Please check the examination details below before entering your candidate information

Candidate surname: StemUp Model Solution

Other names:

Pearson Edexcel
International Advanced Level

Centre Number

Candidate Number

Tuesday 2 June 2020

Morning (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 from 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.

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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 India specialises in services while China specialises in manufacturing.

If each country specialises and trades in the sector in which it has a comparative advantage, then which **one** of the following is likely to occur?

- ☒ **A** An increase in world output
- ☒ **B** A fall in exports and imports
- ☒ **C** A fall in the standard of living
- ☒ **D** An increase in absolute poverty

(Total for Question 1 = 1 mark)

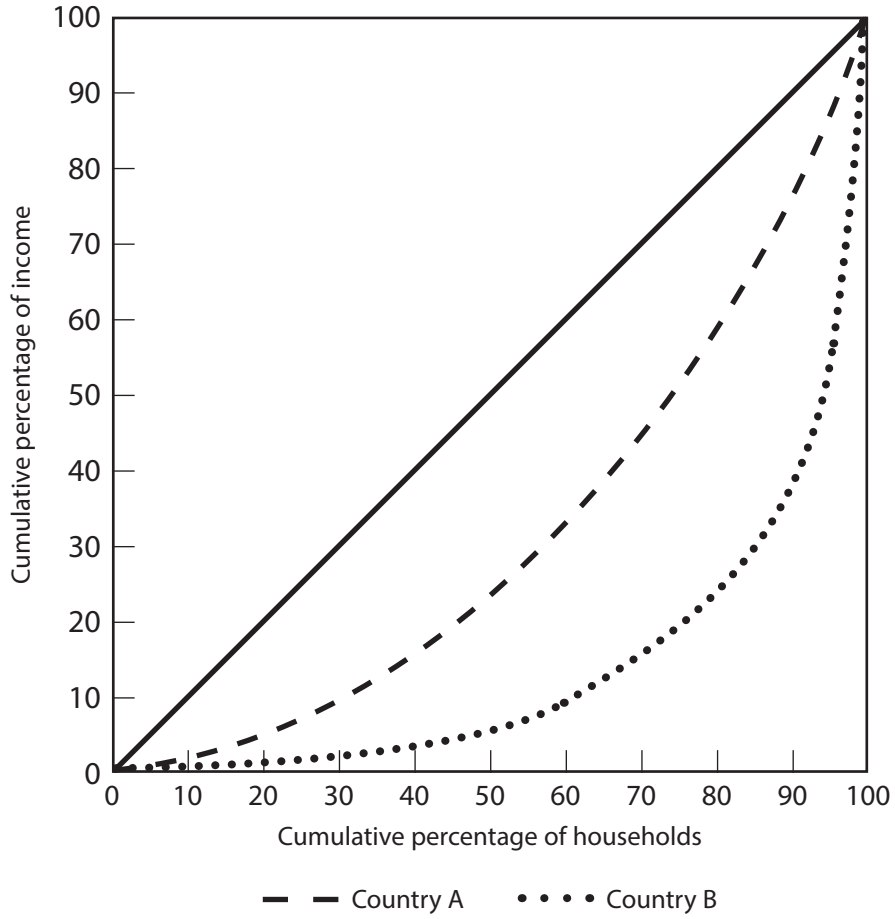
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2 The diagram illustrates the Lorenz curves of Country A and Country B.



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

- ☒ **A** GDP per capita in Country B is higher than in Country A
- ☒ **B** Income tax rates in Country B are higher than in Country A
- ☒ **C** The Gini coefficient of Country A is larger than it is for Country B
- ☒ **D** Income is more evenly distributed in Country A than in Country B

(Total for Question 2 = 1 mark)

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3 According to the Global Competitiveness Index, Finland's international competitiveness rank fell six places between 2015 and 2018.

Which **one** of the following measures is most likely to increase Finland's international competitiveness?

- ☒ **A** A reduction in spending on infrastructure
- ☒ **B** Stricter regulation of labour markets
- ☒ **C** Improvements in education and training
- ☒ **D** More restrictions on free trade

(Total for Question 3 = 1 mark)

4 The UK pound sterling exchange rate is allowed to float freely. The value of the pound sterling changed from £1 = $1.53 in January 2015 to £1 = $1.26 in January 2019.

This means that the value of pound sterling against the dollar has

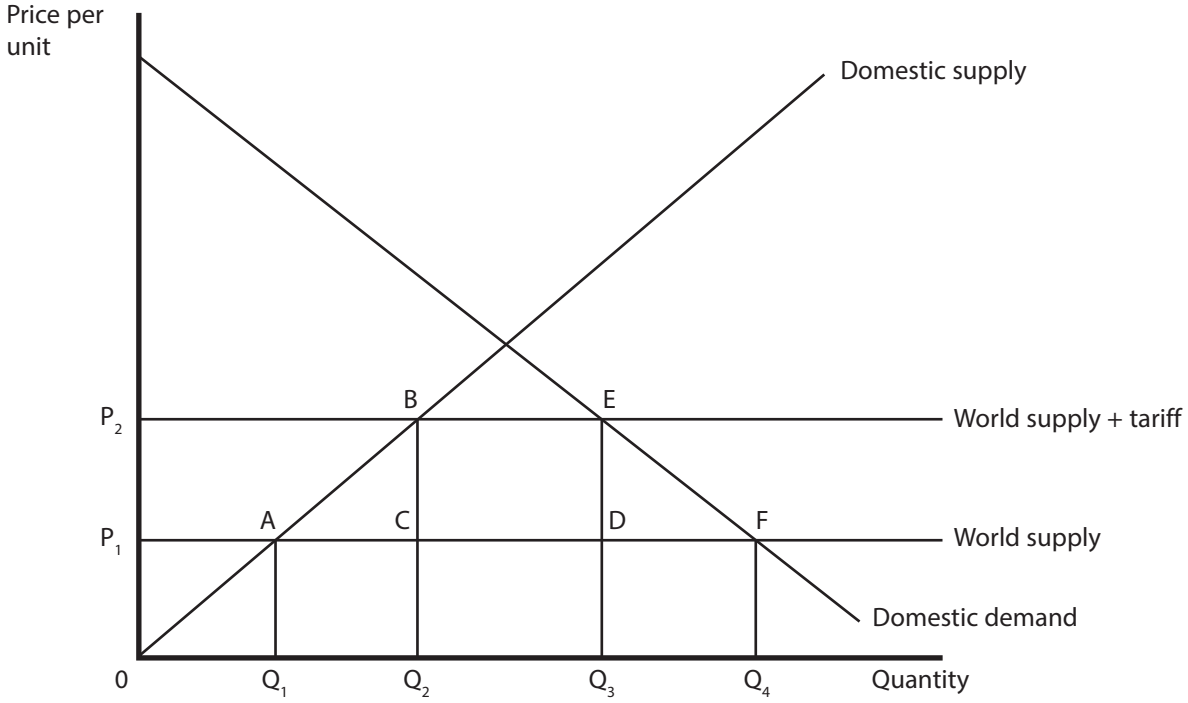
- ☒ **A** devalued
- ☒ **B** revalued
- ☒ **C** depreciated
- ☒ **D** appreciated

(Total for Question 4 = 1 mark)

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5 The diagram illustrates the imposition of a tariff.



Which **one** of the following statements is true?

- ☒ **A** Government tax revenue is area BEDC
- ☐ **B** Net welfare loss areas are ACQ_2Q_1 and DFQ_4Q_3
- ☐ **C** Producer surplus has decreased by the area P_1 P_2 E F
- ☐ **D** Consumer surplus has increased by the area P_1 P_2 B A

(Total for Question 5 = 1 mark)

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6 The table shows Sweden's GDP per capita between 2015 and 2017.

Year	GDP per capita
2015	$55 395
2016	$56 473
2017	$56 935

If 2016 is the base year, the index number for 2017 is:

- ☒ **A** 100.0
- ☒ **B** 100.8
- ☒ **C** 101.9
- ☒ **D** 102.8

(Total for Question 6 = 1 mark)

TOTAL FOR SECTION A = 6 MARKS

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QUESTION 7 BEGINS ON THE NEXT PAGE.

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SECTION B

Study Figures 1 and 2 and Extracts A and B in the Source Booklet before answering Question 7. Write your answers in the spaces provided on the following pages.

7 (a) With reference to Figure 1, calculate the percentage change in the number of tourists between 2012 and 2017. You are advised to show your working.

(2)

(b) With reference to Figure 1 and Extract A, analyse **two** economic benefits of the growth in the number of tourists to Mauritius.

(6)

(c) Explain what is meant by a 'reduction in the fiscal deficit' (Extract A, line 16).

(4)

(d) With reference to the information provided, examine **two** likely effects on Mauritius' economy of the reduction in the 'base interest rate from 4% to 3.5%' (Extract A, line 10).

(8)

(e) With reference to Extract B, discuss measures that the Government can implement to ensure that the private sector continues to grow.

(14)

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(a) With reference to Figure 1, calculate the percentage change in the number of tourists between 2012 and 2017. You are advised to show your working.

(2)

Percentage change = (new – old) ÷ old × 100

= (1.34m – 0.97m) ÷ 0.97m × 100

= 0.37 ÷ 0.97 × 100 = 38.1% increase in tourist arrivals

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(b) With reference to Figure 1 and Extract A, analyse **two** economic benefits of the growth in the number of tourists to Mauritius.

(6)

Benefit 1: higher economic growth through the multiplier. Figure 1 shows tourist arrivals rose from 0.97 million in 2012 to 1.34 million in 2017, and Extract A says earnings from tourism exceeded $1 billion. Spending by tourists on hotels, food and transport is an export of services, so it is an injection into the circular flow that increases aggregate demand. Hotel workers and suppliers then spend part of their extra income, so via the multiplier national income rises by more than the initial spending. This is why real GDP growth rose from 3.3% in 2013 to 3.9% in 2017, "mainly a result of significant growth in the tourism sector", and tourism now contributes nearly 7% of GDP.

Benefit 2: more employment and higher tax revenue. Tourism is a labour-intensive industry, so as the sector grows (it is expected to grow by an average of 6% a year from 2018 to 2023) firms demand more workers, which reduces unemployment and raises household incomes and living standards. Higher incomes, profits and spending increase receipts from income tax, corporation tax and indirect taxes, which Extract A shows helped reduce the fiscal deficit. The government can use this revenue to fund public services and infrastructure, which raises economic development (HDI). Tourist spending is also an important source of foreign currency, which improves the current account of the balance of payments.

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(c) Explain what is meant by a 'reduction in the fiscal deficit' (Extract A, line 16).

(4)

A fiscal (budget) deficit is when government spending is greater than government revenue, mainly tax revenue, in a year, so the government must borrow to cover the gap. A reduction in the fiscal deficit means this gap gets smaller, so public sector borrowing falls. This happens when tax revenue grows faster than public expenditure (or spending falls while revenue rises).

In Mauritius, public expenditure rose by only 0.3 percentage points, from 25.1% to 25.4% of GDP (2016 to 2017), while total tax revenue rose by 0.8 percentage points, from 21.7% to 22.5% of GDP, because of higher income tax, corporation tax and indirect tax receipts.

So the deficit fell from 25.1 – 21.7 = 3.4% of GDP in 2016 to 25.4 – 22.5 = 2.9% of GDP in 2017, a reduction of 0.5 percentage points.

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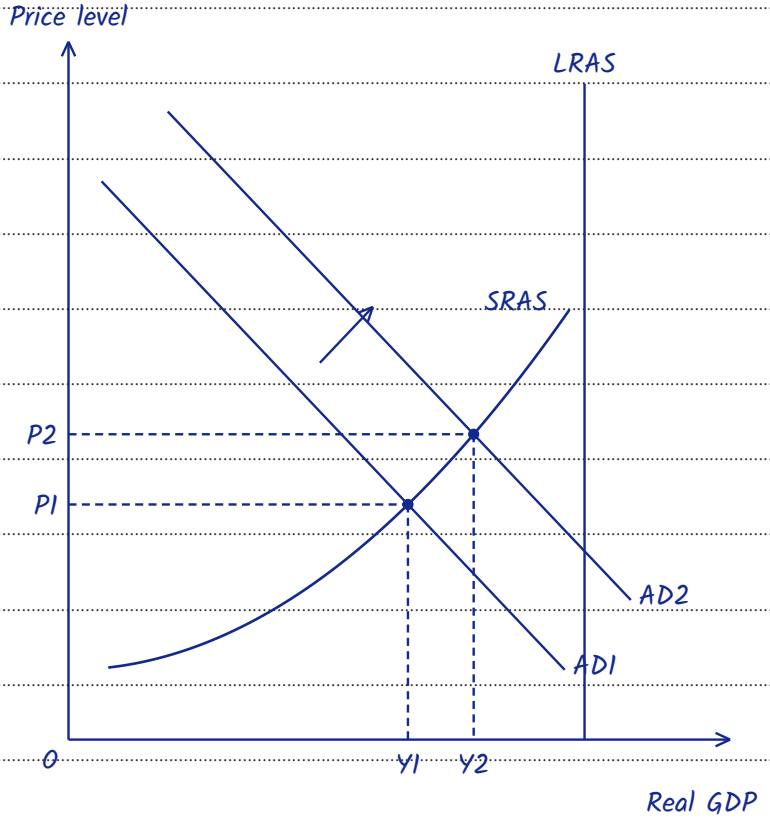
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(d) With reference to the information provided, examine **two** likely effects on Mauritius' economy of the reduction in the 'base interest rate from 4% to 3.5%' (Extract A, line 10).

(8)

The base interest rate fell by 0.5 percentage points, from 4% to 3.5%, as part of the Bank of Mauritius' reflationary monetary policy.

Effect 1: higher consumption and investment, so higher economic growth. A lower interest rate reduces the cost of borrowing and the reward for saving, so households borrow and spend more on consumer durables, and those with variable-rate loans have more disposable income. Firms face lower interest repayments, so more investment projects become profitable. Consumption and investment are components of AD, so AD shifts right from AD1 to AD2 and real GDP rises from Y1 to Y2 (diagram below), helping explain why real GDP growth rose to 3.9% in 2017 and creating jobs.



Effect 2: a rise in the price level. As AD rises the price level increases from P1 to P2. This was

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intended, because inflation was very low (1.29% in 2015 and 0.98% in 2016, Figure 2) and the Bank wanted to avoid deflation. Inflation did rise to 3.67% in 2017. Lower interest rates may also reduce hot money inflows, so the rupee depreciates, making exports cheaper and imports dearer, which raises net exports and adds to AD and import prices.

However, the effects may be small. A cut of only 0.5 percentage points is modest, and if consumer and business confidence is low, households and firms may not borrow more, so the multiplier effect is weak. There are also time lags of up to two years, and people on fixed-rate loans are not affected at first. Finally, much of the 2017 rise in inflation came from global commodity and food prices, which are volatile and outside the Bank's control, so a rise in these costs plus higher AD could push inflation up more than intended.

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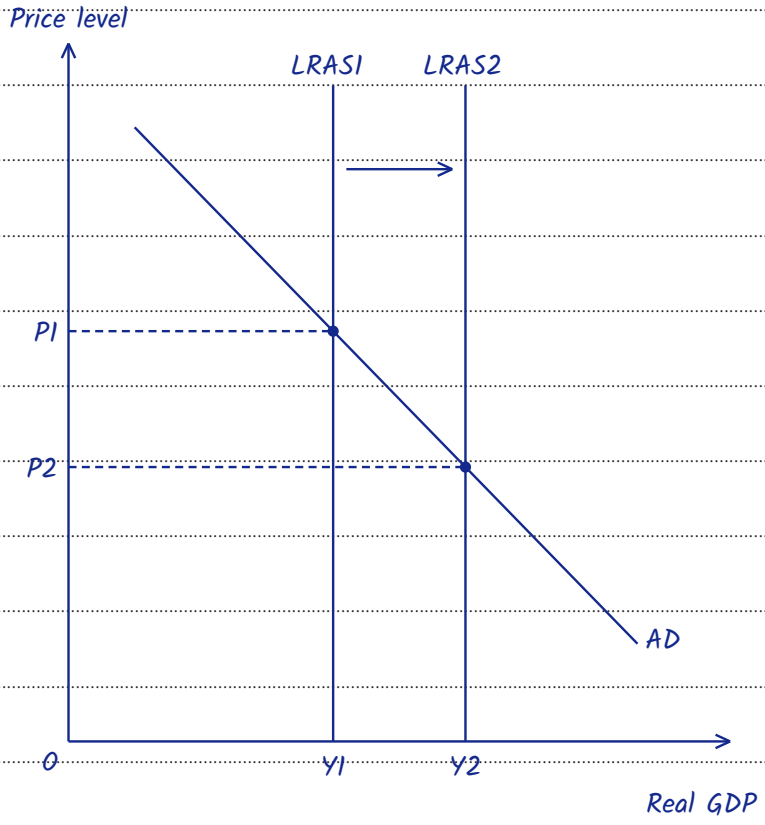
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(e) With reference to Extract B, discuss measures that the Government can implement to ensure that the private sector continues to grow.

(14)

The private sector matters greatly to Mauritius: in 2017 SMEs alone contributed 40% of GDP and employed 55% of the workforce. Extract B identifies several supply-side measures the Government can use.

Firstly, education and training. The private sector "suffers from a shortage of highly qualified labour" and there is a "skills mismatch". The Government could fund vocational training, apprenticeships and university places in science and engineering. This raises human capital and labour productivity, so unit labour costs fall and firms become more internationally competitive. More scientists and engineers would also support innovation, so firms grow and the LRAS curve shifts right from LRAS1 to LRAS2, raising potential output from Y1 to Y2 without extra inflationary pressure (price level falls from P1 to P2).



Secondly, subsidies and tax incentives for research and development. There is "a lack of finance

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to fund research and development", which is risky and expensive for SMEs. R&D tax credits or grants lower the cost of innovation, so firms develop new products and processes, improving dynamic efficiency and allowing them to export more.

Thirdly, infrastructure investment in "power sources, water supply, transport and telecommunications". Reliable electricity and water and better transport links reduce firms' costs and delays, raising productivity. Spending on infrastructure also increases AD in the short run through the multiplier, then increases LRAS in the long run.

Fourthly, reducing bureaucracy. Cutting red tape lowers the time and cost of starting and running a business, which encourages entrepreneurship and new SMEs entering markets.

However, these measures have limits. Training and infrastructure require large public expenditure, and financing them "remains a key issue because the country has relatively high levels of public sector debt". The Government has only just reduced the fiscal deficit (from 3.4% to 2.9% of GDP), so extra borrowing could raise interest rates and crowd out private investment, the opposite of what is intended. A public-private partnership or FDI could share the cost instead.

There are also long time lags. Education takes years to produce qualified engineers, and skills may become obsolete or graduates may emigrate (brain drain), so the shortage may persist. Large infrastructure projects take years to plan and build, and the benefits depend on their quality.

Subsidies risk government failure: officials may support inefficient firms, so resources are misallocated and firms become dependent, and there is an opportunity cost of spending on health or welfare.

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Reducing bureaucracy is probably the least urgent, because Mauritius is already "amongst the most business-friendly countries in the region" and improved its Doing Business ranking in 2018 after reforms to starting a business, construction permits and registering property.

Overall, the most effective measure is likely to be education and training, targeted at science and engineering, because the skills shortage is the root cause of both weak productivity and weak innovation, and SMEs employ 55% of workers. However, its success depends on the Government financing it without raising public debt further, so it should prioritise a few well-chosen infrastructure projects and combine them with targeted training.

(Total for Question 7 = 34 marks)

TOTAL FOR SECTION B = 34 MARKS

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SECTION C

Answer TWO questions from this section.

8 Between 2008 and 2017, Portugal's national debt increased from 71% of Gross Domestic Product (GDP) to 126% of GDP. Italy's national debt increased from 102% of GDP to 132% of GDP over the same period.

Evaluate the extent to which an increase in the national debt is a cause for concern. Refer to a developed country of your choice in your answer.

(Total for Question 8 = 20 marks)

9 In January 2018 Saudi Arabia and five neighbouring countries introduced a value added tax (an indirect tax) at a rate of 5%.

Evaluate the likely macroeconomic effects of the introduction of an indirect tax on a developing country of your choice.

(Total for Question 9 = 20 marks)

10 In 2017 Turkey's deficit on the current account of the balance of payments was $47.1 billion. In the same year, France's deficit on the current account of the balance of payments was $36.8 billion.

Evaluate the possible causes of a current account deficit. Refer to a country of your choice in your answer.

(Total for Question 10 = 20 marks)

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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 24.

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

National debt is the total accumulated stock of government borrowing that has not yet been repaid, built up from past fiscal deficits (each year's deficit adds to the debt). It is usually measured as a percentage of GDP. Italy is a good example: its national debt rose from 102% to 132% of GDP between 2008 and 2017, one of the highest ratios in the EU and far above the 60% limit in the Stability and Growth Pact.

Firstly, a rising debt means higher interest payments. Italy pays around 3.5 to 4% of GDP each year in debt interest. This has a high opportunity cost, because the money could have been spent on education, healthcare or infrastructure, which would raise long-run growth. It also transfers a burden to future generations, who must pay higher taxes or receive fewer public services to service the debt, creating a problem of intergenerational equity.

Secondly, there is a risk of financial crowding out. To sell more bonds the government may have to offer higher yields, which raises interest rates across the economy. Higher borrowing costs reduce private sector investment and consumption, so AD and LRAS grow more slowly. In Italy, bond yields rose to around 7% during the 2011 eurozone debt crisis, increasing costs for Italian banks and firms.

Thirdly, high debt can cause a loss of confidence and credit rating downgrades. Italy's rating was cut several times, to only a few notches above "junk" status. Lower ratings mean higher future borrowing costs and may discourage FDI. Because Italy is in the eurozone, it cannot print

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its own currency or devalue to deal with the debt, and in the worst case it might need help from the ECB or the IMF, as Greece and Portugal did. Portugal's debt rose by 55 percentage points of GDP, to 126%, and it needed an EU-IMF bailout in 2011.

Fourthly, a high debt limits the scope for fiscal policy. When the next recession comes, a country with a debt of 132% of GDP cannot easily use expansionary fiscal policy, and it may be forced into austerity (higher taxes and spending cuts), which reduces AD, raises unemployment and can even raise the debt-to-GDP ratio if GDP falls faster than the debt. This happened in Italy after 2011.

Finally, if investors refuse to buy bonds, a government with its own central bank might finance deficits by printing money, which increases the money supply and can cause inflation.

However, the extent of concern depends on several factors.

The cause of the debt matters. Much of the rise in Italy and Portugal after 2008 was caused by the global financial crisis and recession: tax revenue fell and spending on benefits rose automatically. Cyclical deficits like this fall as the economy recovers, so they are less worrying than structural deficits. Debt is also less of a concern if it was used to fund investment in infrastructure or education that raises future GDP and tax revenue.

Interest rates matter. Since 2015 the ECB's quantitative easing has bought large amounts of Italian bonds and kept interest rates very low, so the cost of servicing the debt is much lower than the size of the debt suggests, and crowding out is limited. Inflation is also unlikely, because Italy faced very low inflation and even deflation in this period and does not control its money supply.

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Who owns the debt matters. A large share of Italy's debt is held by domestic investors such as Italian banks and households, so interest payments stay within the economy and there is less risk of sudden capital flight. Japan shows that a very high debt (over 200% of GDP) can be sustainable when it is domestically owned in the country's own currency.

The key factor is the relationship between growth and interest rates. If nominal GDP grows faster than the interest rate on the debt, and the government runs a primary surplus, the debt-to-GDP ratio will fall over time. Italy has run a primary surplus in most years, but its growth has been very weak, with real GDP in 2017 still below its 2008 level, so the ratio has not fallen.

In conclusion, an increase in national debt is not always a cause for concern: in the short run, cyclical borrowing to support an economy in recession is sensible. However, for Italy the increase is a serious concern, because the debt is already very high at 132% of GDP, growth is weak, it cannot devalue or set its own interest rates, and it is vulnerable to a rise in bond yields if ECB support ends. The concern is greatest when debt is high, growth is slow and the debt is held by foreign investors, so the most important factor is whether the economy can grow fast enough to stabilise the debt ratio.

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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** ☒

The current account of the balance of payments records the trade in goods, trade in services, primary income (eg investment income and wages) and secondary income (current transfers such as remittances and aid) between a country and the rest of the world. A current account deficit occurs when total outflows are greater than total inflows, mostly when the value of imports exceeds the value of exports. I will refer to Turkey, which had a deficit of $47.1 billion in 2017, around 5.5% of its GDP, compared with France's $36.8 billion, which was under 2% of its much larger GDP.

Firstly, rapid economic growth. In 2017 Turkey's real GDP grew by over 7%, boosted by a government credit guarantee scheme and cheap borrowing. As incomes rise, consumers spend more, and with a high marginal propensity to import much of this spending goes on imported goods such as cars and electronics. Firms also import machinery and components to meet the extra demand. So imports rise faster than exports, widening the deficit. This is a cyclical cause.

Secondly, dependence on imported energy and intermediate goods. Turkey imports nearly all of its oil and gas, so its energy import bill is very large. Demand for energy is price inelastic, so when world oil prices rose in 2017 the value of imports increased. Many Turkish exports also rely on imported components, so even when exports grow, imports grow with them.

Thirdly, high relative inflation and a loss of price competitiveness. Turkish inflation was around 11% in 2017, much higher than in its main trading partners in the EU. If the exchange rate does not fall by the same amount, the real exchange rate appreciates, so Turkish exports become

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relatively more expensive and imports relatively cheaper. Exports are less competitive, demand for them falls, and the trade deficit widens. An overvalued currency has the same effect.

Fourthly, low productivity and low investment in human capital and technology. If unit labour costs are high relative to competitors, firms cannot compete on price or quality, so a country exports low-value goods and imports high-value ones. This is more relevant to France, where high unit labour costs and the loss of manufacturing to lower-cost countries have caused persistent deficits. This is a structural cause.

Fifthly, low domestic savings. Since the current account balance equals national savings minus investment, a country with a low savings rate, like Turkey, must borrow from abroad to fund investment, which appears as a current account deficit financed by capital inflows.

Other causes include a fall in demand from trading partners (eg slow growth in the eurozone reduces demand for Turkish exports), a fall in service exports (Turkey's tourism revenue fell sharply in 2016 after security problems and a dispute with Russia), protectionism by trading partners, and large outflows of primary income, such as interest and profits paid to foreign investors.

Evaluation. The importance of each cause differs between countries. For Turkey the main causes in 2017 were cyclical, rapid credit-fuelled growth plus energy imports, whereas for France the deficit is mainly structural, reflecting weak competitiveness. This matters, because a cyclical deficit is likely to be short-term: when Turkey's growth slowed and the lira depreciated sharply in 2018, imports fell and the deficit narrowed rapidly, and the current account was close to balance by 2019.

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The effect of growth depends on the marginal propensity to import. If it is high, as in Turkey, a rise in income has a large effect on imports; if it is low, growth causes only a small deficit.

Inflation only reduces competitiveness if it is higher than in trading partners and is not offset by a depreciation. Turkey's lira depreciated against the euro over this period, which partly offset the higher inflation, so price competitiveness may have fallen by less than the inflation gap suggests. Non-price factors such as quality and design also matter.

Some causes are outside the government's control, such as oil prices and growth in the eurozone, whereas others, such as low productivity, can be addressed with supply-side policies, but only in the long run. Trends may also change: some firms are reshoring as costs rise in East Asia.

The data is also limited. The figures are for one year only and in absolute terms; as a share of GDP, Turkey's deficit is about three times larger than France's, so the absolute figures make France's deficit look more serious than it is.

In conclusion, a current account deficit usually has several causes at once. For Turkey, the most important cause was the rapid growth of domestic demand combined with a high marginal propensity to import and dependence on imported energy, with high inflation as a secondary factor. Because these causes are mainly cyclical, the deficit was likely to fall when growth slowed, as it did. In contrast, deficits caused by low productivity, as in France, are harder to correct and more persistent, so the cause of the deficit determines how long it lasts and how serious it is.

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TOTAL FOR SECTION C = 40 MARKS
TOTAL FOR PAPER = 80 MARKS

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Time: 2 hours | Paper Reference **WEC14/01**

Economics

International Advanced Level
Unit 4: Developments in the global economy

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Sources for use with Section B.

The economy of Mauritius

Figure 1 Number of tourist arrivals, 2012–2017 (millions)

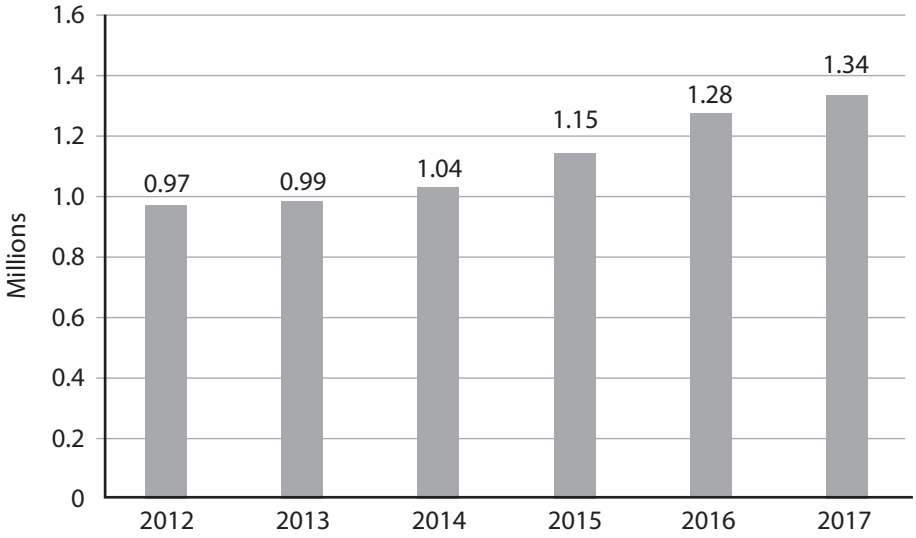
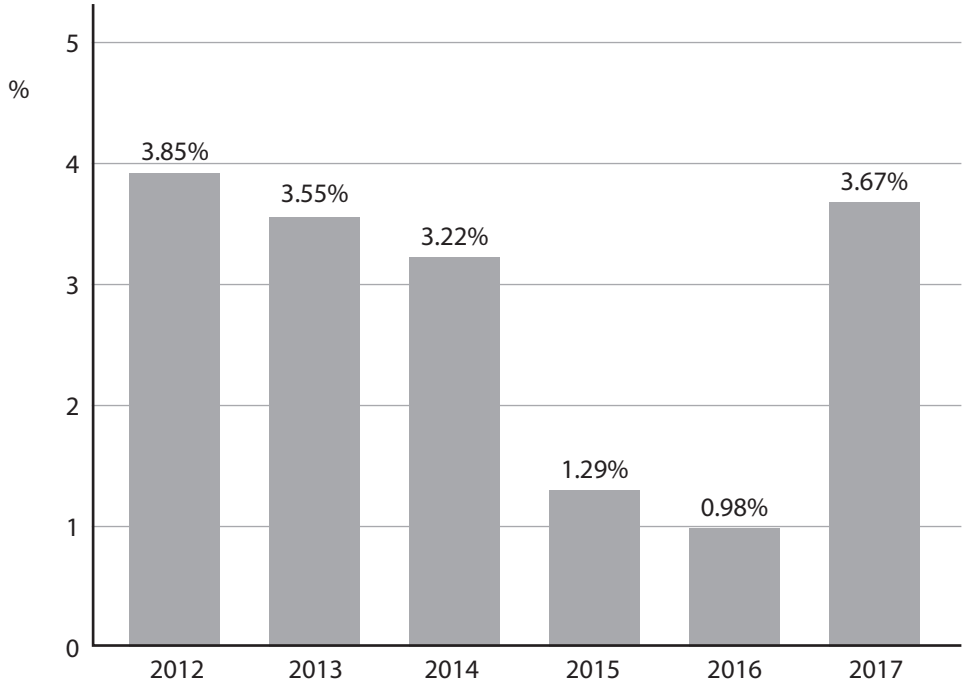


Figure 2 Annual inflation rate as measured by the Consumer Price Index, 2012–2017



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Extract A Economic growth

Mauritius' economy has continued to grow steadily. Real GDP growth rose from 3.3% in 2013 to 3.9% in 2017. This was mainly a result of significant growth in the tourism sector. Earnings from tourism exceeded $1 billion. The Government aims to further develop this sector and expects it to grow by an average of 6% every year between 2018 and 2023. Tourism contributes nearly 7% of Mauritius' GDP.

The country's economic growth was also supported by the Bank of Mauritius' reflationary monetary policy. Mauritius experienced low inflationary pressures in 2015 and 2016. This was as a result of falling global commodity and food prices. In 2017 the Bank reduced the base interest rate from 4% to 3.5%.

Public expenditure increased from 25.1% of GDP in 2016 to 25.4% of GDP in 2017. This was caused by a rise in government expenditure on public sector wages and major infrastructure projects. Over the same time period, total tax revenues increased from 21.7% of GDP to 22.5% of GDP. Higher tax revenue was received from income tax, corporation tax and indirect taxes. Consequently, there was a reduction in the fiscal deficit.

Extract B The private sector

Mauritius' private sector consists of large companies as well as many small and medium-sized enterprises (SMEs). In 2017 SMEs contributed 40% of the country's GDP and employed 55% of the country's workforce.

The private sector has the potential to grow further but a number of problems need to be addressed. The Government needs to reduce the economy's skills mismatch, increase innovation and reduce bureaucracy. It also needs to make significant improvements in the country's infrastructure.

The private sector in Mauritius suffers from a shortage of highly qualified labour. This is mainly as a result of insufficient skills and training. Innovation remains inadequate because there is a shortage of scientists and engineers. There is also a lack of finance to fund research and development.

The Government has identified several infrastructure projects for improving the country's power sources, water supply, transport and telecommunications. Financing of these infrastructure developments remains a key issue because the country has relatively high levels of public sector debt.

However, Mauritius continues to be amongst the most business-friendly countries in the region. There was a significant improvement in Mauritius' position on the World Bank's *Doing Business* index in 2018. This was as a result of substantial reforms under three indicators: starting a business, dealing with construction permits and registering property.

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Acknowledgements

Figure 1 based on data taken from https://www.statista.com/statistics/801358/tourist-arrivals-mauritius/;
Figure 2 based on data taken from https://www.statista.com/statistics/729017/inflation-rate-in-mauritius/
Extracts A and B adapted from https://www.afdb.org/fileadmin/uploads/afdb/Documents/Generic-Documents/country_notes/Mauritius_country_note.pdf

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