22085103

International Baccalaureate®
Baccalauréat International
Bachillerato Internacional

ECONOMICS
HIGHER LEVEL
PAPER 3

Wednesday 14 May 2008 (morning)

2 hours

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Answer three questions.
- Use fully labelled diagrams and references to the text / data where appropriate.

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

Grape growing and wine making

❶ Winemakers and grape growers have been warned they may have to pull up some of their vines. Large crops, and a slower than expected export market for Australian wine, have resulted in excess supply this year.

❷ There are now too many vines and demand is not meeting the growth in supply. The result is a falling **equilibrium price** for grapes.

❸ An industry spokesman said there is a need for grape growers to find substitute products to grow, and for a vine retirement program where unwanted varieties are pulled out and other varieties planted. This would improve **allocative efficiency** in the industry.

❹ While producers are suffering with falling profit levels, one clear winner is the consumer, with wine prices falling because of the over production. Per capita consumption of wine is expected to continue to increase.

❺ Much of the future success of the wine industry will depend on exports which account for around 60 % of Australian wine sales. It is estimated that it will take at least another two years to clear the oversupply of wine, with exports, hopefully, growing significantly to achieve a balance between supply and demand. Unfortunately, at the moment an appreciating Australian dollar is making it difficult to export more wine.

❻ A government spokesperson indicated that the Federal Government does not intend to remove a 10 % indirect tax on wine production to ease the situation for the industry over the next few years.

[Source: adapted from *Melissa Marino, The Age*, 18 November 2005]

(This question continues on the following page)

(Question 1 continued)

(a) Define the following terms indicated in bold in the text:

(i) equilibrium price *(paragraph ❷)* *[2 marks]*

(ii) allocative efficiency *(paragraph ❸)*. *[2 marks]*

(b) Using an appropriate diagram, explain the likely impact of removing the 10% indirect tax on wine (an ad valorem tax) on the supply of, and demand for, wine. *[4 marks]*

(c) Using a production possibility curve (PPC) diagram, explain how grape growers having to pull out some of their vines, could reduce the potential economic output of the Australian economy. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the role of falling prices in reallocating resources in Australia's wine market. *[8 marks]*

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

The softwood timber dispute

❶ The United States (US) and Canada have ended a long-standing and bitter $4.5 billion trade row over softwood timber (lumber) tariffs. The agreement ends a two-decade dispute over America's anti-dumping tariffs, which were imposed on Canadian timber when America claimed Canada was dumping timber on the US market.

❷ In 2001, Canada exported timber products to the US worth C$10 billion. This was unfair, according to the Americans, because of Canadian subsidies to Canadian timber producers. In 2002 the Americans, in response, imposed tariffs on Canadian timber imports.

❸ The tariffs imposed by the US have hurt the Canadian timber industry. A large number of Canadian timber mills have been forced to close or cut their output because the demand for Canadian timber from the US has fallen. This has created an increase in **structural unemployment** in Canada and a consequent fall in income, expenditure and output. However, despite this, the Canadian timber industry has emerged more competitive than before. With production now concentrated at the larger, more efficient timber firms, the industry's **average costs** have fallen significantly. This has allowed Canadian firms to earn normal profits.

❹ Under the new agreement, all US tariffs will be removed, and Canadian exporters will get back more than C$4 billion in paid tariffs from the Americans.

❺ The removal of tariffs is bound to affect consumer welfare, producer efficiency and the ability of government to achieve its macroeconomic objectives.

❻ The agreement is said to respect the needs of industries and consumers in both Canada and the US.

[Source: adapted from *The Economist*, 1 February 2003 and http://www.turkishpress.com/news.asp?id=131473, 7 January 2006]

(This question continues on the following page)

(Question 2 continued)

(a) Define the following terms indicated in bold in the text:

(i) structural unemployment *(paragraph ❸)* *[2 marks]*

(ii) average costs *(paragraph ❸)*. *[2 marks]*

(b) Using a production possibility curve (PPC) diagram, explain how increased unemployment could lead to a fall in the output of a nation. *[4 marks]*

(c) Using an appropriate diagram, explain why average costs in Canadian timber firms might fall in the long-run. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the effects of the removal of US timber tariffs on US consumers, US producers and the US government. *[8 marks]*

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

New Zealand lifts interest rates to stop rising inflation

❶ New Zealand's Reserve (Central) Bank yesterday raised interest rates to 7.25 %, the highest **nominal** interest rates in the developed world, in its attempt to use monetary policy to reduce very strong consumer spending and rising inflation.

❷ Allan Bollard, the governor of the Reserve Bank, said the interest rate rise, the ninth recent tightening of monetary policy, was necessary to slow down consumer spending. The hope is to moderate demand-side pressures that were significantly adding to aggregate demand.

❸ Various indicators explain why the Reserve Bank is worried. The 2005 inflation rate is above the Reserve Bank's target of 3 %; household savings are at negative levels; house prices are up 16 %; and consumer credit growth has increased in the last year by 15.3 %, creating an increasingly large **inflationary gap**.

Key New Zealand economic data 2004/2005

	Exchange rate ($US)	Current account ($m)	Inflation rate (%)
2004	0.71	–$9824	2.7
2005	0.69	–$12898	3.2

❹ The Organisation for Economic Cooperation and Development (OECD) believes the tightening of monetary policy will have the desired effect, and expects a fall in forecast economic growth (actual growth) from 4.4 % to 2.8 %.

❺ Some economists are, however, very unhappy about the latest interest rate rise. Specifically, they are concerned that it will attract large inflows of foreign capital, which will, in turn, affect the currency and price competitiveness of New Zealand exports.

[Source: adapted from Ray Marcelo, *Financial Times*, 9 December 2005]

(This question continues on the following page)

(Question 3 continued)

(a) Define the following terms indicated in bold in the text:

(i) nominal *(paragraph ❶)* *[2 marks]*

(ii) inflationary gap *(paragraph ❸)*. *[2 marks]*

(b) Using an appropriate diagram, explain how the change in New Zealand's current account in 2005 could have contributed to the depreciation of New Zealand's exchange rate during 2005. *[4 marks]*

(c) Explain the likely impact of "a fall in forecast economic growth (actual growth) from 4.4% to 2.8%" *(paragraph ❹)*, on the amount of goods and services produced. *[4 marks]*

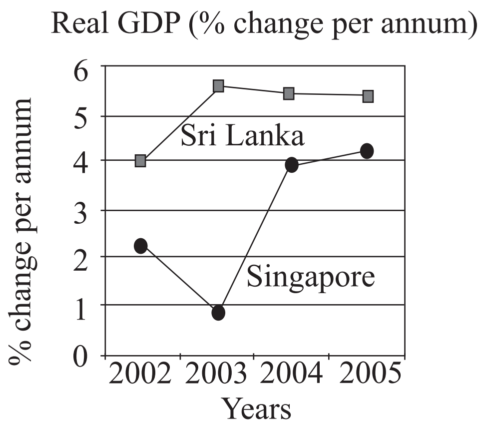
(d) Using information from the text/data and your knowledge of economics, evaluate the consequences for New Zealand of raising domestic interest rates. *[8 marks]*

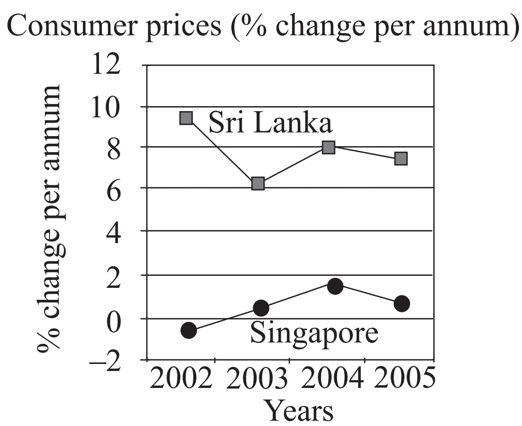
4. *Study the extract and data below and answer the questions that follow.*

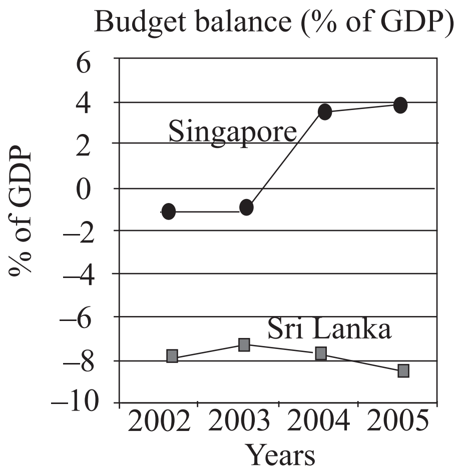
Sri Lanka and Singapore

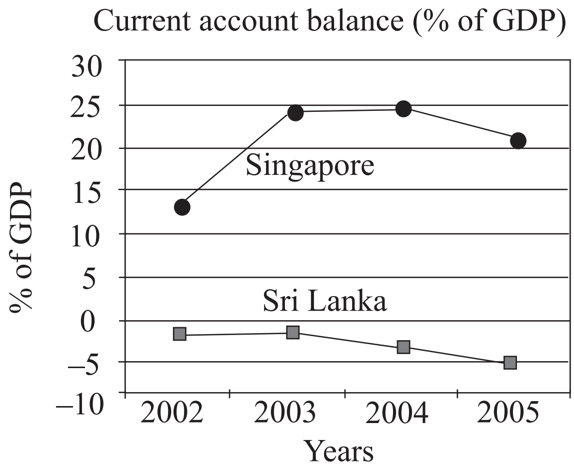
❶ Singapore is a wealthy island state at the tip of the Malay peninsula. The sudden downturn in world trade in 2001-2002 presented the country with its severest economic challenge since its independence in the 1960s. In response, the government pushed up spending and intensified efforts to restructure the economy, encouraging innovation, and developing new service industries.

❷ Sri Lanka is an island nation off the coast of India. Recently, the government's budget has been used to encourage businesses to expand into new areas and ensure that development occurs in the lower income groups in agriculture and fisheries. The problem is that current and past government budget deficits have contributed to government debt equivalent to more than 100% of GDP. The economic challenge is to repair the public finances, and this implies higher taxation through higher rates of direct and **indirect taxation**, without **crowding out** the private sector.









[Source: adapted from Khozem Merchant, *Financial Times*, 9 December 2005, and *The Economist*: *Country Briefings*]

(This question continues on the following page)

(Question 4 continued)

(a) Define the following terms indicated in bold in the text:

(i) indirect taxation *(paragraph ❷)* *[2 marks]*

(ii) crowding out *(paragraph ❷)*. *[2 marks]*

(b) Using an appropriate diagram, explain how "the sudden downturn in world trade in 2001-2002" *(paragraph ❶)* could have contributed to the fall in the rate of growth of real GDP in Singapore in 2002-2003. *[4 marks]*

(c) Using an appropriate diagram, explain how a government budget deficit could stimulate the economy. *[4 marks]*

(d) Using information from the text/data and your knowledge of economics, evaluate the relative performance of Sri Lanka's economy compared with Singapore's economy since 2002. *[8 marks]*

5. *Study the extracts below and answer the questions that follow.*

Fighting poverty in Africa

Text box 1

There are those, not least in Africa, who fear this massive debt relief will produce the same circumstances that have followed smaller debt write-offs. Incompetent governments will run-up large new debt, spend the money on unrealistic projects and place spare cash into Swiss bank accounts.

[Source: *Arab News, Editorial, Saudi Arabia,* 12 June 2005]

Text box 2

Doubling official aid, even if it is **tied aid** and cancelling Africa's debt are theoretically very attractive proposals. They fail because they are based on a misguided faith that you can rely on human unselfishness to end human misery. Tony Blair and his partners would do the continent a lot of good if they promoted trade, removed agricultural subsidies and encouraged investment relationships, rather than offering kindness and generosity through more aid and debt relief.

[Source: *Sunday Monitor,* Andrew M Mwenda, Uganda 12 June 2005]

Text box 3

If we are serious about addressing Africa's poverty, far more money and effort will be needed as well as freeing these countries from debt repayment, which then allows them to invest in economic development and improve the health and education of their citizens. Africa has 11% of the world's population, but accounts for only about 1% of the world's economic output. Export-led growth is needed. Without more help from the developed countries, the future looks bad.

[Source: *Seattle Times, Editorial US*, 12 June 2005]

Text box 4

Africa is not poor. As the Africa commission report has noted, while it lacks **infrastructure**, Africa is rich in human and natural resources. The problem is that Africans have been forced to live in countries, which have not wanted to enrich the lives of people within them, but rather to transfer resources abroad. The struggle of Africa is to be part of the world economic order based on mutual respect, not exploitation.

[Source: *Observer,* Ken Wiwa 12 June 2005]

(This question continues on the following page)

(Question 5 continued)

(a) Define the following terms indicated in bold in the text:

(i) tied aid *(Text box 2)* *[2 marks]*

(ii) infrastructure *(Text box 4)*. *[2 marks]*

(b) Using an appropriate diagram, explain how the removal of agricultural subsidies in developed countries *(Text box 2)* would affect the farmers in those countries. *[4 marks]*

(c) Using an AD/AS diagram, explain the likely supply-side impact of increased investment in Less Developed Countries (LDCs). *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the significance of debt relief to fight poverty in Less Developed Countries (LDCs) in Africa. *[8 marks]*
