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Centre number

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Candidate number

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Surname StemUp Model Solution

Forename(s) _____

Candidate signature _____

I declare this is my own work.

INTERNATIONAL A-LEVEL ECONOMICS

Unit 4 Economic Development and the Global Economy

Monday 8 January 2024

07:00 GMT

Time allowed: 2 hours

Materials

For this paper you must have:

- the Source Booklet, provided as an insert (enclosed)
- a calculator, which you are expected to use where appropriate.

Instructions

- Use black ink or black ball-point pen. Pencil should only be used for drawing.
- Fill in the boxes at the top of this page.
- Answer **all** questions in **Sections A, B and C**.
- Answer **EITHER** Question 15 **OR** Question 16 in **Section D**.
- You must answer the questions in the spaces provided. Do **not** write outside the box around each page or on blank pages.
- Do **not** write in the Source Booklet.
- If you need extra space for your answer(s), use the lined pages at the end of this book. Write the question number against your answer(s).
- Do all rough work in this book. Cross through any work you do not want to be marked.

Information

- The marks for questions are shown in brackets.
- The maximum mark for this paper is 90.
- You may use a bilingual dictionary for this exam.
- You may **not** use an English dictionary.

For Examiner's Use	
Question	Mark
1–10	
11	
12	
13	
14	
15	
16	
TOTAL	



J A N 2 4 E C O 4 0 1

Section A

Answer **all** questions in the spaces provided.

Only **one** answer per question is allowed.

For each question completely fill in the circle alongside the appropriate answer.

CORRECT METHOD 

WRONG METHODS    

If you want to change your answer you must cross out your original answer as shown. 

If you wish to return to an answer previously crossed out, ring the answer you now wish to select as shown. 

0 1

Which one of the following options identifies **two** characteristics of globalisation?

[1 mark]

A Free trade and transnational corporations

☒

B International capital flows and protectionism

☐

C Protectionism and free trade

☐

D Transnational corporations and controls on immigration

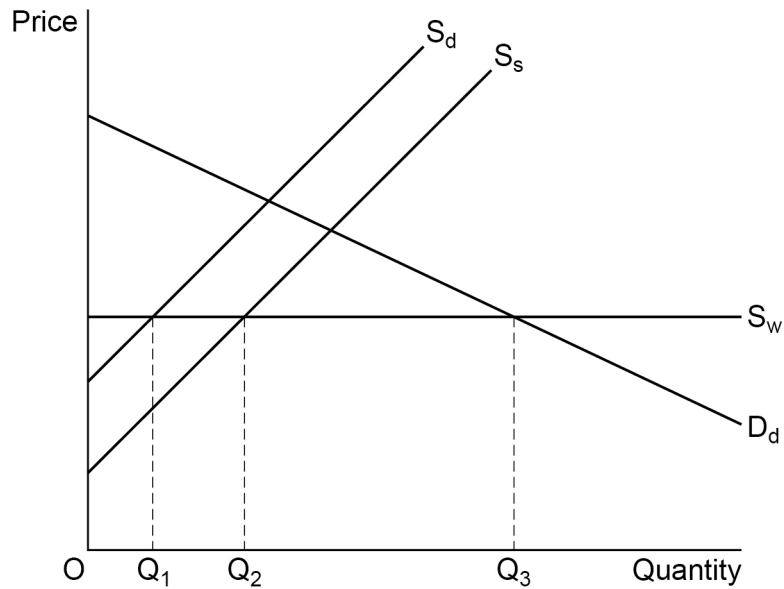
☐


0 2

Figure 1 shows the domestic demand (D_d) and supply (S_d) curves for a product and the world market supply (S_w) curve for the product.

The government introduces a subsidy which shifts the domestic supply curve to S_s .

Figure 1



The subsidy reduces imports from

[1 mark]

- A** OQ_2 to OQ_1 ☐
- B** OQ_3 to OQ_2 ☐
- C** $(OQ_3 - OQ_1)$ to $(OQ_2 - OQ_1)$ ☐
- D** $(OQ_3 - OQ_1)$ to $(OQ_3 - OQ_2)$ ☒

Turn over for the next question

Turn over ►



0 3

Which one of the following is a role of the International Monetary Fund (IMF)?

[1 mark]**A** To finance infrastructure projects in less-developed countries☐**B** To help a country with a balance of payments problem☒**C** To promote free trade and reduce protectionism☐**D** To reduce fluctuations in world commodity prices☐**0 4****Table 1** shows the Human Development Index (HDI) and Gini coefficient for four countries in Year 1 and Year 2.**Table 1**

	HDI		Gini coefficient	
	Year 1	Year 2	Year 1	Year 2
Country W	0.732	0.698	0.343	0.358
Country X	0.569	0.597	0.402	0.372
Country Y	0.848	0.856	0.321	0.305
Country Z	0.782	0.801	0.403	0.451

Which country is most likely to have had the greatest improvement in its economic development between Year 1 and Year 2?

[1 mark]**A** Country W☐**B** Country X☒**C** Country Y☐**D** Country Z☐

0 5

Which one of the following is an expenditure-switching policy that a government might use to reduce a deficit on the current account of the balance of payments?

[1 mark]**A** A cut in indirect taxation☐**B** A reduction in government spending☐**C** A tariff on imports☒**D** An increase in income tax☐**0 6**

Table 2 shows a country's nominal (money) GDP and its price index in 2022 and 2023.

Table 2

Year	GDP (\$bn)	Price index
2022	250	140
2023	280	150

The country's rate of economic growth in 2023, to one decimal place, was

[1 mark]**A** 4.5%☒**B** 10.7%☐**C** 12.0%☐**D** 20.0%☐

Turn over for the next question

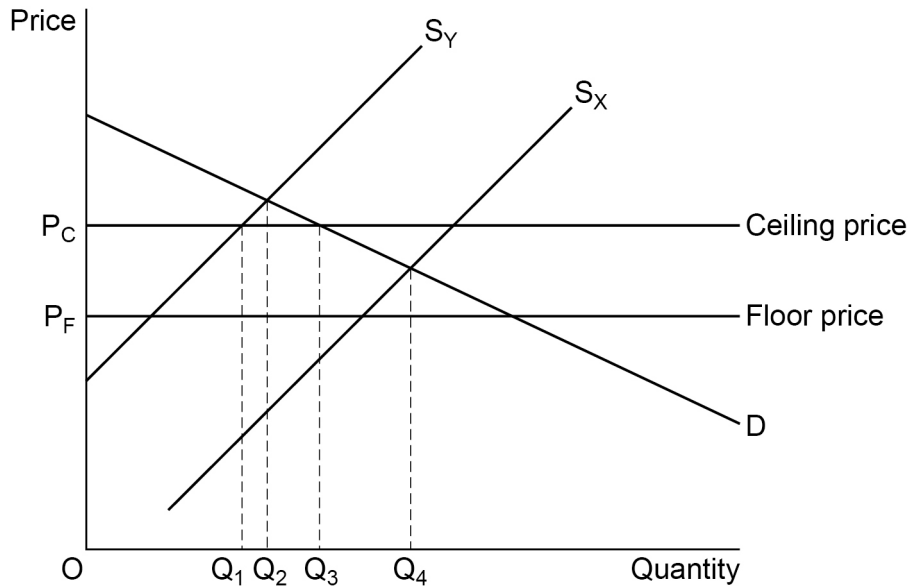
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0 7

Figure 2 shows the original demand (D) and supply (S_X) curves for an agricultural commodity. An agency runs a buffer stock scheme that aims to keep the price of the commodity between P_C and P_F , as shown in **Figure 2**.

Figure 2



Bad weather causes the supply curve of the commodity to shift from S_X to S_Y .

Which one of the following actions by the buffer stock agency will keep the price between P_C and P_F ?

[1 mark]

- A Buying $OQ_3 - OQ_1$ of the commodity ☐
- B Buying $OQ_4 - OQ_2$ of the commodity ☐
- C Selling $OQ_2 - OQ_1$ of the commodity ☐
- D Selling $OQ_3 - OQ_1$ of the commodity ☒



0 8

The value of goods imported by a country equals \$240 billion. The country's income elasticity of demand for imports is -0.2 .

All other things being equal, what will happen to the value of goods imported if the country's national income rises by 5%?

[1 mark]

- A** Decrease by \$2.4 billion ☒
- B** Decrease by \$4.8 billion ☐
- C** Increase by \$2.4 billion ☐
- D** Increase by \$4.8 billion ☐

0 9

Which one of the following is an example of asymmetric information in a financial market?

[1 mark]

- A** A bank being involved in both commercial and investment banking activities ☐
- B** A commercial bank borrowing short term and lending long term ☐
- C** A government providing financial support to any bank that might go out of business ☐
- D** A person applying for a loan without revealing they will soon lose their job ☒

Turn over for the next question

Turn over ►



1 0

Table 3 below shows the marginal capital-output ratio (MCOR) and the savings ratio for four countries.

Table 3

	MCOR	Savings ratio
Country W	2:1	0.25
Country X	3:1	0.22
Country Y	4:1	0.24
Country Z	5:1	0.15

According to the Harrod-Domar model, which country is likely to have the highest rate of economic growth?

[1 mark]**A** Country W
☒
B Country X
☐
C Country Y
☐
D Country Z
☐

10



Section B

Answer **all** questions in the spaces provided.

1	1
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A change in a country's terms of trade will affect its balance of payments.

1	1	.	1
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Define 'balance of payments'.

[2 marks]

The balance of payments is a record of all of a country's financial transactions with the rest of the world over a period of time: its exports and imports of goods and services (the current account) together with international capital flows (the capital and financial accounts).

Question 11 continues on the next page

Turn over ►



1 1 . 2

Table 4 shows the index of export prices and the index of import prices for a country in January 2021 and January 2023.

Table 4

Date	Index of export prices	Index of import prices
January 2021	98	104
January 2023	117	113

Calculate the change in the country's terms of trade between January 2021 and January 2023.

Give your answer to **one** decimal place.

[4 marks]

$$\text{Terms of trade} = (\text{index of export prices} \div \text{index of import prices}) \times 100$$

$$\text{January 2021: } (98 \div 104) \times 100 = 94.23$$

$$\text{January 2023: } (117 \div 113) \times 100 = 103.54$$

$$\text{Change} = 103.54 - 94.23 = 9.31$$

Answer: the terms of trade improved by 9.3 (index points)



1 1 . 3

The price elasticity of demand for a country's exports of goods and services is inelastic. The price elasticity of demand for its imports of goods and services is also inelastic.

The price of the country's exports rises and the price of its imports falls.

Explain the effect of these changes in the price of the country's exports and imports on its balance of trade in goods and services.

[4 marks]

The balance of trade in goods and services is the value of exports minus the value of imports of goods and services. When demand is price inelastic (PED less than 1), a given percentage change in price causes a smaller percentage change in quantity demanded, so total spending moves in the same direction as price.

Exports: the rise in export prices reduces the quantity of exports demanded, but by a smaller percentage than the rise in price because demand is inelastic. Export revenue (price $\times$ quantity) therefore rises.

Imports: the fall in import prices increases the quantity of imports bought, but by a smaller percentage than the fall in price, so the total amount spent on imports falls.

Since the value of exports rises and the value of imports falls, the balance of trade in goods and services improves: a deficit becomes smaller or a surplus becomes larger. This is consistent with the improvement in the terms of trade.



Section C

Look at the Source Booklet and answer **all** questions in the spaces provided.

Do **not** write in the Source Booklet.

1 2

Extract A shows the US Federal Reserve's base rate of interest and the US dollar exchange rate index.

1 2 . 1

Explain why the US Federal Reserve's base rate of interest is likely to affect the US dollar exchange rate index.

[4 marks]

The base rate is the interest rate the central bank sets (in the US, the Federal Reserve's rate for lending to banks), which influences all other interest rates in the economy. The exchange rate index measures the value of the US dollar against a weighted basket of other currencies.

If the Federal Reserve raises its base rate, commercial banks raise the interest rates they pay on deposits and charge on loans, so US financial assets give a higher return relative to assets in other countries. Investors move 'hot money' into US bank deposits and bonds, so the demand for US dollars on the foreign exchange market (FOREX) increases, while fewer US residents sell dollars to invest abroad, so the supply of dollars falls. With higher demand and lower supply, the dollar appreciates and the exchange rate index rises.

Higher interest rates also reduce aggregate demand, so Americans buy fewer

Extra space *imports and supply fewer dollars, adding to the appreciation. A cut in the base rate has the opposite effect, causing the dollar to depreciate.*



1 2 . 2

To what extent do the data suggest that the US Federal Reserve's base rate of interest affected the US dollar exchange rate index between January 2022 and September 2022.

Use the data in **Extract A** to support your answer.

[4 marks]

The data provide strong evidence of a link. Between January and February 2022 the base rate was unchanged at 0.25% and the dollar exchange rate index hardly changed, falling from 115.1 to 115.0. After the base rate rose to 0.5% in March, the index rose by 2.3 points from 115.0 in February to 117.3 in April. From early May to late September the base rate was raised from 1.0% to 3.25% and the index rose by 5.9 points, from 119.8 to 125.7.

Over the whole period the base rate rose from 0.25% to 3.25% and the index rose from 115.1 to 125.7, showing a strong positive correlation, consistent with higher US interest rates attracting hot money and raising the demand for dollars.

However, the relationship is not exact. At the end of July the base rate rose from 1.75% to 2.5%, yet the index fell from 122.8 in July to 122.4 in August.

Extra space This suggests that the exchange rate also depends on expectations of future rate rises (which may already have been priced in), on interest rates in other countries and on factors such as the US balance of payments and global uncertainty.

Overall, the data strongly suggest that the rising base rate was the main influence on the rise in the dollar exchange rate index between January and September 2022, but it was not the only factor.



1 3

Extract B (lines 6–8) states: 'the US central bank (the Federal Reserve) became determined to reduce inflation. It increased its base rate of interest, in stages, from 0.25% in January to 3.25% in September.'

Explain how the rise in the Federal Reserve's base rate of interest is likely to affect the rate of inflation in the US.

[12 marks]

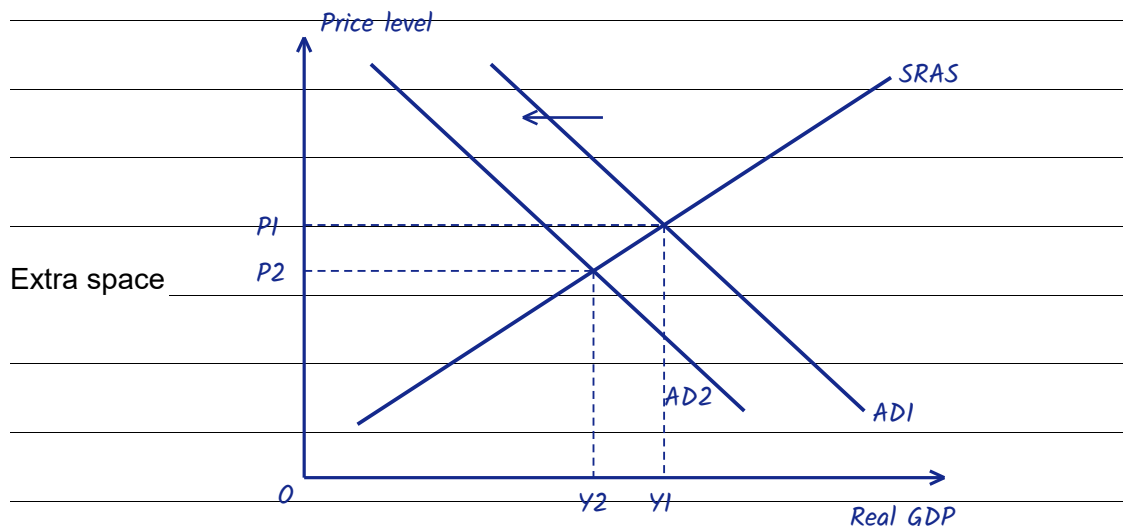
Inflation is a sustained rise in the general price level, measured by the % change in the consumer price index. The base rate of interest is the rate set by the Federal Reserve at which it lends to commercial banks; a rise from 0.25% to 3.25% is a large tightening of monetary policy. Inflation can be demand-pull, caused by aggregate demand (AD) growing faster than productive capacity, or cost-push, caused by rising costs of production such as wages, energy and imported materials.

First, when the Federal Reserve raises its base rate, commercial banks raise the interest rates they charge on mortgages, credit cards, car loans and business loans, and the rates they pay on savings. Borrowing becomes more expensive, so households are less willing to borrow to buy durable goods and houses, and households with variable-rate mortgages have less disposable income after paying higher interest. At the same time, the reward for saving rises, so the opportunity cost of spending increases and households save more. Consumption, the largest component of AD, therefore falls.

Second, firms face a higher cost of borrowing, so fewer investment projects are profitable when the expected rate of return is compared with the interest rate. Investment falls. Lower share and house prices also cause a negative wealth effect.

In addition, by raising rates in stages and showing it is 'determined to reduce inflation', the Federal Reserve gains credibility. Workers and firms expect lower inflation, so they ask for smaller wage rises and set smaller price increases, so inflation falls further.





As shown in the diagram, the fall in consumption and investment shifts AD to the left from AD1 to AD2, made larger by the multiplier effect. Excess demand is removed and the price level is lower than it otherwise would have been, falling from P_1 to P_2 , so demand-pull inflation falls.

Higher interest rates also attract hot money into the US, which increases the demand for dollars and causes the dollar to appreciate. Imported raw materials, energy and components become cheaper in dollars, reducing firms' costs and cost-push inflation, and cheaper imported consumer goods directly reduce the CPI. The appreciation also makes US exports dearer, reducing net exports and AD further.

Furthermore, as AD and output fall, firms demand less labour, unemployment rises and workers have less bargaining power, so wage growth and firms' costs slow. Higher interest rates also slow the growth of bank lending and therefore of the money supply, which, according to the quantity theory of money, reduces inflation.

The effect will occur with a time lag of up to two years and will be smaller if inflation is mainly caused by global cost-push factors such as energy prices, or if confidence remains high. However, a rise of 3 percentage points is likely to reduce US inflation significantly over time.



1 4

Extract C (lines 6–7) states: ‘Financial institutions provide a variety of services to individuals, businesses and governments’.

Discuss how financial markets may affect the economic development of a country and the economic well-being of its people.

[25 marks]

Financial markets are markets in which funds are borrowed and lent and financial assets are traded, for example the money market, the capital market and the foreign exchange market, operating through institutions such as banks, insurance companies, stock exchanges, credit unions and microfinance providers.

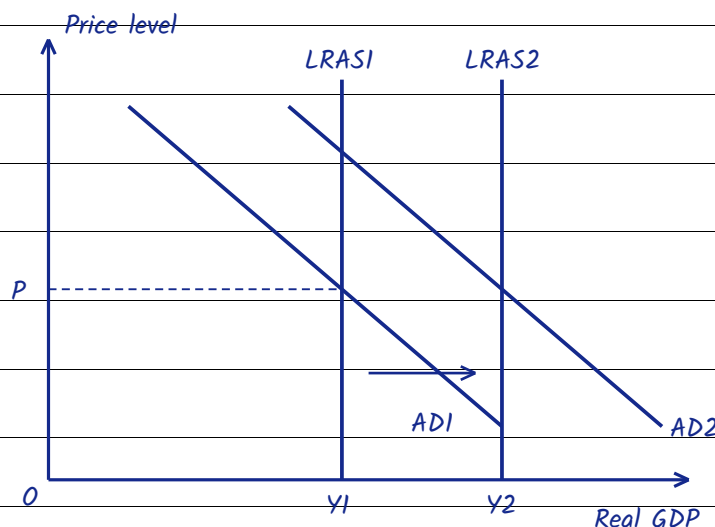
Economic development is an improvement in the welfare of a country's population, including higher real incomes, less poverty, better health and education and greater freedom of choice. Economic well-being refers to the material living standards and financial security of individuals.

As Extract C states, financial institutions provide a variety of services. First, banks provide an efficient means of payment, such as cards and mobile money transfers. This reduces transaction costs, making it easier to buy and sell goods and services. More trade allows greater specialisation and division of labour, which raises productivity and real incomes, so living standards improve.

Second, financial markets channel funds from savers to borrowers. Banks collect the savings of many households and lend them to firms, while firms can also raise funds by issuing shares and bonds. Investment in capital goods and infrastructure raises productivity and shifts the LRAS curve to the right, increasing potential output. The Harrod-Domar model shows that growth depends on the savings ratio and how efficiently savings are turned into productive investment, so an efficient financial system that closes the savings gap is vital for development. Without banks, savings are often hoarded as cash, gold or livestock, so they are not available to firms, and productive projects cannot be financed. A well-functioning stock market also allocates



funds to the firms with the highest expected returns, improving allocative efficiency.



In the diagram, higher investment raises AD from AD1 to AD2 and productive capacity from LRAS1 to LRAS2, so real GDP rises from Y1 to Y2 without higher inflation. Growth creates jobs and tax revenue for health and education, raising HDI.

Third, banks provide foreign exchange and trade finance, helping firms to trade, and financial markets attract international investment flows such as FDI and portfolio investment. International trade allows a country to exploit its comparative advantage, and inward investment brings capital, technology and skills, all of which support development.

Fourth, insurance allows individuals and firms to pool risks. Farmers can insure crops against drought and families can insure against illness. This reduces the risk of falling into poverty after a shock and encourages entrepreneurs to take risks and invest. Governments also borrow in financial markets by selling bonds, which finances infrastructure, schools and hospitals and protects public services in recessions.

Fifth, microfinance and credit unions give small loans to poor people who lack collateral and are excluded from commercial banks, as in Bangladesh's Grameen

Turn over ►



Extra space *Bank. These loans allow people to set up and expand small businesses, raising incomes and reducing poverty and inequality. Microfinance is often lent to women, increasing their independence and their spending on children's education and health, which improves well-being for future generations.*

However, financial markets can also harm development. Because of asymmetric information and moral hazard, banks may take excessive risks, believing they are 'too big to fail'. When banks fail, as in the 2008 financial crisis, credit dries up, investment collapses and unemployment and poverty rise. Speculation causes asset bubbles, and sudden outflows of hot money can cause a currency crisis, and a depreciation increases the burden of foreign currency debt, as happened to many heavily indebted poor countries (HIPC's) when interest rates rose. Microfinance can also cause over-indebtedness if interest rates are very high.

The impact therefore depends on several factors. It depends on how well financial markets are regulated: strong regulation, capital requirements and a lender of last resort reduce the risk of crises. It depends on access: many poor rural people are 'unbanked', although mobile banking such as M-Pesa in Kenya has widened access. It depends on whether funds are lent for productive investment rather than speculation or consumption, and on macroeconomic stability and secure property rights.

In conclusion, well-regulated and accessible financial markets are essential for economic development, because they enable trade, channel savings into investment and help the poor through microfinance and insurance, but poorly regulated markets can cause damaging instability. On balance, the benefits are likely to outweigh the costs, provided markets are well regulated and access reaches the poorest people.



Section D

Answer **EITHER** Question 15 **OR** Question 16.

Shade the circle below to indicate which optional question you have answered.

Question 1 5 ☐Question 1 6 ☒CORRECT METHOD ☒

WRONG METHODS

**Either**

1 5

The damaging impact of climate change is being felt around the world. In recent years, some countries have experienced droughts and extreme heat whereas in other parts of the world there have been floods and severe storms.

Discuss whether governments' attempts to improve living standards conflict with policies to preserve the natural environment.

[25 marks]**or**

1 6

The Bretton Woods system, that collapsed in 1973, was a fixed exchange rate system. Since then, many countries have adopted managed floating exchange rates.

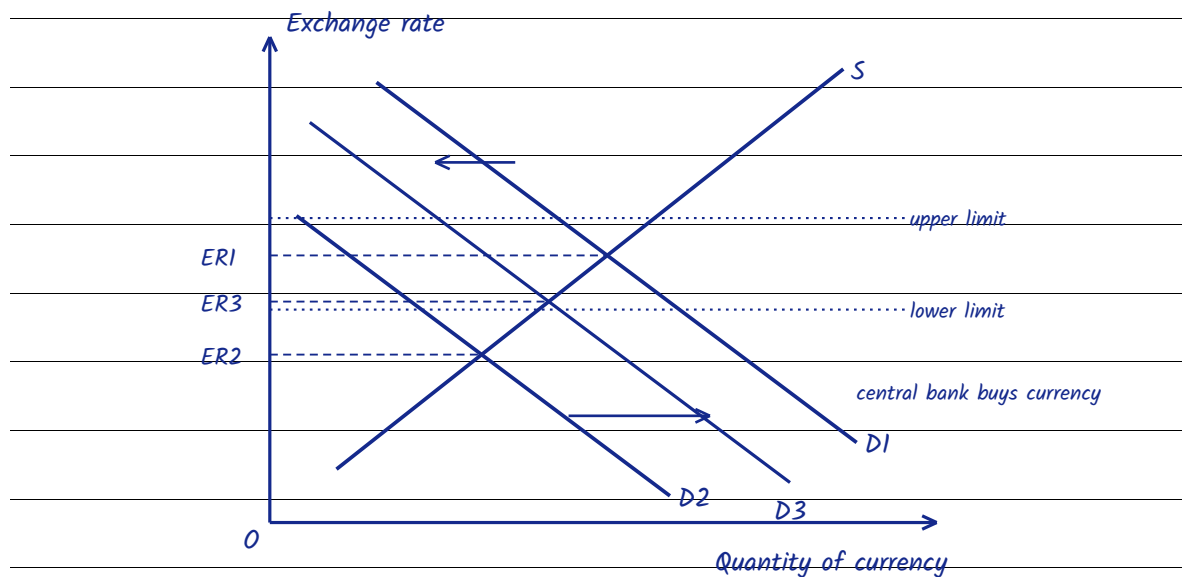
Assess the arguments for and against a managed floating exchange rate system.

[25 marks]

An exchange rate is the price of one currency in terms of another. Under a fixed exchange rate system, such as Bretton Woods, the central bank keeps the currency at an official parity. Under a free float, the exchange rate is determined only by the demand for and supply of the currency on the foreign exchange market (FOREX). A managed float lies between the two: the rate is mainly set by market forces, but the central bank intervenes, by buying or selling its currency using foreign exchange reserves or by changing interest rates, to influence the rate or keep it within an unofficial target range.

The demand for a currency comes from foreigners buying the country's exports and assets, and its supply from residents buying imports and foreign assets, so the rate fluctuates as these flows change, but within limits set by the central bank.

Turn over ►



In the diagram, a fall in demand for the currency from $D1$ to $D2$, for example due to speculation, would push the exchange rate below the target range from $ER1$ to $ER2$. The central bank buys its own currency with reserves, shifting demand to $D3$, so the rate stays at $ER3$ within the range. To stop an excessive rise it would sell its currency and add to its reserves.

The first argument for a managed float is that the exchange rate can adjust to help correct balance of payments disequilibrium. If a country has a current account deficit, the supply of its currency exceeds demand and it depreciates gradually. Exports become cheaper and imports dearer, so, provided the Marshall-Lerner condition holds, the deficit falls without the need for deflationary policies that cause unemployment. Under a fixed system this adjustment would require a fall in domestic prices and incomes.

Second, a managed float gives the government greater independence over monetary and fiscal policy. Interest rates can be set to achieve domestic objectives, such as low inflation or full employment, rather than to defend a parity, and the country needs to hold fewer reserves than under a fixed system. Third, flexibility protects the economy from external shocks. If there is a world recession or a fall in commodity prices, the currency depreciates, supporting exports and employment. As



the structure of the economy changes, the rate can adjust gradually to reallocate resources, whereas under Bretton Woods parities became overvalued and the system collapsed in 1973.

Fourth, a managed float has advantages over a free float. A free-floating rate can be very volatile and may overshoot because of speculation and hot money flows. By intervening, the central bank can smooth out short-term fluctuations and deter destabilising speculation, giving firms more certainty. This combines some of the stability of a fixed rate with the flexibility of a floating rate.

However, there are arguments against. Exchange rates still fluctuate, which creates uncertainty for exporters and importers about future revenues and costs. Firms may need to hedge, which raises costs, and some may trade less, so countries may not

Extra space gain the full benefits of specialisation and trade. Fluctuations also discourage long-term international capital flows such as FDI.

Compared with a fixed rate, a managed float removes the discipline on governments. Under a fixed rate, inflation makes exports uncompetitive and drains reserves, so governments must control it. Under a managed float, a depreciation can hide the loss of competitiveness, but it raises import prices, causing cost-push inflation and a wage-price spiral, so the system may have an inflationary bias.

Managing the rate also requires large foreign exchange reserves, which have an opportunity cost, and intervention may fail against massive speculative flows, as in the 1997 Asian financial crisis. Because there is no announced parity, the central bank's intentions may be unclear, encouraging speculation. Using interest rates to influence the exchange rate may conflict with domestic objectives: raising rates to stop a depreciation could cause a recession. Finally, governments may intervene to keep their currency undervalued, a 'dirty float' or competitive devaluation, to make their exports more competitive. This harms trading partners, distorts trade flows and may lead to retaliation and currency wars.

Turn over ►



The strength of these arguments depends on several factors. It depends on how much the central bank intervenes: light intervention gives most of the benefits of floating, while heavy intervention resembles a fixed rate with its costs. It depends on the size of the country's reserves and the credibility of its central bank. It depends on the type of economy: a small open economy that relies on a few commodity exports may value stability more, while a large economy with deep financial markets may prefer more flexibility. It also depends on 'the rules' agreed internationally, for example through the IMF, and whether countries follow them rather than manipulating their currencies.

In conclusion, a managed floating system is, on balance, the most suitable system for most countries, which is why so many have adopted it since 1973. It gives the flexibility to adjust to shocks and balance of payments problems and greater policy independence, while intervention reduces the excessive volatility of a free float.

However, its benefits depend on central banks intervening only to smooth fluctuations, holding adequate reserves and not using intervention to gain an unfair competitive advantage.

END OF QUESTIONS



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2 8



2 4 1 X E C O 4