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

Monday 15 May 2023

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.

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 withdrawal from the circular flow of income?

- ☒ **A** Investment
- ☒ **B** Consumption
- ☒ **C** Savings
- ☒ **D** Exports

(Total for Question 1 = 1 mark)

2 Spain's unemployment rate fell from 13.6% in quarter 1 2022 to 12.5% in quarter 2 2022.
Its annual rate of inflation increased from 6.1% in January 2022 to 10.2% in June 2022.

Which **one** of the following best illustrates the possible conflict between the macroeconomic objectives of a low rate of inflation and a low rate of unemployment?

- ☒ **A** The short-run Phillips curve
- ☒ **B** The aggregate demand curve
- ☒ **C** The short-run AS curve
- ☒ **D** The Keynesian LRAS curve

(Total for Question 2 = 1 mark)

3 Which **one** of the following statements about the classical long-run aggregate supply (LRAS) curve is correct?

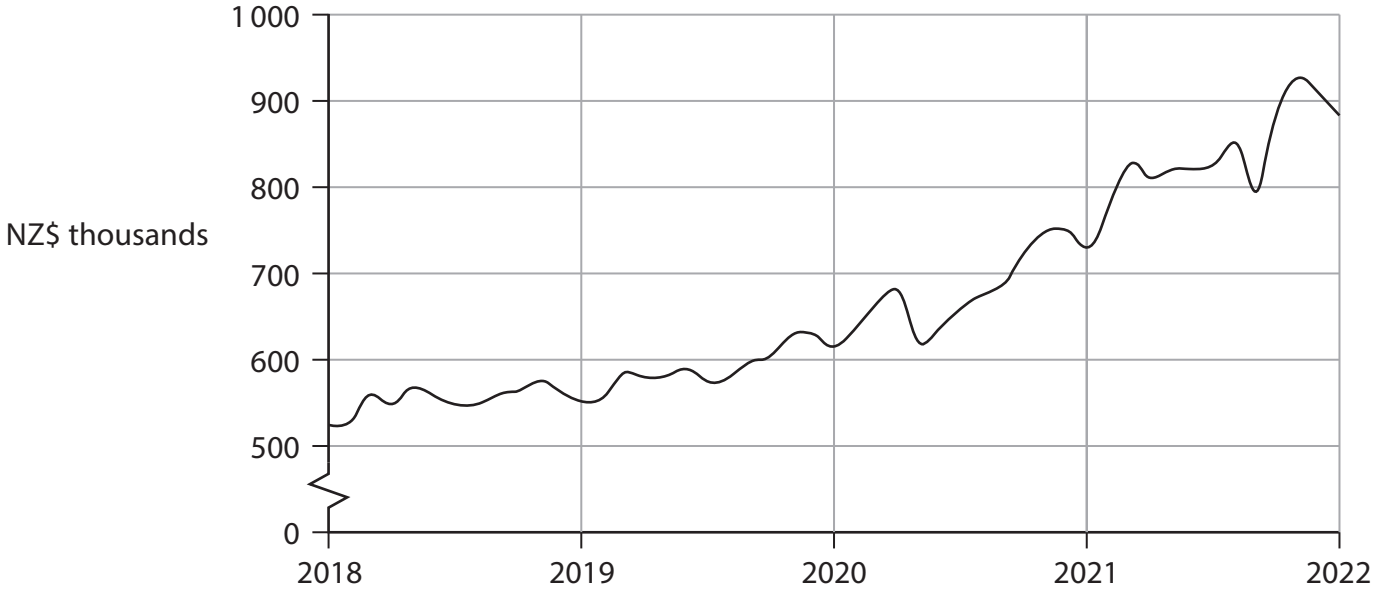
- ☒ **A** It is relatively elastic at high levels of spare capacity
- ☒ **B** It is perfectly inelastic at the full employment level of real output
- ☒ **C** It is perfectly inelastic at high levels of spare capacity
- ☒ **D** It is relatively elastic at the full employment level of real output

(Total for Question 3 = 1 mark)

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4 The chart shows changes in average house prices in New Zealand between January 2018 and December 2021.



Which **one** of the following is the most likely impact of the change in average house prices on existing homeowners between January 2018 and December 2021?

- ☒ **A** Higher consumer confidence
- ☒ **B** Negative wealth effects
- ☒ **C** An increase in net investment
- ☒ **D** Lower consumer expenditure

(Total for Question 4 = 1 mark)

5 In December 2021 the European Central Bank (ECB) decided to end its asset purchases (quantitative easing) scheme. In August 2022 the ECB started to sell these assets.

Which **one** of the following describes this economic policy?

- ☒ **A** Reflationary fiscal policy
- ☒ **B** Deflationary fiscal policy
- ☒ **C** Reflationary monetary policy
- ☒ **D** Deflationary monetary policy

(Total for Question 5 = 1 mark)

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6 The table shows China's nominal Gross Domestic Product (GDP) and population for 2011 and 2021.

Year	GDP ($ billion)	Population (billions)
2011	7 550	1.345
2021	17 730	1.412

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

☒ **A** Between 2011 and 2021 nominal GDP increased by 5%

☒ **B** Between 2011 and 2021 population increased by 134.8%

☒ **C** GDP per capita in 2011 was $10 155

☒ **D** GDP per capita in 2021 was $12 557

(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 Between 2018 and 2021 the annual rate of unemployment in Pakistan increased from 4.1% to 6.5%.

Explain **one** possible effect of the increase in the rate of unemployment on the public finances of Pakistan.

Public finances refer to the government's tax revenues and its public expenditure. The rate of unemployment is the percentage of the labour force who are actively seeking work and willing to work but do not have a job.

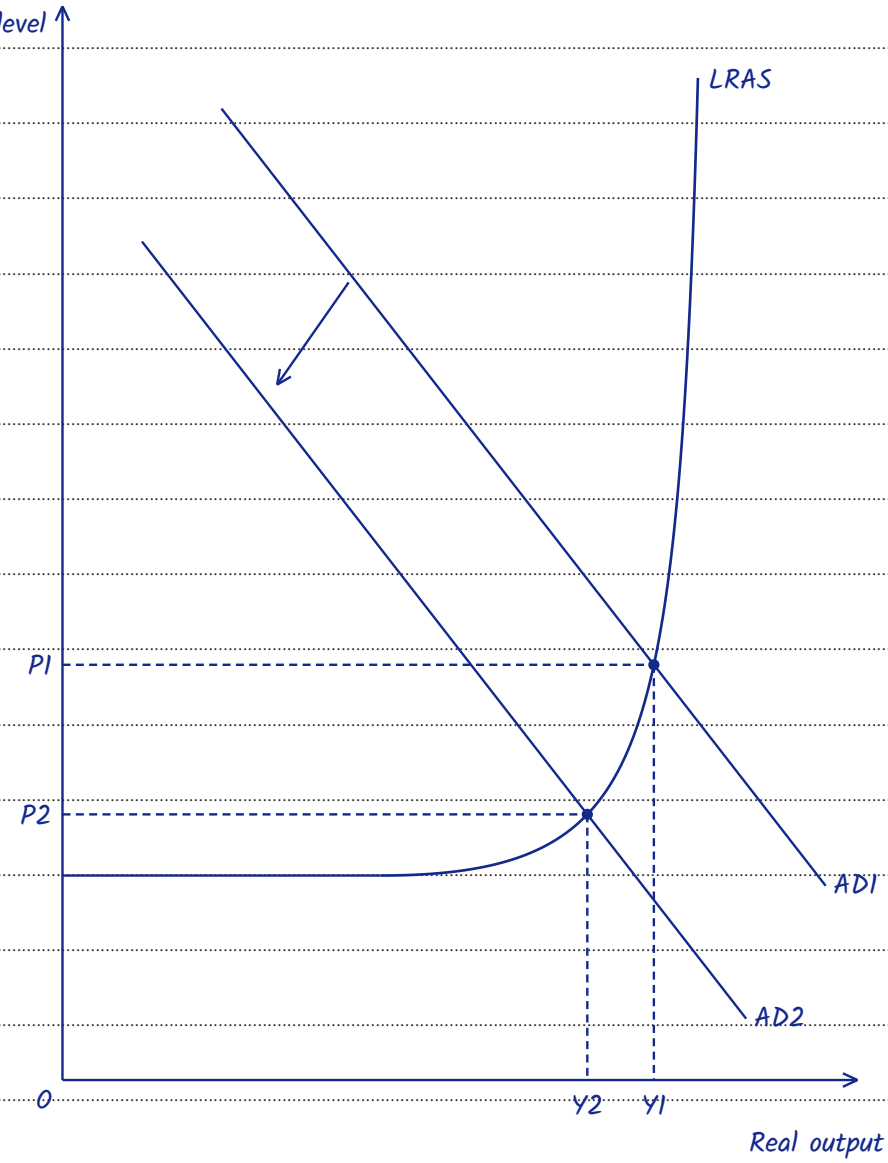
In Pakistan the unemployment rate rose from 4.1% in 2018 to 6.5% in 2021, an increase of 2.4 percentage points. As more people lose their jobs, fewer people earn an income and pay income tax, and because they spend less, indirect tax revenue (eg sales tax) also falls. At the same time more people claim unemployment and welfare benefits, so government spending rises. Lower tax revenue and higher spending lead to a larger budget deficit, a deterioration in Pakistan's public finances, which may increase government borrowing and the national debt.

(Total for Question 7 = 4 marks)

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8 Between July 2021 and July 2022 there was a fall in business confidence in Germany.

Draw an AD and LRAS diagram to show the likely impact of a fall in business confidence on the economy of Germany.



A fall in business confidence reduces investment, so AD shifts left from AD1 to AD2. The price level falls from P1 to P2 and real output falls from Y1 to Y2.

(Total for Question 8 = 4 marks)

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9 In 2022 it was estimated that an increase in government spending of $25 billion in an economy would eventually result in an increase in the country's national income of $100 billion.

Based on this information, calculate the marginal propensity to consume (MPC) in this economy. Show your workings.

MPC = ΔC ÷ ΔY, the proportion of an extra unit of income that households spend.

Multiplier = 1 ÷ (1 − MPC)

Multiplier = change in national income ÷ change in government spending

= $100 billion ÷ $25 billion = 4

1 ÷ (1 − MPC) = 4, so 1 − MPC = 1 ÷ 4 = 0.25 (this is the MPW)

MPC = 1 − 0.25 = 0.75

(Total for Question 9 = 4 marks)

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10 In 2022 Vietnam's output gap was forecast to be between –5% and –10%.

Explain **one** likely impact of a negative output gap on Vietnam's economy.

A negative output gap is when actual real GDP is below potential (trend) real GDP, so the economy has spare capacity. Vietnam's output gap was forecast to be between –5% and –10% in 2022, meaning actual output could be up to 10% below its potential.

One likely impact is higher unemployment. Because AD and real output are low, firms need fewer workers to produce the lower level of output, so they make workers redundant and stop hiring. This causes cyclical (demand-deficient) unemployment, so labour is an idle resource, Vietnam's resources are allocated inefficiently and living standards fall as household incomes fall. Higher unemployment also puts downward pressure on wage rates, so there is little demand-pull or cost-push inflationary pressure and inflation is likely to be low.

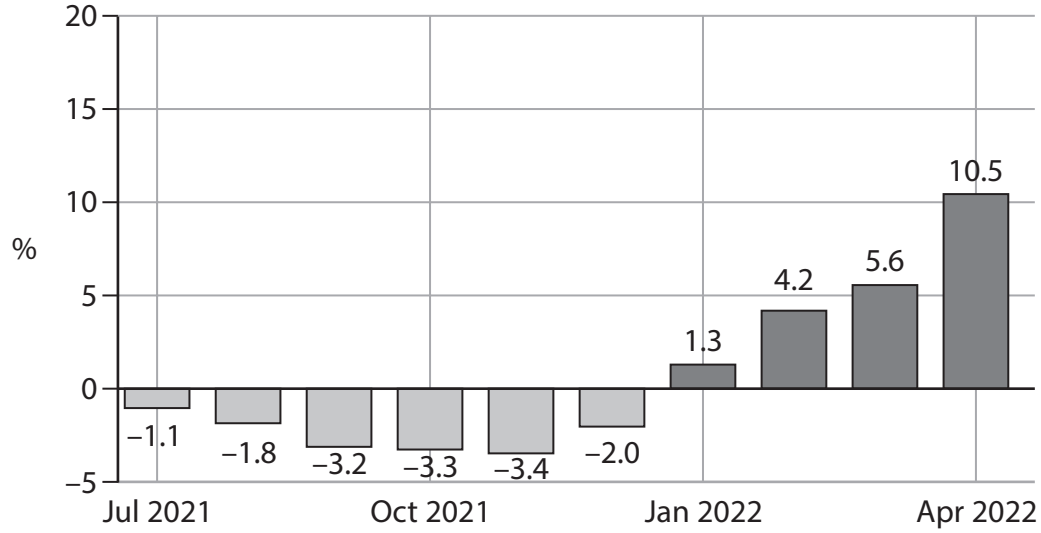
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11 The chart shows the CPI inflation rate* in Rwanda between July 2021 and April 2022.



*This is the year-on-year inflation rate calculated monthly.

With reference to the chart, explain what is meant by deflation.

Deflation is a fall in the average (general) price level in an economy over time, so the rate of inflation is negative, below zero.

The chart shows that Rwanda experienced deflation in every month from July 2021 to December 2021, as the inflation rate was below zero. For example, the inflation rate was −3.3% in October 2021, and the deepest deflation was −3.4% in November 2021, so prices were 3.4% lower than a year earlier. From January 2022 (1.3%) inflation was positive, so the deflation had ended.

(Total for Question 11 = 4 marks)

TOTAL FOR SECTION B = 20 MARKS

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SECTION C

Study Figure 1 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 'GDP growth rate' (Extract A, line 23).

(2)

(b) With reference to Figure 1, explain the difference between a balance of trade deficit and a balance of trade surplus.

(4)

(c) Analyse how an increase in the rate of inflation could have a 'negative impact on India's balance of trade' (Extract A, line 9).

(6)

(d) Examine the likely impact on India's real output of its 'increased expenditure on imported oil' (Extract A, line 7).

(8)

(e) With reference to the information provided and your own knowledge, discuss the likely effects of the increase in the base rate of interest on the Indian economy.

(14)

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12 (a) Define the term 'GDP growth rate' (Extract A, line 23).

(2)

The GDP growth rate is the annual percentage change in the total value of goods and services produced in an economy (real GDP) over a period of time, usually a year.

(b) With reference to Figure 1, explain the difference between a balance of trade deficit and a balance of trade surplus.

(4)

A balance of trade deficit is when the value of a country's imports of goods and services is greater than the value of its exports (M > X). Figure 1 shows India had a deficit in every month from July 2020 to July 2022, eg a deficit of $15.4 billion in December 2020 and a record $30.0 billion in July 2022.

A balance of trade surplus is when the value of exports is greater than the value of imports (X > M). India had a surplus in only one month, June 2020, when the surplus was $0.8 billion.

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(c) Analyse how an increase in the rate of inflation could have a 'negative impact on India's balance of trade' (Extract A, line 9).

(6)

An increase in the rate of inflation means the general price level of goods and services in India rises at a faster rate. The rate of inflation was 7.01% in June 2022 compared with June 2021, the second highest of the larger Asian economies, and economists expected it to rise further.

First, higher inflation raises the prices of goods and services produced in India, including its exports. If Indian inflation is higher than that of its main trading partners, Indian exports become less price competitive in world markets. Foreign buyers switch to cheaper substitutes from other countries, so demand for Indian exports falls and the value of exports falls.

Second, imported goods become relatively cheaper than Indian-produced goods. Indian consumers and firms therefore switch from domestic products to imports, so demand for imports and the value of imports rises.

With the value of exports falling and the value of imports rising, M rises relative to X, so India's balance of trade deficit widens. This would make the problem worse, because in July 2022 India already had a record trade deficit of $30 billion, one of the largest of all the Asian economies.

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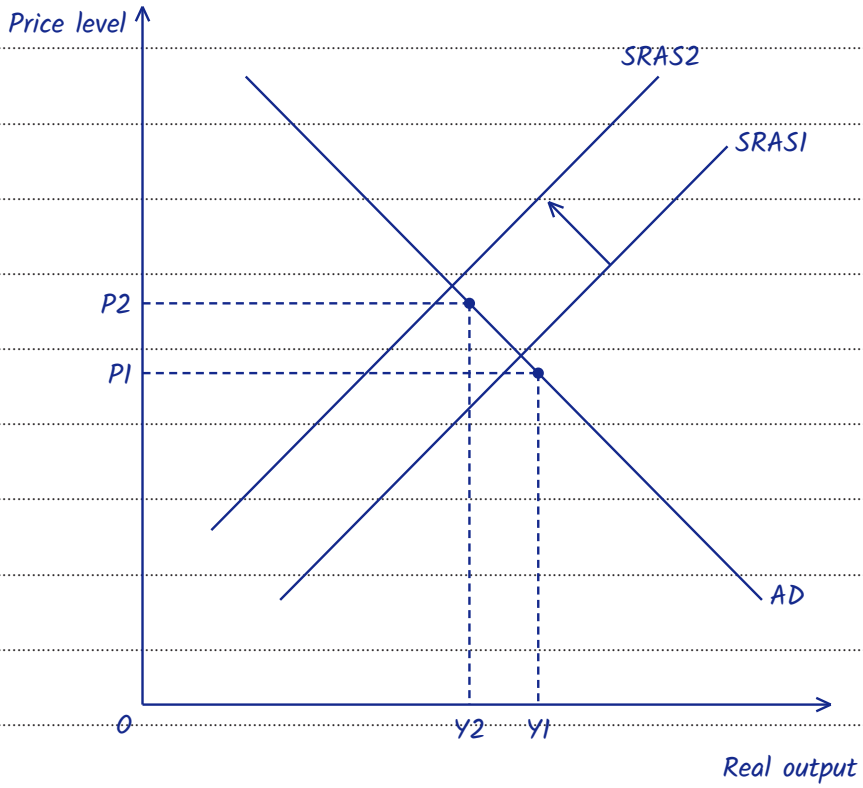
(d) Examine the likely impact on India's real output of its 'increased expenditure on imported oil' (Extract A, line 7).

(8)

Real output is the value of goods and services produced, adjusted for inflation. The likely impact of India's increased expenditure on imported oil is a fall in real output.

Oil accounts for 30% of India's imports by value, more than double the 14.7% average for other major Asian economies such as China, Japan and South Korea. Higher spending on imported oil increases imports (M), which is a withdrawal from the circular flow of income. Since net trade is a component of AD (C+I+G+(X−M)), AD falls, and through the negative multiplier real output falls by more than the initial rise in import spending.

Also, oil is a key input in production and transport, so higher oil costs raise firms' costs of production. As the diagram shows, SRAS shifts left from SRAS1 to SRAS2, so the price level rises from P1 to P2 (cost-push inflation) and real output falls from Y1 to Y2.



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However, the size of the fall in real output may be limited. Extract A states that exports of services contribute more to India's economic growth than exports of goods, so if service exports rise faster than oil imports, net trade and real output may not fall. The impact also depends on the elasticity of LRAS: if India has spare capacity, the fall in AD mainly reduces real output, but near full capacity it mainly lowers the price level. In the long run other components of AD, such as consumption, which the ADB predicted would rise slightly, may offset the fall. Overall, as oil is 30% of imports the impact is likely to be significant, but real output may only grow more slowly rather than fall.

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(e) With reference to the information provided and your own knowledge, discuss the likely effects of the increase in the base rate of interest on the Indian economy.

(14)

The base rate of interest is the rate set by the central bank, a monetary policy instrument. India's central bank raised it by 0.5 percentage points, from 4.4% in May 2022 to 4.9% in June 2022, to control inflation of 7.01% and to stop the rupee falling further against the US dollar.

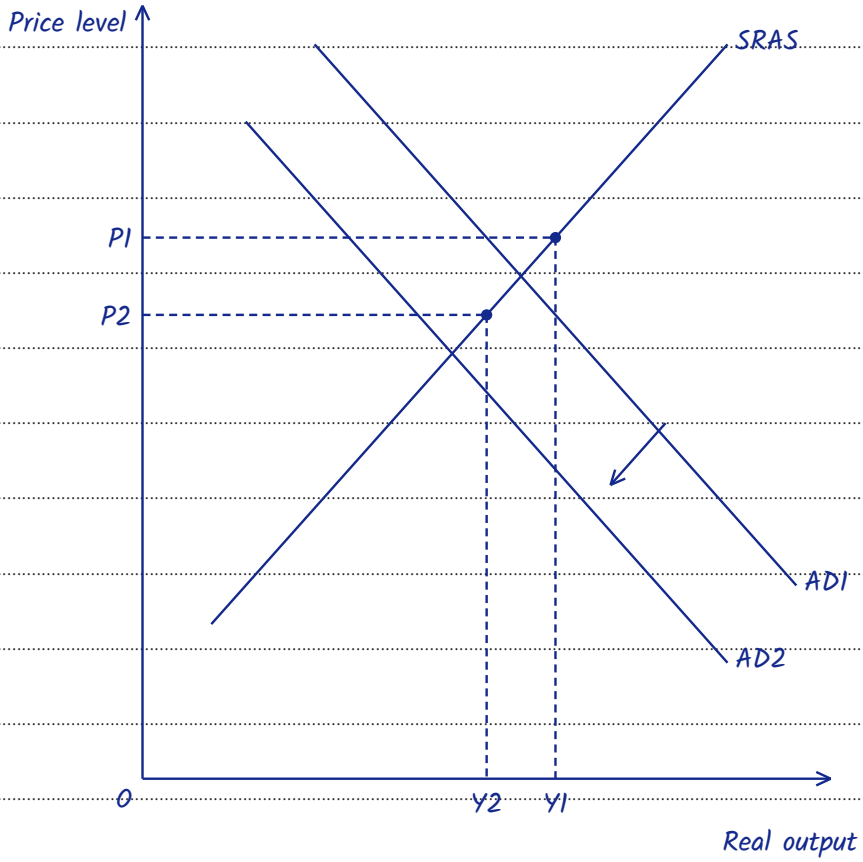
First, higher interest rates raise the cost of borrowing and increase the reward for saving. Households borrow less to buy cars and houses and save more, and those with variable rate loans or mortgages face higher repayments, which reduces their discretionary income. Higher borrowing costs also reduce house prices, creating negative wealth effects. Consumption therefore grows more slowly, supported by Extract A, which says consumer expenditure would increase at a slower rate in the second half of 2022. Firms also face higher costs of borrowing to finance investment, so fewer projects are profitable and investment falls.

Second, higher interest rates attract inflows of hot money from abroad seeking a higher return, so demand for the rupee rises and its exchange rate appreciates. This makes Indian exports more expensive and imports cheaper, which reduces net exports, although lower consumption also reduces spending on imports, which helps the trade balance.

As C, I and (X–M) fall, AD shifts left from AD1 to AD2 in the diagram. The price level falls from P1 to P2, reducing demand-pull inflation, which is the aim of the policy, but real output falls from Y1 to Y2, so the rate of economic growth falls. The ADB cut its GDP growth forecast for India to 6.7% for 2022 partly because of this deflationary monetary policy. Lower real output means firms need fewer workers, so unemployment is likely to rise.

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However, the effects may be small. A rise of only 0.5 percentage points may not be enough when inflation is above 7%, and real interest rates are still negative (4.9% – 7.01% ≈ –2.1%), so saving is still not very attractive. Commercial banks may not pass the full increase on to borrowers, and if consumer and business confidence are high, spending may not fall much.

Also, monetary policy works with a time lag of around 18 to 24 months, so the full effect on inflation in India may not be felt until 2023 or 2024. The size of the effect on real output depends on the size of the multiplier and on how much spare capacity India has.

Most importantly, India's inflation is largely cost-push, caused by its dependence on imported oil. Higher interest rates reduce AD but do not reduce the world price of oil, so they may cut growth and jobs without bringing inflation down much. On the other hand, a stronger rupee makes oil, which is priced in US dollars, cheaper to import, which does help to reduce cost-push inflation.

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Overall, the rise in the base rate is likely to slow consumption, investment and growth, as the lower 6.7% forecast shows, but its effect on inflation is likely to be limited and delayed, mainly working through the exchange rate, because the main cause of inflation is the price of imported oil.

(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 In 2022 Japan's productivity was approximately 30% lower than that of the USA.

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

(Total for Question 13 = 20 marks)

OR

14 Many economists are expecting several of the world's leading economies to enter a recession in 2023.

Evaluate the likely costs of a recession on an economy of your choice.

(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:

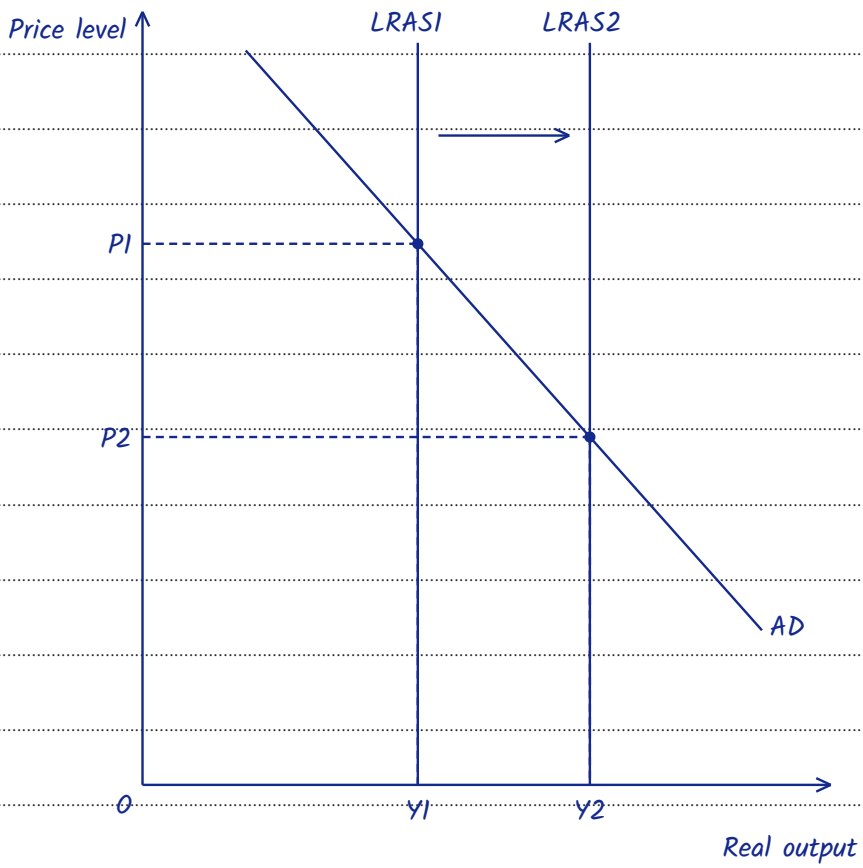
Productivity is output per worker or output per hour worked. Supply-side policies aim to increase the productive capacity of an economy by improving the quality and quantity of factors of production, competition and incentives. Japan's productivity was about 30% lower than that of the USA in 2022, so Japanese workers produce much less output per hour, which limits growth and living standards.

One interventionist policy is more government spending on education and training. Better skills increase human capital, so each worker can produce more output per hour, for example by using digital technology more effectively, as many Japanese firms, especially small ones, still rely on paper-based and manual processes. Higher productivity lowers unit costs, makes Japanese exports more competitive and shifts LRAS right from LRAS1 to LRAS2, as in the diagram below, raising potential output from Y1 to Y2 and lowering the price level from P1 to P2.

A second policy is more government spending on infrastructure, such as high-speed broadband and digital networks. This reduces firms' costs and improves access to markets, so firms can produce more with the same inputs and productivity rises.

Third, market-based policies such as lower corporation tax increase firms' post-tax profits, giving them the incentive and the funds to invest in new capital and research and development. Japan cut its corporation tax rate during the 2010s to encourage investment. More and better capital per worker and new technology raise output per worker. Deregulation and lower barriers to entry also increase competition, so firms are forced to cut waste and innovate, raising productive efficiency.

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Fourth, labour market reforms can raise productivity. Japan has an ageing population and a shrinking labour force, so it needs each worker to produce more. Reforming long working hours and seniority-based pay so that pay is linked to performance gives workers an incentive to work more efficiently, and policies such as more childcare increase female participation, adding skilled workers.

However, these policies have significant limitations. Education and infrastructure spending has a long time lag: it may take 10 to 20 years before today's students enter the workforce, so the 30% productivity gap with the USA will not close quickly. They are also very costly, and Japan's government debt is already over 200% of GDP, so there is a large opportunity cost, as the money cannot be spent on healthcare for its ageing population. The effectiveness also depends on the quality of the training and projects: the government may lack information about which skills firms need, leading to government failure.

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Cutting corporation tax may not raise productivity if firms use the higher profits to pay dividends or simply save them rather than invest; Japanese firms already hold large cash reserves. Tax cuts also reduce government revenue, worsening the budget deficit. Deregulation may lead to lower safety or environmental standards, and reducing bureaucracy may cause short-term unemployment. Labour market reforms may face cultural resistance and take time to change working practices.

Supply-side policies also only create potential growth. If there is a large negative output gap and AD is weak, as Japan has experienced in long periods of low growth and deflation, higher productive capacity may not lead to higher actual output. It is also hard to measure productivity accurately, especially in services, so part of the gap with the USA may reflect measurement problems.

In conclusion, supply-side policies can increase Japan's productivity, and investment in skills and digital technology is probably the most effective because it directly raises output per worker and helps offset its shrinking labour force. However, they work only in the long run, are costly given Japan's high debt, and need to be combined with policies that support AD, so the gap with the USA is likely to narrow only slowly.

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

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Monday 15 May 2023

Afternoon (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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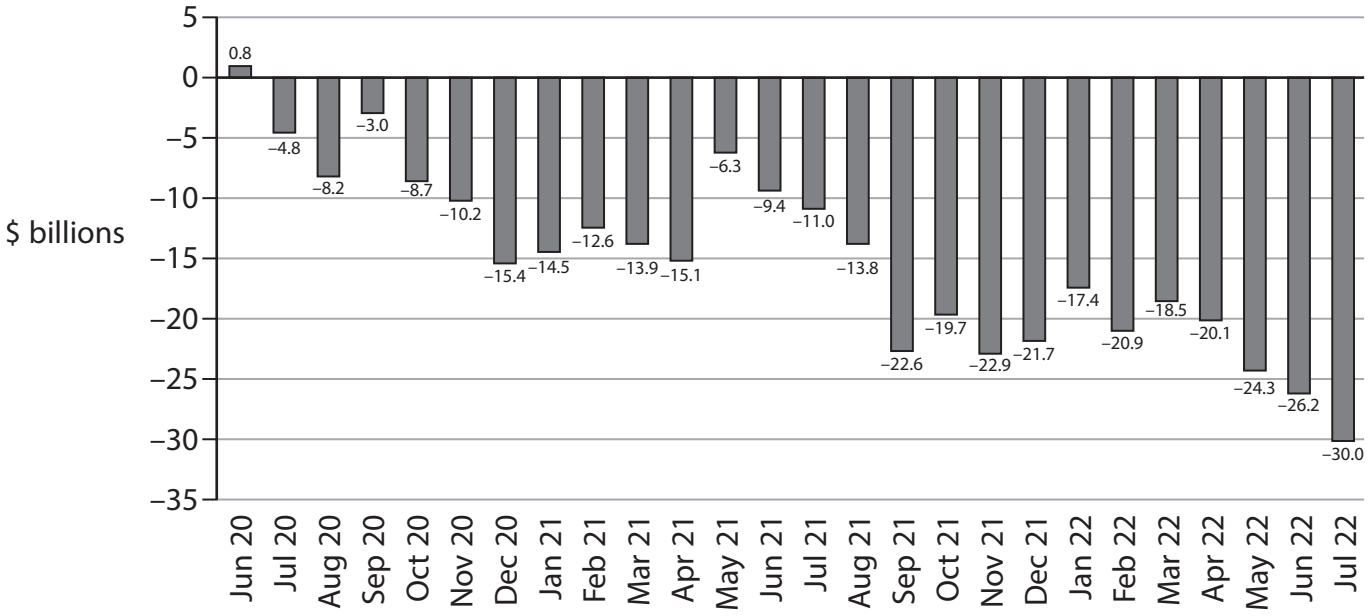
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Sources for use with Section C

The Indian economy

Figure 1 Balance of trade, June 2020 to July 2022



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Extract A Balance of trade, inflation and economic growth

In 2022 the Indian economy was experiencing several challenges following the global health crisis. In particular, there was a rising rate of inflation caused by its dependence on imported oil. Oil accounts for 30% of India's imports by value. This is more than double the average of 14.7% for other major Asian economies, such as China, Japan and South Korea. In July 2022 India reported a record balance of trade deficit of $30 billion, largely caused by the increased expenditure on imported oil. This deficit was one of the largest of all the Asian economies. Economists expect the rate of inflation to increase which will have a further negative impact on India's balance of trade.

The rate of inflation was 7.01% in June 2022 compared with June 2021. This was the second highest rate of inflation of the larger Asian economies. This higher rate of inflation reduced the purchasing power of consumers in India. As a result, many consumers were struggling to afford basic necessities. According to economists there were increasing signs that consumer expenditure would increase at a slower rate in the second half of 2022 than in the first half of 2022. This was likely to cause a fall in the rate of economic growth.

During 2022, India's currency, the rupee, fell in value against the US dollar. In order to prevent the rupee from falling further, and to control the rising rate of inflation, India's central bank raised the country's base rate of interest to 4.9% in June 2022. This represented an increase of 0.5 percentage points from the previous month.

Unlike several other Southeast Asian countries, exports of services contribute more to India's economic growth rate than exports of goods.

The Asian Development Bank (ADB) decreased its projected GDP growth rate for India to 6.7% for 2022. This was as a result of the high rate of inflation in India and the deflationary monetary policy adopted by India's central bank. The ADB predicted a small increase in consumer expenditure in the second half of 2022. However, it believed that this increase in consumption will not be sufficient to maintain India's rate of economic growth.

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Acknowledgements

Figure 1 adapted from https://tradingeconomics.com/india/balance-of-trade

Extract A adapted from https://www.ft.com/content/30a87a08-6ca6-40a7-9372-16c8e0cee323