



**ECONOMICS
HIGHER LEVEL
PAPER 3**

Monday 9 November 2009 (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.

Airlines and passengers urge commission to end BAA's monopoly

- ① Airlines and passenger groups have given BAA*, the world's largest private airport company, a strong message by calling for the UK company's break-up. As a result, the Competition Commission announced yesterday that it will investigate whether BAA's monopoly of London's airports is bad for passengers.
- ② BAA claims that its ownership of the London airports of Heathrow, Gatwick and Stansted is good for passengers, because it allows BAA to achieve **economies of scale** and to use its profits to invest more efficiently. It argues that the criticisms and the investigation will result in delays to the **investment** that is needed to "improve the passenger experience and increase capacity". BAA is set to double the price it charges airlines for each departing passenger so that it can increase its investment. However, airlines and passenger groups argue that BAA's monopoly means that it may just increase profits instead of investing the profits in new facilities.
- ③ The Competition Commission has noted the criticisms of BAA's operations, particularly at Heathrow, Gatwick and Stansted. These include delays, inadequate availability of facilities such as lifts (elevators) and escalators, overcrowding and concerns about cleanliness. Its investigation will look at how BAA's monopoly position might affect incentives to improve services and whether it results in high levels of both allocative and productive inefficiency.
- ④ Some economists suggest that the Competition Commission should force the break-up of the monopoly, allowing the airports, or at least the terminals within the airports, to be run separately, with greater competition.
- ⑤ Heathrow Airport is facing another massive challenge from climate change activists who have been demonstrating to draw attention to aircraft greenhouse emissions. Scientists say air transport emissions contribute heavily to global warming. One protester argued that this market failure means that, "we are bringing totally unacceptable levels of risks for future generations and people around the world".

[Source: adapted from Airlines and passengers urge regulator to end BAAs monopoly, *The Times*, 10 August 2007 and IATA boss attacks "out of control" monopoly, *Director of Finance Online*, 13 August 2007]

* BAA: British Airports Authority

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(Question 1 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) economies of scale (*paragraph 2*) [2 marks]
 - (ii) investment (*paragraph 2*). [2 marks]
- (b) Using an appropriate diagram, explain why BAA's monopoly operation of London's airports might result in allocative inefficiency (*paragraph 3*). [4 marks]
- (c) Using an appropriate diagram, explain why air transport emissions are seen as an example of market failure (*paragraph 5*). [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the argument that the BAA monopoly should be broken up by the Competition Commission. [8 marks]

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

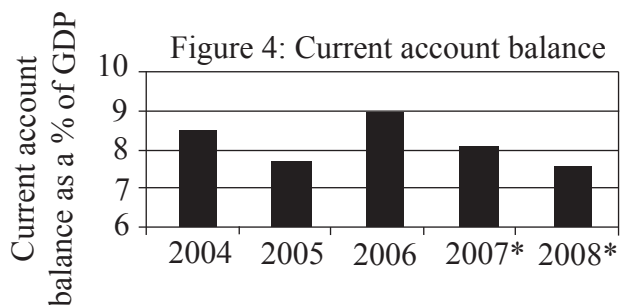
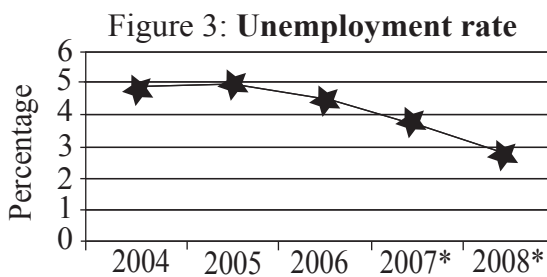
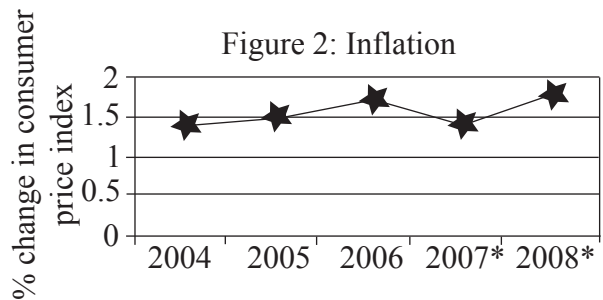
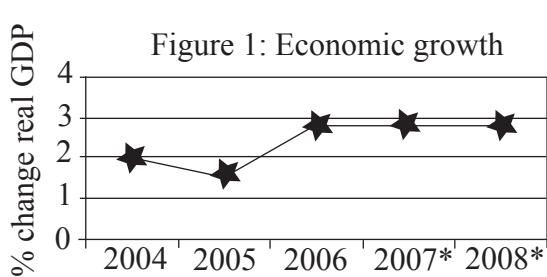
The Dutch economy

Table 1

Expenditure by sector	Current prices 2003 (€ billion)
Consumption	238
Government spending	117
Investment	93
Exports of goods and services	300
Imports of goods and services	270

Text A

The economy grew well in 2006. Economic growth was almost 3%. Exports benefited from faster demand in the Euro area, but export growth may slow down as a result of the strength of the Euro. Consumption was increased by higher real wages and a decrease in unemployment. If economic growth is higher than expected, it will result in an inflationary gap and the risk of an overheating economy. If this happens a tighter fiscal policy should be put in place to reduce demand pressures. As well, the government needs to implement policies to increase labour market participation and the number of hours worked.



[Source: adapted from *The OECD Economic Outlook 81 Database*, June 2007]

* Forecast values

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(Question 2 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) consumption (*Table 1*) *[2 marks]*
 - (ii) unemployment rate (*Figure 3*). *[2 marks]*
- (b) Using the data in Table 1, calculate the value of GDP. Explain your calculation. *[4 marks]*
- (c) Identify **one** positive statement and **one** normative statement from Text A. Explain your reasoning. *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the role of demand-side policies and supply-side policies in maintaining the growth of the Dutch economy. *[8 marks]*

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

Central bank says that China's inflation rate may get bigger

- ① Some economists are predicting that the Chinese central bank is getting ready to announce that China has recorded its highest inflation rate in 10 years. They are predicting that the inflation figure, due to be released shortly, may be 5.5% or more, the highest since February 1997.
- ② Price increases are not only the result of temporary factors, such as rising food prices, but also the result of long-term structural factors such as rising labour costs, the People's Bank of China said in a second-quarter **monetary policy** report today. According to the Bank, the upward pressure on prices is growing, and the inflation risk deserves attention. Energy costs, high foreign demand, and expectations of rising prices are also adding to inflationary pressure. The risk of high inflation rates has increased, it said.
- ③ Rising consumer prices may add pressure on the central bank to increase interest rates for the fourth time this year to slow down the economy.
- ④ The world's fourth-biggest economy expanded by 11.9%* in the second quarter, powered by record trade surpluses caused by increased demand for Chinese exports.
- ⑤ The **current account surplus** may "stay at a relatively high level", the bank said, noting that export gains are usually larger in the second half of the year.
- ⑥ The central bank repeated its commitment to increase the flexibility of the yuan. Trading partners including the US have urged China to allow the exchange rate to strengthen. The yuan has climbed 9.3% against the dollar since the end of a fixed exchange rate in July 2005. However, many do not feel that this is enough of an appreciation and urge the Chinese government to allow market forces to set the price of the yuan.

[Source: adapted from *Bloomberg* by Zhang Dingmin and Nipa Piboontanasawat, 8 August 2007]

* 11.9%: an annualized figure

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(Question 3 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) monetary policy (*paragraph 2*) [2 marks]
 - (ii) current account surplus (*paragraph 5*). [2 marks]
- (b) Using an appropriate diagram, explain why rising labour costs could contribute to high inflation rates (*paragraph 2*). [4 marks]
- (c) Using an appropriate diagram, explain why market forces are likely to lead to an appreciation of the yuan. [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the likely consequences for the Chinese economy if the government allows the yuan to appreciate. [8 marks]

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

**The European Union (EU) and South Korea
hold second round of talks on free trade agreement**

- ❶ The EU has opened a second round of discussions on a free trade agreement with South Korea. “The EU has never before taken such an ambitious position in a bilateral free trade negotiation” said an EU spokesperson. An agreement could increase two-way trade by up to 40% – or €24 billion a year. The South Korean president said a trade deal would “expand opportunities for both sides, while giving valuable momentum to the liberalization of global trade. Opening our market is not a matter of choice but a matter of survival”.
- ❷ The EU is South Korea’s second-biggest trading partner after China. Important EU exports to South Korea include machinery (despite South Korea being more efficient at producing machinery), chemicals and transport equipment, along with more than €1 billion in agricultural products such as pork and wines. South Korea wants easier access to European markets for its ships, automobiles, consumer electronics and semi-conductors. South Korea has a lower opportunity cost in the production of ships compared to all other goods it produces.
- ❸ Although both sides have stressed the benefits of a deal, they face a number of difficult issues, most notably in the automobile sector. The export of cars accounts for the largest share of South Korea’s trade surplus with the EU. Currently, the EU places a 10% tariff on imported cars. South Korea sets an 8% tariff on imported cars and is offering to reduce it to zero over seven years. Tariff-free access of South Korean cars to the European market could increase South Korean car exports by up to 124000 cars per year, worth \$1.4 billion. European car-makers also expect great advantages from a free trade agreement.
- ❹ The EU also wants investment to be discussed in the negotiations. The EU is the biggest investor in South Korea with a total investment accounting for 45% of **foreign direct investment** inflows to South Korea. The EU also wants to discuss the non-tariff barriers to trade that reduce EU-South Korean trade. The EU stressed that a global deal (multilateral agreement) remains a priority and such bilateral talks are not aimed at replacing the **WTO**.

[Source: adapted from *The Associated Press*, 16 July 2007 and *People’s Daily online*, 17 July 2007]

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(Question 4 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) foreign direct investment (*paragraph 4*) *[2 marks]*
 - (ii) WTO (*paragraph 4*). *[2 marks]*
- (b) Explain **two** non-tariff barriers that might reduce EU-South Korean trade (*paragraph 4*). *[4 marks]*
- (c) Using a comparative advantage diagram, explain why free trade in machinery and ships between South Korea and the EU may be beneficial to both economies (*paragraph 2*). *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the possible outcomes of the proposed free trade agreement between South Korea and the EU. *[8 marks]*

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

Growers hurt by the low price of tea

- ❶ The world produces so much tea that British people are paying far less for their favourite drink than they did 30 years ago.
- ❷ Global overproduction, supermarket price wars and a weak dollar mean that the price is less than a penny a cup. The real price of a cup of tea is actually a quarter of what it was in 1977, industry research has revealed.
- ❸ The figures are good news for the world's second-biggest *per capita* tea-drinking nation, but bad news for the 36 tea-growing countries, which last year produced 3.5 million tonnes of tea, of which 160 000 tonnes were shipped to Britain.
- ❹ Tea is grown in some of the poorest countries in the world and is often a primary source of income; for Uganda, for example, it is the third-largest export earner. For many growers and pickers it is their only source of income.
- ❺ A tea consultant said: “continuing low prices and deteriorating terms of trade mean that planned investment in **infrastructure** has to be postponed or cancelled and this is likely to result in a less than expected rate of economic growth. This impacts on the individual small farmers and puts more pressure on their day-to-day existence”.
- ❻ British tea importers argue that many countries, led by Bangladesh and Vietnam, are planting and growing far more tea bushes than the world needs, under pressure from poor local farmers desperate to make a living.
- ❼ The chairman of the UK Tea Council, said: “there is too much being grown in some countries, and producers need to balance supply with demand”.
- ❽ Some in the industry believe that Britain is not paying enough for the 165 million cups it drinks every day, and that a slightly higher price would benefit farmers without hurting consumers.
- ❾ Cafédirect, Britain's largest ethical tea and coffee wholesaler (distributor) which deals only in fair trade products, said: “we are the only major brand to guarantee a **minimum price** for tea, and this year announced an increase of 8%”.

[Source: adapted from *The Times*, 25 July 2007]

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(Question 5 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) infrastructure (*paragraph 5*) *[2 marks]*
 - (ii) minimum price (*paragraph 9*). *[2 marks]*
- (b) Using an appropriate diagram, explain the main reason for the change in the real price of tea since 1977 (*paragraph 2*). *[4 marks]*
- (c) Explain why falling tea prices may result in deteriorating terms of trade for countries where income from tea is the primary source of income. *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate **two** possible measures which might be used to improve the standard of living of tea farmers. *[8 marks]*
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