Rewarding Learning

ADVANCED
General Certificate of Education
January 2013

Economics

Assessment Unit A2 2

The Global Economy

[AE221]

AE221

WEDNESDAY 30 JANUARY, AFTERNOON

TIME

2 hours.

INSTRUCTIONS TO CANDIDATES

Write your Centre Number and Candidate Number on the Answer Booklet provided.
Answer **Question 1** and **one** question from **Questions 2**, **3** or **4**.

INFORMATION FOR CANDIDATES

The total mark for this paper is 80.
Quality of written communication will be assessed in all parts of **all** questions **except 1(a)**.
Figures in brackets printed down the right-hand side of pages indicate the marks awarded to each question or part question.

ADVICE TO CANDIDATES

You are advised to take account of the marks allocated for each part question in allocating the available examination time.

Question 1

The following passages were written in August 2011, and were adapted from a variet
sources. Please read them carefully and answer the questions which follow.

Case Study: Instability in world currencies

Source 1: Euro stumbles from crisis to crisis

Hardly a day passes without banner headlines in the financial press relating to the sovereign debt crisis faced by many Eurozone nations and in particular Ireland, Italy, Greece, Portugal and Spain.

In the face of this constantly negative flow of news it could be expected that the exchange rate of the euro would fall significantly. However, examination of its rate against the American dollar and the British pound contradicts this view.

US dollars per euro

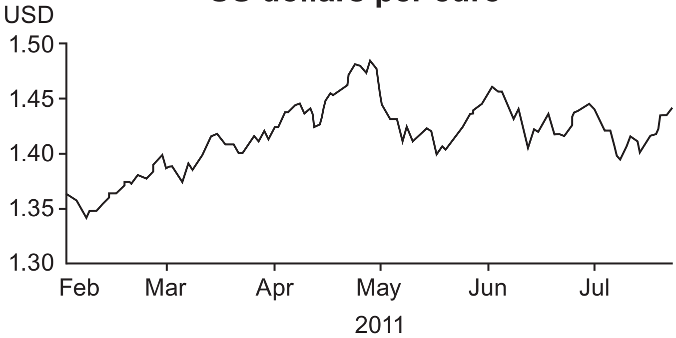

Fig. 1 *© A McCann, CCEA*

British pounds per euro

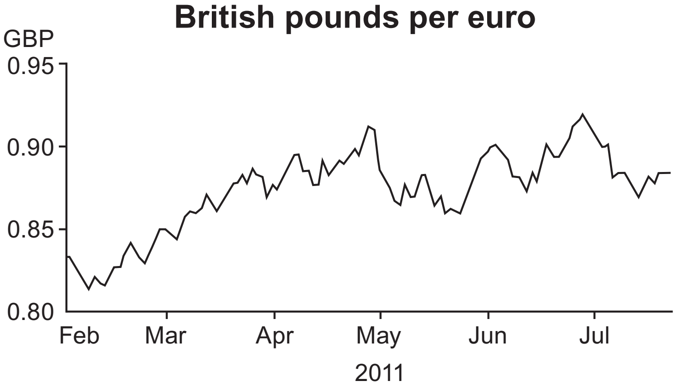

Fig. 2 *© A McCann, CCEA*

Far from falling, the euro has risen significantly against both currencies since the beginning of February. However, this is certainly not a vote of confidence in the euro but simply reflects the fact the UK and the USA also have significant debt problems.

A much better picture of the state of the euro can be gauged by looking at its value against the currency of its thrifty neighbour Switzerland which is pursuing a vigorous debt reduction programme.

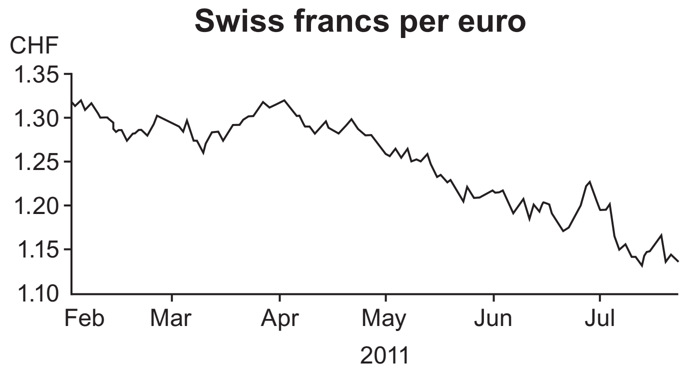

Fig. 3 *© A McCann, CCEA*

It is apparent that a country's exchange rate is heavily influenced by the level of its national debt with low debt countries having higher exchange rates than the more indebted ones. The problem in the Eurozone is that some of its members have run up debts of such proportions that there is an ever-present risk of default.

Most economists attribute this debt explosion to the "one size fits all interest rate" which is a necessary feature of any currency union. The Eurozone interest rate is set mainly to reflect economic conditions in its core countries like France and Germany and has not proved to be appropriate for peripheral members such as Greece and Ireland. The result has been excessive lending, property bubbles, government bail outs for the banks and a legacy of debt.

Source 2: What is to be done?

Economists may be agreed on the cause of the sovereign debt crisis but they are certainly not agreed on the solution. There are three broad schools of thought on this:

- **Austerity**
  The indebted nations are forced to pay off most of their debts, though the interest rate may be reduced and the repayment time extended. This will lead to low rates of economic growth for many decades and has been referred to as a form of "debt slavery".

- **Devalue and Default**
  The indebted nations abandon the euro and default on most of their debts. There is a possibility that this might cause another world financial crisis similar to that precipitated by the collapse of Lehman Brothers in 2008. However, it has worked for other countries, most notably Argentina in 2002.

- **Closer economic integration**
  The indebted nations abandon control of their fiscal policy and the core countries agree to make substantial transfers to them. The problem is that German public opinion is totally opposed to such transfers.

The Eurozone has yet to agree on a clear strategy for dealing with its sovereign debt crisis and until it does so, there will be instability in both the currency and bond markets. This has already impacted on economic growth both within the Eurozone and beyond. One way or another the crisis must be resolved.

Source 3: Chinese yuan managed upwards

In stark contrast to the volatility of the euro the Chinese yuan is a beacon of stability. [illegible] because its value is determined by The Peoples' Bank of China (PBOC), the Chinese c[illegible] bank. The PBOC can use changes in the rate of interest and direct intervention in currency markets in order to achieve a particular exchange rate.

At certain times it has been totally fixed against the dollar and at others it has been allowed to float within a narrow range of a pre-announced rate, set by PBOC.

Between 1998 and 2005 the value against the US dollar was fixed at 8.27 yuan to the dollar. Between 2005 and 2008 an element of flexibility was introduced with the yuan allowed to float within a narrow band around a rate announced each day by the Chinese central bank.

A totally fixed exchange rate, this time at 6.82 yuan to the dollar, was restored in July 2008 only to be replaced once again by a managed floating rate around a value of 6.48 yuan to the dollar.

The Chinese central bank seems content to manage a steady upward movement in the yuan. In 2005 a yuan bought just under $0.12 but by 2011 it had risen to around $0.15. This is a response, not just to political pressure from the USA, but also to rising inflation within China.

Source 4: Euro crisis will affect the UK

Winston Churchill once declared that Britain was an island nation. No-one could fault the great war leader's geography, but in this age of closer economic integration it is impossible for the UK to remain unaffected by events in mainland Europe and the Eurozone in particular.

British banks hold some 23 billion euros of bonds issued by the weakest and most indebted countries with Barclays the most exposed. A default on this debt could create another credit crunch similar to that of 2008. Already first time buyers with low deposits are finding it difficult to acquire mortgage finance as banks cut back on lending. This can only get worse if banks have to write off large chunks of Eurozone sovereign debt.

In addition the Eurozone is collectively the UK's largest export market. Our fragile economic recovery would be at severe risk from a deepening financial crisis and the possible break-up of the Eurozone.

(a) Using the information in **Figs 2** and **3**, compare the trends in the value of the euro against the UK pound and the Swiss franc between the start of February 2011 and the end of July 2011. [5]

(b) Explain how the Chinese central bank controls the exchange rate of its currency (yuan). [10]

(c) Analyse the impact of the Eurozone crisis on the UK economy. [10]

(d) Critically examine the view that the best solution to the Eurozone debt crisis is for highly indebted countries such as Greece and Ireland to "devalue and default". [15]

Essays: Answer **one** question from **Questions 2**, **3**, **or 4**.

2 Aid remains crucial to economic development

(a) Explain the main differences between Less Developed Countries and Newly Industrialised Countries.

(b) Critically examine the view that free trade alone is insufficient to promote economic development. [25]

3 Current account deficits cannot be ignored

(a) Explain the differences between the current account and the financial account of the UK balance of payments. [15]

(b) Evaluate the view that current account deficits are still economically significant. [25]

4 Globalisation has been a mixed blessing

(a) Explain the main factors that have led to globalisation. [15]

(b) Critically examine the impact of globalisation upon living standards in the UK. [25]

THIS IS THE END OF THE QUESTION PAPER