ECONOMICS
HIGHER LEVEL
PAPER 3

Wednesday 10 November 2004 (morning)

2 hours

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Section A: answer one question.
- Section B: answer one question.
- Use diagrams and real-world examples where appropriate.

SECTION A

*Answer **one** question from this section.*

Either

Question 1

Read the passage below and answer all the parts of the question that follow.

50 yen burger means new price war in Tokyo

McDonald's is planning to cut the price of a hamburger from 80 yen to 59 yen in Japan. This pricing strategy is aimed at reversing a near 20 % drop in sales in recent months. But it may cause a **price war** among its direct competitors in the fast food business. These competitors provide a range of fast foods including traditional Chinese and Japanese dishes as well as burgers.

The prices charged by some of Japan's fast food shops for food items which are considered substitutes for McDonald's products are shown below.

Cost of fast food

- **McDonald's** — Hamburger (80 yen), Big Mac (250 yen)
- **Kentucky Fried Chicken** — One piece (200 yen), Two piece set with coleslaw (490 yen)
- **Yoshinoya** — Beef bowl (280 yen)
- **Mos Burger** — Hamburger (210 yen), Teriyaki chicken burger (290 yen)
- **Tenya** — Tendon (bowl of tempura on rice, 490 yen)
- **Ringer Hut** — Sara udon (deep-fried noodles with vegetable and meat topping, 390 yen)
- **Komoro Soba** — Plain soba (buckwheat noodles, 200 yen), Soba with tempura (300 yen)

KWAN WENG KIN

Price cuts for McDonald's are not new and may not pay as high a dividend as before.

McDonald's recent problems began with the discovery of mad cow disease in Japan last September. Many Japanese people stopped eating beef products despite the fact that McDonald's and others in the fast food business used mainly imported beef.

When the company cut hamburger prices two years ago, long lines (queues) formed at lunchtime. Being able to buy a meal of two burgers at a very low price was a tremendous relief for many business people on a tight budget.

However, this time it might not work out as well for McDonald's. Since McDonald's cut prices, many others in the fast food business also reduced their prices. For example, the Daiei Group operates a one-price fast food shop in a fashionable Tokyo district where everything, including rice balls, salads and bottled tea, costs just 88 yen. If McDonald's reduces its prices now, competitors are likely to follow.

So it remains to be seen whether or not McDonald's has made the right decision. In February, its president said, "low prices alone will not move customers." In fact Japanese economists have observed that low prices have not stimulated consumer spending. This may be due to the reluctance of Japanese consumers to spend money during the current **recession**.

[Source: adapted from *The Independent* Oct 2002]

(a) What is meant by the following words printed in bold in the text?

(i) price war *[2 marks]*

(ii) recession *[2 marks]*

(b) Using a supply and demand diagram, explain how the discovery of mad cow disease in Japan affected the market for hamburgers. *[4 marks]*

(c) Given the pricing strategy chosen by McDonald's what can you conclude about McDonald's view of the price elasticity of demand? Illustrate your answer with a diagram. *[5 marks]*

(d) (i) Which market structure is most closely represented by the fast food market in Japan? *[1 mark]*

(ii) Justify your answer using evidence from the text. *[4 marks]*

(e) Using information from the text and your knowledge of economics, evaluate the possible outcome of a price war in the Japanese fast food industry. *[7 marks]*

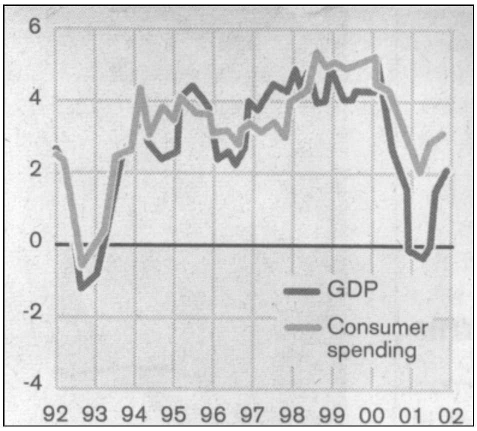
Or

Question 2

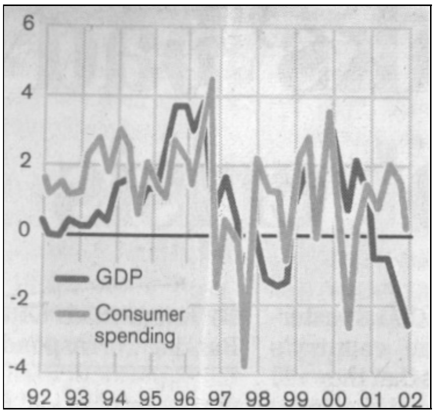
Read the data and passage below and answer all the parts of the question that follow.

Consumers need to keep spending or recession could return

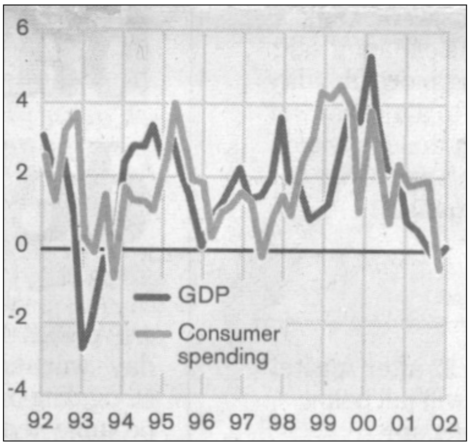
US percent



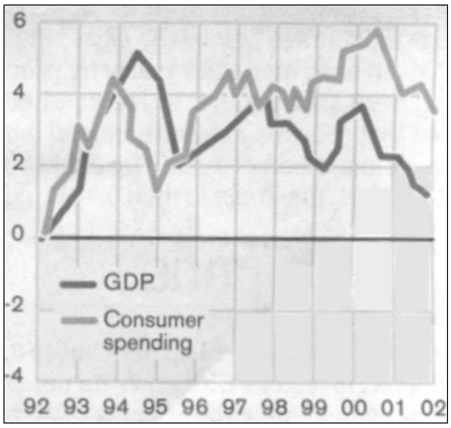
Japan percent



Germany percent



UK percent



❶ How long can consumers keep going? It has become clear that avoiding recession will depend on **consumption** continuing to grow strongly for another year or two, particularly in the USA but also in the rest of the world.

❷ At present consumption is being financed by increased borrowing, but at some stage families will want to pay off their debts and start saving. But for now, the longer consumption keeps rising, the more time companies have to get **investment** going, take on more labour and become profitable again. The recovery will not get under way until investment revives, so in the meantime it is up to consumers to “shop until you drop”.

❸ Growth of consumption has been faster than growth of GDP in the USA and even more notably in the UK for several years. Even in Japan consumption growth has risen above GDP growth. Only in Germany has lack of consumption been a serious problem. These four economies account for 57 % of world GDP and 60 % of world consumption, so they determine what happens to world demand.

❹ There is a danger that consumption could fall quickly. US consumer confidence figures are at a nine-month low, Japan is importing less than the other three economies, while in Germany unemployment is rising towards four million and the government's share of GDP has risen to 48 %. In Britain large tax increases are proposed in April as well as traffic congestion charges in London which will make it harder to spend money in London's shops and restaurants.

❺ If consumption falls the authorities will respond by cutting interest rates. If they were really sensible the central banks of the US, Japan, UK and Europe would coordinate a cut in rates for maximum effect.

[Source: adapted from an article by Hamish McRae, *The Independent* 31 Oct 2002]

(a) What is meant by the following words printed in bold in the text?

(i) consumption *[2 marks]*

(ii) investment *[2 marks]*

(b) The writer claims that growth of consumption has been faster than growth of GDP in several countries *(paragraph ❸)*. In which country has this trend been most evident? Explain your answer. *[4 marks]*

(c) The diagrams show the changes in the growth of consumption for the four countries. What can be inferred about changes in the other components of aggregate demand? *[5 marks]*

(d) Use aggregate demand/aggregate supply analysis to explain how the changes to consumption suggested in *paragraph* ❹ could be damaging to the economies mentioned. *[5 marks]*

(e) Using information from the text and your knowledge of economics, explain the extent to which a coordinated cut in interest rates might be the best solution to a fall in consumption. *[7 marks]*

SECTION B

*Answer **one** question from this section.*

Question 3

(a) Explain the concepts of maximum and minimum price controls. *[10 marks]*

(b) Evaluate the idea that government intervention in the form of price ceilings and price floors is well intentioned, but often leads to undesirable side effects. *[15 marks]*

Question 4

Evaluate the effectiveness of demand-side and supply-side policies in the short and long run. *[25 marks]*

Question 5

(a) Explain the components of the balance of payments. *[10 marks]*

(b) Evaluate the extent to which the balance of payments may be controlled by the manipulation of interest rates. *[15 marks]*

Question 6

(a) Explain the different forms of aid that may be available to a developing nation. *[10 marks]*

(b) To what extent is aid effective in terms of addressing the problems faced by LDCs? *[15 marks]*