OCR
RECOGNISING ACHIEVEMENT

ADVANCED GCE

ECONOMICS

The Global Economy

F585

MARK SCHEME

Duration: 2 hours

MAXIMUM MARK 60

PRE-STANDARDISATION VERSION

Please note that the following mark scheme and the associated question paper have not been used as part of live assessment and are provided as additional specimen assessment material only. The mark scheme has not been subject to refinement and finalisation by examiners at a standardisation meeting.

This document consists of 12 pages

Question Number	Answer	Max Mark
1 (a)	**Describe what is meant by the 'economic cycle'.** The economic cycle is the regular fluctuations in economic activity as measured by GDP, characterised by four distinct stages: • recession – the period in which GDP falls and unemployment typically rises • recovery – the period after recession when GDP rises at a rate below trend growth • boom – the period in which GDP growth is above trend, and inflationary pressures arise as the output gap closes • slowdown – a period in which the rate of GDP growth falls below trend *Synoptic knowledge: AS Unit 2, The national economy* *Government economic policy objectives and indicators of national economic performance* 1 mark for a recognition of fluctuations in economic activity/GDP growth Up to 2 marks for a list of the four stages only, or an unexplained diagrammatic representation 1 mark for each description of the four stages **Additional Guidance** An answer can achieve full marks if the stages are described without being named	[4]
1 (b)	**Analyse the circumstances in which a slowdown in the rate of economic growth may raise fears of a recession in the UK <u>or</u> in the US.** The slowdown in economic growth in the both the UK and the US appears to be caused by a fall in the growth of consumer spending and a fall in the level of investment. These trends would reduce the growth of AD and consequently economic growth, unless offset by growth in the other components of AD. Candidates who adopt this approach have obviously built upon their AS knowledge and understanding. To step up to A2 candidates are expected to develop their answers in terms of the interaction of the multiplier and accelerator or by drawing on the references to the 'build-up of stocks' mentioned in the Extract. Job losses have multiplier effects on AD. The reduction in the level of investment is related to the slowdown in the growth of demand in the economy, via the accelerator effect. Slower growth in demand will cause stock levels to rise as production exceeds demand. Eventually firms will cut back production in order to stop stock levels growing and the economy will enter the recession phase of the economic cycle as demand is met largely from stocks of finished goods. In addition, there is a concern that interest rates in the UK have not been reduced sufficiently to raise AD because of the need to control rising inflation. Alternatively, candidates may pick up on the references to global demand and link this to AD. There	[6]

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	is much that candidates can draw on Extracts 1 and 2 to analyse the circumstances in which a slowdown might result in a recession – for example, the US situation is helped by aggressive cuts in interest rates and the weak exchange rate. *Synoptic knowledge: AS Unit 2, The national economy* *Aggregate demand and aggregate supply and their interaction.* Up to 2 marks for an understanding of the causes of the slowdown in economic growth in the UK or the US. Up to 4 marks for an analysis of the reasons why this raises fears of recession through a consideration of the interaction of the multiplier and accelerator, the impact of changes in the levels of stocks or the constraint on monetary policy created by rising inflation.	
1 (c)	**Comment on the extent to which rapid economic growth inevitably leads to rising inflation, such as that experienced in Vietnam.** Extract 3 provides the stimulus for this question. Economic growth can have the consequence of rising inflation where increases in AD are not matched by increases in AS. As an economy reaches full capacity increases in AD result in the general level of prices rising. This comes about because shortages of inputs put upward pressure on production costs. In such circumstances firms have little spare capacity to meet demand and respond by raising prices in order to maintain profit margins. Candidates are likely to analyse this consequence using an AD/AS diagram, although it is not necessary to do so to achieve a mark in Level 3 of the mark scheme. Developed analysis in Level 3 will make use of the concept of the output gap to show the step up from AS to A2. A commentary on the extent to which rapid economic growth inevitably leads to rising inflation should focus on the supply side response of the economy or the nature of economic growth. Measures to raise productive capacity will reduce the inflationary consequences of economic growth. This should be linked to investment in human and physical capital and Aggregate supply. An alternative approach would be for candidates to consider the role of monetary policy in creating the conditions for non-inflationary economic growth. Some candidates may discuss the consequences by considering inflationary pressures linked to growth of the global economy. They could argue, for example, that a growth in the global economy may create inflationary pressures of a cost-push nature, despite the existence of an output gap domestically. *Synoptic knowledge: AS Unit 2, The national economy and international economy* *Aggregate demand and aggregate supply and their interaction.* *Government economic policy objectives and indicators of national economic performance*	[10]

Question Number	Answer	Max Mark
	Level 4 [7-10 marks] For a commentary on the extent to which rapid economic growth inevitably leads to rising inflation, supported by explicit economic analysis of the circumstances in which economic growth might and might not lead to rising inflation. **Level 3 [4-6 marks]** For a one-sided analysis of the question. This is likely to be from Extract 3 for Vietnam where rapid economic growth has resulted in inflation. Responses in this level should make explicit use of AD/AS analysis. **Level 2 [2-3 marks]** For an application of knowledge and understanding, and critical understanding of, the causal links between rapid economic growth and inflation. Responses in this level, however, will lack any clear economic analysis of the relationships in terms of AD/AS. **Level 1 [1 mark]** For knowledge and understanding of rapid economic growth and/or inflation only, but which shows no understanding of the causal link between the two.	
2 (a)	**India has become the world's leading exporter of IT services. Show how the principle of comparative advantage might be used to explain this.** Comparative advantage arises when one country produces a good or a service at a lower relative opportunity cost than another. Different countries have different endowments of the factors of production – land, labour and capital. Different goods and services are produced with different factor intensities. Countries which have more abundant supplies of labour relative to capital will, therefore, have a comparative advantage in the production of goods and services which are labour intensive. Countries which have more abundant supplies of capital relative to labour will tend to have a comparative advantage in the production of goods and services which are more capital intensive. In the case of India, the country could be argued to have abundant supplies of highly skilled/educated labour leading to a comparative advantage in knowledge-based industries, such as IT services. *Synoptic knowledge: AS Unit 1, Markets in action* *The reasons for individuals, organisations and societies having to make choices – factors of production and opportunity cost* 1 mark for a definition of comparative advantage 1 mark for an example of comparative advantage – this is likely to take the form of a numerical or diagrammatic example Up to 4 marks for an explanation of the sources of comparative advantage; at the top end to include explicit reference to factor endowments and factor intensities.	[4]

Question Number	Answer	Max Mark
2 (b)	**Analyse the significance for developing countries of changes in the terms of trade.** The terms of trade are a measure of the average price of exports relative to the average price of imports given by the formula: $\textbf{Terms of trade} = \dfrac{\textbf{Index of average export prices}}{\textbf{Index of average import prices}} \textbf{ x 100}$ The terms of trade determine the volume of exports required to 'purchase' a given volume of imports. Changes in the terms of trade, therefore, indicate the extent to which countries benefit from international trade. For example, a reduction in export prices relative to import prices will require higher export volumes to 'pay for' the same volume of imports. For developing countries such a deterioration in the terms of trade can hinder economic development. This is likely to be the case where a developing country's exports are dominated by primary products. Primary products tend to have price inelastic and income inelastic demand. Falling primary product prices reduce the value of exports, as there is a less than proportionate increase in volume, making the import of capital goods required for industrialisation more difficult. Rising global income leads to a less than proportionate increase in exports of primary products. It is argued by some economists that declining terms of trade limit the benefits of international trade for developing economies whose economic structure is dominated by primary production. This is not true of all developing countries as the analysis, however, is dependent on the PED and YED of exports, which in turn is dependent on economic structure. Equally valid is an explanation of rising terms of trade, which some candidates might offer in the light of the recent significant increases in commodity prices. Improvements in the terms of trade may not be desirable depending on what has caused the change – rising export prices may be considered undesirable, for example. *Synoptic knowledge: AS Unit 1, Markets in action* *Competitive markets and how they work – price and income elasticities of demand* **Level 3 [5-6 marks]** For an analysis of the significance for developing countries of changes in the terms of trade. Analysis can be recognised where a candidate is making use of the economist's toolkit of concepts and theories in order to establish cause and effect. Candidates do not need to analyse both an improvement and a deterioration in the terms of trade to be awarded full marks in this level. There must, however, be some recognition of the determinants of effects for full marks to be awarded. **Level 2 [3-4 marks]** For application of knowledge and understanding of the effect on an economy of changes in the terms of trade. At the bottom end this will lack application to the case of developing economies.	[6]

Question Number	Answer	Max Mark
	Level 1 [1-2 marks] For knowledge and understanding of the terms of trade, changes in the terms of trade and the characteristics of developing countries in terms the structure of exports and imports. Candidates in this level will not be able to make any link between changes in the terms of trade and the impact on the economy.	
2 (c)	**With reference to Fig. 4.3, comment on the limitations of GDP per capita as a measure of development.** GDP per capita is a measure of national output, expenditure and income per head of the population. It is often used to indicate average income per person and to measure living standards in a country. Fig. 4.3 shows an imperfect relationship between GDP per capita and development as measured by the Human Development Index (HDI). For example, India has a higher GDP per capita than Vietnam but a lower HDI value and Nepal has a lower GDP per capita than Bangladesh but a similar HDI value. GDP per capita has a number of limitations as a measure of development, including: • it does not adjust for differences in local purchasing power; • it does not account for the distribution of income; • economic activity may be unrecorded, especially if there is a large subsistence sector; • it does not take account of how GDP is 'spent' (to what extent GDP is allocated towards infrastructure investment or education); • it takes no account of pollution and resource depletion. Candidates should explain these limitations in order to gain Level 3 marks. Marks at the top of Level 3 should be awarded for a clear link between these limitations and the concept of development. In particular, candidates should recognise that development is a broad concept which encompasses much more than just levels of income. Candidates should recognise that development focuses on the outcomes of economic activity and resource allocation in terms of improvements in people's well being. Expect to see reference to Todaro's definition of development, or something similar. Commentary on the limitations could seek to: • show how it is possible to adjust GDP per capita for purchasing power (Fig. 4.3 gives GDP per capita at PPP); • show how GDP per capita can be supplemented with data on income distribution, pollution, expenditure on education, infrastructure investment, etc. In this case, the commentary might be along the lines that some limitations can be accommodated by adjustments.	10

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	Other lines of commentary might be to emphasise that development bears some relationship to GDP per capita, since growth in GDP per capita raises a nation's income and it is, therefore, possible to provide more health care, better education, more jobs and to reduce poverty. In this case the commentary might seek to defend GDP per capita as a measure of development. Another line of commentary would be to argue that the limitations are significant, such that development needs alternative measures to GDP per capita. This is likely to lead to commentary which seeks to show that measures such as the HDI or HPI are better indicators than GDP per capita. **Level 4 [7-10 marks]** For a commentary on the limitations of GDP per capita as a measure of development. At the top end of this level, candidates' commentary will be underpinned by explicit economic analysis. **Level 3 [4-6 marks]** For an analysis of the limitations of GDP per capita as a measure of development. At the top end of this level, candidates' analysis will be underpinned by an analytical explanation of the limitations of GDP per capita and the link to the concept of development. **Level 2 [2-3 marks]** For an application of knowledge and understanding, and critical understanding of, the limitations of GDP per capita as a measure of development. **Level 1 [1 mark]** For knowledge and understanding of GDP per capita or of development only.	
3*	**Discuss the impact of foreign direct investment (FDI) on an economy.** The instruction to candidates to relate the impact of FDI to an economy of their own choice is designed to meet the requirements for stretch and challenge, in addition to the open-ended nature of the question itself. A discussion of the impact of FDI, and, therefore, the award of a Level 4 mark, is likely to include a consideration of both benefits and costs. It should be stressed that candidates can also achieve a Level 4 mark by making judgements on either the benefits or the costs alone. For example, a candidate could analyse the employment or output benefits of FDI and then discuss these by questioning the nature of the employment or output. Rising foreign direct investment has an impact of AD and AS. Higher investment raises the level of aggregate demand in the short term and may lead to higher levels of exports in the long term. AD increases. There may also be an impact on AS since investment is direct rather than portfolio. There should be an increase in the productive capacity of the economy and there could be an increase in efficiency and productivity.	[20]

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	Rising AD and AS will result in higher levels of GDP and employment. Where FDI raises the efficiency of industry and may bring greater capital, the increased GDP and economic growth should not involve a policy conflict with inflation. Where there is an increase in exports there may be an improvement in net trade. Where production is for the domestic market this may reduce the value of imports, also improving net trade. There are likely to be multiplier effects of rising FDI by one company which may attract other manufacturers, further enhancing the benefits to the recipient economy. Candidates should relate these impacts to the characteristics of the economy of their own choice – this may lead them into evaluative comment on the significance of the impacts. As stated above, a discussion of the impact of FDI can seek to establish the significance of the effects, as well as examining the costs of FDI; although it is more likely that candidates will offer the approach of the two-handed economist. The extent of the benefits is dependant on a range of factors. Candidates are expected to show some degree of breadth in their discussion of these; although differentiation is likely to be achieved on the quality and depth of discussion. The size of the FDI will determine the size of the impact, as will FDI as a % of GDP. The extent of the multiplier effects is also relevant. These may be affected by the nature of employment, the capital/labour intensity of the FDI, the nature of the investment (assembly, local sourcing of supplies vs import of components). There are issues related to the geographical and occupational mobility of labour – this may limit the domestic employment effects or create wage pressure with a potential inflation trade-off. The benefits for the balance of payments may be limited by imports of components. The ability to regulate environmental consequences is a valid point of discussion. The creation of a narrow industrial/manufacturing base may create dependencies and susceptibility to external shocks. There is also the question of the extent to which the investment is short or long term – rising GDP per capita arising from rising FDI may limit the period in which the economy is attractive as a location for FDI. Discussion of impact on GDP and GNP and profit repatriation is relevant. **Level 4 (a) [16-20 marks]** For a discussion that includes a judgement on the extent of the impact of foreign direct investment (FDI) on a developing economy such as Vietnam extraction. **Level 4 (b) [11-15 marks]** For a balanced discussion of the impact of foreign direct investment (FDI) on a developing economy such as Vietnam extraction. **NB** A discussion that lacks balance should be awarded a maximum of 13 marks. Complex issues have been expressed clearly and fluently using a style of writing appropriate to the complex subject matter. Sentences and paragraphs, consistently relevant, have been well structured, using appropriate technical terminology. There may be few, if any, errors of spelling, punctuation and grammar.	

Question Number	Answer	Max Mark
	Level 3 [5-10 marks] For a one-sided analysis of the impact foreign direct investment (FDI) on an economy. Relatively straightforward ideas have been expressed with some clarity and fluency. Arguments are generally relevant, though may stray from the point if the question. There will be some errors of spelling, punctuation and grammar, but these are unlikely to be intrusive or obscure meaning. **Level 2 [3-4 marks]** For an application of knowledge and understanding of the impact of foreign direct investment (FDI) on an economy. Marks in this Level will show a total lack of economic analysis of the impacts but will make some valid general points. There are likely to be some errors of spelling, punctuation and grammar of which some may be noticeable and intrusive. **Level 1 [1-2 marks]** For knowledge and understanding of the impact of foreign direct investment (FDI) on an economy. Some simple ideas have been expressed. There will be some errors of spelling, punctuation and grammar.	