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ECONOMICS
STANDARD LEVEL
PAPER 2

Tuesday 17 May 2011 (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.*

Price controls on food

❶ In 1985, the Peruvian president ordered controls on the price of rice, sugar and other goods to keep basic foods affordable for the poor. However, when shortages and a black market arose, Peruvians were forced to queue (stand in line) for hours for basic foods, and later the presidency dissolved in a spiral of hyperinflation. As Peru again faces rising food prices, the re-elected president has rejected price controls and is focusing this time on tighter monetary policy to control **inflation**.

❷ From Argentina and Venezuela to Russia, China and Thailand, governments are meeting the challenge of rising food prices by imposing price controls – fixing prices below market level – hoping to ease the burden on their populations and avoid social unrest.

❸ However, evidence shows that such measures do not reverse price trends and can end up having the opposite effect. Some economists prefer income transfers or food assistance for the poor instead and warn that price controls lead to market distortions such as reduced supplies because they discourage domestic production. By reducing the underlying causes of inflation, price controls prevent market solutions.

❹ According to experts, price controls are only likely to work where basic foods are a small share of total household spending, or when controls are implemented for a very short time, such as in Morocco during Ramadan. If price controls remain in place for too long, large price increases are more likely to occur when price controls are removed.

❺ While price controls may be seen as a quick solution, there is little proof that they have worked to reduce inflation. Government officials in China, and other developing nations, see their current price control measures as temporary and insist they will not cause long-term problems. The government intervention is "not a price freeze," but rather a method of limiting "unreasonable" price increases and reducing "inflationary expectations of the public".

❻ The key to dealing with higher prices, the International Monetary Fund (IMF) argues, is that governments tackle the problem with targeted **transfer payments**, rather than economy-wide subsidies. "In general we don't like price controls," says the IMF. "However, we do recognize that governments may want to slow down the impact on consumers."

[Source: adapted from http://www.reuters.com/article/latestCrisis/idUSN25386402, 6 April 2008]

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(Question 1 continued)

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

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

(ii) transfer payments *(paragraph ❻)*. *[2 marks]*

(b) Using a demand and supply diagram, explain the impact of a subsidy on the market for food. *[4 marks]*

(c) Using an appropriate diagram, explain the likely impact of imposing price controls on food items. *[4 marks]*

(d) Using information from the text/data and your knowledge of economics, evaluate the use of price controls to limit the impact of rising food prices on consumers. *[8 marks]*

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

German economy contracts

❶ Europe's biggest economy and a leading exporter, contracted by 0.5% in the third quarter of 2008 after it contracted 0.4% in the three months to the end of June, leading to increasing concerns about **deflation**.

❷ Growth slowed due largely to a strong euro and rising oil prices. "A negative effect on gross domestic product (GDP) resulted from foreign trade, with a strong increase in imports and weakening exports," the statistics office said. Many businesses have reduced production due to falling demand. GDP is now expected to contract by a record 6.2% for 2009, the worst fall since World War II.

❸ German unemployment could increase by around one million in 2009 and reach 4.4 million or 10.5% by mid-2010. There will be gradual recovery starting in the second half of 2009, but economic growth will not return until the second half of 2010, according to the OECD*.

❹ A 12 billion euro government spending package has been announced by the German Chancellor. The government says the new spending, which includes loans for medium-sized industry and a tax reduction for purchasers of new cars, will cause increased spending of 50 billion euros in Germany.

❺ The package of measures to stimulate the economy may be a step in the right direction in terms of boosting the economy and reducing unemployment. At best, however, it will provide a small solution to the global economic downturn. This has been recognized by the German government, which recently passed a second package of emergency spending worth 50 billion euros (2% of GDP).

❻ Major measures planned for 2009–2010 include additional infrastructure investment of 17.5 billion euros, cuts in personal income and corporate taxes, social welfare spending of 15.8 billion euros, a reduction in health insurance contributions and subsidies for individual industries.

* OECD: the Organization for Economic Cooperation and Development (formed in 1961). The members in 2006 were: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea (South), Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States.

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(Question 2 continued)

❼ However, some economists say the government has been too hesitant in its efforts to stimulate the economy. The impact of some measures may be limited by the rising **savings** ratio. Many of the measures in the government's fiscal stimulus will not come into effect until the end of 2009 and the effects will not be felt until 2010, a time when the economy is already expected to start growing.

[Source: adapted from http://www.dw-world.de/dw/article/0,,3788397,00.html, 13 November 2008; http://www.dbresearch.com, 29 January 2009 and http://www.businessweek.com, 5 June 2009]

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

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

(ii) savings *(paragraph ❼)*. *[2 marks]*

(b) Using a business cycle diagram, explain Germany's economic position in 2008 in relation to the business cycle. *[4 marks]*

(c) Using an AD/AS diagram, explain **one** type of unemployment experienced in Germany in 2009. *[4 marks]*

(d) Using information from the text/data and your knowledge of economics, evaluate the likely effectiveness of the German government's fiscal policies designed to boost the economy and reduce unemployment. *[8 marks]*

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

Economic crisis hits Brazil

❶ In September 2008, record foreign reserves, low inflation, solid growth and a healthy budget surplus prompted Brazilian president da Silva to say that the financial crisis would not affect his country.

❷ Now, in 2009, Brazil faces a severe economic slowdown and rising unemployment as a result of the recession in the developed world. Sales of cars, new apartments, home appliances and exports have slowed. Interest rates have doubled for many companies wanting to borrow money for new projects. The lack of credit and higher borrowing costs have hurt export plans for 2009.

❸ As the global financial crisis intensified, the value of Brazil's currency (the real) has depreciated nearly 40 % from mid-2008 compared to the US dollar.

❹ Industrial production declined in sectors which rely on credit, such as the motor industry and consumer appliances. Economic activity also slowed due to a fall in net exports, while the **terms of trade** continued to deteriorate.

❺ With the economy sliding towards recession, at least Brazil's central bank was able to cut interest rates by 2.5 % to 11.25 % during January–March 2009. In the past, a weak currency and high inflation prevented such counter-cyclical measures. There is still ample room for the central bank to increase the money supply, because inflation expectations are falling below the inflation target and the impact on consumer prices of the significant exchange rate depreciation has been modest.

❻ Domestic demand and exports are expected to remain weak through most of 2009. Increased availability of credit and liquidity are expected to boost private consumption and private investment growth. Credit conditions remain tight but are showing signs of improvement.

[Source: adapted from *McClatchy Report*, 9 November 2008 and "OECD Interim Report on Brazil", *The Economist*, 11 March 2009]

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(Question 3 continued)

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

(i) terms of trade *(paragraph ❹)* *[2 marks]*

(ii) current account *(Table)*. *[2 marks]*

(b) Using the concept of the circular flow of income, explain the impact of falling net exports on the economy of Brazil. *[4 marks]*

(c) Using an AD/AS diagram, explain the impact that a "significant exchange rate depreciation" is likely to have on prices in Brazil *(paragraph ❺)*. *[4 marks]*

(d) Using information from the text/data and your knowledge of economics, evaluate the likely effectiveness of the response by the central bank of Brazil to the economic crisis facing Brazil. *[8 marks]*

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

Car subsidies blow good money out of the exhaust

❶ The Australian government intends to reduce tariffs on foreign car imports from 10% to 5% in 2010. They say the future of the industry lies in "innovation and global integration, not industry protection with old-fashioned **quotas** and tariffs". However, its plan keeps protection for the Australian car industry through increased subsidies, doubling industry assistance to 6.2 billion Australian dollars.

❷ The 1.3 billion Australian dollars Green Car Innovation Fund provides some environmental respectability to an outdated industry policy. However, Australia can import as many fuel efficient cars as it wants without having to make them itself.

❸ Car makers are already responding to the **demand** for more fuel-efficient cars and the car industry does not need further incentives. If the government's intention is to lower carbon emissions from car use in Australia, then it should aim to provide consumers with access to low-emission cars at the cheapest possible price. Lowering tariffs on imported cars achieves this objective at a much lower cost than building cars locally.

❹ The government argues "only 15 countries, including Australia, can design, engineer and build a car from scratch" and says its car plan "demonstrates the government's commitment to modern manufacturing and to providing high-skill, high-wage jobs for Australians". The notion that only the car industry can provide high-skill, high-wage jobs is mistaken.

❺ What cost will taxpayers pay for the government's determination to maintain the capacity to build cars locally? The billions of dollars in help provided by successive Australian governments to the local car industry has come at the expense of consumers and taxpayers, destroying jobs and income in other industries. This is the real, but largely unseen, cost of industry assistance.

❻ The new car plan is the latest of many support packages for this industry, yet the government argues things will be different this time, with "a high level of support at the beginning, eventually falling towards zero".

❼ The car industry has failed to benefit from the efforts of previous Australian governments to support it, because such support limits the competitive pressures that are the best guarantee of a competitive car industry.

Source: "Car subsidies blow good money out the exhaust" by Dr Stephen Kirchner (Source: Sydney Morning Herald), 11 November 2008, News and Features, page 13. Used with the author's permission.

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(Question 4 continued)

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

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

(ii) demand *(paragraph ❸)*. *[2 marks]*

(b) Using an appropriate diagram, explain how reduced tariffs are likely to affect the Australian car industry. *[4 marks]*

(c) Using an appropriate diagram, explain how increased subsidies will impact on the production of cars in Australia. *[4 marks]*

(d) Using information from the text/data and your knowledge of economics, evaluate whether increased protection for the Australian car industry will benefit the Australian economy. *[8 marks]*

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

Nigerian people seeing little benefit from record oil revenue

❶ Nigeria, the world's eighth largest oil exporter, has earned US$1.2 trillion from oil production over the past four decades. Oil prices have been at record highs, yet the vast majority of Nigeria's 140 million people live in very poor conditions. Nigeria's size and two-million-barrel-per-day output make the contrasts between poverty and wealth extreme.

❷ In Nigeria, the four state-owned refineries are not fully operational, largely due to mismanagement and vandalism; its distribution network is chaotic; and it relies heavily on fuel imports, which cost around US$4 billion each year.

❸ The oil industry employs about 35 000 Nigerians. Even if the industry were to add new jobs every year and replace departing staff, the number of jobs it can create in a year is below 5000. The Niger Delta alone has nearly 30 million people, about one-fifth of the nation's population. Its population grows at 2.4 % a year, implying the need for some three million jobs a year. Oil can only play a small role in such an equation.

❹ Oil can fuel the engine of the economy, with other industries creating jobs. However, over the years, easy money from oil has distorted investment decisions, allowing Nigeria to neglect other industries. Given that 95 % of its foreign-exchange earnings come from oil, Nigeria might think it has no reason to look beyond oil. Its reserves include approximately 36 billion barrels and, at the current rate of production, it has enough oil to last another 40 years.

❺ The government has set a maximum price for fuel, but retailers have taken advantage of the shortages to more than double the price of diesel fuel in some parts of Nigeria.

❻ 9 out of 10 Nigerians live on less than US$2 a day and inflation rose 9.7 % in May due largely to a rise in food prices. The public health system, education and roads in Nigeria are all in chaos, largely due to **corruption** and mismanagement during decades of military rule. People survive despite what the government does, not because of it and are trapped in a **poverty cycle**.

"Nigerian people seeing little benefit from record oil revenues"
by Tume Ahemba, New York Times, 21 July 2008.

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(Question 5 continued)

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

(i) corruption *(paragraph ❻)* *[2 marks]*

(ii) poverty cycle *(paragraph ❻)*. *[2 marks]*

(b) Using an appropriate diagram, explain how a maximum price for fuel will impact on the market for fuel in Nigeria. *[4 marks]*

(c) Using an appropriate diagram, explain how the discovery of new oil deposits may affect the potential output of Nigeria. *[4 marks]*

(d) Using information from the text/data and your knowledge of economics, evaluate the consequences of oil dependency on the growth and development of Nigeria. *[8 marks]*