Edexcel (A) Economics A-level

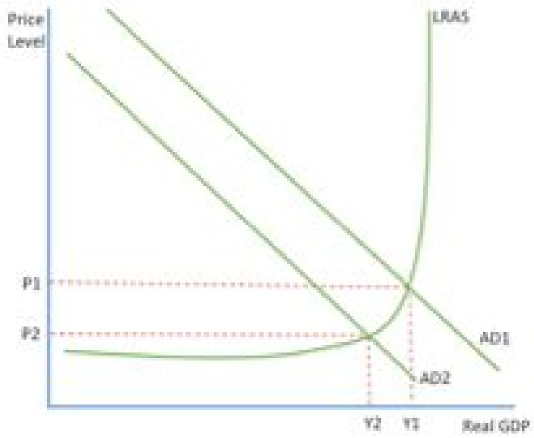
A-level Paper 2: National and Global Economy

Example answers

June 2017

b) With reference to the information provided and your own knowledge, examine two factors which might explain the change in the rate of Eurozone inflation as shown in Figure 2. (8)

Inflation has fallen from 3.1% to 0.15% from 2011 to 2015. One reason for this fall is a fall in confidence. The recession meant that consumers were unwilling to spend large sums of money and were more likely to save, meaning the marginal propensity to consume fell and thus consumption fell. On top of this, firms were unwilling to invest as they did not believe that they would see significant rates of return on their investment and they would have been fearful about future prospects. This would lead to a fall in investment. Together, this would mean that AD fell from AD1 to AD2 and thus prices fell from P1 to P2, showing a fall in inflation. This is likely to be significant since it means that bank changes, such as lower interest rates, make little difference on consumption and investment due to the lack of confidence.



In addition, there may have been a fall in net exports. The global economy suffered from the recession and so this will mean that other countries will be unwilling to buy EU exports. This would mean that there is reduce injections into the economy as well as a fall in X-M, meaning a fall in AD. This would have worsened the effect of the fall in consumption and investment. However, this is likely to be less significant since consumption and investment make up a larger percentage of AD than net trade. Also, it is likely that imports also fell and so the impact on net trade may have been negligible. The fall in the Euro would have also helped competitiveness and thus may have helped to increase exports. The fall in confidence would be more significant.

Teacher's comments: 8/8

c) Since mid-2015, the euro has appreciated. Assess the likely impact of an appreciation of the euro on the current account of the balance of payments for Eurozone countries. (10)

An appreciation is the rise in the value of the country's exchange rate under a floating system. The current account includes the balance of trade and income and current transfers. Some EU countries have a current account deficit whilst others have a surplus, such as Germany. The appreciation is likely to cause imports to become cheaper and exports to become more expensive, which will worsen the current account. This assumes the Marshall-Lerner condition, which says that the price elasticity of imports and exports must be more than 1 for an appreciation to worsen the current account. However, this condition may not hold since imports may be inelastic since they

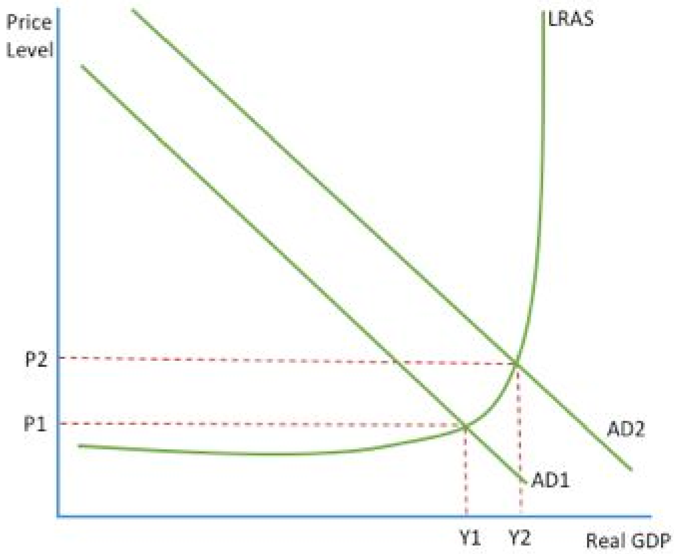
have to be imported anyway, for example oil, and so it is possible that there will be an improvement in the current account. The elasticities will be different in different countries and so there will be different effects on different countries. Some exports may be so competitive, for example in Germany, that the rise in the value of the Euro will have no effect on volume and simply increase the value of exports.
In the short run, the current account may improve whilst it may worsen in the long run. The J-curve shows that an increase in the value of a currency will initially improve the current account since people are in long term contracts and they may not originally notice the difference, so imports and exports will not change in volume but exports will rise in value whilst imports will fall in value, which will improve the current account. However, in the long term, people will switch their purchases and thus there will be a worsening on the current account.

Although the most significant part, the balance of trade is only one section of the current account and thus the incomes and transfers will play a role, for example whether government transfers to the EU may change. Moreover, factors other than currency will play a significant role, for example Frances' macroeconomic reforms will hopefully improve competitiveness and thus increase exports, improving the current account. The impact of Brexit will also be significant, some countries may run a deficit with the UK whilst others run a surplus.

Teacher's comments: 9/10. KAA: 6/6, Ev: 3/4
A great deal of the trade is between Eurozone countries so it will make no difference
Size of the appreciation.

d) Discuss the likely success of the ECB's quantitative easing programme in moving Eurozone inflation closer to the 'central bank's ceiling of 2%'. (12)

Quantitative easing is when the central bank electronically creates money to buy illiquid assets from banks and private companies. Firstly, they can buy assets from banks or place more money into reserves in their account in the ECB. This will encourage them to lend money and thus there will be an increase in consumption and investment. The banks will have more money to lend and will have larger reserves, which will improve confidence and encourage them to spend. However, this does not necessarily work. Interest rates have been lowered to -0.3% and business and consumers are still unwilling to borrow money due to low confidence, whilst banks are also unwilling to lend in fear of not being able to get the money back. If quantitative easing is successful in improving confidence and investment, it will lead to an increase in AD from AD1 to AD2 and thus lead to a rise in the price level from P1 to P2. This depends on where the economy is producing- it is possible that the economy is on the perfectly elastic part of the curve due to the recession and thus quantitative easing and the subsequent rise in AD will lead to no increase in inflation.



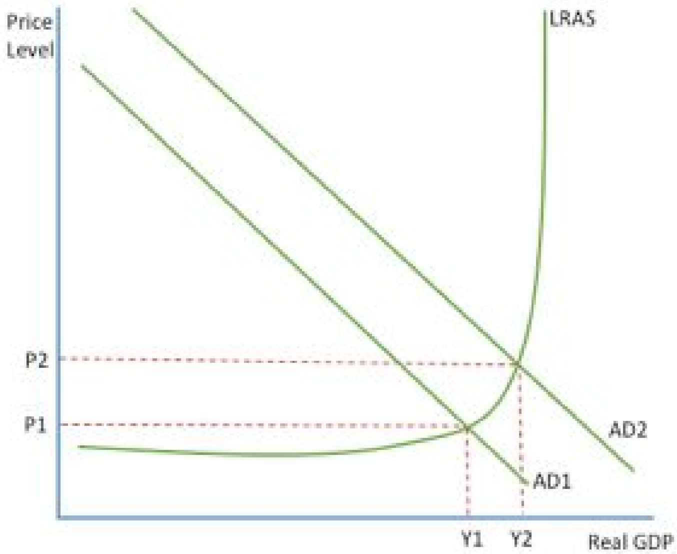
The uncertainty over whether banks will increase lending means that the ECB may be more effective if they buy assets from the private sector. This will lead to the rise in prices of these assets, for example bond yields in Italy and Spain jumped by 0.27%. This will mean that there is a wealth effect, where the increase in asset prices increases the wealth of those who own them and this increases their confidence and leads to higher consumption. This will compliment lower interest rates as it means that consumers will now be more likely to borrow. In addition, it can increase the profits of those who sell these assets and thus increase their investment. Both of these will lead to an increase in AD, which will lead to price rises from P1 to P2 as seen in the diagram. However, some argue that it has no impact on the real economy at all and simply leads to a rise in price and market bubbles for assets, rather than increasing inflation.

To conclude, quantitative easing is a fairly new policy tool and so its effectiveness thus far is still uncertain. One fear is that European banks are now overly dependent on the asset buying of the central bank. The continued fall in inflation despite the policy suggests that it has not been effective enough in increasing inflation and more needs to be done, perhaps through fiscal stimulus as Draghi suggests. The Bank of England has said that in England the policy led to 1% higher growth than there would have been without it, which would have encouraged inflation, and so this could mean the policy in the EU is just as effective. However, there are other variables involved and it is difficult to determine the effect of this policy alone.

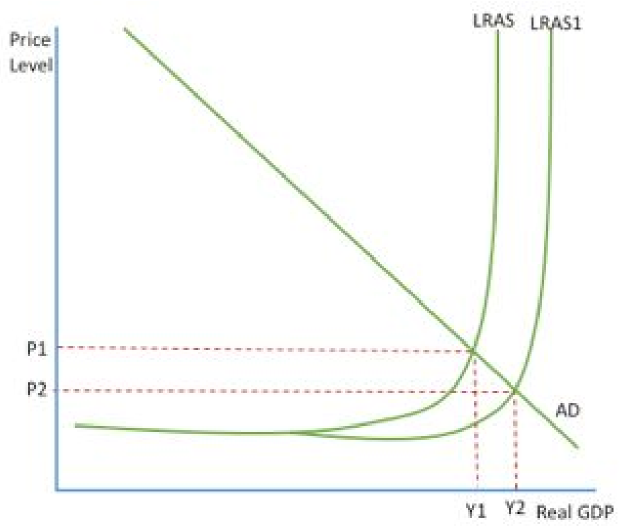
Teacher's comments: 10/12, KAA: 8/8, Ev: 2/4
Stress- time lag! Still below target?
Low inflation in part due to low oil prices etc. – so it is beyond their control.

e) Discuss 'looser fiscal policy' and 'supply side reforms' that may be used by governments of Eurozone countries to increase economic growth. (15)

Fiscal policy is the use of government spending and taxation to manipulate AD. This can encourage growth in a number of ways. Firstly, the government can increase spending which will increase AD, since government spending is one component of AD. As a result, this will lead to a rise in growth from Y1 to Y2. On top of this, they could reduce direct taxes which will increase disposable increase and thus increase consumption, leading to higher AD. Again, growth will rise from P1 to P2. The effect of both of these will depend on the multiplier. If the multiplier is high, there will be an even larger increase in AD, which will further increase growth. Tax cuts and spending can be aimed to the poor, who have the highest MPC and this will lead to the highest growth. Tax cuts may also increase incentives and thus lead to an increase in LRAS which will further increase in growth. There are two main problems with these policies: their effects on inflation and on the budget. The rise in AD will lead to price increases from P1 to P2. This will depend on where the economy is producing and given the low levels of inflation currently in Europe, rising inflation will not necessarily be a big thing. The bigger problem will be on the budget. Some countries, such as France, run high budget deficits which they are trying to reduce and so this will cause conflicting objectives. The EU has policies on the level of budget deficit allowed and thus it may be impossible for some countries to use this method. It is possible for the fall in tax to increase revenue, as seen by the Laffer curve, but this may not necessarily be the case.



Furthermore, the government could use supply side policies to increase growth. One example could be improved education which will create more skilled workers and lead to improved productivity since workers are better at what they're doing. This will mean that more goods and services can be produced within country and thus output will increase. There are a number of ways they could do this, for example apprenticeship schemes like those in Germany. In some poorer Eurozone countries, increase standards in schools may be more appropriate. The education could be focused on filling skills shortages. In addition, they could encourage investment by firms which will increase productivity since more cost-effective production techniques are developed and therefore more can be produced. This could be through tax breaks or investment subsidies. Other policies include improved infrastructure, increase incentives and competition policy. All of this will lead to an increase from LRAS to LRAS1 which will mean higher output of Y2 compared to Y1. These policies are much longer term and are not guaranteed to be successful, for example investment does not always implement new techniques. They also often have effects on the budget and this incurs similar issues to fiscal policy. Germany has been extremely successful in its supply side policies.



To conclude, both supply side and fiscal policies can improve growth but may be difficult for EU countries with budget obligations to undertake.

Teacher's comments: 12/15, KAA: 8/9 Ev: 4/6
Evaluate that it will take time!

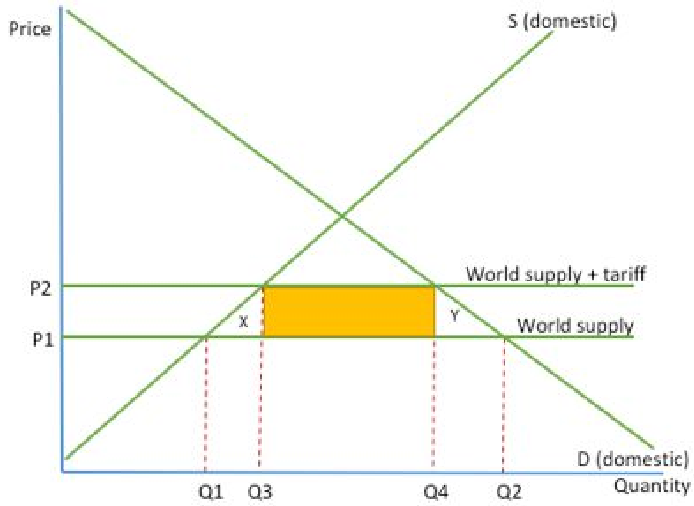
7) Since the global financial crisis of 2008 there have been over 5700 increases in tariffs, quotas and administrative controls on global trade. Evaluate the likely effects of an increase in protectionism on a developing country of your choice. (25)

China is a developing country which has experienced massive export led growth, despite its high use of protectionist policies. There are a range of protectionist policies, including quotas, imports, tariffs, subsidies and competitive devaluation.

Initially, protectionism in China was beneficial as it allowed their industries to develop. The use of domestic subsidies on goods such as airplanes and cars has allowed these industries to develop and be able to compete overseas with firms who have been established much longer and have high brand loyalty. It also makes it harder for these firms to compete in China as Chinese firms have much lower costs due to the level of subsidies they receive. This has allowed for the creation of jobs in China and allowed firms to enjoy economies of scale. Firms in China are able to make vast profits and this allowed them to invest heavily, which has made the country more efficient.
In addition, protectionist policies have allowed China to experience a large trade surplus. The use of competitive devaluation of the Chinese currency means that exports are kept cheap and imports are kept dear, which means they are able to enjoy a huge surplus. The Marshall Lerner condition, which says the price elasticity of imports and exports must be more than one for a depreciation to have an effect, appears to hold in this situation and means they do have a surplus. This surplus means that net exports is a positive figure and so they see higher AD, creating growth and employment. It is one reason why China have experienced such rapid growth over recent years. However, there are other reasons why China have been able to maintain their surplus. Goods in their country are produced much cheaper due to vast labour supply and low labour costs, which increases competitiveness and therefore increases exports. Protectionism has enabled China to

develop a surplus, but other factors have been important. Domestic subsidies also enable this surplus since they mean that firms have been able to grow large and experience economies of scale, which helps competitiveness.

However, protectionist policies reduce welfare. China has many tariffs on imports. In the diagram, the interaction of world supply and demand means that prices are set at P1 and Q2-Q1 are imported. The imposition of a tariff will raise prices to P2 and mean that only Q3-Q4 is imported. This will be beneficial for the current account and for net trade, leading to higher AD. It will also collect revenue of the shaded area for the government, which will improve government finances. However, there will be a fall in consumer surplus from ABDP1 to ABCP2, which will mean lower living standards for consumers. There will also be deadweight welfare loss of X and Y. Whilst the tariff protects domestic products and creates jobs, it reduces welfare and quality of life so causes government failure.



Another significant issue of protectionism is retaliation. Previously, this did not seem to be such an issue because China was still able to enjoy huge trade surpluses and were able to experience growth. However, as China has developed further and is becoming a middle-income country with global power, other countries seem determined to prevent this sort of government intervention from impacting their own industries. This can be seen through the US- China trade war, which could greatly reduce trade in both countries and limit growth. If protectionist policies continue, China risks cutting itself off from the majority of the Western world as the EU appears to be taking a similar approach. This would reduce growth as exports make up a significant part of AD.

On the whole, protectionism in China had previously been beneficial as it had been hugely successful in allowing their industries to develop and become such vast companies. Policies like subsidies and devaluations have become significant in China in allowing export-led growth, whilst quotas and tariffs have not had a significant impact on these exports. China joined the WTO, suggesting it is beginning to move away from protectionism, but the recent possible trade wars can suggest otherwise. It appears that, although recent protectionism had been beneficial, continued protectionism may not be.

Teacher's comments: 21/25