



**ECONOMICS
HIGHER LEVEL
PAPER 3**

Thursday 11 May 2000 (morning)

2 hours

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Answer one question from Section A and one question from Section B.
- Use diagrams where appropriate.

SECTION A

Answer one question from this Section.

Question 1

Study the extract below and answer the questions which follow.

Investors Pull Out of the Third World as Aid is Cut Back

- (1) Developing countries face a deepening crisis as governments' aid budgets sink to new lows. The problems will be made worse by the fall-out from the Asian crisis which has caused private investors to pull out of emerging markets. "The East Asian crisis and its world-wide effects reminds us of the risks that private capital poses for all countries," said Joseph Stiglitz, the chief economist at the World Bank.
- (2) The bank forecasts that three of the five countries involved in the crisis, Indonesia, Thailand and South Korea, will suffer economic contraction or **zero growth** this year, while growth rates in Malaysia and the Philippines will fall sharply. Third World countries not involved in the original crisis will also suffer from the fall-out, according to the Bank, as investors include them with countries in trouble.
- (3) Official aid from western governments, which remains the most important source of development finance for the poorest countries, has fallen to 0.25% of the annual output of rich countries, compared with 0.35% in the early 1980s, and aid budgets are nearly a third lower than 10 years ago in real terms – donors are getting meaner at a time when more people need aid. "The decrease in foreign aid threatens many of the poorest countries which are most in need of capital, but have the least ability to attract private money," said Professor Stiglitz.
- (4) There is consensus that a common factor behind the crisis in East Asia was the rapid **financial liberalisation** which allowed short term foreign capital to pour in during the early 1990s. When things went wrong last year, the stampede of departing capital destroyed the currencies and with them the 'Asian miracle': the outflow of 'hot money' from the crisis-hit countries made their structural problems worse. However, while there may be agreement on the dangers of recklessly opening up financial markets, there is fierce argument about the proper response.
- (5) Many now want the process of financial deregulation to stop, and re-regulation, especially of short-term capital flows, to be implemented. There are several proposals, such as the 'Tobin Tax' – a 0.25% levy on every international capital transaction, which would deter short-term, speculative flows in favour of longer term investment; or the insistence that a certain percentage of any loan or bank deposit from abroad be placed, interest-free, in the central bank for a year.
- (6) The IMF, on the other hand, argues that the answer is to push ahead with financial deregulation, while making countries better able to withstand capital surges into and out of their economies by strengthening their banking systems; that is, the IMF blames domestic economic systems, not markets in general.

[Source: Adapted from World Bank statements and various newspaper reports, April 1998.]

- (a) Explain the meaning of the following terms which are in bold in the text:
- (i) zero growth (paragraph 2). *[2 marks]*
 - (ii) financial liberalisation (paragraph 4). *[2 marks]*
- (b) Give and explain
- (i) **one** possible reason for the fall in official aid from western governments (paragraph 3). *[3 marks]*
 - (ii) **two** reasons why this trend represents a serious threat to many of the poorest countries in the world. *[4 marks]*
- (c) Use the article and your own knowledge to
- (i) explain how financial markets could be
 - (a) re-regulated.
 - (b) deregulated. *[6 marks]*
 - (ii) assess the benefits and risks of private capital flows for Less Developed Countries. *[8 marks]*

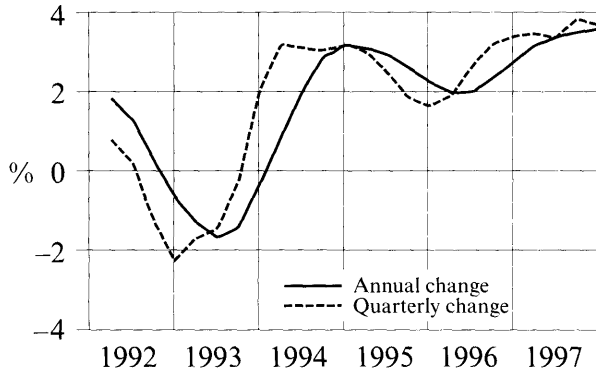
Question 2

Study the data below and answer the questions which follow.

SPAIN: MAIN ECONOMIC INDICATORS

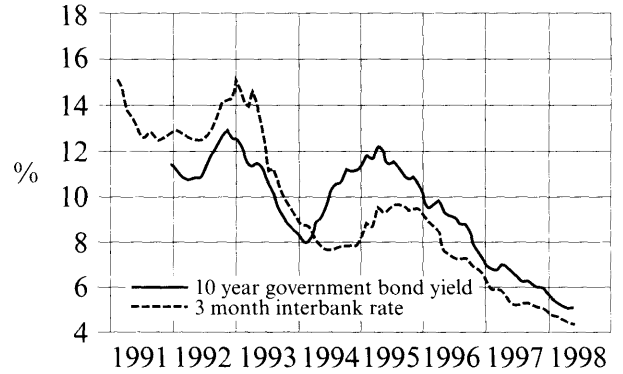
Item 1

Gross Domestic Product



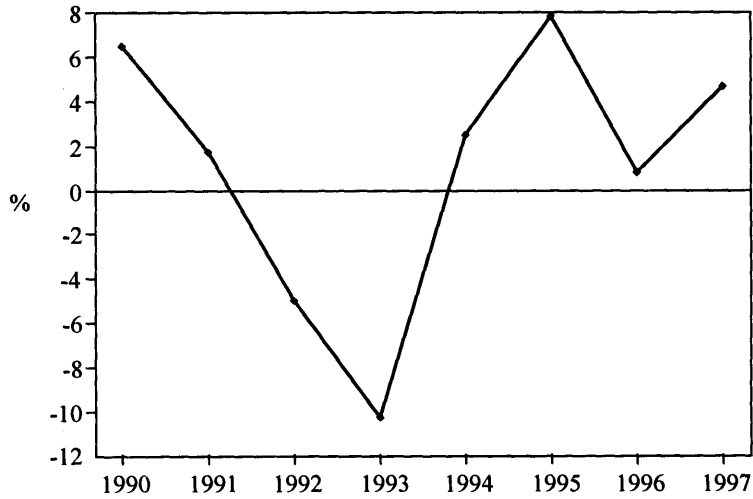
Item 2

Interest rates



Item 3

Annual % Change in Gross Fixed Capital Formation (investment)



Item 4

Year	Unemployment (% of the active population)	Change in Retail Prices (%)	Balance of Payments on Current Account 000s of millions of pesetas
1990	16.2	6.7	-1830
1991	16.4	5.9	-2054
1992	18.5	5.9	-2161
1993	22.9	4.6	-695
1994	24.1	4.7	-913
1995	22.9	4.7	59
1996	22.2	3.6	64
1997	20.8	2.0	359

[Source: Ministerio de Economía y Hacienda. (12 June 1998)]

- (a) Define the term Gross Domestic Product. *[2 marks]*
- (b) Describe **and** explain the relationship between Gross Domestic Fixed Capital Formation (investment) and
- (i) interest rates. *[5 marks]*
- (ii) the annual change in GDP. *[5 marks]*
- (c) What other information might be useful to an economist trying to explain the causes of change in Gross Domestic Fixed Capital Formation (investment)? *[4 marks]*
- (d) Using the data provided and your knowledge of economics, assess the performance of the Spanish economy. *[9 marks]*

SECTION B

Answer *one* question from this Section.

Question 3

- (a) State the law of demand and distinguish between movements along the demand curve and shifts of the demand curve. *[10 marks]*

- (b) Explain, with the help of diagrams, the effect that an increase in the price of petrol is likely to have on
 - (i) the market for cars.

 - (ii) the market for coal. *[15 marks]*

Question 4

“Monopoly price is higher and output smaller than is socially ideal. The public is the victim.” (J.K. Galbraith, 1974)

- (a) Explain the economic reasoning behind the statement that “monopoly price is higher and output smaller than is socially ideal”. *[12 marks]*

- (b) Do you agree that the public is always the ‘victim’ of monopoly? Justify your answer. *[13 marks]*

Question 5

- (a) Discuss the main problems involved in measuring the national income of a country. *[12 marks]*

- (b) Why do many economists prefer to use composite indexes, such as the Human Development Index and the Human Poverty Index, as well as national income figures, to indicate living standards? *[13 marks]*

Question 6

Is economic growth compatible with the protection of the environment? Discuss with reference to sustainable development. *[25 marks]*
