



**ECONOMICS  
STANDARD LEVEL  
PAPER 2**

Tuesday 22 May 2007 (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 references to the text / data where appropriate.

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

### New drought threat to economy

- ① Farmers and economists are praying for rain.
- ② Australia recorded the lowest rainfall in 40 years in the four months from 1st January to the end of April and, if there is not substantial rain in the next four weeks, 60 per cent of the winter grain crop is threatened.
- ③ Some farmers have yet to recover from the devastation to their winter crop in 2002. That drought resulted in the value of rural exports slumping by almost 30 per cent in the year to mid 2003 and cut about one per cent off Australia's **real output**.
- ④ Economists say the time for planting the winter crop is rapidly closing, but dry subsoil conditions mean farmers are holding off. Many farmers have not fully recovered from the last drought, as total farm exports have remained almost 13 per cent below the record highs of 2002.
- ⑤ Rainfall in the four months from January to April has been the lowest since 1965, and the second lowest since 1950. The lack of rain means beef farmers cannot keep their cattle on pasture, and this has resulted in soaring cattle sale numbers. As a result, the price per kilo beef farmers are receiving is down. At the peak of the **trade cycle** farmers were getting \$2.20 a kilogram, but are now receiving \$1.85 a kilogram.
- ⑥ Government intervention has been widely called for, yet the form it should take has been hotly debated. The main form of government support would be income relief in the form of unemployment benefits for up to two years for those most affected by the drought. A second form of aid would involve an interest rate subsidy, which would allow farmers to borrow finance at a discounted rate. A third form of intervention could be price controls for products such as milk. A fourth form of aid would involve financial assistance for infrastructure improvements. Critics of government intervention have argued that the market system should be left alone to resolve issues of resource allocation.

[Source: *The Sunday Age*, 8 May 2005 and *The Age*, 21 May 2005]

*(This question continues on the following page)*

*(Question 1 continued)*

- (a) Define the following terms indicated in bold in the text:
- (i) real output (*paragraph 3*) *[2 marks]*
  - (ii) trade cycle (*paragraph 5*). *[2 marks]*
- (b) Using an appropriate diagram, explain how the drought has impacted on the Australian beef market. *[4 marks]*
- (c) Using an appropriate diagram, explain how the drought may impact on the exchange rate of the Australian dollar. *[4 marks]*
- (d) Using information from the text and your knowledge of economics, evaluate the consequences of possible government intervention to reduce the economic impact of severe droughts in Australia. *[8 marks]*

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

### Campaign grows for malaria drug

- ❶ Campaigners in Africa say governments, donor agencies and pharmaceutical firms must take action now to prevent a shortfall in malaria treatments. They fear targets for eradicating the disease, set by governments and health agencies at a summit in Nigeria four years ago, may not be met. The mosquito-borne disease kills an estimated one million children a year.
- ❷ Nine-tenths of all fatalities from malaria are in Africa, and it is second only to AIDS in the list of the continent’s killer diseases. But many charities and other groups – including the World Health Organization’s Roll Back Malaria campaign – say they do not believe the targets set at that summit will be met. The biggest problem is that current therapies such as chloroquine are not working.
- ❸ Campaigners in some parts of Africa say that one of the most effective weapons against malaria – DDT – is being ignored by Western donors. DDT is a powerful insecticide that was widely used on crops in Europe and North America until the 1970s. However DDT has major **negative externalities** such as proven evidence that it kills birds and fish, and has been banned in the US since 1972.
- ❹ The World Health Organization (WHO) is advocating a new plant-based treatment which it describes as a highly effective merit good. But the treatment based on plants is expensive, costing up to 20 times as much as existing therapies. The WHO has called on governments and pharmaceutical companies to place large orders to guarantee supply of the treatment. “Placing large orders for the treatment (large scale production) is the main factor that will eventually drive down prices and alter **resource allocation**,” said Dr Fatoumata Nafou-Traore, Director of the WHO’s Roll Back Malaria campaign.

[Source: *BBC News*, 25 April 2004]

*(This question continues on the following page)*

*(Question 2 continued)*

- (a) Define the following terms indicated in bold in the text:
- (i) negative externalities (*paragraph 3*) *[2 marks]*
  - (ii) resource allocation (*paragraph 4*). *[2 marks]*
- (b) Using an appropriate diagram, explain how the fatalities from malaria are likely to affect future economic growth. *[4 marks]*
- (c) Using a diagram that illustrates externalities, explain why a new plant-based treatment would be regarded as a “merit good” (*paragraph 4*). *[4 marks]*
- (d) Evaluate a decision by governments to place large orders for the new plant-based treatment as the only way to “guarantee supply of the treatment” (*paragraph 4*). *[8 marks]*

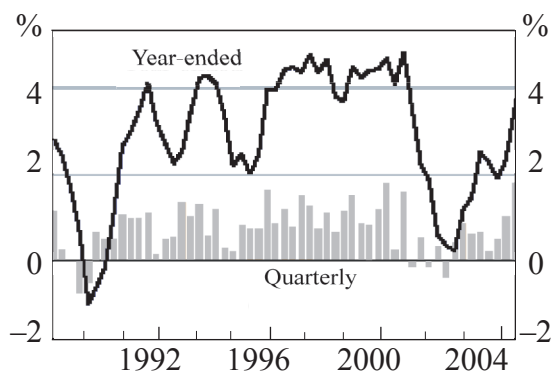
3. Study the extract and data below and answer the questions that follow.

### Finding a cure for an ailing US economy

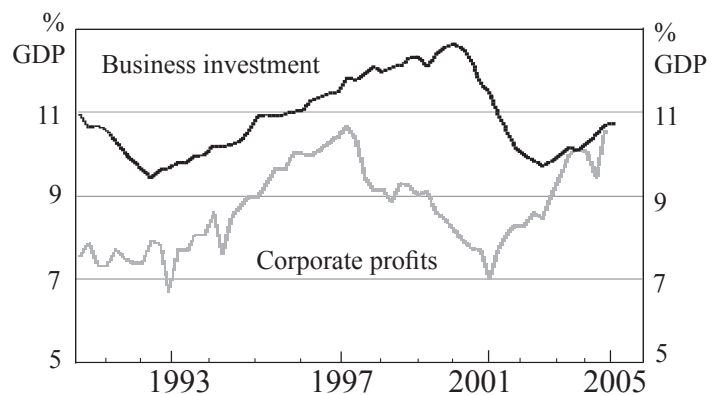
- ❶ Official unemployment statistics are not bad by historical standards, and inflation is in the low single digits. But inflation is creeping up, and it's doing so despite a labour market that is in worse shape than the official unemployment rate suggests. The official unemployment rate is 5.2 per cent.
- ❷ But unemployment statistics only count those who are actively looking for jobs. Every other indicator shows a situation much less favourable to workers than that of the 1990s. A lower fraction of the adult population is employed and the average duration of unemployment is higher than it was in the 1990s. **Real wages** are falling and those whose standard of living depends on wages are certainly being disadvantaged.
- ❸ Underlying these disappointing numbers is sluggish job creation. Private-sector employment is still lower than it was before the 2001 **recession**.
- ❹ Why then, in 2004, has the Federal Reserve been raising interest rates? Because it is worried about inflation, which has risen to the top end of the 2-3 per cent target range. What's driving inflation? Not wages: labour costs have been falling, because wages are growing less than productivity. Oil price rises are the main reason for the increase in inflation.

[Source: *The New York Times*]

*Graph 1*  
**United States – GDP**  
 Percentage change



*Graph 2*  
**United States – Business Conditions**

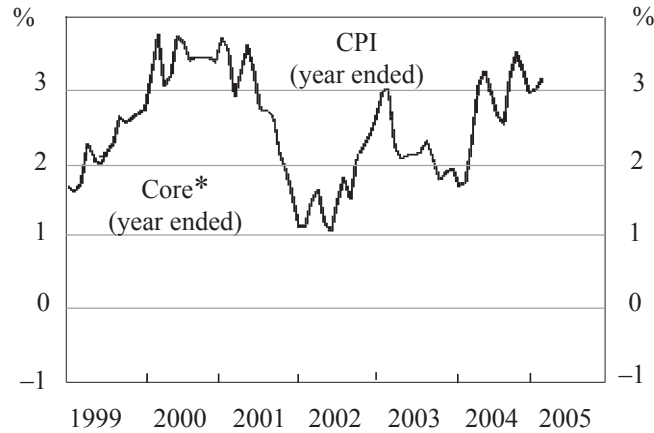


[Source: *Thomson Financial*]

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(Question 3 continued)

**Graph 3**  
**United States – Consumer prices**  
Percentage change



\* Excluding food and energy

[Source: Thomson Financial]

- (a) Define the following terms indicated in bold in the text:
- (i) real wages (*paragraph 2*) [2 marks]
  - (ii) recession (*paragraph 3*). [2 marks]
- (b) With reference to Graph 2 – United States – Business Conditions, explain the possible relationship between business investment and corporate profits. [4 marks]
- (c) Using an appropriate diagram, explain how the oil price rises (*paragraph 4*) might lead to an increase in inflation. [4 marks]
- (d) Using information from the text and graphs and your knowledge of economics, evaluate the Federal Reserve’s decision to raise interest rates (*paragraph 4*). [8 marks]

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

**WTO raps EU over sugar subsidies**

- ① European Union (EU) subsidies given to sugar producers have violated global trade rules, according to a ruling by the World Trade Organization (WTO).
- ② At a meeting in Geneva to discuss **free trade**, the WTO upheld a complaint filed by Brazil, Australia and Thailand. The EU had been exceeding agreed sugar export limits by almost 500 % since 1995.
- ③ Development agency, Oxfam, called the WTO's decision a triumph for **developing countries**. The decision marks a major step forward in the fight against unfair agricultural subsidies and export dumping.
- ④ The WTO said that by breaking agreed limits on export subsidies the EU was hurting developing countries by undercutting their producers' prices.
- ⑤ The EU had claimed that its sugar policy was legal, warning that if Brazil chose to boost sugar production, this could, in turn, harm poorer developing countries, particularly in Africa and the Caribbean.
- ⑥ According to the Brazilian Agriculture Minister, the decision means the EU will have to cease exporting two million tons of sugar from 2005 while Brazil will be allowed to export 10 % more.
- ⑦ The Brazilian foreign minister said: "another important step has been taken to eliminate the distortions of the international market in farm products".
- ⑧ The WTO agreed over the weekend to push ahead with talks on slashing farm subsidies with the aim of eventually eliminating all direct aid to exporters. The current plans involve a progressive reduction by one third of the guaranteed minimum prices for European farmers, such as wheat farmers, by the end of 2007 and a cut in production quotas.

[Source: *BBC News*, 4 August 2004 and *Agency France-Press*, 29 April 2005]

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*(Question 4 continued)*

- (a) Define the following terms indicated in bold in the text:
- (i) free trade (*paragraph 2*) *[2 marks]*
  - (ii) developing countries (*paragraph 3*). *[2 marks]*
- (b) Using an appropriate diagram, explain how, according to the EU, an increase in sugar production by Brazil could “harm poorer developing countries” (*paragraph 5*). *[4 marks]*
- (c) Using an appropriate diagram, explain the likely impact on EU consumers and producers of a reduction in the guaranteed minimum price for wheat. *[4 marks]*
- (d) Using information from the text and your knowledge of economics, evaluate the WTO’s aim of “eventually eliminating all direct aid to exporters” (*paragraph 8*). *[8 marks]*

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

### Rich nations to write off \$100bn debt

#### Text 1

The world's seven richest countries have agreed that the **indebtedness** of 37 of the world's poorest countries should be written off by up to \$100 billion. The finance ministers of the G7 – representing the US, Britain, France, Germany, Italy, Japan and Canada – agreed in principle that the crippling international debts owed by some African and other poor nations should be forgiven. Most of the country-to-country debts owed by the Third World have already been written off, but a substantial amount is still owed to organisations like the World Bank and IMF.

[Source: adapted from *Sydney Morning Herald*, 6 February 2005]

#### Text 2

The Heavily Indebted Poor Countries (HIPC) debt initiative of the World Bank and the IMF has committed \$25.6 billion in debt reduction. The resulting savings on debt servicing, and the related impact on the **current account** balance, have translated into a rise in pro-poor expenditures of about 1.5 % of GDP.

[Source: adapted from <http://www.imf.org/external/pubs/ft/afr/reo/2004/eng/02/pdf/reo1004.pdf>]

#### Text 3

Uganda became the first country to receive debt relief under the Heavily Indebted Poor Countries (HIPC) debt initiative. Uganda's Minister of Planning and Economic Development, Richard Kaijuka, expressed his country's gratitude for the package and said it would help make more funds available for social programs. "This debt relief will help us put more resources into our National Poverty Eradication Plan, which includes universal primary education, providing basic health care and improved nutrition to our people, and the overall enhancement of rural development" said Kaijuka.

[Source: adapted from <http://www.web.worldbank.org/website/external/countries/africaext/ugandaextn/0,,content MDK:20018974-menuPK:374959-page PK: 141137-piPK:141127-the SitePK:374865,00.html>]

#### Text 4

Supporters of the IMF and the World Bank believe that the policies of multilateral organizations foster good governance, reduce corruption and create strong institutions that will attract investment and generate economic growth, encourage economic stability and lead to democracy. Both organizations, however, face unprecedented criticism. They are accused of enforcing one-size-fits-all recommendations that are too harsh and anti-development in certain areas, including structural reforms. They are criticized for their failure to take proper account of human and environmental needs in their projects.

[Source: adapted from <http://news.bbc.co.uk/2/hi/business/95218.stm>]

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*(Question 5 continued)*

- (a) Define the following terms indicated in bold in the text:
- (i) indebtedness (*Text 1*) *[2 marks]*
  - (ii) current account (*Text 2*). *[2 marks]*
- (b) Using your knowledge of the balance of payments, explain the relationship between high levels of international indebtedness and the size of a current account deficit. *[4 marks]*
- (c) Using a production possibilities diagram, explain how Uganda’s National Poverty Eradication Plan might lead to potential economic growth. *[4 marks]*
- (d) Using information from the text and your knowledge of economics, evaluate the role of multilateral organizations like the World Bank and the IMF in assisting the economic development of Heavily Indebted Poor Countries. *[8 marks]*
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