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 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.

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 The World Bank calculates a 'Purchasing Power Parity (PPP)-adjusted level of GDP' for different countries.

Which **one** of the following is compared when calculating PPP?

- ☒ **A** The price of a basket of comparable goods and services in different countries
- ☒ **B** Real incomes, national happiness and wellbeing in different countries
- ☒ **C** The external value of one currency in terms of the US dollar
- ☒ **D** Inflation rates in different countries over a given time period

(Total for Question 1 = 1 mark)

2 The table below shows Bahrain's Gross National Income (GNI) between 2017 and 2019.

Year	GNI ($ billion)
2017	33.5
2018	35.6
2019	36.3

(Source: https://data.worldbank.org/indicator/NY.GNP.MKTP.CD?locations=BH)

If 2017 is the base year, which **one** of the following represents the index number for 2019?

- ☒ **A** 100.0
- ☒ **B** 102.0
- ☒ **C** 106.3
- ☒ **D** 108.4

(Total for Question 2 = 1 mark)

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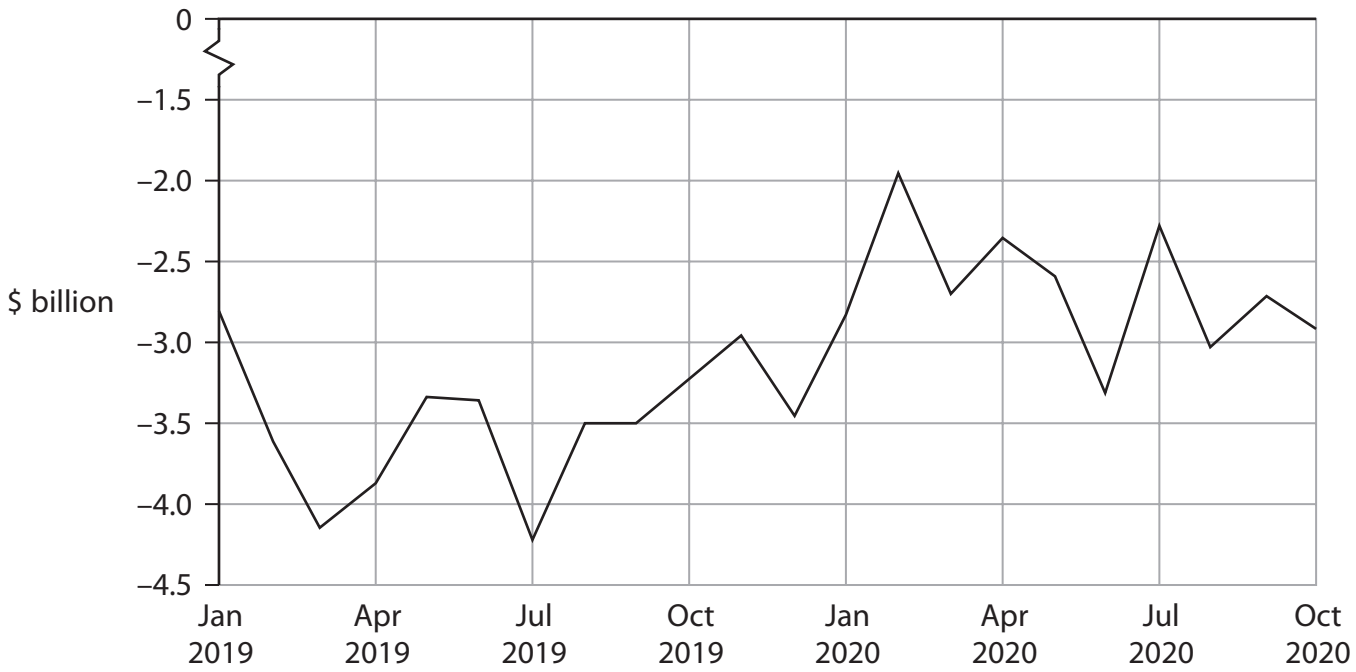
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3 Which **one** of the following is likely to cause a decrease in the value of a country's multiplier?

- ☒ **A** A decrease in the marginal propensity to tax
- ☒ **B** A decrease in the marginal propensity to save
- ☒ **C** An increase in the marginal propensity to import
- ☒ **D** An increase in the marginal propensity to consume

(Total for Question 3 = 1 mark)

4 The chart shows Egypt's net monthly balance of trade in goods and services, January 2019 to October 2020.



(Source: https://tradingeconomics.com/egypt/balance-of-trade)

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

- ☒ **A** The value of injections was always greater than the value of withdrawals
- ☒ **B** The Government was spending more than it received in taxation
- ☒ **C** Egypt's balance of trade was always in a surplus
- ☒ **D** The value of imports was always greater than the value of exports

(Total for Question 4 = 1 mark)

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5 Between Q1 2020 and Q4 2020 the savings ratio in the Netherlands increased from 15.3% to 24.3%.

Ceteris paribus, which **one** of the following is the most likely effect of this increase in the savings ratio?

- ☒ **A** A decrease in withdrawals from the circular flow of income
- ☒ **B** An increase in injections into the circular flow of income
- ☒ **C** A decrease in consumption
- ☒ **D** An increase in imports

(Total for Question 5 = 1 mark)

6 The table shows the annual percentage change in the real GDP of Canada between 2017 and 2019. The long-term trend rate of economic growth for the economy is estimated to be 2.7%.

Year	Change in real GDP (annual %)
2017	3.2
2018	2.0
2019	1.7

(Source: https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2019&locations=CA&start=2017)

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

- ☒ **A** The positive output gap increased between 2017 and 2018
- ☒ **B** There was a negative output gap in 2018 and 2019
- ☒ **C** There was a positive output gap in 2018 and 2019
- ☒ **D** The negative output gap decreased between 2018 and 2019

(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 The table shows selected changes to the UK's Consumer Price Index (CPI) basket of goods and services in 2020.

Items now included in the basket	Items removed from the basket
Reusable bottles	Fruit pies
Vegetable crisps	Frozen chicken
Portable digital music player	MP4 music player

(Source: https://www.theguardian.com/business/2020/mar/16/reusable-bottles-and-mugs-added-to-ons-inflation-basket)

With reference to the table, explain **one** reason why it is necessary to regularly update the CPI basket of goods and services.

The CPI basket must be updated regularly so that it accurately reflects what households actually buy, otherwise the CPI will not measure the true rate of inflation faced by consumers.

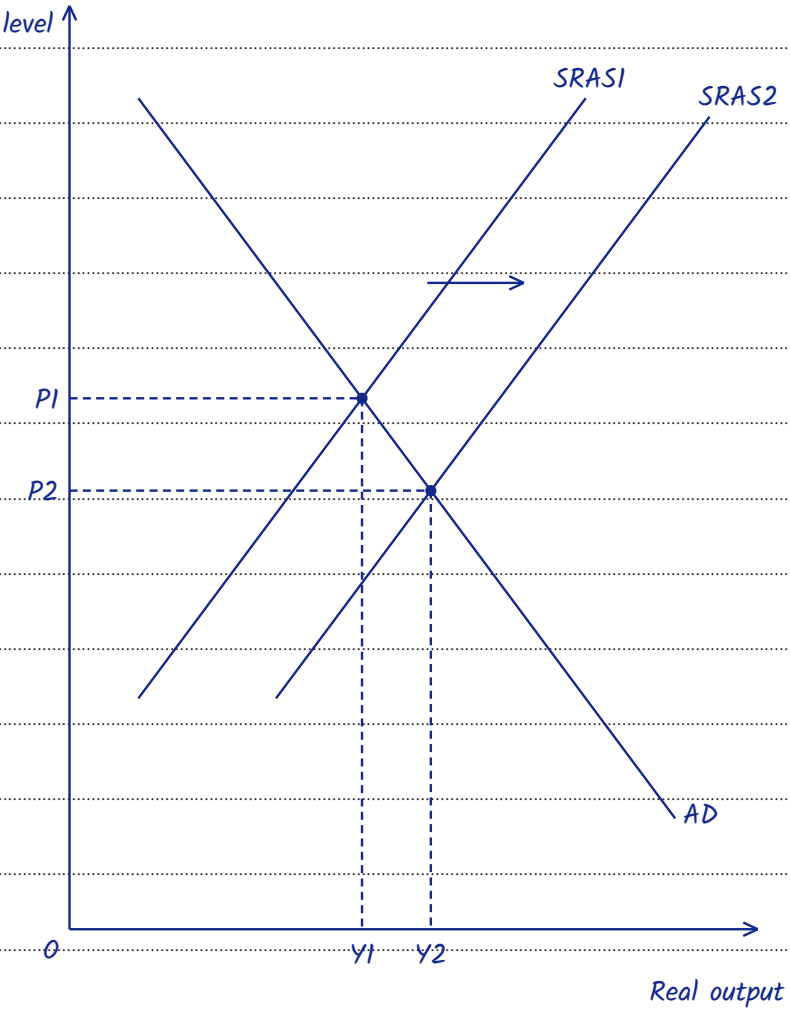
Consumer tastes change and technology advances, so consumers switch to newly developed or more fashionable products and stop buying older ones. For example, in 2020 reusable bottles, vegetable crisps and portable digital music players were added, while fruit pies, frozen chicken and MP4 music players were removed. If the basket still contained MP4 players, which few people now buy, their price changes would distort the index, so the CPI would no longer represent current spending patterns and the measured inflation rate would be inaccurate.

(Total for Question 7 = 4 marks)

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8 Between January 2014 and September 2020 the price of natural gas fell from $5.60 per cubic foot to $1.66 per cubic foot. Natural gas is an important source of energy for Japanese producers.

Draw a SRAS and AD diagram to show the effect of the decrease in the price of natural gas on the price level and real output for Japan.



The fall in the price of natural gas from $5.60 to $1.66 per cubic foot lowers the costs of production for Japanese firms, so SRAS shifts to the right from SRAS1 to SRAS2. The price level falls from P1 to P2 and real output rises from Y1 to Y2.

(Total for Question 8 = 4 marks)

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9 The table shows the nominal GDP and population of Argentina in 2018 and 2019.

	GDP ($ millions)	Population (millions)
2018	517 627	44.5
2019	445 445	44.9

(Source: https://data.worldbank.org/country/argentina)

Based on this information, calculate the *change* in Argentina's GDP per capita between 2018 and 2019. Show your workings.

GDP per capita = GDP ÷ population, i.e. the average output (income) per person.

2018: $517 627 million ÷ 44.5 million = $11 632.07 per person

2019: $445 445 million ÷ 44.9 million = $9 920.82 per person

Change = $9 920.82 − $11 632.07

= −$1 711.25

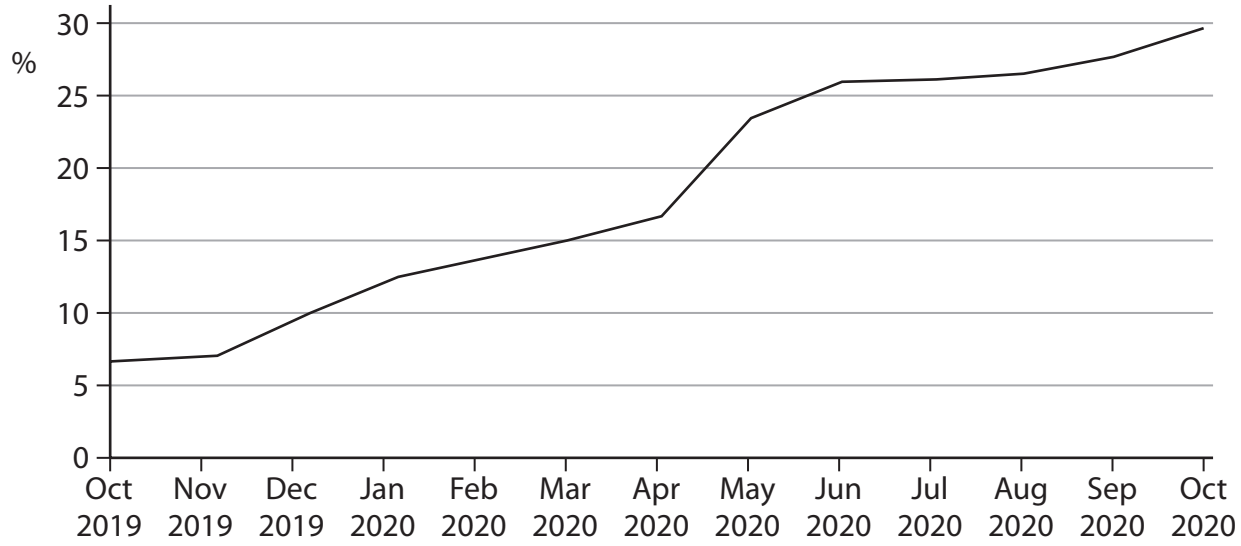
So Argentina's GDP per capita fell by about $1 711.25 per person between 2018 and 2019 (a fall of about 14.7%), because GDP fell while the population grew.

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10 The chart shows the annual percentage increase in house prices in Turkey between October 2019 and October 2020.



(Source: https://www.ceicdata.com/en/indicator/turkey/house-prices-growth)

With reference to the chart, explain **one** likely macroeconomic impact of an increase in house prices on existing homeowners.

A rise in house prices is likely to increase consumption, and so aggregate demand, through the wealth effect. In Turkey annual house price inflation rose from about 7% in October 2019 to about 30% in October 2020, an increase of about 23 percentage points. Existing homeowners see the value of their main asset rise, so they feel wealthier and more confident about their finances. They therefore save less and spend more, and some may borrow against the higher value of their homes (equity withdrawal) to fund spending. Since consumption is the largest component of AD, AD shifts right, raising real output and also putting upward pressure on the price level.

(Total for Question 10 = 4 marks)

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11 For the year ending June 2020, there were 509 600 immigrants arriving in Australia and 315 200 emigrants leaving Australia.

With reference to the information above, explain what is meant by net migration.

Net migration is the difference between the number of people entering a country to live (immigrants) and the number of people leaving the country to live elsewhere (emigrants). Net migration = immigration – emigration.

For Australia, year ending June 2020:

Net migration = 509 600 – 315 200 = +194 400 people

Net migration is positive because more people arrived in Australia than left, so migration added 194 400 people to Australia's population, increasing the size of its labour force.

(Total for Question 11 = 4 marks)

TOTAL FOR SECTION B = 20 MARKS

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SECTION C

Study Figure 1, Figure 2 and Extract A in the Source Booklet before answering Question 12.

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

12 (a) Define the term 'real GDP' (Figure 1).

(2)

(b) With reference to Figure 2, explain the difference between disinflation and deflation.

(4)

(c) With reference to Figure 1 and the first paragraph of Extract A, analyse **two** influences on the level of investment in the eurozone.

(6)

(d) Examine the likely effects of 'the increase in the exchange rate of the euro against the US dollar' (Extract A, lines 25–26) on the net trade balance of the eurozone.

(8)

(e) With reference to the information provided and your own knowledge, discuss the likely macroeconomic effects of the ECB's monetary policy on the eurozone economy.

(14)

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12 (a) Define the term 'real GDP' (Figure 1).

(2)

Real GDP is the total value of all goods and services produced in an economy over a period of time, adjusted for inflation (measured at constant prices).

(b) With reference to Figure 2, explain the difference between disinflation and deflation.

(4)

Disinflation is a fall in the rate of inflation: prices are still rising, but at a slower rate. In Figure 2 there was disinflation between January and May 2020, as the inflation rate fell from 1.4% to 0.1%; for example, it fell from 0.7% in March to 0.3% in April 2020, yet the price level was still rising.

Deflation is a sustained fall in the general price level, i.e. a negative rate of inflation. In Figure 2 there was deflation from August to December 2020, when the inflation rate was negative, e.g. −0.3% in November 2020, so the average price level was actually falling.

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(c) With reference to Figure 1 and the first paragraph of Extract A, analyse **two** influences on the level of investment in the eurozone.

(6)

Investment is spending by firms on capital goods, such as machinery and buildings, which adds to the capital stock of the economy.

Influence 1: the rate of economic growth. Figure 1 shows the eurozone's real GDP growth rate fell to −14.7% in Q2 2020 and was still −4.3% in Q3 2020. Because output and incomes were falling, consumer demand for goods and services fell, so firms had spare capacity and expected lower sales and profits. Through the accelerator effect, a fall in the growth of output means firms need fewer new capital goods, so they cut investment. This also lowered business confidence: Extract A says low business confidence caused a fall in the demand for bank loans, because firms were uncertain about future revenues and so postponed investment projects.

Influence 2: the availability of credit. Extract A states there was "a decrease in the availability of credit". Many firms finance investment by borrowing from banks. If banks are unwilling to lend, or apply strict conditions and higher interest rates to loans, the cost of borrowing rises and some projects are no longer profitable or cannot be funded at all. Therefore investment falls. Together these factors "resulted in significantly lower levels of investment", which reduces AD and also limits future growth in productive capacity.

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(d) Examine the likely effects of 'the increase in the exchange rate of the euro against the US dollar' (Extract A, lines 25–26) on the net trade balance of the eurozone.

(8)

An increase in the exchange rate (appreciation) means the euro buys more US dollars, i.e. the value of the euro rises in terms of the dollar. The net trade balance is the value of exports minus the value of imports (X – M).

In 2020 the euro traded at its highest level against the US dollar for more than two years. This makes eurozone exports relatively more expensive in dollar terms, so American buyers demand fewer of them, and makes imports from the US relatively cheaper in euro terms, so eurozone consumers and firms buy more of them. As a result the value of exports is likely to fall and the value of imports to rise, so the net trade balance worsens (a smaller surplus or larger deficit). Since net exports are a component of AD, AD shifts left, which is why the ECB said it was "very carefully" monitoring the impact, as it weakens the recovery.

However, the effect depends on the size of the appreciation and how long it lasts: a small or temporary rise may have little impact. In the short run, trade is often fixed by pre-agreed contracts, so volumes adjust slowly and the balance may even improve at first (a J-curve effect), with the full worsening only in the long run. It also depends on the price elasticity of demand for exports and imports: if eurozone exports are price inelastic because they compete on quality and brand (for example German cars and machinery), export values may fall only slightly. Finally, eurozone firms may cut their euro prices to keep dollar prices stable, and the cheaper imported raw materials lower their costs. Also the US is only one trading partner, so overall the net trade balance is likely to worsen, but probably only modestly.

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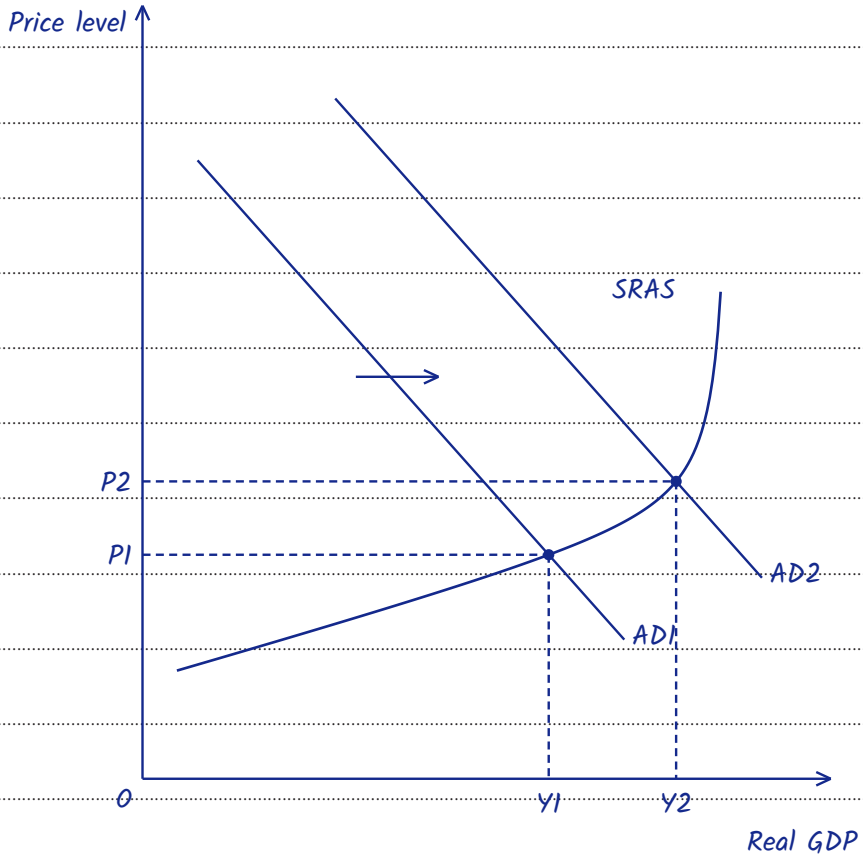
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(e) With reference to the information provided and your own knowledge, discuss the likely macroeconomic effects of the ECB's monetary policy on the eurozone economy.

(14)

Monetary policy is the use of interest rates, the money supply and the availability of credit to influence aggregate demand. The ECB's policy is reflationary; it announced a €500 billion increase in its quantitative easing (QE) programme and agreed to lend to banks at a negative interest rate of −1% until June 2022, provided they continue to lend.



QE means the central bank creates new money to buy bonds from banks and other financial institutions. This injects liquidity into the banking system, so banks have more funds to lend. Bond prices rise and their yields fall, lowering long-term interest rates and the cost of borrowing for firms. Asset prices such as shares and property also rise, creating a positive wealth effect that encourages consumption. The very cheap −1% funding means banks are paid to borrow, so they can offer cheaper loans. Lower interest rates reduce the reward for saving

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and the cost of borrowing, and households with variable rate mortgages have more disposable income, so consumption (C) and investment (I) rise. Lower rates may also reduce the demand for the euro, causing it to depreciate from its two-year high, which raises net exports (X – M).

As shown in the diagram, higher C, I and (X – M) shift AD right from AD1 to AD2, so real GDP rises from Y1 to Y2 and the price level rises from P1 to P2. This helps the eurozone recover from its 2020 growth rate of –6.7% (–14.7% in Q2 2020, Figure 1) towards the forecast growth of 3.9% in 2021 and 4.2% in 2022. As firms produce more, the derived demand for labour rises, reducing the "rising unemployment". Higher AD creates demand-pull pressure, helping to end the deflation of –0.3% seen from September to December 2020 (Figure 2) and move inflation towards the 2% target, as the ECB forecasts. Since the economy has a large negative output gap, most of the effect is likely to be on output rather than prices.

However, the effects may be small. Interest rates are already "extremely low", so further cuts have limited impact, and with low business and consumer confidence firms and households may not borrow however cheap credit is: demand for bank loans has already fallen. Banks may be risk averse and hold the extra liquidity rather than lend, and negative rates squeeze bank profits, making them less willing to lend and less likely to pass the low rates on to customers. The wealth effects of QE mainly benefit high income asset owners, who have a low MPC, so the rise in consumption is small and inequality may widen. The size of the QE matters too: €500 billion is large, but this is an additional round, so its marginal effect is likely to be smaller. There are also time lags of 18 to 24 months, so the full effect may not be felt until 2022, and the strong euro is already offsetting the policy.

In conclusion, the ECB's policy should raise AD, growth and inflation and reduce unemployment, but because rates are already near their floor and confidence is weak, its impact is likely to be

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limited. As the ECB's own forecast of below-target inflation in 2023 suggests, monetary policy alone is unlikely to be enough, and reflationary fiscal policy, such as higher government spending, will probably be needed alongside it.

(Total for Question 12 = 34 marks)

TOTAL FOR SECTION C = 34 MARKS

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SECTION D BEGINS ON THE NEXT PAGE.

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SECTION D

Answer ONE question from this section.

Write your answer in the space provided.

EITHER

13 In the first two quarters of 2020, pollution in China decreased by 10.8% as a result of the slowdown in the country's rate of economic growth.

Evaluate the potential conflicts between the objective of economic growth and **two** other macroeconomic objectives.

(Total for Question 13 = 20 marks)

OR

14 In 2019 India's productivity increased by 5.2%. To achieve its GDP growth target of 8% in 2020, India needed to increase its productivity to 6.3%.

Evaluate supply-side policies that the Indian government could use to increase the country's productivity.

(Total for Question 14 = 20 marks)

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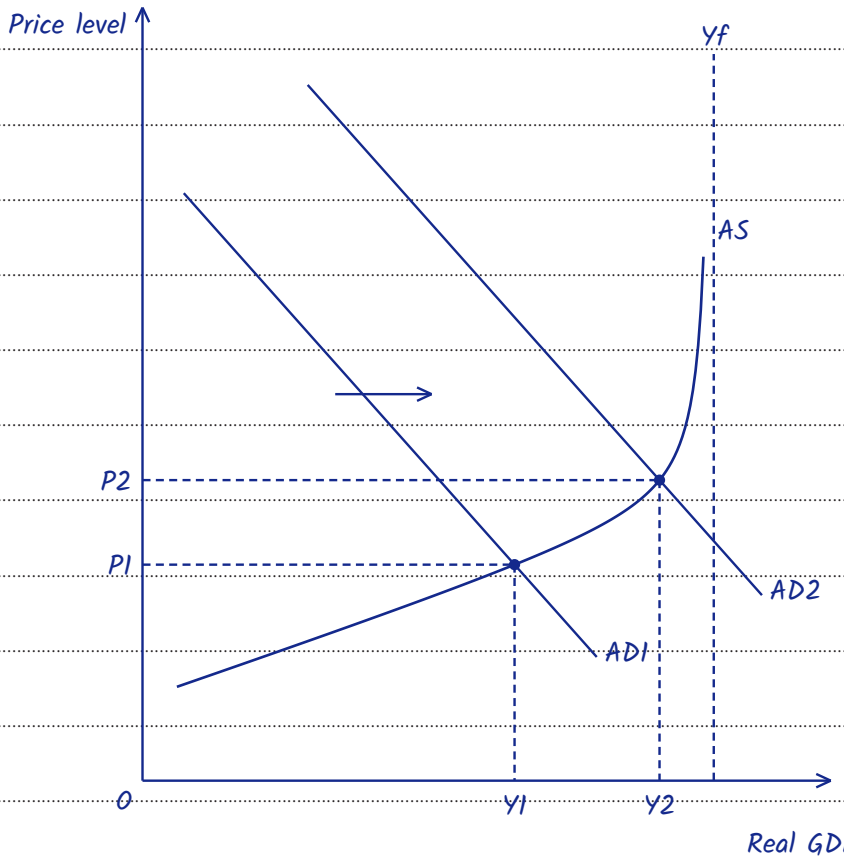
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Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

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

Write your answer here:

Economic growth is an increase in real GDP over time. Actual growth is an increase in the output produced, caused by higher AD or using spare capacity; potential growth is an increase in the productive capacity of the economy, shown by an outward shift of the LRAS. Governments also aim for low and stable inflation, low unemployment, a sustainable balance of payments, protection of the environment and a fair distribution of income. Growth can conflict with some of these objectives, particularly the environment and price stability.



Conflict 1: economic growth and the environment. Production uses resources and energy, and much of it, especially in industrialising economies like China, relies on burning fossil fuels such as coal. As output rises, more fuel is burned and more pollution and greenhouse gases are

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emitted, creating negative externalities such as health problems for third parties and climate change. Growth also depletes non-renewable resources and can lead to deforestation and soil erosion, which reduces the economy's future productive capacity. The evidence supports this: when China's growth slowed in the first two quarters of 2020, pollution fell by 10.8%. This implies that faster growth is likely to bring higher pollution, so the two objectives conflict.

However, the extent of this conflict depends on the type of growth. If growth comes from the service sector or from renewable energy and green technology, output can rise with much less pollution. As countries become richer they can also afford stricter environmental regulation and cleaner technology, so in the long run growth may even reduce pollution per unit of output. The 10.8% fall in China was caused by a sharp, unusual slowdown during the pandemic, and pollution is likely to rebound when factories reopen, so this suggests a short-run trade-off rather than a permanent one. Government policies such as carbon taxes or tradable permits can also reduce the conflict by making polluters pay the external cost.

Conflict 2: economic growth and low inflation. If growth is driven by rising AD, for example higher consumption or government spending, then as the economy approaches full capacity (Yf) firms face shortages of skilled labour and raw materials. As the diagram shows, AD shifting from AD1 to AD2 raises real GDP from Y1 to Y2, but because the AS curve becomes steeper near full capacity, the price level rises from P1 to P2. Bottlenecks in supply chains push up costs and wages, which firms pass on in higher prices, so demand-pull and cost-push inflation increase. Rising inflation reduces real incomes and international competitiveness.

However, this conflict depends on the stage of the economic cycle. If there is a large negative output gap with much spare capacity, as in China during the 2020 slowdown, AS is elastic, so AD growth raises output with little inflation. The conflict is also smaller if growth is supply-side

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(potential) growth, from higher productivity, investment or better education: LRAS shifts right, which increases output and reduces inflationary pressure at the same time. The impact also depends on the starting inflation rate: if a country has low inflation or deflation, some extra inflation may even be desirable. What matters is whether actual growth exceeds the growth of productive capacity (the trend rate).

Growth can also conflict with the balance of payments, because higher real incomes increase spending on imports and firms import more raw materials and components, worsening the trade balance. However, this depends on the marginal propensity to import, and for an export-led economy like China, growth driven by exports may actually improve the current account. Growth may also increase inequality, as owners of capital gain more than low-paid workers.

In conclusion, there is a clear short-run conflict between growth and the environment, as shown by China's 10.8% fall in pollution, and between demand-led growth and low inflation when the economy is close to full capacity. The most significant conflict is probably with the environment, since its external costs are long-lasting. However, these conflicts are not inevitable: they are smallest when growth is sustainable, supply-side growth from green technology and productivity, and when the economy has spare capacity. Governments can therefore reduce the conflicts by combining growth policies with environmental regulation and supply-side policies.

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TOTAL FOR SECTION D = 20 MARKS
TOTAL FOR PAPER = 80 MARKS

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Time 1 hour 45 minutes

Paper reference **WEC12/01**

Economics

International Advanced Subsidiary
UNIT 2: Macroeconomic performance and policy

Source Booklet

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Sources for use with Section C

The eurozone economy

Figure 1 Annual real GDP growth rate, Q1 2018 to Q3 2020

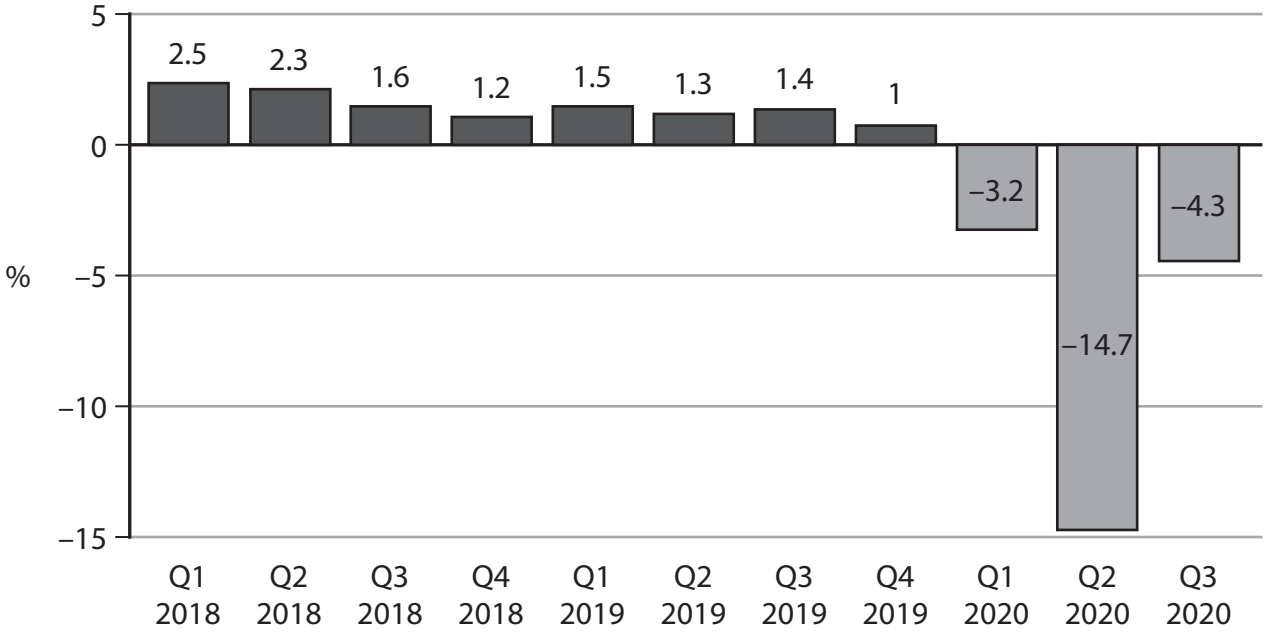
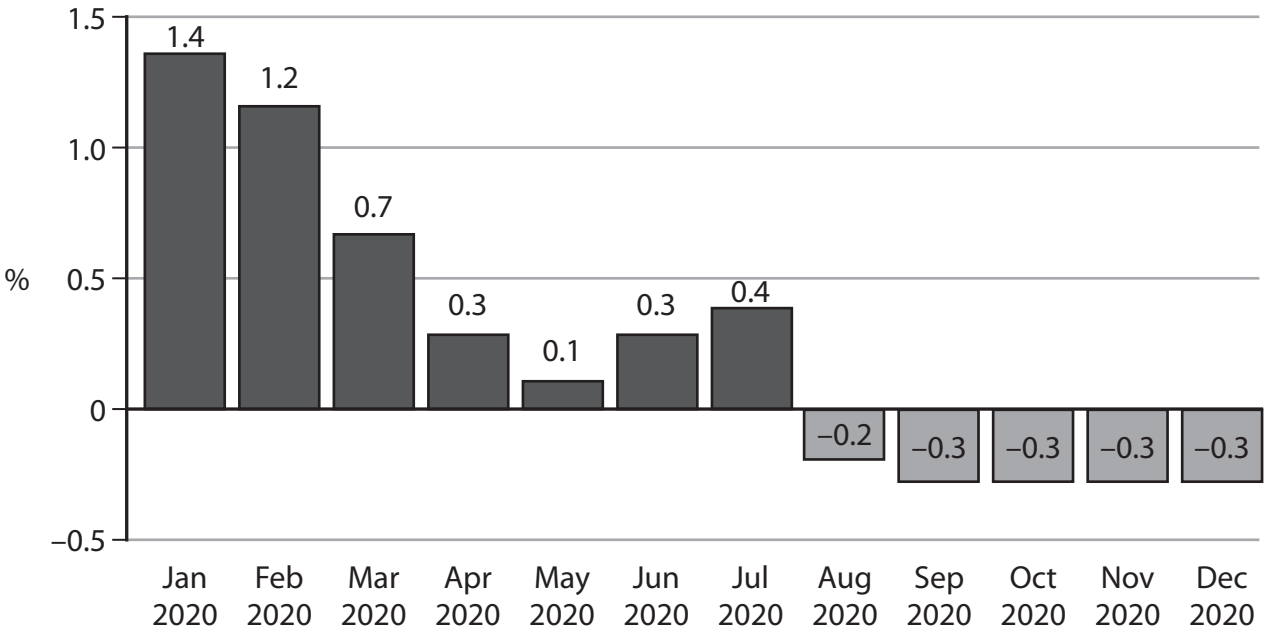


Figure 2 Inflation rate, as measured by the Consumer Price Index (CPI), January 2020 to December 2020



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Extract A Monetary policy

In November 2020 the European Central Bank (ECB) highlighted that there were "worrying signals" about the future state of the eurozone economy. It indicated that low business confidence had caused a fall in the demand for bank loans. At the same time, there was a decrease in the availability of credit. These factors resulted in significantly lower levels of investment.

In response the ECB immediately launched an additional round of quantitative easing in December 2020. This programme was reintroduced to help the eurozone economy to recover from negative rates of economic growth, rising unemployment and to prevent another recession. It announced a €500 billion increase in the size of its quantitative easing programme for the period January 2021 to September 2021.

The ECB also announced the provision of extra low-cost funding for banks, aimed at encouraging an increase in bank lending. It agreed to finance the banks at negative interest rates of –1% until June 2022. This meant that the ECB would be paying banks to borrow more money, provided they continue to lend.

Economists have suggested that a reflationary policy could be needed for years, given the weak state of the eurozone economy. In 2020 economic growth in the eurozone was –6.7%. The ECB forecast an economic growth rate of only 3.9% in 2021, 4.2% in 2022 and 2.1% in 2023. The ECB also forecast that the rate of inflation in 2023 will increase but remain below its 2% target.

However, it is unlikely that the ECB can manage the entire burden of supporting the eurozone recovery. Market forces have already reduced the effectiveness of existing policies. For example, in 2020 the eurozone's currency, the euro, traded at its highest level against the US dollar for more than two years. The ECB said it was "very carefully" monitoring the impact of the increase in the exchange rate of the euro against the US dollar.

Economists are concerned that the ECB's asset purchases will have a limited impact because interest rates are already extremely low. They argue that reflationary fiscal policy will be necessary to stimulate economic recovery.

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Acknowledgements

Figure 1 adapted from https://tradingeconomics.com/euro-area/gdp-growth-annual

Figure 2 adapted from https://tradingeconomics.com/euro-area/inflation-cpi

Extract A adapted from FT; https://www.ft.com/content/94d82ff8-b56d-4f3c-aea4-2bdc975ec340