



Rewarding Learning

ADVANCED

General Certificate of Education

2017

Economics

Assessment Unit A2 2
The Global Economy



AE221

[AE221]

MONDAY 19 JUNE, 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 articles below were written in 2015. Please read them carefully and answer the questions which follow.

Case Study: Turbulence in Currency Markets

Source 1: The performance of Sterling

Value of UK Pound in US Dollars

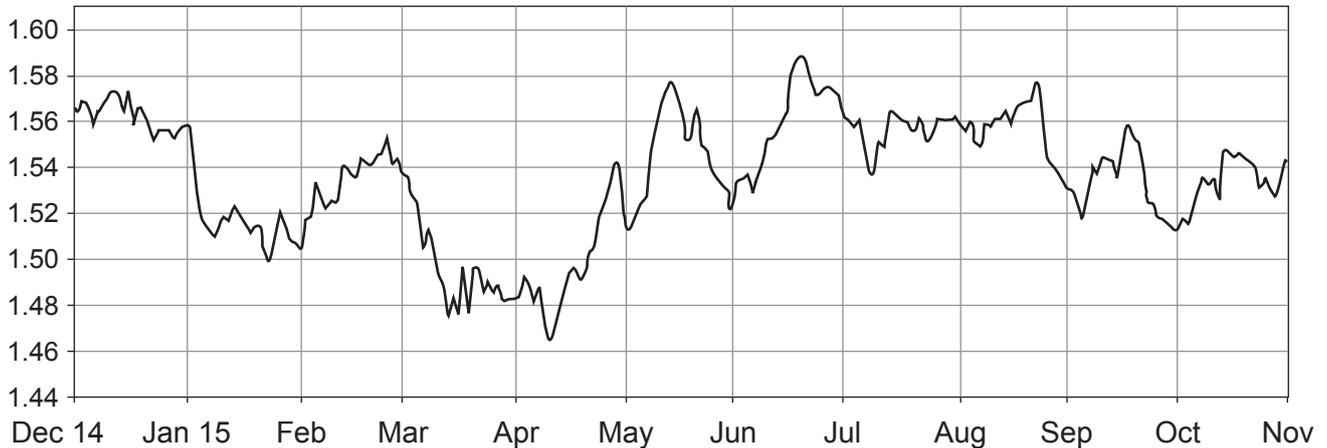


Fig. 1

Value of UK Pound in Euros

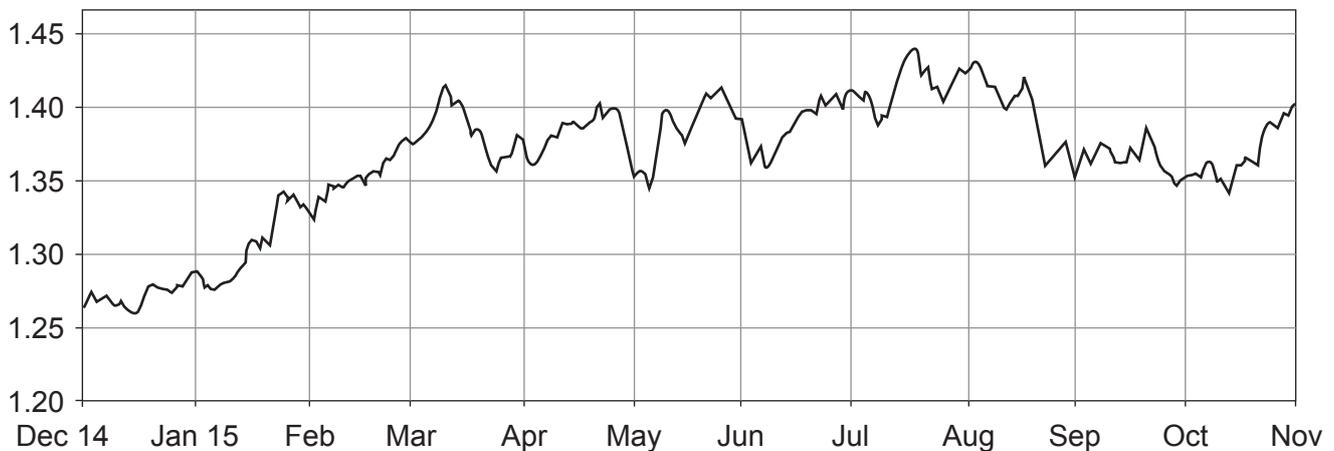


Fig. 2

Daily spot exchange rates against Sterling. © Bank of England.

Source 2: US dollar strengthens

The rouble is down; the euro is down; the yen is down but the US dollar is soaring to its highest level in five years. On a trade weighted basis its value has risen from an index of 75.6 at the end of March 2010 to 95.3 at the end of March 2015.

So what lies behind this remarkable resurgence in the US dollar? Part of the answer lies in the weakness of so many other currencies. The relative strength of the dollar is in part a function of the weakness of the euro, the rouble and the yen.

There are, however, a number of other factors at work. The US economy represents one fifth of world output and has become the engine of growth for global production. During 2014 American GDP rose by 3.6 per cent. This compares favourably with Eurozone growth of a mere 0.9 per cent and Japan whose economy shrank by 0.5 per cent. American share prices, as measured by the Dow Jones Index, rose by 8.4 per cent in 2014. It is not therefore surprising that demand for US dollars has risen significantly.

Furthermore, 2014 saw a significant increase in uncertainty in the world with wars in Ukraine, Syria and Libya. Many investors sought a safe haven in which to store their money and where better than the USA?

Arguments in favour of investment in the USA do not end there. The falling oil price and an increase in shale production in the USA have significantly improved the US balance of payments and reduced the outflow of dollars to pay for oil imports. Low and, in some cases, negative interest rates in other countries have made investment in US government bonds seem attractive with the 10 year bond currently paying 1.75 per cent.

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Source 3: Swiss franc soars

At the height of the Eurozone sovereign debt crisis many investors saw the Swiss franc (CHF) as a safe haven and Switzerland experienced a massive inflow of funds. The Swiss franc rose in value by 20 per cent against the currencies of its main trading partners.

This surge risked damaging exporters, whose goods and services were losing competitiveness abroad. Imported goods, which had become substantially cheaper, were also pushing down domestic inflation. The Swiss economy appeared destined for a prolonged period of significant deflation.

Faced with this prospect the Swiss National Bank (SNB) stepped in and set a maximum value or ceiling of 0.78 euros per Swiss franc. It maintained this ceiling by intervening in the foreign currency markets to buy euros whenever it threatened to breach this level.

At first this was extremely costly and until the end of 2012 the SNB had to buy large quantities of foreign currency assets to show its commitment to maintaining the ceiling. However, thereafter its interventions were scaled down as speculators learnt that betting on an appreciation of the franc was a loss-making exercise.

It therefore came as a complete surprise to the currency markets when in January 2015 the SNB announced that it was abandoning the ceiling. Immediately the Swiss franc rose to 1.04 euros and in so doing bankrupted a number of currency dealers.

SNB Chairman Thomas Jordan denied that the move was, “a panic reaction” but rather a, “well thought out decision, reflecting the fact that the franc was no longer over-valued, particularly against the US dollar”. Others were more sceptical about the SNB’s decision. Simon Smith, Chief Economist at FX ProBrokerage, said that the decision was based on the probability of a massive programme of quantitative easing by the European Central Bank which would leave the SNB powerless to prevent a massive rise in the franc.

© 'Currency ceiling enjoyed short-lived success' by Ferdinando Giugliano. Published by Financial Times, 15 January 2015.

Source 4: Exchange rates are important

Exchange rates are more than just the subject matter of dry economics text books! They have a significant impact on the lives and prosperity of ordinary families. The sinking Russian rouble has forced General Motors to cease production of its Opel brand in Russia. In February 2015 Opel sales were down by 86 per cent on the previous year. The unexpected surge in the Swiss franc in January 2015 caused the bankruptcy of currency dealer Alpari and deprived West Ham United football club of its major sponsor.

Countries with strong currencies are importing deflation from weaker nations who find it increasingly expensive to purchase imports. This has caused many central banks including those of Ireland and Sweden to introduce negative interest rates on government bonds whereby investors pay for the privilege of lending to these governments.

The Organisation for Economic Co-operation and Development (OECD) has warned that these “exceptional measures” were threatening global financial stability. Its Chief Economist, Catherine Mann, said, “excessive reliance on monetary policy is building up financial risks while not reviving business investment”. This view was echoed by the Bank of International Settlements (BIS) which warned that a world of low inflation, negative bond yields, and rock bottom interest rates would push the boundaries of economic and political stability to breaking point. It continued, “this low interest rate environment has led to significantly reduced income for pension funds and lower bank profits. Thus there is a risk of a backlash from ordinary people whose savings are being eroded away”.

It is therefore no surprise that many economists are attracted by the idea of a return to the system of fixed exchange rates which existed for 30 years after World War 2. Independent analyst, Gavin Richards said, “the current system is little short of anarchy. Uncertainty about exchange rates is undermining exporters, importers and investors. The current volatility in world currency markets is threatening global growth. The time has come for the world’s major economies to agree on the implementation of a system of fixed exchange rates”.

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- 1 (a) Using the information in **Fig. 1** and **Fig. 2**, compare the performance of the UK pound against the euro with its performance against the US dollar. [5]
- (b) Explain the main factors behind the rise in the value of the US dollar. [10]
- (c) With the assistance of an appropriate diagram, examine how the Swiss National Bank could maintain a ceiling on the value of the Swiss franc against the euro. [10]
- (d) Critically examine the view that the world’s major economies should introduce a system of fixed exchange rates. [15]

Essays:

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

2 Foreign aid no longer needed

(a) Explain how economists attempt to measure a nation's level of economic development. [15]

(b) Critically examine the view that high levels of foreign aid to Less Developed Countries are no longer desirable. [25]

3 Imports are destroying the UK economy

(a) Compare the roles of the International Monetary Fund and the World Trade Organisation in the global economy. [15]

(b) Critically examine the view that import controls are essential for the UK economy to protect jobs and promote growth. [25]

4 Current account deficits and surpluses don't matter

(a) Explain how the main components of the UK balance of payments are related. [15]

(b) Critically evaluate the view that a deficit on the current account of the UK balance of payments is of no economic significance. [25]

THIS IS THE END OF THE QUESTION PAPER

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