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ECONOMICS
HIGHER LEVEL
PAPER 2

Wednesday 5 November 2014 (morning)

1 hour 30 minutes

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- You are not permitted access to any calculator for this paper.
- Section A: answer one question.
- Section B: answer one question.
- Use fully labelled diagrams and references to the text/data where appropriate.
- The maximum mark for this examination paper is *[40 marks]*.

SECTION A

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

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

Indian exchange rates

❶ In 1991, India moved from following an import substitution policy to one of export promotion. There was a significant current account deficit and there were not even enough reserve assets to buy three weeks' worth of required imported goods and services. Emergency measures were needed along with a strategy to ensure it did not happen again. The strategy was trade liberalization and the economy was to be opened up to increase domestic competition.

❷ This would be achieved through both **foreign direct investment (FDI)** as well as greater imports of goods and services. It was hoped that these measures would ultimately increase exports so easing the pressure on the balance of payments. The new companies that emerged would attract portfolio investment, further easing the pressures on the balance of payments.

❸ Twenty-one years later, in 2012, it is clear that elements of this strategy have done well. The lowering of tariff and other barriers did increase the availability of imported products and contributed to the growth of the export sector. Trade now accounts for a major share of gross domestic product (GDP). Growth in trade and other services has been self-sustaining and contributed to the high growth rates that Indian officials are proud of.

❹ However, the present crisis in Europe is hurting stock markets across the world and raises the possibility of an outflow of portfolio investment from the Indian stock markets. At the same time, recessions in Europe and the United States will have an impact on Indian exports. This pressure on the balance of payments is already being felt on the **exchange rate** of the Indian rupee (India's currency), which is weakening and has fallen by about 20% in the period January 2011 to January 2012. The falling rupee has also created inflationary pressures, which has led the government to keep interest rates high.

❺ Currently, India has a large current account deficit which the depreciation of the rupee would be expected to correct. However, recent trade data suggest that this has not happened. Exports have been falling on a month-on-month basis from July 2011, with the slowing demand for Indian goods in Europe and the United States. Some economists say that many exporters rely heavily on imported inputs, so depreciation may increase the cost of inputs more than it lowers the price of the exports.

❻ Exchange rate policy should not aim at export promotion alone, but should balance both export and import growth.

[Sources: adapted from "Europe crisis can unravel the growth strategy of the Indian economy", *Mail Online India*, 24 January 2012 and "Trade data defies traditional view", *Business Standard India*, 23 January 2012]

(This question continues on the following page)

(Question 1 continued)

(a) (i) Define the term *foreign direct investment (FDI)*, indicated in bold in the text *(paragraph ❷)*. *[2 marks]*

(ii) Define the term *exchange rate*, indicated in bold in the text *(paragraph ❹)*. *[2 marks]*

(b) Using an appropriate diagram, explain **one** reason why the rupee may have fallen in value "by about 20% in the period January 2011 to January 2012" *(paragraph ❹)*. *[4 marks]*

(c) Using an AD/AS diagram, explain why "the falling rupee has also created inflationary pressures" *(paragraph ❹)*. *[4 marks]*

(d) Using information from the text/data and your knowledge of economics, evaluate the possible economic consequences of the fall in the value of the rupee on the Indian economy. *[8 marks]*

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

Increase tariff on foreign chicken

❶ In the country of Trinidad and Tobago, it has been reported that the price of domestic chicken (poultry) will not increase in the near future, even if the government introduces a higher tariff on imported whole chicken from the United States.

❷ The Poultry Association of Trinidad and Tobago (PATT) hosted a news conference to reduce public concerns about reports of an increase in poultry prices. The association says that there will be an increase in prices, but this will only be on imported chicken. However, economists know that this will not be the case.

❸ The association is insisting that the current 40% tariff on imported chicken be increased to 80% to make things fairer between domestic and imported chicken. They argue that Trinidad and Tobago's poultry industry has been operating at a major disadvantage in comparison with other Caribbean nations. For instance, Barbados has a 180% tariff on imported chicken, Jamaica 280% and Guatemala 257%.

❹ The President of PATT said imported chicken was hurting the local industry, with some firms in danger of shutting down. "Chickens are remaining longer on farms, and it's not because we want to keep them as pets, it's because they are not selling," he said.

❺ A domestic poultry producer said the local industry had to compete with goods that came from the United States, the European Union and Brazil, which were heavily subsidized by their governments. "We don't need subsidies and the government cannot afford to pay us any. We want the tariff. We don't want to ban imported chicken; once the tariff is on, everything will be fine."

❻ Trinidad and Tobago imports two types of chicken. The first type, "mechanically deboned meat (MDM)", is used to make processed meat products, such as chicken sausages and chicken burgers. The second type is whole chickens. There is a **quota** on MDM chickens at 0% tariff because domestic producers have accepted that they cannot meet the local demand by firms.

❼ However, there is a concern that the importers are abusing this tariff-free access to bring whole chicken into the domestic market. Data from customs show that 3.29 million kilograms of chicken was imported in August, but almost 75% was brought in duty-free.

❽ Local chicken sells for approximately \$4.50 per kilogram while imported chicken, according to PATT's information from Customs, is about \$1 to \$2 per kilogram. "That just covers the cost of shipping the chicken. If these figures are correct, there is something very wrong," said the domestic producer.

❾ The poultry industry makes up 60% of the agriculture sector in Trinidad and Tobago and generates over 10 000 jobs and \$1 billion in revenue.

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(Question 2 continued)

(a) (i) Define the term *quota* indicated in bold in the text *(paragraph ❻)*. *[2 marks]*

(ii) List **two** reasons why the government might wish to protect the domestic poultry industry. *[2 marks]*

(b) Using an appropriate diagram, explain the likely effect that the suggested increase in the tariff *(paragraph ❸)* would have on the domestic production of poultry. *[4 marks]*

(c) Using an AD/AS diagram, suggest what will happen to employment if imports continue to damage the domestic poultry industry. *[4 marks]*

(d) Using information from the text/data and your knowledge of economics, discuss the arguments for and against the protection of the domestic poultry market. *[8 marks]*

SECTION B

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

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

Ethiopia: country's partnership with China

❶ During his recent trip to China, the Ethiopian Prime Minister visited the Pearl River Delta, where higher costs are driving Chinese manufacturers out of the country. He invited a Chinese delegation to visit Ethiopia to look at a leather project Ethiopia is developing to better use its large cattle population.

❷ Within weeks, the delegation had arrived in Addis Ababa, the capital of Ethiopia. Among them was the privately owned Huajian Group, which produces 16 million pairs of leather shoes per year. Huajian Group decided to invest in Ethiopia, hired 50 Ethiopian technical school graduates, and sent them to China for training.

❸ In 1972, China financed a road across Ethiopia's Rift Valley. Between 1998 and 2004, the Chinese contributed 15 % of the cost of Addis Ababa's ring road (Ethiopia paid the rest). When Ethiopia's economic growth reached the same high levels as Asian rates, the Chinese saw increased opportunities.

❹ An industrial zone is being built and run by a private Chinese company, with **subsidies** from China's economic co-operation fund. Chinese telecommunications firm ZTE teamed up with Chinese banks to provide a $1.5 billion commercial loan to provide cellular and 3G service across the country. Another loan is paying more than half of the $612 million cost of a toll road that will cut travel time between Addis Ababa and Djibouti (a small country bordering Ethiopia), whose port now provides landlocked Ethiopia access to the sea. The tolls will raise money to help repay the loan over 20 years.

❺ China's Eximbank has provided commercial loans for infrastructure such as electricity distribution lines, to be repaid from Ethiopia's exports to China: these exports are mainly sesame seeds. These loans are known as "mutual benefit loans". A Chinese company gets the business, Ethiopia gets finance for development. To the Chinese, Ethiopia, with a fast growing economy and 90 million consumers, looks like good business.

❻ In 2002, Chinese companies building the ring road complained they couldn't find enough local skilled workers. The Ethiopian government asked China to establish a college that would focus on construction and industrial skills. The fully-equipped Ethio-China Polytechnic College opened in late 2009, funded by Chinese aid. Chinese companies are waiting to hire their first group of graduates.

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(Question 3 continued)

❼ Of course, there are downsides to China's engagement. For example, Chinese banks continue to show interest in financing large hydro-power projects in Ethiopia with worrying **negative externalities** and social challenges.

[Source: Copyright Guardian News & Media Ltd 2011]

(a) (i) Define the term *subsidies* indicated in bold in the text *(paragraph ❹)*. *[2 marks]*

(ii) Define the term *negative externalities* indicated in bold in the text *(paragraph ❼)*. *[2 marks]*

(b) Using an externalities diagram, explain the benefits of the Ethio-China Polytechnic College *(paragraph ❻)*. *[4 marks]*

(c) Explain **two** economic reasons why China may benefit from its involvement in the Ethiopian economy. *[4 marks]*

(d) Using information from the text/data and your knowledge of economics, discuss the possible effects of Chinese involvement in Ethiopia on economic growth and development in the Ethiopian economy. *[8 marks]*

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

Nigeria

❶ Nigeria is the largest country in Africa and accounts for 47% of West Africa's population. It is also the biggest oil exporter in Africa. With these large reserves of human and natural resources, Nigeria is in a position to build a healthy economy, significantly reduce poverty, and provide health, education and **infrastructure** services to its population.

❷ Resources from saved oil-export revenues proved important to Nigeria during the global financial crisis of 2008–2009, and financed a fiscal stimulus that maintained strong growth in domestic demand and gross domestic product (GDP) throughout this period, but can also be associated with Nigeria's high inflation of 13.8%.

❸ Despite Nigeria's strong economic performance, poverty is significant, and reducing it will require strong non-oil growth and a focus on human development. Challenges to growth and development have been identified, and include the investment climate; infrastructure; incentives and policies affecting agricultural productivity; and the quality of university education. Perhaps the greatest challenge is the core issue of governance. Despite some successful initiatives in human development, Nigeria may not be on track for meeting most of the Millennium Development Goals (MDGs).

Senegal

❹ Senegal is part of the West African Economic and Monetary Union, and its economy is dominated by a few strategic sectors, including groundnuts, fisheries and services. High rural poverty and limited access to rural infrastructure and basic services have encouraged migration to urban areas. The capital city, Dakar, accounts for one-quarter of the population of Senegal and over 60% of the country's economic activity. The country's informal sector accounts for about 60% of GDP.

❺ Senegal's economy has started to recover from the economic slowdown of the past few years, with real GDP growth of 4.25% in 2010. All the main sectors, agriculture, construction, telecommunication, and transport, contributed positively to the GDP growth. Growth was expected to further improve to 4.5% in 2011. However, this may not be achieved due to a crisis in the electricity sector, and weak performance in the services sector. Export volume declined somewhat in the first half of 2011, but this was more than compensated for by higher world prices for Senegal's main exports. Current transfers and tourism have grown in 2011.

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(Question 4 continued)

Figure 1: Economic data for Nigeria and Senegal – 2011

	Nigeria	**Senegal**
Human Development Index (HDI) ranking (value)	156 (0.459)	155 (0.459)
Population	158 million	13.7 million
Gross national income (GNI) per capita in purchasing power parity (PPP) terms ($)	2069	1708
Life expectancy at birth (years)	51.9	59.3
Expenditure on health, public (% of GDP)	1.7	3.2
Expenditure on education, public (% of GDP)	0.8	5.8
Gini coefficient	0.43	0.39
Population living below $1.25 PPP per day (%)	64.4	33.5

(a) (i) Define the term *infrastructure* indicated in bold in the text *(paragraph ❶)*. *[2 marks]*

(ii) List **two** of the Millennium Development Goals (MDGs) *(paragraph ❸)*. *[2 marks]*

(b) Using a Lorenz curve diagram, explain the meaning of the difference in the Gini coefficient figures for Nigeria and Senegal *(Figure 1)*. *[4 marks]*

(c) Using an AD/AS diagram, explain why "a fiscal stimulus that maintained strong growth ... can also be associated with Nigeria's high inflation" *(paragraph ❷)*. *[4 marks]*

(d) Using information from the text/data and your knowledge of economics, discuss the extent to which economic development is likely to be achieved in Nigeria in comparison to Senegal. *[8 marks]*