 marks

Figures in brackets printed down the right-hand side of pages indicate the marks awarded to each question or part question.

ADVICE TO CANDIDATES

You are advised to take account of the marks for each part question in allocating the available examination time. In questions involving calculations, you are advised to show your workings. Quality of written communication will be assessed in Questions **6(b)**, **(c)** and **(d)**, **7** and **8**. Quantitative skills will be assessed where appropriate.

Section A (20 marks)

Answer all questions

- 1 The table below shows some data adapted from the United Kingdom balance of payments accounts for 2018.

Item in accounts	Net value (£ billion)
Trade in goods	-138
Trade in services	107
Primary income	-27
Secondary income	-24

- (a) Using the data in the table above, calculate the UK's current account balance in 2018. [2]
- (b) Along with the **current account balance** and **net errors and omissions**, identify the two other sections which make up the UK's balance of payments accounts. [2]

- 2 The table below shows the Gross National Income (GNI) per capita of Malaysia in 2018 measured in

- Malaysian national currency, the ringgit (MYR)
- US dollars (US\$) at the prevailing market exchange rate
- US dollars (US\$) using a Purchasing Power Parity (PPP) exchange rate

GNI per capita (MYR)	GNI per capita US\$ market exchange rate	GNI per capita US\$ PPP exchange rate
41 840	10 460	30 600

- (a) Explain what is meant by a Purchasing Power Parity exchange rate. [2]
- (b) Using the information in the table above, calculate the Purchasing Power Parity exchange rate between the Malaysian ringgit and the US dollar. [2]

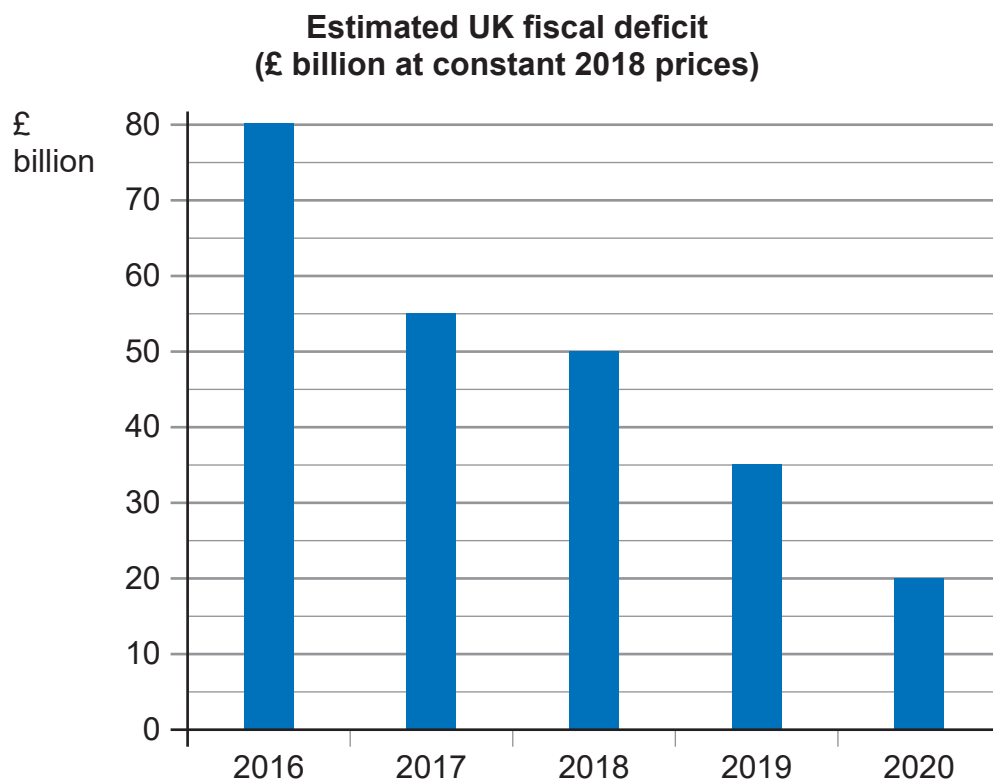
- 3 The table below shows the Human Development Index (HDI) and Gross National Income (GNI) per person in US dollars (US\$) at Purchasing Power Parity (PPP) exchange rates for Cuba and South Africa in 2018.

Country	HDI 2018	GNI per capita, US\$ at PPP 2018
Cuba	0.777	7524
South Africa	0.699	11 923

- (a) Identify one piece of data that is used by the United Nations to calculate the Human Development Index. [2]
- (b) Explain what the information in the table above tells us about the relative development of Cuba and South Africa. [3]

- 4 The chart below shows estimates of the UK fiscal deficit, including the costs of servicing the national debt, for the period 2016 to 2020. UK national debt was £1660 billion in 2015.

These estimates were made in 2018 and all figures are at constant prices.



- Using the information in the chart above, calculate the level of UK national debt that economists had predicted by the end of 2020. [3]

- 5 The currency of a country is the South Pacific dollar (SP\$). The effective exchange rate for the SP\$ is measured by a trade-weighted index.

Some details of this are shown in the table below:

Trading area	Relative importance in the country's trade (%)	Exchange rates for SP\$ on 2 July 2019 as a percentage of exchange rates on 2 July 2018
Africa and the Americas	15	120
Asia	50	108
Australia and New Zealand	20	95
Europe	15	100

Using the information in the table above, calculate the percentage change in the effective exchange rate of the South Pacific dollar between 2 July 2018 and 2 July 2019. [4]

Section B (40 marks)

Answer all questions

The following passages were compiled during 2019. Read them carefully and answer the questions which follow.

6 Case study: “For better, for worse, for richer, for poorer”

Source 1: Economic expansion, geographical contraction

In a document prepared for the United Nations Department of Economic and Social Affairs in 2000, Professor Gao Shangquan of Beijing University stated that “economic globalisation is an irreversible trend”.

He defined globalisation as “the increasing interdependence of world economies”, and suggested that increasing levels of co-operation were “making the concept of national boundaries and distance for certain economic activities meaningless”. Globalisation has resulted in a wider range of goods and services being available for consumers, and at lower prices. It is also considered to have led to higher rates of growth and improved living standards. **Fig. 1**, below, shows rates of growth in Gross Domestic Product (GDP) globally and in the UK over the past two decades.

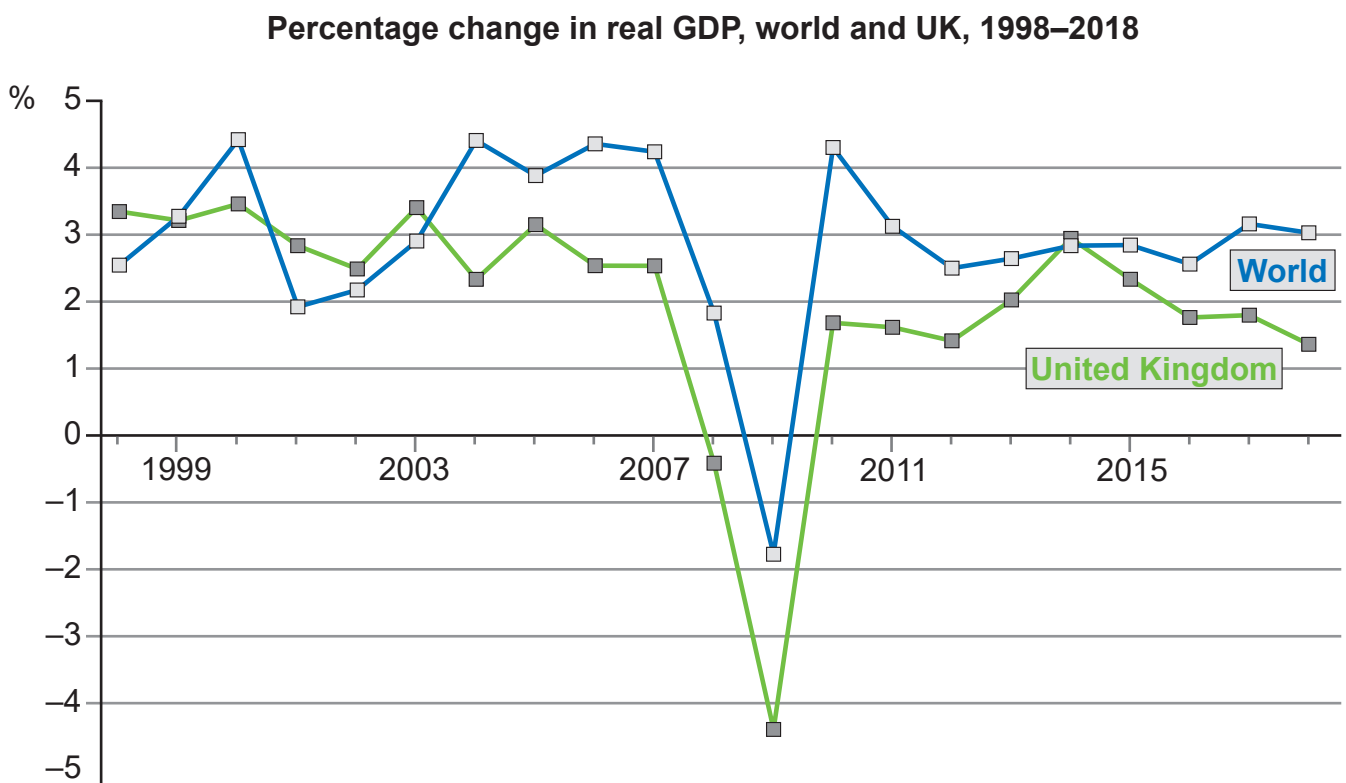


Fig. 1

An important driver of globalisation is what Professor Shangquan describes as “marketisation”. Organisations such as the International Monetary Fund have been influential in discouraging interference by national governments with the market forces of demand and supply. The process has been further accelerated due to global streamlining

and co-ordination of production, which have yielded economies of scale and specialisation. There has been rapid progress in science and technology, communications and transport, health and international relations. The World Trade Organisation has also helped in promoting international trade by encouraging the dismantling of tariffs and other trade barriers.

Source 2: “Nothing comes without opportunity costs”

Even enthusiasts for globalisation agree that there are losers as well as winners. Critics claim that removing restrictions on the operation of markets risks many of the undesirable consequences of market failure. Stakeholders in industries unable to survive in conditions of intense global competition are among the most adversely affected.

The theme of a report published by Dr Joan Thompson, entitled *Why Economics Stopped Working*, is that the irresistible momentum of globalisation must be harnessed as a solution to economic and social problems, rather than mismanaged to make them worse.

She feels that people need to participate in, and benefit from, the economic prosperity of the place where they live. When people feel side-lined, social cohesion is threatened. Dr Thompson fears that politics in developed countries is moving away from broad agreement on social issues towards extremism and conflict. She is concerned about protest movements such as the “yellow vests” in France and “Extinction Rebellion” in the UK.

One of the issues raised in the report is that political pressure to reduce the numbers of people coming from abroad to make the UK their home may well lead to significant and harmful reductions in the UK workforce.

As in nearly all developed countries, people in the UK are living longer. This can lead to an imbalance in the distribution by age of the population, with higher ratios of dependants to working people. Costlier pensions and welfare provision need to be funded by the wealth created and taxes paid by a shrinking proportion of the country’s residents. Another important consideration is that parts of the agricultural and healthcare sectors are extremely reliant on foreign workers.

In Dr Thompson’s opinion, politicians, having tried and failed to control immigration, should instead be convincing people that an expanded workforce is essential for economic renewal.

Source 3: Prosperity today – problems tomorrow?

Activist Kitty White is an outspoken critic of multinational companies (MNCs) and their operations. She argues that these organisations exploit the dismantling of international barriers to the movement of goods and services; information; capital and labour, by moving production facilities to countries where costs of production are lowest.

“It’s not just a question of sweatshops in Less Developed Countries,” she told delegates at a fair trade conference in May 2019. “Giant corporations are at least as powerful as national governments. They use their vast wealth to buy control of manufacturers in the UK and elsewhere. Then they break all their promises and move production offshore. This weakens the secondary sectors of developed economies by eroding their industrial base, and forces them to develop new and possibly more volatile areas of comparative advantage.”

She also condemns “MNCs’ cunning shuffling of their resources to avoid paying taxes and to bypass inconvenient legislation designed to protect workers or national environments”.

Ms White believes that long-term deficits on the UK’s current account are not sustainable. “Reserves are finite; inward flows of foreign funds only offset consumption expenditure abroad in the short term. They not only incur liabilities in terms of outward flows of interest, profits and dividends in the future, but also are reversible at virtually any time. In fact,” she asserts, “inward Foreign Direct Investment (FDI) is generally more damaging than beneficial.”

- (a) Compare the trends in the growth rate of world and UK GDP during the period illustrated in **Fig. 1**. [4]
- (b) Analyse some of the factors which led to the accelerating process of globalisation. [9]
- (c) Examine the possible consequences for the United Kingdom of a significant reduction in immigration. [12]
- (d) Evaluate Kitty White’s assertion that inflows of Foreign Direct Investment are generally more damaging than beneficial. [15]

Section C (30 marks)

Answer one question

- 7 Financial services such as banking, investment and insurance contribute significantly to UK exports, GDP and employment. The success of the sector and its complexity have been cited as justification by successive UK governments for a policy of minimal intervention. However, a former Chancellor of the Exchequer, Alistair Darling, speaking on the tenth anniversary of the start of the global banking crisis, warned that rising levels of both debt and asset prices still threatened financial stability.

Critically examine the view that government intervention in financial markets is likely to make matters worse rather than better. [30]

- 8 Over the past 10 years, the exchange rate for the UK pound has fluctuated sharply, creating uncertainty for consumers, manufacturers and holidaymakers. Some economists feel that the instability associated with floating exchange rates will have an increasingly negative effect on living standards in the future.

Evaluate the case for the introduction of an international system of fixed exchange rates. [30]

THIS IS THE END OF THE QUESTION PAPER

Sources

Q1.....© Adapted from www.ons.gov.uk
<https://www.nationalarchives.gov.uk/doc/open-government-licence/version/3/>

Q2.....Source: World Bank Open Data

Q3.....Source: <https://hdr.undp.org/>
<https://creativecommons.org/licenses/by/3.0/igo/legalcode>

Q4.....Adapted from © Office for National Statistics
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Q6.....Graph - Adapted from © Office for National Statistics. Contains public sector information licensed under the Open Government Licence v3.0 and Adapted from © The World Bank. Datasets are provided to you under a Creative Commons Attribution 4.0 International License (CC BY 4.0)

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Surname	<i>StemUp Model Solution</i>
Answer booklet	Write the question number in the left-hand margin at the start of each answer.

Question number	
1 (a)	<i>Current account balance = $-138 + 107 + (-27) + (-24) = -£82$ billion, i.e. a current account deficit of £82 billion.</i>
1 (b)	<i>The capital account and the financial account.</i>
2 (a)	<i>A PPP exchange rate is a rate of currency conversion that adjusts for the different price levels in two countries, so that it equalises the domestic purchasing power of the currencies: the same basket of goods would cost the same in both countries once converted.</i>
2 (b)	<i>PPP exchange rate = $41\ 840 \div 30\ 600 = 1.367$, so US\$1 = 1.37 ringgits (MYR), or 1 MYR = US\$0.73.</i>
3 (a)	<i>Life expectancy at birth.</i>
3 (b)	<i>Cuba is more developed than South Africa: its HDI is 0.777 compared with 0.699, even though its GNI per capita at PPP is much lower (US\$7524 against US\$11 923). Since Cuba scores lower on income, the UN's other criteria must be higher, so Cubans must have a longer life expectancy at birth and/or more mean and expected years of schooling than South Africans. Income alone does not determine development.</i>
4	<i>Each year's deficit adds to the national debt: $80 + 55 + 50 + 35 + 20 = £240$ billion. Predicted debt at end of 2020 = $£1660$ billion + $£240$ billion = $£1900$ billion.</i>

5

Weighted change = weight $\times$ exchange rate as % of 2018 rate:

Africa and the Americas: $0.15 \times 120 = 18.00$

Asia: $0.50 \times 108 = 54.00$

Australia and New Zealand: $0.20 \times 95 = 19.00$

Europe: $0.15 \times 100 = 15.00$

Total = $18 + 54 + 19 + 15 = 106.00$, so the SP\$ is at 106% of its 2 July

*2018 value: the effective exchange rate of the SP\$ appreciated by 6.0% between
2 July 2018 and 2 July 2019.*

6 (a)

World GDP grew faster than UK GDP in most years, the exceptions being 1998, 2001 to 2003 and 2014: average growth was about 3% a year for the world and only about 2% for the UK. However, UK growth rates tend to mirror world trends, with peaks and troughs in similar years. World GDP grew in every year except 2009 (−1.7%), whereas UK GDP fell in both 2008 (about −0.4%) and 2009 (about −4.3%), so the UK slump was about two and a half times as severe as the world's. Both recovered in 2010, but since then world growth has stabilised at around 3% (3.0% in 2018), while UK growth has stayed lower at about 1.4% to 2.9%, falling to about 1.4% in 2018.

6 (b)

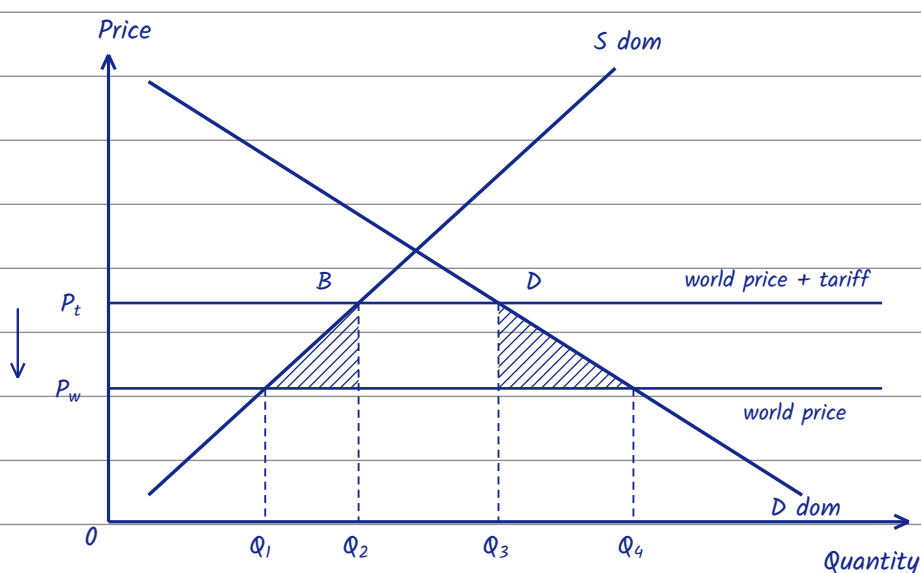
Globalisation is the increasing interdependence of world economies through trade, capital flows, migration and the spread of technology (Source 1). Several factors have accelerated it.

Transport and communications. Containerisation, larger ships and cheaper air freight have slashed transport costs, so the delivered price of imports has fallen and goods can be traded profitably over longer distances. Modern communications such as the internet are virtually instantaneous and cheap, so firms can co-ordinate production across continents, and the sharing of ideas and information raises productivity. Improvements in technology, computers and machinery have increased the efficiency of production.

Specialisation and economies of scale. Global streamlining and co-ordination of production (Source 1) allow MNCs to split production into stages and locate each where costs are lowest, exploiting division of labour and specialisation on a global scale. Serving a world market lets firms gain economies of scale, lowering average costs and prices, which increases trade further. Improvements in welfare and productivity of workforces in LDCs have made them attractive locations.

Marketisation and capital flows. The move towards market economies, encouraged by the IMF, and the opening up of China and Eastern Europe, has added billions of workers and consumers to world markets. Deregulation of capital markets has made it easier to invest across national frontiers through both FDI and portfolio investment, and there are fewer barriers to workers moving between countries, for example within the EU.

Trade liberalisation. The WTO has encouraged the dismantling of tariffs and other trade barriers (Source 1), and the number and influence of trading blocs has grown. As the diagram shows, removing a tariff lowers the domestic price from P_t to the world price P_w ; domestic consumption rises from Q_3 to Q_4 and domestic production falls from Q_2 to Q_1 , so imports increase from Q_2Q_3 to Q_1Q_4 .



Tariff removed: imports rise from Q_2Q_3 to Q_1Q_4 ; welfare gain $B + D$

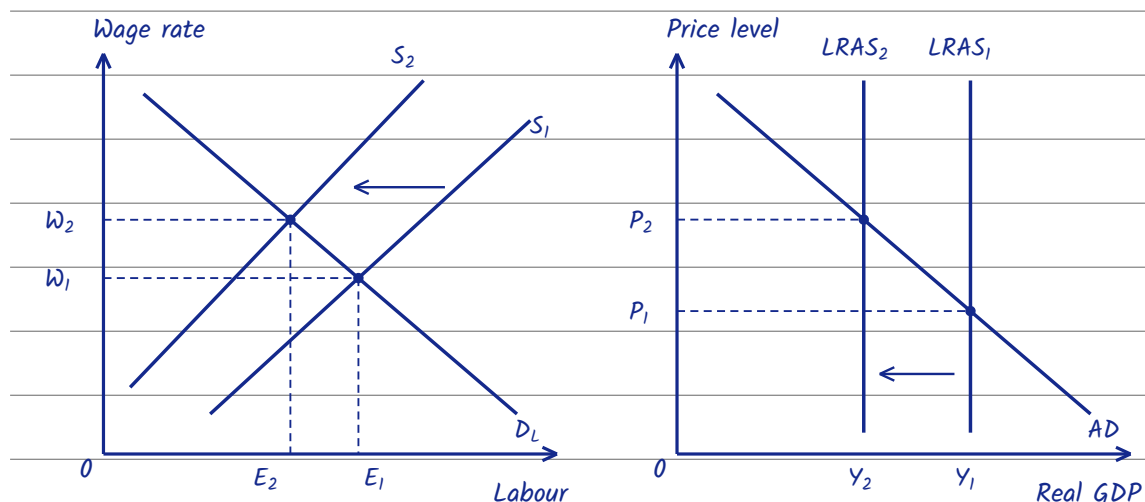
The deadweight loss $B + D$ is removed, so welfare rises. Because imports are now cheaper, countries specialise more according to comparative advantage and

trade grows, which is why trade has risen faster than world output. These factors reinforce each other: cheaper transport and communications make it profitable for MNCs to use lower trade barriers, accelerating the process.

6 (c)

Net migration adds to the UK labour force, since most migrants are of working age. A significant reduction would affect the labour market, macroeconomic objectives and public services.

Labour market. Lower immigration reduces the supply of labour, shifting S_1 to S_2 in the left-hand diagram, so the wage rate rises from w_1 to w_2 and employment falls from E_1 to E_2 . This may create greater job opportunities and higher wages for lower-skilled UK workers. However, Source 2 notes that parts of agriculture and healthcare are extremely reliant on foreign workers, so there may be serious labour and skill shortages, for example unpicked crops and NHS vacancies that are difficult to fill.



Macroeconomic effects. A smaller workforce reduces the productive capacity of the economy, shifting LRAS left from $LRAS_1$ to $LRAS_2$ (right-hand diagram), reducing potential growth from Y_1 to Y_2 . Higher wage costs shift SRAS left, causing cost-push inflation (P_1 to P_2). Fewer migrants also means less consumption, so AD falls. The UK, like other developed countries, has an ageing population, so the dependency ratio would rise: costlier pensions and welfare would be funded by a shrinking share of taxpayers (Source 2), causing fiscal

problems as tax revenues fall.

Public services and society. Reduced immigration may lower pressure on health, education and the housing market, and reduce social tensions between migrants and the local population, which Dr Thompson links to political extremism. Fewer overseas students would reduce university income and could raise costs for British students; there would be less need for translation services, but a loss of cultural diversity.

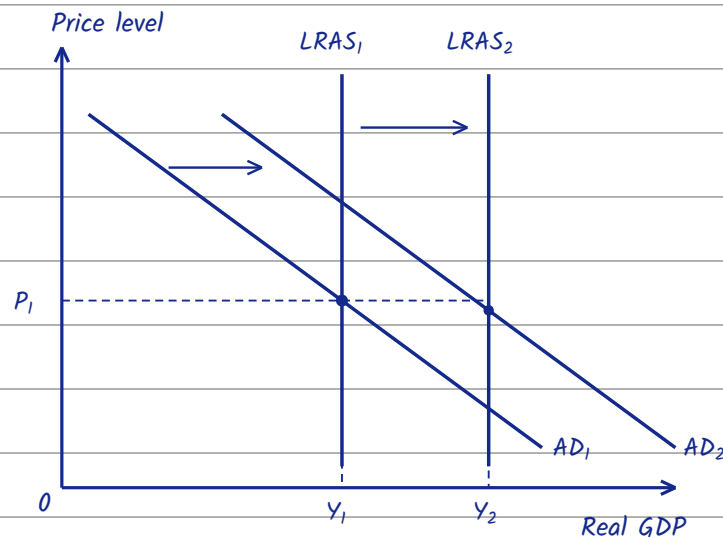
Evaluation. The pressure-on-services argument is weak, since most migrants are of working age and less likely to use health care, and the taxes they pay and the labour they provide help keep public services running. In the long run, labour shortages and higher wages may force firms to invest in capital and technology, raising productivity, which could offset the fall in LRAS. The impact depends on which migrants are restricted: cutting high-skilled migration is likely to be most damaging, while the effect is smaller if UK workers can be trained to fill vacancies, which takes time. On balance, Dr Thompson is probably right that a significant reduction would be harmful, as the loss of labour and tax revenue in an ageing economy outweighs the gains in wages for some workers and reduced pressure on housing.

6 (d)

Foreign direct investment (FDI) is investment by a firm or investors from abroad in productive assets in another country, for example an MNC expanding a foreign operation, building a new factory (greenfield investment) or acquiring a significant share of an existing company. Unlike gross fixed capital formation, FDI may create new capital but need not do so, as a takeover simply transfers ownership.

Benefits. In the UK, where investment has long lagged behind comparable nations, greenfield FDI increases the capital stock. Investment raises AD (AD_1 to AD_2) and, with the multiplier, creates jobs, while new capital, technology and management practices raise productivity and shift LRAS right from $LRAS_1$ to $LRAS_2$, as the diagram shows, so real GDP rises from Y_1 to Y_2 without inflation.

Nissan in Sunderland, for example, created thousands of jobs, introduced lean production that spread to UK suppliers, and exports most of its cars, improving the current account.



Inward FDI is recorded on the financial account and funds the UK's current account deficit. Even if an MNC avoids corporation tax, it may employ many highly paid workers who pay income tax and further taxes through their spending. Foreign ownership may also safeguard jobs, as when Tata bought Jaguar Land Rover and invested heavily.

Costs. Kitty White argues that MNCs buy UK manufacturers, break promises and move production offshore, eroding the industrial base, as with Kraft's closure of Cadbury's Somerdale factory after its 2010 takeover. Inflows of funds create future liabilities, since outward flows of interest, profits and dividends appear as debits on the primary income account and worsen the current account in the long run. Funds can be withdrawn at virtually any time, for example if global conditions change, making the UK vulnerable. MNCs may use transfer pricing and tax havens to avoid tax, bypass worker protection or environmental legislation, crowd out domestic firms, and foreign ownership of strategic industries such as energy and telecoms raises national security concerns.

Evaluation. Whether FDI is damaging depends on its type: greenfield investment adds to capacity and jobs, while acquisitions may only transfer ownership and

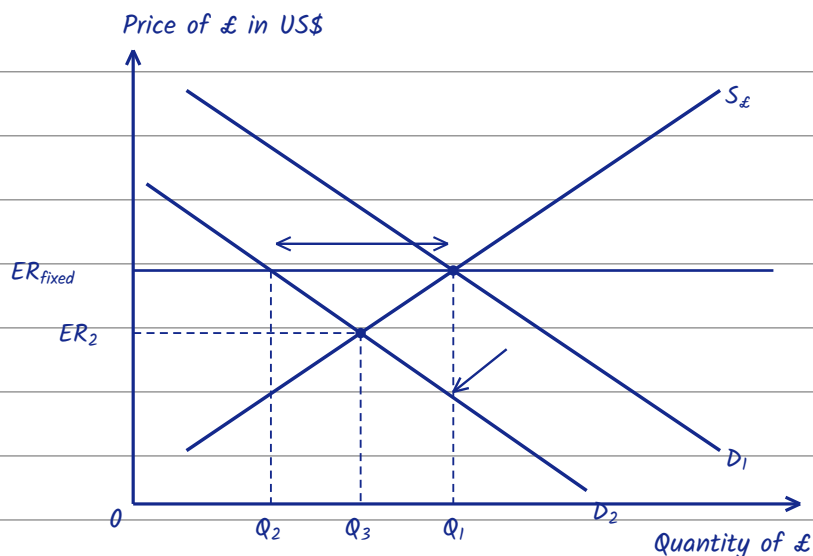
profits abroad. It depends on the time scale: the current account benefits in the short run but faces profit outflows later, though these may be outweighed if the FDI generates exports. It depends on regulation: governments can reduce the costs through tax rules such as the OECD's 15% global minimum tax, employment law, and screening of strategic takeovers under the National Security and Investment Act. Ms White's examples are real but selective; most evidence suggests foreign-owned firms in the UK are more productive and pay higher wages than domestic firms.

Overall, her assertion is not supported: inward FDI is generally more beneficial than damaging, particularly greenfield investment, provided governments regulate tax avoidance and protect strategically important industries.

8

A floating exchange rate is determined by the market forces of demand for and supply of a currency on the foreign exchange market, with no government intervention. Under a fixed exchange rate system the government or central bank pegs the value of its currency against another currency, a basket of currencies or gold, and maintains it by buying and selling its currency using foreign exchange reserves and by changing interest rates. Between these are managed floats and adjustable pegs. From 1944 to the early 1970s the Bretton Woods system fixed major currencies to the dollar, which was pegged to gold, with the IMF overseeing adjustments; today the Chinese yuan is partially fixed against a basket, and eurozone members have irrevocably fixed rates through the euro.

How a fixed rate is maintained. Suppose demand for the pound falls, for example because of a current account deficit or speculation, shifting D_1 to D_2 . Under a float the pound would fall to ER_2 . At the fixed rate there is an excess supply of pounds of Q_2Q_1 , so the Bank of England must buy Q_2Q_1 pounds using its foreign currency reserves, shifting demand back to D_1 , or raise interest rates to attract hot money inflows.



At ER_{fixed} there is an excess supply of £ of Q_2Q_1 ; the Bank of England

buys Q_2Q_1 pounds with reserves, shifting demand back from D_2 to D_1

The case for fixed rates. First, the most important advantage is certainty and price stability for exporters and importers. Firms know what their foreign earnings and import costs will be, so there is less need to hedge, reducing transaction costs, and long-term planning and investment become easier. The pound's sharp fluctuations over the past ten years, such as its fall of around 15% after the 2016 referendum, created uncertainty for consumers, manufacturers and holidaymakers. Greater stability should encourage trade and FDI, allowing countries to specialise according to comparative advantage and raising living standards.

Second, fixed rates help to control inflation and impose discipline on governments. A government cannot allow inflation to rise above that of its trading partners, since its exports would become uncompetitive and the current account would deteriorate, putting pressure on the peg. It must therefore pursue anti-inflationary fiscal and monetary policies. Under a float, a depreciation raises import prices, causing imported cost-push inflation that reduces real incomes. Fixed rates also impose a healthy discipline on exporting firms, which cannot rely on devaluations to remain competitive and must instead control costs and raise productivity, improving non-price competitiveness.

Third, fixed rates may reduce speculation and instability. Closer integration of the world's economies through globalisation has made it easier for hot money to move between countries, spreading financial contagion; a credible peg can remove the incentive to speculate on currency movements.

The case against fixed rates. First, the fixed rate must be set at the right level. If it is set too high, exports are uncompetitive and there is a persistent current account deficit; if too low, it causes inflation and trading partners may accuse the country of manipulation, as the US has with China. Economic conditions change over time, so a rate that is right today may become wrong as productivity and inflation rates diverge.

Second, governments lose control of monetary policy. Interest rates must be used to maintain the exchange rate rather than to target domestic inflation, growth and unemployment. To defend a rate in a recession, a government may have to raise interest rates and adopt deflationary policies, cutting AD, which leads to higher unemployment and lower growth: the system has a deflationary bias. Workers may dislike the downward pressure placed on their wages as the only way to restore competitiveness. In contrast, floating rates in theory correct a current account deficit automatically: the deficit means supply of the currency exceeds demand, so it depreciates, making exports cheaper and imports dearer until the deficit is corrected, provided the Marshall-Lerner condition holds.

Third, the cost of maintaining reserves is high. Central banks must hold large foreign currency reserves which could otherwise be used productively, and this is relatively advantageous to large nations such as China, with reserves of over \$3 trillion, while smaller countries may run out. No system is truly proof against speculation: in 1992 speculators led by George Soros sold pounds heavily, and despite the Bank of England raising interest rates from 10% to 12% (and announcing 15%) and spending billions of reserves, the UK was forced out of the ERM on Black Wednesday. Speculators face a one-way bet when a rate looks overvalued. Similarly, Greece in the eurozone could not devalue during its debt crisis and suffered unemployment of over 25%.

Fourth, an international system would need a body such as the IMF to moderate it, agree when realignments are allowed and lend to countries in difficulty, and the major economies would have to agree. The Bretton Woods system collapsed in 1971 because the US could not maintain the dollar's link to gold; it is unlikely that the US, China and the eurozone would surrender monetary independence today.

Evaluation. The case depends on the economic agents considered: exporters, importers and holidaymakers gain from stability, while workers and the unemployed may lose if governments must adopt deflationary policies. It depends on the type of fixed system: an adjustable peg such as Bretton Woods, which allowed devaluation in the event of a structural deficit, offers more flexibility than a rigid peg, though it invites speculation when a change seems likely. It depends on whether the instability of floating rates is really harmful: firms can hedge risk using forward contracts, and much of the pound's volatility reflected genuine shocks such as Brexit, where a depreciation helped cushion the economy. The problem of speculation could be tackled more directly by regulating capital flows or introducing a Tobin tax on currency transactions rather than fixing rates. Finally, the degree of economic convergence matters: fixed rates work best between economies with similar inflation rates and business cycles. In conclusion, the case for an international system of fixed exchange rates is weak. Although fixed rates would reduce uncertainty for traders and impose anti-inflationary discipline, the loss of monetary policy independence, the difficulty of choosing the right rates, the cost of reserves and the vulnerability to speculation, shown by Black Wednesday and the collapse of Bretton Woods, outweigh these benefits for major economies like the UK. A managed float, with independent central banks targeting inflation, offers most of the stability of fixed rates while keeping the flexibility to absorb shocks, so it is a better way to protect future living standards.