# Model Answers Unit 4 June 2010

**4) A) Explain the characteristics of 'deglobalisation' (Extract 1, line 4). (5)**

Deglobalisation refers to the disintegration of economies resulting in a decrease in international trade, fall in MNCs/FDI and reduction in tourism ***(Knowledge 3 marks)***. World trade dropped by 5% in November 2008 (extract 1) ***(Application 2 marks)***.

**B) Explain why some countries may experience a more severe recession than others. (8)**

A country may suffer more from a recession if it is extremely dependent on exports ***(Knowledge 2 marks)***. Singapore, an East Asian Tiger economy, had exports worth 186% of its GDP in 2008 and its economy shrank at an annualised rate of 17% (extract 1) ***(Application 1 mark)***. As a global recession occurs, world incomes fall, countries demand less imports and this means less exports for countries dependent on exports ***(Analysis 2 marks)***. Another reason why a country may suffer more from a recession than others is the degree and effect of decreasing house prices ***(Knowledge 1 mark)***. House prices were rising rapidly and steadily in the UK up until the 2007/08 credit crisis ***(Application 1 mark)***. As the credit crisis hit the UK, the housing bubble burst, houses prices fell by a sharp amount and there was a major negative wealth effect as some homeowners defaulted on mortgages while others cut their consumption significantly ***(Analysis 1 mark)***.

**C) Examine the possible effects of the global recession on countries with well-established tourist industries. (10)**

An effect is a fall in GDP ***(Knowledge 1 mark)***. The Caribbean may suffer a 33% fall in the number of its visitors (extract 1) ***(Application 1 mark)***. Less tourists means less consumption in the Caribbean, AD falls and, due to the multiplier effect, AD falls again so real GDP decreases ***(Analysis 2 marks)***. Another effect is a decline in employment. For example, Mexico may suffer a fall in employment if less tourists visit the Mayan ruins ***(Application 1 mark)***. Less tourists in Mexico means less tour guides are needed so unemployment rises. Also, less tourists means less consumption, AD falls and, due to the multiplier, AD falls again so firms produce less and fire workers so unemployment rises further ***(Analysis 1 mark)***.

However, the effects depend on the magnitude of the tourist sector as a share of GDP. An economy with a small tourist sector will likely feel no effects as the decline in the number of tourists to the country will be small so the lost consumption will be small ***(Evaluation 2 marks)***. Moreover, the length of the recession is significant. A recession that lasts only for the first quarter of a year may not have that much effect on tourism as people may still save up for the rest of the year to go on holiday. Also, the recession may occur during the Christmas holidays and not affect tourism much as the summer holidays is the peak season for tourism ***(Evaluation 2 marks)***.

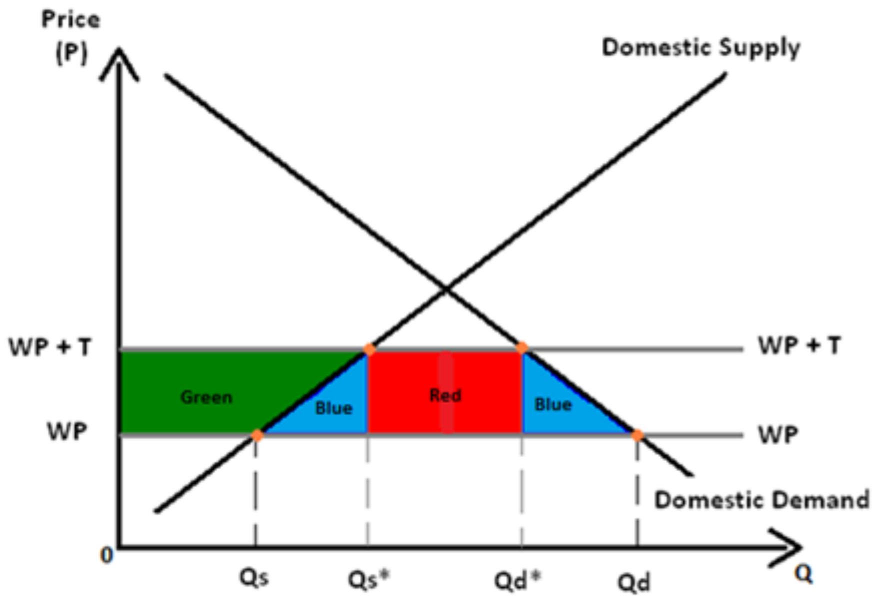
***D) With reference to lines 26-34 of Extract 1, evaluate reasons why the banking crisis has hit world trade so severely. (12)**

A first reason may be that the banking crisis, or global recession, was deeper than predicted (extract 1) ***(Application 1 mark)***. A deeper global recession than predicted means most economies are affected and damaged significantly, leading to a major reduction of incomes around the world and thus a major fall in imports and exports ***(Analysis 2 marks)***. Another reason may be that the world economy was very closely integrated at the time of the recession ***(Knowledge 1 mark)***. Global supply chains and the interdependence of economies (extract 1) means that, for example, as the US falls into a recession, US incomes fall and imports fall so exports from the UK fall, UK incomes fall and imports fall so exports from Japan fall and the recession spreads quickly amongst the integrated economies ***(Analysis/Application 3 marks)***.

However, the recent decline in world trade may have been inevitable as it has followed 60 years of global prosperity (extract 1). Many years of booming international trade will likely be followed by a decline in international trade as the global economy cannot always be expected to boom. After such a boom in international trade, it can only be expected that international trade will eventually boom again ***(Evaluation 3 marks)***. Additionally, some economies may not have suffered that much depending on what they export. For example, during a recession, consumers do not demand that much less food, so African economies that export agricultural primary commodities may suffer only a slight decline in their exports ***(Evaluation 2 marks)***.

***E) In the light of the global recession, assess the likely economic effects of an increase in protectionism on the world economy. (15)**

A tariff is a tax on imports. Let's say we are in the US economy, the world price of a good is $WP$, the US economy produces $Q_s$ of the good but $Q_d$ is demanded so $Q_d - Q_s$ is imported. A tariff T is then placed on the good, US and foreign prices rise to $WP + T$, US supply rises to $Q_{s*}$, US demand falls to $Q_{d*}$ and imports fall to $Q_{d*} - Q_{s*}$ ***(Diagram 2 marks)***.




A first effect is a fall in consumer surplus for US consumers ***(Knowledge 1 mark)***. A tariff raises the price of imported goods so US consumers must pay more and consumer surplus falls by the red, green and blue regions ***(Analysis 1 mark)***. Another effect is a rise in producer surplus for US firms ***(Knowledge 1 mark)***. Firms receive a higher price so producer surplus rises by the green region. US tax revenue rises by the red region. Overall there is a welfare loss equal to the blue regions. Some of the consumer surplus is transferred to producers (green region) and the government (red region), but a welfare loss remains (blue regions) ***(Analysis 2 marks)***. Another effect is the US current account moving towards a surplus. A US tariff on imports means US consumers buy less imports and switch to buying relatively cheaper US goods, so US imports fall and the US current account moves towards a surplus ***(Analysis 2 marks)***.

But, if the US uses protectionism then other countries may retaliate and do the same. Maybe Japan retaliates and places tariffs on US goods exported to Japan. This means the US' exports to Japan will fall and the US current account moves towards a deficit ***(Evaluation 2 marks)***.Moreover, US imports will only decrease if US imports have an elastic PED. If US consumers have an inelastic demand for imports then the tariff will cause the quantity demand of imports to fall by only a small amount ***(Evaluation 2 marks)***. Lastly, protectionism may be required for political reasons maybe to keep employment high amongst certain voters. For example, the US government subsidize farmers and ensure their exports remain internationally competitive ***(Evaluation 2 marks)***.

**5) A) With reference to Figure 1, how might the expected change in the UK's fiscal deficit between 2007/08 and 2009/10 be explained? (5)**

The UK's fiscal deficit rose from roughly 2.5% in 2007/08 to about 12.4% in 2009/10 (figure 1) ***(Application 2 marks)***. The fiscal deficit may have rose because of the 2007/08 credit crisis. The credit crisis caused a deep recession which meant tax revenue fell and government spending had to rise to decrease unemployment. Also, the UK government nationalised banks such as RBS to avoid a banking collapse ***(Knowledge/Analysis 3 marks)***.

**B) With reference to the information provided, explain the problems resulting from the deterioration in the public finances for the UK or any country of your choice. (8)**

One problem is that taxes may rise in the future to repay the debt ***(Knowledge 2 marks)***. In 2009/10, France had a fiscal deficit of roughly 8.3% (figure 2) ***(Application 1 mark)***. A large fiscal deficit means the government must borrow money and eventually repay this money in the future either through further loans or raising taxes ***(Analysis 1 mark)***. Another problem is the potential loss of AAA credit rating ***(Knowledge 1 mark)***. In 2009/10, France's national debt was 67% of GDP (figure 4) ***(Application 1 mark)***. This is above the EMU's restriction of a national debt of up to 60% of GDP. Creditors may fear that France cannot repay such a large debt so creditors may downgrade France's credit rating from AAA. In the future, France will have to pay higher interest rates on foreign loans ***(Analysis 2 marks)***.

**C) Evaluate the reasons why the UK economy was in a weak state following the financial crisis in autumn 2007. (10)**

A likely reason is that London specializes in financial services ***(Knowledge 1 mark)***. The UK was exposed to the 2007/08 credit crisis due to its own big banks (extract 2) ***(Application 1 mark)***. As the credit crisis caused a decrease in demand for loans and homeowners to default on their mortgages, UK banks would have suffered heavy losses. Banks making losses then mean that workers are fired so unemployment rises, consumption falls and real GDP falls ***(Analysis 2 marks)***. Another likely reason is the large UK housing market bubble bursting. UK house prices had rose rapidly and steadily throughout 2000-2007 and were amongst the most extreme internationally (extract 2) ***(Application 1 mark)***. As the bubble burst, house prices fell dramatically and there was a major negative wealth effect as some homeowners defaulted on mortgages and others felt less wealthy so they took out less loans, consumption fell, AD fell and real GDP fell ***(Analysis 1 mark)***.

The most important factor may be London's specialization in financial services. African economies do not depend on financial services and resultantly were not harmed much by the 2007/08 credit crisis whereas the UK's overdependence on financial services allowed them to be hit hard during a financial downturn ***(Evaluation 2 marks)***. However, in the long-run, the UK government may rebalance the economy so that it is not over-dependent on financial services. Maybe the UK could further develop its tourist sector or develop its exports so that the economy is more diverse and less susceptible to shocks ***(Evaluation 2 marks)***.

***D) Evaluate the likely effectiveness of monetary policy in the management of the economy in light of the information provided. (12)**

Monetary policy is the manipulation of monetary variables (interest rate and money supply) by the MPC to influence AD and inflation ***(Knowledge 1 mark)***. Between 2008/09, the BoE reduced interest rates from 5% to 0.5% and injected £200 billion into the economy through quantitative easing (extract 2) ***(Application 2 marks)***. A fall in interest rates means the cost of borrowing falls so consumers take out more loans and buy more credit-bought items. Furthermore, the return on savings falls so saving becomes less attractive and consumption becomes more attractive. Consumption rises, AD rises, the price level rises and real GDP rises ***(Analysis 2 marks)***. With quantitative easing, the BoE pumping money into the economy by buying assets (usually government bonds) from banks like Barclays, Barclays and other banks have more money to lend, consumers can take out more loans so consumption rises, firms can take out more loans so investment rises and AD rises. Multiplier effects make AD shift further and inflation increases ***(Analysis 2 marks)***.

But, monetary policy takes time to come into effect due to time lags. An interest rate change takes roughly 2 years to exert its full effect. Moreover, it takes up to 2 years for the multiplier to exert its full effect. ***(Evaluation 3 marks)***. Additionally, quantitative easing is relatively untried in the UK, it was first used in 2009, so its effects may be unpredictable. Maybe quantitative easing is dangerous, it could make inflation rise above target and become out of control ***(Evaluation 2 marks)***.

***E) Assess the likely economic implications of 'the 27% decline in sterling's trade-weighted index... between July 2007 and March 2009' (*Extract 2, lines 17–18*). (15)**

Sterling's trade weighted index is the value of the £ in relation to a weighted basket of other currencies. A weaker £ means the UK current account moves towards a surplus ***(Knowledge 1 mark)***. If the £ is weaker, the UK is more internationally price competitive, UK exports are cheaper so exports rise, imports are dearer so imports fall and the current account moves towards a surplus ***(Analysis 2 marks)***. UK exports fell by far less than other countries like Japan (extract 1) ***(Application 2 marks)***. Also, a weaker £ means UK real GDP will rise ***(Knowledge 1 mark)***. If the £ is weaker, UK exports are cheaper so exports rise, imports are dearer so imports fall, the current account moves towards a surplus, AD rises and shifts right so real GDP increases ***(Analysis 2 marks)***. Moreover, the weaker £ is safeguarding the UK against deflation ***(Application 1 mark)***. If the £ is weaker, UK exports are cheaper so exports rise, imports are dearer so imports fall, the current account moves towards a surplus, AD rises and shifts right so there is demand-pull inflation. Also, because imports are dearer, UK firms' imported raw materials are dearer, UK firms' costs rise and there is cost-push inflation ***(Analysis 1 mark)***.

But, the current account will only move towards a surplus if the Marshall-Lerner condition holds. A weaker £ only moves the current account towards a surplus if the sum of the elasticities of demand for exports and imports is greater than one ***(Evaluation 2 marks)***. Furthermore, as shown by the J-curve, After the £ weakens, the current account moves into a deficit in the short-run because of fixed contracts for exports and imports. Exports are cheaper and imports are dearer yet their volumes remain the same, so the current account initially moves towards a deficit. After contracts are renegotiated in the long-run, exports rise, imports fall and the current account moves towards a surplus ***(Evaluation 2 marks)***. Lastly, the magnitude of the fall in the value of the £ is large, a 27% decline, this could mean the current account surplus is too high, AD is too high and the UK suffers from a major rise in inflation ***(Evaluation 2 marks)***.

# Model Answers Unit 4 June 2011

**4) A) With reference to lines 18–19 of Extract 1, explain why many development economists consider that a growth rate of 6% is the minimum desirable in most African economies. (5)**

GDP per capita is GDP divided by population ***(Knowledge 1 mark)***. If an LDC's population grows faster than its GDP, GDP per capita falls, average incomes fall and living standards fall ***(Analysis 2 marks)***. Kenya will struggle to grow by 3% in 2010 (extract 1), resulting in a fall in living standards if population growth is greater than 3% (extract 1) ***(Application 2 marks)***.

**B) With reference to Figure 1 and Extract 1, analyse why the growth rate of the Sub-Saharan African economies was higher than that of Advanced Economies between 2000 and 2010. (8)**

Between 2000-2010, Sub-Saharan Africa (SSA) economies' economic growth was roughly 3% higher than Advanced Economies' economic growth (figure 1) ***(Application 2 marks)***. This may be due to SSA's banks being less exposed to the 2007/08 credit crisis ***(Knowledge 1 mark)***. The subprime mortgage crisis hit Advanced Economies' banks hard and caused large losses but SSA banks were not involved as much so they suffered less losses and had more credit available so SSA economies grew faster ***(Analysis 2 marks)***. Another reason may be that FDI remained steady (extract 1) ***(Knowledge 1 mark)***. As SSA's FDI flows were steadier than Advanced Economies' FDI flows, SSA's investment was stable, the infrastructure could be developed, firms were investing and thus SSA could grow faster than Advanced Economies ***(Analysis 2 marks)***.

**C) With reference to Figure 2 and Extract 2, assess the benefits of foreign direct investment in primary sector industries of countries in Sub-Saharan Africa. (10)**

Since January 2010, $800 million of FDI flowed from Brazil to Angola's oil industry and $500 million of FDI flowed from Russia to Angola's construction industry (figure 2) ***(Application 2 marks)***. A benefit of FDI flows may be better infrastructure ***(Knowledge 1 mark)***. Brazil's MNCs may have developed roads and utility networks around Angola's oil industry so as to extract and transport oil quicker ***(Analysis 1 mark)***. Another benefit may be more tax revenue. Russia's MNCs would have to pay the Angolan government corporation tax and, if Russia's MNCS hire workers, income tax revenue would also rise ***(Analysis 2 marks)***.

However, MNCs may exploit LDC workers. Russia's MNCS may have set up production in Angola's construction industry to exploit cheap labour in Angola by paying them low wages and making them work long hours ***(Evaluation 2 marks)***. Also, MNCs may repatriate profits to avoid taxes in Angola. Brazil's MNCs may repatriate profits by buying imports from their sister firms in Brazil at a high price and exporting oil from Angola to their sister firms in Brazil at a low price. MNCs take their profits out of Angola and pay less corporation tax in Angola ***(Evaluation 2 marks)***.

***D) With reference to Extract 2, evaluate the benefits to African countries of increased trade with the BRIC economies. (12)**

A first benefit to African economies is that trade with BRIC economies helps offset the fall in trade with Advanced Economies ***(Knowledge 1 mark)***. As Advanced Economies suffered from the 2007/08 credit crisis their incomes fell and they demanded less exports from Africa. BRIC buying Africa's exports like raw materials (extract 2) ***(Application 1 mark)*** would offset this and keep Africa's exports at roughly the same level ***(Analysis 2 marks)***. Another benefit is that Africa will export to BRIC economies so Africa will receive more foreign currency ***(Knowledge 1 mark)*** and be able to service their foreign debts and also import vital capital goods like machinery required for economic growth ***(Analysis 1 mark)***.

However, Africa may suffer as BRIC economies want to buy Africa's raw materials (extract 2) ***(Application 1 mark)***. If Africa exports primary products like raw materials it may suffer from declining terms of trade. Over time this means Africa's export prices fall and import prices rise so the value of its exports fall, the value of its imports rise and Africa's current account moves towards a deficit ***(Evaluation 3 marks)***. Additionally, Africa may become too reliant on trade with BRIC economies. If BRIC economies suffer a recession they will demand less imports so African economies' exports will fall, AD will fall and they may be dragged into a recession too ***(Evaluation 2 marks)***.

***E) With reference to Extract 2, to what extent might aid from the BRIC economies promote development in Sub-Saharan Africa? (15)**

African economies may be able to plug their domestic savings gap with aid ***(Knowledge 1 mark)***. China will give Africa $10 billion of cheap loans (extract 2) ***(Application 1 mark)***. African economies could use this aid as a replacement for domestic savings, invest in the manufacture sector, boost AD and through the multiplier create more jobs, boost income, consumption and AD again so that African economies can grow ***(Analysis 2 marks)***. Moreover, African economies may use aid to plug their foreign exchange gap ***(Knowledge 1 mark)***. Aid can provide African economies with foreign currency that they need to service foreign debts and import vital capital goods like machinery required for economic growth ***(Analysis 2 marks)***. Furthermore, African economies may use aid to develop the infrastructure by fixing roads, this will increase efficiency, shift LRAS right and increase real GDP ***(Analysis 1 mark)***.

But, aid may lead to 'aid dependency'. African economies may become reliant on aid to boost their economies. African economies may then remain undeveloped by investing little to attract aid from BRIC economies ***(Evaluation 2 marks)***. Also, aid may be tied. Maybe China attaches strings on aid like forcing African economies to use the money to buy China's military exports. This not only means that aid does not help develop Africa but instead African economies actually suffer as their own military firms sell less to African governments ***(Evaluation 2 marks)***. Finally, China may give aid to corrupt regimes in Africa (extract 2) ***(Application 1 mark)***. Aid may be given to military leaders in Africa and wasted on guns and tanks to oppress civilians in Africa rather than to African economies that will use aid to develop ***(Evaluation 2 marks)***.

**5) A) With reference to Extract 1, explain the role of the World Trade Organisation (WTO). (5)**

The World Trade Organization (WTO) promotes free trade between all of its member countries ***(Knowledge 2 marks)***. The WTO provides a forum for free trade negotiations by conducting rounds, a series of negotiations designed to lead to major free trade agreements such as the removal of tariffs and quotas ***(Knowledge 1 mark)***. Brazil persuaded the WTO to allow Brazil to retaliate against US cotton export subsidies by imposing $560 million worth of tariffs (extract 1) ***(Application 2 marks)***.

**B) With reference to Figures 1 and 2 and to Extract 2, analyse the effects of an undervaluation of the Chinese currency, the renminbi, for the US economy. (8)**

Since roughly mid-2008, China devalued the renminbi down to 6.83 per dollar (figure 1) ***(Application 2 marks)***. A first effect on the US is a rise in US imports ***(Knowledge 1 mark)***. A devaluation of the renminbi means China gains international price competitiveness, China's exports are cheaper, US consumers buy more cheap Chinese goods, US imports rise and the US current account moves towards a deficit ***(Analysis 2 marks)***. Another effect is lower US economic growth ***(Knowledge 1 mark)***. A devaluation of the renminbi means Chinese consumers buy less US exports because they are more expensive, US exports fall, the US current account moves towards a deficit, AD falls and real GDP falls in the US ***(Analysis 2 marks)***.

**C) To what extent might a higher level of savings in the USA be sufficient to eliminate trade imbalances between China and the USA? (10)**

Between 1990-2009, the US' accumulated trade deficit with China was $2,009 billion (figure 2) ***(Application 2 marks)***. A rise in US savings should lead to lower US imports ***(Knowledge 1 mark)***. A rise in US savings means US consumers should be consuming less, so US consumers will demand less Chinese goods, US imports should fall and the trade deficit should improve ***(Analysis 1 mark)***. Additionally, more US savings means more funds for investment, US firms may then invest more, develop new and more competitive goods to compete internationally, US exports will rise and the US trade deficit will improve ***(Analysis 2 marks)***.

However, if US consumers save more, they will only demand a lot less imports if the marginal propensity to import (MPI) is high. If the MPI is high then when US consumers start to save more of their income they must reduce their spending on imports by a large amount ***(Evaluation 2 marks)***. Also, if the dollar becomes stronger against the renminbi (maybe due to further renminbi devaluations), Chinese goods become even cheaper for US consumers, US imports will rise further and the US trade deficit will worsen ***(Evaluation 2 marks)***.

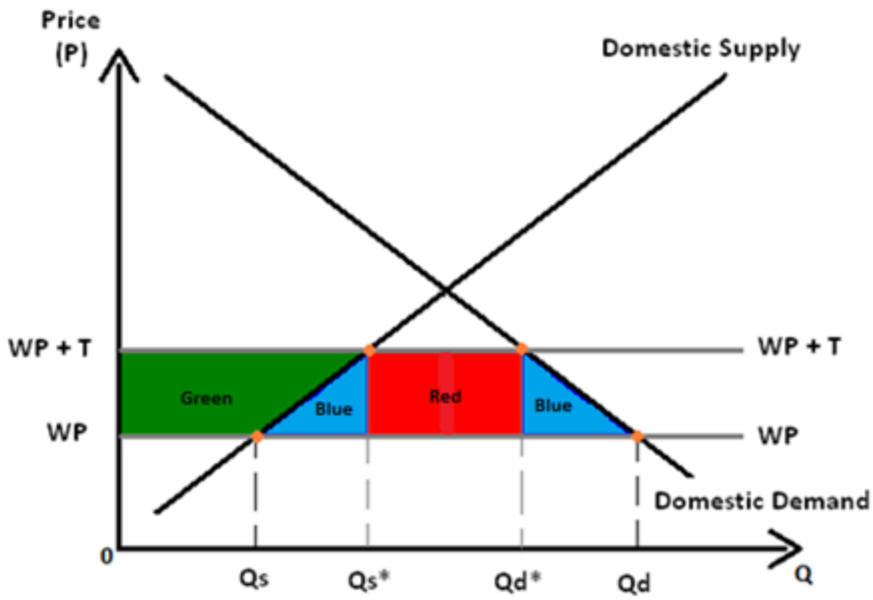
***D) To what extent are large trade imbalances a cause for concern? (12)**

In 2008, the US' trade deficit with China was $268 billion (figure 2) ***(Application 1 mark)***. The US also has a trade deficit with Mexico (extract 1) ***(Application 1 mark)***. A trade deficit may be a problem because it indicates that US goods are not internationally competitive ***(Knowledge 1 mark)***. Maybe the US' goods are poor quality relative to the rest of the world so US exports are in low demand. This is a concern because it is a long-term problem and requires a large investment by firms to regain competitiveness ***(Analysis 2 marks)***. A trade deficit may also be a problem because, if the US is producing too little exports, there may not be enough jobs ***(Knowledge 1 mark)***. Labour is a derived demand, if there is not enough demand for US exports then US firms do not require workers and unemployment rises ***(Analysis 1 mark)***.

However, a trade deficit may be funded by a financial account surplus. Money flowing out of the US due to the trade deficit may be cancelled out and funded by money flowing into the US if the US attracts enough FDI/MNCs ***(Evaluation 3 marks)***. Also, a trade deficit may not be a problem if the domestic economy imports a lot of capital goods. Machinery may be imported so the domestic economy's productive capacity rises, LRAS shifts right and, in the future, the domestic economy can produce more consumer goods for its domestic consumers so its imports fall and the domestic economy can sell more consumer goods to foreign consumers so the domestic economy's exports rise ***(Evaluation 2 marks)***.

***E) With reference to Extract 1, assess the impact of tariffs, such as those imposed by Mexico and Brazil, on US consumers and producers. Illustrate your answer with an appropriate diagram. (15)**

Brazil won a trade dispute with the WTO in 2009 to put up $560 million of retaliatory tariffs against US cotton, beauty products and cars (extract 1) ***(Application 1 mark)***. In 2009, Mexico imposed $2.4 billion in tariffs on various US goods (extract 1) ***(Application 1 mark)***.




A tariff is a tax on imports. Let's say the world price of a good is $WP$, Mexico produces $Q_s$ of the good but $Q_d$ is demanded so $Q_d - Q_s$ is imported. A tariff T is then placed on the good, Mexican prices and the prices of imports from the US rise to $WP + T$, Mexico's domestic supply rises to $Q_{s*}$, Mexico's domestic demand falls to $Q_{d*}$ and imports fall to $Q_{d*} - Q_{s*}$ ***(Diagram 2 marks)***.

Because Mexico imports less US goods, US consumers will suffer from job losses of roughly 25,000 (extract 1) ***(Analysis 2 marks)***. Also, because Mexico buy less US exports, US firms will sell $2.6 billion (extract 1) less exports and suffer lower profits ***(Analysis 2 marks)***. Additionally, the US may export less goods in which it has a comparative advantage so the US economy's efficiency is distorted, US real incomes fall and US consumers cannot buy as much as before ***(Analysis 1 mark)***.

However, the effect on job losses depends on Mexico's PED for US exports. If Mexican consumers have an inelastic demand for US exports then, as the tariff is imposed on US exports, Mexican consumers will only demand a little bit less so the tariff may not lead to a significant amount of job losses for US consumers ***(Evaluation 2 marks)***. Furthermore, US firms may respond by investing to develop new technology, become more efficient, reduce their costs and export prices and continue to export to Mexico and earn high profits ***(Evaluation 2 marks)***. Moreover, the US may retaliate, lobby the WTO and receive the right to subsidize its exports to Mexico so that Mexican consumers continue to buy US exports ***(Evaluation 2 marks)***.