GCE A LEVEL – NEW

A520U20-1

S17-A520U20-1

ECONOMICS – A level component 2
Exploring Economic Behaviour

TUESDAY, 13 JUNE 2017 – AFTERNOON

2 hours 30 minutes

A520U201
01

ADDITIONAL MATERIALS

In addition to this examination paper, you will need:

- a calculator;
- a WJEC pink 16-page answer booklet.

INSTRUCTIONS TO CANDIDATES

Use black ink or black ball-point pen.
Answer **all** questions.

INFORMATION FOR CANDIDATES

The number of marks is given in brackets at the end of each question or part-question.
You are reminded of the necessity for good English and orderly presentation in your answers.

© WJEC CBAC Ltd.

Answer **all** *the questions.*

1. Up or down? The price of oil just can't win.

US President Harry S Truman once famously demanded: "Give me a one-handed economist! All my economists say, on the one hand this… on the other hand that." Oil prices seem to be an area where economists are likely to disagree as to whether rising or falling oil prices are better.

Figure 1 – Crude oil price ($ per barrel, 2015 prices)

Nearly 45 years ago the world was in shock from the news that oil prices had surged from just under $3 per barrel in 1972 to over $12 in 1974 (around $54 in today's terms – see **Figure 1**). This was caused by OPEC, an important group of oil producing countries restricting the supply of oil.

This oil price increase fed into an inflation rate of more than 24%. As a result powerful trade unions gained higher wages from employers, as rising prices led to expectations of higher inflation. This led to industrial disputes, the introduction of a three-day working week and ultimately the fall of the Conservative Government in the general election of February 1974. In 1975 the coal miners gained a pay rise of 35%. Company profits and share prices collapsed and by this time the Phillips curve trade-off had also become significantly less favourable.

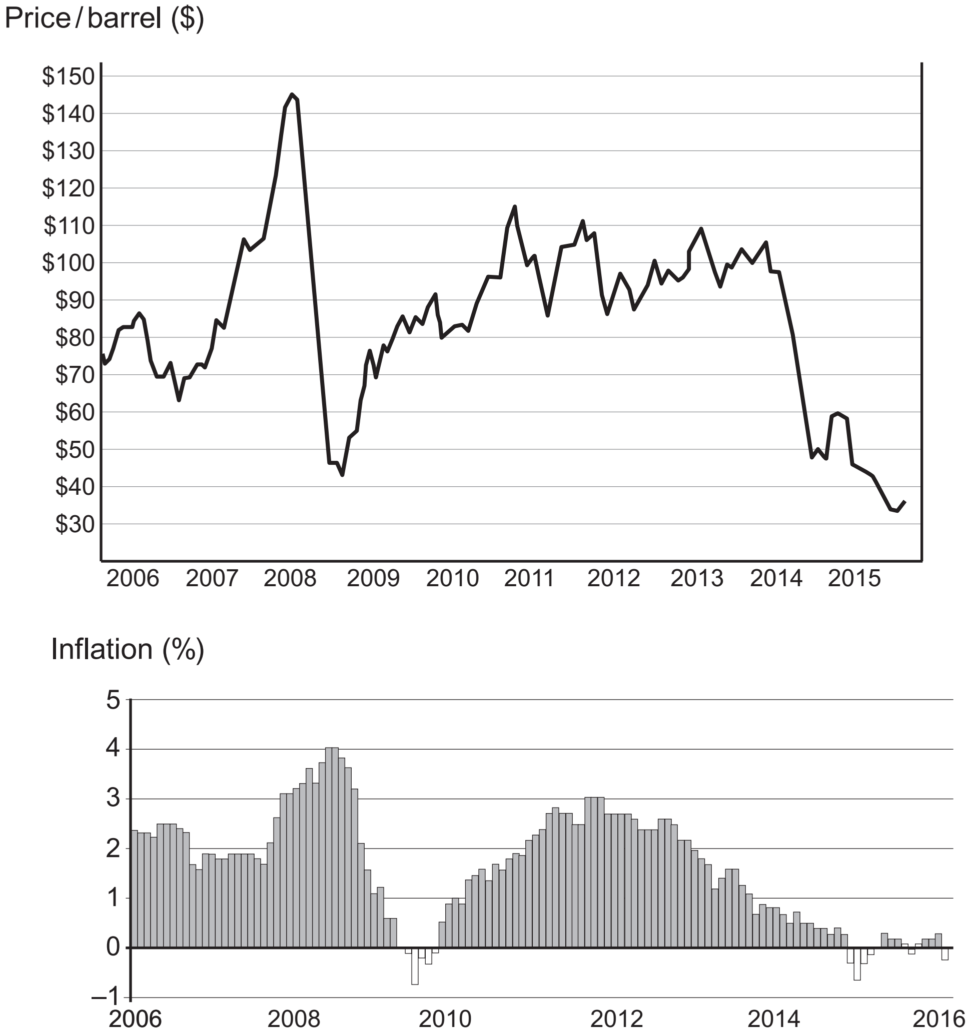
This period of high energy prices was not good for the country's already shaky manufacturing base. The gradual decline of the once highly important British car industry was accelerated by the extra costs of production. High oil prices also encouraged a switch to smaller vehicles and helped create the environment in which Japanese firms such as Toyota and Honda became dominant in both the UK and global markets.

Turning to the present day, one might suppose that the world would have welcomed the slump in oil prices since 2014, but some economists are worried.

Lower oil prices are not a good thing for major oil exporting countries such as Russia, Iran and Iraq, but what about for everyone else? The sharp fall in crude oil prices has led to concern that, with inflation already dangerously low across much of the developed world, cheaper oil will worsen the problem creating a deflationary spiral that will prove hard to stop.

The problem is likely to be particularly serious within the eurozone. There, with demand too weak to match productive capacity and interest rates at or near zero, a sustained fall in the price level means that real interest rates rise. Higher real rates will encourage households further to postpone consumption and create a vicious circle of slow growth and excess capacity.

Figure 2 – Crude oil prices and eurozone inflation 2006-2015



But while lower oil prices will have a one-off effect on the price level and therefore reduce inflation, that reduction in the price level should boost growth rather than reduce it. Lower oil prices may hurt firms such as Shell and BP in the medium term, but they benefit households almost immediately through cheaper petrol and other fuels. An unexpected fall in the general price level raises real incomes. This is particularly welcome in the UK, where real household incomes last year were six per cent lower than they were before the global financial crisis, despite a relatively healthy economic recovery.

Government policy makers must be careful that a drop in the price level does not lead to deflationary expectations becoming established. But the answer to that is clear: keep monetary policy loose to boost aggregate demand. With soaring government debt restricting the power of fiscal policy and zero interest rates limiting conventional monetary policy, some economists argue that organisations such as the European Central Bank and the Bank of Japan should continue expanding their programmes of quantitative easing especially with economic growth in both areas currently so weak. The US Federal Reserve, which recently raised interest rates in anticipation of rising inflationary pressure, looks to be the exception rather than the rule.

Whatever the case, it seems that whether oil prices are high or low, some economists are unhappy; not something likely to have pleased President Truman.

© WJEC CBAC Ltd.

(a) Describe what is meant by an oil price of $12 in 1974 being equivalent to '$54 in today's terms'. (Lines 11-13) [2]

(b) With the use of an appropriate cost and revenue diagram, describe how the events of the 1970s led to a collapse in company profits. (Lines 20-27) [4]

(c) Using a diagram, explain how the oil shock in the early 1970s might have caused the Phillips curve trade-off to become significantly less favourable. [6]

(d) With reference to **Figure 2**, discuss the possible relationship between oil prices and eurozone inflation. [6]

(e) Discuss whether the lower oil prices since 2014 are likely to be beneficial for the UK economy. [10]

(f) Discuss whether it is right to suggest that "the European Central Bank and the Bank of Japan should continue expanding their programmes of quantitative easing". (Lines 55-56) [12]

BLANK PAGE

2. Rwanda bounces back

Rwanda is a small land-locked country in sub-Saharan Africa which is one of the most densely populated countries in Africa. Just over 20 years ago Rwanda hit the headlines all over the world for the wrong reasons when civil war broke out and hundreds of thousands of mainly Tutsis (the minority tribe in Rwanda) were murdered by the majority Hutus in the space of only 100 days.

At the end of the civil war Rwanda made a remarkable recovery and is now considered to be one of the most stable countries in Africa. President Paul Kagame and his government have set out an ambitious vision for Rwanda to become a middle-income country by 2020. Economic growth has averaged over 6% per annum, the service sector has overtaken agriculture in its contribution to GDP despite over 80% of the population working in agriculture (much of it subsistence agriculture).

Regional trade has increased and poverty and income inequality have gone down according to the latest government data. Child and maternal mortality have dropped significantly and free, universal primary education has been established along with better access to health care. Rwanda spends huge proportions of its national budget on health and education. In 2011, almost 24% of total government expenditure went to health and 17% to education.

Rwanda has been praised for the effectiveness of its government systems and reduced government corruption. There is also an increasing number of women in government with the highest number of female parliamentarians in the world.

In its long-term economic development plan, Vision 2020, Rwanda aims at becoming a knowledge-based economy and the development of the services sector is considered as essential. Services account for 53% of GDP, while agriculture and manufacturing are at 33% and 14% of GDP respectively. In recent years, the service sector's average growth was estimated at 10% as a result of growth in transport, storage, communication (9%), wholesale and retail trade (8%) and financial services (24%). Rwanda is also industrialising with manufacturing growing at around 5% per annum. In terms of exports, apart from the traditional commodities (coffee, tea), Rwanda also exports transport services and financial services mainly to neighbouring countries. Its main imports are food, manufactured goods and petroleum.

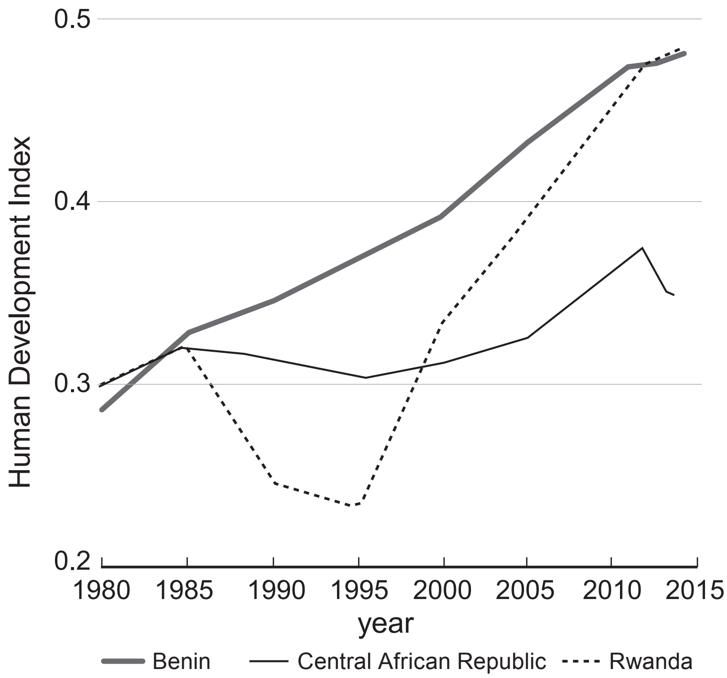
Less positively, however, there has been a decline in political freedom with government restrictions imposed on the media and opposition political parties as well as some irregularities in the 2003 and 2010 elections. Relationships between the various ethnic groups of people within Rwanda remain poor even 20 years after the civil war. Poverty has fallen, but an estimated 63% of Rwandans continue to live on less than the equivalent of $1.25 a day and 82% on less than $2. In 2011, the top 10% of the population took home 43% of the country's income and the average wage is only $4 per day – income inequality is still a problem.

Table 1 – Estimated GDP data (2015 US$)

	GDP (purchasing power parity)	GDP per capita (purchasing power parity)	Real Growth rate of GDP
2015	$20.32 billion	$1,800	6.5%
2014	$19.09 billion	$1,700	6.9%
2013	$17.85 billion	$1,600	4.7%

Rwanda's HDI value for 2014 was 0.483 which puts the country in the low human development category ranking it at 163 out of 188 countries. Among low human development countries, Rwanda is considered as a country where human development is ranked 20 places higher than its GDP per head ranking, the highest positive difference among low human development countries.

Figure 1



Rwanda along with Kenya, Burundi, Tanzania, Uganda and South Sudan form the East African Community (EAC). The EAC established a customs union in 2005 and is fast-tracking its economic integration process which in 2013 saw EAC members signing up to a monetary union, including ambitious plans for a single currency to be introduced in 2024.

The EAC has an estimated GDP of over $150bn and a total population of 162 million. Unfortunately, landlocked countries such as Rwanda carry significant transport costs, one of several non-tariff barriers to trade that still exist within the EAC. Rwanda is a huge distance from the main seaports of Mombasa and Dar es Salaam. As a result the export cost of Rwanda is currently $3245 per container and the import cost $4990 per container; the sub Saharan African average is about $2500. Other non-tariff barriers for Rwanda include poor road infrastructure, a lack of railways, delays at border crossings and a lack of standardised import and export procedures. An additional problem is that there is political and civil unrest within some EAC countries, especially in its newest member South Sudan.

A Chinese consortium led by China Railway Materials has been awarded a $7.6bn contract to build a 2,561 km railway from Dar es Salaam to Burundi, Rwanda and the DR Congo. TradeMark East Africa which supervises the major EAC infrastructure projects has said that the railway is key to unlocking the great economic potential of EAC countries which are now enjoying huge discoveries of oil and gas.

(a) (i) Describe how the Human Development Index (HDI) is calculated. [4]

(ii) With the aid of the data discuss the extent to which the HDI can be said to be an accurate measure of economic development in a country. [8]

(b) With reference to **Table 1**:

(i) Calculate the population of Rwanda in 2015. [2]

(ii) What is meant by 'GDP at purchasing power parity'? [2]

(c) With the aid of a diagram explain why exports for Rwanda such as coffee and tea are subject to significant price volatility. [4]

(d) Using the data evaluate the view that further industrialisation will be beneficial for Rwanda's economic development. [8]

(e) To what extent might a monetary union within the East Africa Community (EAC) benefit Rwanda? [12]

END OF PAPER

© WJEC CBAC Ltd.