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**ECONOMICS
STANDARD LEVEL
PAPER 2**

Tuesday 12 May 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.

Cyclone devastates Australia's banana crop

- ❶ Cyclone Larry, with winds of up to 300 kilometres per hour, has devastated Australia's banana industry, destroying fruit worth \$350 million and leaving up to 4000 people out of work.
- ❷ Australians now face a shortage of bananas and prices have risen sharply after the cyclone damaged the nation's biggest growing region. In Sydney, banana prices have hit \$14 per kilo. Prior to the cyclone, consumers were only paying \$2 per kilo for bananas. The reduced **supply** of bananas will also impact on the markets for products that are complements and substitutes.
- ❸ The Australian Banana Growers Council said the storm had ruined the industry, destroying 200 000 tonnes of fruit. This means more than 80% of the total Australian crop has been destroyed.
- ❹ Cyclone Larry caused the worst cyclone damage to crops in 16 years and the storm is having an immediate impact on **unemployment** in the region. 4000 people will be unemployed within the next week because there will be no bananas to pick or pack.
- ❺ A local industry leader stated "transport operators are going to be out of production for six to nine months. There's going to be a negative effect on towns and supermarkets and so people are going to move away".
- ❻ Banana farmers are hopeful that growers and workers will receive some emergency financial assistance from the government. Some Australian economic commentators have also called for a temporary price control, specifically a maximum price (ceiling price) on bananas. This would certainly help consumers, but would lead to excess demand and, therefore, problems of rationing the product. Banana producers would not be happy with a maximum price because their incomes would be affected.
- ❼ Australia does not allow banana imports because of the biosecurity risks involved.

[Source: adapted from *Sydney Morning Herald*, 20 March 2006]

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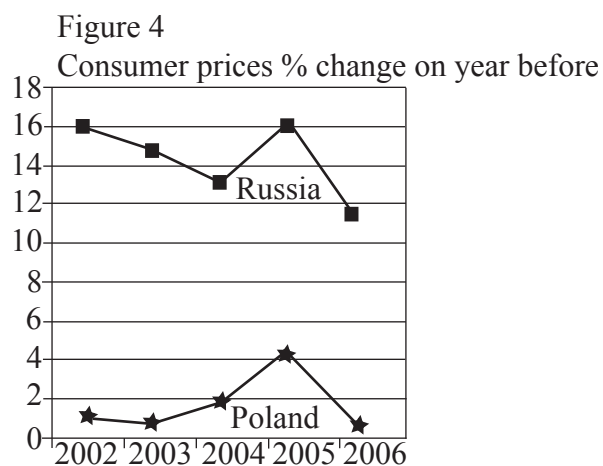
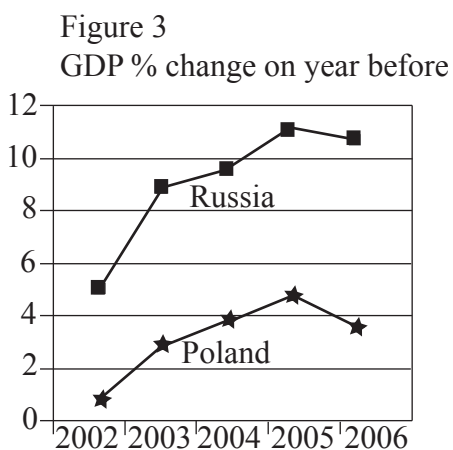
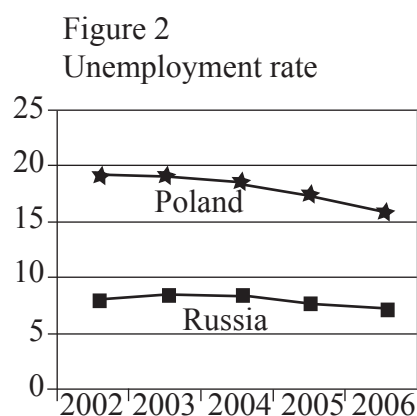
(Question 1 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) supply (*paragraph 2*) *[2 marks]*
 - (ii) unemployment (*paragraph 4*). *[2 marks]*
- (b) Using an appropriate diagram, explain why the supply of Australian bananas will be perfectly inelastic in the immediate to short-term period of time. *[4 marks]*
- (c) Using an appropriate diagram, explain the impact of the cyclone on the price of substitute goods such as apples. *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate a decision to impose a maximum price (ceiling price) on bananas in Australia. *[8 marks]*

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

A tale of two economies

- ❶ Both Russia and Poland faced serious challenges in transition when moving from centrally planned to free market economies. In the 1990s, both countries decided to open themselves to international trade and foreign direct investment.
- ❷ Poland reformed its economic institutions, strengthened property rights, tightened monetary policy using interest rates, and built a competitive market sector through the use of supply-side policies. However, Poland’s labour market is still “rigid” and suffers from significant **structural unemployment**, resulting in a high rate of natural unemployment.
- ❸ Russia did not reform all its economic institutions, including the property rights system, before opening its economy to competition. This resulted in corruption and crime. Poor economic restructuring has worsened inequality of income and concentrated economic power of firms in an **oligopoly** market structure. Russia has come to depend on the performance of a small number of companies in the natural resource area, especially oil, but these industries are not expected to sustain its economic growth, unless new oil reserves are discovered.



[Source: adapted from <http://www.economist.com/countries>, accessed July 2007]

(Question 2 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) structural unemployment (*paragraph 2*) *[2 marks]*
 - (ii) oligopoly (*paragraph 3*). *[2 marks]*
- (b) Using an AD/AS diagram, explain how supply-side policies could affect real output in the long-run. *[4 marks]*
- (c) Using a production possibility curve diagram, explain how the discovery of new oil reserves might affect the Russian economy. *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the economic performance of Russia and Poland since the 1990s. *[8 marks]*

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

China's inflation causes concern

- ❶ Like tens of millions of shoppers across China, Zhou Benqi has had to change her buying habits to cope with sharply rising prices of pork and eggs – basic foods for any Chinese family. “Because of price rises, an ordinary meal is a problem for us, as my pension has already been spent on fees for electricity, water, broadband, gas and so on,” said Ms Zhou, a Shanghai resident.
- ❷ In the short term, Chinese inflation has been driven by a combination of higher corn prices (which pushed up the cost of feed for animals) and a shortage of pigs due to disease. Such factors may be merely cyclical, or one-off occurrences, quickly corrected, for example, by farmers sending more pigs to market, which would bring prices down. However, a range of other factors has prompted a debate on broader inflationary pressures in China.
- ❸ Some believe higher farm prices in China have become structural rather than cyclical because of declining **factors of production**, including arable land and water. As well, wage rises have started to outstrip rises in productivity for the first time in years. Costs are also coming under renewed pressure from other sources, most notably a central government determined that industry should bear the true cost of managing the environment and acquiring land.
- ❹ Inflationary pressures are also coming from a more traditional source, an accelerating economy “already running above its potential”, according to one commentator. Such above-trend growth in **aggregate demand** will translate into supply constraints and inflation.
- ❺ The government is expected to respond to rising inflation with one or possibly two interest rate rises. However, government leaders will be reluctant to increase interest rates because of the pressure it will place on borrowers, and also for fear it will cause further capital inflows from speculators looking to profit from a rising currency. This rise in the value of the currency has the potential to damage the competitive position of Chinese exporters.

[Source: Adapted from Richard McGregor, “Impact of China inflation spurs concern”,
by permission of Financial Times 16 July 2007]

(This question continues on the following page)

(Question 3 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) factors of production (*paragraph 3*) [2 marks]
 - (ii) aggregate demand (*paragraph 4*). [2 marks]
- (b) Using an appropriate diagram, explain why the Chinese government is expected to “respond to rising inflation with one or possibly two interest rate rises” (*paragraph 5*). [4 marks]
- (c) Using an appropriate diagram, explain how the effect of capital inflows from speculators “has the potential to damage the competitive position of Chinese exporters” (*paragraph 5*). [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate factors that could have caused China’s inflation to increase recently. [8 marks]

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

Tariff cuts in Vietnam

- ❶ The Vietnamese economy began to feel the impact of entry to the World Trade Organization (WTO) in January. Under its WTO commitments, Vietnam has begun to cut tariffs on more than 1800 imported items. The cut is quite large for some commodities, such as fabrics, where the **tariff** has dropped from 40 % to 12 %.
- ❷ Taking advantage of the lower tariffs, businesses have imported a large quantity of foreign goods, and the prices of goods at the retail stores have fallen as the tariff cuts have been passed on to consumers. In particular, the price of imported motorbikes has been reduced significantly. For example, the price of a Honda motorbike has gone down from US\$2200 to US\$1600. The tariff cuts expand consumer choice, with more goods available, and provide increased competition between local and foreign goods. Also it is hoped that the tariff cuts will reduce costs for businesses, putting downward pressure on inflation.
- ❸ The government has estimated that the loss of revenue due to tariff cuts will be US\$63 million per year for the first 5 years, equivalent to 7% of the total revenue from import tariffs. In order to offset the revenue loss, the government hopes to collect more revenue from a growing economy. WTO membership will create opportunities for Vietnam to attract **foreign direct investment**, expand markets, develop business and increase exports.
- ❹ Economists think that as Vietnam opens its market under WTO rules, prices should fall further. For example, allowing more foreign producers into Vietnam will increase the supply of goods and services. Economists also believe that less protection will lead to a more efficient allocation of resources. It is expected that all the changes will help create a more competitive market.

[Source: adapted from *Saigon Times Weekly*, 14 April 2007]

(This question continues on the following page)

(Question 4 continued)

- (a) Define the following terms indicated in bold in the text:
 - (i) tariff (*paragraph 1*) *[2 marks]*
 - (ii) foreign direct investment (*paragraph 3*). *[2 marks]*

- (b) “The price of a Honda motorbike has gone down from US\$2200 to US\$1600” (*paragraph 2*). Using an appropriate diagram, explain the impact on the quantity demanded of Honda motorbikes of a decrease in price of Honda motorbikes. *[4 marks]*

- (c) Using a tariff diagram, explain how tariff cuts could put “downward pressure on inflation” (*paragraph 2*). *[4 marks]*

- (d) Using information from the text/data and your knowledge of economics, evaluate the impact of the lower tariffs in Vietnam on domestic producers, consumers and the government. *[8 marks]*

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

Make trade fair

- ❶ Although development assistance and debt relief are important, no African person or government wants to rely on official aid for the provision of goods and services to meet basic needs. African people want a fairer system which lets them trade with rich nations and earn more money, so they can develop their economies and pay for their own health care and education. Unfortunately, instead of earning more money to invest and improve the lives of its people, Africa has been earning less and less.
- ❷ In 1980, Africa had a 6% share of world trade. By 2002, this had dropped to just 2%, despite Africa having 12% of the world's population. If Africa could regain an additional 1% of world trade, it would earn \$70 billion more in exports each year – far more than what the region currently receives in foreign aid.
- ❸ Wealthy countries like to talk about the importance of trade as the primary cause of **economic growth** in developing countries, but these wealthy countries protect their own markets against exports from the poorest countries through tariffs and **quotas**. These rich countries continue to use subsidies to protect their own agricultural sector by about \$1 billion a day, making it impossible for African farmers to compete internationally.
- ❹ African countries could earn more from basic crops if they were allowed to process them for export. For example, Ghana can export raw cocoa into Europe without paying duties but if they process the cocoa and wish to export it to Europe, they would have to pay a 25% tariff. It is this processing (roasting, tinning, labelling) which helps a country earn more money and develop its manufacturing base, thereby allowing the economy to grow. While unfair trade rules exist, it makes it impossible for many African countries to escape the poverty cycle that is a barrier to development.

[Source: adapted from <http://www.data.org/whyafrika/issuetrade.php> accessed 31 August 2007]

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(Question 5 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) economic growth (*paragraph 3*) [2 marks]
 - (ii) quotas (*paragraph 3*). [2 marks]
- (b) Explain how the poverty cycle acts as a barrier to economic development (*paragraph 4*). [4 marks]
- (c) Using a subsidy diagram, explain how a subsidy given by a wealthy country to its own producers, could lead to reduced income for producers in a poor African country. [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate ways in which wealthy countries could encourage economic development in African nations. [8 marks]
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