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

Monday 13 January 2020

Afternoon (Time: 1 hour 45 minutes) | Paper Reference **WEC12/01**

Economics

International Advanced Subsidiary
Unit 2: Macroeconomic performance and policy

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, B and C.
- Answer **ONE** question in Section D.
- 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 Mongolia experiences higher unemployment in the winter when the demand for agricultural labour is lower than in the summer months.

Which **one** of the following best describes the cause of unemployment experienced in Mongolia?

- ☒ **A** Seasonal unemployment
- ☒ **B** Real wage inflexibility
- ☒ **C** Structural unemployment
- ☒ **D** Demand deficiency

(Total for Question 1 = 1 mark)

2 The table shows the number of people in employment in Jordan.

	Number of people in employment
January 2017	10 279 000
January 2018	9 353 000

(Source: https://tradingeconomics.com/jordan/employed-persons)

What is the percentage change in the number of people in employment between January 2017 and January 2018?

- ☒ **A** –10%
- ☒ **B** –9%
- ☒ **C** 9%
- ☒ **D** 10%

(Total for Question 2 = 1 mark)

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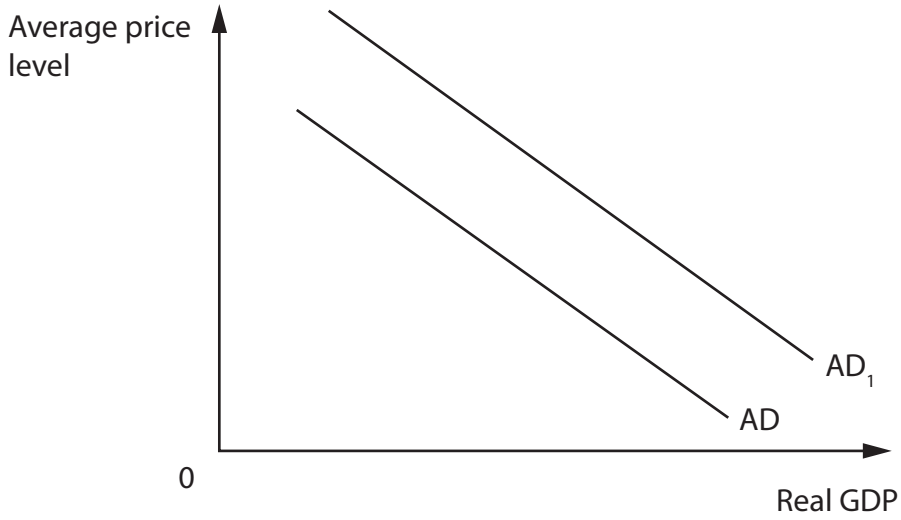
3 In 2017 Uzbekistan experienced an 8% increase in real GDP.

Which **one** of the following is most likely to be a benefit of economic growth?

- ☒ **A** Environmental damage
- ☒ **B** Improved public services
- ☒ **C** A negative output gap
- ☒ **D** A decrease in tax revenues

(Total for Question 3 = 1 mark)

4 The diagram shows a shift in the aggregate demand curve for an economy.



Which of the following combinations was the most likely cause of the change from AD to AD_1?

		Interest rate	Exchange rate
☒	**A**	Rise	Fall
☒	**B**	Rise	Rise
☒	**C**	Fall	Fall
☒	**D**	Fall	Rise

(Total for Question 4 = 1 mark)

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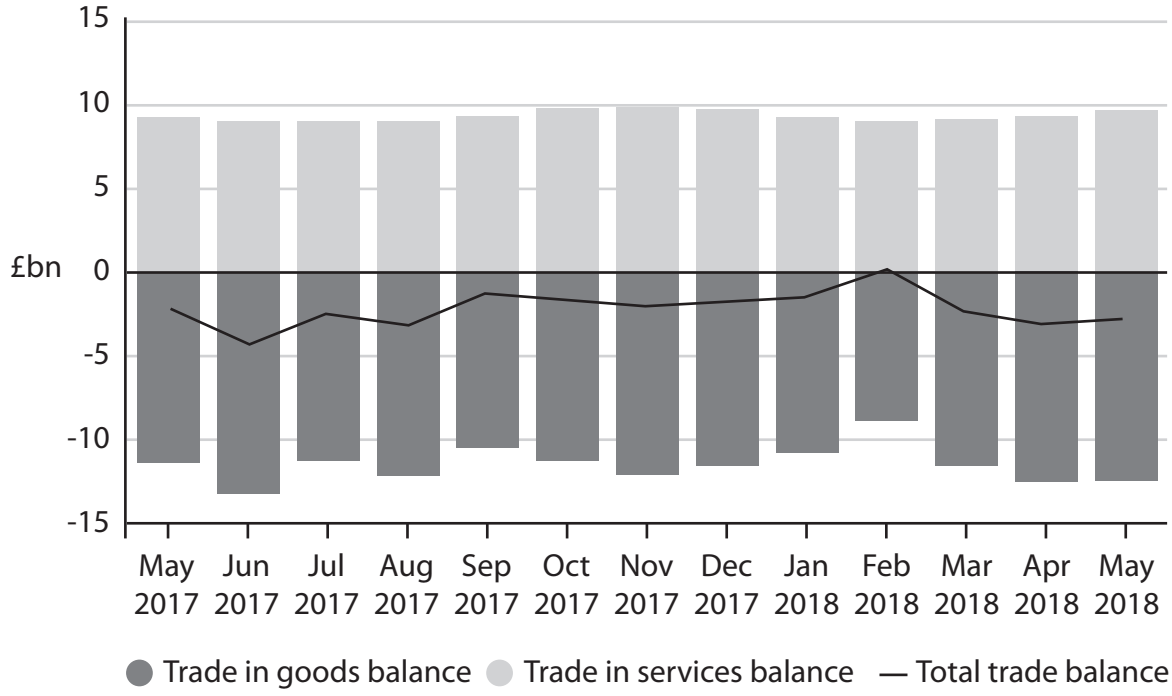
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5 The Ethiopian Government has made significant investments in the agricultural sector and has plans to allocate a further US$15 billion to irrigation development by 2020. The UK Government paid a subsidy for a windfarm. Which **one** of the following is also an interventionist supply-side policy?

- ☒ **A** Deregulation of the labour market
- ☒ **B** Privatisation
- ☒ **C** A reduction in interest rates
- ☒ **D** Regional policy

(Total for Question 5 = 1 mark)

6 The chart shows the UK balance of trade on current account, month on month, May 2017 to May 2018 (£ billion, seasonally adjusted).



(Source: https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/bulletins/uktrade/may2018)

What can be deduced from this chart?

- ☒ **A** The trade in services balance was in deficit in May 2017
- ☒ **B** The trade in goods deficit was smallest in February 2018
- ☒ **C** The value of exports exceeded the value of imports in September 2017
- ☒ **D** The total UK trade deficit was the largest in November 2017

(Total for Question 6 = 1 mark)

TOTAL FOR SECTION A = 6 MARKS

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SECTION B

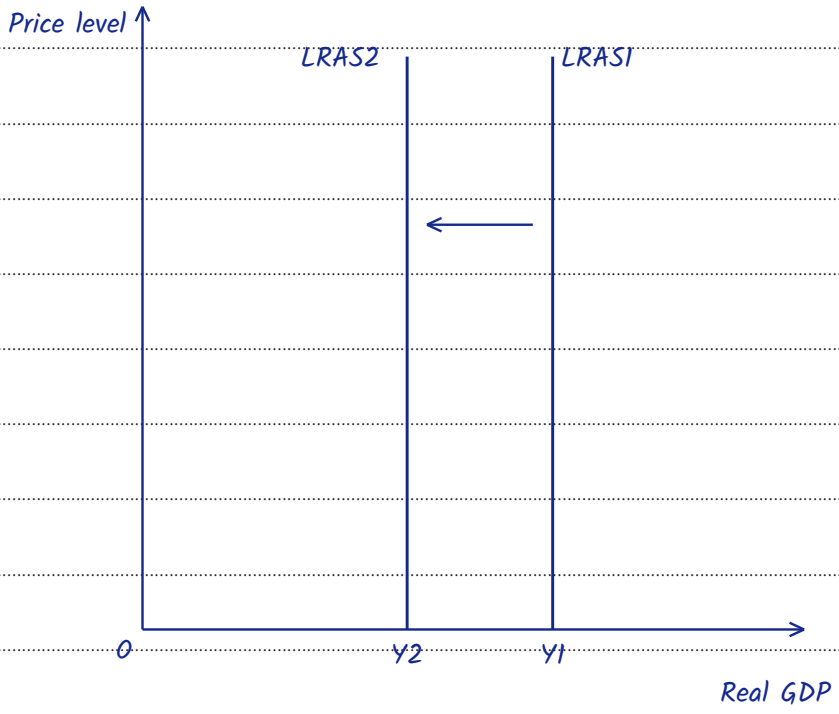
Answer ALL questions in this section in the space provided.

7 Net migration in Lithuania fell from 1.4% of the population in 2003 to –6.1% in 2017.

Explain **one** possible effect of this change in net migration on Lithuania's long-run aggregate supply.

Net migration is immigration minus emigration. In Lithuania it fell from +1.4% of the population in 2003 to −6.1% in 2017, a fall of 7.5 percentage points, so far more people are now leaving the country than arriving.

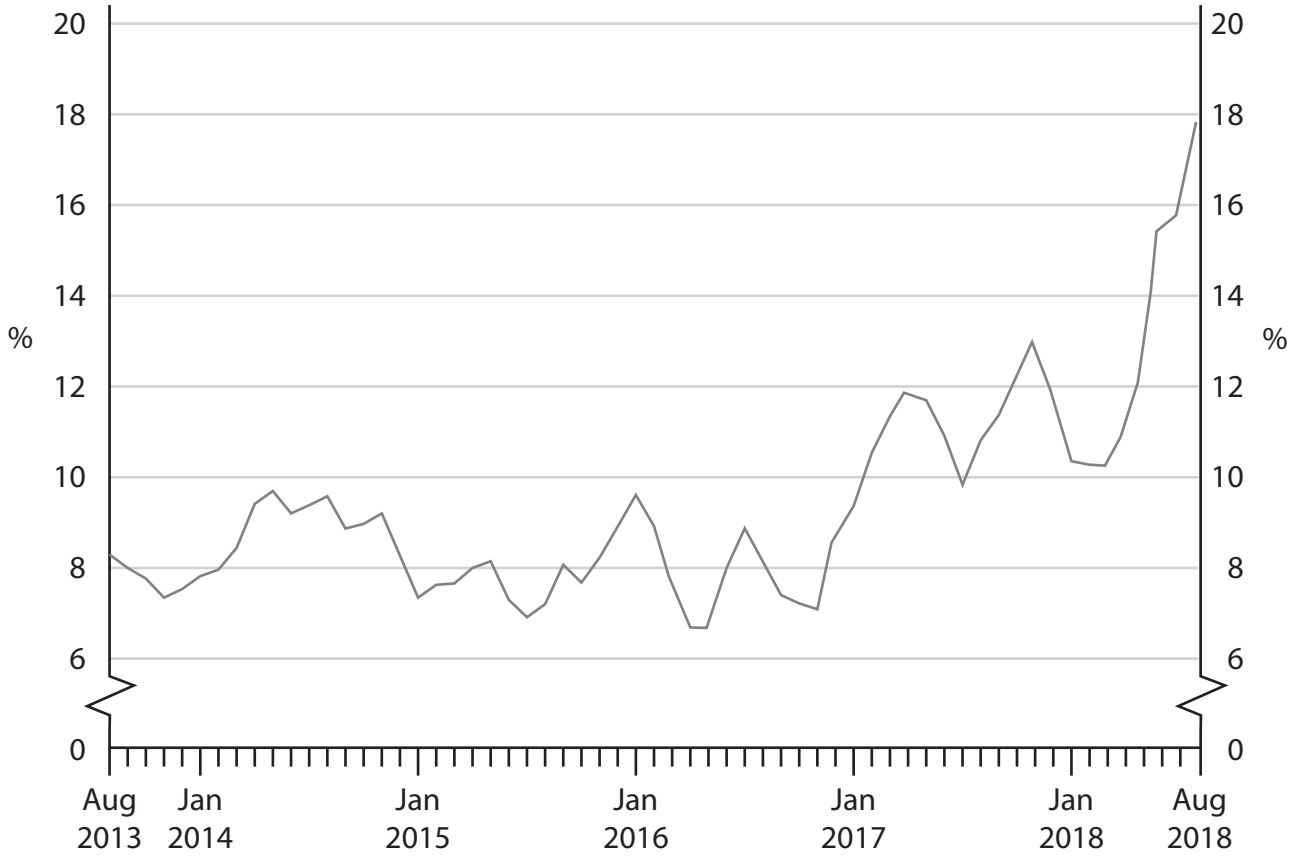
Long-run aggregate supply (LRAS) shows the productive capacity of the economy. Because many emigrants are young, working-age and often skilled, the quantity of labour (a factor of production) falls. If skilled workers leave, average productivity of the remaining workforce may also fall. This reduces Lithuania's productive capacity, so LRAS shifts to the left from LRAS1 to LRAS2, reducing potential real GDP from Y1 to Y2.



(Total for Question 7 = 4 marks)

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8 The chart shows the annual change in consumer prices in Turkey for the period August 2013 to August 2018.



(Source: https://tradingeconomics.com/turkey/consumer-price-index-cpi)

With reference to the chart, explain the difference between inflation and disinflation.

Inflation is a sustained increase in the general (average) price level over time. The chart is always above zero, so Turkey had inflation throughout, eg about 10.3% in January 2018 and a peak of nearly 18% in August 2018, when prices were rising quickly.

Disinflation is a fall in the rate of inflation, so the price level is still rising but at a slower rate. For example, inflation fell from about 13% in November 2017 to about 10.5% in February 2018: prices still rose, just more slowly. So disinflation is not the same as deflation, where prices actually fall.

(Total for Question 8 = 4 marks)

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9 In the USA real incomes increased by 1.8% in the year to September 2018.

Explain **one** possible impact of increased real incomes on the USA's net trade balance.

Real income is income adjusted for inflation, so it measures the actual quantity of goods and services people can buy. The net trade balance is the value of exports of goods and services minus the value of imports (X – M).

In the USA real incomes rose by 1.8% in the year to September 2018. With higher real incomes, households have more purchasing power, so consumption rises. Because the USA has a high marginal propensity to import, part of this extra spending goes on imported goods and services, such as cars and electronics from China, Japan and Germany, so the demand for imports increases.

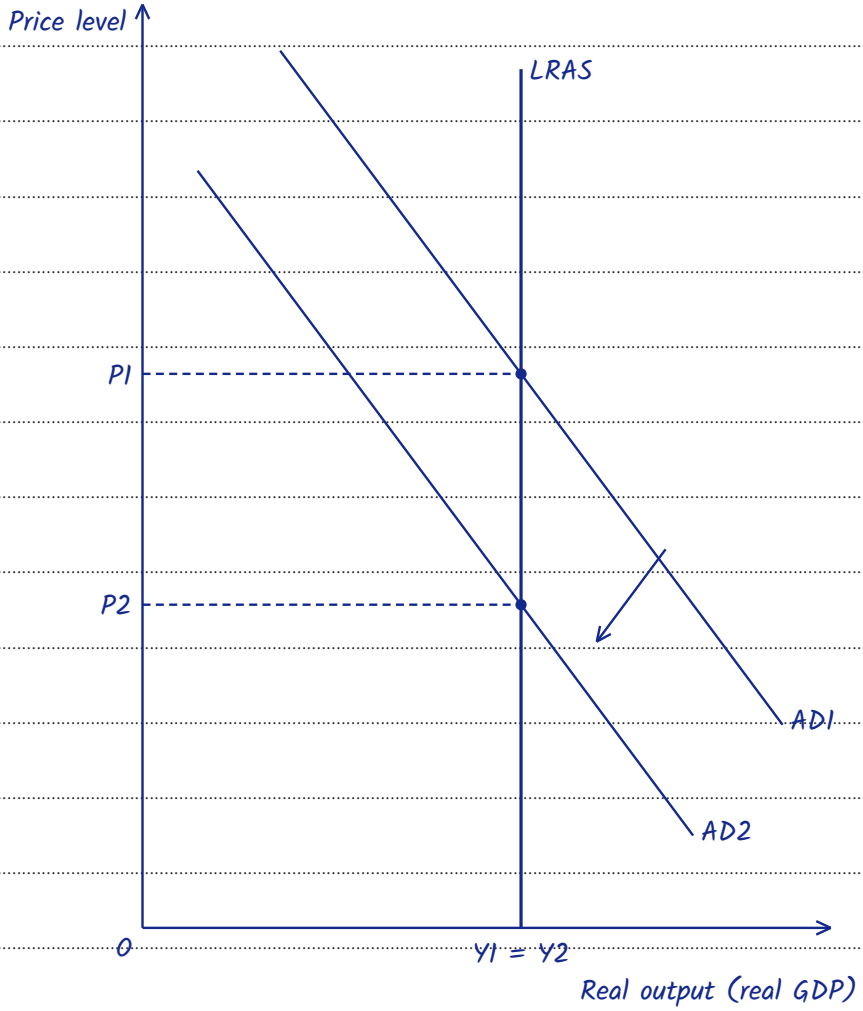
Ceteris paribus, if the value of imports (M) rises while exports (X) do not change, X – M falls, so the USA's net trade balance deteriorates, widening its trade deficit. Some goods bought at home may also be diverted from export markets, worsening the balance further. However, as the rise is only 1.8%, the impact is likely to be fairly small.

(Total for Question 9 = 4 marks)

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10 Turkey's central bank increased its base interest rate from 12.75% in April 2018 to 24% in September 2018.

Draw a LRAS and AD diagram to show the possible long-run impact of this significant increase in the base interest rate on AD, the price level **and** real output for Turkey.



The rise in the base rate from 12.75% to 24% raises the cost of borrowing and the reward for saving, so consumption and investment fall and AD shifts left from AD1 to AD2. In the long run, with a vertical LRAS, the price level falls from P1 to P2 while real output returns to its full-capacity level, so Y1 = Y2.

(Total for Question 10 = 4 marks)

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11 It is estimated that the marginal propensity to consume for Spain is 0.72. In January 2018 the Spanish Government announced an €18 billion investment on national defence.

Calculate the final increase in GDP resulting from this €18 billion investment. Show your workings.

Multiplier = 1 ÷ (1 − MPC)

= 1 ÷ (1 − 0.72) = 1 ÷ 0.28 = 3.57

Final increase in GDP = initial injection × multiplier

= €18 billion × 3.5714

= €64.29 billion (€64.286 billion)

(Total for Question 11 = 4 marks)

TOTAL FOR SECTION B = 20 MARKS

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SECTION C

Study Figures 1 and 2 and Extracts A and B in the Source Booklet before answering Question 12.

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

12 (a) Define the term 'Consumption' (Extract A, line 9).

(2)

(b) With reference to Figure 1, explain the term 'real GDP growth rate'.

(4)

(c) With reference to Extract A, analyse **one** possible macroeconomic impact of the increase in house prices on the Canadian economy.

(6)

(d) With reference to Extract B, examine the likely impact of government policies to increase wellbeing.

(8)

(e) Using the information in Figure 2 and Extract A, discuss the impact of low investment on Canada's economy.

(14)

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12 (a) Define the term 'Consumption' (Extract A, line 9).

(2)

Consumption is the total spending by households on goods and services over a given time period. It is the largest component of aggregate demand (AD = C + I + G + (X − M)) and is the part of income that is not saved. In Canada consumption rose during 2017.

(b) With reference to Figure 1, explain the term 'real GDP growth rate'.

(4)

GDP is the total value of goods and services produced in a country over a period of time. The real GDP growth rate is the percentage change in GDP from one period to the next, after adjusting for inflation, so it measures the change in the actual volume of output rather than in prices. Figure 1 shows quarterly growth rates.

In Figure 1 real GDP growth was highest in quarter 2 of 2014 at 1.2%, meaning real output was 1.2% higher than in the previous quarter. Growth was negative in quarters 1 and 2 of 2015 (about −0.2% and −0.1%) and in quarter 2 of 2016 (about −0.3%), so real output actually fell in those quarters.

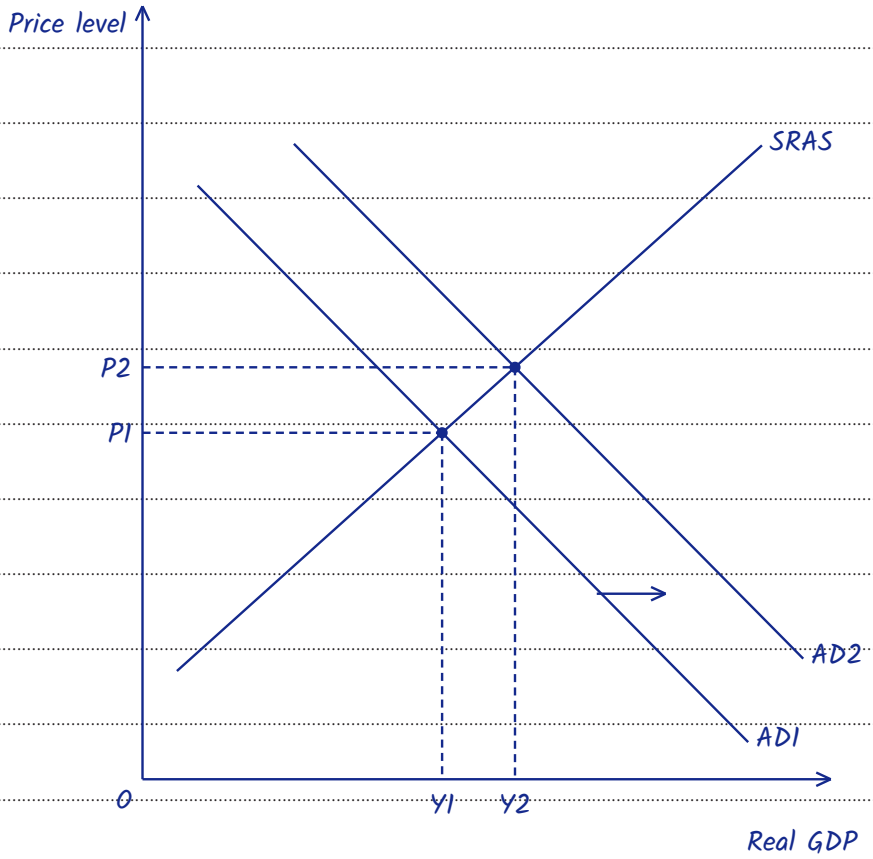
Growth was then positive in every quarter from quarter 3 of 2016 to quarter 2 of 2018. Even when growth slowed to 0.4% in late 2017, real GDP was still rising, just more slowly.

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(c) With reference to Extract A, analyse **one** possible macroeconomic impact of the increase in house prices on the Canadian economy.

(6)

One macroeconomic impact is higher aggregate demand through the wealth effect. Houses are assets, so when house prices rise homeowners feel wealthier. According to Extract A, average house prices in Canada increased by 5.7% in 2017.



Because the value of their assets has increased, homeowners become more confident and are willing to save less of their income and spend more. Higher house values also mean households can borrow more against their homes (equity withdrawal), which further increases spending. This helps explain why consumption in Canada rose during 2017, together with unemployment falling from 7% to 5.8%.

Consumption is the largest component of AD, so AD shifts right from AD1 to AD2. As shown in the diagram, real GDP rises from Y1 to Y2, which supports the sustained economic growth

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Canada experienced after the 2016 downturn, and firms may hire more workers, reducing unemployment further. However, as the economy moves closer to full capacity, the price level also rises from P1 to P2, creating demand-pull inflationary pressure.

The size of this effect depends on how many Canadians own their homes; renters and first-time buyers may actually feel worse off.

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(d) With reference to Extract B, examine the likely impact of government policies to increase wellbeing.

(8)

Wellbeing refers to how satisfied people are with their lives, including their happiness, health and overall quality of life, not just their income. Extract B shows the Canadian Government is committed to increasing wellbeing through higher financial benefits for low-income households and people unable to work, and more funding for low-cost housing, healthcare and better quality drinking water.

Firstly, higher benefits give low-income households better access to basic necessities such as food. Around one in ten people live in low-income households and 2.7 million people do not have enough food, which causes health problems. Better nutrition makes people healthier, so they are able to work and children can attend school, which directly raises their wellbeing.

Secondly, better quality low-cost housing and healthcare improve both mental and physical health. Healthier people are more employable, which reduces long-term unemployment and raises household incomes. Higher school attendance also increases skills and human capital, which increases the productive capacity of the economy, shifting LRAS to the right in the long run.

However, the impact may be limited. Wellbeing is subjective and hard to measure, so it is difficult to know whether the policies have worked. Higher benefits do not guarantee that the money is spent on healthy food, and they may act as a disincentive to work, reducing productive capacity. Even if people become healthier, they may lack the skills employers want, and with unemployment still at 5.8% there may not be enough jobs available.

In addition, the extra government spending may increase the budget deficit, so the government may have to raise taxes or cut spending elsewhere, which could reduce wellbeing for other

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groups. The magnitude of spending also matters: if it is small relative to the needs of 2.7 million people, the impact will be modest. Overall, the policies are likely to raise wellbeing for the poorest households, but the effect on the wider economy will be gradual and long-term.

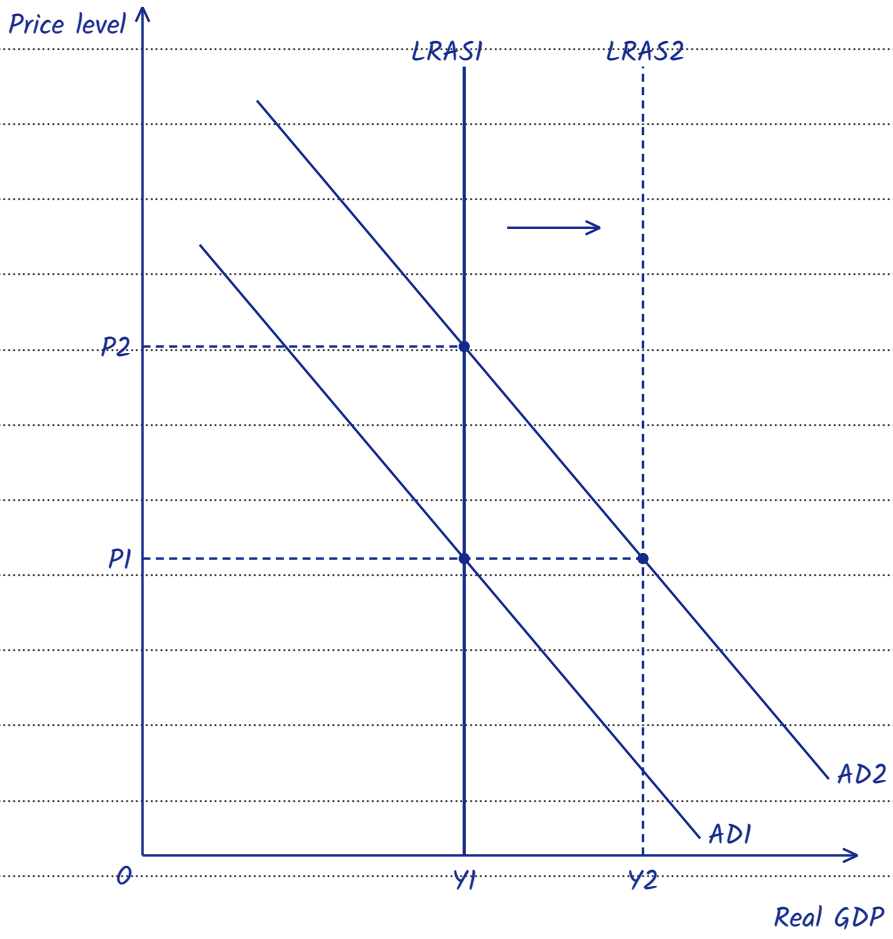
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(e) Using the information in Figure 2 and Extract A, discuss the impact of low investment on Canada's economy.

(14)

Investment is spending by firms on capital goods, such as machinery, equipment and buildings, which are used to produce other goods and services. Figure 2 shows that business investment in Canada was only 10.9% of GDP in 2015 to 2017, the second lowest of the selected OECD countries and about half of South Korea's 21.3%. Extract A states that there has been little investment in new machinery and equipment.

Firstly, investment is a component of AD (AD = C + I + G + (X − M)). Low investment means AD is lower than it could be, so in the short run real GDP growth and employment are lower, and there is a smaller multiplier effect on incomes.



Secondly, and more importantly, low investment limits the growth of Canada's productive

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capacity. Extract A states that capital equipment per worker is very low by international standards, so labour productivity is low. Without new capital, LRAS does not shift to the right from LRAS1 to LRAS2. As the diagram shows, when AD rises from AD1 to AD2, for example because oil and petrol exports grew by 42%, the economy hits its capacity constraint, so the price level rises from P1 to P2 with real output stuck at Y1. If investment had been higher, LRAS would have shifted to LRAS2, allowing output to rise to Y2 with less inflation.

Low productivity also means lower real wages and slower growth in living standards. Canadian firms' unit costs will be higher than those of rivals using modern equipment, so they become less internationally competitive. Over time this could reduce demand for Canadian exports, worsening the current account, and lower profits reduce the funds available for future investment, creating a vicious circle of slow long-run economic growth.

However, the impact may be less serious than it appears. Investment is measured as a share of GDP, and Canada experienced sustained growth in 2017 and 2018, so the share could be falling because GDP is rising quickly, even if the absolute amount of investment is still growing. Strong growth and higher exports may also improve business confidence and profits, encouraging more investment in the future, so the problem could be short-term.

The comparison also depends on the type of economy. If Canada's economy is mainly service-based, it may need less machinery than manufacturing economies such as South Korea or Germany, so low capital investment is less significant. Canada's 10.9% is still higher than the UK's 9.4% and only slightly below Finland's 11.8%, so it is not an extreme outlier. Furthermore, the quality of investment, for example in new technology, matters more than the quantity, and investment in human capital through education is not included in these figures.

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In conclusion, low investment is likely to have a significant negative impact on Canada in the long run because it holds back productivity, competitiveness and LRAS growth. However, the short-run impact is limited while exports and consumption remain strong, and the size of the problem depends on whether investment is genuinely low or just falling as a share of a fast-growing GDP.

(Total for Question 12 = 34 marks)

TOTAL FOR SECTION C = 34 MARKS

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SECTION D

Answer ONE question from this section.

Write your answer in the space provided.

EITHER

13 India's GNI per capita was Rs 45 326 in 2010 and grew rapidly to Rs 125 089 by 2017. A study conducted by the World Health Organisation identified that nine out of the ten most polluted cities in the world are located in India.

Evaluate the costs of rapid economic growth on an economy of your choice.

(Total for Question 13 = 20 marks)

OR

14 In 2018 the Chinese Government increased the amount an individual could earn before paying tax in an attempt to raise aggregate demand.

Evaluate the impact of reflationary demand-side policies on an economy of your choice.

(Total for Question 14 = 20 marks)

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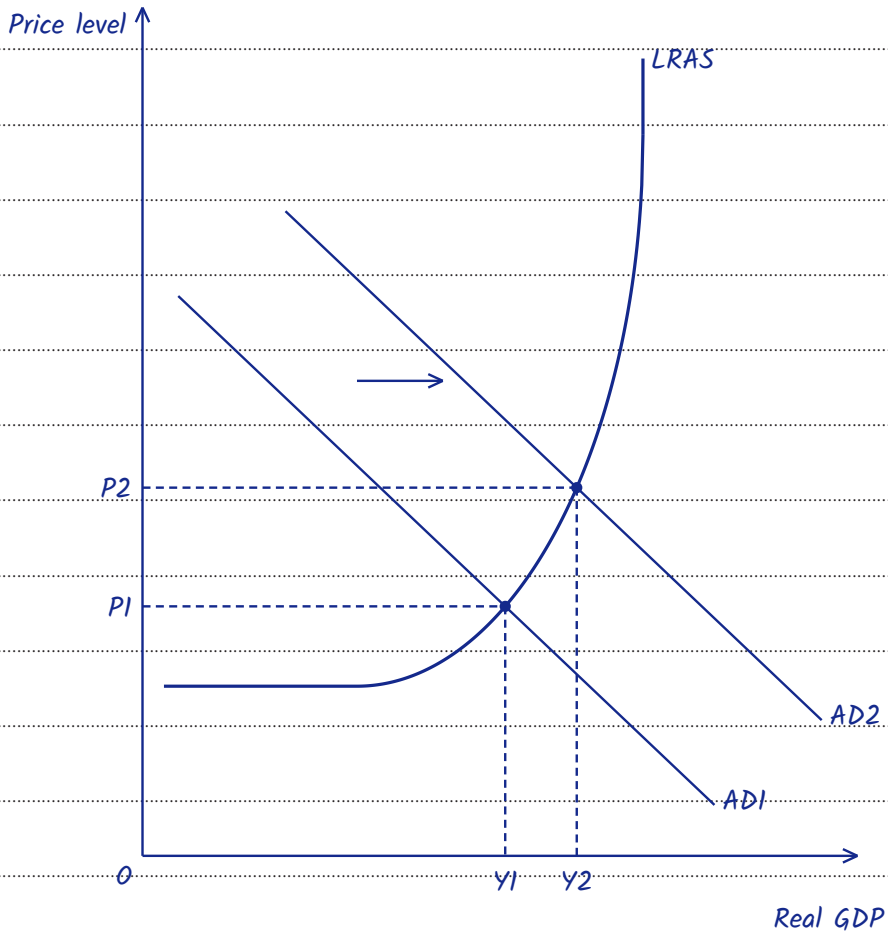
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Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Chosen question number: **Question 13** ☐ **Question 14** ☒

Write your answer here:

Reflationary demand-side policies are fiscal and monetary policies used to increase aggregate demand (AD) in order to raise real GDP and employment when an economy is growing slowly. Fiscal reflation includes cutting taxes or raising government spending, while monetary reflation includes cutting interest rates or increasing the money supply. China used both in 2018 as growth slowed to about 6.6%, its slowest rate for decades, and as the trade war with the USA hit confidence.



In 2018 the Chinese Government raised the income tax threshold, the amount an individual can earn before paying tax, from 3 500 to 5 000 yuan per month. This raises disposable income for

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millions of workers, so with a positive marginal propensity to consume, consumption rises. The People's Bank of China also cut banks' reserve requirement ratio several times in 2018, increasing the funds available for lending and lowering the cost of borrowing, which encourages consumer spending on credit and business investment. The government also increased spending on infrastructure such as railways and roads.

Since consumption, investment and government spending are components of AD, AD shifts right from AD1 to AD2. The initial injection is then multiplied: workers who receive the extra income spend part of it, which becomes income for others, so the final increase in real GDP is larger than the initial injection. As the diagram shows, real GDP rises from Y1 to Y2, firms need more workers, so cyclical unemployment falls and living standards rise.

However, the price level also rises from P1 to P2, causing demand-pull inflation. Higher incomes will also increase the demand for imports, so with a constant level of exports China's current account surplus may shrink. If inflation makes Chinese goods less price competitive, exports may fall too. Lower taxes and higher spending also widen the government's budget deficit and increase national debt.

The effectiveness of these policies depends on several factors. Firstly, it depends on how much spare capacity exists. If China is on the horizontal or upward-sloping section of the Keynesian LRAS, as in 2018 when inflation was only around 2%, a rise in AD mainly increases real output. But if the economy is close to full capacity, on the vertical section, the policies will be mostly inflationary. Classical economists argue that in the long run LRAS is vertical, so reflation only raises the price level.

Secondly, the size of the multiplier depends on the marginal propensity to withdraw. Chinese

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households have a very high savings ratio, partly because of limited welfare provision, so much of the tax cut may be saved rather than spent. The tax cut also only benefits those earning above the old threshold, so the poorest rural workers gain little. As a result, the final increase in AD may be smaller than expected.

Thirdly, consumer and business confidence matter. During the trade war with the USA, firms facing uncertainty may not borrow even if credit is cheaper, and households worried about job security may save more. Lower interest rates also have limited effect if banks are unwilling to lend, and rising debt could create risks in the property market.

Fourthly, there are time lags. Tax changes and infrastructure projects take time to be implemented and the effects of lower interest rates may take 18 months or more to feed through, by which time the economy may have recovered and the extra demand may just add to inflation. In addition, higher government borrowing could crowd out private investment by raising interest rates.

On the other hand, some demand-side policies have supply-side benefits. Infrastructure spending on transport and energy increases productive capacity, shifting LRAS to the right, which helps reduce the inflationary pressure in the long run. The magnitude of the policy also matters: China's stimulus was relatively large compared with its GDP, which increases its likely impact.

In conclusion, reflationary demand-side policies are likely to increase real GDP and reduce unemployment in China in the short run, especially because there was spare capacity and low inflation in 2018. However, their overall impact depends on the high savings ratio, confidence during the trade war and time lags, so they are most effective when combined with supply-side policies that increase LRAS, ensuring that growth is sustainable and not just inflationary.

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TOTAL FOR PAPER = 80 MARKS

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Afternoon | Paper Reference **WEC12/01**

Economics

International Advanced Subsidiary
Unit 2: Macroeconomic performance and policy

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Sources for use with Section C.

The Canadian economy

Figure 1 Quarterly real GDP growth rate, quarter 1 2013 – quarter 2 2018

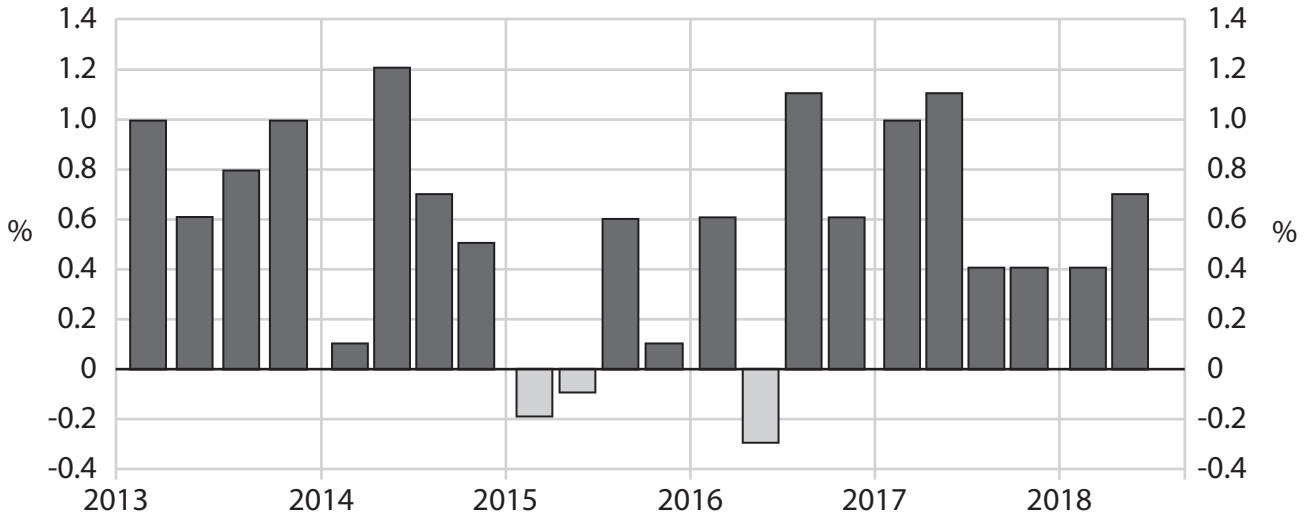
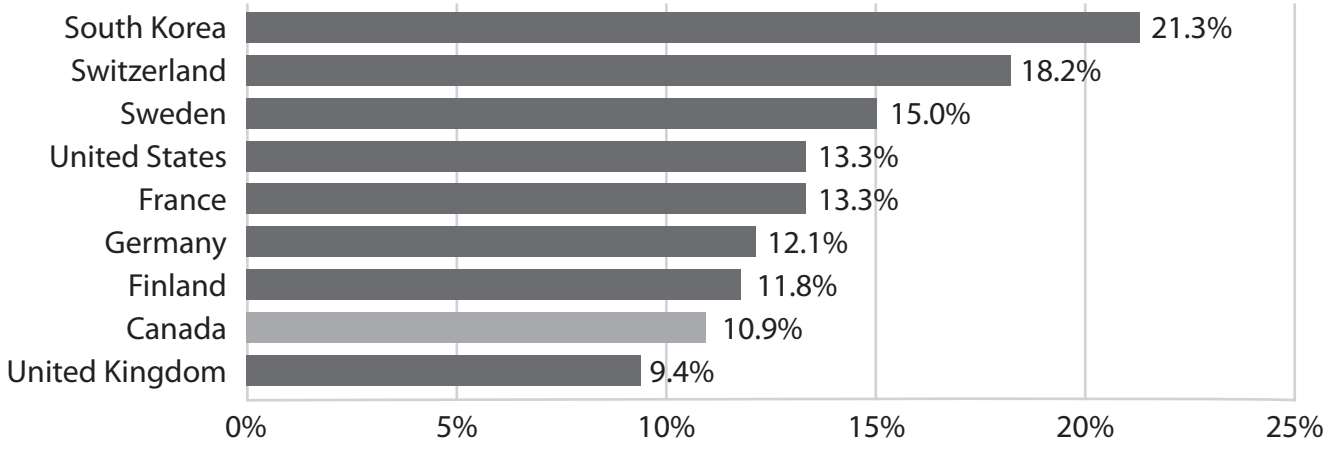


Figure 2 Business investment as a share of GDP in selected countries of the OECD (Organisation for Economic Co-operation and Development), 2015–2017



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Extract A The economic climate

After a downturn in 2016, the Canadian economy experienced sustained economic growth. This was partly caused by a significant increase in the demand for exports. Canadian oil and petrol exports grew by 42% compared with 2016. Car exports increased by 3.8%. Most other exports grew by an average of 1%. Much of the increase in foreign demand came from the European Union as its economies started to strengthen. The increase in exports caused an improvement on the current account on the balance of payments. The exchange rate of the Canadian dollar also increased.

Consumption also rose during 2017. This was mainly the result of two factors:

- the unemployment rate fell from 7% in 2016 to 5.8% in 2017
- average house prices increased by 5.7% in 2017.

However, business investment remains relatively low. In particular, there has been little investment in new machinery and equipment. This has a negative impact on productivity because capital equipment per worker in Canada is very low by international standards.

Extract B Government policies to increase wellbeing

In 2018 the Canadian Government announced its continued commitment to improving the wellbeing of the population. The Government identified the need for increased government spending on wellbeing, particularly for those people who have a very low income. For low-income households the lack of access to basic necessities, such as food and housing, can lead to both mental and physical health problems. Around one in ten people live in low-income households. The 2.7 million people living on a low income do not have enough food, which causes health problems. This often prevents them from working or attending school.

The Government has increased the financial benefits to low-income households and to people who are unable to work. There has also been an increase in funding for low-cost housing, healthcare and better quality drinking water.

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Acknowledgements

Figure 1 based on data taken from https://tradingeconomics.com/canada/gdp-growth

Figure 2 based on data taken from https://www.fraserinstitute.org/sites/default/files/business-investment-in-canada-falls-far-behind-other-industrialized-countries.pdf

Extract A adapted from https://www.cbc.ca/news/business/canadian-economy-grew-at-2-9-pace-in-second-quarter-lower-than-expected-1.4804512 and http://www.cbj.ca/canadas-economy-is-booming-but-will-it-last/

Extract B adapted from https://www.budget.gc.ca/2018/docs/plan/chap-05-en.html