Please check the examination details below before entering your candidate information

Candidate surname	Other names
StemUp Model Solution	

Pearson Edexcel
International Advanced Level

Centre Number | | | | | |

Candidate Number | | | | |

Thursday 16 May 2019

Morning (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 In 2017 Turkey's deficit on the current account of the balance of payments increased to $4.2 billion.

This increase in the deficit on the current account is most likely to have resulted from

- ☒ **A** an increase in the value of imports
- ☐ **B** an increase in the value of exports
- ☐ **C** a decrease in government spending
- ☐ **D** a decrease in employment

(Total for Question 1 = 1 mark)

2 The table shows Malaysia's rate of inflation between February 2017 and July 2017.

Month	Rate of inflation (%)
February	4.5
March	5.1
April	4.4
May	3.9
June	3.6
July	3.2

From this table it can be deduced that

- ☐ **A** there was deflation between April and May
- ☒ **B** there was disinflation between May and June
- ☐ **C** the rate of inflation was at its highest in July
- ☐ **D** inflation increased at a constant rate between May and July

(Total for Question 2 = 1 mark)

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3 The Moroccan economy had a large negative output gap in 2017.

Which **one** of the following is usually associated with a negative output gap?

- ☒ **A** Demand-pull inflation and decreasing unemployment
- ☒ **B** Cost-push inflation and high employment rates
- ☒ **C** Real GDP growth less than the long-term productive potential
- ☒ **D** Real GDP growth more than the long-term productive potential

(Total for Question 3 = 1 mark)

4 Between 2010 and 2016 Indonesia recorded a 44.4% fall in the value of its exports. This resulted from a decrease in the demand for Indonesian clothing.

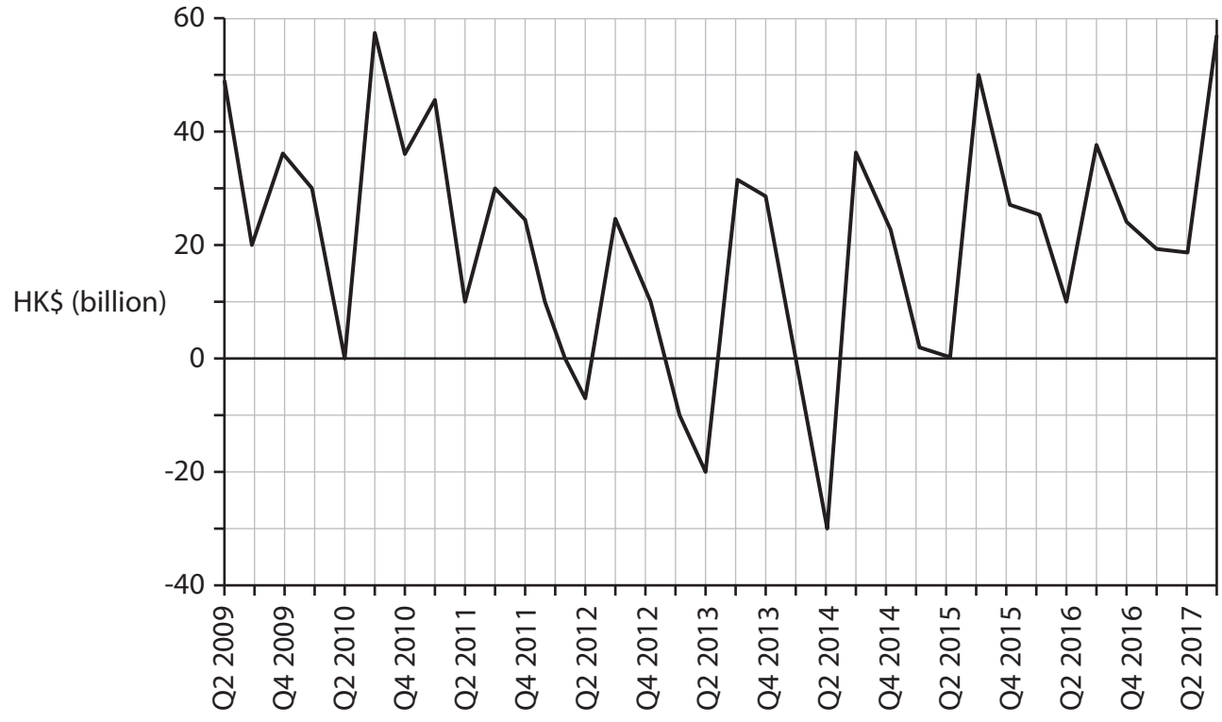
Ceteris paribus, which **one** of the following is likely to result from this situation?

		Rate of unemployment	Rate of inflation
☒	**A**	Falling	Rising
☒	**B**	Falling	Falling
☒	**C**	Rising	Rising
☒	**D**	Rising	Falling

(Total for Question 4 = 1 mark)

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5 The chart shows the current account of the balance of payments for Hong Kong, quarter 2 2009 to quarter 3 2017 HK$ (billion).



(Source: http://www.censtatd.gov.hk/FileManager/EN/UTIL_STAT_CHART/041chart01.gif)

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

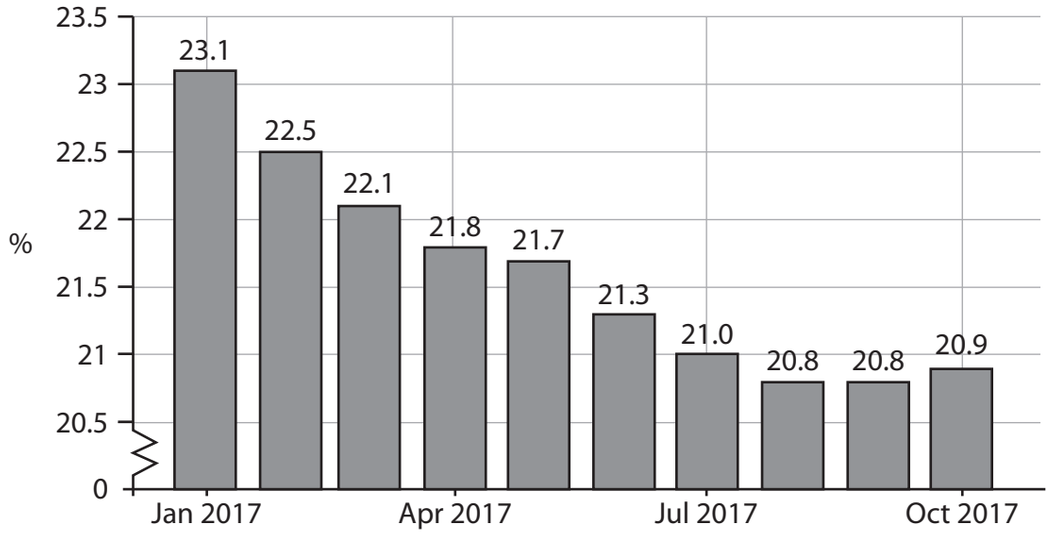
- ☒ **A** There was a current account surplus in Q2 2013
- ☒ **B** The current account surplus fell by HK$20 billion between Q4 2009 and Q2 2010
- ☒ **C** The current account was in a deficit in Q2 2014
- ☒ **D** There was a balanced government budget in Q2 2015

(Total for Question 5 = 1 mark)

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6 The chart shows the ILO unemployment rate for Greece between January 2017 and October 2017.



(Source: https://tradingeconomics.com/greece/unemployment-rate)

Which **one** of the following is the percentage change in the unemployment rate for Greece between January 2017 and October 2017?

- ☒ **A** –2.2
- ☒ **B** –9.52
- ☒ **C** –10.53
- ☒ **D** –10.7

(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 In January 2018 South Korea's Central Bank raised its base interest rate from 1.25% to 1.5%.

Explain **one** likely economic effect of this increase in the base interest rate.

The base interest rate is the rate the central bank charges when it lends money to commercial banks, so it determines the cost of borrowing in the economy.

South Korea's central bank raised the base rate by 0.25 percentage points, from 1.25% to 1.5%. Commercial banks pass this on, so loans become more expensive for firms. This raises the cost of financing new capital, so fewer investment projects are profitable and investment falls.

As investment is a component of aggregate demand (AD = C + I + G + X − M), AD shifts to the left. Through the multiplier effect this leads to a fall in real output (slower economic growth) and reduces demand-pull inflationary pressure. However, the rise is small, so the effect is likely to be limited.

(Total for Question 7 = 4 marks)

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8 New Zealand has a population of 4.693 million people. In 2017 its net migration was 73 000, with more individuals arriving than leaving the country.

Explain **one** possible impact on the level of unemployment of this net migration.

Net migration is immigration minus emigration. Unemployment is the number of people who are willing and able to work but cannot find a job.

In 2017, 73 000 more people arrived in New Zealand than left. This is about 1.56% of the population (73 000 ÷ 4 693 000 × 100), which is significant.

Most migrants are of working age, so the size of the labour force (working population) increases. If the number of jobs does not grow as quickly as the labour supply, there is more competition for jobs, especially in low-skilled occupations, so the level of unemployment may rise.

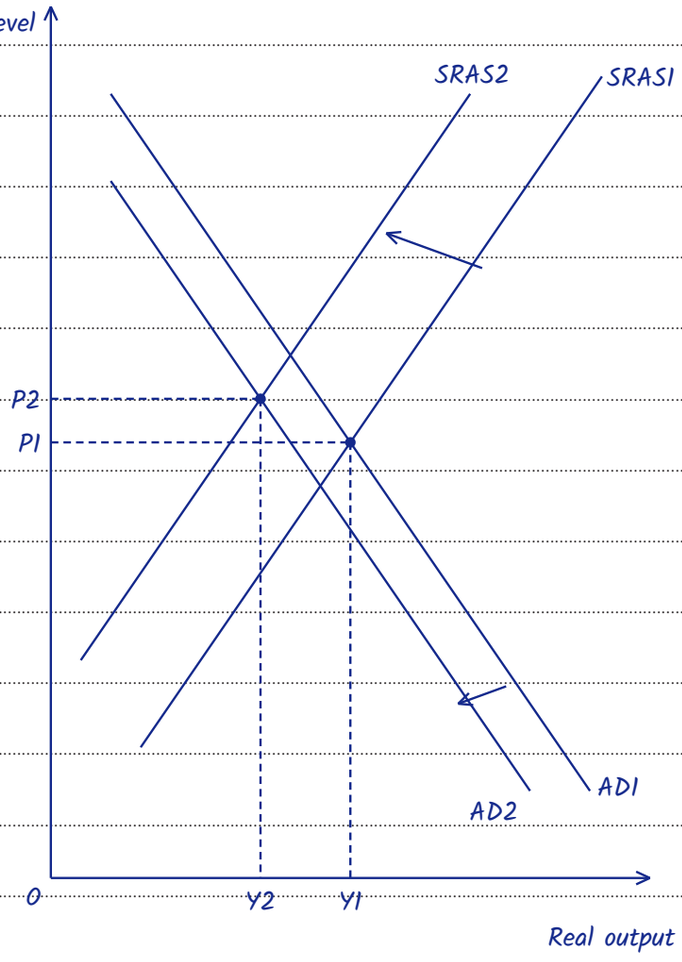
On the other hand, the extra population increases consumption, so AD rises and firms demand more workers (derived demand), which could reduce unemployment in the longer run.

(Total for Question 8 = 4 marks)

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9 Between January 2016 and January 2018 the price of oil rose from $30 per barrel to $65 per barrel. France is a net importer of oil.

Draw a short-run AS and AD diagram to show the effect of the increase in the price of oil on the price level and real output for France.



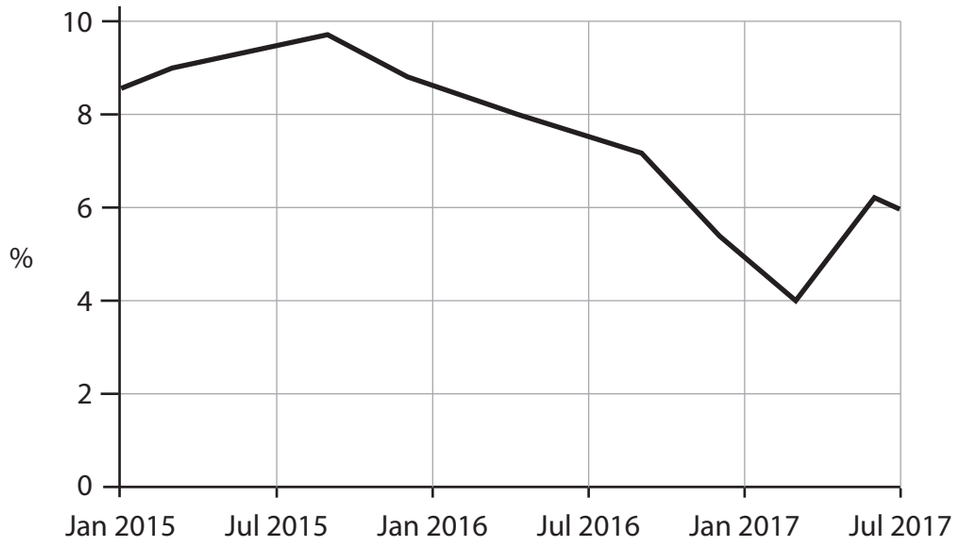
Oil is a key input, so the rise in its price from $30 to $65 per barrel raises firms' costs of production and SRAS shifts left from SRAS1 to SRAS2. As France is a net importer of oil, the higher import bill and lower real incomes also reduce AD from AD1 to AD2. At the new equilibrium real output falls from Y1 to Y2 and the price level rises from P1 to P2.

(Total for Question 9 = 4 marks)

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10 This chart shows the savings ratio for the UK between January 2015 and July 2017.



(Source: https://tradingeconomics.com/united-kingdom/personal-savings)

With reference to the overall trend of the data, explain what is meant by 'the savings ratio'.

The savings ratio is the percentage of households' total disposable income that is saved rather than spent; (total savings ÷ total disposable income) × 100. Saving is the part of income not spent on consumption.

The overall trend in the UK is downward. The savings ratio fell from about 8.5% in January 2015 to 6.0% in July 2017, a fall of about 2.5 percentage points, reaching a low of about 4% in early 2017. So households were saving a smaller proportion of their income and spending more of it.

(Total for Question 10 = 4 marks)

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11 The Central Bank of Egypt has estimated that the marginal propensity to consume for Egypt's economy is 0.6. In October 2017, the Egyptian Government announced a LE11.9 billion investment into renewable energy. (LE = Egyptian currency).

Ceteris paribus, calculate the final increase in the national income resulting from the LE11.9 billion investment.

Multiplier = 1 ÷ (1 − MPC) = 1 ÷ MPW

MPW = 1 − 0.6 = 0.4

Multiplier = 1 ÷ 0.4 = 2.5

Final increase in national income = multiplier × initial injection

= 2.5 × LE11.9 billion

= LE29.75 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 'fiscal policy' (Extract A, line 6).

(2)

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

(4)

(c) With reference to Extract A, analyse **one** macroeconomic effect of the reduction in indirect tax.

(6)

(d) With reference to the information provided, examine the likely impact of increased investment on Romania's economy.

(8)

(e) Discuss the likely effects of the increase in the rate of inflation on Romania's economy.

(14)

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12 (a) Define the term 'fiscal policy' (Extract A, line 6).

(2)

Fiscal policy is the use of government spending and taxation (and so the budget balance) by the government to influence the level of aggregate demand and economic activity, for example to affect growth, unemployment and inflation.

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

(4)

Real GDP growth is the percentage increase in the value of a country's output of goods and services (GDP) over a period of time, after adjusting for inflation, so it measures the increase in the volume of output rather than in prices.

Figure 1 shows that Romania had positive real GDP growth in every quarter of 2016 and 2017, so real output was always higher than a year earlier. Growth was rapid, rising from 4.3% in Q1 2016 to a peak of 8.8% in Q3 2017, before slowing to 6.9% in Q4 2017.

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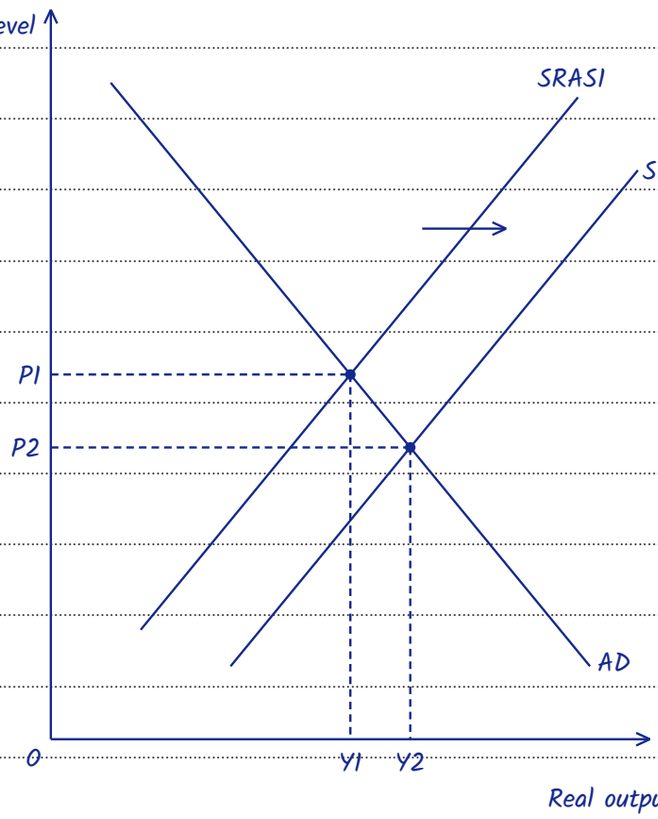
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(c) With reference to Extract A, analyse **one** macroeconomic effect of the reduction in indirect tax.

(6)

An indirect tax is a tax on spending on goods and services, such as VAT, which firms can pass on to consumers through higher prices. In 2015 the Romanian Government cut VAT from 24% to 20%.

One macroeconomic effect is an increase in real output (economic growth). VAT is a cost to firms, so the 4 percentage point cut lowers their costs of supplying goods. As shown in the diagram, SRAS shifts right from SRAS1 to SRAS2.



The price level falls from P1 to P2 and real output rises from Y1 to Y2. Lower prices mean that households' incomes have greater purchasing power, so real disposable income rises and consumption increases (a movement along AD). As firms sell more, they increase output and demand more labour, so unemployment falls, which helps explain why unemployment fell to

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4.6% in 2017 and Romania grew faster than other European countries.

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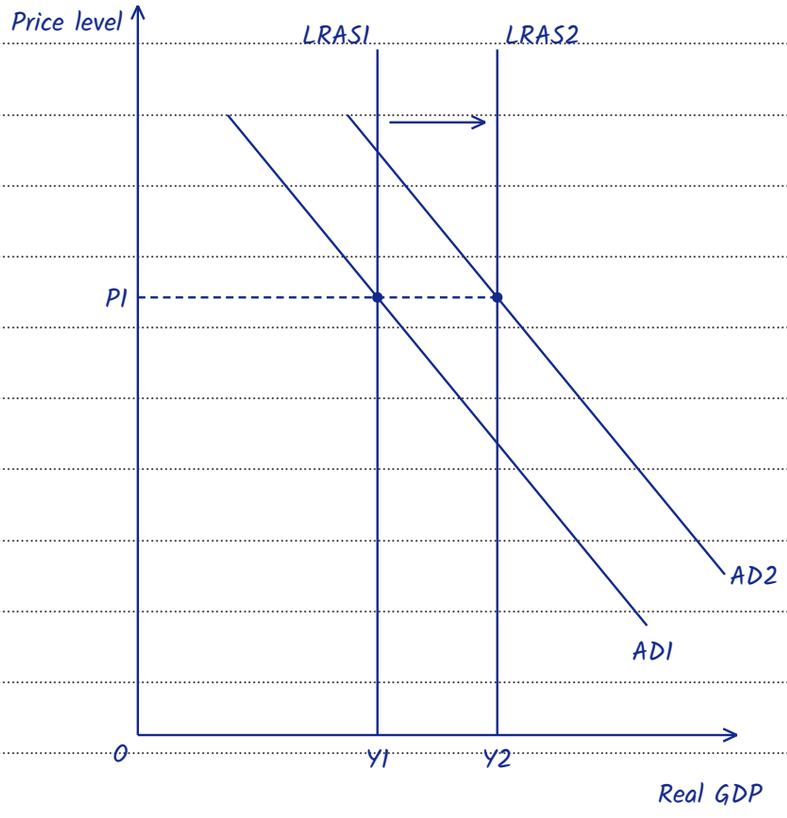
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(d) With reference to the information provided, examine the likely impact of increased investment on Romania's economy.

(8)

Investment is spending on capital goods, such as factories, machinery and new technology, which increases the capital stock. It is a component of aggregate demand and also increases the productive capacity of the economy (LRAS).

In Romania, large foreign firms such as Siemens and Ford have set up factories in Bucharest, and there has been high investment in new technology for manufacturing. In the short run this spending shifts AD right from AD1 to AD2 and, through the multiplier, real output increases. In the long run the extra capital and technology raise productivity, so LRAS shifts right from LRAS1 to LRAS2. Real GDP rises from Y1 to Y2 without a rise in the price level (P1).



The investment has increased production and generated strong growth in exports. Higher exports add further to AD and improve the current account of the balance of payments. More production

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also increases the demand for labour, which reduces unemployment (4.6% in 2017) and could encourage Romanian migrants to return to fill vacancies.

However, labour shortages mean firms may struggle to recruit, so wages may be bid up, causing cost-push inflation, and output may not rise by as much as expected. Demand for Romanian exports also depends on the exchange rate and on incomes in the rest of Europe. Finally, the benefit depends on how much of the profit stays in Romania, as foreign firms may send profits home.

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(e) Discuss the likely effects of the increase in the rate of inflation on Romania's economy.

(14)

Inflation is a sustained increase in the general price level, measured in Romania by the consumer price index (CPI). Figure 2 shows that Romania had deflation throughout 2016 (as low as about −3.5%), but inflation rose throughout 2017, from about 0.1% in January to about 3.3% in December. Extract B shows this was partly caused by a 3.8% rise in food prices and a 4.1% rise in non-food prices.

First, higher inflation reduces real incomes and living standards for households whose incomes do not rise as fast as prices, such as those on fixed incomes or pensions. Food is a large share of spending for low-income households, so the 3.8% rise in food prices hits the poorest hardest. This reduces their real disposable income, so consumption may fall, which slows the growth of AD and real GDP.

Second, the central bank has responded by raising its base rate for the first time in ten years, from 1.75% to 2%. This increases the cost of borrowing and the reward for saving, so consumption and investment fall. Lower investment could reduce the investment in new technology that has driven Romania's growth, and growth already slowed from 8.8% in Q3 2017 to 6.9% in Q4 2017.

Third, if Romania's inflation is higher than that of its trading partners, its exports become less price competitive and imports relatively cheaper. Exports fall and imports rise, so net exports fall, reducing AD and worsening the current account of the balance of payments. This could threaten the export growth generated by firms such as Siemens and Ford.

Fourth, with labour shortages and a low unemployment rate of 4.6%, workers expecting higher

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prices will demand higher wages. This raises firms' costs and causes cost-push inflation, so a wage-price spiral could develop. Higher costs reduce profits and may lead firms to cut jobs, increasing unemployment. On the other hand, inflation reduces the real value of debt, which helps the Government finance its fiscal deficit of 3% of GDP, and fiscal drag raises tax revenue.

However, the effects are likely to be limited. Inflation of about 3% is moderate and close to the targets of many central banks, so it is not high enough to cause serious damage, and it is much better than the deflation of 2016, which may have led consumers to delay purchases. Wages are also rising, as the Government plans to double the minimum wage and has raised public sector pay, so real incomes may not fall.

In addition, with growth of up to 8.8% the economy probably has a positive output gap, so some slowing of growth may be beneficial and sustainable. The rise in interest rates should reduce inflation over time, although there are time lags. Investment may stay high because Romanian wages are still low compared with other European countries and the workforce is highly skilled, which offsets the higher costs.

In conclusion, the main effects are likely to be lower real incomes for poorer households and reduced competitiveness, but as inflation is only about 3% the overall impact is likely to be small in the short run. The size of the effects depends on whether inflation keeps rising: if expansionary fiscal policy continues and wages keep rising, a wage-price spiral could make the effects much more serious.

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(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 China's economic growth has resulted in a significant increase in pollution within the country. It is believed that recent government legislation to lower pollution will cause China's real GDP to increase at a slower rate.

Evaluate the view that conflicts between macroeconomic objectives are inevitable.

(Total for Question 13 = 20 marks)

OR

14 Increasing household consumption is a major factor contributing to India's high rate of economic growth.

Evaluate the view that rising consumer expenditure will always benefit an economy.

(Total for Question 14 = 20 marks)

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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** ☐

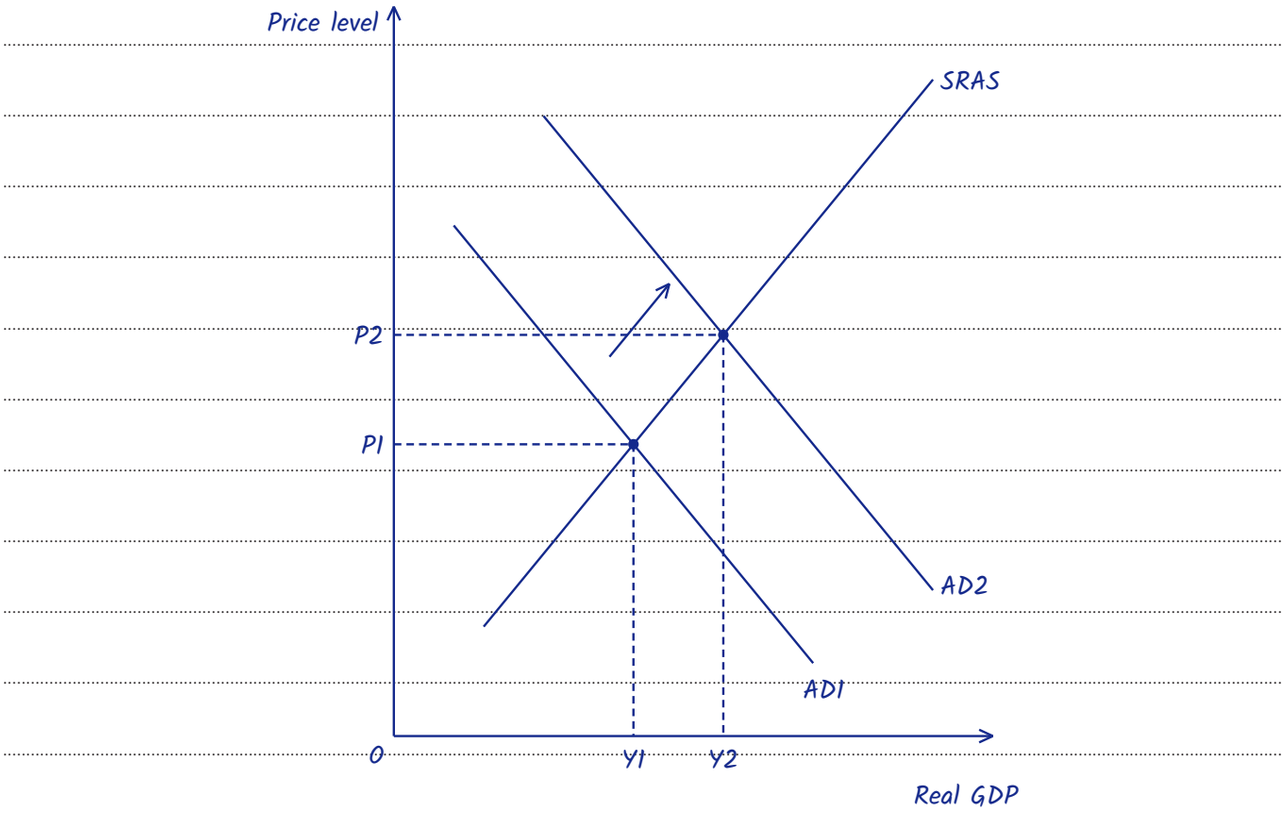
Write your answer here:

The main macroeconomic objectives are strong and sustainable economic growth, low unemployment, low and stable inflation, equilibrium on the current account of the balance of payments, a fair distribution of income and protection of the environment. A conflict occurs when policies that help achieve one objective make it harder to achieve another.

One conflict is between economic growth and the environment. China's rapid growth has been driven by manufacturing and coal-powered energy, so higher output has created negative externalities such as air pollution, causing health problems and lowering living standards. The new legislation to lower pollution raises firms' costs, shifting SRAS left, so China's real GDP is expected to grow at a slower rate.

A second conflict is between growth (or low unemployment) and low inflation. If AD increases, for example through higher consumption or expansionary fiscal policy, AD shifts right from AD1 to AD2. Real GDP rises from Y1 to Y2 and, because firms need more workers, unemployment falls. However, the price level rises from P1 to P2, causing demand-pull inflation.

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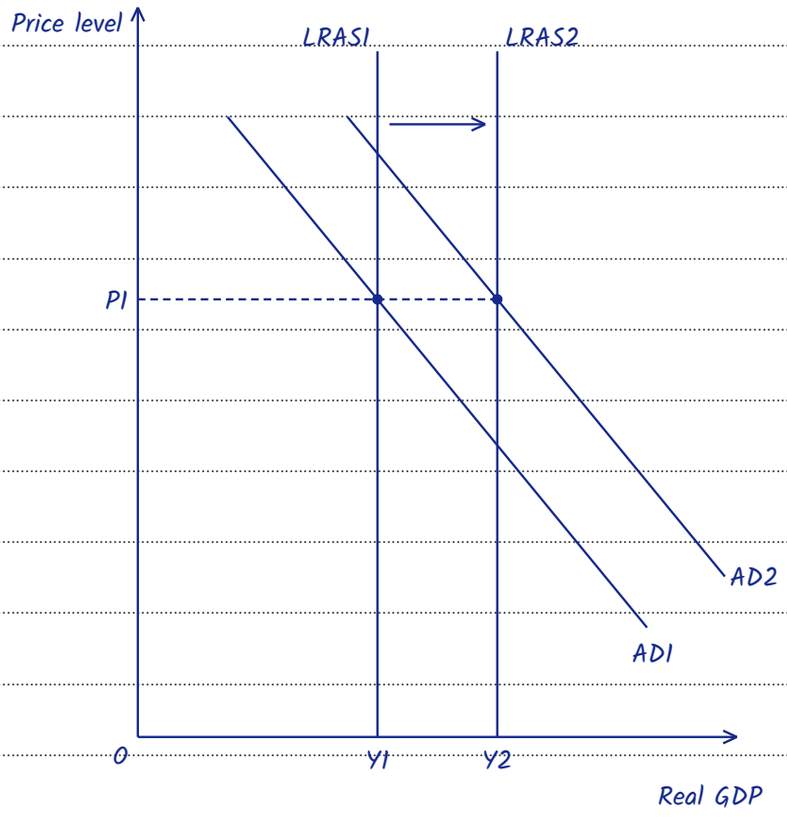
This is shown by the short-run Phillips curve: as unemployment falls, labour becomes scarce, so workers can bargain for higher wages, which firms pass on as higher prices. So the closer the economy is to full capacity, the greater the trade-off between unemployment and inflation.

A third conflict is between growth and the current account. As incomes rise, households demand more imports, so the current account may move into deficit. Higher inflation also makes exports less price competitive. Finally, growth may widen income inequality if the gains go mainly to owners of capital and skilled urban workers, as has happened in China between coastal cities and rural areas.

However, conflicts are not inevitable. If growth comes from the supply side, for example from investment in education, infrastructure or new technology, productivity rises and LRAS shifts right from LRAS1 to LRAS2. If AD also rises, real GDP increases from Y1 to Y2 while the price level stays at P1, so growth, falling unemployment and low inflation are achieved together.

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The extent of the conflict also depends on the state of the economy. If there is a large negative output gap with high unemployment, the AS curve is very elastic, so an increase in AD raises real output and employment with little or no inflation. The trade-off only becomes serious when the economy is close to full capacity.

The type of growth also matters. Export-led growth increases AD while improving the current account, so these objectives do not conflict. Growth in the tertiary (services) sector is much less polluting than growth in manufacturing and mining, and as China shifts towards services and adopts green technology, such as solar and wind power, growth and the environment can conflict less. Higher growth also raises tax revenues, which the government can use for public transport, cleaner energy and redistribution through benefits, reducing inequality.

The time period is important too. China's pollution legislation may slow growth in the short run,

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but cleaner air improves the health and productivity of workers and avoids future clean-up costs, so it may support more sustainable growth in the long run. Similarly, the long-run Phillips curve is vertical, so there is no permanent trade-off between unemployment and inflation.

In conclusion, conflicts between macroeconomic objectives are common, especially in the short run when growth is driven by demand and the economy is close to full capacity, as with China's growth and pollution. However, they are not inevitable. Whether they occur depends on the source of growth, the size of the output gap and the time period. Supply-side, export-led and green growth allow several objectives to be achieved together, so the government's choice of policies is the key factor.

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

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Pearson Edexcel International Advanced Level

Thursday 16 May 2019

Morning | 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 Romanian economy

Figure 1 Year-on-year real GDP growth by quarter, 2016-2017

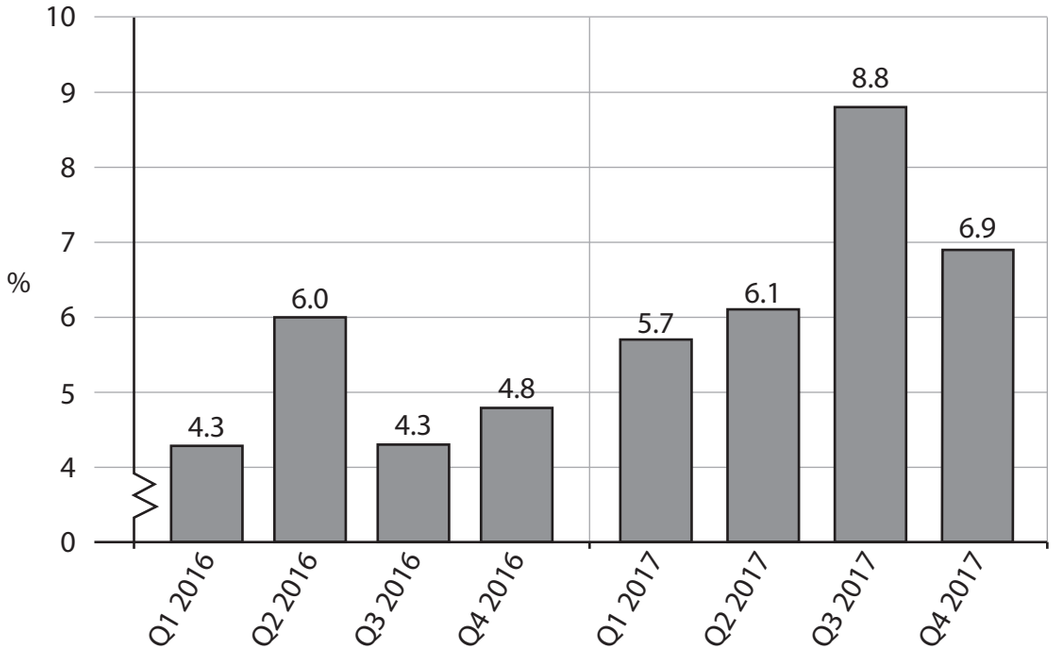
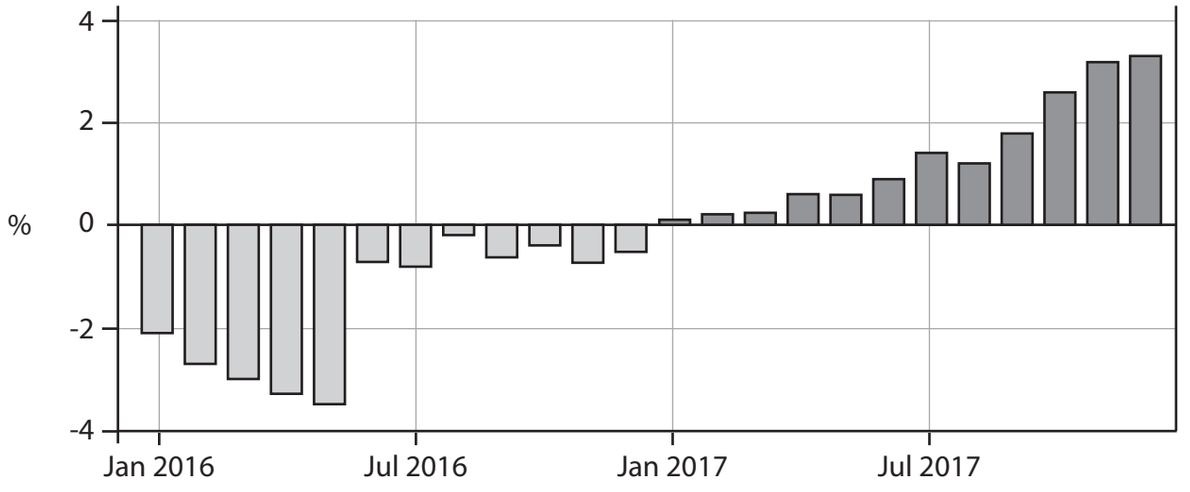


Figure 2 The rate of inflation, as measured by the consumer price index, 2016-2017



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Extract A Romania's economic growth

For many years Romania had been viewed as a poor country by European standards, experiencing low wages and a slow rate of economic growth. However, since 2015, Romania's rate of economic growth outperformed other European countries. This growth was stimulated by a number of factors including the Government's expansionary fiscal policy, increased household consumption and high levels of investment in new technology for manufacturing industries.

In 2015 the Government cut VAT from 24% to 20%. It planned to double the minimum wage over a four-year period. It also increased the salaries of public sector employees. However, wage levels are still low compared to other European countries leading to high levels of migration out of the country. This resulted in labour shortages as businesses found it hard to fill vacancies. The unemployment rate fell to 4.6% in 2017.

Romania has one of the fastest broadband internet speeds in the world, behind Singapore, Hong Kong, South Korea and Iceland. It also has a very well-educated workforce, with excellent language, maths and science skills. The technology sector is expanding fast in the country, and many large foreign firms such as Siemens and Ford have set up factories in Bucharest, the Romanian capital. This has increased production in the country and generated strong growth in exports.

Extract B Inflationary pressures

As disposable incomes have risen, consumption has also increased significantly reaching a ten-year peak in 2017. The rate of inflation has risen throughout 2017. This was partly caused by a 3.8% increase in food prices and by a 4.1% price increase in non-food products.

The central bank responded to this inflationary pressure by increasing its base interest rate for the first time in 10 years from 1.75% to 2%. Mugur Isarescu, the Governor of the central bank, suggested that the Romanian Government's fiscal policies are to blame for the higher rate of inflation. The fiscal deficit rose to 3% of GDP in 2016. The Government defended its position, believing that reductions in tax rates and increased government spending on infrastructure will lead to long-term economic growth.

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Acknowledgements

Figure 1 and 2 based on data taken from Tradingeconomics.com

Extract A adapted from https://www.theguardian.com/world/2017/oct/14/romania-economy-booming

Extract B adapted from https://www.nytimes.com/2017/10/18/business/europe-economy-romania.html

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