Please check the examination details below before entering your candidate information

Candidate surname: StemUp Model Solution

Other names:

Centre Number | Candidate Number

Pearson Edexcel International Advanced Level

Wednesday 25 October 2023

Afternoon (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 Sections A and 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 ▶

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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 Which **one** of the following is a *non-economic* factor that might constrain the rate of economic growth and economic development of a country?

- ☒ **A** A poorly educated workforce
- ☒ **B** Volatile commodity prices
- ☒ **C** Capital flight
- ☒ **D** High levels of corruption

(Total for Question 1 = 1 mark)

2 In 2021 the UK experienced a fall in labour productivity. It remained below the average labour productivity of its main trading partners.

Ceteris paribus, which **one** of the following can be deduced from this statement?

- ☒ **A** UK goods and services were less internationally competitive than those of its trading partners
- ☒ **B** Average export prices of UK goods and services were lower than the average export prices of its trading partners
- ☒ **C** Unit labour costs in the UK were the same as the average unit labour costs of its trading partners
- ☒ **D** The UK experienced a significant deterioration in its terms of trade

(Total for Question 2 = 1 mark)

3 In 2020 Japan's central bank, the Bank of Japan, increased its reserve asset (liquidity) requirements for commercial banks.

Ceteris paribus, which **one** of the following is the most likely effect of this decision?

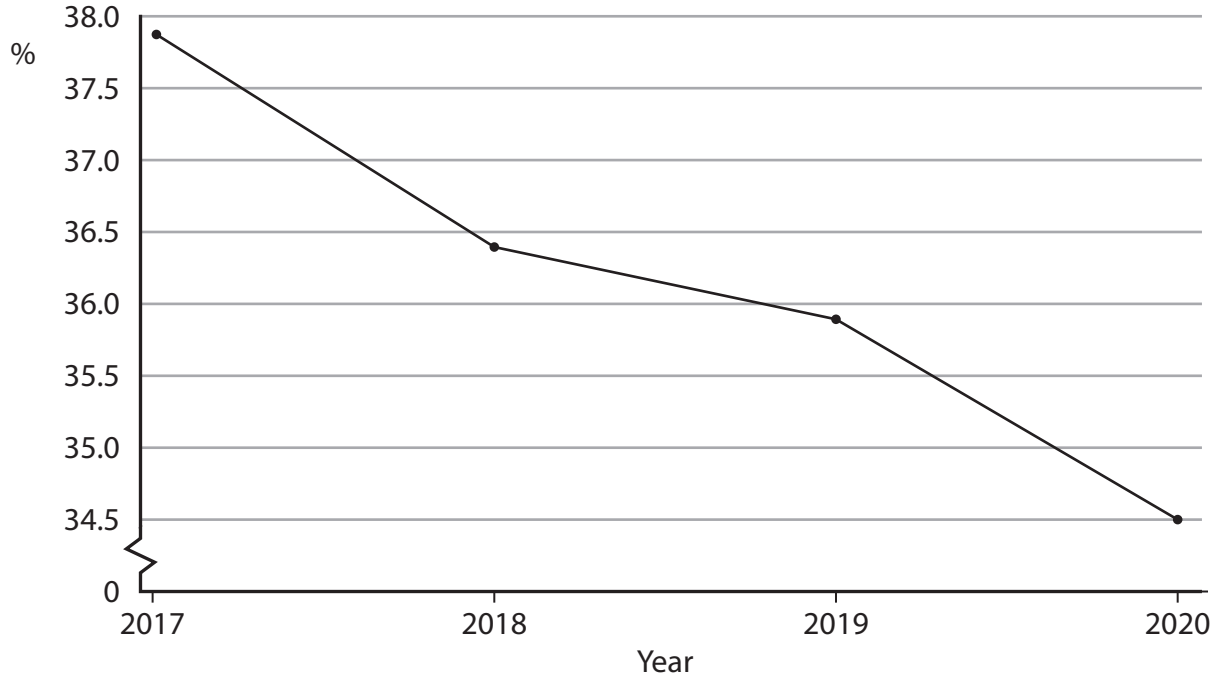
- ☒ **A** An increase in the money supply
- ☒ **B** An increase in the level of real output
- ☒ **C** A decrease in the rate of inflation
- ☒ **D** A decrease in the rate of unemployment

(Total for Question 3 = 1 mark)

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4 The chart shows Georgia's Gini coefficient, expressed as a percentage, between 2017 and 2020.



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

- ☒ **A** The distribution of income became more unequal
- ☒ **B** Georgia experienced perfect income equality
- ☒ **C** Income inequality increased by 3.4%
- ☒ **D** Georgia's Lorenz curve shifted closer to the line of perfect equality

(Total for Question 4 = 1 mark)

5 In 2022 Madagascar had an absolute poverty rate of 71%.

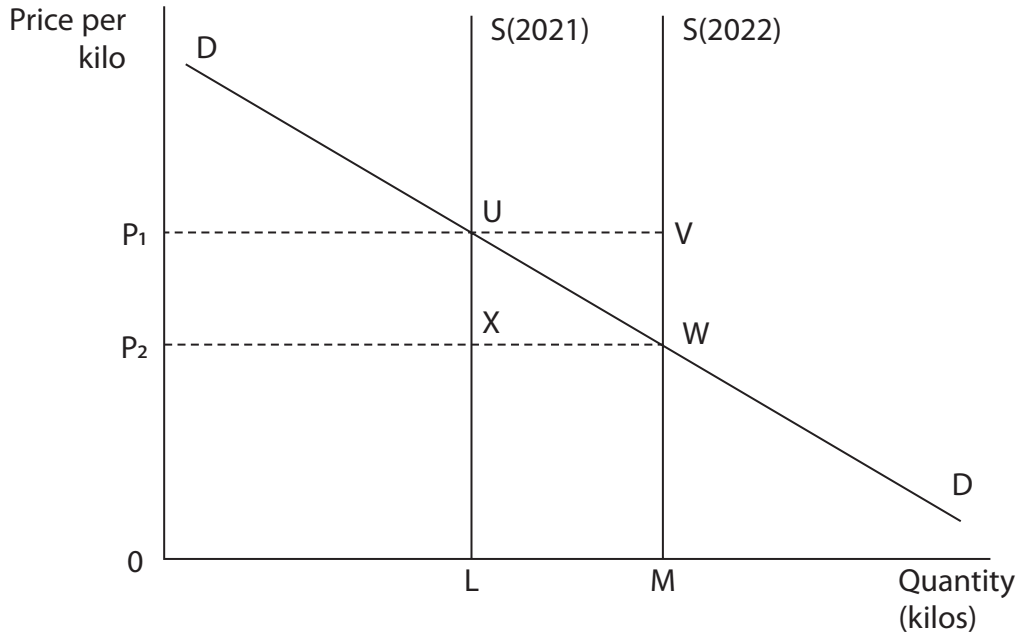
Which **one** of the following statements about absolute poverty is true?

- ☒ **A** Absolute poverty is the inability of individuals or groups to meet their basic needs
- ☒ **B** Absolute poverty is based on value judgements and is subject to changes over time
- ☒ **C** Absolute poverty measures the percentage of people within a country earning less than 60% of median income
- ☒ **D** Absolute poverty measures the percentage of people earning more than $2.15 a day at 2017 PPP values

(Total for Question 5 = 1 mark)

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6 The graph shows the market for rice in Indonesia. The Government guarantees a minimum support price of P_1 and operates a buffer stock scheme. Between 2021 and 2022 output of rice increased from 0L to 0M.



Which **one** of the following areas would be the government expenditure on the buffer stock scheme?

- ☒ **A** UVWX
- ☒ **B** UVML
- ☒ **C** P_2P_1UX
- ☒ **D** P_2P_1VW

(Total for Question 6 = 1 mark)

TOTAL FOR SECTION A = 6 MARKS

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SECTION B

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

7 (a) In 2021, the Government of Pakistan made a debt servicing payment of $32.27 billion.

With reference to Figure 1, calculate debt servicing payments as a proportion of national debt in 2021. You are advised to show your working.

(2)

(b) Explain what is meant by a 'foreign currency gap' (Extract A, line 13).

(4)

(c) With reference to Figure 2 and the first paragraph of Extract A, examine **two** likely effects of the depreciation of the rupee against the US dollar.

(8)

(d) With reference to Extract A, analyse **two** roles of the IMF.

(6)

(e) With reference to the information provided and your own knowledge, discuss the likely macroeconomic effects of an increase in income tax rates, aimed at high-income households, on the economy of Pakistan.

(14)

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(a) In 2021, the Government of Pakistan made a debt servicing payment of $32.27 billion.

With reference to Figure 1, calculate debt servicing payments as a proportion of national debt in 2021. You are advised to show your working.

(2)

National debt in 2021 = $145.25 billion (Figure 1)

Debt servicing as a proportion = ($32.27 billion ÷ $145.25 billion) × 100

= 22.22% of national debt

(b) Explain what is meant by a 'foreign currency gap' (Extract A, line 13).

(4)

A foreign currency gap occurs when a country's inflows of foreign currency (from exports, investment and borrowing) are less than its outflows of foreign currency (for imports and debt servicing). It means the country lacks the foreign exchange reserves needed to finance a current account deficit and to buy the imported capital goods needed for economic growth and development.

In Pakistan foreign currency reserves fell from $16 billion in June 2021 to $10 billion in June 2022, a fall of $6 billion or 37.5% ((6 ÷ 16) × 100). The SBP warned that the gap would reduce Pakistan's ability to import and would widen further because of higher debt servicing payments, so it suggested a temporary ban on imports of non-essential goods.

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(c) With reference to Figure 2 and the first paragraph of Extract A, examine **two** likely effects of the depreciation of the rupee against the US dollar.

(8)

Figure 2 shows the rupee depreciated from about Rs 175 per US$1 in January 2022 to about Rs 205 per US$1 in June 2022, so the number of rupees needed to buy one dollar rose by about Rs 30, or 17% ((30 ÷ 175) × 100). Extract A says this was mainly due to rising global inflation and the strong appreciation of the US dollar.

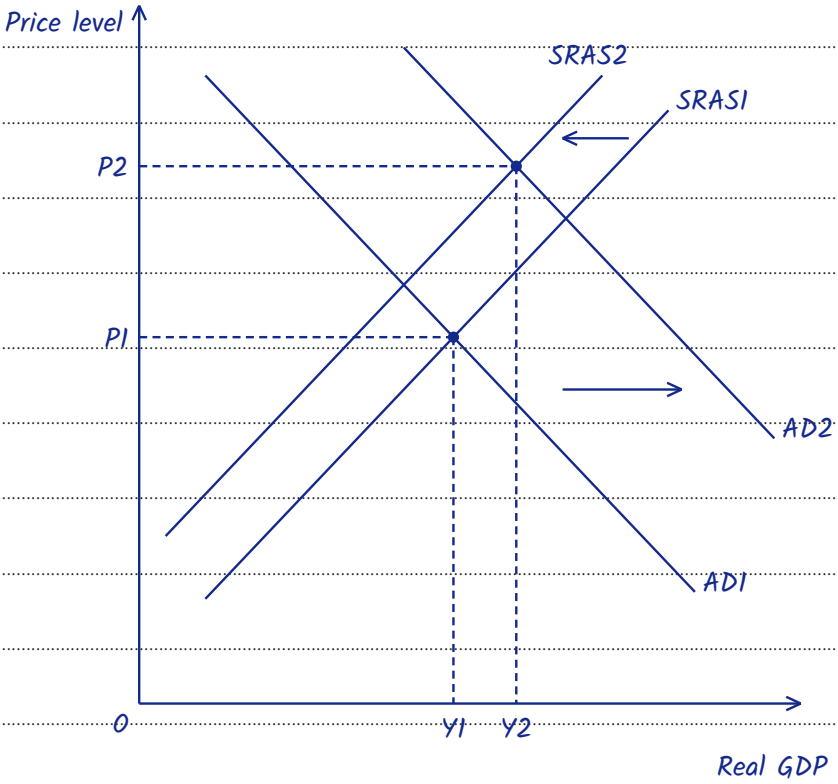
Effect 1: the current account of the balance of payments is likely to improve. Pakistan's exports, such as textiles, become cheaper in dollar terms, so they are more price competitive and export volumes rise. Imports become more expensive in rupees, so Pakistani households and firms buy fewer imports. Net exports rise, which reduces the current account deficit and helps to close the foreign currency gap.

However, this depends on price elasticities. Under the Marshall-Lerner condition the current account only improves if the sum of the price elasticities of demand for exports and imports is greater than one. In the short run demand is inelastic because contracts are fixed and many imports such as oil are essential, so the deficit may first get worse before it improves, following a J-curve.

Effect 2: inflation is likely to rise. Pakistan imports most of its oil, so import prices in rupees rise, raising firms' costs of production. SRAS shifts left from SRAS1 to SRAS2 (cost-push inflation). Higher net exports also shift AD right from AD1 to AD2 (demand-pull inflation), so the price level rises from P1 to P2.

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The magnitude of the effect is likely to be significant because a 17% depreciation in six months is large. However, the effect may be short term: the rupee peaked at about Rs 211 per US$1 and economists expected its external value to rise again in the third quarter of 2022, so firms may not change their trading plans.

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(d) With reference to Extract A, analyse **two** roles of the IMF.

(6)

Role 1: to provide temporary financial assistance to countries with balance of payments problems. The IMF lends foreign currency to member countries that cannot finance a current account deficit or that are running out of reserves. Pakistan borrowed $1.2 billion from the IMF to prevent a further fall in its foreign currency reserves. This means Pakistan can keep paying for essential imports such as fuel and meet its debt servicing payments, which reduces the risk of default and of an economic collapse, and Extract A says the loan helped reduce the current account deficit and finance the national debt.

Role 2: to promote exchange rate stability and sound economic policy through policy advice and conditions attached to loans. The IMF required Pakistan to reduce its fiscal deficit, partly by removing fuel and energy subsidies, and required the State Bank of Pakistan to raise its base rate of interest to stabilise the rupee. A higher interest rate attracts hot money inflows into Pakistan, which increases the demand for rupees and stops the currency depreciating further. A smaller fiscal deficit restores the confidence of investors and lenders, so the economy becomes more stable in the long run and Pakistan is able to repay its debts.

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(e) With reference to the information provided and your own knowledge, discuss the likely macroeconomic effects of an increase in income tax rates, aimed at high-income households, on the economy of Pakistan.

(14)

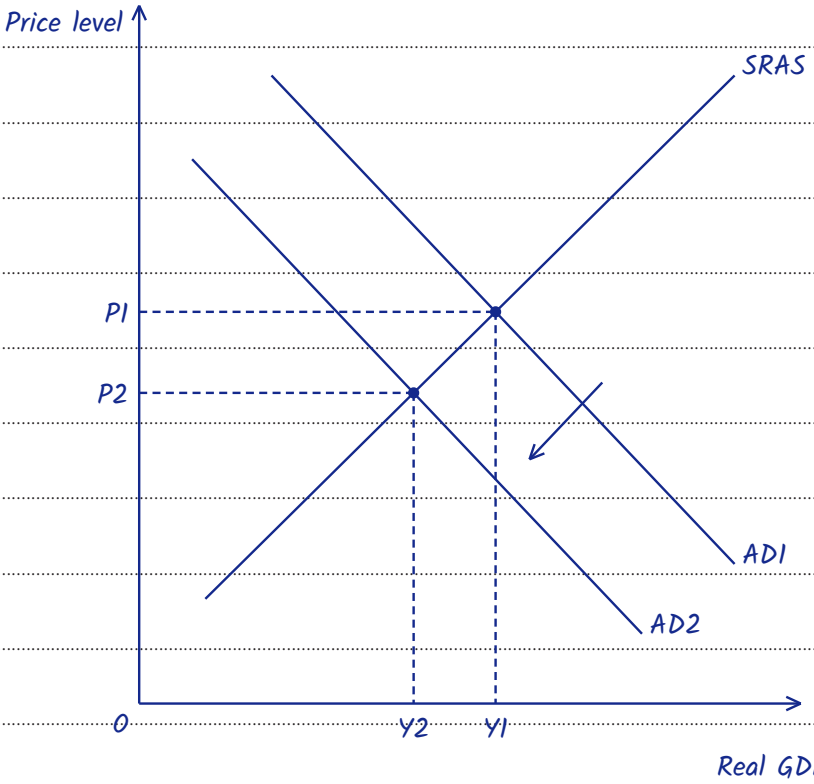
Income tax is a direct tax on the income of individuals. Raising the rates paid by high-income households makes the tax system more progressive, so the rich pay a higher proportion of their income in tax. Extract A says the IMF proposed that high-income households should pay significantly more income tax because Pakistan collects very little revenue from direct taxes.

Effect on public finances. If the higher rates raise more revenue, the fiscal deficit falls, meeting the IMF loan conditions. Less government borrowing slows the growth of the national debt, which rose from $89.90 billion in 2018 to $179.49 billion in 2022 (Figure 1), so debt servicing payments, already 22.22% of the debt in 2021, become more affordable and confidence in Pakistan rises.

Effect on AD, growth, unemployment and inflation. Higher income tax reduces the disposable income of high-income households, so consumption falls. AD shifts left from AD1 to AD2 and, via the negative multiplier, real GDP falls from Y1 to Y2, so economic growth slows and unemployment may rise. However, the price level falls from P1 to P2, which reduces the demand-pull inflation caused by the depreciation of the rupee.

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Effect on the current account and inequality. High-income households buy many imported goods such as cars and electronics, so lower disposable income reduces imports, which improves the current account and narrows the foreign currency gap. If the extra revenue is spent on transfers or public services for low-income households, the distribution of income becomes more equal and the Gini coefficient falls.

Effect on incentives and FDI. Higher marginal tax rates may reduce the incentive for high earners to work longer hours, seek promotion or start businesses, reducing LRAS. Skilled workers and managers of TNCs may move abroad, reducing inward FDI and causing a brain drain.

Evaluation. First, the effect on revenue is uncertain. The Laffer curve suggests that if tax rates rise above the optimal rate, revenue falls because of disincentives, tax avoidance and tax evasion. In Pakistan only a small proportion of people pay income tax and much income is earned in the informal economy, so weak tax collection may mean little extra revenue is raised and few people are affected.

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Second, the fall in AD may be small. High-income households have a low marginal propensity to consume, so they may pay the higher tax out of savings rather than cutting spending, and the multiplier effect will be small. The effects also depend on the size of the increase and on how the Government spends the revenue: if it is spent on infrastructure, AD and LRAS could both rise.

Third, income tax may not be the best tool. Extract A shows that owners of houses worth between $0.5 million and $2 million pay only a small proportion as tax, so a property tax could raise more revenue with fewer disincentive effects, as property cannot move abroad.

Overall, the main effect is likely to be an improvement in the public finances and a more equal distribution of income, with only a small fall in growth because the rich have a low MPC. However, the size of the benefit depends mostly on whether Pakistan can enforce collection, so it should be combined with property taxes.

(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 2000 and 2020, Gibraltar's terms of trade worsened by 44.6% and Greece's terms of trade worsened by 14.3%.

Evaluate factors that might cause a country's terms of trade to worsen.

(Total for Question 8 = 20 marks)

9 In 2021 it was estimated that a large proportion of the fiscal deficits in both Brazil and Suriname was structural.

To what extent is a structural fiscal deficit more serious than a cyclical fiscal deficit? Refer to a developing country of your choice in your answer.

(Total for Question 9 = 20 marks)

10 In the first quarter of 2022 the USA and Australia both experienced inflows of foreign direct investment (FDI) of $67 billion and $59 billion respectively.

Evaluate the potential economic benefits to a developed country of FDI inflows.

(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 22.

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

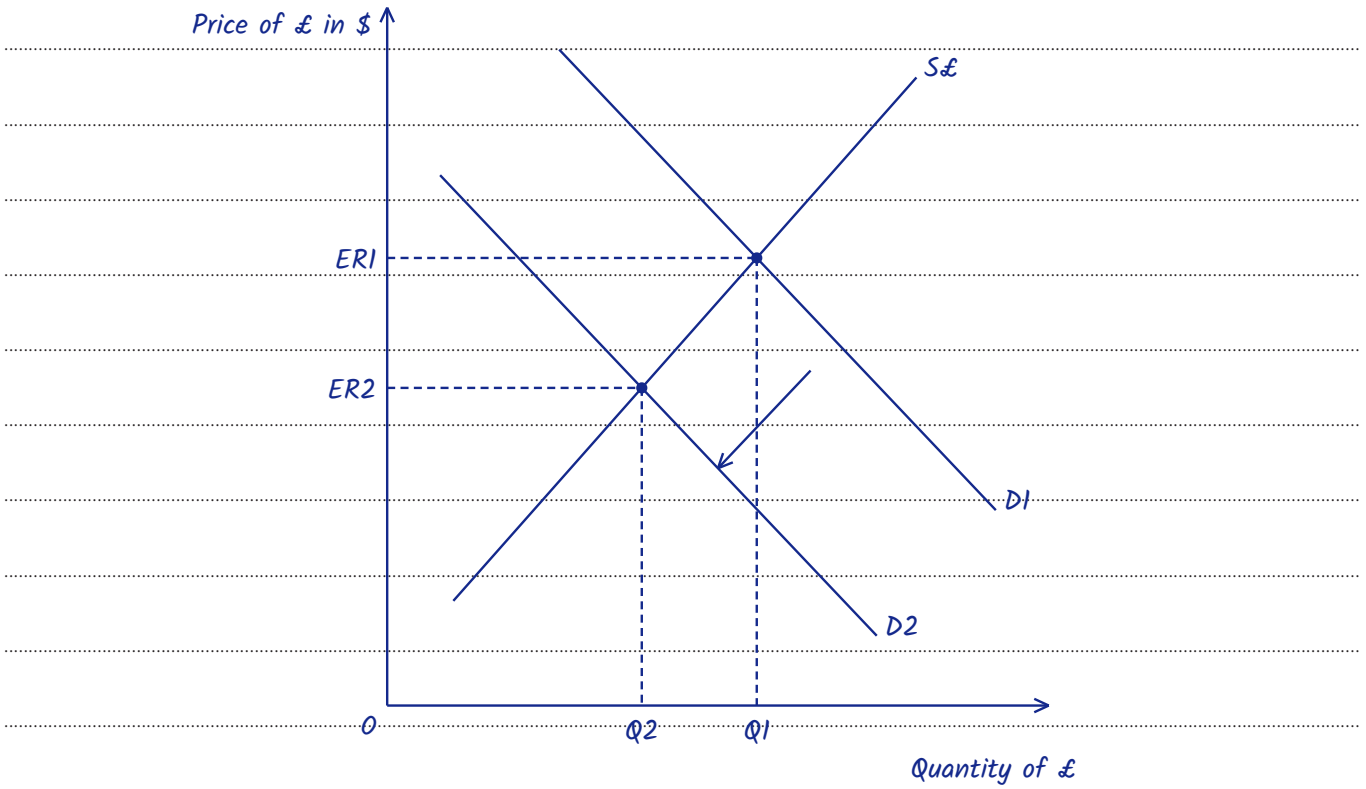
The terms of trade measure the average price of a country's exports relative to the average price of its imports: (index of average export prices ÷ index of average import prices) × 100. A worsening (deterioration) means the index falls, so a given quantity of exports buys fewer imports. Between 2000 and 2020 Gibraltar's terms of trade worsened by 44.6%, about three times as much as Greece's 14.3%, so each unit of Gibraltar's exports now buys only about 55% of the imports it bought in 2000.

Factor 1: depreciation of the exchange rate. If a currency depreciates, export prices in foreign currency fall and import prices in domestic currency rise, so the terms of trade worsen. Gibraltar uses the Gibraltar pound, which is fixed at par with sterling. Sterling depreciated sharply after the 2008 financial crisis and again after the 2016 Brexit referendum. Lower demand for pounds, for example as hot money left the UK when interest rates were cut and confidence fell, shifted demand from D1 to D2, so the exchange rate fell from ER1 to ER2. As Gibraltar imports almost all its goods, including food and fuel, its import prices rose sharply.

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Factor 2: lower relative inflation and labour costs. If a country's inflation rate, wage costs or unit labour costs rise more slowly than those of its trading partners, its export prices fall relative to import prices. Greece is in the eurozone so it could not devalue after its debt crisis began in 2010. Instead it went through an internal devaluation: wages and public spending were cut, unemployment rose above 25% and prices grew more slowly than in other eurozone countries, so Greek export prices fell relative to import prices.

Factor 3: changes in world commodity prices. A fall in the price of a commodity that a country exports, or a rise in the price of a commodity it imports, worsens its terms of trade. Both Greece and Gibraltar are net importers of oil. World oil prices rose from under $30 a barrel in 2000 to over $100 for much of 2011 to 2014, raising their import prices and worsening their terms of trade.

Factor 4: higher relative productivity and more competition in export markets. Investment in new capital and technology reduces unit costs, so firms can cut export prices. Rising competition in a

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country's export markets, for example Greek tourism competing with lower-cost Turkey, forces exporters to cut prices. Protectionism can also matter: a tariff imposed by the country itself raises the price of its imports, worsening its terms of trade.

Evaluation. First, the most significant factor depends on the country. For Gibraltar, a small, very open economy that imports nearly everything, the depreciation of sterling and higher import prices for fuel and food are likely to be the most important, which explains why its worsening was much larger than Greece's. For Greece, lower relative inflation and wages during the eurozone crisis are more important, since its exchange rate against its main trading partners in the eurozone could not change.

Second, different factors matter in different time periods. Exchange rates and commodity prices are volatile and can quickly reverse: oil prices fell sharply in 2014 and 2020, which would have improved the terms of trade of oil importers. Over a 20-year period, long-run factors such as relative productivity and the type of goods and services a country specialises in are more significant than short-run swings. The data only compares 2000 and 2020, so it hides large changes in between.

Third, the cause matters more than the size of the change. A worsening caused by higher productivity or lower relative costs makes exports more price competitive, so if demand for exports is price elastic, export volumes and revenue rise and the current account can improve. A worsening caused by higher commodity import prices has no such benefit, because demand for oil and food is price inelastic, so the import bill rises and living standards fall. The importance of labour costs also depends on whether a country exports labour-intensive services, such as Greek tourism, or capital-intensive goods.

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Finally, it is likely to be a combination of factors. In Greece, lower wages and higher oil prices both worked in the same direction, and in Gibraltar a weaker currency raised import prices at the same time as world fuel prices rose. Retaliation by trading partners can also quickly reverse any change caused by protectionism.

In conclusion, the most significant factor is the one that affects the largest share of a country's trade: import prices driven by the exchange rate and commodity prices for an import-dependent economy like Gibraltar, and relative inflation and labour costs for a eurozone member like Greece. Whether the worsening is harmful depends on its cause and on the price elasticities of demand for exports and imports.

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Write the answer to your SECOND chosen question here

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

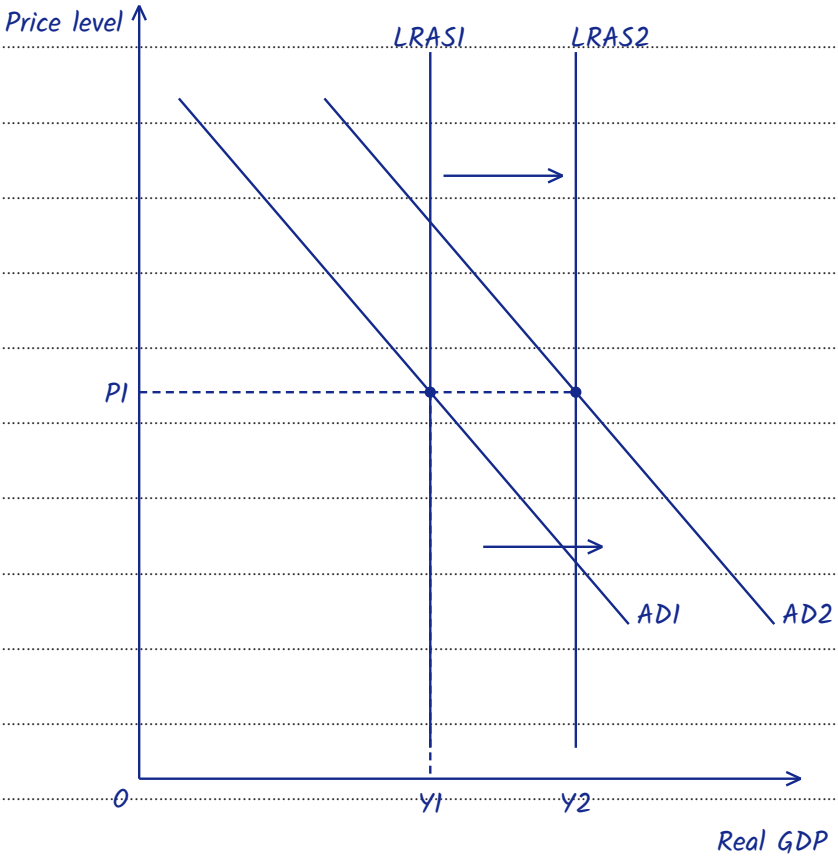
Foreign direct investment (FDI) is investment by a firm based in one country, usually a transnational company (TNC), in productive assets in another country, either by building new facilities (greenfield investment) or by buying a controlling stake in a domestic firm (mergers and acquisitions). In the first quarter of 2022 FDI inflows were $67 billion into the USA and $59 billion into Australia.

Benefit 1: higher economic growth and employment. FDI is an injection into the circular flow and raises investment (I), a component of aggregate demand. AD shifts right from AD1 to AD2 and, through the multiplier effect, real GDP rises by more than the initial investment. Because the demand for labour is derived from the demand for output, TNCs hire workers and their suppliers expand, so unemployment falls. New factories and equipment also increase the productive capacity of the economy, so LRAS shifts right from LRAS1 to LRAS2, allowing non-inflationary growth: real GDP rises from Y1 to Y2 while the price level stays at about P1.

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Benefit 2: higher productivity through technology transfer. TNCs bring new technology, management methods and working practices, and often train workers. These skills and ideas spread to domestic suppliers and to competitors as workers move between firms, so labour productivity and international competitiveness rise. FDI can also bring cleaner technology, reducing negative externalities.

Benefit 3: the balance of payments and public finances. FDI is an inflow on the financial account, which helps to finance a current account deficit. This is important for the USA, which runs a large and persistent current account deficit. If TNCs use the host country as an export base, exports rise and the current account improves in the long run. TNCs also pay corporation tax, and their workers pay income tax, so government revenue rises without higher tax rates, helping to reduce the fiscal deficit.

Evaluation. First, the size of the benefit depends on FDI relative to the size of the economy. US

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GDP is more than ten times larger than Australia's, so although the USA received $8 billion more FDI, the $59 billion inflow is far more significant for Australia as a proportion of GDP and is likely to have a larger effect on its growth.

Second, the type of FDI matters. In developed countries much FDI takes the form of mergers and acquisitions, which change the ownership of existing firms rather than creating new capacity, so there may be little increase in LRAS or employment, and jobs may even be lost as the new owner cuts costs. Developed countries already have advanced technology and skilled workers, so technology transfer is smaller than in developing countries.

Third, there are costs in the long run. TNCs repatriate profits and dividends to their home country, which is an outflow on the primary income account of the current account. TNCs may use transfer pricing to declare profits in low-tax countries, so tax revenue rises less than expected. TNCs are footloose and may withdraw if costs rise, causing sudden unemployment. In Australia, much FDI goes into mining, which is capital intensive, creates few jobs and may cause environmental damage.

Fourth, the effect on growth depends on spare capacity and the multiplier. If the economy is close to full capacity, as the USA was in 2022 with unemployment below 4% and high inflation, extra AD mainly raises prices unless LRAS also increases. Net FDI (inflows minus outflows) also matters, since US firms invest heavily abroad.

In conclusion, FDI inflows can bring significant benefits to a developed country through higher investment, productivity and financing for current account deficits. The benefits are likely to be greatest for a smaller economy like Australia, where the inflow is large relative to GDP, and when the FDI is greenfield investment that adds new capacity. The overall benefit depends on

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the type of investment, how long TNCs stay and how much profit is repatriated.

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TOTAL FOR PAPER = 80 MARKS

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Wednesday 25 October 2023

Afternoon (Time: 2 hours)

Paper reference **WEC14/01**

Economics

International Advanced Level

UNIT 4: Developments in the global economy

Source Booklet

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Sources for use with Section B

The economy of Pakistan

Figure 1 National debt, $ billions, 2018-2022

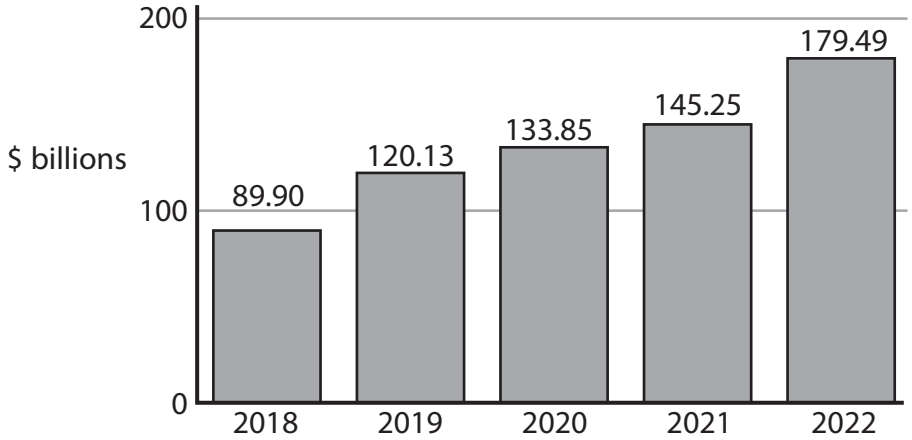
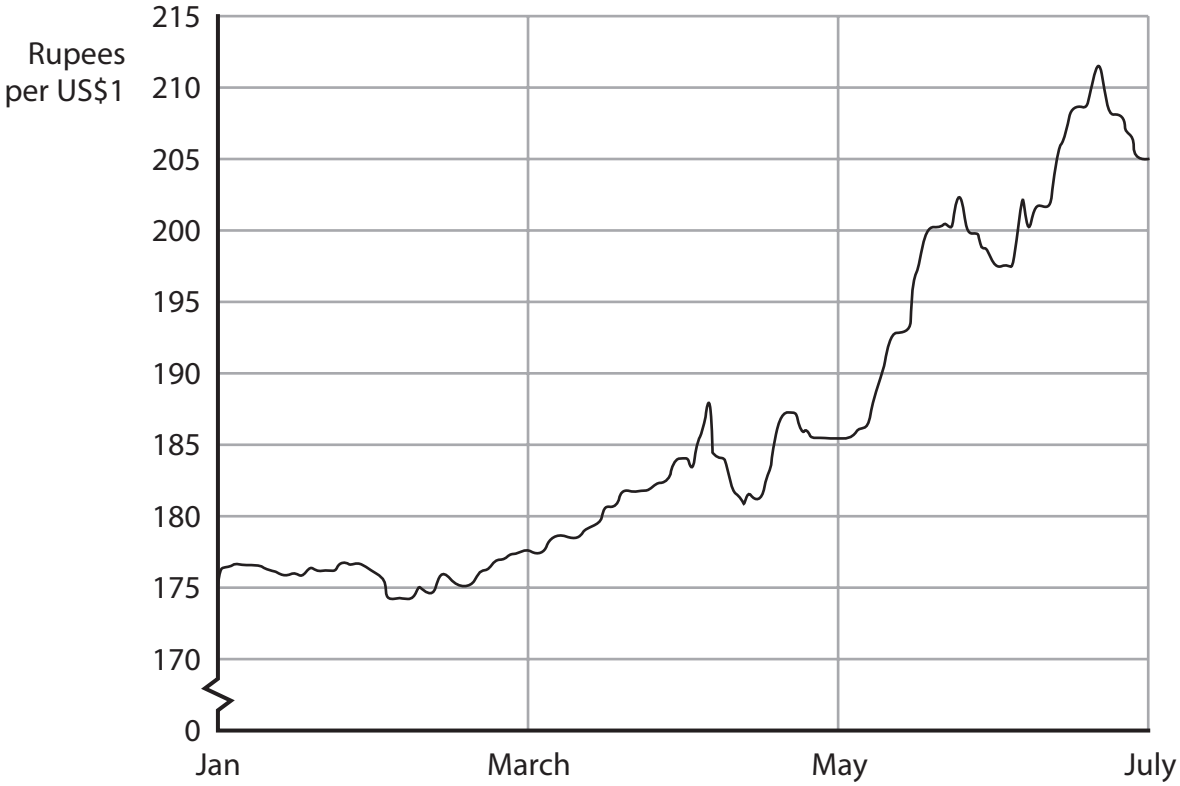


Figure 2 Rupee-US dollar exchange rate, January 2022 to June 2022



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Extract A Economic outlook

Between January and June 2022 Pakistan's currency, the rupee, depreciated against the US dollar. This was mainly as a result of rising global inflation rates and the strong appreciation of the US dollar. However, economists expected the external value of the rupee to increase against the US dollar in the third quarter of 2022. They anticipated that the dollars earned by Pakistan from its exports would be greater than the dollars paid for its imports and debt servicing.

Pakistan experienced a significant decline in foreign currency reserves from $16 billion in June 2021 to $10 billion in June 2022. Many economists believed that the economy could be on the verge of an economic collapse in the third quarter of 2022.

In June 2022, Pakistan's central bank, the State Bank of Pakistan (SBP), informed Pakistan's Government that the country's rising foreign currency gap would have a negative impact on its ability to import. The SBP claimed that the rising foreign currency gap was likely to increase further because of higher debt servicing payments. To prevent these reserves from running out, the SBP suggested a temporary ban on the import of non-essential goods.

Pakistan's Government borrowed $1.2 billion from the IMF to prevent a further fall in foreign currency reserves. This financial support enabled the Government to reduce its current account deficit of the balance of payments and to help finance the country's national debt.

The loan from the IMF required the Government of Pakistan to meet certain conditions. These included a reduction in the fiscal deficit, partly by the removal of fuel and energy subsidies. The IMF also required Pakistan's central bank to raise its base rate of interest to stabilise the rupee.

Previous governments of Pakistan have not always met the terms of their loan agreements with the IMF. For example, the fiscal deficit has not been reduced significantly because the government collects very little revenue from direct taxes, especially from the booming property market. Large houses cost anywhere between $500 000 and $2 million to purchase but the owners only pay a small proportion as tax. The IMF proposed that high-income households should pay significantly more income tax than low-income and middle-income households.

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Acknowledgements

Figure 1 from:
https://www.statista.com/statistics/531850/national-debt-of-pakistan/

Figure 2 adapted from:
Trading economics, https://tradingeconomics.com/pakistan/currency

Extract A adapted from:
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