H1 Economics 8819 Paper 1 Question 2: Suggested Mark Scheme

(a) (i) With reference to Table 2, which component of GDP contributed the most for UK and for China in 2015? [2]

- Consumer expenditure contributed the most to GDP for UK. [1]
- Investment expenditure contributed the most to GDP for China. [1]

(ii) With reference to Extract 5 and 6, account for your answer in a(i). [4]

- Extract 6: Growing economic confidence in the UK economy [1] →
- Causes a "national spending spree" because consumers have higher expectations of future income [1]
- OR higher household income leading to greater purchasing power OR low interest rates leading to lower cost of borrowing to purchase consumer goods

- Extract 5: Chinese government decided to encourage more investments to sustain economic growth rates [1] →
- Increase accessibility to loans → Increase in lending → large increase in investment expenditure [1]
- OR low interest rate / ease of credit for firms

2 marks each for identifying and explaining for each country

(b) Explain what determines the impact of a devaluation in Yuan on a Chinese exporting firm's revenue. [4]

- Impact is determined by the price elasticity of demand for the goods [1]
- Devaluation of Yuan causes Chinese goods to be cheaper in terms of other currencies [1]
- If PED>1 such as for goods with many substitutes, a fall in price causes a greater than proportionate increase in quantity demanded, thus total revenue increases. Opposite is true for goods with PED<1 such as necessities [2]

1 mark for identifying the determinant
1 mark to explain change in price of goods
2 marks to explain how changes in price and quantity affect revenue

(c) With reference to Extract 5, explain how an interest rate cut could have helped to revive China's economy and suggest one possible reason why it did not work. [4]

Explain interest rate cut
- Decrease in i/r → lower cost of borrowing and increase returns to savings [1]
- Increase C and I [1]
- Increase AD → economic growth [1]

Possible reasons why it did not work [1 mark for any one reason well explained]
- Poor confidence in the economy → increase in I will not encourage C and I as consumers and firms are more cautious in their spending
- Saving culture in China → consumers unwilling to spend even with lower interest rate.
- Private firms already have a high level of debt from past investments → may not want to borrow and further increase debt even if interest rates are low.

(d) With the help of an AD/AS diagram, explain why attempting to increase consumption in China would "threaten their export-driven model". [6]

- To encourage increase in C, government would have to raise wage shares of national income, so that consumers would have greater ability to consumer goods.
- However, rising wages would result in increase in cost of production for firms. There would be a fall in SRAS resulting in cost push inflation and increase in price of exports.
- As price of exports increases, there is a loss in export competitiveness. China may experience a fall in export revenue.
- As exports fall, AD will fall. Overall, there would be slower economic growth. *(Note: students need not shift AD to the left. With same AD curve, students can still show rise in GPL and fall in real GDP.*

Level		**Marks**
L3	• Well-developed explanation of how increase in wages will increase cost of production and decrease AD and AS	**5-6**
L2	• Some analysis on how rising wages may affect export revenue • May have missing links or incomplete explanations	**3-4**
L1	• Wrong analysis • No application to Extract 5: ○ *Students who explain that increase C will cause demand pull inflation and reduce X competitiveness*	**1-2**

(e) With reference to Extract 6, explain how households' standard of living in the UK may be affected if interest rates were to rise. [2]

- Rise in interest rate → debt burden rise or need to repay a greater debt [1]
- Increase in amount needed to service debt → purchasing power fall, less ability to consume goods → SOL fall [1]

(f) Assess the effectiveness of the UK government's proposed strategy of boosting exports to reduce the trade deficit. [8]

Students can introduce answer by briefly explaining meaning of trade deficit.

<u>Analysis of UK's proposed strategy boost exports:</u>
Students must identify the various strategies from the Extract

- (Evidence: boosting productivity, addressing skills deficit, tackling infrastructure obstacles)
  → reduce unit labour cost → lowers price of exports →improve price competitiveness of UK exports → UK export revenue rise (assuming price elastic demand) → reduce UK trade deficit
- (Evidence: innovators access to capital)
  → government's financial support for innovation → product or process innovation → reduction in unit production costs or new products → could lead to lower price or quality products → reduce PED → (non-pricing, branding strategy, niche-marketing) → increase demand of UK exports → rise in export revenue → reduce UK trade deficit

<u>Counterargument:</u>
Possible constraints that could cause UK proposed strategy to be ineffective

- (Extract 7) Stronger pound (appreciation) will make UK exports more expensive in foreign currency → price competitiveness due to the lower unit labour production cost may be eroded (assuming demand is price elastic)
- (Extract 7) Slowdown in economic growth in UK's major trading partners (Eurozone, China) → falling household income, lower consumption (including imports) → UK exports to these countries may fall.
- Skills training to raise labour productivity may encounter resistance from both employees and employers. Impact on labour productivity can also be seen only in the LT
- Financial support for Innovation requires long incubation period → unpredictable outcome even in LT
- (Table 3) Given UK's debt increasing to almost 90% of GDP, UK govt may not be able to provide adequate financial support for innovation (sustainability of this strategy is questionable)

Possible Judgement

- Proposed strategy seems to be ineffective in the ST as intended outcomes can only be seen in the LT
- Unintended consequences likely to arise → rendering it ineffective
  - High UK import expenditure (% of GDP)
    Unless the high UK Consumption and import expenditure (% of GDP) can be reduced, any rise in export revenue may not lead to fall in trade deficit. Rise in export revenue may lead to rise in AD, ec growth, spurring rise in import demand. Hence UK govt needs to consider reducing import expenditure as well.
  - Lack of public support
    Public support for Skills training to upgrade labour productivity would only be politically acceptable provided govt provides subsidy for such training to both workers (cost of training + loss of income during training) and employers (loss of labour service) → requires heavy govt funding.
  - Increased Govt debt
    High UK govt debt made it difficult for govt to sustain support for innovation and skills training
  - Trade policies of trading partners
    UK trading partners likely to undertake trade policies (protectionism) or exchange rate policies (depreciation) → erode competitiveness of UK exports.

- Possible complementary measures to increase effectiveness of proposed measures: Expenditure reducing measures or depreciation of currency.
  (Note: these other measures are only relevant after students have analysed UK proposed strategies identified in the extract).

Level		**Marks**
L2	• Well-developed explanation of how UK's proposed strategy could correct the trade deficit AND the constraints that will limit its effectiveness. A balanced answer with supporting evidence.	**5 - 6**
L2	• Balanced answer but superficial explanation of how strategy works to correct the trade deficit and constraints. • No / Inadequate evidences cited incidentally. • One-sided answer.	**3 - 4**
L1	• Brief statements of effectiveness / ineffectiveness of UK proposed strategies • Many conceptual errors	**1 - 2**

	• No reference to extracts / context	
E	• Make a reasoned judgment on whether UK strategy is likely to be effective	**1 - 2**