Oxford Cambridge and RSA

A Level in Economics

H460/02 Macroeconomics

Sample Question Paper

Date – Morning/Afternoon

Time allowed: 2 hours

You may use:
- a calculator

First name	
Last name	

Centre number						**Candidate number**					

INSTRUCTIONS
- Use black ink. You may use an HB pencil for graphs and diagrams.
- Complete the boxes above with your name, centre number and candidate number.
- Read each question carefully before you start to write your answer.
- Section A: Answer **all** questions in this section.
- Sections B and C: Answer **one** question in each of these sections.
- Write your answer to each question in the space provided.
- Additional paper may be used if required but you must clearly show your candidate number, centre number and question number(s).
- Do **not** write in the bar codes.

INFORMATION
- The total mark for this paper is **80**.
- The marks for each question are shown in brackets **[ ]**.
- Quality of extended responses will be assessed in questions marked with an asterisk (*).
- This document consists of **8** pages.

SECTION A

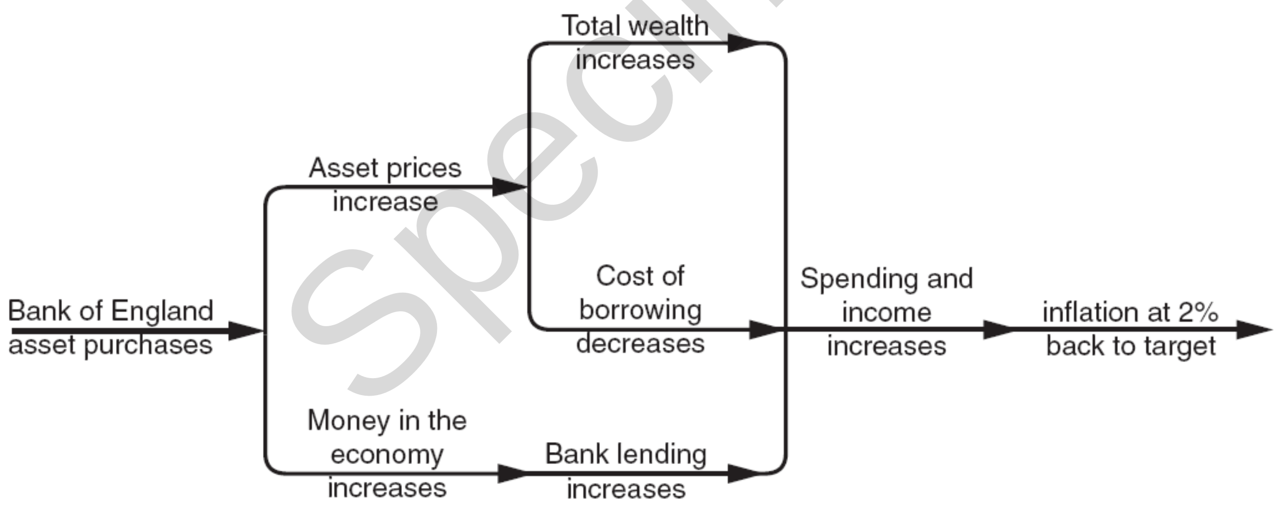
Read the following stimulus material and answer **all** parts of question 1 which follow in this section.

US and UK monetary policy and the 'Fragile Five'

The Fragile Five was a name invented in August 2013 by a banking analyst, James Lord, to describe Brazil, India, Indonesia, South Africa and Turkey. These emerging economies accounted for 12% of global GDP and 20% of global economic growth between 2009 and 2013. They had, however, a heavy reliance on external finance and were seen as the most susceptible to sudden changes in the direction of hot money flows. In early 2014 they had large current account deficits, slowing economic growth, inflation rates between 6% and 11% and were generally experiencing falling exchange rates.

One influence on the direction and volume of hot money flows to and from the Fragile Five is changes in the monetary policy measures of the US and UK. The US Federal Reserve Bank and the Bank of England had been using quantitative easing to increase the money supply (see Fig. 1). This monetary policy measure had been adopted because it was considered that nominal interest rates were already close to zero and that these very low interest rates were having little effect on aggregate demand. The Bank of England's monetary policy is influenced by its need to meet the government's inflation rate target.

Fig. 1 – The anticipated transmission mechanism of quantitative easing



Towards the end of 2013 and at the start of 2014 US and UK monetary policy changed. There was a reduction in the growth of the money supply in the two countries and the prospect of a rise in interest rates in the US. This led to a significant withdrawal of short term funds from the Fragile Five. In January 2014 all of the Fragile Five economies raised their interest rates to prevent an outflow of foreign funds and further falls in their currencies.

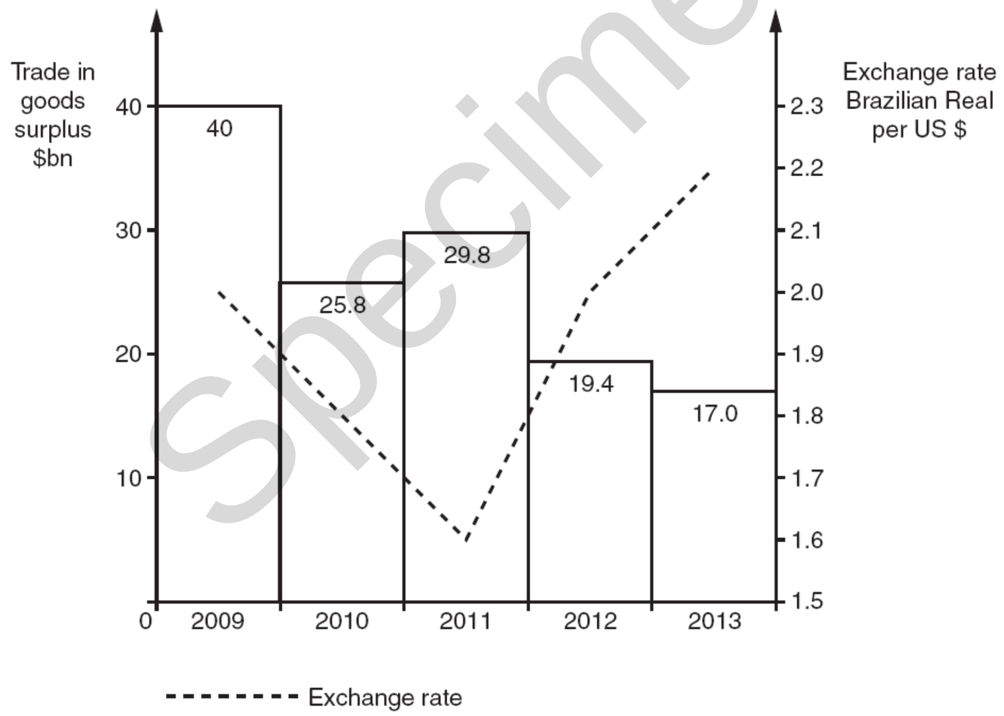
At an emergency midnight meeting the Turkish central bank raised the country's interest rate from 7.75% to 12%. Hot money flows finance more than 80% of Turkey's current account deficit. Turkey's currency, the Turkish lira, fell by 13% against the US dollar in January 2014. Table 1 provides details of changes in Turkey's export and import prices and volumes and current account position in recent years. Among these changes were that Turkey's terms of trade altered from 101 in 2011 to 98 in 2012 and 97 in 2013.

Brazil's trade balance and the value of its currency, which is called the real, also fluctuated over the period. Fig. 2 shows the change in Brazil's exchange rate against the US dollar and its trade balance between 2009 and 2013.

Table 1 – Turkey's export prices, import prices, export volumes, import volumes and current account position, 2009–13

Year	Index of export prices	Index of import prices	Index of export volumes	Index of import volumes	Balance on the current account of the balance of payments as % of GDP
2009	96	95	103	105	–2.5
2010	102	98	120	110	–8.0
2011	108	107	116	120	–10.0
2012	109	111	129	126	–7.0
2013	110	113	130	138	–5.7

Fig. 2 – Brazil's exchange rate and trade balance, 2009–13



The governments of Brazil, Turkey and the other three Fragile Five economies urged the US and the UK to continue with quantitative easing and not to raise interest rates. Janet Yellan, the Chairman of the Federal Reserve Bank, however, stated that US monetary policy will be influenced only by the US economy. This led to criticism by the governors of the central banks of the Fragile Five economies. Raguram Rajan, India's central bank governor, argued for greater policy cooperation between developed and emerging economies. He said that, 'We would like to live in a world where countries take into account the effect of their policies on other countries and do what is right broadly, rather than what is right given the circumstances of that country.'

1 **(a)** Identify **one** piece of evidence in the stimulus material of the existence of the 'liquidity trap' and explain why it is an example of the liquidity trap.

(Insert 4 x line)

[2]

(b) Using Table 1:

(i) Calculate the change in Turkey's terms of trade between 2009 and 2010.

(Insert 4 x line)

[2]

(ii) Explain what happened to Turkey's terms of trade over the whole period shown.

(Insert 4 x line)

[2]

(c) Using Fig. 2:

(i) Explain what happened to Brazil's exchange rate between 2011 and 2013.

(Insert 4 x line)

[2]

(ii) Explain what effect the change in Brazil's trade in goods surplus between 2009 and 2010 would have been expected to have had on the country's exchange rate.

(Insert 4 x line)

[2]

(d) Using Fig. 1, evaluate whether an increase in the money supply will enable the Bank of England to achieve its inflation rate target.

(Insert 32 x line)

[8]

(e)* Evaluate the extent to which an emerging economy, such as India, can operate an independent monetary policy.

(Insert 48 x line)

[12]

SECTION B

Answer **EITHER** question **2 OR** question **3.**

EITHER

2* Ethiopia exports mainly primary products whereas Japan exports mainly manufactured goods.

Evaluate, with the use of opportunity cost ratios, the extent to which comparative advantage explains the pattern of trade between developed and developing economies.

[25]

OR

3* The Labour Party announced in 2014 that, if elected, it would restore the 50% income tax rate for high earners in the UK.

Evaluate, with the use of an appropriate diagram(s), whether UK macroeconomic performance would be strengthened by an increase in the top rate of income tax.

(Insert 100 x line)

[25]

SECTION C

Answer **EITHER** question **4 OR** question **5.**

EITHER

4* The income gap between the richest 1% of US households and the other 99% of households widened to a record amount in 2012 with the top 1% receiving more than 19% of total household income.

Evaluate whether globalisation always increases income inequality in a developed economy.

[25]

OR

5* The performance of Citigroup, one of the largest US retail banks, has recently improved. The bank had suffered huge losses during the financial crisis of 2008 and it had to be rescued by the US central bank and government.

Evaluate whether a central bank should ever allow a retail bank to fail.

(Insert 100 x line)

[25]

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