Please check the examination details below before entering your candidate information

Candidate surname	Other names
StemUp Model Solution	

Centre Number | Candidate Number

Pearson Edexcel International Advanced Level

Time 2 hours

Paper reference **WEC14/01**

Economics

International Advanced Level
UNIT 4: Developments in the global economy

You must have:
Source Booklet (enclosed)

Total Marks

Instructions

- Use **black** ink or ball-point pen.
- **Fill in the boxes** at the top of this page with your name, centre number and candidate number.
- Answer **ALL** questions in Section A and Section B.
- Answer **TWO** questions in Section C.
- Answer the questions in the spaces provided
  – *there may be more space than you need.*

Information

- The total mark for this paper is 80.
- The marks for **each** question are shown in brackets
  – *use this as a guide as to how much time to spend on each question.*
- Calculators may be used.

Advice

- Read each question carefully before you start to answer it.
- Check your answers if you have time at the end.

Turn over ▶

P67006A

©2022 Pearson Education Ltd.

1/1/1/1/

P 6 7 0 0 6 A 0 1 2 8

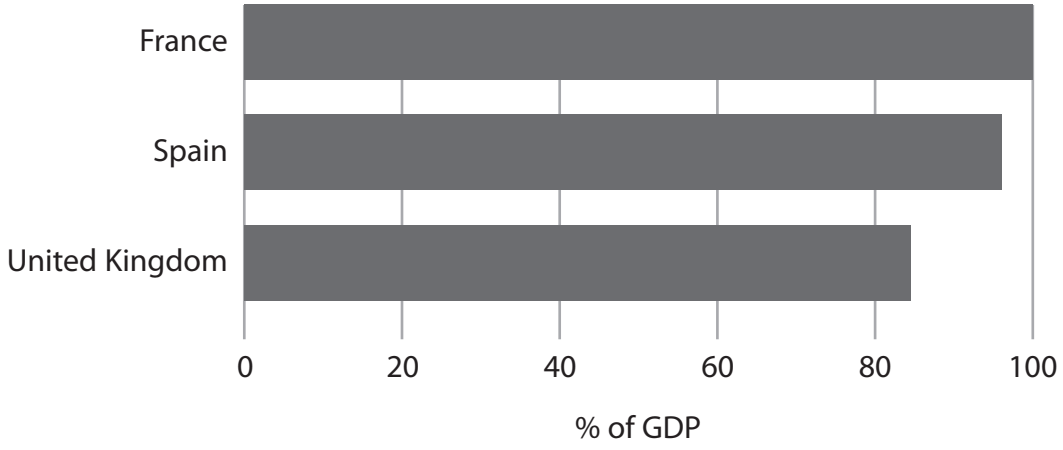
Pearson

SECTION A

Answer ALL questions in this section.

Questions must be answered with a cross in a box ☒. If you change your mind about an answer, put a line through the box ☒ and then mark your new answer with a cross ☒.

1 The chart shows national debt as a percentage of GDP for selected countries in 2020.



Which **one** of the following can be deduced from the chart?

☒ **A** In the UK tax revenues must have been lower than public expenditure in previous years

☒ **B** In Spain public expenditure as a percentage of GDP must have been higher than in France

☒ **C** In France imports must have been greater than exports

☒ **D** In the UK crowding out is more likely than in Spain

(Total for Question 1 = 1 mark)

2 In South Korea manufacturing as a share of GDP was 17% in 1969 and 25% in 2019.

Which **one** of the following theories suggests that industrialisation is a strategy to promote economic growth and development?

☒ **A** The Prebisch–Singer hypothesis

☒ **B** The Marshall–Lerner condition

☒ **C** The Harrod–Domar model

☒ **D** The Lewis structural dual-sector model

(Total for Question 2 = 1 mark)

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

3 In 2020 Denmark's international competitiveness rank was six places higher than in 2019.

Which **one** of the following is the most likely reason for this increase in Denmark's international competitiveness?

- ☒ **A** An increase in its unit labour costs relative to other countries
- ☒ **B** An increase in its transportation costs relative to other countries
- ☒ **C** An increase in its labour productivity relative to other countries
- ☒ **D** An increase in its rate of inflation relative to other countries

(Total for Question 3 = 1 mark)

4 In December 2020 the Spanish Government announced that it was increasing the highest rate of income tax from 45% to 47%.

Which **one** of the following is the most likely impact of this change?

- ☒ **A** The Government will receive an additional 2% tax from all workers in Spain
- ☒ **B** The value of Spain's Gini coefficient will fall and the country's Lorenz curve will shift inwards
- ☒ **C** The burden of tax will fall mostly on low income households, as the tax change is regressive
- ☒ **D** There will be an increased incentive for people to set up businesses in Spain

(Total for Question 4 = 1 mark)

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

5 The table shows the maximum production possibilities for Country X and Country Y in a given year.

Country	Bags		Shoes
X	80 000	**OR**	80 000
Y	35 000	**OR**	35 000

Which **one** of the following can be deduced from this table?

☒ **A** Neither country will benefit from specialisation and trade

☒ **B** Country X has a comparative advantage over Country Y in the production of bags and shoes

☒ **C** Country Y has an absolute advantage over Country X in the production of bags and shoes

☒ **D** There is no opportunity cost for either country in producing bags or shoes

(Total for Question 5 = 1 mark)

6 Between September 2019 and September 2020, Australia's export prices decreased by 9.9% and import prices decreased by 5.7%.

If September 2019=100, what was Australia's terms of trade in September 2020?

☒ **A** 57.58

☒ **B** 95.55

☒ **C** 104.66

☒ **D** 173.68

(Total for Question 6 = 1 mark)

TOTAL FOR SECTION A = 6 MARKS

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

BLANK PAGE

SECTION B BEGINS ON THE NEXT PAGE.

stemup.co.uk

SECTION B

Study Figures 1, 2 and 3 and Extract A in the Source Booklet before answering Question 7.

Write your answers in the space provided on the following pages.

7 (a) With reference to Figure 1 and Figure 2, calculate Turkey's real interest rate in July 2020. You are advised to show your working.

(2)

(b) With reference to Figure 3 and Extract A, analyse **two** factors, other than changes in interest rates, that may have led to a depreciation of the Turkish lira.

(6)

(c) Explain what is meant by a 'customs union' (Extract A, lines 22–23).

(4)

(d) With reference to the last paragraph of Extract A, examine **two** likely economic benefits to Turkey of joining the European Union.

(8)

(e) With reference to the information provided, discuss the likely economic effects of a further increase in the base interest rate.

(14)

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

7 (a) With reference to Figure 1 and Figure 2, calculate Turkey's real interest rate in July 2020. You are advised to show your working.

(2)

Real interest rate = nominal base interest rate – rate of inflation (CPI)

July 2020: base interest rate = 8.25% (Figure 1), inflation = 11.76% (Figure 2)

Real interest rate = 8.25% – 11.76%

= –3.51%

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

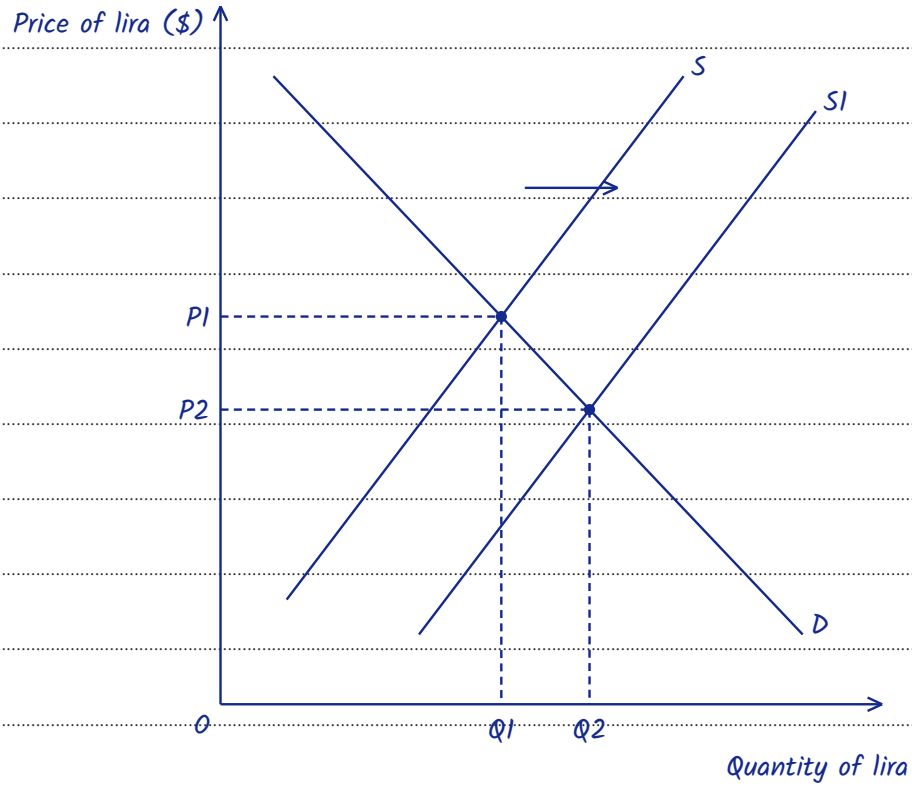
stemup.co.uk

(b) With reference to Figure 3 and Extract A, analyse **two** factors, other than changes in interest rates, that may have led to a depreciation of the Turkish lira.

(6)

Figure 3 shows the lira depreciated sharply; the number of lira needed to buy one US dollar roughly doubled, from about 3.8 lira in January 2018 to about 7.7 lira in December 2020 (peaking near 8.6), a depreciation of nearly 100%.

Factor 1: a large current account deficit. Extract A states that Turkey has a "large current account deficit", so the value of its imports is greater than the value of its exports. Turkish importers must sell lira to buy dollars to pay for imports, while foreign buyers need relatively few lira to pay for Turkish exports. The supply of lira on the foreign exchange market is therefore high relative to the demand for lira, so the supply curve shifts right from S to S1 and the price of the lira falls from P1 to P2.



Factor 2: capital flight. Extract A says capital flight has contributed to the fall in the lira. As confidence in Turkey fell, with inflation above 10% throughout 2018 to 2020 (Figure 2) and

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

economists warning that "the risk of a financial crisis in Turkey was growing", investors sold lira assets and moved their money into dollar assets abroad. This increases the supply of lira and reduces the demand for lira on the foreign exchange market, so the external value of the lira falls further. High inflation also makes Turkish exports less price competitive, reducing demand for the lira.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

(c) Explain what is meant by a 'customs union' (Extract A, lines 22–23).

(4)

A customs union is an agreement between countries to remove tariffs and other trade barriers on trade between member countries, so there is free trade within the bloc, and to impose a common external tariff on imports from countries outside the bloc. Members also negotiate trade agreements with non-members as one group.

The European Union is a customs union (Extract A): goods move between members such as Germany and France with no tariffs, but an import from outside, for example from the USA, faces the same EU tariff whichever member country it enters. Turkey is an important trade partner for the EU and already has a customs union agreement with the EU covering industrial goods, so Turkish manufactured exports enter the EU tariff free.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

(d) With reference to the last paragraph of Extract A, examine **two** likely economic benefits to Turkey of joining the European Union.

(8)

Benefit 1: trade creation and faster economic growth. Joining the EU would give Turkish firms tariff free access to a single market of about 450 million consumers, extending free trade to agriculture and services. Following the law of comparative advantage, Turkey could specialise in goods it produces at a lower opportunity cost, such as textiles, cars and fruit, and trade creation would replace high cost domestic production with cheaper imports from EU partners. Higher exports raise net exports (X – M), so aggregate demand increases and, through the multiplier, real GDP and employment rise, supporting the "long-term economic growth" the extract says Turkey needs.

However, trade diversion may occur. Turkey would have to apply the EU common external tariff, so imports might switch from low cost producers outside the EU, such as China, to higher cost EU producers, which reduces allocative efficiency. Turkish firms would also face intense competition from large EU firms with big economies of scale, which could force some Turkish firms out of business.

Benefit 2: more foreign direct investment. Extract A says Turkey's growth "will depend on attracting foreign direct investment". As an EU member, Turkey would attract TNCs from outside the bloc, for example from Japan or the USA, that want to produce inside the EU to avoid the common external tariff while using Turkey's lower labour costs. FDI is an injection that raises aggregate demand, and it also increases the capital stock and brings new technology and management skills, so labour productivity rises and long run aggregate supply shifts right. EU governments see a "mutually beneficial relationship", so investment flows are likely to grow.

However, the size of this benefit depends on confidence. With high inflation, a weak lira (Figure

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

3) and political control of the Central Bank, TNCs may still be cautious. Free movement of labour could also lead to emigration of skilled Turkish workers to higher wage EU countries, a loss of human capital that would offset some of the gains from FDI.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

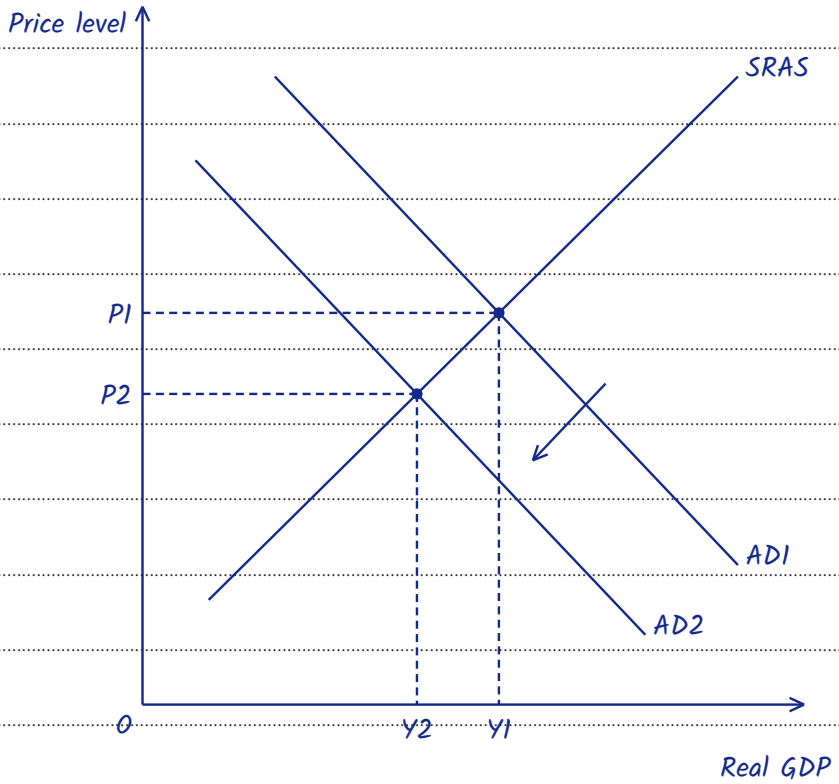
stemup.co.uk

(e) With reference to the information provided, discuss the likely economic effects of a further increase in the base interest rate.

(14)

The base interest rate is the rate at which the Central Bank lends to commercial banks, and it influences all other interest rates in the economy. Figure 1 shows it rose from 8.25% in July 2020 to 17% in December 2020, an increase of 8.75 percentage points, and some economists want it raised further.

Lower inflation. A further rise increases the cost of borrowing and the reward for saving. Households borrow less to buy durable goods and save more, so consumption falls, and firms cut investment because loans cost more relative to expected returns. With C and I falling, aggregate demand shifts left from AD1 to AD2, so the price level falls from P1 to P2 and demand pull inflation eases. This matters because inflation was 11.76% in July 2020 and had risen to about 15% by December 2020 (Figure 2). It would also "slow the pace of credit growth", reducing the risk of debt fuelled asset bubbles.



DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

Positive real interest rates. In July 2020 the real interest rate was −3.51%, so savers lost purchasing power and households hoarded cash, dollars or gold. With a 17% base rate and inflation of about 15% the real rate is now about +2%, and a further rise would protect the real value of savings in lira.

A stronger lira. Higher interest rates attract hot money inflows as foreign investors seek a better return on Turkish deposits and bonds. Demand for the lira rises, so the lira appreciates or at least stops falling, helping to "avoid a currency crisis". Cheaper imports, such as energy, reduce cost push inflation, and firms with loans in dollars face lower repayment costs in lira. It also supports the lira without the Central Bank using its foreign currency reserves, which have already been "reduced".

Costs. Lower consumption and investment mean slower economic growth and higher unemployment, the opposite of the President's aim "to stimulate Turkey's rate of economic growth". A stronger lira makes Turkish exports less price competitive and imports cheaper, which could widen the "large current account deficit". Higher interest payments squeeze indebted households and firms, risking bankruptcies, and raise the cost of servicing government debt.

Evaluation. The effect depends on the size of the rise. The increases since July 2020 are smaller than the cuts from 24% in 2019, and Figure 3 shows the lira kept falling to about 8.6 lira per dollar in late 2020, so investor confidence may still be low and only a large rise may work. There are also time lags of around 18 months to 2 years before interest rate changes fully affect AD and inflation, so inflation may stay high in the short run. If inflation is mainly cost push, caused by the weak lira raising import prices, higher rates cut output with little effect on prices unless the lira appreciates. Most importantly, the Central Bank is not independent: the President "controls the Central Bank", opposes high rates and dismissed the previous Governor,

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

so markets may expect any rise to be reversed and hot money inflows may be small.

Overall, a further rise is likely to be beneficial in the short run, because the most urgent problems are high inflation and a weak currency that threatens a financial crisis, even though growth will be slower. The size of the benefit depends mainly on credibility: if the Central Bank is seen as committed, a moderate rise could restore confidence in the lira, but with continued political interference even large rises may have limited effect.

(Total for Question 7 = 34 marks)

TOTAL FOR SECTION B = 34 MARKS

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

SECTION C

Answer TWO questions from this section.

8 Between 1980 and 2020 it was estimated that total global shipping container volumes increased from 100 million tonnes to 2 billion tonnes.

Evaluate factors that have contributed to increased globalisation in the last 50 years. Refer to examples of countries in your answer.

(Total for Question 8 = 20 marks)

9 In 2020 the European Union imposed retaliatory tariffs of 25% on many US goods in a dispute over aircraft subsidies.

Evaluate possible reasons why developed countries might restrict free trade.

(Total for Question 9 = 20 marks)

10 In 2020 Pakistan had a Human Development Index (HDI) score of 0.60 whereas Argentina had a HDI score of 0.85.

Evaluate economic factors that constrain the growth and development of a developing country.

(Total for Question 10 = 20 marks)

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

Write the answer to your FIRST chosen question here.

Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Write the answer to your SECOND chosen question on page 22.

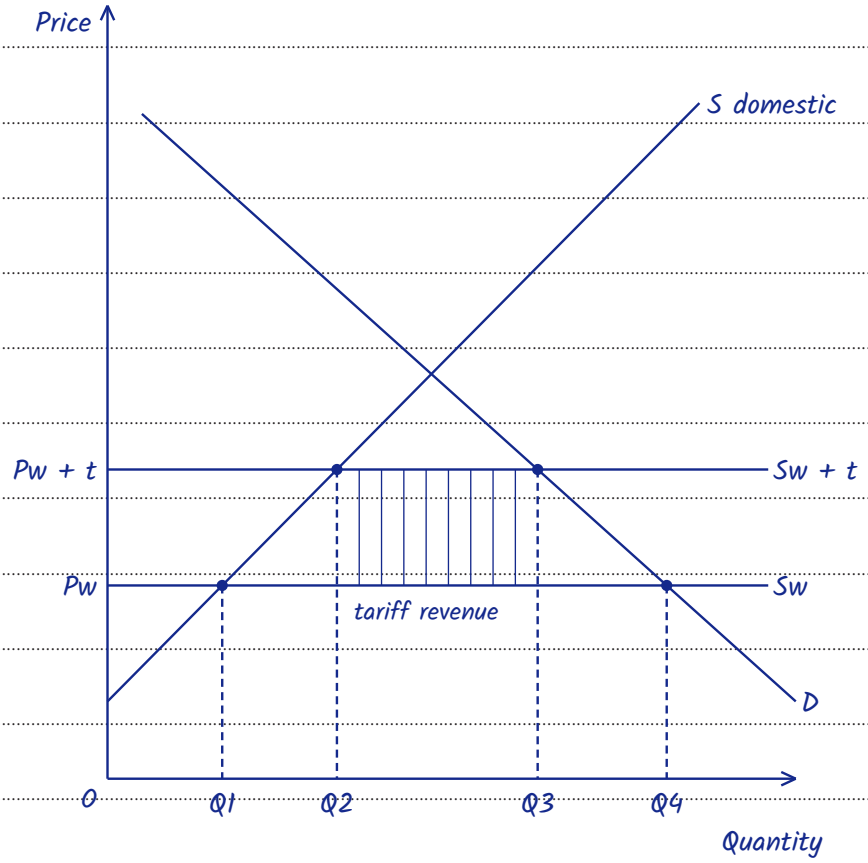
Chosen question number: **Question 8** ☐ **Question 9** ☒ **Question 10** ☐

Free trade is international trade without government restrictions such as tariffs, quotas, subsidies to domestic producers and non-tariff barriers. Protectionism is the use of these measures to protect domestic producers from foreign competition. Although developed countries such as the USA and EU members support free trade through the WTO, they still restrict trade for several reasons.

Retaliation against unfair subsidies and dumping. In 2020 the EU imposed 25% tariffs on many US goods because it argued US subsidies to Boeing gave it an unfair price advantage over Airbus. The EU also places anti-dumping duties on Chinese steel, which it argues is sold in Europe below its average cost of production. Dumping is a form of predatory pricing: foreign firms win market share, efficient domestic firms are forced out and prices may later rise, so dumping distorts comparative advantage. A tariff raises the price of the imports so domestic firms can compete on fair terms.

Protecting employment and geriatric industries. In 2018 the USA imposed 25% tariffs on steel imports to protect jobs in its steel industry, a declining industry facing low cost competition from China. As domestic output rises from Q1 to Q2 (see the diagram below), the derived demand for labour rises, which reduces structural unemployment in regions that depend on steel. Protection also gives the industry time to restructure, invest in new technology and lower its average costs so it can compete again.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA



In the diagram, with free trade the price equals the world price Pw, domestic firms supply Q1, consumers demand Q4 and Q4 – Q1 is imported. A tariff raises the price to Pw + t, so domestic output rises to Q2, demand falls to Q3 and imports fall to Q3 – Q2. The government gains the shaded tariff revenue.

Strategic industries and national security. Developed countries protect industries such as agriculture, steel, defence and, since the 2020 pandemic, medical supplies and semiconductors, so they are not dependent on imports in a crisis or conflict. The EU's Common Agricultural Policy subsidises farmers partly to protect food security.

Health, safety and environmental standards. The EU bans imports of hormone treated beef from the USA on health grounds. Restrictions stop firms in countries with weak regulation from producing unsafe goods at lower average cost and undercutting firms that meet higher standards.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

Correcting a current account deficit. The USA has a large trade deficit with China. Tariffs raise the price of imports, so spending on imports falls, net exports (X – M) improve and AD rises.

However, these reasons must be evaluated. First, protection causes a welfare loss: consumers pay Pw + t instead of Pw and consumer surplus falls by more than the gain in producer surplus and tariff revenue, leaving deadweight losses from inefficient domestic production and lost consumption. Retaliation also turns protection into a trade war: the US imposed tariffs on about $7.5 billion of EU goods in 2019 and the EU responded in 2020, so exporters in both blocs lost sales, and world trade and GDP fall.

Second, the employment argument is weak. Jobs saved in steel may be offset by jobs lost in industries that use steel, such as car makers, whose costs rise, and in export industries hit by retaliation. Evidence from the US suggests job losses in steel using manufacturing may have outweighed the jobs gained. Protecting geriatric industries is also ineffective if their costs are far above those of foreign producers, since it only delays decline and encourages inefficiency (government failure through lobbying).

Third, dumping is hard to prove: low Chinese prices may reflect genuine economies of scale and comparative advantage rather than predatory pricing. The current account argument depends on price elasticity: if demand for imports is price inelastic, imports fall little, so the deficit hardly improves and consumers simply pay more. Tariffs on imported components also raise costs for exporters. Raising revenue is a minor reason, as tariffs are a tiny share of revenue in developed countries compared with income tax.

Finally, it depends on the measure used. Tariffs and quotas are visible, but in developed

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

countries non-tariff barriers such as product standards and subsidies like the CAP are often more significant restrictions.

In conclusion, the most significant reasons for developed countries are responding to unfair practices such as subsidies and dumping, and protecting strategic industries, because these are the cases that WTO rules accept, as in the Airbus and Boeing dispute. Arguments based on jobs, revenue and the current account are much weaker, since the costs to consumers and the risk of retaliation usually outweigh the benefits. Restrictions are most justified when they are targeted and temporary.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

Write the answer to your SECOND chosen question here.

Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Chosen question number: **Question 8** ☐ **Question 9** ☐ **Question 10** ☒

Economic growth is an increase in real GDP, or in the productive capacity of the economy. Economic development is a broader improvement in living standards and welfare, often measured by the Human Development Index (HDI), which combines life expectancy, years of schooling and GNI per capita. Pakistan's HDI of 0.60 compared with Argentina's 0.85 shows that many developing countries face constraints on both.

The savings gap (Harrod–Domar model). In the Harrod–Domar model the growth rate depends on the savings ratio divided by the capital–output ratio. In a low income country such as Pakistan most income is spent on necessities, so savings are low, the funds available for investment are low and the capital stock grows slowly. For example, with a savings ratio of 10% and a capital–output ratio of 4, growth is only 2.5% a year, and with population growth of about 2% a year GDP per capita hardly rises. Low incomes then keep savings low, a vicious circle of poverty that also limits spending on health and education, so HDI stays low.

Primary product dependency. Many developing countries depend on exports of commodities, for example Zambia on copper and Pakistan on cotton and textiles. The Prebisch–Singer hypothesis argues that the terms of trade of primary products fall over time, because primary products have a low income elasticity of demand while manufactured imports have a high one, so a given volume of exports buys fewer imports of capital goods. Commodity prices are also volatile because demand and supply are price inelastic, so export earnings and tax revenue are unstable and farmers and governments cannot plan investment.

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA

Foreign currency gap and debt. Because export earnings are low, many developing countries lack the foreign currency needed to import capital goods and fuel. They borrow abroad, and debt servicing then takes revenue that could be spent on infrastructure, schools and hospitals. Pakistan has needed repeated IMF programmes, including a $6 billion loan in 2019, which came with spending cuts that limit development.

Poor human capital and infrastructure. Low school enrolment and literacy (adult literacy in Pakistan is only around 60%) reduce labour productivity and directly lower the education part of HDI. Poor infrastructure, such as frequent power cuts (load shedding) in Pakistan, raises firms' costs and deters both domestic and foreign investment, so LRAS grows slowly.

Capital flight. Rich individuals and firms move savings abroad when they fear inflation, currency depreciation or political instability, which widens both the savings gap and the foreign currency gap and reduces the tax base.

However, the significance of these constraints can be questioned. The savings gap can be filled by FDI, aid, remittances and microfinance: Pakistan receives large remittances from workers in the Gulf and Chinese investment through the China–Pakistan Economic Corridor. The Harrod–Domar model also assumes investment is used efficiently; if the capital–output ratio is high because of corruption or poor planning, more savings will not raise growth much.

Primary product dependency is not always a constraint. If a country has a comparative advantage in a commodity, specialising uses its resources efficiently, and during commodity booms export earnings rise strongly. Botswana grew rapidly on diamond exports because revenue was invested well. The impact therefore depends on how revenue is managed and whether the country diversifies.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

Debt is not a constraint if borrowing finances productive investment in human or physical capital that raises future growth, and if the debt is small relative to GDP at low interest rates. Population growth may even provide a demographic dividend: a large young workforce can raise output faster than population if jobs and education are available.

The comparison with Argentina also shows that growth and development do not always move together. Argentina has high HDI because of good education and health services, yet it has had slow, unstable growth, high inflation and a debt default in 2020. So macroeconomic instability can constrain growth even where development is high, while non-economic factors such as corruption, weak institutions and conflict may be more significant than economic factors in many countries.

In conclusion, no single factor explains low growth and development; the constraints are linked, since low savings, primary product dependency and the foreign currency gap reinforce each other. For a country like Pakistan, the savings and foreign currency gaps are probably the most significant constraints on growth in the short run, while low human capital is the most important constraint on development in the long run. Their importance depends on governance: where governments use FDI, remittances and commodity revenue productively, these constraints can be overcome.

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

TOTAL FOR SECTION C = 40 MARKS

TOTAL FOR PAPER = 80 MARKS

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

BLANK PAGE

stemup.co.uk

BLANK PAGE

DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA
DO NOT WRITE IN THIS AREA

stemup.co.uk

Pearson Edexcel International Advanced Level

Time 2 hours

Paper reference **WEC14/01**

Economics

International Advanced Level
UNIT 4: Developments in the global economy

Source Booklet

Do not return this Booklet with your question paper.

Turn over ▶

P67006A

©2022 Pearson Education Ltd.

1/1/1/1/

P 6 7 0 0 6 A

Pearson

stemup.co.uk

Sources for use with Section B

The economy of Turkey

Figure 1 Central bank base interest rate, January 2018 to December 2020

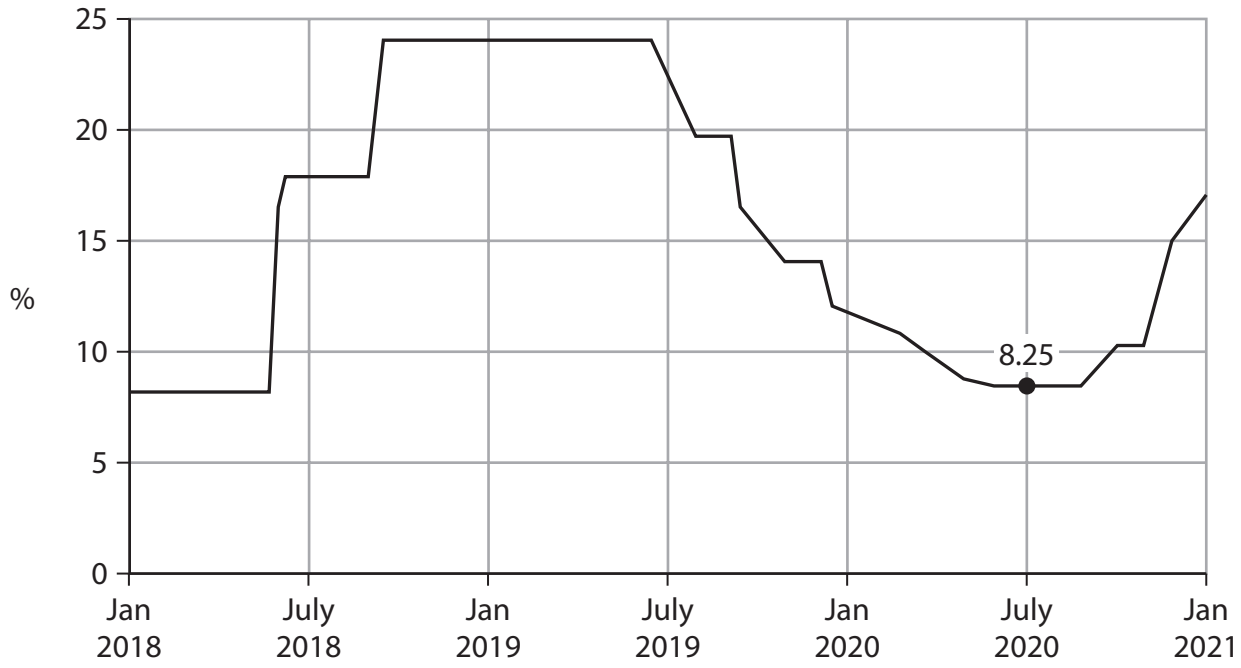
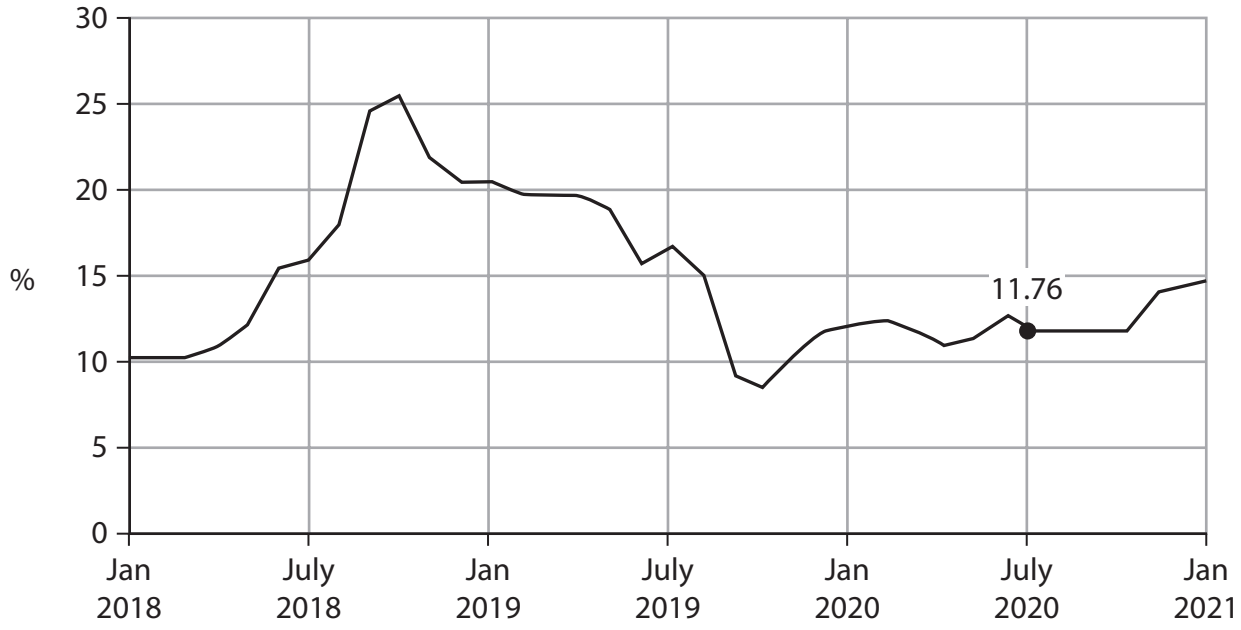
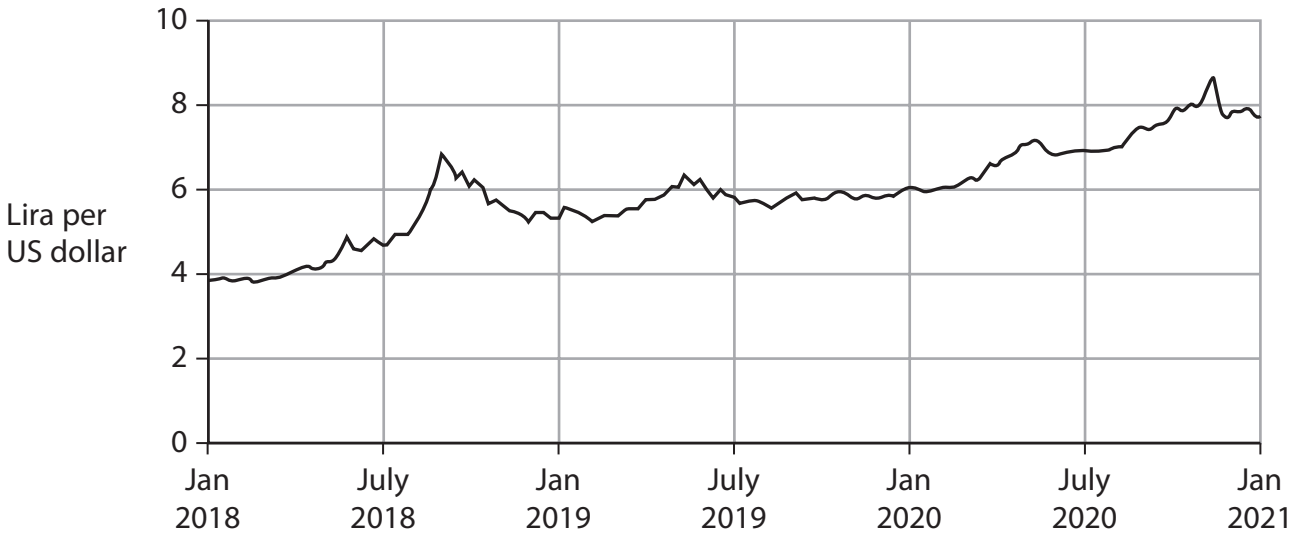


Figure 2 Rate of inflation, as measured by the Consumer Price Index (CPI), January 2018 to December 2020



stemup.co.uk

Figure 3 Turkish lira–US dollar exchange rate*, January 2018 to December 2020



* Turkey's currency is known as the Turkish lira

stemup.co.uk

Extract A Currency depreciation

Turkey's President, who controls the Central Bank of Turkey, is an opponent of high interest rates. He dismissed the Central Bank's previous Governor in 2019, complaining that "he would not follow instructions on interest rates". The Central Bank made a series of interest rate cuts after a new Governor was appointed. The President wanted a reduction in interest rates to encourage borrowing by businesses and consumers in order to stimulate Turkey's rate of economic growth.

By contrast, some economists urged the Central Bank to raise interest rates to slow the pace of credit growth and to avoid a currency crisis. They argued that following the reduction in base interest rates, there was a further fall in the exchange rate of the Turkish lira against the US dollar. Turkey's large current account deficit and capital flight have also contributed to the depreciation of the Turkish lira. Attempts to increase the external value of the lira while keeping interest rates low have reduced most of the Central Bank's foreign currency reserves. Economists warned that the risk of a financial crisis in Turkey was growing.

In response, the new Governor of the Central Bank of Turkey raised the base interest rate. This increase indicated that the Central Bank was concerned about the weakness of the lira and a high rate of inflation. By December 2020 the base interest rate had increased to 17%. However, some economists argued that the Central Bank would need to raise the base interest rate further to support the weak currency.

Turkey's long-term economic growth will depend on attracting foreign direct investment and establishing a stronger partnership with the European Union (EU) which is a customs union and common market. Turkey is an important partner for the EU on matters related to trade, investment and migration. Governments of many EU countries believe that they have an economic interest in developing a mutually beneficial relationship with Turkey.

stemup.co.uk

BLANK PAGE

stemup.co.uk

BLANK PAGE

stemup.co.uk

BLANK PAGE

stemup.co.uk

Acknowledgements

Figure 1 based on data taken from tradingeconomics, 'Turkey interest rate', https://tradingeconomics.com/turkey/interest-rate,

Figure 2 based on data taken from tradingeconomics, 'Turkey inflation rate', https://tradingeconomics.com/turkey/inflation-cpi,

Figure 3 based on data taken from YCHARTS, 'US Dollar to Turkish Lira Exchange Rate', https://ycharts.com/indicators/us_dollar_to_turkish_lira_exchange_rate

Extract A adapted from 'Turkey raises interest rate in unexpected move to tackle lira's fall', https://www.ft.com/content/68abcd57-3553-404a-ab23-fc5a13b385a0

Extract A adapted from 'EU plans new sanctions on Turkey over Mediterranean dispute', https://www.ft.com/content/9edf14e1-db2e-4cba-845d-ef11a6f5d680