



**ECONOMICS  
HIGHER LEVEL  
PAPER 3**

Tuesday 15 November 2005 (morning)

2 hours

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**INSTRUCTIONS TO CANDIDATES**

- Do not open this examination paper until instructed to do so.
- Answer three questions.
- Use fully labelled diagrams and real-world examples where appropriate.

Answer **three** questions. Each question is worth [20 marks].

1. Study the extract below and answer the questions that follow.

### Demand for chicken up after price cut

- ① There has been a fall in the demand for chicken following the avian flu<sup>1</sup> scare which led to people being afraid to eat chicken for fear of becoming ill. In response to this, chicken farmers reduced the selling price.
- ② Yesterday, there was a 10 per cent increase in the sales of both processed chickens and live chickens, with some 800 000 birds sold in the market nationwide. The price cuts were agreed upon at a meeting of the Federation of Livestock Farmers' Association, Malaysia (FLFAM). The FLFAM is a cartel, which sets prices for livestock sales in Malaysia. It controls 80 % of the suppliers in the country. Processed chicken now costs only RM<sup>2</sup> 3.20 per kg and live chicken RM 2.80 per kg. Previously, the prices were RM 4.00 and RM 3.50 respectively.
- ③ “The response is good and we hope that consumers now realise that chicken sold in Malaysia is safe to eat,” said a FLFAM spokesperson, adding that the industry was worried when chicken sales dropped by 300 000 a day following the avian flu outbreak in neighbouring countries. Some 1.1 million chickens are available daily to meet consumer demand.
- ④ The spokesperson said that the drop in prices was to overcome the excess supply of chicken in the market, adding that poultry farmers in the country were holding an “Eat Chicken” campaign and were considering other marketing schemes. “We will continue with the current production of chicken,” he said, “we have decided not to reduce the supply as planned earlier when sales dropped.”
- ⑤ It was feared that, if the supply were reduced, then the **maximum price** of chicken that had been fixed by the Agriculture Ministry, would have to be increased. The FLFAM was considering getting their baby chick supply for production from abroad, especially from Australia and the European Union countries. These would take the place of supplies from neighbouring countries, although the prices of the new imports would be higher.
- ⑥ Cattle farmers were initially hoping that the misfortune of the chicken farmers might lead to a bonus for them. However, a positive **cross elasticity of demand** and a fall in the price of chicken is now likely to hurt suppliers of beef and lamb if the demand for chicken continues to rise.

<sup>1</sup> avian flu – a disease that humans contract from eating chicken

<sup>2</sup> RM – Malaysian Ringit

[Source: adapted from *The New Straits Times*, Malaysia, February 2004]

*(This question continues on the following page)*

*(Question 1 continued)*

- (a) Define the following terms indicated in bold in the text:
- (i) maximum price (*paragraph 5*) *[2 marks]*
  - (ii) cross elasticity of demand (*paragraph 6*). *[2 marks]*
- (b) Using a supply and demand diagram, explain why there was an “excess supply of chicken in the market” (*paragraph 4*). *[4 marks]*
- (c) Using an appropriate diagram, explain the likely effect of importing higher priced baby chicks from Australia and the EU on the market for chickens. *[4 marks]*
- (d) Using information from the text and your knowledge of economics, especially elasticity of demand, evaluate the economic situation facing the chicken farmers and consumers of chicken. *[8 marks]*

2. Study the extract and data below and answer the questions that follow.

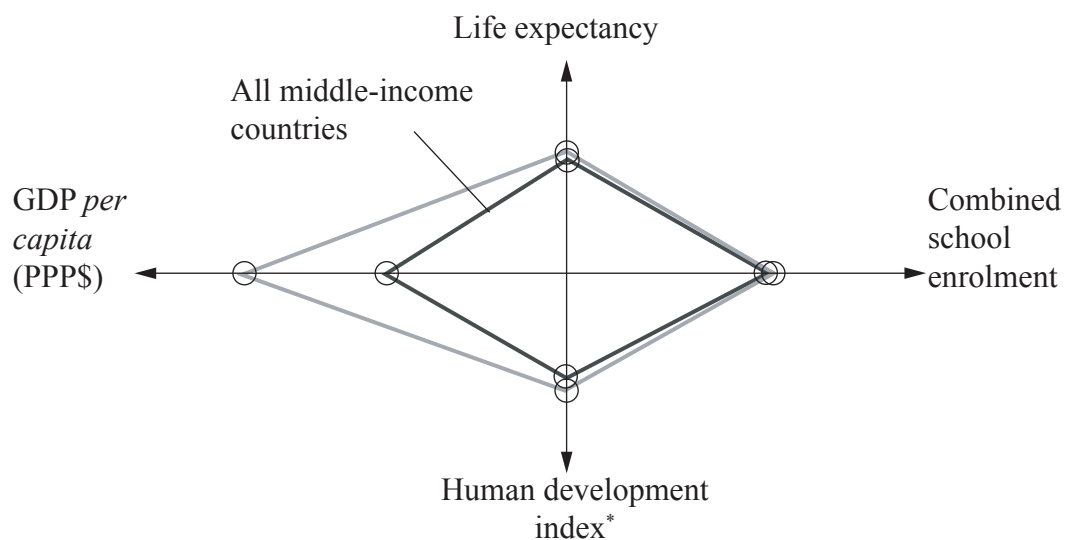
**Chile**

Chile is a small, open economy in South America. Copper is its biggest single export commodity, and accounts for approximately 40 % of exports by value. Although Chile has shown much improvement in economic terms in the last few years, the Gini coefficient still stands at approximately 0.57, one of the highest figures in the world. Chile's terms of trade have deteriorated a great deal over the last ten years and the **current account** of the balance of payments has been persistently in deficit.

**Figure 1: Statistics for Chile**

Statistics	Figures	Year
Population	15.5 million	2001
% of population living in poverty	17 % (40 % – 1987)	1998
% of population living in urban areas	86 %	2001
<b>GDP per capita</b>	US\$ 4350	2001
Agriculture	8.8 % of GDP	2001
Manufacturing	15.8 % of GDP	2001
Services	56.9 % of GDP	2001

**Figure 2: Development diamond comparing Chile with all middle-income countries**



\* Human development index – composite development indicator including income measurements and indicators of health and education

[Source: adapted from *The Human Development Report 2002* and *The World Development Report 2003*]

(This question continues on the following page)

*(Question 2 continued)*

- (a) Define the following terms indicated in bold in the text:
- (i) **current account** *[2 marks]*
  - (ii) **GDP per capita (figure 1)**. *[2 marks]*
- (b) Using a supply and demand diagram, explain why Chile may suffer because of its overdependence on copper for earning export revenues. *[4 marks]*
- (c) Using an appropriate diagram, explain the phrase, “...the Gini coefficient still stands at approximately 0.57, one of the highest figures in the world”. *[4 marks]*
- (d) Using information from the text, the figures, and your knowledge of economics, evaluate the situation facing the Chilean economy. *[8 marks]*

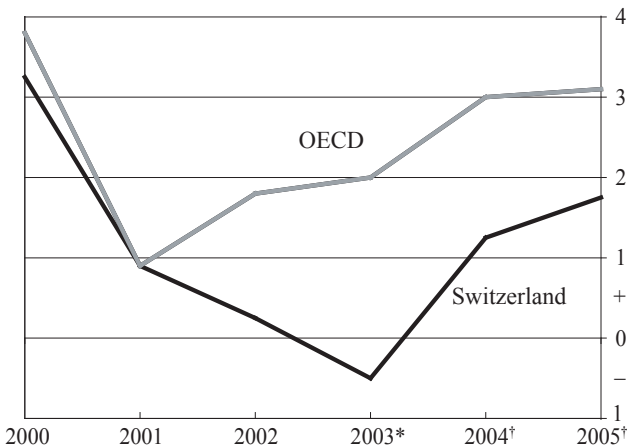
3. Study the extract and data below and answer the questions that follow.

**Switzerland**

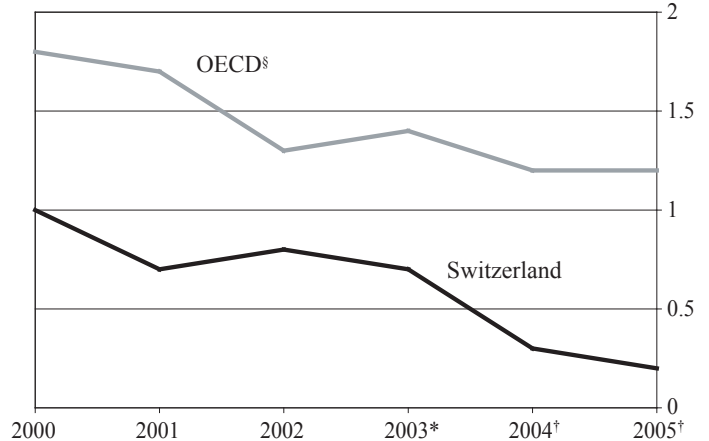
The Swiss economy has suffered in the past two years as businesses have cut **investment** and run down stocks in response to the world downturn. Exports have also been harmed by the appreciation in the Swiss franc. Output stagnated in 2002 and fell by 0.5 % in 2003. Only a modest recovery is likely over the next two years. The OECD\* predicts GDP growth of 1.2 % in 2004 and 1.8 % in 2005, which will still leave the economy operating below capacity. As a result, consumer-price **inflation** is forecast to decline to 0.2 % in 2005. The OECD says that, with interest rates virtually at rock bottom, the Swiss National Bank should be ready to take action if deflationary pressures emerge. If it is necessary, the OECD recommends a strategy of intervening in the foreign exchange markets in order to weaken the Swiss franc.

\* OECD is the Organization for Economic Cooperation and Development (formed 1961). The members are the EU countries, USA, Canada, Japan, New Zealand, Australia, Mexico and Turkey.

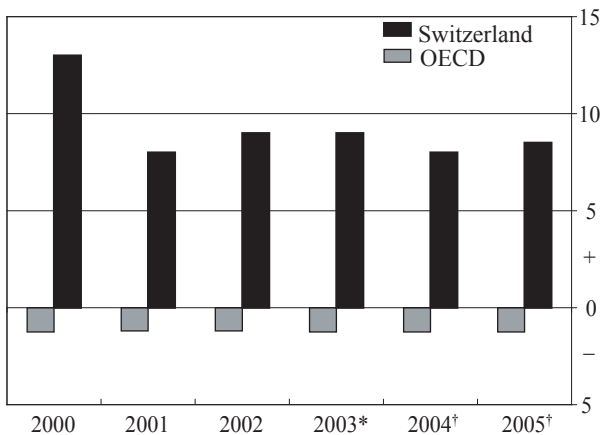
GDP  
% change on a year earlier



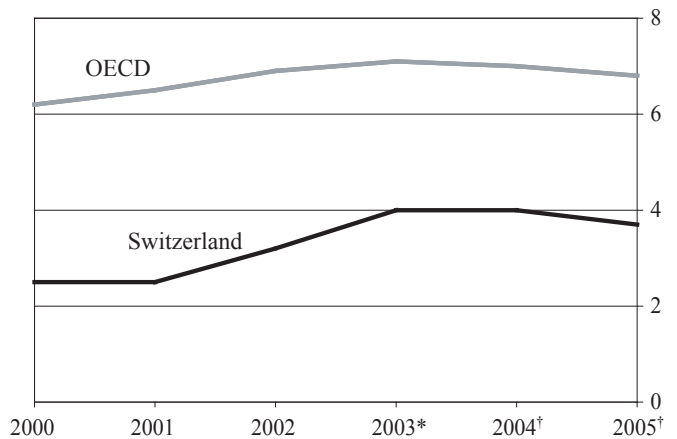
Consumer prices‡  
% increase on a year earlier



Current-account balance  
as % of GDP



Unemployment  
as % of labour force



\* Estimate † Forecast ‡ Private-consumption deflator § Excluding Hungary, Mexico, Poland and Turkey

[Source: adapted from *The Economist*, © The Economist Newspaper Limited, London, 28th February 2004]

(This question continues on the following page)

*(Question 3 continued)*

- (a) Define the following terms indicated in bold in the text:
- (i) investment *[2 marks]*
  - (ii) inflation. *[2 marks]*
- (b) Using an appropriate diagram, explain what is meant by the economy “operating below capacity”. *[4 marks]*
- (c) Using an appropriate diagram, explain how the Swiss National Bank may be able to bring about the desired change for the Swiss franc. *[4 marks]*
- (d) Using information from the text, the diagrams, and your knowledge of economics, evaluate the performance of the Swiss economy. *[8 marks]*

4. Study the extract below and answer the questions that follow.

### Price wars

- ❶ Three years ago, the arrival of a major supermarket in Kempsey, Australia was a boost to a town already recovering after a period of **recession**.
- ❷ The Woolworths supermarket, with bank, Woolworths liquor store and Woolworths petrol station, was soon joined by a Woolworths department store with photo-processing and a garden centre.
- ❸ But three years later, Kempsey is counting some unforeseen external costs. The old shopping centre in the town centre has been left partly vacant and other parts of town “quite deserted”. In order to keep customers, businesses gravitated from the shopping centre towards the Woolworths “kingdom” on the main road.
- ❹ Local shopkeepers tried to compete by investing in shop fittings and staff training. But their inability to match the prices of a large corporation which had expanded into specialist markets – from bakery to flowers, and soon pharmacy – is causing concern for the future of a town where an increasing percentage of residents’ disposable income is being taken out of town in a Woolworths’ truck.
- ❺ Bob Barron, who has sold his local news agency after 15 years, said book and video sales dropped significantly because Woolworths sells them for 30 per cent less. “We can’t compete. That is the price we buy them for!” says Barron.
- ❻ Wayne Perks, who owns a petrol station on the same road as Woolworths, describes the supermarket’s pricing policy as “devastating”. Last month he quietly wrote to customers offering to match Woolworths’ 4 cents a litre discount. Woolworths responded by cutting its petrol prices even further. Perks says he doesn’t call this competition: “We call it elimination.”
- ❼ The large superstores use their huge buying power to demand lower prices from suppliers. They argue that it is the consumer who wins as prices fall. Woolworths says its price advantage is due to **economies of scale**: “It is not predatory pricing to sell at prices which reflect such cost structures; our costs are lower than those of our competitors.”
- ❽ But consumer groups fear that prices will rise in the future, when there is no competition. In Australia, that risk is heightened by the concentration of the market where Coles Myer and Woolworths control 77 per cent of packaged grocery sales.

[Source: adapted from *Trolley Wars*, www.smh.com.au, 6 October 2003]

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*(Question 4 continued)*

- (a) Define the following terms indicated in bold in the text:
- (i) recession (*paragraph ①*) *[2 marks]*
  - (ii) economies of scale (*paragraph ⑦*). *[2 marks]*
- (b) Using an appropriate diagram, explain how the establishment of a Woolworths store in Kempsey has created external costs. *[4 marks]*
- (c) Using an appropriate diagram, explain why Woolworths is able to sell its products at lower prices than the local stores. *[4 marks]*
- (d) Using information from the text and your knowledge of economics, evaluate the view that the Australian government should regulate the behaviour of Woolworths. *[8 marks]*

5. Study the extract below and answer the questions that follow.

### Let's Keep the Steel Tariffs

*This is a Letter to the Editor written by Leo Gerard, International President, United Steel Workers of America.*

- ❶ Eighteen months ago the US steel industry was in ruins. Years of unfair foreign trade and **dumping** had devastated our domestic market, and the results were grim: more than 30 companies bankrupted, 17 companies sold out, more than 50 000 jobs destroyed and the health-care benefits of more than 200 000 retiring workers were lost.
- ❷ President Bush recognized this grave danger and put in place a three-year program of tariffs on certain steel products. His goal was to protect American manufacturing jobs, to help the steel industry to recover by regaining its **comparative advantage**, and to stand up for the principle that free trade must be fair trade.
- ❸ Across our industry, companies are benefiting. Labour and management have made agreements that increase worker productivity and reduce unnecessary levels of management. Productivity is up, and billions of dollars have been invested in new technologies and improved facilities. None of this would have been possible without the extra time provided by the three-year steel tariff program.
- ❹ Just as important, the gloomy predictions of opponents of the tariff program have not become reality. Steel prices in America are among the lowest in the world. Steel supplies are readily available. Above all, the industries that are the biggest consumers of steel are in better competitive shape today than they were before the program was introduced.
- ❺ We have made great progress, but significant work remains. Rebuilding an industry isn't an event; it's a process. And we are very much in the middle of that process.
- ❻ The president's steel program planned for three years of gradually declining tariffs. Despite the critics, the challenge now is to continue with the program so that the sweeping changes made possible by the tariffs can be fully realized and turned into a foundation for long-term strength. We are confident that the president will continue to be true to his word so that this vital industry can continue its recovery, and manufacturing jobs will remain secure in America.

[Source: adapted from *The Washington Post*, October 2003]

*This question continues on the following page)*

*(Question 5 continued)*

- (a) Define the following terms indicated in bold in the text:
- (i) dumping (*paragraph 1*) *[2 marks]*
  - (ii) comparative advantage (*paragraph 2*). *[2 marks]*
- (b) With the help of a supply and demand diagram, show the effects of the US tariff on imported steel. *[4 marks]*
- (c) With the help of an appropriate diagram, explain **one** other protectionist policy (other than a tariff), which the American government might use to support the domestic steel industry. *[4 marks]*
- (d) Using information from the text and your knowledge of economics, evaluate the arguments for and against the protectionism in the steel industry. *[8 marks]*
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