

# Candidate Marks Report

*Series : 6 2018*

This candidate's script has been assessed using On-Screen Marking. The marks are therefore not shown on the script itself, but are summarised in the table below.

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Centre No :	Assessment Code :	H460
Candidate No :	Component Code :	02
Candidate Name :		

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Total Marks :

In the table below 'Total Mark' records the mark scored by this candidate.  
'Max Mark' records the Maximum Mark available for the question.

## SECTION A

Read the following stimulus material and answer all parts of question 1 which follow in this section.

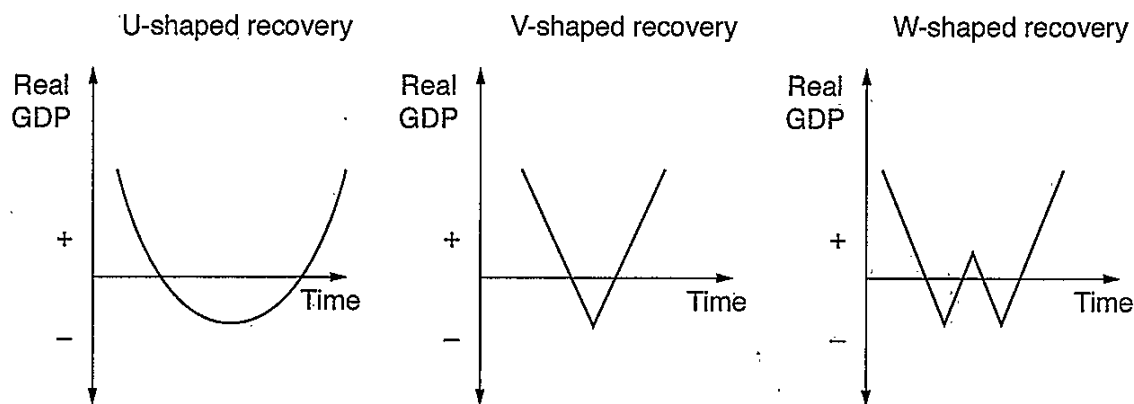
### The recovery of the Icelandic economy

In the last two decades the Icelandic economy has experienced some significant changes in economic activity. One influencing factor has been changes in the standard rate of income tax. The rate was cut in a number of stages from 46% to 36% in 2006. Despite the lower income tax rate, government income tax revenue rose, allowing the government to spend more on the country's infrastructure. In 2009 and 2010 the income tax rate was increased.

In the period 2008 to 2011, the economy experienced a serious recession. The country's three largest banks were allowed to fail. It was the third largest bankruptcy in history and, according to the size of the economy, the biggest banking failure in history. The value of the country's stock market fell by 95%, the currency declined in value by 60%, unemployment increased by 8% and inflation rose to 12%.

From 2011 the economy has made a remarkable recovery. In 2014 its real GDP was US\$14.85bn and it grew by 4% in 2015, one of the fastest rates in Europe. Economists have developed an 'alphabet' of recoveries with the three most common types shown in Fig. 1.

Fig. 1 Different types of economic recovery



In 2015 the Icelandic government was paying back its loans to the International Monetary Fund early. It had removed capital controls and had reformed the country's financial sector. A number of the country's industries were expanding, most noticeably its tourist industry. Income from tourism can fluctuate significantly. In 2015 the total contribution of Iceland's tourist industry to the country's GDP was 23%. The impressive growth of Iceland's tourist industry was contributing to a fall in unemployment due to a rise in hotel construction, and an increase in infrastructure, although this was also putting pressure on house prices as people were buying them to rent out to tourists. In 2015 the unemployment rate was 5.3%, which was lower than in many European countries, but it was predicted to rise in 2016.



For a small country with a population of only 0.33 million in 2014, Iceland has a relatively high HDI value. Fig. 2 shows some details of the HDI values of six countries.

**Fig. 2 The Human Development Index of six selected countries**

Country	HDI ranking 2014	HDI value 2014	GNI per capita (US\$) 2014
Norway	1	0.944	64,992
Australia	2	0.935	42,261
Germany	6	0.916	43,918
USA	8	0.915	52,947
UK	14	0.907	39,267
Iceland	16	0.898	35,182

25 As Iceland's economy has grown, so has the country's aid for developing countries. In 2013, for instance, its foreign aid budget increased by 27.8%

1 (a) Using Fig. 1, explain which type of economic recovery is likely to be most beneficial for an economy.

The U-shaped recovery because it is more stable than the W-shaped recovery and it is not as steep as the V-shaped recovery. It shows more of a process in the recovery even though it takes more time than the V-shaped recovery but it is more certain and stable or steady increase.

[3]

(b) Using information from the stimulus material, including Fig. 2, calculate the difference between Iceland's real GDP per head and its GNI per capita in 2014.

£ 000-000

$$\text{GNI per capita} = 35\,182$$

$$\text{Real GDP per head} = 14.85 \text{ bn} / 0.33 \text{ million}$$

$$= 45\,000$$

$$\therefore \text{difference} = 45\,000 - 35\,182 = 9\,818$$

[2]

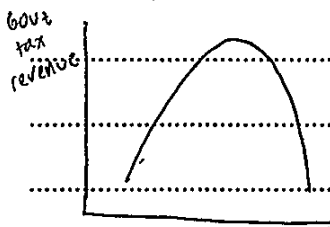


(c) Using Fig. 2, explain why Australia had a higher HDI value than the USA in 2014.

Even though USA had a higher GNI per capita than Australia, 52947 and 42261 respectively, the measurement of HDI is a wider range of indicator because it takes into account education, healthcare, and living standards. So Australia probably had higher life expectancy, years of schooling, and better living standards compared to the USA in 2014.

[2]

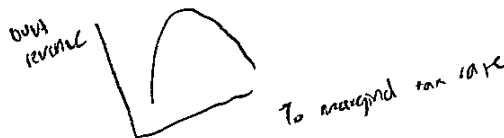
(d) Identify one piece of evidence in the stimulus material of the relationship suggested by the Laffer curve and explain why it is an example of such a relationship.



Cut in the number of tax rate from 46% to 36%. However despite the lower income tax rate, government income tax revenue rose. ~~This explains~~

And then in 2009 and 2010 the income tax rate was increased. This explains such a relationship because it matches the shape of the Laffer curve shown above and also the relationship is true.

[3]



- (e) Using information in the stimulus material, evaluate whether Iceland would be likely to experience a recession after 2015.

On the one hand Iceland is unlikely to experience a recession because they have an expanding tourist industry which takes into account 23% of GDP and this has contributed to a fall in unemployment and increase economic growth by creating more job opportunities in hotel construction, increase in infrastructure, etc. This employment opportunity would give people more income to spend on consumption hence increasing AD.

However, it is not specified in detail how they reformed the financial sector and whether they have improved financial market regulation because if they allow large banks with systemic risk to fail again in the future then there might be a chance of Iceland experiencing a recession again after 2015.

Furthermore Iceland might also be dependent on tourism industry too much as it is 23% of GDP and hence it is more prone to demand shocks and if there is suddenly a decrease in demand in tourism industry then this would affect a big part of the Iceland economy.

And they wouldn't be able to rent those houses to tourists and hence keeping it at higher price. In conclusion, if the government controls economic stability then it is unlikely for Iceland to experience a recession as their service sector is growing and they are becoming more developed, however Iceland might be vulnerable to some demand shocks in the tourism industry which could cause unemployment rate to rise. [8]



- (f)\* Evaluate whether an increase in the aid Iceland provides to developing countries would benefit the Icelandic economy. [12]

On the one hand an increase in the aid for developing countries means contributing to that country's development and by providing aid, the recipient country might have greater national income overall and they might spend this by importing goods from Iceland and hence this would benefit the Icelandic economy by improving their current account of the balance of payments.

Furthermore because of this aid provided by Iceland, Iceland might open up their opportunities on foreign direct investment in this developing country and Iceland can take advantage of the cheaper labour and hence reduce its costs of production and achieve economies of scale in the long run. Iceland ~~could~~ multinational companies could then bring back this profit to their country and use it to create more domestic job opportunities hence increasing employment.

However, this might not necessarily benefit the Icelandic economy because as shown in the stimulus material Iceland ~~spent~~ increased their foreign aid budget by 27.8% and this is quite a significant amount of their overall budget and there is always an opportunity cost.



Iceland could have used this budget to spend on education, health care, and improving living standards directly to their economy so that they could get a better HDI value.

Furthermore they could use this budget to improve their financial market regulation so that they prevent another serious recession caused by allowing retail banks to fail.

In conclusion, the aid given by Iceland to developing countries would help them if the recipient country then buys more imported goods from Iceland and engages in trade and also allows Iceland to increase FDI in that country.

However, there is an opportunity cost of this budget that Iceland could have spent on education, health care, financial market regulation, and many more. So it is not necessarily beneficial to the Icelandic economy.



SECTION B

Answer EITHER question 2 OR question 3.

EITHER

2\* The fall in the value of the South African rand between 2012 and 2016 had an impact on the current account of the country's balance of payments.

Evaluate, with the use of an appropriate diagram(s), whether a fall in the value of a country's currency will always reduce a deficit on the current account of its balance of payments. [25]

OR

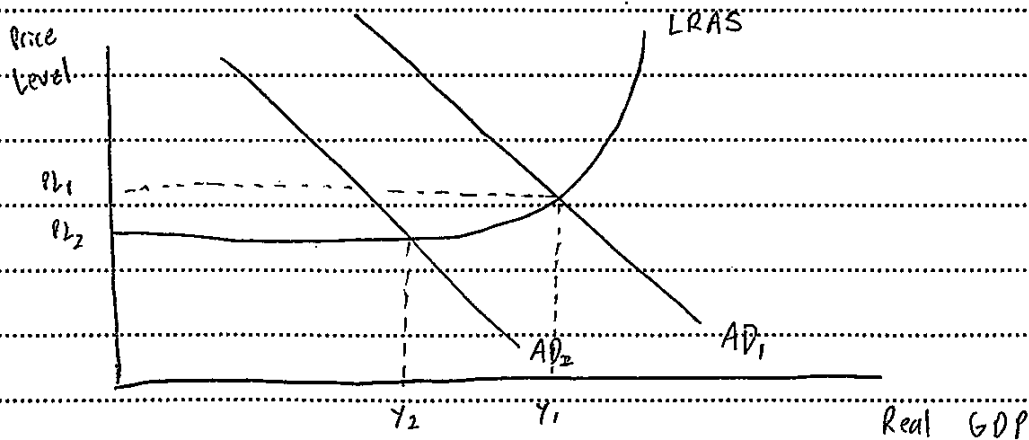
3\* Japan's macroeconomic performance in recent years has been influenced by its experience of deflation.

↑ unemployment  
○ deflationary spiral  
○ less economic growth  
○ price competitive to balance of payments  
○ economic growth  
↳ relevant

Evaluate, with the use of an appropriate diagram(s), whether deflation always harms a country's macroeconomic performance. [25]

Question No 3

Deflation is a situation where there is a decrease in the general price level and increase in the purchasing power of money. Whereas a country's macroeconomic performance is determined by unemployment, inflation, balance of payments, economic growth, income distribution and welfare, and many more.





The diagram shows deflation or decrease in price level from  $PL_1$  to  $PL_2$  caused by a shift to the left of aggregate demand (AD). Deflation means that firms sell their goods and services at a lower price and because of this they might not be as profitable or they might even be making a loss hence they would reduce their labour to reduce wage costs and this will lead to increase unemployment rate which harms a country's macroeconomic performance.

Furthermore deflation could also mean that individuals and firms are holding their consumption and expenditure as they expect prices to fall even further in the future and since consumption and investment are part of AD then this would reduce AD and reduce output from  $y_1$  to  $y_2$  hence less economic growth which harms a country's macroeconomic performance. This is known as deflationary spiral and it is harmful to the economy. This could be worsen by the negative multiplier effect where a decrease in one of the components of AD (consumption and investment) leads to a greater overall decrease in national income.



However, deflation or a decrease in the general price level might mean that Japan's exports are now relatively cheaper and thus it is more price competitive in the international trade and increase in exports could lead to a reduction in the current account deficit on the balance of payments.

Furthermore the decrease in general price level would also mean lower wages and cheaper labour therefore more attractive for foreign direct investments (FDI) to open companies in Japan and this could create job opportunities and employment for the people of Japan and help increase living standards hence increasing economic development because living standards is a major component of Human Development Index (HDI).

If the country (Japan) becomes reliant on their exports then it might harm the macroeconomic performance as it is more prone to demand shocks and could be lead into a recession in the future.

In conclusion, deflation does not always harm a country's macroeconomic performance, despite it increasing unemployment and reducing economic growth and might cause a deflationary spiral, deflation could also make exports more price competitive and improve the current account of



the balance of payments hence might actually lead  
to increase AD and increase economic growth.



contractionary fiscal policy  
 AD shift to the left  
 less job opportunities  
 PL ↓  
 ↳ internationally competitive

SECTION C

Answer EITHER question 4 OR question 5.

spending > revenue

EITHER

4\* Some economists argue that attempts by the Greek Government to reduce its budget deficit have contributed to the rise in the country's unemployment rate.

spending > revenue

Evaluate the extent to which government policy measures to reduce a budget deficit will increase unemployment. [25]

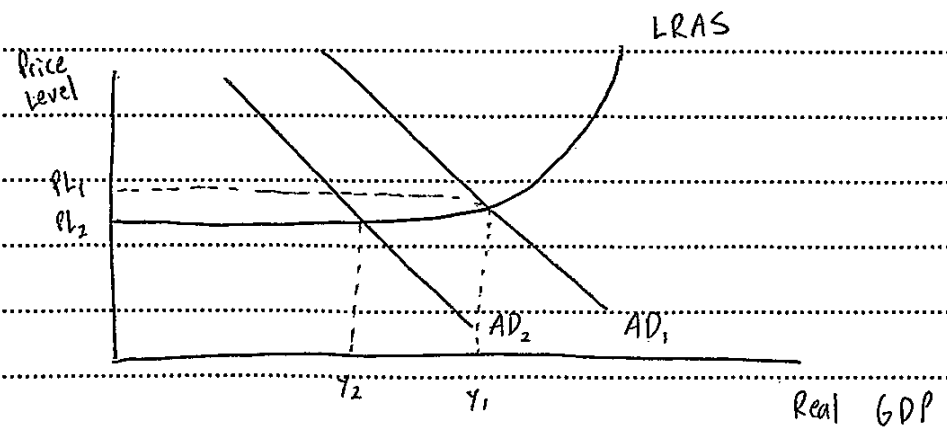
OR

5\* Investment has fluctuated significantly in Poland in recent years. For example, it increased by 8.3% in 2008, fell by 1.5% in 2012 and grew by 5.9% in 2015.

Evaluate the extent to which the accelerator theory explains the level of investment in an economy. [25]

Question No 4

A budget deficit is when a government is spending more than what they are actually gaining from tax revenue. Government policy measures related to reducing a budget deficit is contractionary fiscal policy. Fiscal policy is policies made by the government to influence changes in government spending and taxation. Contractionary fiscal policy is when the government reduces government spending and increases average and marginal tax rates in order to gain more tax revenue.



Contractionary fiscal policy is a demand-side policy so it will affect AD. On the one hand, when government decides to reduce government spending ( $G$ ) it will shift AD curve from  $AD_1$  to  $AD_2$  and reduce output from  $Y_1$  to  $Y_2$ . This means that there might be less spending from the Greek Government on infrastructure, education, defences, etc. hence there is less job opportunities (employment opportunities) for the Greek people and hence it will increase the country's unemployment rate.

However, this depends on the relative size of reduction in government spending which ultimately affects the relative size of shift in AD. If the reduction in  $G$  is not significant then there it probably wouldn't affect unemployment rate that much and there will still be a lot of job opportunities for the people.

Furthermore, reducing a budget deficit could also be done by increasing income and corporation tax. If the government decides to do so then they would get more tax revenue hence help reduce budget deficit. This increase in direct taxation might act as a disincentive for people to work or to enter the labour force. Therefore this will eventually lead to increase unemployment as people might choose to be unemployed and live on benefits rather than look for a job and enter the labour force. However, government needs to consider the negative multiplier effect as an increase in tax which reduces disposable income and reduces consumption and investment hence reducing AD might have a greater proportional effect than the original leakage and may cause damage to the economy such as deflation.



On the other hand, if government reduces a budget deficit by spending less on benefits then this might actually act as an incentive for people to enter the labour force and look for a job hence reducing unemployment rate in Greece. However, we need to take into account the flexibility or mobility of labour whether they are occupationally and geographically mobile. Because someone that is unemployed because of structural unemployment (not able to adapt easily to changes) might not be able to enter the labour force and reduce unemployment.

Furthermore if government spends less on benefits then this might increase the income inequality in Greece and it may lead to relative and absolute poverty. ~~Therefore~~

In conclusion, the extent to which government policy measures to reduce a budget deficit will increase unemployment depends on the size of the shift of AD to the left and also how big the negative multiplier effect is.

Furthermore the amount of reduction in government spending and increase in tax also needs to be taken into account because if governments increase tax by not a significant amount and consumer & business confidence is high then they might still decide to increase consumption and investment hence AD might actually shift to the right and decrease unemployment rate. However there will always still be



The NRU (Natural Rate of Unemployment) which is caused by frictional and structural unemployment. even though cyclical unemployment is at its lowest rate.

END OF QUESTION PAPER



**ADDITIONAL ANSWER SPACE**

If additional space is required, you should use the following lined page(s). The question number(s) must be clearly shown in the margin(s).

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